



LETTERS OF CREDIT

A Guide to Letters of Credit



CONNECTING SASKATCHEWAN BUSINESS WITH THE WORLD

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Letters of Credit

A Letter of Credit, simply defined, is a written undertaking, by a bank, at the request of its customer, the importer (applicant/buyer), whereby the bank promises to pay the exporter (beneficiary/ seller) for goods or services, provided that the exporter presents all documents called for, exactly as stipulated in the Letter of Credit, and meets all other terms and conditions set out in the Letter of Credit.

Revocable and Irrevocable

There are two types of Letter of Credit: revocable and irrevocable. A revocable Letter of Credit can be revoked without the consent of the exporter, meaning that it may be cancelled or changed up to the time the documents are presented. A revocable Letter of Credit affords the exporter little protection therefore is rarely used. An irrevocable Letter of Credit cannot be cancelled or changed without the consent of all parties, including the exporter. Unless otherwise stipulated, all Letters of Credit are irrevocable.

A further differentiation is made between Letters of Credit, depending on the payment terms. If payment is to be made when specified documents are presented, this is referred to as a sight Letter of Credit. Alternatively, if payment is to be made at a future date, (i.e. 60 days Bill of Lading date), this is referred to as a term, usance or deferred payment Letter of Credit.

Confirmed or Unconfirmed

When a Letter of Credit is advised to you by your local banker, the bank is telling you that they have authenticated the Letter of Credit, and are passing it on to you, “without responsibility or engagement”, i.e. your risk of payment rests with the bank that has issued the Letter of Credit. This is an Unconfirmed Letter of Credit.

It may be the case, however, that the Issuing Bank is not considered an acceptable risk and/ or the country where it is located has high political or economic uncertainty. In this situation, the exporter may consider requesting a Confirmed Letter of Credit.

With a Confirmed Letter of Credit, another bank, the “Confirming Bank”, usually located in the same country as the exporter, will add its “confirmation” to the Letter of Credit. By adding its confirmation, the Confirming Bank undertakes to honour the exporter’s claim under the Letter of Credit, assuming all terms and conditions of the Letter of Credit are met. The risk of payment is now assumed by the Confirming Bank, as well as the Issuing Bank, thereby, providing more protection for the exporter.

When requesting a confirmed Letter of Credit, the exporter should first check with his local banks (International Department) to determine whether or not they have the ability or availability to confirm a Letter of Credit issued by the importer’s Bank. Once they determine which bank can handle the request (Confirm the Letter of Credit), they will direct the importer to have their bank issue a Confirmed Letter of Credit through the local bank who has indicated their interest in the transaction.

It is essential to note the key principle underlying Letters of Credit is that ***banks deal only in documents and not in goods***. The decision to pay under a Letter of Credit will be based entirely on whether the documents presented to the bank appear on their face to be in accordance with the terms and conditions of the Letter of Credit. It would be prohibitive for the banks to physically check all

merchandise shipped under Letters of Credit to ensure merchandise has been shipped exactly as per each Letter of Credit.

Sight Payments

One of the documents that may be requested under a Letter of Credit is a Draft. The Draft, also known as a Bill of Exchange, is a legally enforceable instrument, which is regarded as formal evidence of debt under a Letter of Credit.

It is defined as an unconditional order in writing addressed by one person to another, signed by the person giving it, and requiring the addressee to pay at a fixed or determinable time a certain sum of money to or to the order of a specified party. A Draft must be presented with all other documents requested in the Letter of Credit, unless stipulated otherwise.

Drafts may be payable at “sight”, which means when the “available with” or Issuing Bank are in “sight” of the documents, and they have been determined to be in compliance with the Letter of Credit, payment will be made.

Acceptances

If the Drafts are payable at some future date, i.e. 90 days Bill of Lading Date, the Letter of Credit is said to be a “Term Letter of Credit” or “Usance Letter of Credit”. In other words, the importer and exporter have agreed on extended payment terms. (The exporter will ship against the Letter of Credit, present documents, and wait for payment on the due date, calculated in this example, at 90 days after the date of the Bill of Lading).

Once documents and a Usance Draft are presented under the Term Letter of Credit and are found to be in good order, instead of paying the exporter right away, the Drawee bank “accepts” the Draft, which is essentially a promise to pay the exporter on the maturity date stated in the Draft. Once the Draft has been accepted, it becomes a negotiable instrument called a Banker’s Acceptance, or simply referred to as an Acceptance.

Discounting Acceptances

Instead of waiting until the maturity date of an Acceptance to obtain its funds, an exporter may have the accepted Draft “discounted” at prevailing discount rates. This allows the exporter to collect its funds, net of discount charges, as soon as the Draft has been accepted, instead of waiting until the maturity date.

In addition to the exporter receiving funds prior to the maturity date, another advantage to discounting is that the discount is based on the risk of the Accepting Bank, and, therefore can be lower than the exporter’s current borrowing rate.

If the exporter wishes to discount the Acceptance, a formal request is made to the Drawee Bank or any other bank. This request can be made at any time prior to the maturity of the Acceptance.

Deferred Payment

The use of Drafts is not common in all countries; sometimes a Draft is avoided in view of the excise stamp duty that it attracts. While this does not change anything in the case of sight payments under Letters of Credit, the situation is slightly different when a term payment is used. In this case (no drafts), settlement is defined as a “Deferred Payment”, which means that payment will be made at a future date (i.e. 90 days Bill of Lading Date), but there will be no Draft to be accepted, therefore no instrument to discount.

Assignment of Proceeds

The exporter (Beneficiary) may assign part or all of the proceeds of a Letter of Credit to a third party assignee such as a supplier. A key point for the assigned to keep in mind is that payment is forthcoming only if the exporter receives payment under the Letter of Credit, over which the assignee has no control. An assignment of proceeds is irrevocable and, therefore all parties must consent to any changes. This may be an acceptable alternative to a supplier who otherwise might request a Letter of Credit or demand funds in advance of shipment.

Transferable Letter of Credit

A Transferrable Letter of Credit can also be used in the case where there are three or more parties to a transaction, Buyer/Importer, Seller/Exporter, and Supplier(s). Generally the Seller/ Exporter is actually a broker or middleman of some sort, who sources goods and services required by international buyers.

In a Transferable Letter of Credit, again the exporter must source the product from a third party, the supplier. As in the assignment of proceeds, the supplier may request payment in advance, or a Letter of Credit to proceed. As the exporter may not have sufficient working capital to issue his own Letter of Credit to the supplier, he may instead, request a Transferable Letter of Credit from his buyer (in the body of the Letter of Credit, it must indicate that the Letter of Credit is transfer- able).

Under a Transferable Letter of Credit, the intermediary party (Exporter/Buyer) or Beneficiary to the Letter of Credit is referred to as First Beneficiary. In order to transfer a portion of the Letter of Credit to the supplier, the First Beneficiary (Exporter/Buyer) would ask the Transferring Bank (generally also the Advising/Confirming Bank) to transfer, in part or in full, its rights under the Letter of Credit to the supplier of the goods, which is referred to as the Second Beneficiary.

A Transferable Letter of Credit may be transferred only once; therefore the Second Beneficiary is unable to transfer a portion of a Transferable Letter of Credit to a Third Beneficiary. There may, however, be more than one Second Beneficiary. The Letter of Credit can be transferred only on the terms and conditions specified in the original Credit, with the exception of:

- a) The amount of the Credit (may be reduced)
- b) Any unit price stated there in (reduced)

- c) The expiry date (earlier date than original)
- d) The last date for presentation of documents (earlier than original)
- e) The period for shipment (earlier than original)
- f) The percentage for which insurance cover must be effected may be increased in such a way as to provide the amount of cover stipulated in the original Credit.

Standby Letter of Credit (when used as a security for trade transactions)

The basis of a Standby Letter of Credit is that it may be drawn on by the Exporter/Seller/ Beneficiary when the Importer/Buyer/Applicant has failed to perform (pay) in accordance with the underlying contract between the Applicant and Beneficiary.

In simple terms, a Standby Letter of Credit is “standing by” to protect the Beneficiary in case the Applicant defaults on an agreed-upon sales contract. Standby Letters of Credit are commonly issued in favor of suppliers as security for goods purchased on open account. The Standby Letter of Credit, once issued, will secure shipments made up to the amount of the Standby Letter of Credit and before the expiry date of the Standby L/C. Therefore the exporter ships his goods, and sends his invoices (open account basis), the importer makes payment, and the cycle begins again.

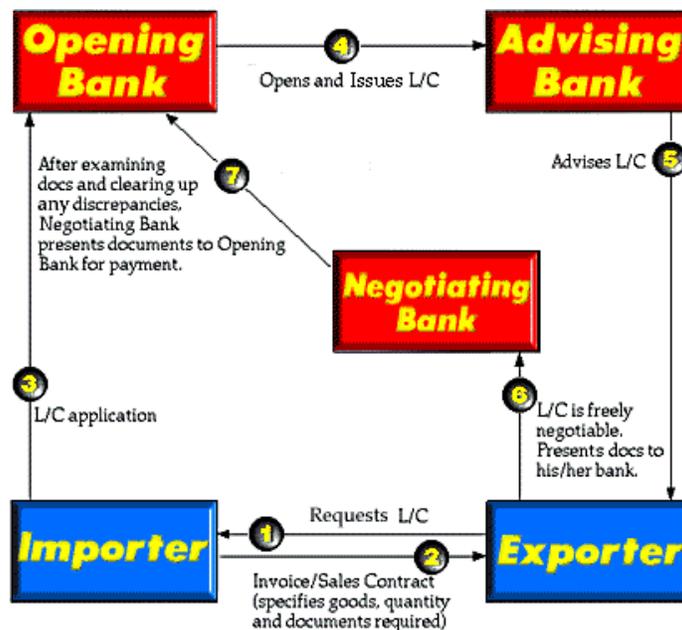
If the Applicant/Importer defaults in payment under the terms of the sales agreement, (i.e. the exporter has shipped his goods, but the payment is not made), the Supplier/Exporter would generally stop further shipment and make a claim for payment under the Standby Letter of Credit.

A Typical Letter of Credit Transaction

After the exporter and customer agree on the sale, the customer arranges for (applies) its bank to issue a Letter of Credit in favor of the exporter (the importer will need a line of credit or other credit facility with the issuing bank).

1. The Issuing Bank issues the Letter of Credit and sends it to the Advising Bank by telecommunications or registered mail in accordance with the importer’s instructions. A request may be included for the Advising Bank to add its confirmation. The exporter may request that a particular bank be the confirming bank, or the foreign bank selects one of its correspondent banks.
2. The Advising and/or Confirming Bank will verify the Letter of Credit for authenticity and send a copy to the exporter. (Adding it’s confirmation if requested).
3. The exporter reviews carefully all terms and conditions in the Letter of Credit. The exporter’s freight forwarder should be contacted to make sure that the shipping date can be met. If the exporter cannot comply with one or more of the conditions, an amendment to the Letter of Credit should be requested at once. (Exporter contacts the importer to request the amendment).

4. The exporter arranges for shipment of the goods, prepares and/or obtains the documents specified in the Letter of Credit and makes demand under the Letter of Credit by presenting the documents within the stated period and before the expiry date to the “available with” Bank. This may be the Advising/Confirming Bank. That bank checks the documents against the Letter of Credit and forwards them to the Issuing Bank. The drawing is negotiated, paid or accepted as the case may be.
5. The Issuing Bank examines the documents to ensure they comply with the Letter of Credit terms and conditions. The Issuing Bank obtains payment from the importer for payment already made to the “available with”/Confirming Bank.
6. Documents are delivered to the importer to allow it to take possession of the goods from the transport company. The trade cycle is complete as the importer has received their goods and the exporter has obtained payment.



Checklist for Export Letters of Credit

The following points may help exporters avoid the misunderstandings and discrepancies that can disrupt trade transactions. When examining your letter of credit and preparing documentation, verify the following:

1. Is the letter of credit irrevocable? Remember, an irrevocable L/C can only be canceled once your consent is received.

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2. What bank has committed itself to pay? As the beneficiary, are you satisfied that this bank can pay? If not, then you may wish to request the importer to have letter of credit confirmed by a major bank.
 3. Is your name and address, and that of your buyer, spelled correctly on all documents?
 4. Is the amount of the credit sufficient to cover the shipment? Here, you should take into consideration factors that depend on the terms of the sale, such as Ex Works, or FOB . . . is there any inland freight or agents charges?
 5. Is there sufficient tolerance allowed on the quantity to be shipped? If you are not sure of the exact amount, you may want to amend the L/C to state about or approximately (10% more or less) immediately before the amount and quantity.
 6. Does the letter of credit describe the merchandise correctly? Remember, the way it is described on the L/C dictates the way it must be described on all documents presented for negotiation.
 7. Is shipment permitted from the place you intend to use?
 8. Does the place of destination quoted by you agree with the L/C?
 9. Do the expiration and shipping dates give sufficient time to effect shipment and assure payment?
 10. Is partial shipment permitted, if required?
 11. Is transshipment permitted, if required?
 12. If the letter of credit stipulates shipment to be effected on a named vessel or vessels of a named steamship company, can you comply with this requirement?
 13. Does the letter of credit stipulate that it is transferable, if required?
 14. Do you need an export license? A certificate of origin?
 15. Can you obtain properly executed shipping, consular, and other documents to conform with the letter of credit terms?

These documents may include:

- Properly consigned bills of lading
- Consular invoice. Is an import license from the buyer necessary to receive this?
- An inspection certificate or analysis by the proper agency
- Properly completed commercial invoice and packing list

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16. If you are chartering vessel or airplane, does the letter of credit allow charter party bills of lading?
 17. Can you comply with insurance risks required in the letter of credit?
 18. Have you prepared and thoroughly checked all documents against the letter of credit to make sure that all working matches, and the proper number of copies are attached?
 19. Have you signed the documents as per the L/C terms?

When preparing quotations for prospective customers, exporters should keep in mind that banks pay only the amount specified in the Letter of Credit – even if higher charges for shipping, insurance or other factors are documented.

Letter of Credit: Terms and Conditions

The following outlines some of the terms and conditions called for in a Letter of Credit, and what they mean to you, the exporter.

1. **Beneficiary:** this is the name and address of the exporter. Check for correctness in the spelling, address, etc.
2. **Currency & Amount:** indicates the total amount that can be drawn under the Letter of Credit. The words “about”, “approximately” or “circa” before an amount indicates the amount may vary up to +/-10%. Other variances may also have been used, i.e. amount and quantity - +/- 5%.
3. **Partial shipments** – if not allowed, you must ship all goods in one shipment.
4. **Transshipment:** transshipment means that, during the course of voyage, merchandise is unloaded and reloaded from one vessel to another vessel or from one mode of transportation to another. Check with your freight forwarder routing of goods.
5. **Transferable Credit:** if allowed, provides the exporter with the flexibility to “transfer” a portion or all of the Letter of Credit to a third party (generally a supplier of goods). More on transferable Letters of Credit later.
6. **Shipment from:** port of loading from which goods will be shipped.
7. **Transportation to:** named place/port to which the goods will be shipped.
8. **Latest date of shipment:** the goods must have been shipped by this date as evidence by shipping documents.

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9. Presentation period: number of days after date of shipment, within which the exporter must pre- sent documents to the appropriate bank counters, but within the validity of the Letter of Credit. If not specified, 21 days.
 10. Expiry Date: last possible date for presentation of documents.
 11. Banking Charges: as specified in the L/C. Generally each party pays for the banking charges incurred in their own country.

Export Document Preparation

Correct preparation of documents is necessary for speedy payment. The following list should be used to ensure that documents have been prepared in accordance with the letter of credit requirements

The Draft

1. Must be signed on the front.
2. Must be drawn on the correct party (Drawee - to whom the draft is addressed - usually the paying bank, in letter of credit transactions).
3. The amount should be spelled out, and in figures, both of which should agree.
4. Tenor must be correct -i.e., at sight - at 280 days sight.
5. Must be endorsed on the reverse, if payable to drawer (Drawer - person making the draft - in letter of credit transactions, the beneficiary or seller).
6. Draft amount must agree with the invoice amount.
7. Draft must not be altered; i.e., no corrections or mark overs.

The Commercial Invoice

1. Must show the terms of sale - i.e., CIF, FOB, Ex-Works.
2. Must be addressed to the buyer.
3. Must be signed by the beneficiary as required by the L/C
4. The amount of freight charges must agree with those shown on the Bill of Lading (if shown).

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5. The exact merchandise description as shown in the letter of credit must be shown on the invoice. The invoice may show other information but must also have the letter of credit description.

The Bill of Lading

1. There are to be no indications that there is any defect in the goods or packaging. (A Clean Bill of Lading is a bill of lading showing no defects in the goods or packing.)
2. Charter Party Bills of Lading are not acceptable, unless specifically allowed in the letter of credit.
3. Bills of Lading issued by forwarding agents are not acceptable.
4. In cases when shipment is to be made by air, it is advisable to have transshipment allowed in the letter of credit.
5. The bills of lading must show shipment on board a named vessel and the on-board date must be noted on the bill of lading.
6. Bills of lading showing shipment on deck are not acceptable (unless specifically allowed in the letter of credit).
7. The bills of lading must show the number of original Bills of Lading issued, and if more than one original has been issued all the originals must be presented.
8. Amount of freight charges shown on the bill of lading must agree with those on the invoice.
9. Weight and number of packages shown on the bill of lading must agree with those shown on weight lists or packing lists (if any).
10. Merchandise description must be consistent with that shown on the commercial invoice and letter of credit.
11. Ports of loading and destination, consignee, notify party, and must coincide with those shown in the letter of credit.
12. All the original bills of lading must be signed.
13. Any corrections, changes, or additions must be initialed.
14. Bills of lading must be presented to the paying bank within 21 days from the on-board date shown on the bill of lading, unless otherwise specified in the letter of credit.

The Insurance Policy

1. Unless otherwise stipulated in the credit, insurance must be issued for the total invoice value of the goods, including freight and insurance charges, plus 10%.
2. Must not be dated later than the on-board date shown on the bill of lading, unless the merchandise has been insured with coverage to start prior to shipment on board i.e., coverage from warehouse to warehouse.
3. The insurance must be issued in the same currency as the letter of credit.
4. Broker cover notes are not acceptable unless allowed.
5. If the insurance is payable to the shipper, then the shipper must endorse the insurance policy or certificate on the reverse.
6. Insurance documents must be as specified in the credit, and must be issued and/or signed by insurance companies or their agents or by underwriters.
7. Any corrections, changes or additions must be initialed.
8. Coverage must be adequate to cover all the risks required on the letter of credit.

Packing List -The packing list must show the number of packages, etc., and be consistent with the other documents.

The Certificate of Origin or Consular Invoice

1. Must agree in form with invoice, bill of lading, and L/C.
2. Description of merchandise must agree with L/C, invoice and other documents.
3. Weight shown must match bill of lading and other documents.
4. Value shown (if applicable) must match all other documents.
5. It is visaed by the Chamber of Commerce or the buyers Consul, unless otherwise specified in credit.
6. Any changes or alterations must be properly authorized by the Consul or Chamber of Commerce. A separate letter of correction is usually issued.

Documents that May Accompany the L/C

Basic Ordering Agreement – A basic ordering agreement is not a contract. A basic ordering agreement is a written instrument of understanding, negotiated between the exporter and the buyer that contains (a) terms and clauses applicable to future contracts (orders) between parties during its term; (b) a description, as specific as practicable, of supplies or services to be provided; and (c) methods for pricing, issuing, and delivering future orders. Each order against a BOA is a separate contract

Bill of Lading (B/L) - Is the primary trade transport document required to ensure the security of goods shipped by an exporter. It serves as:

- The carrier's receipt to the shipper that the goods have been received for shipment
- a memorandum of the terms and conditions of the contract between the carrier and the shipper for the transportation of the goods to a specified destination
- evidence of title to the goods
- may be negotiable or non-negotiable
- various types include air bill, ocean bill, highway probill and rail waybill

Certificate of Origin (CO) – An export document under NAFTA showing that the specified goods presented at Customs originated in either the United States, Canada, or Mexico, and are therefore entitled to the preferential NAFTA tariff.

Documentary Draft - is a written document prepared by the Seller/ Exporter and the foreign Buyer agrees to pay a given sum of money, for value received at sight (i.e., immediately) or at a stipulated future date, known as a time draft.

One important reason for using a draft is that, should the importer fail to pay for the goods purchased, the exporter, or more usually the foreign bank involved, can sue for the money on the basis of the documentary draft alone. It does not have to prove the terms of the export sales contract. The exporter knows that the branch of its bank in the foreign country, or its correspondent bank, will not hand over the shipping documents (including the bill of lading that transfers ownership of the goods to the foreign importer). Unless the importer has made payment or, in the case of credit sales, accepted a draft for future payment.

Another reason for the use of a draft is that the exporter can fund sooner, even though it has granted credit terms to the foreign importer, by discounting the draft with its own bank.

A third reason for use of a draft is, for the exporter to give direction in writing to the foreign importer to pay the money owed to the bank which is acting on the exporter's behalf.

Invoice - is a written record of a transaction, often submitted to a customer or client when requesting payment.

Packing List – a form describing the specific contents of a container, pallet or package, crucial to any insurance claim for loss or damage.

Proforma Invoice – a billing sent in advance of a shipment, usually to enable the buyer to get an import and/or exchange permit.

Purchase Order - A purchase order is the accepted instrument used to procure goods and services for businesses and institutions. It spells out the agreement between the buyer and the seller, and once accepted, has the legal force of a binding contract, committing the buyers to accept and pay for the described goods and the supplier to deliver them as ordered.

Common Letter of Credit document Discrepancies

1. Letter of credit has expired.
2. Time allowed for shipping has passed.
3. Letter of credit is overdrawn.
4. Late presentation of documents (over 21 days after shipment date or over the number of days specified in the L/C).
5. Merchandise description on invoice does not match the description on the L/C.
6. Bill of lading not consigned per L/C.
7. Insurance document dated later than bill of lading
8. Draft and invoice amounts don't match (acceptable if L/C expressly allows).
9. Draft drawn incorrectly (tenor, drawee, drawer).
10. Draft not signed or endorsed correctly.
11. Invoice indicates charges not covered by L/C.
12. Invoice doesn't show terms of shipment as specified by L/C; e.g., CFR or CIF.
13. Insurance coverage is insufficient or in currency other than L/C.
14. Insurance does not cover risks stipulated by L/C.
15. Bill of Lading is not clean (evidences damage to merchandise).
16. Bill of Lading is not properly endorsed, if necessary (to order of).