

# Practical Insights Series

Five Trends. Five Tools. Five Tips.



## DOCUMENTARY

### LETTERS OF CREDIT

Effective Use of Letters of Credit in Import/Export:  
Understanding Realities, Protecting Your Interests

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## Documentary Letters of Credit

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# Documentary Letters of Credit

## Five Trends

1. While new solutions in trade finance and transaction banking have been under development, recent events have highlighted the effectiveness, importance and continued relevance of traditional solutions such as Documentary Letters of Credit.
2. There is a global consolidation in the financial sector, which is also leading to a consolidation of trade finance providers. Several of the top names in trade finance were significantly impacted by the global crisis. The full implications remain unclear.
3. There is a “flight to quality” in banking, including trade finance. Banks have been selective in their focus and maintenance of customer relationships. Commercial clients have been reviewing their banking relationships, in light of the crisis in the global financial sector.
4. Financing costs related to international trade had increased by a factor of 300-400% over the course of the crisis. Rates are trending down, but have not yet normalized to pre-crisis levels.
5. Some non-bank providers of trade finance had partly retreated from the market, but are cautiously re-entering some markets. Non-bank sources are worth investigating.

## Five Tools

1. Download (or obtain) detailed guides to trade finance—including Documentary Letters of Credit—from a major international bank.
2. Obtain a copy of the official publication which governs the use and interpretation of Letters of Credit—the Uniform Customs & Practice, UCP 600, from a trade finance bank, or from the International Chamber of Commerce in Paris: [www.iccwbo.org](http://www.iccwbo.org)
3. Seminars and courses on trade finance are available from various sources. An introductory course is available through FITT in Canada, and can be taken online. [www.fitt.ca](http://www.fitt.ca)
4. Freight forwarders and other service providers can be very helpful and effective in the preparation of documents to be presented under Letters of Credit.
5. Visit the website of the International Trade Centre in Geneva for various guides related to trade and trade finance: [www.intracen.org](http://www.intracen.org)

## Five Tips

1. Discrepancies under Documentary Credits represent a potentially serious risk to exporters. The terms and conditions of the L/C should be carefully reviewed to ensure they can be fully met, or, an amendment to the L/C should be requested.
2. Assess and approach risk in terms of optimization, not elimination.
3. Review a proposed L/C transaction end-to-end; assess all fees, commissions and interest that may arise. If financing is required, ensure that L/C-based financing is cost-effective.
4. L/C Confirmations can be invaluable to exporters in higher-risk transactions and markets. Exporters can look beyond their primary bankers for Confirmation options and pricing.
5. In international trade, it is important to understand the role and value proposition of export credit and export insurance agencies, as well as import promotion organizations

# Basics

**“A Letter of Credit is just like cash in hand...”**

**No!**

A Documentary Letter of Credit can be one of the most secure methods of payment and financing in international trade, and while the instrument is proven and effective in many circumstances, it is, in practice, prone to error and potentially risky if poorly structured.

A Documentary Credit (also a Letter of Credit, or simply an L/C) should be carefully issued, to ensure it protects both importer and exporter as it was intended to do.

L/C's have been used to facilitate international trade for hundreds of years. They are well and consistently understood across the world, with over 160 countries agreeing to be guided in their interpretation and enforcement of L/C obligations, by the Uniform Customs and Practice for Documentary Credits (UCP), published and updated by the international Chamber of Commerce in Paris.

Documentary Credits are financial instruments typically issued by a bank (the Issuing Bank) at the request of the importer (buyer/Applicant), in favour of the exporter (seller/Beneficiary). An L/C is an independent and binding promise to pay, by the Issuing Bank to the Beneficiary (exporter), provided the terms and conditions specified in the L/C are fully complied with by the exporter.

Documentary Credits are typically sent to the exporter's bank, which receives, reviews and authenticates the L/C, then Advises the Credit to the Beneficiary (exporter), commonly sending a copy of the L/C to the exporter.



L/C's may be straightforward instruments with only basic terms and conditions, or they can be detailed, highly complex and rich in options, generally depending upon the monetary value and the complexity of a shipment or transaction. L/C's can be used to cover a low-value shipment meant to test a new trading relationship, or they can cover shipments valued in the tens of millions, involving complex procedures and examination of dozens of documents prior to payment.

Documentary Credits can serve multiple purposes in an import/export transaction: facilitation of efficient and secure cross-border payment; risk mitigation for both trading parties; financing for either or both trading parties, and the facilitation of timely information flow about the transaction.

A Documentary Credit protects importers by ensuring that payment is effected only once the banks verify that all terms and conditions have been fully complied with by the exporter.

Exporters are protected because an L/C represents a payment promise from the Issuing Bank. Once the exporter meets all terms and conditions specified, the L/C ensures that payment will be approved and processed.

In Theory. Read on, for Practical Insights about L/C's...

**“L/C's will soon be a thing of the past. They have no purpose in 21st Century trade...”**

**No!**

# Documentary Credits

## Payment

- Secure
- Timely & Prompt
- Global
- Low-cost
- All leading currencies

## Financing

- Available to importer or exporter
- Several stages in the transaction
- No impact in Operating Line for exporters

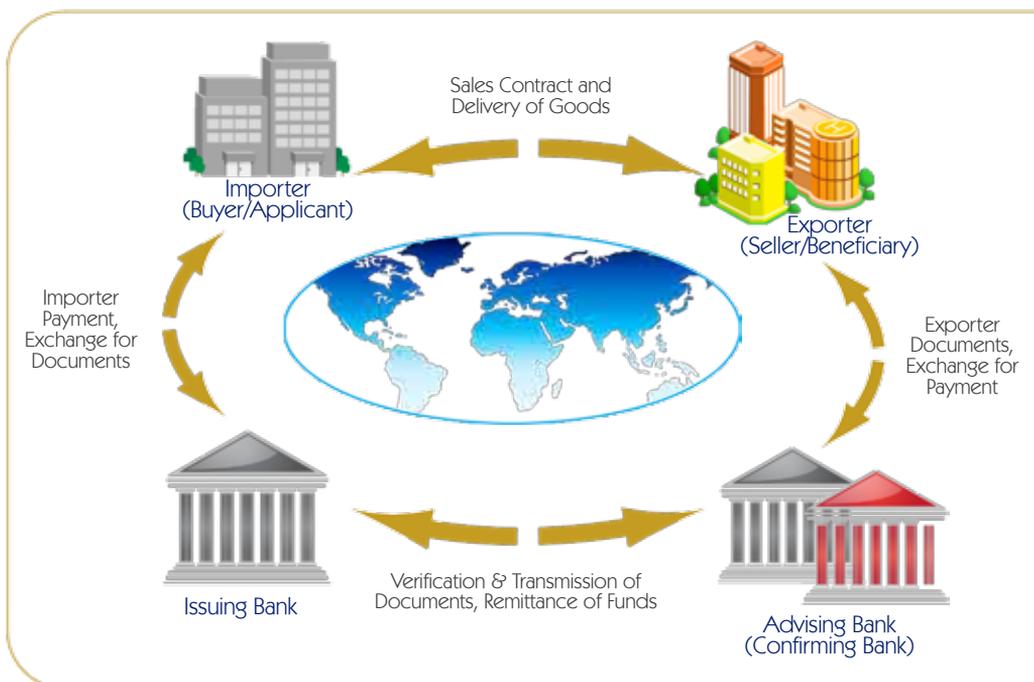
## Risk Mitigation

- Risk Transfer
- Country, Bank and Commercial Risk
- Transport Insurance
- Export Credit Insurance

## Information

- Financial flows
- Shipment Status
- Quality of Shipment
- L/C systems include web & desktop solutions

The global financial and economic crisis of 2008-09 brought sharply into focus, the continuing value of traditional trade financing instruments such as the Documentary Letter of Credit. Emerging solutions proved lacking in the risk mitigation aspect of trade finance. L/C's remain viable and important in the conduct of international trade, especially in conditions, markets or with trading partners where an element of risk exists.



## Simple L/C Flow

- Importer applies for L/C, specifies Terms & Conditions
- Issuing Bank structures & transmits to Advising Bank
- Advising Bank reviews L/C for consistency & workability, transmits to exporter
- Exporter reviews L/C & prepares documents/shipment
- Presents documents for settlement as per L/C terms
- Documents are verified against L/C terms, if fully compliant, settlement is effected or authorized
- Documents sent to importer to clear shipment through Customs

L/C transactions can involve multiple parties including several banks acting in various capacities. Payments can be "At Sight" - literally meaning that payment is due immediately after documents have been verified against the L/C and deemed compliant, or they can be "Term" - at an agreed future date, such as 30 days after Sight, or 90 days after shipment date. Both the Advising Bank (commonly the exporter's bank) and the Issuing Bank (the importer's bank) must examine the documents presented by the exporter.

An exporter may be concerned that the payment promise represented by the L/C is at risk, either due to the dubious standing of the Issuing Bank, or as a result of risks related to the importer's country (civil unrest, economic or financial instability, shortages in foreign currency...). In such cases, the exporter may require that the L/C be issued so as to allow Confirmation: the addition of a separate and independent payment promise by a trusted financial institution, usually selected by the exporter and usually located in the exporter's home country. Confirmations of L/C's can be costly, but are an excellent risk mitigation option for exporters.

The exporter presents documents to the Confirming Bank, and is assured of payment against compliant documents, regardless of what happens thereafter. Risk is transferred from Issuing to Confirming Bank.

# Discrepancies

**"A Letter of Credit can even protect against fraud..."**

**No!**

L/C's cannot protect against fraud, as the obligation of banks to verify the transaction stops at verification of documents. If a document presented in support of a request for payment looks authentic, banks will accept this to be the case. Even Inspection documents, thought to mitigate the risk of fraud, can be counterfeited. Goodwill and a desire to see the transaction completed as well as trust between buyer and seller remain key to the conduct of international trade .

## Discrepancies: Non-Compliance

Non-compliant documents are documents presented by the exporter in support of a request for payment under an L/C, that are deemed to have failed to meet the terms and conditions set out in the Letter of Credit. Certain discrepancies are considered significant, others trivial in nature. Late Shipment is significant; a minor typographical error in certain documents is likely to be considered trivial, but even minor discrepancies can delay or prevent payment.

Discrepancies can, in worse-case scenarios, have the effect of completely eliminating the protection provided to the exporter under an L/C, since the banks can either refuse payment on the basis of the discrepancies, or the importer, given an opportunity to waive the discrepancies, may refuse to do so. Given that the goods are likely at destination by the time the document verification process is complete, the exporter may be forced to provide a significant discount, or secure another buyer for the goods—likely at a loss, and having incurred unanticipated expense to store the goods at the port of destination while identifying an alternate buyer.

Banks are meant to make determinations about documents on an independent basis, but many will consult with their respective clients—exporters offered the opportunity to “correct” discrepancies where feasible, and importers in some cases asked by the Issuing Bank to verify the documents before the bank provides a response to the Advising Bank. There have been cases where importers have instructed their bankers to “find a discrepancy” as a means of refusing shipment (as when the price of the items purchased has dropped significantly and can be secured elsewhere, at lower cost).

It can be important to understand the approach of banks relative to document verification and the handling of discrepancies: certain banks take a “black letter approach” and will point out every discrepancy identified, no matter how trivial, while others take a more commercially-oriented view, and acknowledge only material discrepancies.

**"A minor difference in the Description of the Goods, between the L/C and, for example, the Commercial Invoice, is a critical discrepancy"**

**Yes!**

Excessive detail in a Documentary Letter of Credit can often prove counterproductive, particularly in the context of transactions that are beneficial to and desired by both trading partners. Excess detail can result in otherwise avoidable discrepancies, may delay the verification of documents, and may cause errors in the shipment, the shipping documentation, or the document-checking process at the banks.

An L/C should be structured and issued in a manner which maximizes the likelihood of a secure and timely conclusion of the transaction, and ideally, supports the development of trust in the trading relationship between buyer and seller, importer and exporter.

# Risk & L/C Confirmations

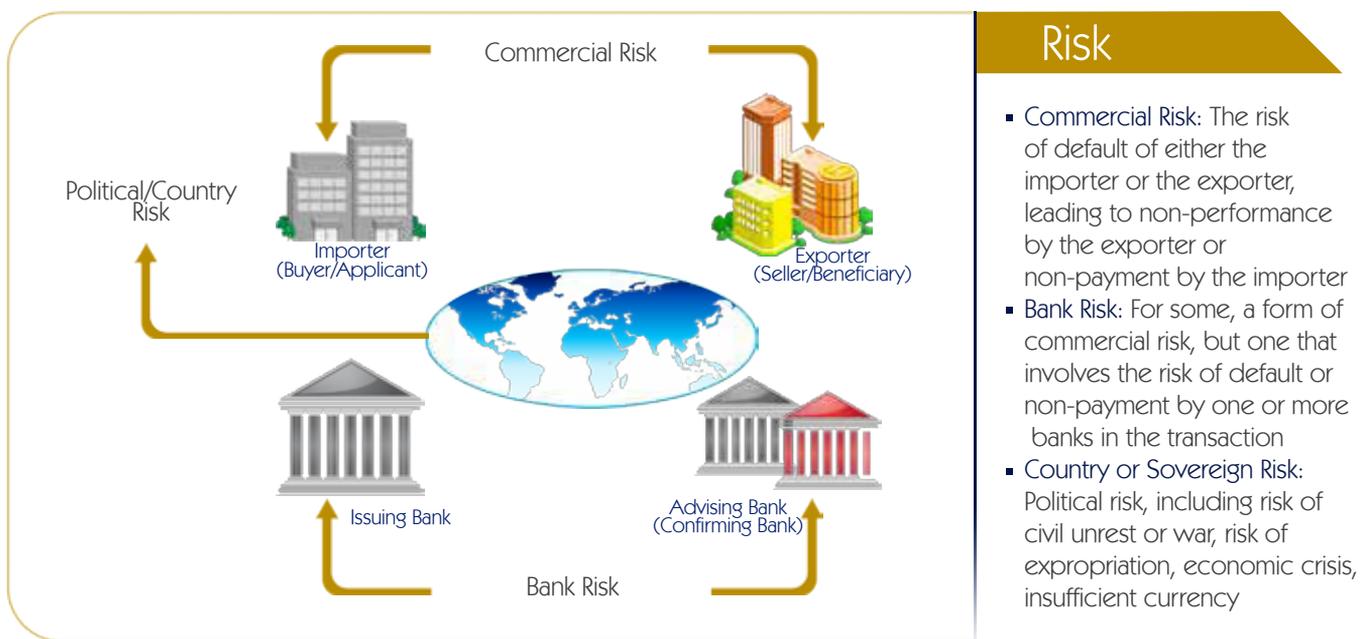
Eliminating risk is, in most cases, impractical, and even if it were feasible, would involve prohibitively high cost.

Risk and reward (profitability) are directly related, and the presence of (perceived or actual) risk can serve as an effective barrier, discouraging potential competitors. Risk is to be assessed in terms of related return as well as risk appetite, then optimized: applying appropriate and cost effective risk mitigation techniques and strategies.

**“The best way to handle risk in international business, is to eliminate it.”**

**No!**

Effective risk management and mitigation starts with due diligence—knowing trading partners and markets, and ensuring that appropriate measures are taken, to protect commercial interests. While risk tolerances clearly vary between individuals and organizations, prudent management of risk in international business is a matter of sound business practice. Applying excessive/unnecessary mitigation can be costly



Risk mitigation is a critical element of trade finance, and a core value proposition of the Documentary Letter of Credit. When an exporter requests that an L/C be Confirmed by a trusted financial institution (generally located in the exporter’s country), this is a very effective form of risk mitigation in that it addresses commercial, bank and country risk altogether, assuming of course that the exporter’s country of residence, and the Confirming Bank, are both secure.

L/C Confirmations represent a significant risk for the Confirming Bank. Often, the Confirming Bank will obtain export credit or private sector insurance to mitigate its own exposure, and the exporter will incur additional costs as a result. Confirmation Commissions charged by banks can be significant, especially in high-risk or developing markets, and the margin on the trade transaction—or the perceived/expected potential of the trading relationship—must justify the added cost.

Banks will differ on the Confirmations they are prepared to provide (and at what cost), both by country, and based on their assessment of the Issuing Bank. Approval timeframes related to Confirmations may also vary depending on the extent to which the transaction falls within existing country and bank lines and within established risk parameters.

# Bank Relationships & Fees

**“Relationship Banking is no longer available: everything is transaction-based now”**

**No!**

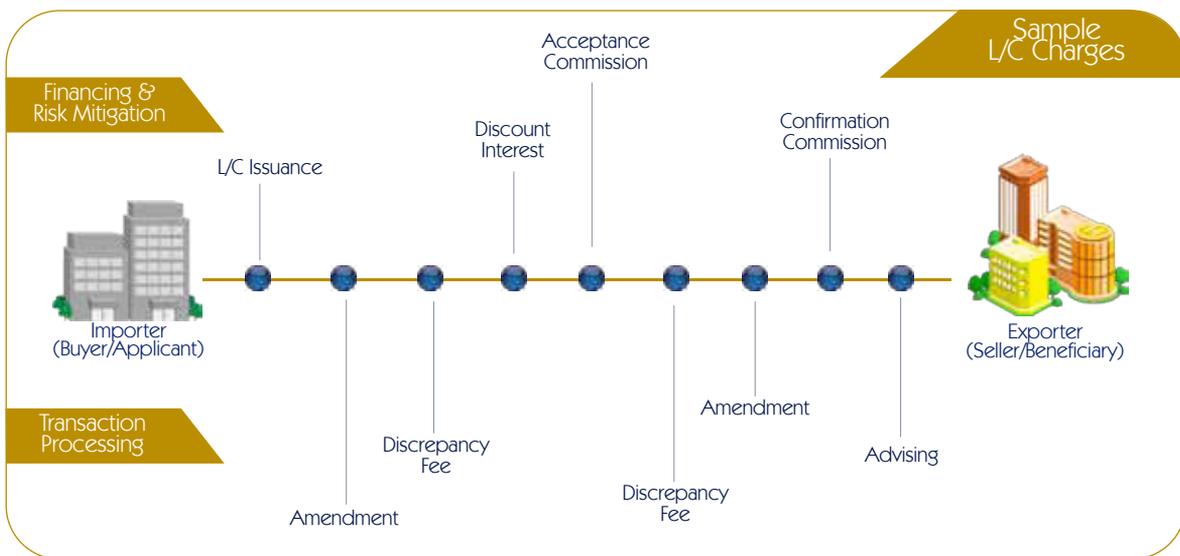
The global crisis motivated a “flight to quality” both among banks seeking to preserve top-tier commercial and corporate client relationships, and more uniquely, among corporates concerned for the first time in many decades, about the long-term viability of their financial institutions in many parts of the world.

Enduring, secure and sustainable relationships are highly prized, and a relationship approach is likely to be well received.

Although an increasing number of exporters are now also importers (sourcing inputs to their products in foreign markets), it is useful to note an important difference in the link between banks and their importer versus exporter clients.

An import Letter of Credit is issued by a bank for an importer, on the basis of an existing relationship and some type of facility—usually a line of credit which the bank will debit in settlement of the importer’s payments under the L/C. It would be difficult, in most situations, to walk into a bank branch and request issuance of an L/C without an existing relationship, or without going through an account setup and due diligence process. Importers are tied to the banks where they have, or can obtain, facilities and lines of credit.

An exporter, however, may have more flexibility in choosing a financial institution to help with a transaction under an export L/C. This is the case, because any risk or financial liability undertaken on the export side is typically a matter of bank risk and/or country risk—not commercial risk associated with the exporter. Fees will vary in relation to the risk associated with the risk of the Issuing Bank. Confirmation of an L/C involves risk related to the Issuing Bank and the country in which the Issuing Bank is based. Similarly, financing extended on the basis of an export L/C will ultimately be repaid by the Issuing Bank—not the exporter. The implication is that an exporter can, where appropriate or necessary, seek assistance from a financial institution other than the company’s primary bankers.



L/C fees, commissions and financing costs can be significant, particularly in high-risk markets. Where Term L/C’s are used, banks will charge Acceptance Commission to guarantee the payment obligation until maturity. Financing based on bank risk may be less expensive than financing based on commercial (importer or exporter) risk.

**“L/C’s can be expensive: it is worth looking carefully at the expected fees, commissions and interest...”**

**Yes!**

Review the proposed structure and features of an L/C, and the likely related costs. Where financing is required, assess the most effective financing option available: in some cases, financing through an operating line may prove to be cost-effective.

## A Banker's View

**“Why is it that my bankers are never active in the most promising/interesting markets?”**

Exporters throughout the world fault their trade finance bankers for being risk-averse, or for providing little or no transaction or financing support in higher-risk (often profitable) markets.

Even when they are active, clients often complain that trade bankers offer only limited facilities, and may do so only with the top-tier financial service providers in those higher-risk countries.

In many markets, banks and financial services providers are commercial ventures, with revenue and profit targets, and with obligations related to stewardship of financial resources, and the obligation to provide returns to shareholders.

Lines of business within banks—from credit cards to corporate lending to trade finance—compete for capital and for the resources of the bank, based upon the strategic priority of the business, and the historical/expected return that the business generates with the capital which is allocated to that business. In export-related trade finance, banks allocate lines of credit at the country level. They also allocate lines to banks within each country, with which they maintain correspondent relationships. When an exporter seeks financing or risk mitigation (such as L/C Confirmation) and the lines are available at the country and bank levels, generally, the approval process is straightforward and quick, if the deal is acceptable to the bank. In the event that lines are not available, or the timeframe—the length of exposure—is beyond standard parameters, trade finance specialists must present the transaction to a central credit group for review and approval. Regulatory and compliance issues are increasingly fundamental to the approval process as well.

The bank may simply decide that a transaction is not in line with credit and risk guidelines; in other cases, trade financiers can articulate a compelling case, and support is extended even when the transaction is unusual. The nature of the global relationship with a client can be a factor. Commercial clients can help their trade bankers by providing as much detail about the trading partner and the transaction as possible.

Banks engaged in trade finance transactions certainly consider their commercial customers' requirements in L/C transactions. They must also consider the nature of the Documentary Credit and its use and function in international trade.

An L/C is a payment undertaking—a promise which is legally binding—by the Issuing Bank, to pay the exporter in cases where the terms and conditions of the L/C are fully met. A bank which fails to meet this obligation may face legal action, and in any case, will soon find that its instruments, and the commitment they represent, are neither trusted nor accepted by other financial institutions, and/or by exporters in international markets. Banks may thus make payment under an L/C even if a client disagrees.

**“Why does my bank decide to make payment for a shipment under MY import L/C, without my prior approval?”**

While some financial institutions will quietly cooperate with their importer clients to identify discrepancies in order to invalidate the protection afforded under an L/C, the International Chamber of Commerce frowns upon such practices, and countries or banks which have been found to engage in such activities have faced commercial consequences as a result.

International trade transactions work best when they are conducted and concluded in good faith and with a long-term, relationship view. As an importer, the standing of an Issuing Bank is very important to the successful and cost-effective conduct of business, and requests to abuse the instruments and processes of international trade will increase costs, and discredit the system to the detriment of all.

## A Corporate's View

**"My trade finance customers are interested primarily in fast, efficient processing"**

Trade finance bankers, particularly those with a transactional or operations background, often express the view that the greatest concern of trade clients, is the accurate and timely processing of transactions.

Leading providers will document and be guided by Service Level Agreements (SLA's) in which they commit to timeframes and turnaround, related to transaction processing.

Trade banks can organize their transaction processing business in several ways. Options include:

- By product or transaction type, (Import L/C, Export L/C, or Issuance/Advising, Document Verification and Settlement)
- By customer, including potentially by industry sector
- Outsourced to another financial institution

While the operational model of the bank should be immaterial from a client point of view, there is some advantage to having at least an assigned contact to assist with communication, resolution of issues, and generally to ensure timely and correct processing of transactions.

Trade finance units typically separate the operations and transaction processing groups from sales and relationship specialists, as well as senior experts whose focus is on structuring more complex deals involving export credit insurance and other related mechanisms.

Leading providers will often encourage sales and relationship staff to learn something about the operational side of the business, while providing operations specialists the opportunity to participate in business development planning and client calls.

World-class trade finance banks understand the value of a holistic, solution-oriented approach to meeting the needs of clients engaged in international business.

**"We are lenders and processors of transactions —not consultants or advisors"**

In addition to providing financial solutions and transaction processing support, top trade banks understand the value of their expertise, and are both able to and interested in providing advisory support.

The need for advisory support in international trade can arise even in the most experienced organization, based on the unique characteristics of a specific deal, or the temporary challenges in an otherwise familiar market.

A partnership approach to managing trade banking relationships can prove valuable in many respects. As with traditional banking, the more a trade specialist understands about the business of a commercial client, the more promptly and effectively the trade banker can respond with advice or solutions.

Engaging trade financiers early in the development of a new trading relationship or market allows the provider to conduct necessary due diligence, and to prepare adequately to meet any internal requirements (such as credit approvals), in order to best meet client needs. Trade finance is more than transaction processing. A strategic and holistic approach—by bank and client—is best.

# SWIFT

SWIFT is the Brussels-based Society for World Inter-bank Financial Telecommunications—a membership based organization, which through its network, facilitates trade finance-related transactions and payments across the globe. SWIFT allows financial institutions to send secure and authenticated messages and/or financial transactions such as transfers of funds and payments between banks.

SWIFT has also devised a series of formatted message types, the structure, purpose and usage of which are well understood across the world, and which enable fast, secure and consistent communication across borders.

700-Series SWIFT messages relate to Documentary Letters of Credit. The example below is from SWIFT.

Documentary Credit Number	:20:12345
Reference to Pre-Advice	:23:PREADV/030510
Date of Issue	:31C:030517
Applicable Rules	:40E:UCP LATEST VERSION
Date and Place of Expiry	:31D:030730AMSTERDAM
Applicant	:50:ABC COMPANY KAERTNERSTRASSE 3 VIENNA
Beneficiary	:59:AMDAM COMPANY PO BOX 123 AMSTERDAM
Currency Code/Amount	:32B:EUR100000,
Available With ... By ...	:41A:AMRONL2A BY PAYMENT
Partial Shipments	:43P:ALLOWED
Transshipment	:43T:ALLOWED
Taking in Charge ...	:44A:AMSTERDAM
For Transportation to ...	:44B:VIENNA
Description of Goods	:45A:+400,000 BOTTLES OF BEER PACKED 12 TO AN EXPORT CARTON +FCA AMSTERDAM
Documents Required	:46A:+SIGNED COMMERCIAL INVOICE IN QUINTUPLICATE + FORWARDING AGENTS CERTIFICATE OF RECEIPT SHOWING GOODS ADDRESSED TO THE APPLICANT
Period for Presentation	:48:WITHIN 6 DAYS OF ISSUANCE OF FCR
Confirmation Instructions	:49:CONFIRM
'Advise Through' Bank	:57A:MEESNL2A
End of Message Text/Trailer	

A sample MT-700 SWIFT is shown here (MT is “Message Type”); the fields in the message are intended to contain very specific data, as illustrated.

The MT-700 is the message format used to transmit a Documentary Letter of Credit.

In the graphic, the left column is an explanation of the information typically contained in a given field.

The right column shows the “Field Tag - the field number— in the formatted MT 700 message, followed by a sample of the type of information that might be included in an actual L/C.

The first entry, for example, shows Field Tag 20, with the data being the L/C number assigned by the Issuing Bank, No. 12345.

Each financial institution, and in many cases, subsidiaries and individual branches, are assigned a SWIFT Code—a unique code which identifies that individual entity within the SWIFT system. Field 41A shows SWIFT Code AMRONL2A, identifying the bank with which the L/C is available, and field 57A shows MEESNL2A as the bank through which the L/C is to be Advised.

SWIFT is a critical contributor to and enabler of international payments and trade. The organization offers numerous solutions in support of trade and trade finance, and is currently in the process of providing corporate clients (non-bank) with access to the SWIFT network.

## Selected Quotes...

Technology is increasingly central to the efficient conduct and flow of trade, including trade finance.

Documentary Credits are used in about 5-7% of global trade transactions. Pre-crisis, there was a global shift away from L/C's in favour of Open Account.

Non-bank providers of trade finance have been and will continue to be active in this sector.

The ability to offer financing at competitive rates is often a determinant in the selection of a vendor or service provider.

Trade finance is an important but poorly understood subject. Obtain expert advice to extract maximum value and to effectively mitigate risk.

The profile of trade finance at all levels has been unprecedented since the global crisis. Programs have been launched globally, in support of trade finance.

Industry estimates suggest that 50-70% of documents presented for payment under Documentary Credits are non-compliant.



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[www.opus-seminars.com](http://www.opus-seminars.com)

## Selected Resources

FITT—The Professional Path to Global Markets  
[www.fitt.ca](http://www.fitt.ca)

International Trade Centre  
[www.intracen.org](http://www.intracen.org)

IFC Global Trade Finance Program  
[http://www.ifc.org/ifcext/gfm.nsf/Content/  
TradeFinance](http://www.ifc.org/ifcext/gfm.nsf/Content/TradeFinance)

International Chamber of Commerce  
[www.iccwbo.org](http://www.iccwbo.org)

OECD Trade Section  
<http://www.oecd.org/>