

## DOCUMENTARY LETTERS OF CREDIT

also referred to as

Documentary Credit (DC)  
or  
Letter of Credit (LC)

Jeffrey Blum

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## INTRODUCTION

- **Trading internationally can bring rewards, but it also involves risks.**

Exporters must ensure that they are paid for the goods provided. Importers need to ensure they receive the correct goods for which they have paid.

Four principal methods of payment available to exporters and importers and the different levels of risk associated with each one:

- 1/ Advance Payment
- 2/ Documentary Collection
- 3/ Documentary Letters of Credit
- 4/ Open Account

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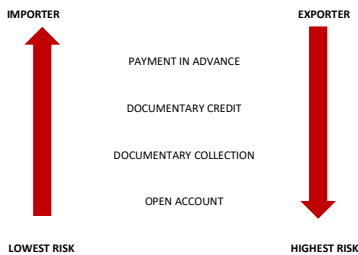
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## Basic Principles of the Risk Ladder



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### INTRODUCTION

- The method of payment your company applies will depend on a variety of factors: first the political, economic, currency exchange, legal system in the importing country, followed by the importer's track record, credit worthiness, bargaining power and the level of trust between both parties.
- A 'DC' is a written undertaking given by a bank (issuing bank) to pay the Beneficiary a given sum of money within a specified time, provided that the Beneficiary presents documents which comply with the terms laid down in the 'DC'.
- A 'DC' is subject to internationally agreed banking rules UCP 600.

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### WHAT IS A DOCUMENTARY LETTER OF CREDIT ?

- A DC is a banking instrument which allows the Importer to offer secure payment to the Exporter. Under a DC the words "Applicant" and "Beneficiary" are used when referring to "Importer" and "Exporter".
- Art 2 UCP 600: "Credit means any arrangement, however named or described, that is irrevocable and thereby constitute a definite undertaking of the Issuing Bank to honor a complying presentation"
- Issuing Bank means the bank that issues a credit at the request of an applicant or on its own behalf

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### WHAT IS A DOCUMENTARY LETTER OF CREDIT ?

- Calls for presentation of complying documents as specified in the L/C, covering the agreed goods/services of goods and presented within specified time limits
- the documents are to be presented at a place stated in the DC (place of availability)
- A DC can be for any amount and in any freely traded currency

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WHAT IS A DOCUMENTARY LETTER OF CREDIT ?

- DC's are subject to

UCP 600

Uniform Customs & Practice for Documentary Credit

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WHAT IS UCP 600?

- The International Chamber of Commerce (ICC) has established rules on documentary credits worldwide for more than 80 years. UCP 600 (2007 revision), the latest version of ICC's universally used rules on Documentary Credits, came into effect on July 1, 2007 and replaced the former version UCP 500 (1993 revision.)

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WHAT IS UCP 600 ?

- Used by letter of credit practitioners worldwide, the Uniform Customs and Practice for Documentary Credits (UCP) are the most successful private rules for trade ever developed.
- Bankers, traders, lawyers, carriers, freight forwarders, insurers, academics and all who deal with letter of credit transactions worldwide will refer to UCP 600 on a daily basis.

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### WHAT IS UCP 600 ?

- UCP 600 are rules that apply to any DC when the text of the DC expressly indicates that it is subject to these rules.
- They are binding on all parties thereto unless expressly modified or excluded by the credit.
- Art 1. 'Application of UCP' refers

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### WHY ANOTHER REVISION TO UCP

- UCP 500 and previous revisions fell short of the expected reduction in disputes arising from inconsistent interpretation
- Changes have been made with a view to addressing any deficiencies of UCP and keeping up to date with current business practices, technology and regulations
- Nevertheless, with the continuous development of trade and implementation of new rules and regulations, some DC practitioners are now calling for a review of UCP 600

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### • ISSUING BANK UNDERTAKING

- Art 7a: "Provided that the stipulated documents are presented to the nominated bank or to the issuing bank and that they constitute a complying presentation, the issuing bank must honour if the credit is available by sight, acceptance, deferred payment..."
- Art 7b: "An Issuing Bank is irrevocably bound to honour as of the time it issues the credit"
- Give a binding undertaking to the Beneficiary that if compliant documents are presented, the Bank will pay the Beneficiary the amount due. This offers security to the Beneficiary.

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**Documentary Letters of Credit deal with documents, not goods or services**

- Art 5. UCP 600
  - “Banks deal with documents not with goods, services or performance to which the documents may relate”
- Typically the documents requested will include
  - (i) a commercial invoice
  - (ii) a transport document such as a bill of lading, air waybill or rail waybill

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- These are the 2 main documents which are usually expressly stated in a DC
- there are many other documents, depending on
  - what has been agreed between the Applicant and the Beneficiary
  - the import requirement of the country
  - the type of goods
  - consular requirements
  - etc.

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**BENEFITS & ADVANTAGES**

- Give Exporters guaranteed payment without affecting credit limits
- Gives Importers more control over the payment conditions ~ this is especially valuable with new suppliers
- Enhances competitive position

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### BENEFITS & ADVANTAGES

- Known payment date, currency and revenue, helps cashflow management
- Could be used to help raise finance through discounting
- Enable Importers to negotiate longer credit periods

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### WHY USE A DOCUMENTARY LETTER OF CREDIT?

DCs are used for the following reasons:

- To protect against buyer risk.

If the buyer is of unknown creditworthiness, then the seller has the security of the bank's payment undertaking to protect against "country risk" or client risk.

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### WHY USE A DOCUMENTARY LETTER OF CREDIT?

- The buyer may be willing and able to pay; but economic or political conditions in the buyer's country may prevent or delay payment. This is a real concern when dealing with less developed countries and/or countries with foreign exchange shortages.
- To protect against these risks, a Confirmed DC will be necessary - a bank will (for a fee) add its confirmation, i.e. own payment undertaking to that of the Issuing Bank.

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## WHY USE A DOCUMENTARY LETTER OF CREDIT?

- DCs are also used as part of exchange control or import control regimes operating in the buyer's country. In such cases the use of a letter of credit is mandatory, even if not required by the seller for security reasons.

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## LETTER OF CREDIT PROCESS

- Stage 1. Importer & Exporter negotiate terms of the contract
- Stage 2. Applicant / importer instructs his bank, the Issuing Bank, to open a DC in favour of the Beneficiary/Exporter
- Stage 3. Applicant's Bank, the Issuing Bank, issues the DC to the Beneficiary's Bank, the Advising Bank

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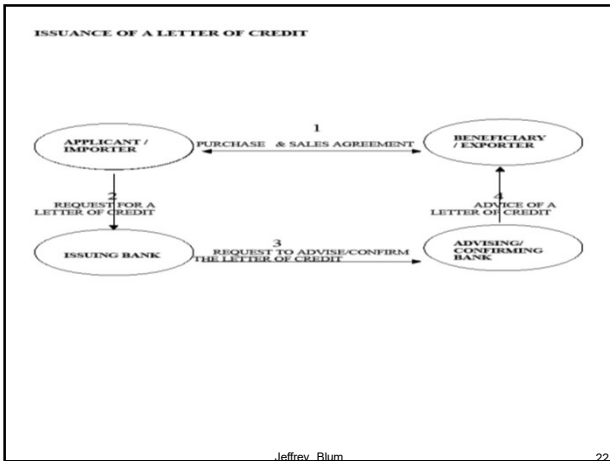
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ISSUE OF A DOCUMENTARY CREDIT *** SWIFT MESSAGE ***
MTY - MTY PRIORITY
SENDER TBSJ20 / ...
RUC ...
INDUSTRIAL BANK OF ASIA          CBIKAS
TOKYO / JAPAN                    CBIKJ1 GENEVA 2

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:22: * SEQUENCE OF TOTAL *
:23: 01
:45A: * FORM OF DOCUMENTARY CREDIT *
       SIGHT CREDIT
:30: * DOCUMENTARY CREDIT NUMBER *
       12345678901234
:31D: * DATE OF ISSUE *
       21 MAR 2010
:32A: * DATE AND PLACE OF EXPIRY *
       21 MAR 2010, SWITZERLAND
:50: * APPLICANT *
       ELECTRIC SUPPLY LTD
       FOURTH FLOOR
       OSAKA / JAPAN
:58: * BENEFICIARY *
       GENERATOR SA
       CHE-1211 GENEVA 18, SWITZERLAND
:520: * CURRENCY CODE, AMOUNT *
       CHF 5000000
:41A: * AVAILABLE WITH ... BY ... *
       01 MAR 2010, GENEVA, CH
:430: * PAYMENT *
       BY PAYMENT
:431: * CAPITAL INSTRUMENTS *
       NEGOTIABLE
:432: * INSTRUMENT *
       RECEIPT
:45A: * DISPATCHING INSTRUCTIONS IN CHARGE AT PRESENT *
       BY TELEGRAPHIC TRANSFER (MTS) TO ...
:460: * FOP TRANSPORTATION TO ... *
       00000000000000
:460: * LATEST DATE OF SHIPMENT *
       21 MAR 2010
:46A: * DESCRIPTION OF GOODS AND/OR SERVICES *
       1 CONTRACT GENERATOR UNIT AS PER ORDER NO. 0306 OF 04TH MARCH 2010
       IN OSAKA
:46B: * DOCUMENTS REQUIRED *
       COMMERCIAL INVOICE, 3 SETS
       FULL SET OF CLEAN ON BOARD MARINE BILLS OF LADING, ISSUED TO
       ORDER, BLANK ENDORSED, NOTIFY ELECTRIC SUPPLY LTD,
       # 2 D/D TO OSAKA AND MARKED 'TREATY PAY'
       + CERTIFICATE OF ORIGIN IN OSAKA AND 2 COPIES, # 2 COPIES TO GENVA,
       AND ISSUED BY THE CHAMBER OF COMMERCE
       AND CLEARANCE
:49: * PRIMA LITI *
:49: * CONFIRMATION INSTRUCTIONS *
       CONFIRM
:54A: * CONFIRMING BANK *
       SUIHKB, CHIBOSUI, SWITZERLAND
:57A: * BANK TO RECEIVE INFORMATION *
       BANKRUPT TO THE CREDIT OF OUR SWISS BANK'S CURRENT ACCOUNT
    
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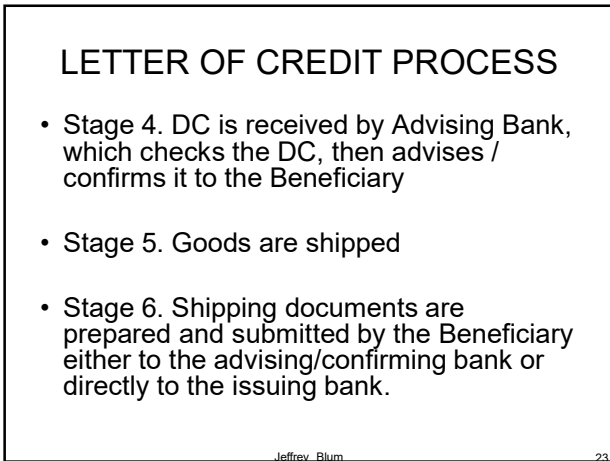
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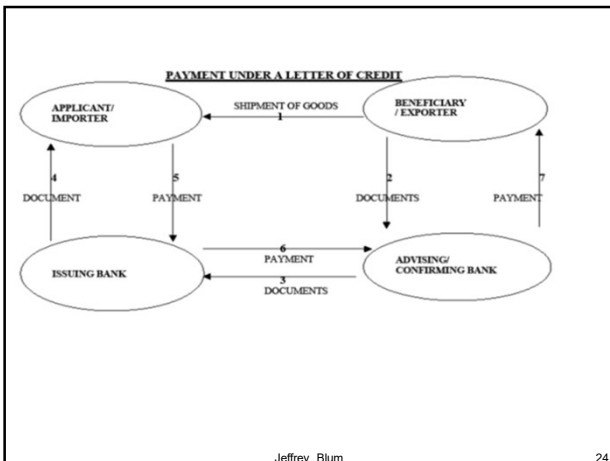
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**LETTER OF CREDIT PROCESS**

- Stage 7. Advising Bank checks the documents. If they comply with DC they send the documents to Issuing Bank and may pay the Beneficiary in advance of being reimbursed by the Issuing Bank
- Stage 8. Issuing Bank checks documents again, if correct they are released to the Applicant and the Applicant's account is debited
- Stage 9. Issuing Bank reimburses the Advising Bank

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**FOR TROUBLE-FREE DC TRANSACTION**

- Communicate with your customers in detail before they apply for a Documentary Letters of Credit. The DC is part of the sales process, **not** the shipping process !
- Consider whether a **confirmed** letter of credit is needed - if in doubt, seek advice.

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**FOR TROUBLE-FREE DC TRANSACTION**

- Ask for a copy of the application to be sent to you prior to the opening of the credit, so you can check for terms or conditions that may cause you problems with compliance.
- Upon first advice of the letter of credit, check that all its terms and conditions can be complied with within the prescribed time limits. Many presentations of documents run into problems with time-limits.

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FOR TROUBLE-FREE DC TRANSACTION

- Be aware of up to three time constraints:

- the expiry date of the credit,
- the latest shipping date

and

- the presentation period: the maximum time allowed between dispatch and presentation of documents.

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FOR TROUBLE-FREE DC TRANSACTION

- Also take into account the place of presentation.
- If the letter of credit calls for documents supplied by third parties, make reasonable allowance for the time this may take to organise.

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FOR TROUBLE-FREE DC TRANSACTION

- **After dispatch of the goods**, check all the documents against:

- the terms of the DC
- UCP 600 (for example signature of the B/L)
- ISBP
- each other for internal consistency.

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