

Letter of Credit Glossary

BUYING AND SELLING GOODS INTERNATIONALLY

International sales transactions between sellers and buyers require an agreement as to the form of payment for the goods. Various methods of payment settlement include but are not limited to open account, foreign collection, cash in advance and documentary credit. One of the most common forms of payment is documentary credit, which is also known as a Letter of Credit.

What is a Letter of Credit?

A Letter of Credit is literally a "letter" pertaining to a sales transaction between a buyer and seller. The "letter" is initiated by the buyer and is directed to the seller or beneficiary, in most cases. In some cases, the beneficiary may not necessarily be the Seller but would be the party possessing the right to receive payment for the goods or services.

A Letter of Credit is the traditional worldwide risk management tool for international transactions. Issued by a foreign bank (representing the buyer) and confirmed by a corresponding bank usually in the country of the seller, a Letter of Credit is the overseas bank's commitment to pay the seller's drafts. A Letter of Credit is opened by an issuing or opening bank. The buyer chooses the opening bank.

Revocable vs. Irrevocable Letters of Credit

A Letter of Credit may be revocable or irrevocable. In a revocable Letter of Credit, the issuing bank (representing the buyer) has the right to cancel or alter its obligation at any time before payment of a sight draft or acceptance of a time draft. That situation exists even if goods were shipped in reliance on the expectation of payment.

An irrevocable Letter of Credit that is accepted by the seller, however, cannot be altered or canceled without the consent of the seller. Any change to an irrevocable Letter of Credit requires the consent of all parties. Consent would include any parties beyond the buyer and seller. For example the confirming banks would be affected parties.

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Confirmed vs. Unconfirmed

An irrevocable Letter of Credit can be either confirmed or unconfirmed.

In a confirmed Letter of Credit, the issuing bank (representing the buyer) agrees independently to the buyer's commitments to pay the seller the agreed-up amount of money, as long as all the requirements of the Letter of Credit are fulfilled.

A confirmed irrevocable Letter of Credit can become very elaborate. A second bank (often specified as a prime bank) may confirm or otherwise guarantee payment of the foreign bank that initially opened the Letter of Credit. This requirement originates from the seller and usually takes place only if the bank of the buyer is not internationally established.

Other types of Letters of Credit

Other types of Letters of Credit may include straight or negotiation credits. These types of Letters of Credit inform the seller whether any bank, or only certain banks, can process the documents of the seller to receive payment. All of the various types of Letters of Credit can be combined in various ways with extended rights and/or obligations, depending upon the exact type of Letter of Credit issued. A Seller should be aware of rights under a Letter of Credit before proceeding with a sale.

Letter of Credit rules- International Chamber of Commerce

A Standard Documentary Credit Application Form has been developed by the International Chamber of Commerce (ICC), in Paris, France. The ICC has also published a guide to Documentary Credit Operations. Banks throughout the world adhere to the rules developed by the ICC.

The rights and obligations of buyers, sellers and participating banks in international Letters of Credit transactions are presented in careful detail in publications made available by the ICC. Under the Uniform Customs and Practices for Document Credits (UCP), the International Chamber of Commerce has made available in a publication called the UCP 600. The publication is almost always referred to in international Letter of Credit forms and is a part of the Letter of Credit contract. The ICC also has available ICC Publication No. 511, which takes the reader through UCP 600 on an article-by-article and clause-by-clause basis. The ICC Publication No. 511 also explains the reasoning that led the ICC Working Group to develop a thoroughly revised sets of Rules for Documentary Credits under UCP 600.

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Benefits of using a Letter of Credit

By conducting export sales transactions under an irrevocable Letters of Credit, the seller does not have to determine the credit standing of the foreign buyer. Letters of Credit are issued in many different forms from foreign banks and financial institutions. The variations are due to differences in customs and regulations of trade and finance in the country of origin of the issuing bank or financial institution. If, for any reason, a seller cannot comply with one or more conditions of a Letter of Credit, it is absolutely imperative for the seller to contact the buyer to arrange for one or more amendments to the original agreement.

Letter of Credit Discrepancies

If there is a disagreement between a sale contract's shipping and documentation requirements and those in a Letter of Credit, the seller must take immediate action before shipping to arrange for an amendment to the Letter of Credit. If the seller does not arrange for such an amendment, the seller may experience payment problems. Full compliance with all conditions for payment are interpreted by banks rigidly. Any disagreement, however small, represents grounds to reject the payment of the draft.

On a worldwide basis, approximately 60% of document presentations on Letters of Credit are presented with discrepancies. Banks charge for EACH discrepancy. Therefore, it is extremely important to ensure document presentations are accurate and complete to avoid additional costs and delays in payment processing.

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Payment on a Letter of Credit

The documents listed in a Letter of Credit are presented to the negotiating/paying Bank with a draft, which is sometimes referred to as a "bill of exchange". A draft resembles a check. In a Letter of Credit sale, the drawee on the draft is the bank that issued the Letter of Credit. The seller is the drawer of the draft.

Drafts are classified as either sight or time. A sight draft requires a drawee to pay the amount shown in full upon proper presentation of documentation. On a time draft, a payment date later than the date of presentation would be stipulated (such as 60 days after sight or 90 days after sight).

When properly presented, a time draft is accepted by the drawee. This means the drawee indicates an acknowledgement that the necessary conditions to its payment were met and the drawee is obligated to pay on the appointed date.

Paying a sight draft or accepting a time draft when documents or goods have been presented is known as honoring the draft.

If the Letter of Credit states "payment at sight", the seller should receive payment within a reasonable time (usually not exceeding seven days) after documents are presented within the validity period of the Letter of Credit and accepted by the negotiating (paying) bank.

Usual Letter of Credit conditions

The usual conditions included in a Letter of Credit include delivery dates, product specifications and receipt by the bank of specific documents (such as negotiable bills of lading, inspection certificates, commercial invoices and packing lists). Any required documents must be presented to the bank within a specific period of time. There may also be other terms and conditions as negotiated between the buyer and seller.

Letter of Credit terms and conditions (and all required documents) should be agreed upon between the buyer and seller, in advance of opening of a Letter of Credit. Letter of Credit issuance instructions should then conform to the terms of such an agreement.

Exporters in the United States should request the overseas buyer to open an Irrevocable Commercial Letter of Credit, payable 100% at sight, freely negotiable or confirmed by a bank. If the Letter of Credit is to be confirmed, the seller should also request the buyer to instruct the issuing bank to obtain the Letter of Credit confirmed by a bank in the United States.