

A Seller's Guide to Letters of Credit

If there's one thing credit managers learn quickly after agreeing to extend credit, it's how their department is going to get paid. Payment options from least to most risky include cash in advance, letter of credit (LC), documentary collection and open account. Although LCs hold less risk, American Export Training Institute President Chip Thomas, CICP, said the level of risk increases when creditors don't know the process.

Over the course of his 22-year banking career and 43 years in international trade, Thomas said he's seen the trials and tribulations credit managers encounter with LCs in addition to their numerous benefits. Thomas discussed what every exporter needs to know when using LCs during an FCIB webinar, where he described them as "the granddaddy of all payment methods." According to the International Chamber of Commerce (ICC), 41% of ICC's trade volumes is through LCs.

"Many companies get involved in the world of letters of credit, not because they want to, but because letters of credit are brought to them," Thomas said. "It's too late when you get it to figure out what it is. You need to figure out what it is before it's sent to you."

LCs are designed to be a very quick, painless payment tool, he explained, with four key participants: the beneficiary, the advising bank, the issuing bank and the applicant. The beneficiary and applicant are generally the seller and buyer, respectively. The applicant requests an issuing bank to issue/create an LC, which is then sent to the advising bank that authenticates it and makes sure it's a legitimate deal before sending it to the beneficiary. It becomes a credit tool for banks as it allows the buyer to finance their purchase from the bank.

An LC is many things—a payment method, a written payment arrangement, a payment contract—but it is not a payment guarantee. Thomas said LCs assure payment to the beneficiary if performed correctly, i.e., they must present complying documents to the banks after shipment. Complying documents adhere to terms and conditions specifically written into the LC.

"Before an LC is ever created, [the beneficiary] has to negotiate [their] deal," Thomas said. "You may have contract people in your organization to work on contract language with buyers. It could be a sales contract or a simple purchase order."

The deal is comprised of the following points:

1. Logistics (INCOTERMS/pricing);
2. Documentation (keep it simple);
3. Dates (issue, expiry, shipment);
4. Correspondent banking (advising vs. negotiating vs. confirming); and
5. Payment structure (where, when and by whom?).

If the contract doesn't include these elements, he said, the seller is going to have a tough time getting paid. Because the contract always comes first, the seller must negotiate the agreement with the buyer to determine how they'll get paid.

Thomas said it is also important to note the structure of every LC, beginning with irrevocability and ending with confirmation. Sellers commonly believe these will protect them; however, it does not because it allows buyers to control the other characteristics: the Issue Date and Expiry Date/Expiry

Location; Issuing Bank/Advising Bank; Importer/Exporter; Value/Currency; Description of Goods/Services; Required Documents (commercial invoice, packing list, certificates and bills of lading); Payment Terms; INCOTERMS; Port-to-Port Information (Dispatch to Destination); UCP 600, specifically Articles 4 and 5; who pays LC Fees; Latest Ship Date; Presentation Date/Period; whether Partial Shipments and/or Transshipments are allowed; and Paying, Drawee and Reimbursing Banks.

“How can the exporter benefit from an LC when it negotiates and controls only two of the 20 key elements of an LC? You can’t!” Thomas said. “It’s going to be a disaster. You’re not getting any protection at all because you’re not going to be able to control anything else. And if you can’t control it, how are you going to get paid?”

An LC isn’t just an object, Thomas added. There are components to it that have to be understood and synced with the other elements of the seller’s deal.

—Andrew Michaels, editorial associate