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Understanding the Letter of Credit Process

What Every Exporter Needs to Know

FCIB Webinar
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Agenda

- Review the Role of Letters of Credit
 - Security, Payment, Financing
- Major Problems with Letters of Credit
- Why these Problems Occur and What Actions to Take
- The 6-Step Letter of Credit “Process” Explained
 - Logistics
 - Documentation
 - Dates
 - Correspondent Banking
 - Payment Structure
 - LC Structure
- Why Exporters Must Negotiate LC Terms & Conditions with Buyers
- Dangers of Not Embracing the LC Process & Negotiating From Strength



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About Chip Thomas

- 43 Years of International Trade Experience
- 22 Year Banking Career
- 27 Years Educating Exporters on How to Effectively use Payment and Financing Tools
- Lived Abroad for over 12 Years (Africa, Asia & Latin America)
- Passionate about teaching “Best Practices” in International Trade: “What You Must Know to be Successful in the International Market Place.”



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Main Exporter Issues

- How Can I Get Paid?
- How Much Risk Do I Want to Take?

And the Answer Is?



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Understand Your Payment Options

Cash in Advance

Payment Before Shipment
Minimal Bank Involvement

Letter of Credit

Payment After Shipment
Major Bank Involvement

Documentary Collection

Payment After Shipment
Major Bank Involvement

Open Account

Payment After Shipment
Minimal Bank Involvement



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International Trade Payment Survey

Per the International Chamber of Commerce*:

Breakdown, by percentage, of international trade products:

Other: 2%
Open Account: 9%
Collections: 19%
Guarantees: 22%
Standbys: 7%
Commercial LCs: 41%

*2017 ICC Trade Finance Survey



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Role of Documentary Letters of Credit

- Foster Global Trade
- Pay Beneficiary Quickly after Shipment
- Protect Beneficiary against Applicant Payment Risk
- Establish a Universally accepted and structured Payment Methodology (UCP 600)
- Establish a simple and trusted payment method
- Allow Buyers to Finance Purchases



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So What is a Documentary Letter of Credit?

A Payment Guarantee?

A Payment Arrangement?

A Method of Payment?

A Payment Contract?



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A Letter of Credit (LC) is a Written...

- A Payment Method
- A Written Payment Arrangement
- A Written Payment Contract
- It “Assures Payment” to Beneficiary if Beneficiary Performs Correctly (Documentary LC)



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A Letter of Credit is Not...

- A Payment Guarantee!
- It Only “Assures Payment” to the Beneficiary if the Beneficiary Performs Correctly by Presenting “Complying Documents” to the banks After Shipment.
- So Don’t Listen to Anyone who Tells You Letter of Credit “Guarantees” Payment!



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So Who Should the LC Benefit?

Beneficiary: the party who is to receive payment
(typically the Seller)?

or,

Applicant: the party that requests the LC to be issued
(typically the Buyer)?

or

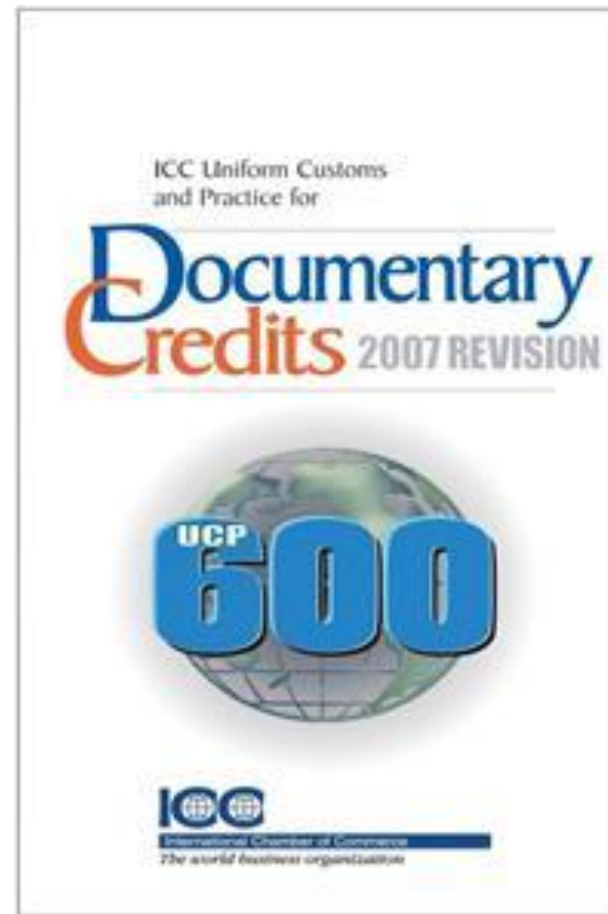
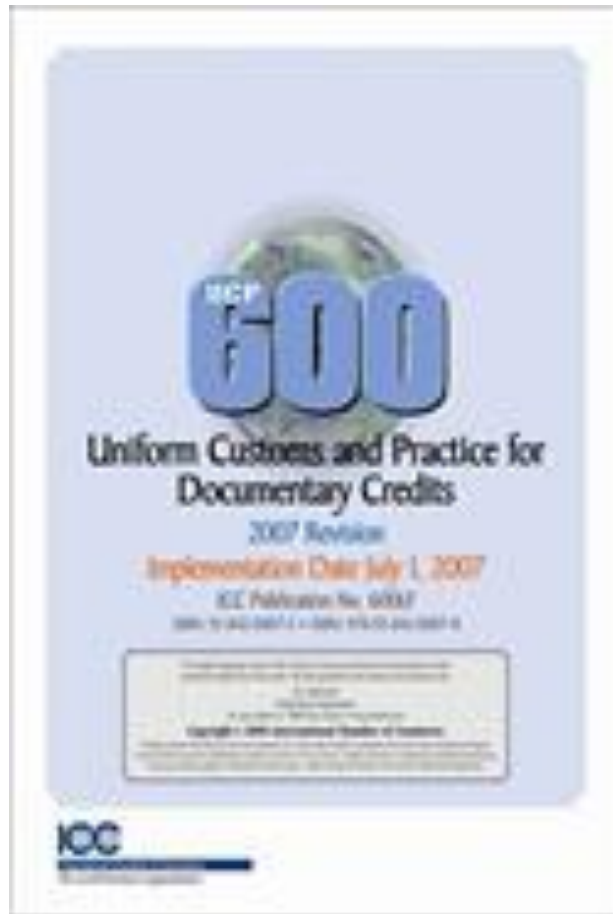
Both?

**Only the Beneficiary (Seller) per the UCP 600 (the
Official Regulations that Govern Letters of Credit!**



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The UCP 600



Link: <http://store.internationaltradebooks.org/lettersofcreditucp6002007revision-2.aspx>



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How Does the UCP 600 Benefit the Seller?

- By detailing in 39 Articles the key elements of using Letters of Credit.
- The 39 Articles discuss Actions the Seller Can Exercise, Not the Buyer.
- 38 of the 39 Articles Benefit the Seller, Not the Buyer!

So if the UCP 600 benefits and protects the Exporter why do Exporters experience so many problems with LCs?



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Problems with Documentary LCs

- Beneficiaries are seldom paid quickly
- Beneficiaries aren't aware of their responsibilities
- Beneficiaries are uneducated about LCs
- Most Banks do not educate their customers
- Beneficiaries allow Applicants to set the terms and conditions of the LCs
- Beneficiaries don't Control All Documents
- The LC process seems too complicated



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Why Beneficiaries Struggle with LCs

- Beneficiaries can't get proper LC advice
- Most Banks are unable to assist their customers
- Beneficiaries don't understand the connection between sales contracts and LC contracts
- Beneficiaries don't know LC rules (UCP 600)
- Beneficiaries don't negotiate their LCs
- Beneficiaries constantly present discrepant documents (75-85%) which delays and/or hinders payment



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So What do Exporters Need to Know?

- How to negotiate and structure their LCs
- All LC details must be negotiated into Sales Agreements
- Understand the critical role of INCOTERMS 2010 and how they directly impact payments under LCs
- Understand the key role of freight forwarders/insurance
- Understand why and how they should control the goods and documents during shipment in an LC transaction
- How to Select and work with the Banks
- Understand the Export LC Process



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What is the Export LC Process?

Pre-LC Negotiation Points:

- **The Deal** (Contract/Sales Agreement/P. Order)
 - Logistics (INCOTERMS/Pricing)
 - Documentation (Keep it Simple)
 - Dates (Issue, Expiry, Shipment)
 - Correspondent Banking (Advising vs. Negotiating vs. Confirming)
 - Payment Structure (Where, When & By Whom?)
- **The LC Structure** (Payment Contract)
 - Must include all of the above

So What Information Needs to be Included in Every Commercial/Documentary LC, and When Should You Begin Negotiating the Details with Your Buyer?



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Info Required in All Documentary LCs

1. Irrevocable
2. Issue Date and Expiry Date/Expiry Location
3. Issuing Bank/Advising Bank
4. Importer/Exporter
5. Value/Currency
6. Description of Goods/Services
7. Required Documents
8. Payment Terms
9. INCOTERMS 2010
10. Port-to-Port Information (Dispatch to Destination)
11. UCP 600
12. LC Fees - who pays?
13. Latest Ship Date
14. Presentation Date/Period
15. Partial Shipments (allowed, not allowed)
16. Transshipments (allowed, not allowed)
17. Paying Bank
18. Drawee Bank
19. Reimbursing Bank
20. Negotiating/Confirming Bank



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So What do Many Exporters Request of Buyers?

They simply request:

An Irrevocable and Confirmed LC!

Apparently, this is supposed to protect them, but does it?

Answer: NO!



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Why Doesn't This Protect The Exporter?

Because the Buyer ends up Controlling the other 18
Key Characteristics of the Letter of Credit!

How can the Exporter Benefit from an LC when it
Negotiates and Controls only 2 of the 20 Key
Elements of the LC?

It Can't!



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Remember the Key Elements of Every LC?

1. **Irrevocable**
2. Issue Date and Expiry Date/Expiry Location
3. Issuing Bank/Advising Bank
4. Importer/Exporter
5. Value/Currency
6. Description of Goods/Services
7. Required Documents
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So Who Should Set the LC Terms?

You, the Exporter!

You Can't let the Importer set the Terms and Conditions (T&C) of the LC if You want to be Successful using Letters of Credit!



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So What are the Key LC Elements?

- Logistics (INCOTERMS/Pricing)
- Documentation (Keep it Simple)
- Dates (Issue, Expiry, Shipment)
- Correspondent Banking (Advising vs. Negotiating vs. Confirming)
- Payment Structure (Where, When & By Whom?)
- LC Structure



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So What are the Key Logistics Terms?

Incoterms[®] 2010 Terms Overview

RULES FOR ANY MODE OF TRANSPORT

Ex Works (EXW)
Free Carrier (FCA)
Carriage Paid To (CPT)
Carriage and Insurance Paid To (CIP)
Delivered at Terminal (DAT)
Delivered at Place (DAP)
Delivered Duty Paid (DDP)

MARITIME (WATERWAYS) RULES

Free Alongside Ship (FAS)
Free On Board (FOB)
Cost and Freight (CFR)
Cost Insurance and Freight (CIF)



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So What are the Key LC Documents?

Standard Trade Documents

- Commercial Invoice
 - Consular or Visaed
- Packing List
- Certificates of:
 - Origin
 - Insurance
 - Beneficiary
 - Inspection
- Bills of Lading
 - Ocean
 - Air



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So What are the Key LC Dates?

- **Issue/Issuance**
- **Expiry/Expiration**
- **Shipment/Latest Shipment**



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So What are the Key Banking Issues?

Advising Bank

Functions:

Advise LC Only:

Assumes no Risk

Advise & Negotiate LC:

Assumes Issuing Bank Risk

Advise & Confirm LC:

Assumes All Risk

Issuing Bank

Functions:

Issues LC:

Assumes All Risk



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So What is meant by LC Payment Structure?

- Where is the LC going to be Paid?
 - At the Issuing Bank?
 - At the Advising Bank?
- When will the LC be Paid?
 - At Sight?
 - Over Time (Usance)?
 - Deferred Payment?
- Which Bank Controls the Payment?
 - Issuing Bank?
 - Advising Bank?



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So What is meant by LC Structure?

1. Irrevocable
2. Issue Date and Expiry Date/Expiry Location
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2 Key UCP 600 Articles For Exporters?

UCP 600 – Article 5

Documents vs. Goods, Services or Performance:

- “Banks deal with documents and not with goods, services or performance to which the documents may relate.”
- This means that the only thing a beneficiary needs to focus on is to properly prepare and submit its documents to the Advising Bank for payment that are “in total compliance with the LC terms.” Sounds easy?
- Globally, 75%-85% of documents presented for payment to banks are found to be discrepant. This either delays payment or potentially eliminates the LC payment.



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2 Key UCP 600 Articles For Exporters?

UCP 600 – Article 4

Credits (LCs) vs. Contracts:

- “LCs by their nature are separate transactions from the sales or other contracts on which the LCs may be based. Banks are not concerned with or bound by such contracts even if a reference to the contract is included in the LC...”
- This creates a huge problem for companies that put a lot of time, effort and money into negotiating contracts that specify payment will be made via LCs. Since the LCs are created after the contract, and the beneficiary doesn’t negotiate the critical terms of the LCs, the LCs aren’t set up to benefit and protect the Beneficiary.



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So What is Typical Contract Language?

Language consistently placed in Commercial Contracts when LCs are going to be the Method of Payment:

“Payment by Irrevocable LC”

What is Wrong with this wording?

The contract does not include any terms and conditions that the LC should contain. Once the contract is signed, the applicant will likely have total control over the wording of the LC, and thus control the payment under the LC. **Result? Buyer Controls the Payment Process!**



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So What must Exporters do?

- Understand and Implement the Export LC Process
- Know how to negotiate and structure their LCs
- Make sure all LC details are negotiated into Sales Agreements
- Understand the critical role of INCOTERMS 2010 and how they directly impact payments under LCs
- Understand the Importance of the Right Banking Structure
- Understand the Importance of Controlling All Documents
- Understand how to use LCs as Effective Security, Payment and Financing Instruments



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So What are the Next Steps?

Attend the Next 3 Webinars!

1. Choosing the Right INCOTERMS for Letters of Credit: February 14
2. Letter of Credit Documentation-How to Avoid Discrepancies: March 21
3. Roles and Responsibilities of Banks in the Payment Process: April 18