Letters of Credit and Trade Finance

Participant's Material

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Module 1

Overview

Letters of Credit and Trade Finance

Objectives—
At the conclusion of the course, participants should be able to:

- Describe the reasons and the process for international sales transactions.
- Describe the methods and process of payment and settlement in trade transactions.
- Describe examples of international import and export collections and financing.
- Describe the process of documentary collection.
- Describe the importance and function of the basic documents used in international trade transactions.
- Examine documents for discrepancies and errors.
- Describe the process of a letter of credit transaction.
- Describe letter of credit variations used in trade finance transactions.
- Describe the background and tenets of the *Uniform Customs and Practice for Documentary Credits*.

- Identify elements of fraud and take steps to guard against fraud in trade transactions.

- Explain the reasoning and factors to consider in bank pricing of international sales transactions.

Overview

Companies sell their products overseas for a number of reasons, some of which are listed below:

1. To achieve higher profit margins on overseas sales
2. To off-load available factory capacity
3. To compete internationally with competitors, and
4. To prepare for growing markets, such as India, China, or Latin America.

International sales are not without problems. Effective communication between buyer and seller before the sales contract can eliminate trouble for both parties.

Major Components of the Trade Transaction

The major components of a trade transaction are:

- Activities occurring before the sales contract
- Pre-shipment activities, and
- Post-shipment activities.

Whether a merchant is a first time trader or has sold product overseas before, he needs to consider at least seven things before the sales contract is negotiated with a new buyer or with a buyer in a recently established relationship.

The seven areas to consider, and their associated activities, are as follows:

Before the Sales Contract	Pre-Shipment	Post-Shipment
1. Find foreign buyers	Pack the shipment problems	Resolve bank
2. Know the buyer	Understand regulations	Receive payment
3. Understand currency risk		
4. Determine payment policy	Prepare documentation	Update receivable system
5. Agree on finance and shipping terms	Ship goods	

The factors to consider prior to a international trade transaction are described in more detail below.

Steps Prior to the Trade Transaction

Find foreign buyers

Sellers typically locate buyers by four methods. These four methods, which are not mutually exclusive, are described below:

- Trade fairs and exhibitions are an excellent way to make initial contact with a buyer or the buyer's agent.
- Some companies use a foreign agent or distributor in a specific country, who locates an appropriate buyer(s) for them, speaks the local language, and typically represents other companies.
- Increasingly, companies are turning to the internet and electronic databases to find buyers.
- Some companies are large enough to have an office(s) in a foreign location, commonly referred to as a sales office or trading arm.

Regardless of how a buyer is found, that is only the first step in building a mutually rewarding relationship.

Know the buyer

The buyer may be a distributor or agent in a foreign country, a retailer, a manufacturer, or trading company. If the buyer has been in business for a few years, he may have a payment history on Dun & Bradstreet or some other financial credit firm. Your bank may be able to use its network of local correspondents in the buyer's country to obtain some bank information. It is important to obtain any information available on the buyer, including his banker and the number of years with the bank.

The following points should be kept in mind when seeking a report on an overseas buyer:

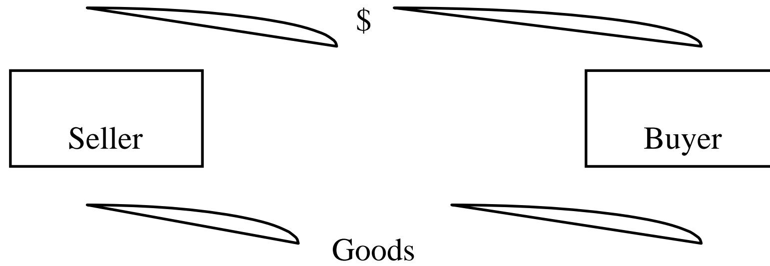
- Whether the specific sum quoted for the buyer is one shipment or many shipments spread over a period of time. A buyer may be good for an amount spread over a period, but may not be good for that sum in a single transaction.

- The terms of payment are important to consider.

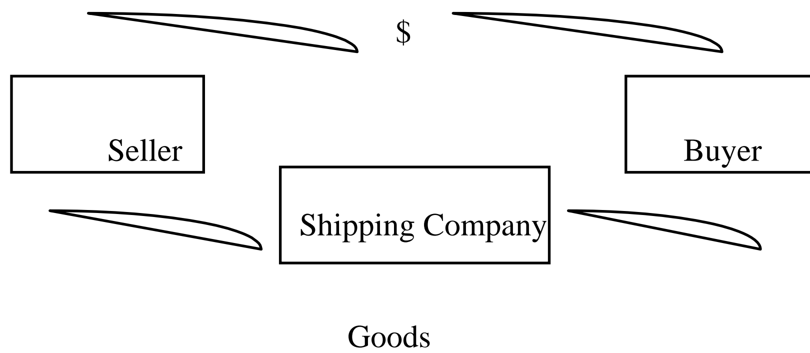
- The exact amount of the transaction should be quoted because an inflated amount may eliminate buyers who would otherwise be satisfactory.

Trade Transaction

An illustration of an international trade transaction when the buyer and seller are near each other is shown below.



An illustration of an international trade transaction when the buyer and seller are far away from each other is shown below.



Objectives of Parties to a Trade Transaction

Buyer’s Objectives:

In an international trade transaction, the buyer’s objectives are:

- Contract fulfillment, including:
    - The delivery of the correct quantity and quality of goods or services
    - On time delivery
    - Payment only if seller fulfills his obligations
- Credit, including the ability to:
    - Manage cash flow
    - Defer payment
    - Finance the transaction
- Convenience of payment, including:
    - Trustworthy third party to facilitate payment

Seller’s Objectives:

In an international trade transaction, the seller’s objectives are:

- Contract fulfillment; including:
    - Delivery of the correct quantity and quality of goods and services
    - On time delivery
    - Assurance of payment if the seller fulfills his obligations
- Prompt and accurate payment, which means:
    - Payment as soon as possible
    - Payment in the correct currency and for the correct amount.

- Convenience of payment, including

  * A trustworthy third party to facilitate payment

* Payment received via the seller’s bank

Understand currency risk

Sales contracts between buyers and sellers should specify the particular currency in which payment is to be made. If another currency will be involved, exporters and importers need to understand the impact of currency fluctuations on the transaction of overseas currencies and the operation of forward rates of exchange. By protecting themselves against foreign currency fluctuations, importers or exporters add an additional cost to the transaction and need to calculate whether the risk protection is worth the added cost.

Because exchange rates fluctuate, an exporter or importer who has transactions in foreign currencies may lose money through movements in rates of exchange between the time of shipment of goods and the payment for them. This exchange risk can be avoided if the buyer or seller covers himself by taking out a *forward exchange contract*.

A forward exchange contract is a contract between a company and a United States bank, under which the bank agrees to buy from, or sell to, the customer a fixed amount in overseas currency, on a fixed future date, at the rate of exchange quoted in the contract. The customer is either arranging to sell a currency or purchase a currency at an agreed rate at a set date in the future.

For example, an exporter who is to receive one million Japanese yen three months from now can immediately fix the rate of exchange of yen/$ at which he will sell the yen when he receives it. If the value of the currency falls before the transaction takes place, a loss would be avoided. The currency can appreciate in value as well. The most important point is that the exporter can fix how much he will receive in his own currency so that his profit on the transaction is assured.

Similarly, an importer can know in advance how much he would have to pay out in foreign currency by fixing a forward contract.

For a number of reasons, including delays in manufacturing and shipping, alteration in payment terms and alteration to the underlying commercial transaction, delivery on the due date of the forward contract may not match payment by a foreign buyer. In such cases, the bank allows the customer to close out the old contract and enter into a new one. With the close out procedure, there is a settlement of the old contract (i.e., either there was a gain or loss on the contract) and a new contract is created.

A contract may be canceled (closed out) at any time. This provision is particularly pertinent when the underlying commercial arrangements have been terminated and there are no other transactions to which deliveries could be applied.

Example: Importer purchases forward contract to buy Yen

An importer with a commitment to pay Yen 10 million due in 90 days wishes to alter the denomination of his yen exchange risk to United States Dollars (i.e., the importer is worried about the yen strengthening against the United States Dollar (USD) and requiring more USD to buy yen).

On **Day 1**, the bank's Treasury Department calculates the forward rate as follows:

Market Rate: =	Yen 98 = US $1
90 day forward selling margin:	-2.00 yen
Forward contract	Yen 96 = US $1

This transaction has effectively switched the importer's future liability from Yen 10 million to USD $104,167 (Yen 10 million / 96 Yen)

At **Contract Settlement** the customer would pay the bank USD $104,167.

If the importer had not covered his position, he would not have known what amount in USD was owed. If the yen had strengthened further against the dollar, to 88 Yen to one USD, what amount would the importer owe his bank?

Answer: (yen 10 million/ 88) = $113,636 at settlement, a difference of $9,469.

Since customers can lose money on forward contracts if they are canceled, banks normally require credit lines for the foreign exchange transactions. Two separate lines are usually granted.

Total outstanding contract limit

This is the maximum local currency equivalent of all contracts that may be outstanding at any one time. Banks may use the customer's sales or import/export trade as a guide in setting these limits.

Total exposure risk

Each day outstanding contracts are revalued against the forward takeover rates and the net profit/loss is calculated. If the net loss is over the customer's credit limit, the customer's accounts will be monitored closely by bank officers.

Determine Payment Policies

Payment policies determine how the buyer will settle payment with the seller. The payment method is a function of the buyer\seller bargaining power, the seller's relationship with the buyer, country risk, and the product type. For example, a seller with a 10 year buyer relationship with the buyer should know that buyer's payment history. By contrast, if the seller has established the relationship with the buyer at a recent trade show, the buyer's payment history warrants further investigation. Although information services exist to collect information on the new buyer, nothing surpasses history.

The payment method is a question of how much guarantee the seller requires in order to make and ship product. While cash in advance provides the most security, other arrangements exist to provide the seller some assurance that he will receive all or part of his money for the transaction.

Payment Considerations

To determine the appropriate method of payment the following factors are considered:

- Credit standing of the buyer and the reliability of the seller
- Type of merchandise
- Value of the merchandise
- Payment terms offered by competitors
- Whether the transactions will occur in the buyer's or seller's market
- Country risk
- Transfer risk
- Customs

Timing of Payment

Perspective of Buyer

To determine timing of payment, the buyer considers the following options:

- Payment in advance when the buyer trusts the seller
- Payment at time of shipment
    - Payment after assurance that goods have been shipped
- Payment after the buyer has received goods, when:
    - The buyer does not know seller
    - The buyer needs financing

Perspective of Seller

To determine timing of payment, the seller considers the following options:

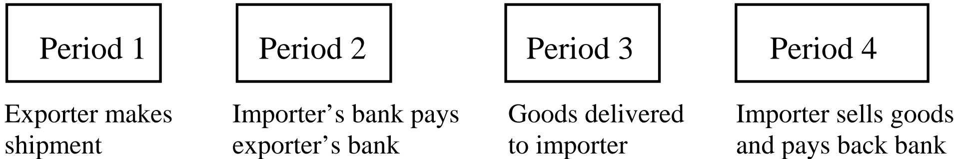
- Payment in advance, when:
    - The seller does not know the buyer
    - The seller needs financing
- Payment at time of shipment, for :
    - Assurance of payment upon the shipment of goods
- Payment after buyer has received goods, when:
    - The seller trusts the buyer

Agree on Finance and Shipping Terms

Finance Terms

The buyer and seller must know how the transaction will be financed and how it will affect their cash position.

In any stage of a transaction, someone, whether it is the buyer, the banker, the seller, or some other party, is financing the transaction.



For example, if the seller gives the buyer 90 day terms, either the seller funds the sale himself or has his banker provide the financing. Similarly, if the buyer makes a prepayment for the goods, either the buyer provides the prepayment out of his own capital or borrows elsewhere.

The cost of borrowing one's own or others' capital should be reflected in the cost of goods sold. Sometimes the cost of funds is very different between two trading partners (for example, Latin America, may have rates higher than 25%, and the party on the other end of the transaction may have lower rates). If interest rates are much higher in the importer's country than those associated with extended payment terms from the exporter, the exporter may want to finance the importer from his capital or his bank's capital and include the cost of funds in the pricing.

Agree on shipping terms and other costs

Buyers and sellers must fully understand their responsibilities in contracts of sale that embody trade terms not customary in domestic trade.

Trade terms are primarily used to define responsibility in the delivery of the goods sold and to show the price basis. When goods are sold, a number of other costs, in addition to the cost of the goods themselves, must be paid by the buyer or seller or shared between them. For example, customs tax, bank fees and interest and shipping costs must be paid. In addition, issues such as customs clearance, multiple transportation points, title to goods, and taxation issues make the international transport of goods from seller to buyer more complicated than domestic delivery.

An issues checklist for shipping terms should include the following:

- Who will pay for the cost of moving the freight to the ocean liner?
- What trade terms protect the exporter’s title to the freight?
- Who pays for the marine insurance?
- Who will be responsible for securing import licenses if needed?
- How does the trade term affect the company’s tax position?
- Are bank fees to be paid by the seller or buyer?

Module 2

Payment, Settlement, Collections and Financing

Payment

Methods of Payment

Open Account
Payment via open account occurs when goods are delivered to the buyer before payment is required.

Documentary Collection
With documentary collection, the seller ships the goods and sends a draft drawn on the buyer along with shipping documents, which usually include title to the goods, to the seller's bank. The seller's bank sends draft and documents along with cover letter to the correspondent bank in the buyer's country. The correspondent bank releases documents to the buyer upon the buyer's payment or acceptance of the draft.

Letter of Credit (L/C) (Documentary Credit)
This arrangement is a commitment issued by a bank for the account of the buyer to pay the beneficiary the value of the draft and/or documents, if the parties to the transaction have complied with the terms and conditions of the letter of credit.

Payment in Advance
With payment in advance, the buyer pays seller prior to shipment of goods.

The chart below exhibits various payment methods and the advantages and disadvantages of those payment methods.

Payment Methods

Payment Method	Major Advantages	Major Disadvantages
Cash in Advance	Seller: • Immediate use of funds for goods or services • The credit standing of the buyer is not an issue • Exposure to country and transfer risk is reduced	Seller: • May hurt sales since some buyers require financing Buyer: • The buyer's funds are encumbered with the transaction before the buyer receives the goods or services
Confirmed Letters of Credit for credit	Buyer: Bank in exporter's country guarantees payment	Seller: • Same as Letters of Credit; in addition, seller charged for the bank's guarantee. Buyer: • Importer must have credit facilities at bank
Letters of Credit	Buyer and Seller: • Issuing Bank guarantees payment • Payment is the obligation of one or more banks • Reduction of commercial risk • Facilitates financing of an international trade transaction • Most banks and parties adhere to UCP 500 • Letters of credit are widely used and understood	Buyer and Seller: • Payment is made on the basis Seller: • Documentation requirements can be extensive and payment may not be made if there are discrepancies Buyer: • No assurance that the goods will be received

Payment Method	Major Advantages	Major Disadvantages
Open Account with Export Insurance	• Helps finance buyers	• Additional cost(1-3%) • Most claims are not fully recovered
Collections	• Can use banks to track documentation; importer does not receive goods until payment accepted or made • No credit facilities required by importer Seller: • Simple process and relatively inexpensive • Buyer must pay for and accept goods to receive the title to the goods	Seller: Banks provide no guarantee money will be paid • Goods are shipped with a conditional promise of payment • Seller is responsible for goods if the buyer defaults • Seller does not have use of fun until buyer pays Buyer: • Legally liable if he defaults on paying or accepting the draft
Open Account	Buyer: • Helps finance buyers • Payment after goods are received and inspected	Seller: • Non-payment risk • Title to the goods is released without assurance of payment • Exposure to country or transfer risk

Settlement

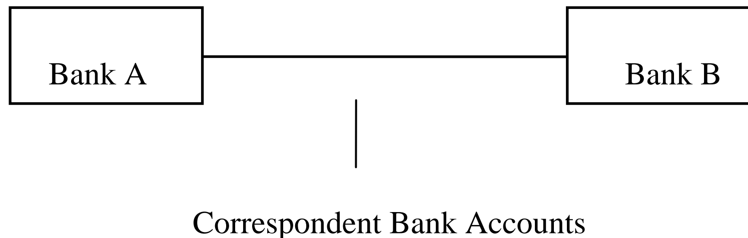
Methods of Settlement

In addition to the method of payment to be used, the buyer and seller must decide how the payment will be effected. The instrument or method by which payment will be effected is called the *method of settlement***.**

The primary methods of settlement include the following:

- Cash
- Check
- Draft or bill of exchange
- Bank draft
- Telex payment instructions
- SWIFT payment instructions

Settlement is usually facilitated by correspondent bank accounts as shown in the illustration below.

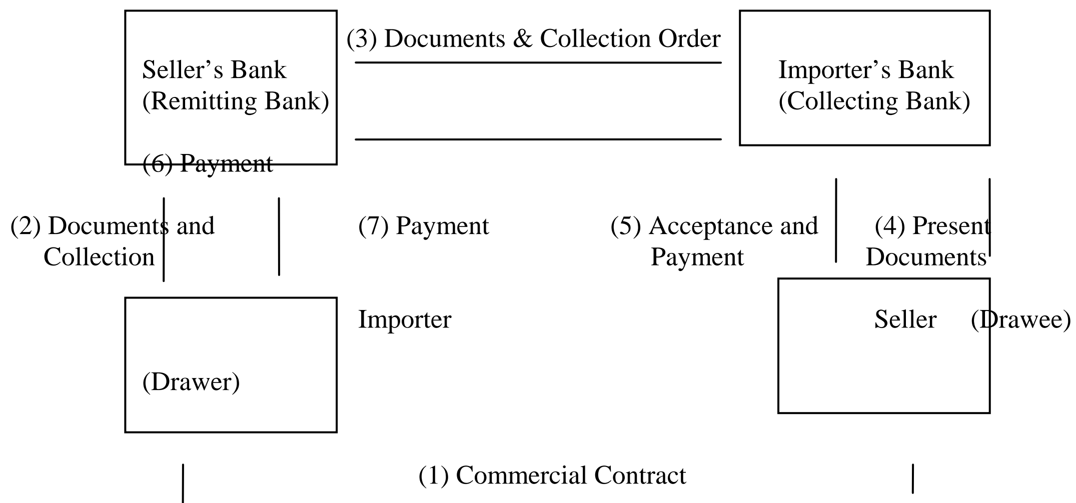


Correspondent Bank Accounts

Collection

Collections Parties and Process

The parties to an international trade contract and their responsibilities are shown below:



The responsibilities of each party are shown below.

Party	Step	Function Performed
Seller (drawer)	1 2	- Agrees to contract - Ships the goods and submits documents to his bank
Exporter's Bank	3 7	- Checks to ensure documents are all there and sends documents to the buyer's country with instructions to collect payment - Pays the exporter when it receives payment from the Collecting Bank
Collecting Bank	4 5 6	- Presents the bill to the buyer for payment/acceptance - Releases the documents to the buyer when the exporter's instructions have been followed - Remits the proceeds of the bill to the Remitting Bank according to its instructions (less any charges for cables, etc.)
Buyer/Importer	1 5	- Agrees to contract - Pays the bill or accepts the bill

Documents used in the collection process are commercial invoices, insurance documents, bill of lading and collection order. These are described in more detail below.

Commercial Invoices

A commercial invoice is a statement of a transaction prepared by the seller and addressed to the buyer. In an export transaction, anyone should be able to read the invoice and determine complete information about the transaction.

Note that where an invoice relates to a documentary credit, the description of the goods must be exactly as stated in the credit.

Insurance Document

Marine insurance can be used to insure goods during transport by various means of carriage (across oceans, rivers, air, or also extended to cover the goods during periods in storage before and after shipment). The seller must determine his responsibility for arranging and paying for insurance.

Bill of Lading

A bill of lading is a receipt issued by a shipping company, or its authorized agents, for goods shipped on board a named vessel, or for goods received for shipment. In addition and most important to the banks, it is a document of title to the goods described.

The bill of lading shows the name of the ocean vessel, the port of loading, and the port of discharge and has the on-board notation. Marine bill of lading is synonymous with the term *ocean bill of lading*.

The description of the bill of lading must agree with the description stated in the related invoice.

Collection Order

Whichever documents the exporter presents to his bank, he always attaches his instructions on a collection order. The collection order is a form issued by the exporter's bank, to be completed by the exporter when he submits a Documentary Collection or Letter of Credit. The exporter submits his collection order instructing the bank to handle the bill in a certain way. These instructions are passed on to the importer telling him how and when to pay.

Examples include whether the:

- Bill should be purchased or sent for collection.
- Documents should be released against acceptance or payment.
- Documents should be sent via air mail or courier.
- Collecting bank should cable advice of non-payment or acceptance by the buyer.
- Charges and interest are on the account of buyer or seller.

Although the exporter's bank handles all the above shipping documents, his bank assumes no responsibility beyond reasonable care.

Documentary Collections

Overview

Trade can be difficult between companies who do not know each other well. Not every exporter has affiliated companies offshore to handle sales and accounts receivable. Nor does a company want to take the risk of open account trading with companies. For smaller companies, this risk can be a gamble, since profits for the year can be wiped away by a transaction that goes bad with a Brazilian or Indian buyer, for example.

Banks act as a trustworthy third party between buyers and sellers. A *Documentary Foreign Collection* is a formal request for payment by a bank on behalf of its customer.

The underlying concept with collections is that the seller retains control of the documents, and therefore of the goods, until they are paid for or until the buyer has given a formal acceptance to his banker. The bank acts solely as agent for the customer, and assumes no responsibility for payment. The major advantage to an exporter of using collections rather than an open account is that the importer must pay (or promise to pay) before taking possession of the goods. Banks are more willing to finance exporters and importers when they can see what the advance is being used for. In addition, banks usually charge lower interest rates for trade facilities than for overdrafts.

Typical users of international collections are exporters with insufficient experience with their customers to warrant sales on an open account basis.

Definition

Under a documentary collection a bank acts upon instructions *to deliver documents against payment or acceptance*.

The party that initiates the documentary collection is called the *principal* and is usually the same party as the *exporter*.

The party to whom presentation is made according to the collection order is the *drawee* and is usually the same party as the *importer*.

In a documentary collection, there are usually at least two banks involved. One is the bank entrusted by the exporter to handle the collection. This bank is usually located in the country of exportation and is called the *remitting bank*.

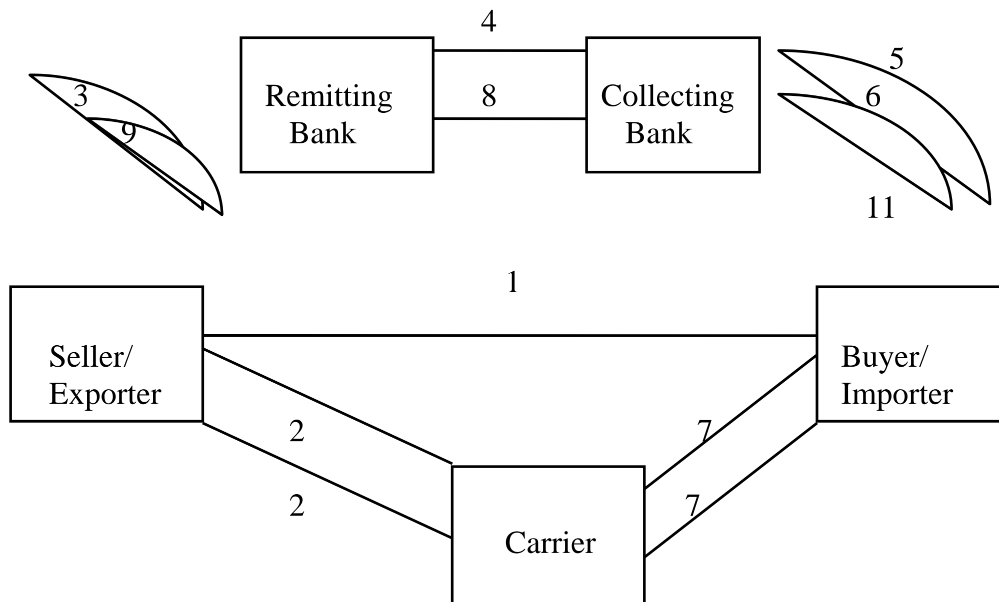
The bank that receives the collection and makes the presentation to the importer is usually located in the country of importation and is called the *collecting bank*.

Under a documentary collection, the remitting and collecting banks:

- Are usually corresponding banks, and
- Act as agents for the exporter.

Steps in a Documentary Collection

The illustration below shows the process of a documentary collection.



1. The sales contract occurs.
2. The seller ships the goods and receives the transport documents from the carrier.
3. The seller instructs the remitting bank to send documentary collection.
4. The remitting bank sends a collection letter and documents to the collecting bank.
5. The collecting bank obtains payment/acceptance from the buyer.
6. The collecting bank delivers documents to the buyer.
7. The buyer forwards the transport document to the carrier and receives goods.
8. The collecting bank sends payment to the remitting bank.
9. The remitting bank pays the seller.

Procedures and Obligations

Because the remitting and collecting banks act as agents for the exporter, *they must follow the exporter's instructions*.

Based on the exporter's instructions, the remitting bank prepares a *collection letter*, or collection order, that is sent to the collecting bank along with the *documents and draft*.

The collection letter includes the following information.

- The name and address of the collecting bank
- The name and address of the drawee
- Delivery instructions, via airmail or courier
- Instructions to release the documents against payment (D/P) or acceptance (D/A)
- Notification instructions if the drawee defaults
- Instructions for payment of collection charges and any interest
- A list of documents
- Remittance instructions
- A "Case of Need" contact

The two methods of obtaining payment from the drawee are:

- Documents against payment (D/P)
- Documents against acceptance (D/A)

How the exporter makes payment

The key step to initiate payment in the collections process is the drawing of a bill of exchange (frequently called a draft). The bill of exchange is an unconditional order in writing, addressed by the exporter to the importer requiring the importer to pay a sum of money. Step 2 in the chart above, where the Seller submits documents and a collection order to his banker, is where the bill of exchange would be submitted.

Bills of exchange may be drawn on demand (alternative words 'at sight' may be used); or, if the seller is offering terms to the buyer, bills may be drawn payable at a determinable time in the future.

Example Bill of Exchange

Number	3141	Exchange for	USD 55,000
Domicile	Philadelphia	Date	25 April, 19xx
(1)	60 days after ____________ sight of this place of Exchange		
	CORESTATES BANK LIMITED (2)		
The sum of	Fifty-five thousand dollars United States currency		
To **(3)**	F.R. Supply Company, 5000 Meridan St, Hexton PA		
For **(4)**	Singapore Traders Pty. Ltd		

A bill of exchange or draft is simple. The four key elements of a draft are described below.

Tenor of the bill

This period is determined by agreement between the buyer and seller. The clock usually commences from the date of the importer's acceptance.

When the drawee becomes liable for the bill

It is critical to note that the drawee is not liable for the bill until he has accepted it. The customary form of acceptance is to make payment if the bill is at sight or, if the bill is payable at a period after sight, sign the bill. The bank will stamp "accepted" on the bill.

The bill of exchange is the critical document associated with collections and letters of credit. The exporter's bank uses this document to make claims of payments on foreign banks.

"Documentary" and "Clean" Collections

If a bill of exchange is accompanied by the shipping documents relating to the goods for which payment is sought, it is termed a ***documentary bill***.

A *clean bill* is one in which there are no shipping documents. It is a valid means for claiming payment by one party (the seller) against another (the buyer); however, this type of bill is not used very often. A clean collection carries no such assurance and simply requires that the foreign bank present the draft and demand payment from the buyer.

A documentary collection provides the importer with the added assurance that the goods have been shipped (i.e., the bill of lading).

Four additional documents that are typically submitted along with the bill of exchange and are essential in overseas trade are:

- Commercial Invoices
- Insurance note
- Bill of lading, or other document showing transport of goods
- Bank collection order

Depending on the type of goods and the country of import, other documents may also be required. Some examples are Health Certificates, Inspection Certificates, or Certificates of Origin.

The exporter should request that the buyer specify the documents required in addition to consulting his own shipping agent. An exporter does not want a situation in which

goods cannot be landed or must be stored because a necessary document has not been provided. This situation causes additional expense, delays and damage to the exporter's reputation.

Under documentary collections, the draft is drawn on the *importer* and when accepted by the importer or buyer becomes a *trade acceptance*.

The transport document is usually consigned *order of shipper, blank endorsed*.

Permission should be obtained from the collecting bank before the transport document is consigned to the order of the collecting bank; otherwise, the *bank is not obligated to clear or care for the merchandise*.

Under a documentary collection, if the drawee defaults by refusing to:

- Make payment,
- Accept a draft, or
- Pay an accepted draft at maturity,

the collecting bank should *follow the instructions in the collection letter*.

In the event of default by the drawee, the options typically specified include:

- Protest
- Warehousing
- Contact "Case of Need"
- Arrange clearance and export

In all of the above options, the costs are for the account of the *principal*.

In the case of a collection, no documentary credit is issued. The collection cycle starts when the seller, having shipped the goods and obtained the necessary documents, presents the documents together with his instructions to his bank (the remitting bank). The bank sends these documents to its branch or correspondent bank (the collecting bank), in the buyer's country for payment. The advantage of collections is mostly for the importer. He can inspect the documents before accepting the documents or paying the seller.

Important Distinction Between D/A and D/P Bills

The term *Documents Against Payments (D/P bill)* is often used to describe the collection of a sight draft.

The term *Documents Against Acceptance (D/A bill)* is often used to describe the collection of a time draft (e.g., 60 days after sight). The exporter is providing credit terms to the buyer. The period of credit is the term of the bill, also known in bank jargon as ***usance*** This release of documents constitutes an extension of credit by the seller.

The important distinction between D/P and D/A is that with D/P bills the documents accompanying the draft will not be released to the buyer until the draft is paid. Without the title to the goods, the buyer will be unable to pick up the goods.

The seller incurs more risk with D/A bills than D/P bills since under D/P terms, the exporter maintains control of the goods (through the banks) until the importer pays. Under D/A terms, the importer can inspect the documents and, if satisfied, accept the bill for payment on the due date, take the documents and clear the goods. At that point, the exporter loses control of the goods. Between the acceptance date and due date, the importer may have gone bankrupt or be unprepared to pay for the goods.

Exporter Concerns

With an international collection, the banks involved are not principals in the transaction, nor does the buyer's bank substitute its credit for that of the buyer. In handling international collections, the banks involved act solely as agents and are strictly guided by instructions from the seller who initiates the collection. In the collection process, banks do not examine the seller's documents or verify correctness of signatures on any document.

Therefore, the seller faces three concerns:

- Non-payment risk
- Country risk
- Difficulty in financing trade

Non-payment Risk

The risk for the exporter is that if the buyer is unable, or refuses, to pay, the exporter must retrieve the goods, find another buyer or abandon the shipment. Therefore, the exporter must have confidence in the financial strength and reliability of the buyer prior to agreeing upon collection terms.

In the worst case scenario, in which the buyer refuses to pay, the bank may be able to use its overseas branch or correspondent to employ a technique called "protest." The bank's protest makes a formal demand for payment. Protesting gives the seller a stronger position in a court of law and is a matter of legal record. Legal and banking costs are for the account of the exporter. The bank may be able to assist the seller in arranging for warehousing and insuring the goods in a foreign country, or help the seller to find another buyer.

The exporter should know that the importer is legally liable on the accepted bill for the action that may be taken against him in the event of default. This liability is independent from the sales contract. Also, the action of protest is sufficient in many countries to damage an importer's reputation.

Other than purchasing credit insurance, the best way to mitigate this non-payment risk is to obtain a buyer's credit status report through firms like Dun & Bradstreet or Dialog, or to obtain information from the Trade Development Council in the buyer's home country.

Country Risk

Funds sometimes are detained in developing countries due to exchange controls. Because of limited funds and liabilities for critical supplies like oil or military goods, countries sometimes put controls on their banks from releasing funds. Firms can obtain credit insurance to help offset this risk.

Difficulty in Financing Trade

Funds are received by the seller only after the bill is paid. Although financing may be provided by the seller's bank, in most cases United States banks are not interested in discounting bills of exchange on foreign accounts receivable.

Importer Concerns

The importer's concerns are far fewer in number (since he can normally inspect the documents before paying or accepting them) and are briefly summarized in the table below.

Risk	Ways to Mitigate
Goods do not arrive, arrive late or are damaged.	Take out insurance coverage.
Lack of financing to take up collections.	Arrange financing secured by collection.
Foreign currency exposure.	Hedge foreign exchange exposure or be invoiced in own currency.

Banks provide financing if the exporter is creditworthy. If the importer refuses a bill purchased by the bank, he must be assured of getting a refund. Banks usually obtain timely status reports on overseas importers to ensure their payment history. Although reasonably secure, collections still have the drawback for the exporter/principal of no guarantee of payment. The possibility remains that the drawee cannot, or will not, pay.

Sometimes, in the course of foreign collection transactions, the documents do not arrive before the goods.

This situation can occur in three cases:

- Goods are sent by air cargo.
- The international postal system has lost the documents.
- Operational problems within banks involved result in the shipment arriving prior to the documents.

When goods are unloaded from the ship or plane, they are cleared through customs and stored in a warehouse that belongs to the shipping company or its agents. The shipping company usually allows a few days storage after which the importer must pay storage fees called *demurrage*.

In such a case, the buyer usually wants quick delivery of goods to avoid demurrage charges (warehouse fees), but cannot take possession without title documents.

The buyer can apply to his bank for a *shipside bond*, which provides security to the shipping company from all liability resulting from its release of goods in the absence

of title documents. The goods are now in possession of the buyer, with no title documents for the bank to review. The bank charges a fee of approximately USD $20. When the title documents finally arrive, the bank sends them to the shipping company to have its liability released.

Export Collection Example

A medical adhesive manufacturer in Philadelphia ships three 20 foot containers to a buyer in Japan. The terms of the contract state that the buyer will pay the supplier 45 days after the presentation of the bill of exchange. This term means 45 days after the Japanese bank presents the bills to the buyer.

The total time the supplier will be financing the buyer can be broken into four periods.

Period 1	**Period 2**	**Period 3**	**Period 4**
2 to 3 Days	1 to 2 days	45 days	2 to 3 days

Therefore, the supplier may be financing the buyer for more than 55 days.

The manufacturer delivers the freight to a shipping line that issues an ocean bill of lading. In many cases, the freight is delivered to a freight forwarder, who receives the bill of lading. The manufacturer then draws a bill of exchange on the buyer (i.e., addresses the draft demanding payment) and presents the bill of exchange, collection letter, shipping documents (including the bill of lading, invoice, and insurance certificate) to the seller's bank for collection, with instructions to air mail them to the buyer's bank in Japan for presentation to the buyer.

The buyer's bank in Japan then notifies the buyer that it has received the documents and will deliver them (including the bill of lading, which is the title document) upon acceptance by the buyer. The buyer goes to his bank, receives the documents and gives the ocean bill of lading to the shipping company to take possession of the cargo. Note that the buyer is obligated to pay his bank 45 days from the presentation date of the documents.

The Japanese bank then remits the proceeds to the seller's bank, which in turn pays the seller.

Questions

1. Describe each period that requires financing.

Period 1:	The document handling time by the seller's bank (2-3 days)
Period 2:	The courier or air mail time for the documents to reach the buyer's Japanese bank
Period 3:	The 45 days the supplier agreed to finance the buyer after presenting the bill of exchange
Period 4:	The time needed for the Japanese bank to remit the funds to the seller's bank (since the seller's bank may not have an account with the Japanese bank in the United States, this process could take an additional 2 to 3 days).

2. If the terms of the agreement were at sight or bill of exchange payable immediately, what obligation would the buyer have?

   The buyer would have to pay the draft before receiving possession of the bill of lading.

If the importer cannot or will not pay, the exporter has four options:

1. Protest the bill and take the importer to court.

2. Find another buyer.

3. Arrange for sale at an auction.

4. Ship the goods back.

In the example above, if the medical adhesive supplier required financing from his banker to support the 45 day terms, the exporter might have asked his bank for financing against a collection bill. This arrangement would allow an exporter to be flexible in the payment terms offered to his buyers. For example, an importer in Mexico may only buy if he is allowed 90 days D/A terms. The shipment may be large and the seller, or bank customer, may not be able to wait for payment, so he asks his bank to finance the collection.

The exporter’s bank may finance the transaction by purchasing or discounting the collection bills under an Export Line of Credit. If the bank decides to grant financing this way, there is no commitment from the importer’s bank.

The instructions provided by the customer may not be clear to the bank. For example, the customer may be requesting an action different from its normal issuance patterns. The bank also checks to determine that insurance is provided, particularly if the terms are FOB or C&F, where insurance is the responsibility of the importer.

Normally, the bank wants to select the advising bank (either its own branch overseas or a correspondent with which it has strong relationship), but the customer has the right to determine which advising bank he wants (usually upon the Exporter's suggestion).

Examples: Collections and Financing

Export Documentation Example (See Documentary Collections)

Import Collection Example

A California importer has agreed to buy toys from a Taiwan exporter. Between them, they agree on the terms of sale and the use of draft terms. The toy supplier delivers the shipment to the shipping line, which issues an ocean bill of lading indicating shipment date, port of loading (Taipei), destination (Los Angeles), and arrival date. The exporter then draws a draft on the buyer (i.e., addresses the draft demanding payment from the buyer) and presents the draft, collection letter, shipping documents (which includes bill of lading, insurance certificate, and certificate of origin) to his banker with instructions to airmail them to the importer's United States bank for presentation to the buyer.

Upon receipt, the importer's bank notifies the buyer that it has received the documents and will deliver them (including bill of lading, which is the title document) upon payment. The buyer receives the documents and instructs his banker to debit his current account. The buyer then presents the bill of lading to the shipping company and takes possession of the goods.

Questions:

1. What kind of collection is this? __ Clean __ Documentary

   Answer: *Documentary*

2. What is the tenor of the collection?

   Answer: *At sight, commonly referred to as Documents against Payment (or D/P bills)*

3. If the importer did not agree to pay his banker, what steps could the exporter take?

   Answer:
   1. *Protest the bill and take the importer to court*
   2. *Find another buyer*
   3. *Arrange for sale at an auction*
   4. *Ship the goods back*

4. Why are documentary collections more secure to the importer than clean collections?

Answer:
A documentary collection provides the importer with the added assurance that the goods have been shipped (i.e., the bill of lading). A clean collection carries no such assurance and simply requires that the foreign bank present the draft and demand payment from the buyer. In this case, the buyer knew that the goods had been shipped from Taipei and were bound for Los Angeles.

5. If the goods were shipped by air rather than sea and arrived before the documents, what could the importer do if he wanted to pick up his goods?

   Answer:
   The buyer can apply to his bank for a shipside bond, which provides security to the shipping company from all liability resulting from its release of goods in the absence of title documents. The goods are now in possession of the buyer, with no title documents or ability of the bank to review.

Module 3

Trade Documentation

Basic Documents

Importance of Documents

The letter of credit is the most common and acceptable method of payment in international trade transactions when:

- The buyer and seller do not know each other well.
- The amount of the transaction is large.

Banks should understand letters of credit, since they allow banks to:

- Serve customers involved in international trade
- Attract new customers
- Earn letter of credit fees
- Expand financing opportunities
- Cross-sell other bank services

Since documents play a critical role in letter of credit transactions, a thorough understanding of documentation commonly used in such transactions is critical.

Letter of Credit Documents

Documents commonly used in letter of credit transactions that will be discussed in this course can be categorized as commercial, government or financial documents.

Commercial Documents
Commercial documents include the following:

- Transport documents
- Commercial invoice
- Insurance

Government Documents
Government documents include the following:

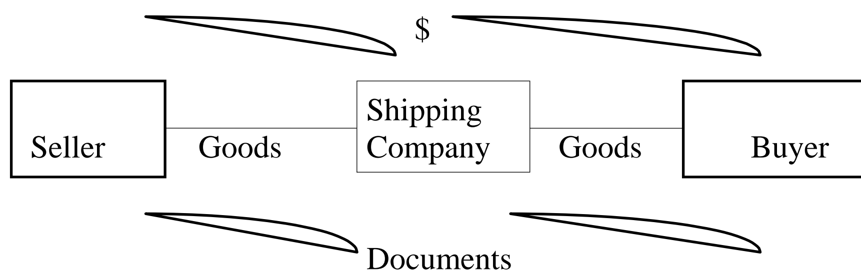
- Certificate of origin
- Consular invoice
- Inspection certificate

Financial Documents
Financial documents include the following:

- Drafts

Documentary Evidence Against Payment

The letter of credit method of payment involves the buyer/bank making payment only after receiving evidence, in the form of documents, that the goods have been shipped.



At a minimum, the buyer wants two kinds of documentary evidence that the goods have been shipped, including:

- The description of goods
- Evidence that the goods have been shipped

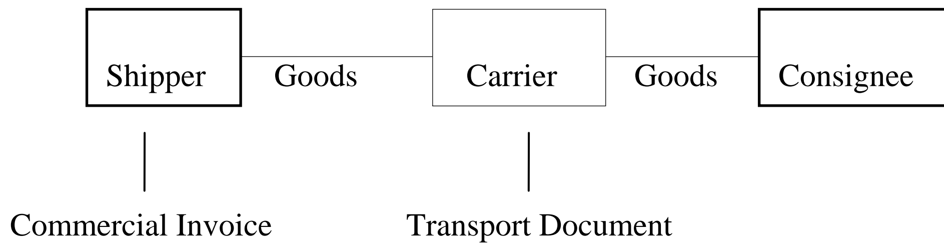
The two documents that provide this evidence are:

- Commercial invoice
- Transport document

Shipper, Carrier, Consignee

The company that transports the goods is called a *carrier*, who receives goods from the *shipper*, and delivers goods to the *consignee*.

The shipper is usually the same party as the seller and the consignee is usually the same party as the buyer.



Transport Documents

Transport documents are typically issued by carriers such as shipping companies, trucking companies, rail companies, and airlines. The transport document is issued by the carrier when the carrier receives the goods from the *shipper*.

A transport document can serve the following functions:

- Verification of receipt for goods
- Contract for delivery
- Title document

The most common types of transport documents and issuers are listed below:

Type	**Issued By**
Marine/Ocean Bill of Lading	Shipping Company
Multimodal Transport Document	Carrier
Air Transport Document	Airline
Road Transport Document	Trucking Company
Rail Transport Document	Railroad
Courier or Post Receipt	Courier or Post Office
Freight Forwarder Transport Document	Freight Forwarder

Marine/Ocean Bill of Lading

Types of consignment specifications:

The types of consignment specifications and a description of each are listed below.

Straight

- Carrier delivers goods to consignee
- Language in the bill of lading is "Consigned to"

Negotiable (To order)

- Goods are delivered to any party the consignee designates
- Ownership of goods is transferred by endorsement
- Language in the bill of lading is "Consigned to the order of"

Endorsement

- An endorsement that allows anyone in possession of the bill of lading to claim the goods is called a *blank* endorsement.
- An endorsement that allows only the named party to claim the goods or endorse it to another party is called a *restrictive* endorsement.

Original bill of lading

- Full set
- Signature of carrier or agent
- Not marked "copy non-negotiable"

Claiming goods and transferring ownership

Straight

- Goods released to consignee
- Not necessary to surrender bill of lading
- Cannot transfer ownership

Negotiable (To order)

- Must present any one of the original bills of lading
- Proper endorsement is required

Dates included in the bill of lading are:

- The issue date
- The on board date

Clean bill of lading

- Damage not indicated

Other Transport Documents

Often, goods are shipped by more than one mode of transportation. For example, the goods may be shipped by ocean vessel then transferred to a truck for overland transport. In these cases, a special kind of transport document is used that is called a *multimodal transport document*.

Marine and multimodal transport documents may be either straight or negotiable. All other types of transport documents are *straight*.

Often, shipment of goods is arranged by a company that handles all of the shipping details for the shipper. Its services typically include making reservations on the carrier, packing the goods, handling transportation to and from the carrier, and issuing the transport document, typically a multimodal transport document. This type of company is called a *freight forwarder*.

Commercial Invoice

A commercial invoice includes the following components:

- Bill of sale
- Claim for payment
- Description of goods
- Payment terms

In a typical trade transaction, the seller provides the buyer with a price quote(s) during the negotiating stage. Once the buyer agrees to a price quote, the trade transaction can proceed. Since a commercial invoice is the bill of sale, it should be consistent with the price quote previously provided by the seller.

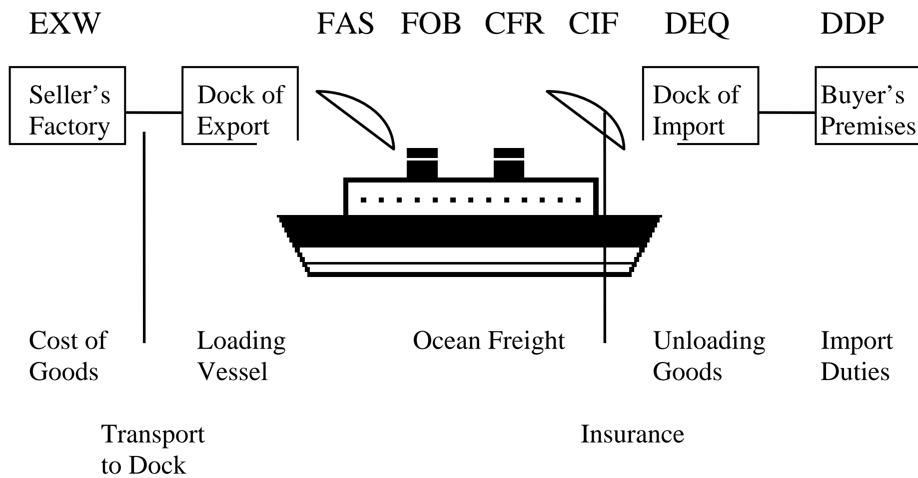
A seller's price quote usually specifies the:

- Price of goods or services
- Cost of shipping and insurance

In an effort to minimize disputes and misunderstandings, the International Chamber of Commerce (ICC) has published a standard set of price quotations. These standard terms are called *incoterms*.

Incoterms

The diagram below shows the sequential charges involved in the movement of goods from the seller's factory to the buyer's premises, and indicates the commonly used incoterms for the charges at each step.



The following briefly describes some of the responsibilities and duties of the two parties for terms and abbreviations frequently encountered in international trade. The International Chamber of Commerce publication *Incoterms* is recommended for a comprehensive review on the subject.

Sample Incoterms

<u>TRADE TERMS</u>
EX WORKS

- Seller Responsibility	The seller makes the goods available to the buyer at the seller's premises (factory, warehouse, etc.)
- Buyer Responsibility	The buyer arranges for delivery of the goods from the warehouse/factory and bears all costs and risks.

Free Alongside Ship (FAS)

- Seller Responsibility	The seller must deliver the goods alongside ship at the port named by the buyer.
- Buyer Responsibility	Once goods have been delivered, the buyer is responsible for any export license, costs and risks from that point on.

TRADE TERMS

Free On Board (FOB)	
- Seller Responsibility	The seller is responsible for all costs and risks of the goods until they have passed the rail at the port of shipment.
- Buyer Responsibility	The buyer is responsible for all costs and risks once the goods have been loaded at port of shipment.
Cost and Freight (CF)	
- Seller Responsibility	The seller must contract for the shipment of the goods and pay the costs and freight to take the goods to the destination point.
- Buyer Responsibility	The buyer must accept delivery of the goods at the agreed port of destination and pay cost of unloading, etc. Cost of insurance is on buyer's account.
Cost, Insurance and Freight (CIF)	
- Seller Responsibility	In addition to paying for the goods to arrive at the destination, the seller pays for insurance and provides the buyer with the policy.
- Buyer Responsibility	Limited

Often buyers and sellers agree to alter the conditions of a particular term. For example, with FOB shipment the seller may agree to pay freight and insurance and bill the buyers separately. These changes do **not** convert a FOB contract to a CIF contract.

In many sales contracts, the price of the goods reflects the shipping and insurance costs. It is still critical to use the right shipping terms, since shipping terms affect the title to the goods, the taxable sales of a company, and the control of risks such as false country of origin markings. For example, a United States importer may better control the country of origin markings if he shifts from FOB terms to land and duty paid. Under FOB, if the goods were marked with the wrong country of origin, the importer would be liable since the title passed to him at the point of shipment.

Incoterm Format

Price quotations should contain the correct incoterm and be in the correct format. Each quote should indicate the last point to which the goods will be shipped for the quoted price. For example, the correct format for a FOB price quotation is as follows:

- Amount, FOB vessel name, port of export

Other Incoterms:

Other Incoterms include:

- FLA
- CPT
- CIP
- DAF
- DES
- DDU

The commercial invoice should be consistent with the price quotation.

Insurance

For large value shipments the buyer should protect against financial loss in the event that the goods are damaged or destroyed while in transit. To provide protection, the buyer can purchase *insurance*.

The amount paid for the insurance protection is a *premium*.

The amount the insurance company pays in the event of loss is a *benefit*.

Party to whom the benefit is paid is the *beneficiary*.

The specific date that the insurance goes into effect is *the effective date of coverage*.

The amount of loss the insured party is responsible for is called the *deductible*.

An insurance policy that covers multiple shipments is *called an open policy*.

The notice of insurance issued by an insurance broker is called a *broker's cover note*.

Insurance that is transferable from one beneficiary to another by endorsement is *negotiable*.

Other Documents

Other documents used in international trade transactions are listed below:

- Certificate of origin
- Inspection certificate
- Consular

Draft

In addition to the documents previously discussed, letter of credit transactions usually involve a financial instrument called a *draft*.

This document is an unconditional order, in writing, addressed from one party to another. It is signed by the party presenting it. It requires the party to whom it is addressed to pay on demand, or at a fixed or determinable future time, a certain sum of money to, or to the order of, a specified party, or to the bearer.

Therefore, a draft is a *demand for payment*.

A draft used in a letter of credit transaction should be drawn to make it a *negotiable instrument.* This means that the draft must be:

- Signed by the drawer
- Unconditional
- Payable to order or to bearer
- For a specific sum, payable in money
- For a specific tenor

Under a letter of credit, the party which completes and signs the draft is usually the seller/exporter and is called the *drawer*.

Under a letter of credit, the party which is ordered to make payment is usually a bank and is called the *drawee*.

Under a letter of credit, the party which receives payment is usually the seller/exporter and is called the *payee*.

Document Examination

Basic Considerations in Document Examination

Upon receiving documents, the bank must check them against *the letter of credit* to determine if *the requirements of the letter of credit have been met*.

If any documents are missing, are not consistent with each other, or do not satisfy the requirements of the letter of credit, these errors are recorded as *discrepancies*.

The most important guideline to follow when examining documents is to *follow the requirements specified in the letter of credit*.

All parties should also keep in mind that banks are *required to examine the documents "on their face."* The banks are not responsible for the "form, sufficiency, accuracy, genuineness, falsification or legal effect" of any documents.

Discrepancies fall into two general categories:

- Correctable by the beneficiary
- Not correctable by the beneficiary

Document Examination Checklists

The document examination checklists for various types of documents are contained in the following pages.

Commercial Invoice Checklist

- Issued by beneficiary of the letter of credit
- Applicant indicated as invoiced party unless otherwise stated in letter of credit
- Not titled “pro forma” or “provisional”
- Description of goods corresponds to description in letter of credit
- No additional descriptions that appear to question the value or condition of goods
- Details of goods, prices, terms as mentioned in letter of credit included
- All other information consistent with other documents
- Currency indicated same as letter of credit
- Amount indicated corresponds with amount of draft
- Amount indicated does not exceed amount specified in letter of credit
- Does not include charges not allowed by letter of credit
- Correct shipping terms
- Covers complete shipment unless partial shipments allowed
- Signed, notarized, certified, legalized, etc., as required by letter of credit
- Information pertaining to transport charges consistent with other documents
- Correct number of originals and copies

Transport Document

- Full set of originals
- Not a “charter party” transport document unless authorized in letter of credit
- Not a “forwarder’s ” transport document unless authorized in letter of credit
- Name of consignee is as required in letter of credit
- Properly endorsed if endorsement required
- Indicates name of the shipper or its agent
- Shipment date does not indicate late shipment
- Port of loading/discharge consistent with letter of credit
- Name and address of notifying party same as required in letter of credit
- Description of goods consistent with description provided in letter of credit
- Other specifications, if any, consistent with other documents
- Freight prepaid or freight collect costs consistent with letter of credit
- No indications rendering transport document “unclean” or “foul”
- Full set presented, if required
- Alterations, if any, properly authorized

Insurance

- Policy, certificate, declaration, or cover note as required by letter of credit
- Full set presented
- Issued and signed by insurance company, underwriter or their agents
- Signed by assured party if required by insurance document
- Effective date at latest from date of loading on board or taking in charge
- Value of goods insured as required in letter of credit
- Currency same as letter of credit, unless otherwise allowed in letter of credit
- Description of goods consistent with invoice
- Coverage from designated point of taking in charge to point of delivery
- Covers risks specified in letter of credit and clearly defines risks
- Marks, numbers, etc., consistent with transport document
- Issued in negotiable form
- Proper endorsement if assured not the issuing bank, confirming bank, or buyer
- All other information consistent with other documents
- Alterations, if any, properly authenticated

Other Documents

Certificate of Origin

- Unique document and not combined with any other document
- Signed, notarized, certified, legalized, etc., as required by the letter of credit
- Data consistent with that of the other documents
- Country of origin specified as required by letter of credit

Inspection Certificate

- Issued by inspection firm nominated in letter of credit
- Properly signed
- Complies with inspection requirements of letter of credit
- Contains no unauthorized detrimental statements about the goods

Weight List/Certificate

- Unique document and not combined with any other document
- Signed if a certificate required, or as stated in letter of credit
- Data consistent with that of the other documents

Packing List

- Unique document and not combined with any other document
- Lists contents of each package as required by letter of credit
- Data consistent with that of the other documents

Draft

- Correct letter of credit reference number
- Authorized signature
- Signature and/or name of drawer corresponds to name of beneficiary
- Current date
- Drawn on correct drawee
- Amount in figures is the same as the amount in words
- Amount drawn does not exceed amount specified in letter of credit
- Amount of draft and commercial invoice amount consistent
- Tenor as required by the letter of credit
- Name of payee identified
- Properly endorsed if endorsement required
- No restricted endorsements
- Contains any necessary clauses as required by letter of credit
- Draft not drawn “without recourse” unless authorized in letter of credit
- Draft not altered

Handling Discrepancies

If the nominated bank discovers discrepancies during the examination of documents, it has the following options:

- Require that the beneficiary correct and re-submit the documents.
- Return the documents; the beneficiary can submit the documents directly to the issuing bank.
- Obtain the beneficiary’s indemnity against non-reimbursement by the issuing/confirming bank.
- Send documents for collection with the beneficiary’s approval.
- Obtain the issuing/confirming bank’s authorization to pay with the beneficiary’s approval.

The last two options also require the issuing/confirming bank to obtain an *account party’s authority to pay*.

Module 4

Letters of Credit, Trade Finance and Uniform Customs and Practice for Documentary Credits

Letters of Credit

Overview of Import Letter of Credit (L/C) Process

Customer —— **Issue Letter of Credit** — **Advising Bank**

Issuing Bank —

- Application processing
- Letter of credit transmission
- Electronic issuance
- Amendments

Definition

A letter of credit (L/C), also called a documentary credit, is a commitment issued by a bank for the account of a buyer (applicant), or for its own account, to pay a beneficiary the value of the draft and/or documents. Payment is made, provided that the buyer and seller comply with the terms and conditions of the letter of credit.

Under a letter of credit, a *bank* substitutes its promise to pay for that of the *buyer*.

Therefore, when a seller/exporter is the beneficiary of a letter of credit, the seller/exporter does not have to depend on the credit standing of the *buyer* because the seller/exporter will be paid by a *bank*.

Under a letter of credit, payment is made when the seller/exporter presents *documents* that are specified in the letter of credit and *that comply with the letter of credit terms*.

Under a letter of credit transaction, banks deal with documents rather than the following:

- Goods
- Services
- Other performances to which the documents relate

Irrevocable vs. Revocable

A letter of credit that represents a bank's promise to pay against the presentation of documents that comply with the terms of the letter of credit, and which cannot be changed or canceled without the agreement of the buyer (applicant), seller (beneficiary), and bank (issuing/confirming bank's), is called an *irrevocable letter of credit*.

A letter of credit that can be changed or canceled without the agreement or knowledge of the seller (beneficiary) prior to payment (or acceptance, negotiation, or issuance of a deferred payment commitment), against documents that comply with the terms of the letter of credit, is a *revocable letter of credit*.

Under a revocable letter of credit, the advising bank usually attempts to notify the beneficiary of any changes or cancellation as soon as such notice is received; however, the advising bank is under no obligation to do so.

Revocable letters of credit are uncommon due to the limited protection provided to the seller. Therefore, this course will deal exclusively with irrevocable letters of credit unless specifically noted. The use of the term "letter of credit" in this course means "irrevocable letter of credit."

Parties to a Letter of Credit Transaction

The party applying for the letter of credit is called *the applicant or account party*.

The applicant or account party is usually the same as one of the following:

- buyer
- importer
- consignee

The party to whom the letter of credit is addressed is called the *beneficiary*.

The beneficiary is usually the same party as one of the following:

- seller
- exporter
- shipper

In a letter of credit transaction, usually at least two banks are involved.

- The bank that issues the letter of credit on behalf of the buyer is usually located in the country of importation and is called the *issuing bank*.
- The bank that advises the seller that the letter of credit has been issued is usually located in the country of exportation and is called the *advising bank*.

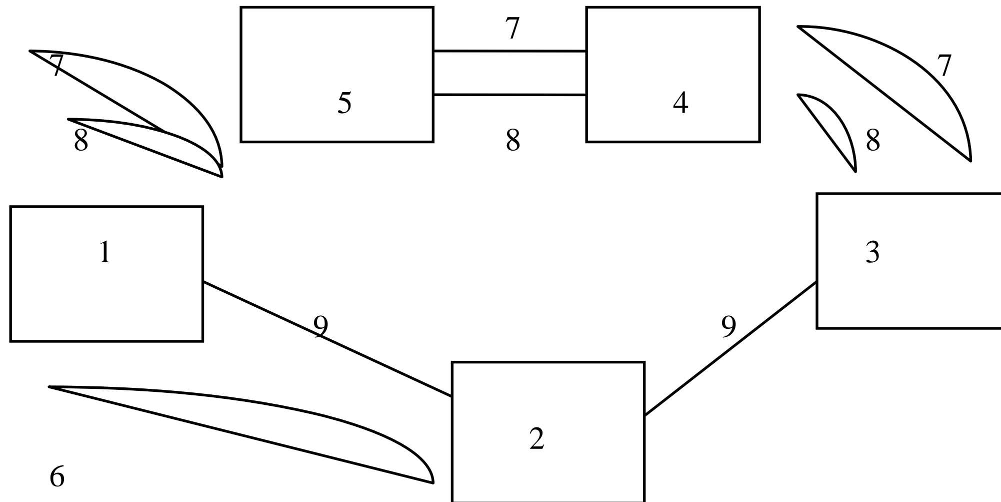
In most cases, the issuing and advising banks will be *correspondents*.

The bank authorized to pay, undertake a deferred payment obligation, accept, or negotiate under a letter of credit is called the *nominated bank*.

The bank upon which the beneficiary draws the draft is called the *drawee bank*.

Movement of Goods, Documents and Money

The movement of goods, documents and money is illustrated below.



"1" represents the seller.

"2" represents the carrier.

"3" represents the buyer.

"4" represents the issuing bank.

"5" represents the advising or nominated bank.

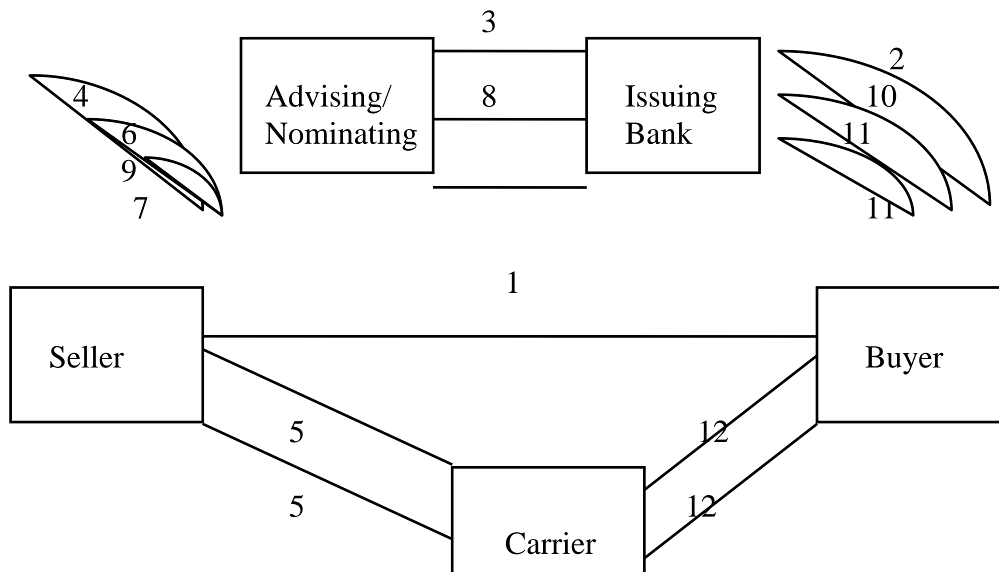
"6" represents the transport document.

"7" represents documents.

"8" represents money.

"9" represents goods.

Steps in a Letter of Credit Transaction



"1" represents the sales contract.

In "2" the buyer instructs the issuing bank to issue the letter of credit.

In "3" the issuing bank issues the letter of credit.

In "4" the advising bank informs the seller about the letter of credit.

In "5" the seller ships goods and receives the transport document.

In "6" the seller presents documents to the nominated bank.

In "7" the nominated bank examines the documents and makes payment.

In "8" the nominated bank forwards the documents to the issuing bank.

In "9" the issuing bank examines the documents and reimburses the nominated bank.

In "10" the buyer reimburses the issuing bank.

In "11" issuing bank releases documents to the buyer.

In "12" the buyer receives goods from the carrier.

Contractual Relationships

Under a typical letter of credit transaction, there are several contractual relationships, including the following:

- Sales contract
- Letter of credit application and agreement
- Letter of Credit
- Confirmation advice (if the letter of credit is confirmed)

Each of these contracts is independent of the others.

Time Limits

The *expiry date* is the date when a letter of credit expires, after which the beneficiary can no longer present documents for payment.

In addition, the letter of credit usually specifies a period of time during which the documents must be presented. This time period is specified as within a certain number of days after the date of shipment, as indicated by the transport document. This period of time is called the *presentation period.*

If no presentation period is specified in the letter of credit, the documents must be presented within *21 days after the date of shipment*.

The definition of date of shipment depends on the type of transport document.

To ensure being paid, the beneficiary must present documents either :

- on or before the expiry date, or
- within the presentation period,

whichever is sooner, and the documents *must comply with the terms of the letter of credit*.

Letter of Credit Application

After the buyer and seller contract for a sale that requires payment by a letter of credit, the buyer requests that his bank issue a letter of credit by submitting a *letter of credit*

application.

Issue an L/C or Amendment Application

Customers can submit a Letter of Credit application or amendment in one of three ways:

1. By submitting a paper application at the international branch office.

2. By sending a pre-formatted electronic message from a computer that interfaces with the bank's host system.

3. By sending a pre-advice by fax to begin processing the application. This still requires the original signature

The letter of credit application form should be similar in format to the letter of credit itself in order to:

- Facilitate issuance

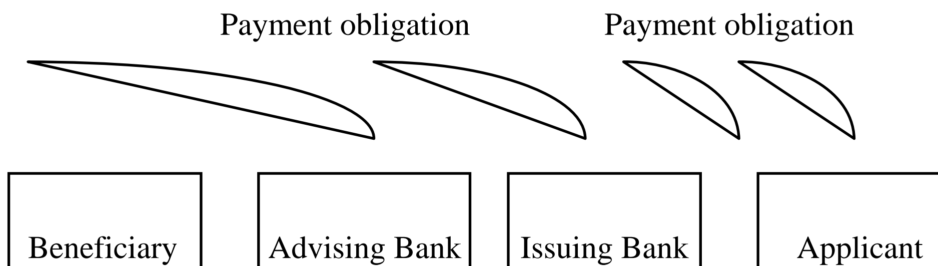
- Minimize errors

Upon receiving a customer's application, a bank allocates an L/C number to allow for tracking in its system. It also checks the customer's signature to ensure it is a valid L/C application. If the L/C is submitted electronically, the bank has encrypted codes for the company officer responsible for signing for L/Cs.

Each letter of credit application should be reviewed carefully since the issuance of a letter of credit represents an *extension of credit*.

The bank must ensure that the amount of the L/C requested does not exceed the customer's approved credit facility amounts. If it does, the bank would refer the credit to the banking officer responsible for the account for a decision. Over-limit situations can cause delays in processing the L/Cs.

The letter of credit requires the bank to make payment against documents that comply with the terms of the letter of credit, even if the bank is *not paid by the applicant.*



To help ensure that the applicant reimburses the issuing bank, most banks also require the applicant to sign a *letter of credit agreement*.
A letter of credit agreement is similar to a loan agreement and may include a security/pledge agreement if the applicant is required to provide collateral.

Review a Letter of Credit Transaction

Upon receiving a letter of credit application from a customer, the bank should review and examine the application for the following:

- Completeness
- Clarity
- Workability

The letter of credit application should only call *for documentary requirements.*

When reviewing a letter of credit application, the bank should check for the following:

- An authorized signature
- The name and address of the applicant and the beneficiary
- The date
- The expiry date and place
- The expiry date set far enough in advance
- Transmittal instructions
- Correct amount
- Specification of nominated bank unless the letter of credit is freely negotiable
- Specification of insurance coverage, if required
- Place of shipment and taking-in charge
- Destination and the place of discharge
- Shipping terms
- Concise merchandise description

- List of the required documents

An example of a letter of credit application form is in the exercise that follows. The format is recommended by the International Chamber of Commerce (ICC).[1]

Transmission of Letter of Credit to Advising Bank

The issuing bank can send L/Cs to the advising bank in the following ways:

METHOD		
I. Airmail	II. Electronically	III. Pre-advise
1) Airmail	3) Telex	5) Brief cable
2) Courier	4) SWIFT	

Thus, there are at least five ways in which the issuing bank can inform the advising bank of an L/C. A short cable gives brief details of the L/C only and serves as a means of providing advance notice. It is not an operative instrument in itself and it must state this fact.

[1] *ICC Standard Documentary Credit Forms*
ICC Publication No. 516 - ISBN 92.842.1160.3
Published in its official English version by the International Chamber of Commerce.
Copyright (1993 - International Chamber of Commerce (ICC), Paris.
Available from: *ICC Publishing S.A.*, 38 Cours Albert 1er, 75008 Paris, France.

A full cable contains all LC details and can be acted upon immediately, provided it is *authenticated*. Authenticating means that the advising bank has tested the message for its validity to ensure the source.

Checking Inward Documents

A drawing represents a shipment made on a letter of credit (either for the full or partial value).

The key components the importer's bank checks are:

- The latest date for shipment
- Documents required
- If trans-shipment is allowed
- Whether partial shipments are prohibited
- Who is responsible for insurance
- The party on whom bills of exchange are to be drawn
- The tenor of the L/C
- Currency

Advising the Exporter (Beneficiary of LC)

The *advising bank* checks the authenticity of the SWIFT message as a control, and relays the SWIFT message to the seller *(beneficiary).* The advising bank's function is to assure the beneficiary that the L/C is a valid instrument of the issuing bank, which is normally in another country. The advising bank either has the beneficiary obtain the SWIFT or airmail L/C at the branch or courier the documents to his site. Increasingly, banks
are pre-advising beneficiaries by fax. The fax allows exporters to begin working on the shipment knowing the L/C has been issued (i.e., the buyer is backed by a bank).

Bill Checking (export negotiations)

The exporter's bank must make sure that consistency exists among the original letter of credit and all the documents called for in the letter of credit (e.g., bill of lading, commercial invoice, packing list). This task can involve, depending on the complexity of the paperwork, several hours of work for a senior bill checker.

Included in this function is the time required to credit the proceeds to the exporter's account, schedule the bill to be sent to the issuing bank and track reimbursement from

the issuing bank.

Money Transfer for Open Account Trading

An importer can settle export claims by:

- Purchasing an international cheque (draft) from his bank, payable at an overseas bank, and mailing it to the supplier (by courier or registered mail).

- Arranging through his bank for an overseas bank to be instructed by SWIFT or telex to pay the supplier. SWIFT is an acronym which stands for the Society of Worldwide Interbank Financial Telecommunications. It is a means for banks to settle payments with each other. These transfers typically cost $25-50, require an account, and take approximately 2 days to clear, depending on correspondent relationships with the exporter's bank.

In addition, companies have options outside the banking system to settle their trade obligations. Below are some examples of International money transfer providers:

Provider	Agent	Delay	A/C Required	Cost	Max Transfer
American Express Moneygram	Amex Branch	Auto	No	$35-$150	$7,150
Western Union	24,000	Auto	N/A	$18-$155	No
IBOS	First Fidelity	Auto	Yes	$10-$25	No

Issuing a Letter of Credit

A bank should issue the letter of credit only after:

- The letter of credit application is properly reviewed
- Proper agreements are in place
- Credit approval is obtained

The steps in issuing a letter of credit are as follows.

1. Assign a reference number.
2. Produce the letter of credit.
3. Select the advising bank if not indicated by the applicant
4. Transmit the letter of credit.
5. Issue reimbursement instructions.

Advising a Letter of Credit

A bank that has received a request from an issuing bank to advise a letter of credit to a beneficiary will proceed with the following steps:

1. Authenticate the letter of credit.

2. Verify that the letter of credit is subject to UCP 500.

3. Determine if the letter of credit is revocable or irrevocable.

4. Review the letter of credit for completeness and workability

5. If specified, verify the bank's ability to act as the nominated bank.

6. Verify reimbursement instructions

7. Determine if confirmation is requested

8. If confirmation is requested, obtain the necessary credit approval .

9. Advise or confirm the letter of credit.

10. Otherwise, make proper notification.

If the letter of credit comes in by teletransmission, the advising bank should authenticate the letter of credit by *verifying the test key*.

If the letter of credit comes in by mail, the advising bank should authenticate the letter of credit by *verifying the signature*.

Once the advising bank has authenticated and reviewed the letter of credit, it can advise the letter of credit to the beneficiary using one of the following ways:

1. If the letter of credit is received via mail, *send the original letter of credit with a cover letter.*

2. If the letter of credit is received via teletransmission:

    - send a re-written letter of credit on the advising bank's letterhead,

    - send the teletransmission with a cover letter.

When a letter of credit is sent from one bank to a second bank, it should be reviewed as carefully as if the second bank were issuing the letter of credit. This should be the case regardless of whether or not the second bank will be confirming the letter of credit.

The second bank should review the letter of credit for the following:

- Completeness

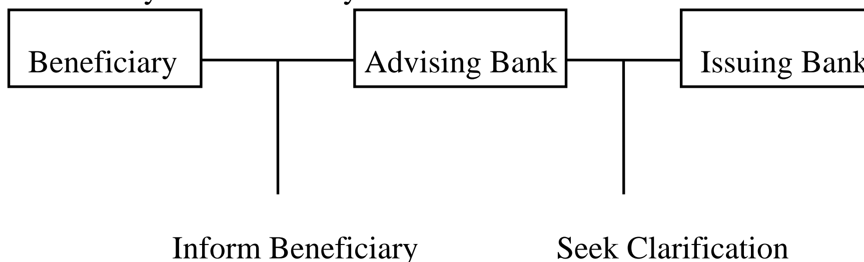
- Clarity

- Workability

If the advising bank finds a problem with the letter of credit it has been requested to advise, it should:

- Ask the issuing bank for clarification, and

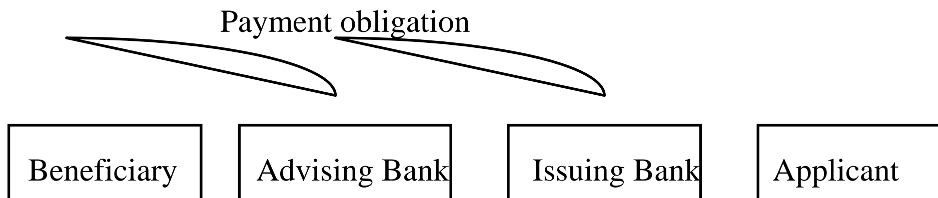
- Notify the beneficiary.



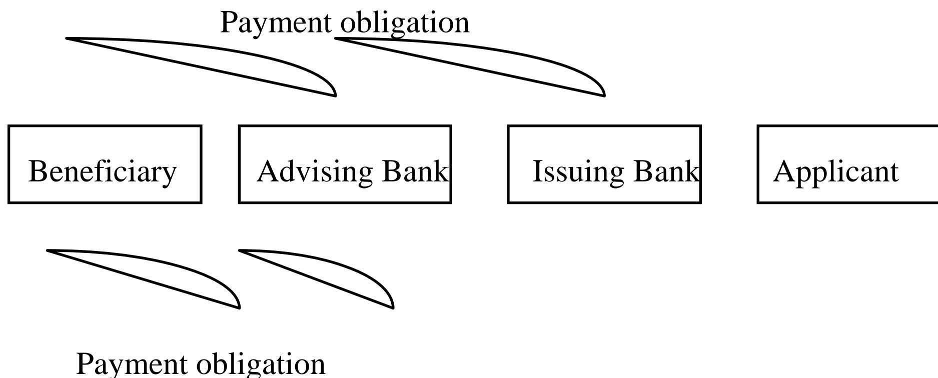
Confirming a Letter of Credit

Under a letter of credit, the issuing bank is obligated to make payment if documents are presented that *comply with the terms of the letter of credit.*

The bank that is requested to advise the letter of credit is *not* obligated to make payment.



If the issuing bank requests a correspondent bank to add its own engagement, or obligation to pay under a letter of credit and the correspondent bank agrees, then the correspondent bank becomes a *confirming bank* and the letter of credit is called *a confirmed letter of credit.*



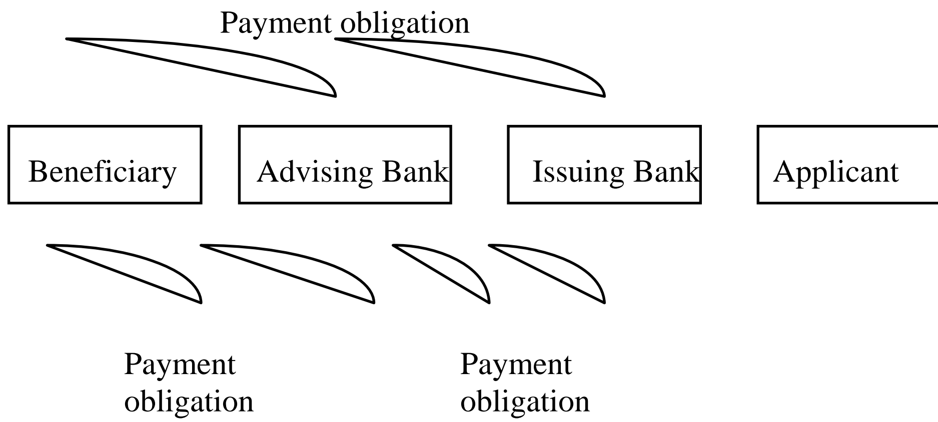
A bank that has confirmed a letter of credit is *obligated* to pay the beneficiary of the letter of credit, if the beneficiary *presents conforming documents.*

The confirming bank relies on the *issuing bank* for reimbursement, but remains *obligated* to pay the beneficiary even if the confirming bank is not reimbursed by the *issuing bank*.

Therefore, a bank that confirms a letter of credit assumes *the credit risk of the issuing bank*.

In most cases, a bank will confirm a letter of credit provided that:

- the issuing bank is a correspondent, and
- a sufficient credit facility exists.



Bank Credit Analysis—IBCA

Since the bank confirming a letter of credit is taking on the credit risk of the issuing bank, it is important that the confirming bank conducts a proper credit analysis of the issuing bank. Various bank analysis services provide information that can help a bank conduct a credit analysis of another bank. One such service is IBCA. Banks should not rely entirely on credit rating services. Banks can use these services to support their own credit analysis.

Amendments

After a letter of credit has been issued, the applicant, or more commonly the beneficiary, may need to change the letter of credit. For example, the beneficiary may discover that it cannot meet one of the documentary requirements of the letter credit and, therefore, needs to have the letter of credit changed.

A change to a letter of credit that has already been issued is called an *amendment*.

The party that must apply to the issuing bank for the amendment is the *applicant*.

The amendment to the letter of credit must be approved by:

- The issuing bank
- The confirming bank
- The beneficiary

Settlement Options and Payment Obligations

The options for settlement of payment under a letter of credit are listed below:

- Sight payment
- Deferred payment
- Acceptance
- Negotiation

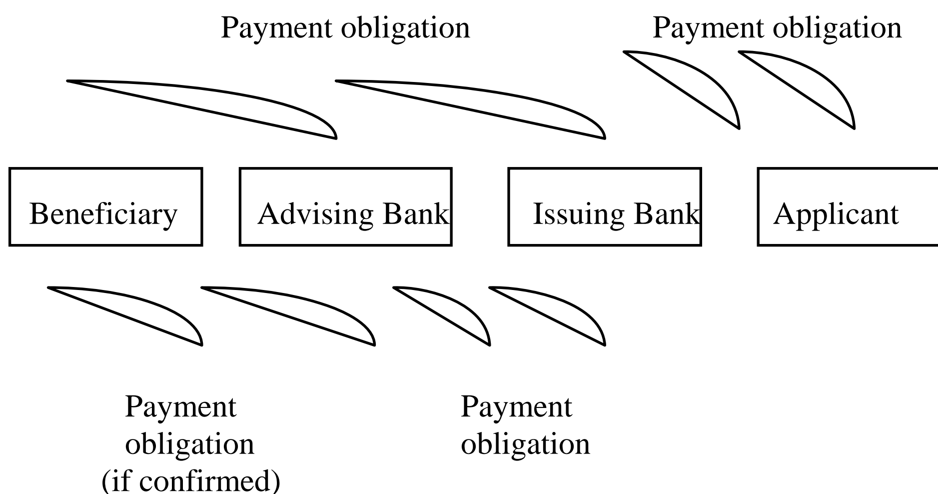
Unless the letter of credit stipulates that it is available only with the issuing bank, all letters of credit must specify a *nominated bank*.

The nominated bank is authorized to execute one of the following:

- Sight payment
- Deferred payment
- Acceptance
- Negotiation

Nomination by the issuing bank does not constitute an undertaking by the *nominated bank,* unless it is also the *confirming bank*.

By nominating another bank, the issuing bank *commits to reimburse the nominated bank*.



Sight vs. Time Letters of Credit

To claim payment under a letter of credit, the beneficiary usually presents documents to the nominated bank along with a demand for payment called a *draft*.

If the beneficiary is to be paid as soon as the draft is presented and honored, the letter of credit is called a *sight letter of credit*, and the draft is called a *sight draft*.

If the beneficiary is to be paid on some future date after the draft is presented and honored, the letter of credit is called a *time letter of credit*, and the draft is called a *time draft*.

The terms of payment for a draft is called the *tenor*.

Tenor is specified in one of the following ways:

- sight
- x days date
- x days sight

If the beneficiary is to be paid "x" number of days after the date of the draft, the draft will be drawn *x days date*, and the date will be specified by the *letter of credit*.

If the beneficiary is to be paid "x" number of days after the bank honors the draft, the draft will be drawn *x days sight*.

Banker's Acceptance Financing Examples (Import and Export)

Before we discuss some financing examples, a fundamental understanding of the Banker's Acceptance instrument is necessary.

Commonly referred to as Banker's Acceptances (or BAs), the bank accepts the bill of exchange drawn upon it by its customer, and then sells it into a secondary market at a discount, including an acceptance commission, and passes the proceeds to its clients. The bank then pays the bill at face value at maturity. Such acceptances can originate under letters of credit or documentary collections.

Drafts are termed "accepted" when a bank assumes the obligation to make payment at maturity and, for accepting the draft, collects a commission. The bank physically marks the draft "Accepted," usually with a stamp applied to its face. Acceptance by the bank makes the draft a readily marketable instrument in the secondary market.

BAs allow exporters selling under collections, or providing terms to the importer, to receive cash up front. By accepting a bill, the bank is adding its guarantee that it will be met in full at maturity, so the acceptance can be sold at a rate that reflects the bank's credit standing.

The Federal Reserve Bank requires that an eligible BA must be supported by one of the following types of transactions:

- Import or export of goods involving United States trade. This acceptance financing is the most common usage.

- Third country trade. Acceptances can finance shipment of goods between countries outside the United States.

- Tenor cannot exceed six months. The maturity date must coincide with the borrower's anticipated receipt of sale proceeds.

Acceptances are created in two ways: from usance (or time) letters of credit and by direct creation. Usance letters of credit are settled through the bank where the credit is made available. When a letter of credit calls for payment to be made to the beneficiary a specified number of days after presentation of clean documentation, the paying bank accepts the accompanying draft and holds it in safekeeping. During the life of the draft, the seller has the choice of discounting the draft at the prevailing discount rate or holding the draft to maturity. If the buyer agrees to absorb the discount charge, the seller will be paid full face value upon presentation of documents and the buyer will pay for the draft plus discount and commission charges. Otherwise, these charges will accrue to the seller (beneficiary).

Payment by Acceptance - Banker's Acceptance

Under a sight letter of credit, the beneficiary presents a sight draft and, if the documents are in order, the bank honors the draft *by paying the beneficiary*.

Under a time letter of credit available for payment by acceptance, the beneficiary presents a time draft and, if the documents are in order, the bank honors the time draft by *accepting the draft*.

A draft that has been *accepted* by a bank is called a *banker's acceptance* and represents the bank's *promise to pay the draft at maturity*.

Banker's acceptances have evolved into actively traded investment instruments because they are *obligations of banks*.

Therefore, a holder of a bankers acceptance can receive payment prior to maturity by discounting the *banker's acceptance*.

However, not all banker's acceptances are readily salable and the willingness of investors to purchase a bankers acceptance depends on the *credit standing of the accepting bank*.

The investor that purchases the banker's acceptance pays less than the face value and receives the full face value at maturity. The difference between the two amounts, or interest required by the investor, is called the *discount*.

Banker Acceptance, An Import Example -- A United States Importer Finances a Sight Draft through a Bankers' Acceptance.

An importer of footwear opens an L/C for USD $1 million with his banker. The exporter presents the drafts to his own banker and ships the footwear. The exporter's banker presents the draft to the importer's bank. If the documents are in order, the importer's bank pays the exporter's bank and debits the importer's account. Upon presentation of the sight drafts under the L/C, the importer draws up a time draft (up to 180 days) on his bank. The bank accepts the draft and discounts it in the market, using the discounted proceeds to credit the importer's account and thereby refinancing the sight negotiation.

At maturity of the acceptance, the importer repays the face amount of the draft to his bank with funds received from the sale of the footwear items.

The price of the discounted acceptance can be calculated by using a straightforward formula. The pricing is a function of four components. The four components are:

- Length of financing
- Bank's commission
- Size of transaction
- Market rate

The larger the transaction, the easier it is for banks to liquidate the draft in the secondary market. The bank’s commission is based on competitive conditions and upon an assessment of the customer as a credit risk. For example, the discount and commission for $1,000,000 acceptance for 180 days would be:

Discount rate = 8.5%

Commission = 1.0%

$1,000,000 X .095 X 180/360 = $47,500

Questions

1. What is the net credit to the importer’s account?

   Answer:
   The net credit to the importer’s account would be $952,500. Since the importer’s bank paid $1 million and only received $952,000 in the marketplace, the importer would be obliged to pay $1,047,500 in 180 days.

2. How much did the importer’s bank have to pay the exporter’s bank upon presentation of drafts?

   Answer: *USD $1 million*

3. If the period of time for financing was 90 days instead of 180 days, what would be the discounted proceeds the bank would have received in the market?

Answer:

Calculate the discounted proceeds in two steps. First determine the discounted commission, then determine the net proceeds.

Step 1: *Discounted Commission = $1,000,000 X .095 X 90/360 = $ 23,750*

Step 2: *Net Proceeds = $1,000,000 less $23,750 = $976,250*

Banker Acceptance, An Export Example -- A United States Exporter using Pre-export Finance.

A New York company receives an order from a Mexico buyer to ship a machine tool in two months time for USD $500,000. The buyer will open a letter of credit in favor of the exporter, but since it will not be paid for 90 days after presentation of documents, it requires help from its banker to obtain the funds to manufacture the machine.

Between shipment and revenue recognition, 150 days elapse, (60 days to prepare machine and ship and 90 days financing credit given to buyer). The customer would issue drafts in its banker's name with a maturity of 150 days.

The customer confirms these details in a letter to the bank certifying that no other financing covers this transaction.

Questions

1. Assuming an interest rate of 9% and a commission of 1.5%, what would be the net proceeds to the exporter?

   Answer: *The net credit to the exporter's account would be $478,125.*

   Discounted value in Market = $500,000 X .105 X 150/360 = $21,875
   Proceeds to exporter = $500,000 less $21,875 = $478,125

2. How would the exporter repay the bank $500,000 in 150 days?

   Answer:
   In this example the exporter is giving the buyer 90 day terms. After shipping the machine and presenting the documents, the buyer would be obligated (assuming all documents are in order) to pay US $500,000 at 90 days from date of presentation.

Example:Determining a Customer’s Import Letter of Credit Line

A customer’s projected sales turnover is $16 million. Imports amount to 15% of turnover. When the customer orders raw material, he must always supply an L/C. The supplier undertakes to deliver the documents in one month. As a result, the bank would structure a limit as follows.

Total imported for the year X average outstanding L/C / 365.
Assume the company has no other banker and the business is not seasonal.

Questions:

1. What are the company’s annual imports?

   Answer: *$16 million X 15% = $2.4 million*

2. How do you calculate the average outstanding L/Cs?

   Answer:
   The average outstanding L/Cs should equal one month of the year’s imports. Therefore the limit should be $2.4 million X 30/365 = $197,000. This amount reflects the average amount outstanding that the customer has tied up in L/Cs.

3. What should the bank set as the letters of credit limit?

   Answer:
   Given that the company has no seasonality, the bank would set the line to equal average outstanding L/Cs or $197,000.

4. If imports happened to jump to 30% of sales (all on letters of credit), what options are available to the bank?

   Answer:
   1. Review credit line for possible adjustment

   2. Approve over-limit letters of credit on a case-by-case basis

Deferred Payment

Under a deferred payment letter of credit, the following occur.

- Payment is made on a specified future date.
- Payment is usually 30 to 270 days after the shipment date.

- A sight draft is presented.

In most cases, deferred payment letters of credit do not offer the opportunity for the beneficiary to receive payment prior to the specified future date because a *time draft is not used*.

Negotiation

Under a straight letter of credit, the obligation of the issuing bank:

- Is extended to the beneficiary;
- Usually expires at the counters of the issuing bank;
- Conveys no commitment to third parties.

Under a negotiation letter of credit, the obligation of the issuing bank is *extended to authorized third parties* that *negotiate*.

A bank that effectively negotiates draft(s)/document(s) buys them from the beneficiary, thereby becoming a *holder in due course*.

There are two options for letters of credit available by negotiation, including:

- Negotiation restricted to a nominated bank
- Freely negotiable

Negotiation by an issuing or confirming bank is *without recourse*.

Negotiation by any other bank is *with recourse*.

Letter of Credit Fees

Banks charge letter of credit fees in order to *earn fee income*.

Customary letter of credit fees include:

- Issuance fee
- Advising fee
- Confirmation fee
- Amendment fee
- Telecommunications costs

The amount of the issuance fee may depend on the risk associated with the *credit standing of the applicant*.

The amount of the confirmation fee may depend on the risk associated with *the credit standing of the issuing bank*.

SWIFT Letter of Credit Format

(Insert SWIFT documentation provided by the instructor after this page.)

Differences Between Documentary Collections and Letters of Credit

The following is a list of the characteristics of a **letter of credit**:

- It is a bank obligation.
- The seller does not rely on the buyer for payment.
- The seller pays upon presentation of conforming documents.
- The draft is drawn on a bank.
- A time draft that is accepted by the bank becomes a banker's acceptance.
- Banker's acceptances are readily discounted.
- Fees are usually higher than with documentary collection.

The following is a list of characteristics of a **documentary collection**:

- It is not a bank obligation.
- The seller relies on the buyer for payment.
- The seller must wait until the documents are presented to the buyer for payment.
- If the buyer defaults, the seller is responsible for the goods.
- The draft is drawn on the buyer.
- The draft that is accepted by the buyer becomes a trade acceptance.
- Trade acceptances are not readily discounted.
- Fees are usually lower than with the letter of credit.

Key Differences with Documentary Credit:

Key Differences	Collection	Letter of Credit
1. Obligation to Pay the Seller	Only the buyer is obligated to pay the seller.	The issuing or confirming bank is obligated to pay (if all documents are in order).
2. Risks to the Seller	• Buyer refuses to • Buyer refuses to pay D/P bills. • Buyer refuses to pay maturing D/A bills.	• Buyer refuses documents due to discrepancies. • Issuing bank defaults. • Exchange controls
3. Documentation	Not checked by banks	Checked for strict compliance by importer's and exporter's bank
4. Role of bank	Passive; act only as agents to clear and trace payments	Active; Issuing or Confirming bank substitutes its credit for that of the buyer.

Letter of Credit Variations and Trade Finance

Banker's Acceptance Financing

A banker's acceptance is separate and distinct from a letter of credit, but often arises as a result of a letter of credit transaction.

To enable an importer to possess and sell merchandise before paying for it, a letter of credit can be issued that calls for the exporter to present *a time draft*.

The exporter presents the draft and documents to the bank. If the documents are in order, the bank creates a banker's acceptance by *accepting the draft*.

The exporter can hold the banker's acceptance until maturity, or can receive immediate payment by *discounting the banker's acceptance*.

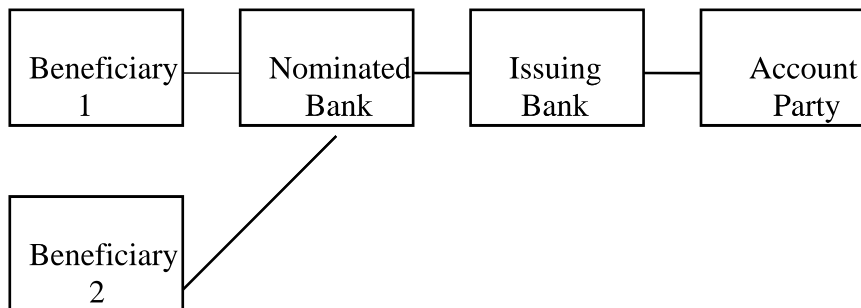
It is the bank's irrevocable commitment to pay, regardless of whether the bank is paid by its customer, that enables intermediaries to hold or trade the banker's acceptance so the bank's customer can be provided with *trade finance*.

Transferable Letter of Credit

Under a transferable letter of credit, the beneficiary is permitted to transfer the rights and protection of the letter of credit to *another party*.

A letter credit can be made transferable by either:

- Issuing the original letter of credit as transferable
- Amending the letter of credit



Two types of transferable letters of credit are *full transfer* and *partial transfer*.

Under a transferable letter of credit:

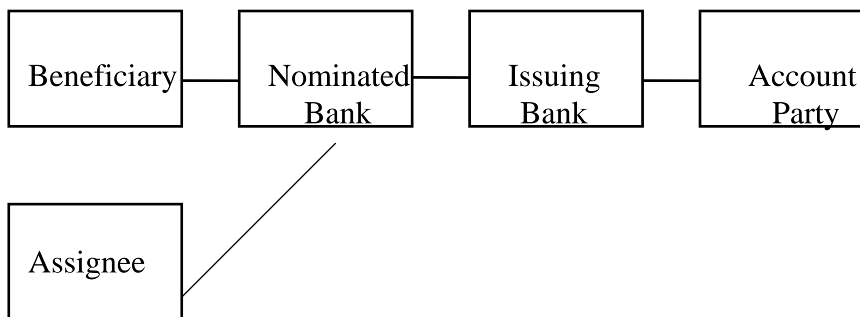
- The letter of credit must state that it is transferable.
- Only one transfer is allowed.
- Partial shipments can be transferred separately.
- Beneficiary #2 presents the documents.

The terms and conditions of the letter of credit cannot be changed, with the following exceptions:

- Applicant's name
- Amount
- Latest shipment date
- Presentation period
- Expiry date and place
- Insurance percentage

Assignment of Proceeds

Assignment of proceeds is another method for making the proceeds from a letter of credit available to another party besides the beneficiary.



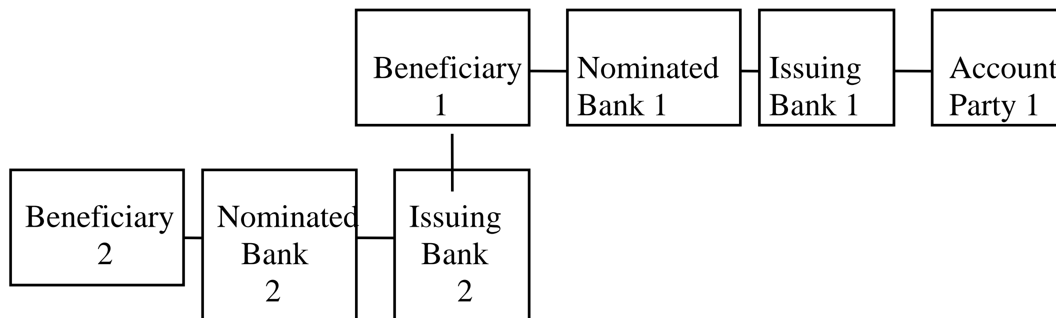
Under an assignment of proceeds:

- The beneficiary requests assignment.
- The bank forwards the notice of the assignment to the assignee.

- The issuing bank and account party are not involved in the assignment.
- The beneficiary presents the documents.
- The assignee is not a party to the letter of credit.

Back-to-Back Letter of Credit

Under a back-to-back letter of credit, the beneficiary of a letter of credit *uses it to induce the issuance of a second letter of credit*.



A back-to-back letter of credit is often requested when:

- A transferable letter of credit is not available.
- Assignment of the proceeds of a letter of credit is not available.

Back-to-back letters of credit are usually structured so that:

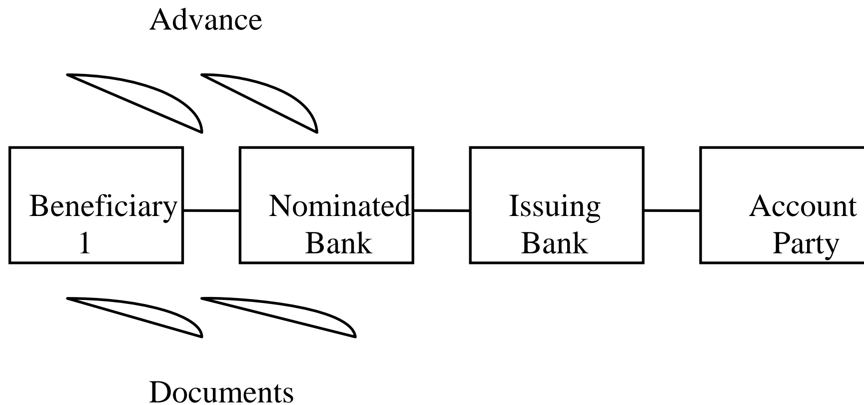
- The amounts of the letters of credit differ.
- Invoices can be substituted.
- Expiration, shipping and presentation dates are changed.
- All other terms are the same.

The main risk of the bank issuing the second letter of credit *is non-performance of beneficiary 1*.

Red Clause Letter of Credit

A red clause letter of credit contains a special provision that authorizes the confirming bank or any other nominated bank to *make advances to the beneficiary prior to document presentation*.

Red clause letters of credit are used as a method of providing the seller with *pre-export financing*.



If the beneficiary fails to present conforming documents:

- The nominated bank can demand repayment from the issuing bank.
- The issuing bank has recourse to the account party.

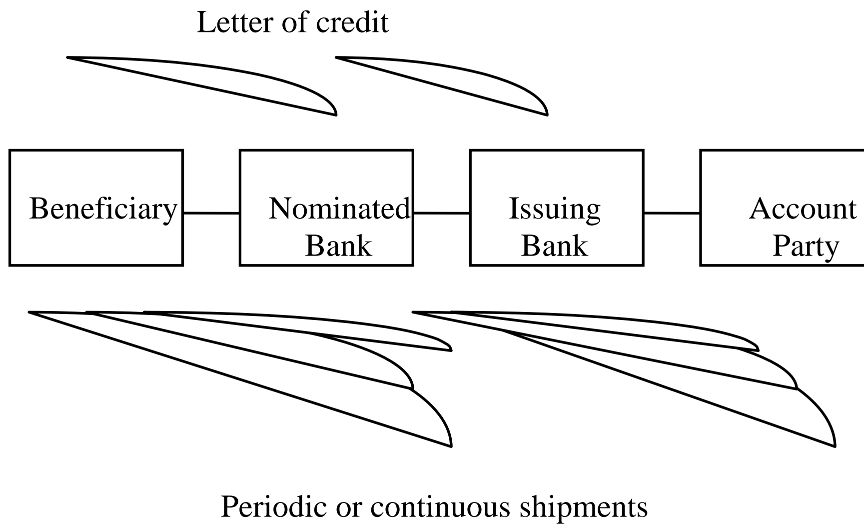
Revolving Letter of Credit

Under a revolving letter of credit the *amount is renewed or reinstated without amendments*.

A revolving letter of credit can revolve with respect to *time* or *value*.

A revolving letter of credit is useful when:

- Periodic or continuous shipments are involved.
- The buyer and seller want to eliminate multiple letters of credit.
- The buyer and seller want to minimize amendments.



Standby Letter of Credit

Whereas a commercial letter of credit is activated by the performance of the beneficiary, that is, the presentation of documents that comply with the terms of the letter of credit, a standby letter of credit is activated *upon the default or non-performance of the account party*.

Standby letters of credit are commonly used as:

- Performance guarantees
- Credit enhancement

Standby letters of credit pose greater risk to the account party, and the issuing and confirming banks, because:

- the condition for drawing against the letter of credit is usually a written claim of default.
- The bank does not determine default or non-performance.
- The bank does not substantiate the beneficiary’s claim.

Standby Letter of Credit Example

American Bank
Trade Services Dept.
100 Main Street
New York, New York 10000

Date: November 30, 1994
Our Irrevocable Standby Letter of Credit No. 12345

ABC Company
200 Main Street
New York, New York 10002
USA

Gentlemen:

We hereby authorize you to draw on us for the account of XYZ Company, 25 Broad Street, New York, New York 10003, for a sum not exceeding USD $100,000.00 (One hundred thousand U.S. dollars) available by your drafts on us at sight accompanied by the following documents:

> Your signed statement reading:
> ''The amount of this drawing USD $100,000.00 represents funds due us as XYZ Company has failed to perform in accordance with their obligations under contract Number: 234710 dated November 30, 1994.''

This standby letter of credit expires at our counters on January 31, 1995.

All drafts must be marked "Drawn under American Bank, New York, Standby Letter of Credit Number 12345, Dated November 30, 1994".

This credit is subject to the Uniform Customs and Practice for Documentary Credits (1993 Revision) International Chamber of Commerce Publication No. 500.

We engage with you that drafts drawn under and in compliance with the terms of this credit will be duly honored upon presentation.

Very truly yours,

Authorized Signature
American Bank

Government and Multilateral Programs

Government programs designed to boost national exports include:

- Preferential interest rate loans
- Guarantees of commercial bank financing
- Insurance against commercial and country risks

These programs are administered by national export agencies such as:

- The United States EXIM Bank
- Export Import Bank of Japan
- ECGD
- Hermes
- COFACE

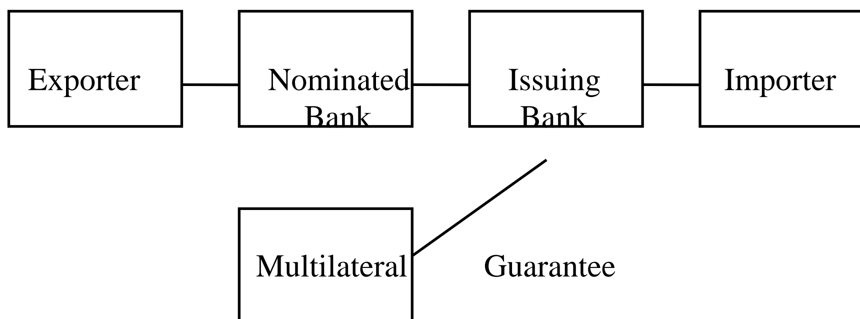
Multilateral organizations that provide capital and advice for economic development include:

- The World Bank
- EBRD
- ADB

Commercial banks cooperate with national and multilateral organizations by:

- Participating in loans and co-financings
- Providing guaranteed financings
- Issuing or confirming letters of credit under guarantees

An illustration of a guarantee relationship is shown below.



Uniform Customs and Practice for Documentary Credits

(UCP 500)

Background

Founded in 1919, the International Chamber of Commerce (ICC) is a non-governmental organization of companies and business associations in more than 130 countries. The ICC is engaged in promoting world trade and investment, harmonizing trade practices, holding seminars and conferences, publishing, and formulating terminology and guidelines for importers and exporters.

Due to the increasing use of letters of credit as a method of payment in international trade, the ICC published, in 1933, the Uniform Customs and Practice for Documentary Credits (UCP) to help standardize the procedures and customs relating to the use of letters of credit.

The UCP has been periodically updated and revised to meet changing circumstances and developments in international trade. The most recent revision was published in 1993 and is referred to as the UCP 500. The UCP 500 replaces the 1983 revision referred to as the UCP 400.

The UCP 500 is not binding law; however, it has gained near universal acceptance.

Key Provisions:

Form and Notification of Credits

Key Provisions:

Key Provisions:

Key Provisions:

Miscellaneous Provisions

Key Provisions:

Transferable Credit

Key Provisions:

Assignment of Proceeds

Key Provisions:

Module 5

Fraud

Fraud

Fraudulent Documents and Fraudulent Issuance

Under a letter of credit, banks deal with *documents* rather than any of the following:

- Goods
- Services
- Other performances to which the documents may relate

Therefore, a letter of credit:

- Does not ensure that the account party will be satisfied with the goods, and
- Offers limited protection against fraud committed by the beneficiary.

Fraudulent letters of credit have been "issued" by the following.

- Fraudulent "banks"
- Dishonest employees of legitimate banks

Banks can avoid schemes involving fraudulent documents or the fraudulent issuance of letters of credit by doing one or more of the following:

- Dealing only with parties that are known
- Checking references of all parties to a transaction
- Using the proper authenticating procedures
- Implementing dual controls
- Checking all documentation and correspondence thoroughly
- Educating customers

Prime Bank Instrument Fraud

During the past few years there has been a rapid increase in the number of reports of

fraudulent investment schemes involving the buying and selling of so-called Prime Bank Instruments.

The instruments used in these fraudulent schemes have also been referred to as:

- Prime Bank Guarantees
- Prime Bank Notes
- Standby Letters of credit
- Prime Bank Letters of credit

Criminals offer these instruments as:

- Alternative investments
- Collateral for loans

The targets of these schemes include:

- Individuals
- Companies
- Charities
- Banks

For arranging these bogus transactions, criminals often require *advance fees*.

Criminals often use the following tactics to further their schemes.

- Use others to support their schemes.
- Use official sounding terminology.
- Use banks to unknowingly further their schemes.
- Use intimidation.
- Use non-disclosure agreements.
- Use misrepresentation.

- Use forged documents.

The best way to avoid being a victim of, or unknowingly facilitating Prime Bank Instrument fraud, is to either:

- Deal only with known parties, or
- Understand thoroughly all the transactions thoroughly

In addition, banks should learn to recognize the following common characteristics of these schemes:

- High returns promised
- Secrecy
- Large transaction amounts
- References that cannot be contacted
- Reluctance to meet face-to-face
- Improper use of terminology
- High pressure
- Confusing transactions

If a bank employee receives an inquiry and suspects possible fraud or criminal activity, he or she should:

- Notify management.
- Not send correspondence to the suspect.
- Not give a business card to the suspect.
- Not meet them outside of the bank.

Some steps a seller or buyer can take to prevent fraud are the listed below:

Seller	**Buyer**
Check on buyer's credit standing.	Make sure the seller ships the goods

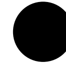
	with a well-established shipping company.
Confirm a documentary credit.	Pre-inspect goods by independent inspection agency.
Contact other suppliers to the buyer.	Make sure insurance coverage is done by a reputable firm.
	Provide for third party arbitration in another country.

Appendix 1

Bank Pricing

Trade Finance Substitute Products
Fee/Foreign Exchange/Interest Charges

Product	Cost to Buyer/Importer	Cost to Seller/Exporter	Time Involved (1)
Open Account	• International money transfer ($30-45) • Foreign exchange OR	• Collection charge for bank cheque or draft • Foreign exchange	
Documentary Collections	• Collection fee incoming sight draft ($80 minimum or .2% of value) • Cost of mailing\receiving documents ($45) • Foreign exchange OR • Shipping guarantee (2) (flat fee)	• Collection fee outgoing sight draft ($80 minimum or .2% of value) • Cost of tracers (if applicable) • Foreign exchange	

Letter of Credit	• LC issuance fee ($110 minimum or .125% of value) • LC amendment fee(3) ($80) • LC negotiation fee (4) $100 minimum or .125% of value) • Foreign exchange OR • SWIFT/telex charge • Shipping Guarantee (2)	• LC advising fee ($50) • L/C negotiation fee ($90 minimum or .25% of value) • Mailing of documents • Cable charges • Foreign exchange • Transit interest (5) • Discrepancy charge (6) ($50) • Confirmation fee (7)	

Notes

(1) Time spent by company staff preparing bank documents Low High

(2) Shipping guarantees are charged when the bank must issue an indemnity to the shipping company to release the goods to the importer when the bill of lading has not yet arrived.

(3) Only if an amendment is issued

(4) Time spent by issuing bank checking inward drawing on Letter of Credit

(5) Transit interest represents the difference (in days) between when the exporter's bank pays the exporter and when the exporter's bank receives the funds from the issuing bank, multiplied by the cost of funds

(6) Some banks charge per discrepancy. It depends on the local accepted practice.

(7) Confirmation fee is a function of the importer's country risk, tenor of draft, and issuing bank risk (for example, whether a government or private bank.

Based on the chart above, there are a few key points to understand. First, converting the currency into a local currency will only be charged to buyer or seller, depending upon which currency the invoice indicated. The buyer or seller will pay a spread to the bank based on the difference between the market exchange rate and the quote given by their banker. For example,

if a United States buyer needed to pay his supplier in Tokyo yen, when converting the USD account, the bank would buy the USD and sell the buyer yen. But the bank rate will not be as good as the market.

The other important component to understand is that banks typically charge fees based on the following rationale:

1. For document checking, a minimum fee is charged, regardless of the value of the transaction.

2. A percentage is normally applied if above the minimum charge.

3. Percentages are usually tiered by transaction value, so that higher transaction values pay smaller percentages. This situation is true because a bank's processing costs do not relate to transaction value, except in one case. Banks have second or third checks by document examiners on high value items.

The various fees, commissions, and charges associated with letters of credit issuance, confirmation, document review, and payment are often confusing because the service provided is frequently difficult to match with the fee, commission, or charge paid. The following chart may be helpful in understanding the letter of credit process and the associated services.

Back Office Examples

Case 1: What Happens When an LC Expires?

Situation:

A Letter of credit was issued with a validity of two months for shipment and three months for presentation of the documents. The validity was extended twice by an amendment on the part of the applicant. When the credit expired, no shipment had been effected and the buyer suffered a financial loss.

Is the seller obligated to fulfill the Letter of Credit obligations? Can the buyer take the seller to court over the contractual obligation?

Answer:

A buyer cannot compel the seller to use a documentary credit. The only action available to the buyer is to determine if he has any claims arising on the seller owing to nonfulfillment of contractual obligations.

The seller is not at fault because he has not used the credit, only because he has not performed under the contract. If the contract has specific clause included for arbitration or claims, the buyer then can take action.

Case 2: Unauthenticated Test Key or Signature Verification

Situation:

A transferable credit arrived by cable with follow up airmail documents requesting the bank transfer the Letter of Credit. The bank transferred the Letter of Credit without test keying the cable or checking the signatures on the airmail Letter of credit.

Is such a Transfer valid?

Is it obligatory for the transferring bank to check the authenticity of a credit before effecting transfer?

Answer:

Article 8 of the Uniform Customs and Practice for Documentary Credit (UCP 500) requires a bank to take reasonable care to check the apparent authenticity of the credit which it advises. The bank would be liable for any mistakes.

Case 3:
Will a Bank Negotiate a Letter of Credit with Discrepancies?

Situation:
A beneficiary submitted documents that contained the following discrepancies:

- Date of presentation was past the expiry date of L/C
- Inspection Certificate not signed by authorized officer
- Address of applicant misspelled
- Certificate of Origin not in triplicate copies

The beneficiary asks his banker to negotiate the letter of credit (have the bank buy the draft from him). The bank asks the beneficiary to fill out an indemnity, authorizing the bank to claim the funds back from the beneficiary in case the importer rejects the LC.

What risk does the bank face when negotiating on a "with recourse" basis to the beneficiary?

What other options are available to the beneficiary?

Answer:
The risk is that by accepting a letter of indemnity covering specific discrepancies in the documents, the bank loses the protection provided by the LC and accepts specific customer risk.

Other options available include:

- Have the bank return documents to the beneficiary for correction.
- Amend the credit. The exporter would have to ask the importer to submit an amendment.
- Telex issuing bank for permission to negotiate. The issuing bank will contact the buyer and follow his instructions
- Send documents on collection basis and hope the importer will want to pay

Case 4: Transit Interest Charges Too High?

Situation:

The exporter's bank received the beneficiary's documents, and when found in order, negotiated and credited the funds into the exporters account. Upon being reimbursed by the issuing bank 10 days later, the bank deducted transit interest and cable charges. The exporter complained, stating that according to UCP 500, a bank has no more than seven banking days to examine documents. Under UCP 400, there was just a provision for "reasonable time."

Does the exporter have a legitimate complaint?

Answer:

As UCP refers to banking days, the following needs to be considered:

- Weekends
- Courier time to get the documents to the examining bank

In this case, ten days transit interest is acceptable.

Case 5: Acceptance or Rejection of Amendments

Situation:

An amendment was made by an applicant to an LC to change the tenor of the LC from "45 days upon presentation of documents" to 90 days. The amendment was sent by the issuing bank to the advising bank and no response was heard. The applicant, on thinking the amendment was accepted, believed he had an additional 45 days of financing.

Is this true? What should be the correct bank procedure here?

Answer:

UCP 500 places a responsibility on the advising bank, as well as the beneficiary, to communicate with each other about the acceptance or rejection of amendments. The onus is now on the bank to contact the client to confirm its acceptance of amendments to letters of credit. A beneficiary should decide whether an amendment is acceptable or not and convey a decision to the advising bank so that the LC opener is properly advised.

In this case, the amendment was detrimental to the beneficiary so the importer would want to make sure the beneficiary responded.

Case 6:
Request for Confirmation

Situation:

A United States exporter selling machinery to the Philippines would like to have the Letter of Credit confirmed he has some doubts as to the Philippine banks ability to reimburse in the future. In fact, he has never heard of the issuing bank.

The exporter would like to know the following:

- Whose responsibility is it to find a confirming bank?
- What criteria are used by the bank in deciding whether to confirm the Letter of Credit. Can the bank nominated refuse to confirm?
- What role does the confirming bank play and what must the exporter provide to them?

Answer:

Usually, the issuing bank requests a bank of its choice to advise and as the case may be, confirm the L/C. If the credit applicant has nominated such a bank, the issuing bank will comply with the nomination unless it has reasons to the contrary. The request is normally stated on the Letter of Credit and may also comes as a separate covering letter from the issuing bank.

If the bank requested to confirm the credit should not wish to comply, it must so inform the issuing bank without delay.

Banks do not add their confirmation to the letter of credit in the following cases:

- The letter of credit is not irrevocable (revocable credits are never confirmed)
- The letter of credit is not subject to UCP 500.
- The bank does not have adequate country lines in place in the issuing bank's country or is not satisfied with the political stability of the country
- The bank does not have credit facilities set up for the issuing bank or is not confident that the issuing bank has the ability to reimburse for drawings under the L/C.
- The confirming bank is not confident the L/C terms can be met by the beneficiary

The confirming bank must pay on documents delivered to them provided that the terms and

conditions of the original letter of credit are met. A confirming bank must see the documents in order to ascertain that its payment, acceptance, or negotiation is effected. The beneficiary is free to present the documents to the confirming bank through the intermediary of his choice (but usually incurs additional handling fees for doing so).

Case 7:
Restricted Versus Freely Negotiated Letters of Credit

Situation:

A beneficiary received a Letter of Credit whose negotiation was restricted to a bank he did not deal with. Since the beneficiary had no account relationship or history there, he attempted to get the applicant amend the Letter of Credit but was told that the issuing bank restricts L/Cs to its foreign branch as a policy.

The exporter wondered who he should deliver his documents to and how his funds would be credited into his own bank account.

Can you advise the exporter what to do?

Is there anything the exporter can do to stop this practice in the future?

Answer:

There is a general preference in the Far East for freely negotiated credits precisely because beneficiaries do not like to deal with other banks and incur extra fees. The practice of restriction is done so banks can earn extra fees from handling the exporters documents.

In this case, the exporter can deliver the documents to his banker. The bank will note the restricted clause on the Letter of Credit and act as a courier and deliver the documents to the restricted bank (Bank 2), who is obligated to check them for discrepancies. If no discrepancies are found, Bank 2 stamps the draft, invoice, and other documents, remits funds to Bank 1, and prepares a covering schedule to send to the issuing bank to claim reimbursement (most of the time, the same bank located in another country or a close correspondent).

Whether the exporter can stop this practice in the future, depends on who has more leverage, the exporter or the importer. If the importer wants to keep the exporter happy, the importer will instruct his banker not to restrict the letter of credit.

Case 8:
What constitutes a discrepancy?

Situation:
A California rice grower submitted documents that were deemed to have no discrepancies by his banker. The documents were negotiated and sent to the issuing bank for reimbursement. The original letter of credit issued by the bank contained the following:

Goods Description: The weight of the goods 12,000 metric tons + 5%

Inspection certificate: Required

When the documents were inspected by the issuing bank, they found the following:

- Grain inspection certificate states 12,600,000 tons
- Commercial invoice state 12,600 metric tons
- Marine Bill of lading 12,600.00 kgs

In addition, the applicants address on the bill of lading was misspelled with no "A" (i.e., Normain Street)

The issuing bank notified the negotiating bank by telex that it refused the documents. The exporter then called on the ocean carrier to rectify the bill of lading and other documents as necessary. The negotiating bank telexed the issuing bank to this effect. However, the ocean carrier's agent was refused access to the documents as a non-concerned party.

1. Were the discrepancies valid?
2. Is the negotiating bank at fault for not originally fixing the discrepancies?
3. Can the issuing bank refuse access to the documents by the agent of the carrier?

Answer:

1. A single discrepancy, including one involving a misspelling, is sufficient to excuse a confirming or issuing bank from paying. What matters is how a court of law would interpret the documents.

2. The negotiating bank has no obligation to mention discrepancies to the issuing bank. Each should independently check the documents. While the negotiating bank is not at fault in getting the documents corrected and in conformity in the first place, it would have been valuable customer service.

3. In the strict interpretation of the letter of credit, may refuse access to the documents. The issuing bank could have acted on the telexed instructions of the negotiating bank, but that is something for the courts to decide.

Case 9:
Air Waybill of Lading the Same as Bill of Lading?

Situation:
A letter of credit stipulated that the shipment be made under the following conditions:

- Must be a bill of lading
- Bill of Lading to be endorsed by the shipper
- Must cover merchandise specified in invoice but may be described in general terms
- Must be presented within 10 days after shipment but always before the expiry date
- Freight must be prepaid

The beneficiary presented an air waybill as the required shipping document.
The negotiating bank rejected the documents because the term bill of lading did not concur with air waybill.

Was the negotiating bank correct?
What is the key differences between an air waybill and a marine bill of lading?

Answer:
Yes, the bank is correct in interpreting a "bill of lading" to relate to transport by water (i.e, marine bill). A bill of lading does not denote movement by air. Besides time and cost differences, air shipments and the associated air waybill is not a document of title to the goods. The consignee does not need to possess a copy of the receipt issued to the shipper to obtain the goods, since the airline company does not require surrender of the air waybill against delivery of goods. However, the ocean bill of lading is a negotiable instrument and represents and gives title to the goods and normally has to be surrendered at destination to obtain the goods.

Case 10:
How Can Exporters Protect Themselves When Using Air Shipments?

Situation:

An garment exporter received a contract from a major fashion retailer. As part of the contract stipulation, the exporter was required to air ship new designs to reach the retailers stores more quickly than the major fashion labels out of Paris. This was to be done using collections as the payment method.

The exporter recognized the inherent advantage of the speed of air transport. But the exporter also knew traders that had problems in obtaining payment from buyers for goods shipped by air. When a documentary credit has been issued to cover the air shipment or when payment has been made in advance, the loss of control over the goods is not a major concern. There is one exception. If the L/C contains discrepancies and the goods have been air freighted, there is no protection for the exporter. In the garment industry, there are always discrepancies related to size, color, and count. However, when the exporter is obtaining payment by documentary collections, the exporter will generally wish to restrict delivery of the goods until the buyer has either paid or accepted the bill of exchange.

The exporter contacted his banker to ask him how he could adhere to the contract and yet protect himself.

What suggestions can you offer the exporter?

Answer:
The following methods can be employed by the exporter:

- Consign the goods to a bank in the buyer’s country

  The exporter can forward the bill to the overseas bank and indicate that the goods are consigned to the bank and can only be released to the buyer after the bill has been paid or accepted.

- Consign the goods to a reliable agent in the buyer’s country

The agent can act on behalf of the exporter in arranging for payment or acceptance by the buyer.