

## Letter of Credit - Documentary Credit

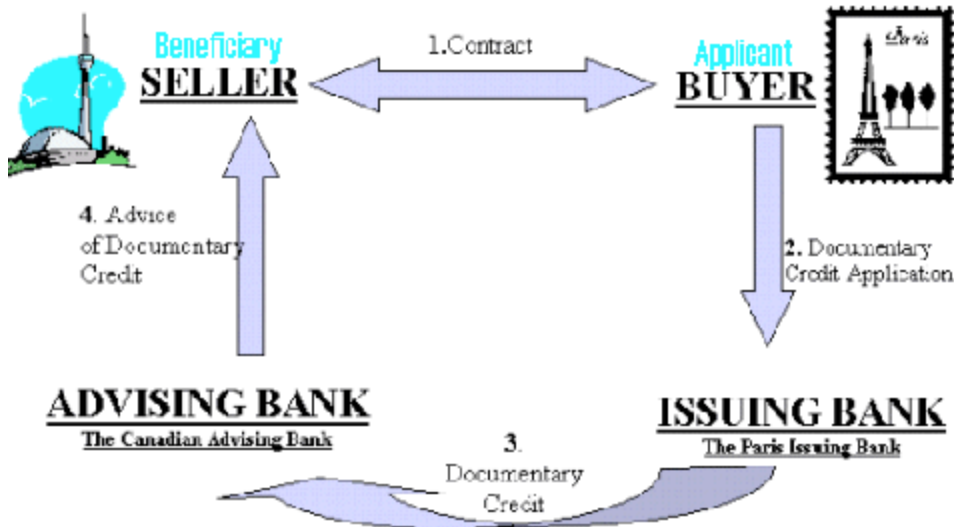
### What is a Letter of Credit?

A Letter of Credit is a payment term generally used for international sales transactions. It is basically a mechanism, which allows importers/buyers to offer secure terms of payment to exporters/sellers in which a bank (or more than one bank) gets involved. The technical term for Letter of credit is 'Documentary Credit'. At the very outset one must understand is that Letters of credit deal in documents, not goods. The idea in an international trade transaction is to shift the risk from the actual buyer to a bank. Thus a LC (as it is commonly referred to) is a payment undertaking given by a bank to the seller and is issued on behalf of the applicant i.e. the buyer. The Buyer is the Applicant and the Seller is the Beneficiary. The Bank that issues the LC is referred to as the Issuing Bank which is generally in the country of the Buyer. The Bank that Advises the LC to the Seller is called the Advising Bank which is generally in the country of the Seller.

The specified bank makes the payment upon the successful presentation of the required documents by the seller within the specified time frame. Note that the Bank scrutinizes the 'documents' and not the 'goods' for making payment. Thus the process works both in favor of both the buyer and the seller. The Seller gets assured that if documents are presented on time and in the way that they have been requested on the LC the payment will be made and Buyer on the other hand is assured that the bank will thoroughly examine these presented documents and ensure that they meet the terms and conditions stipulated in the LC.

### The Documentary Credit Cycle

Letter of Credit



Typically the documents requested in a Letter of Credit are the following:

- Commercial invoice
- Packing List
- Transport document such as a ( Bill of lading or Airway bill, )
- Insurance document;
- Inspection Certificate
- Certificate of Origin

But there could be others too.

Letters of credit (LC) deal in documents, not goods. The LC could be 'irrevocable' or 'revocable'. An irrevocable LC cannot be changed unless both the buyer and seller agree. Whereas in a revocable LC changes to the LC can be made without the consent of the beneficiary. A 'sight' LC means that payment is made immediately to the beneficiary/seller/exporter upon presentation of the correct documents in the required time frame. A 'time' or 'date' LC will specify when payment will be made at a future date and upon presentation of the required documents.

Essential Principles Governing Law Within the United States, Article 5 of the Uniform Commercial Code (UCC) governs L/Cs. Article 5 is founded on two principles: (1) the L/C,s independence from the underlying business transaction, and (2) strict compliance with documentary requirements.

### 1) Strict Compliance

How strict compliance? Some courts insist upon literal compliance, so that a misspelled name or typographical error voids the exporter's/beneficiary's/seller's demand for payment. Other courts require payment upon substantial compliance with documentary requirements. The bank may insist upon strict compliance with the requirements of the L/C. In the absence of conformity with the L/C, the Seller cannot force payment and the bank pays at its own risk. Sellers should be careful and remember that the bank may insist upon strict compliance with all documentary requirements in the LC. If the documents do not conform, the bank should give the seller prompt, detailed notice, specifying all discrepancies and shortfalls.

### 2) The Independence Doctrine

Letters of credit deal in documents, not goods. L/Cs are purely documentary transactions, separate and independent from the underlying contract between the Buyer and the Seller. The bank honoring the L/C is concerned only to see that the documents conform with the requirements in the L/C. If the documents conform, the bank will pay, and obtain reimbursement from the Buyer/Applicant. The bank need not look past the documents to examine the underlying sale of merchandise or the product itself. The letter of credit is independent from the underlying transaction and, except in rare cases of fraud or forgery, the issuing bank must honor conforming documents. Thus, Sellers are given protections that the issuing bank must honor its demand for payment (which complies with the terms of the L/C) regardless of whether the goods conform with the underlying sale contract.

## 3) Most Common Reasons why Letters of Credit Fail

### 1) Time Lines:

The letter of credit should have an expiration date that gives sufficient time to the seller to get all the tasks specified and the documents required in the LC. If the letter of credit expires, the seller is left with no protection. Most LC s fail because Sellers/Exporters/Beneficiaries were unable to perform within the specified time frame in the LC. Three dates are of importance in an LC:

- a) The date by when shipment should have occurred. The date on the Bill of Lading.
- b) The date by when documents have to be presented to the Bank
- c) The expiry date of the LC itself.

A good source to give you an idea of the timelines would be your freight forwarding agent. As a seller check with your freight forwarding agent to see if you would be in a position to comply.

### 2) Discrepancy within the Letter of Credit:

Letters of credit could also have discrepancies. Even a discrepancy as small as a missing period or comma can render the document invalid. Thus, the earlier in the process the letter of credit is examined, the more time is available to identify and fix the problem. This is another common reason why LCs fail.

### 3) Compliance with the Documents and Conditions within the Letter of Credit.

Letters of credit are about documents and not facts; the inability to produce a given document at the right time will nullify the letter of credit. As a Seller/Exporter/Beneficiary you should try and run the compliance issues with the various department or individuals involved within your organization to see if compliance would be a problem. And if so, have the LC amended before shipping the goods.