Letters of Credit and Documentary Collections for Exporters

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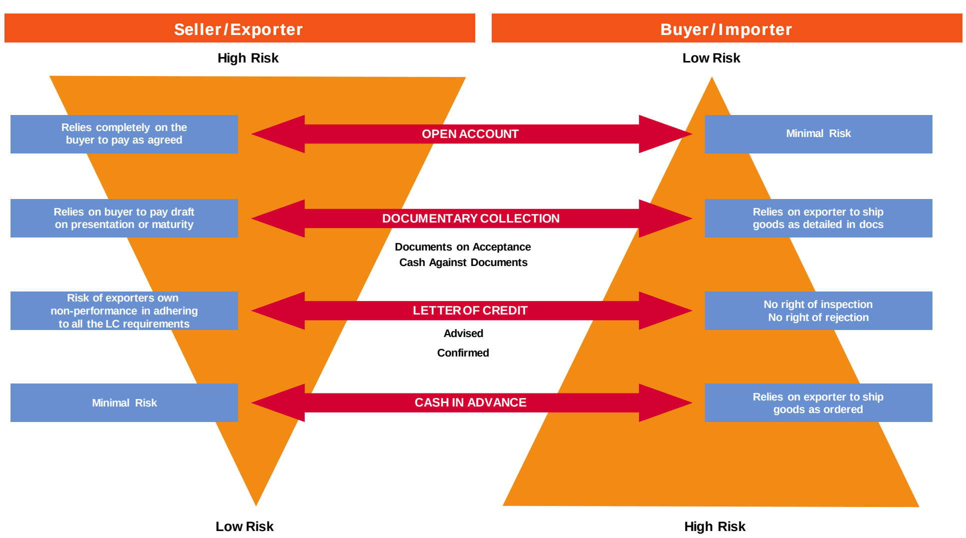
International Trade – Payment options

Risk Triangle - A Comparison of Payment Options



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International Risk Factors

- Political
  - Changes in law
  - Civil strife, strikes
  - Changes in leadership
  - Changes in policy
  - War
- Economic
  - Country or regional crisis
  - Banking instability
  - Price instability
- Commercial
  - Buyer's creditworthiness
- Cultural differences
  - Business differences
  - Time differences
  - Social differences
- Language
  - English differences
  - Translation issues
- Foreign Exchange
  - FX volatility
  - Currency restrictions
- Shipping hazards
  - Weather
  - Piracy
- Foreign Customs
  - Quotas
  - Custom delays
  - Tariffs
- Fraud

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What Exactly is a Letter of Credit?

- Issuing or confirming bank obligation to pay beneficiary upon presentation of complying documents within a specific time period
- Substitution of bank risk for buyer/borrower risk

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Letter of Credit – Primary Parties Involved

- **Applicant** (buyer, importer, borrower)
- **Beneficiary** (seller, vendor, exporter, supplier, creditor)
- **Issuing Bank** (bank that issues the credit)
- **Advising Bank** (bank that receives and then advises the LC to beneficiary or 2nd advising bank)
- **Confirming Bank** (advising bank adds their undertaking to the letter of credit)
- **Negotiating Bank** (bank that advances funds or commits to do so prior to reimbursement)
- **Reimbursing Bank** (bank that honors a reimbursement claim made by nominated or negotiating bank)
- **Nominated Bank** ("available with" bank)

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Why Use a letter of credit?

- Buyer wants financing
- Helps manage of cash flow
- Seller wants mitigation of credit risk
- Buyer wants mitigation of transaction risk

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Confirmation and Advising

- Advised Credit…

  A letter of credit that is conveyed to a beneficiary without engagement or obligation by the advising bank beyond determining that the letter of credit instrument is authentic.

- Advised with Confirmation

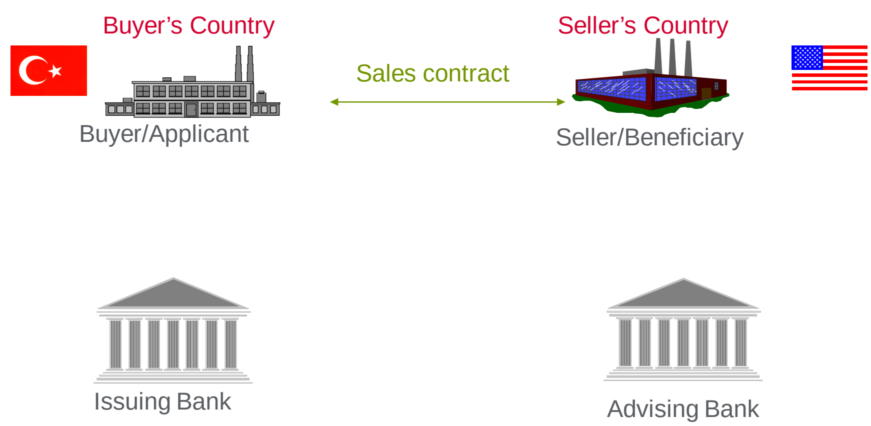
  A letter of credit whereby a bank (usually the advising bank) assumes the obligation of the issuing bank. The confirming bank adds their undertaking to the letter of credit.

When Should You Request Confirmation?

- Are you comfortable with
  - the issuing bank?
  - the amount?
  - the country?
  - the advising bank?
- What is your credit policy?
- Is there line availability?

- Cost is determined by market factors, strength of the issuing bank, country of issuance (political and economic risk), amount of the letter of credit, line availability, tenor and validity period

LC Issuance Process



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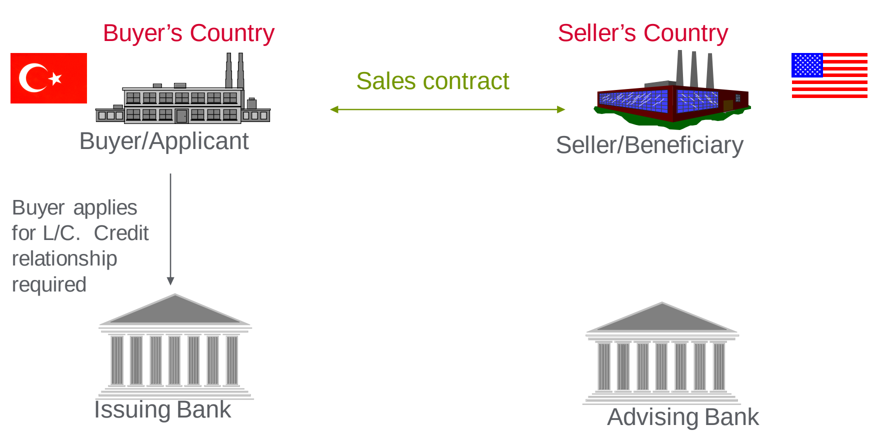
LC Issuance Process



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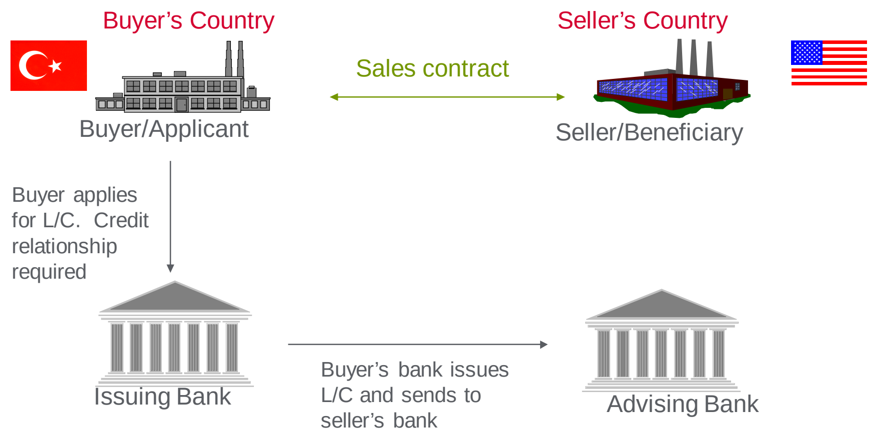
LC Issuance Process



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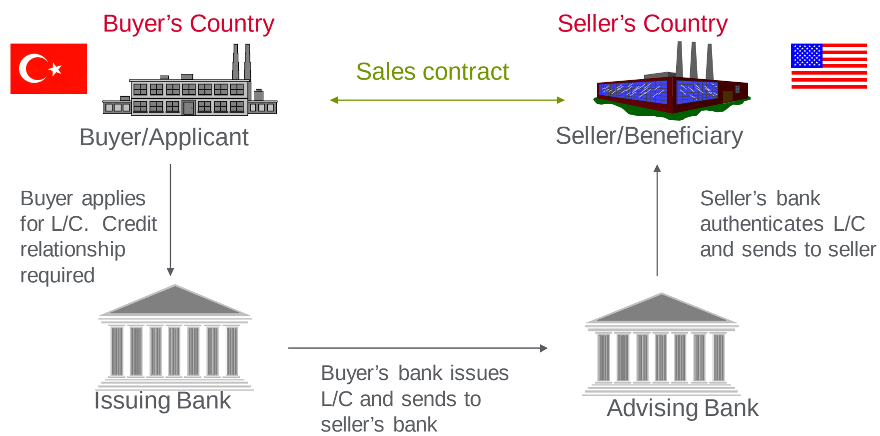
LC Issuance Process



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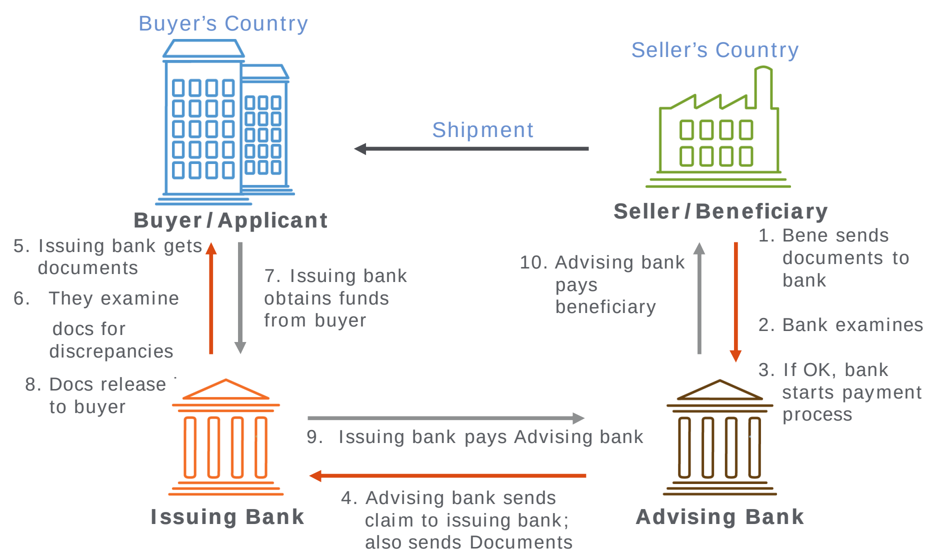
LC Payment Process



What is SWIFT

- Society for Worldwide Interbank Financial Telecommunication
- Operates secure financial messaging network and markets related products
- Started in Brussels, Belgium in 1973
- Has virtually eliminated the use of paper and telex for commercial L/C communications

SWIFT Fields

- 27 – Sequence and page number
- 40A - Form of doc credit
- 20 – Letter of credit number
- 31C – Date of issue
- 31D – Date and place of expiry
- 51A/D – Applicant Bank
- 50 – Applicant
- 59 – Beneficiary
- 32B – Currency code and amount
- 39A – Percentage amount and tolerance
- 41A/B – Nominated bank, available with
- 42 – Drafts, payment, tenor, drawee
- 43P – Partial Shipment
- 43T – Transshipment
- 44 – Shipping details
- 45A – Merchandise description
- 46A/B – Documents required
- 47A – Additional conditions
- 71B – Fees and charges
- 48 – Period for presentation
- 49 – Confirmation instructions
- 53A/B – reimbursing bank instructions
- 78 – Payment, negotiation instructions
- 57A/D – 2nd advising bank
- 72 – Bank to bank information

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LC Risks

- Risk to Exporter:

  Bank risk

  Sanctions

  Discrepancies

  - Watch Out! The more complicated the LC the greater the risk for the exporter.

- Risk to Importer:

  Assured shipment is made, but relies on exporter to ship goods described in documents.

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Document Risk

- The risk that the documents presented for payment under the L/C will not be correct

- Discrepant documents can:
  - Cause payment delays
  - Cause payment rejections
  - Eliminate your risk protection
  - Add extra time and cost to the transaction

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Incoterms

- Define risks, costs and responsibilities in the delivery of goods from seller to buyer

- Although they do not define when title passes, Incoterms do address delivery and insurance, therefore indirectly address when a sale can be booked. Check with your accountant!

- Using the correct Incoterm is important (Google “Incoterms chart” under “images”)

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How to Manage Your LC

- The LC is a contract, but separate from your sales contract
- Structure the LC carefully
- Be proactive – present your LC requirements to your buyer
- Verify shipment details with forwarder
- Find a strong international partner
- Know your buyer
- The fewer documents required, the better for the exporter
- Request your buyer to send LC application to you for review prior to LC issuance

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What to do upon receipt of your LC

- Ensure that
  - Names and address shown are correct
  - There are no unacceptable conditions
  - The amount of LC and goods description are correct
  - Documents are as required by the sales contract
  - The latest shipment date and expiration date are correct
  - Payment terms (Sight or Time) are per sales contract
  - Risks of buyer's bank and country are acceptable
  - Partial shipment or full shipment is permitted as agreed
  - Shipping points – airport, seaport, inland points are correct
  - Who pays bank and freight charges is per sales contract
  - Who insures the goods is per sales contract

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If You Find Irregularities in the LC

- Contact the buyer
- Have the LC amended, if necessary
- Determine who pays the amendment fees

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Your Contract or Sales Agreement

- Terms of payment and price
- Specific ports of loading and discharge – places of receipt and arrival
- Address passing of title
- Description of goods and packaging (possibly HTS codes)
- Incoterm
- Who does what when - timeline
- Applicable law and address resolution of disputes
- Correct addresses of buyer and seller – contact information
- Your pro-forma invoice will tell the buyer what you're willing to do and for what price

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Additional Best Practices

- Review the letter of credit immediately upon receipt to determine if any amendments are necessary
- Have at least two people on staff who understand LCs and are able to create and present documents, or use a doc prep service
- Avoid requirements for buyer issued, or buyer countersigned documents
- Whenever possible the letter of credit should name a USA reimbursing bank, or allow your bank to debit the issuing bank's account with them
- Avoid, whenever possible, requirements to forward original documents outside of the letter of credit
- Avoid ambiguous language, terms, or symbols; be precise

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Consigning the Bills of Lading

Direct Consignments

- In ocean shipments, avoid consigning goods directly to either the buyer or the collecting bank

Consigning to order shipper and blank endorsed

- Mitigates risk of obtaining goods without payment

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Financing with Letters of Credit

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Why offer my buyer financing terms?

- Competitive advantage by offering longer payment terms
- Utilize lower US borrowing rates compared to borrowing rates available in most countries
- Exporter is paid “at sight” while offering your buyer terms of up to 180 days
- Payment is made to exporter without recourse

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Why offer my buyer financing terms?

Indicative Borrowing Rates – Interbank*

US Interbank	2.00%
Argentina	67.21%
Brazil	5.38%
China	2.95%
EU	-0.44%
India	5.32%
Indonesia	5.82%
Japan	-0.11%
Mexico	8.20%
Russia	7.34%
Singapore	1.88%
South Africa	6.78%
UAE	2.31%
UK	0.76%

- tradingeconomics.com 10/13/2019

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Financing using Letters of Credit

A potential win-win payment solution for exporters and their overseas buyers

In terms of optimizing working capital, buyers and sellers have opposing needs regarding the timing of payments in international trade transactions:

- Buyers (importers) want to delay payments as long as possible
- Sellers (exporters) want to receive payments as quickly as possible.

Discounting Letters of Credit allow exporters to receive payment immediately while offering buyers extended payment terms at very attractive rates.

- "Discounting" is simply requesting your bank to make payment to you prior to the letter of credit maturity.
- It is a usance letter of credit (versus "at sight")
- Tenors usually range from 30 to 180 days, but may be longer
- Discount charges are the responsibility of either buyer or seller, and this is stated within the letter of credit.
- Discounting occurs when your bank receives "advice of acceptance" from LC issuing bank.

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How using LC's for financing can benefit U.S. exporters and their buyers

Benefits to exporters

- Reduces days sales outstanding (DSO) with receipt of payment "at sight"
- Increases the marketability of products by providing buyers with the incentive of extended payment terms
- Keeps price of goods lower as the seller does not need to build in the cost for covering extended payment terms
- Maintains quality of receivables since payment assurance remains unchanged
- Strengthens relationships with buyers by allowing for extended payment terms and the availability of lower cost financing

Benefits to overseas buyers

- Improves days payable outstanding (DPO) by providing extended payment terms
- Reduces the cost of credit where the discount rate on the UPAS L/C is lower than the local borrowing rates for import/working capital loans
- Provides an additional source of liquidity
- Keeps the price of goods and associated import duty fees lower as the seller does not incur any cost for the extended payment terms
- Strengthens relationships with sellers by allowing for payment at sight

Sample transaction – Importer pays discount interest

Example:

$11,250 Cost to buyer for a local working capital line of credit
($300,000 at 7.5% p.a. for 180 days)

$3,750 Cost to buyer for Discounting LC
($300,000 at 2.5% p.a. for 180 days)

$7,500 Potential savings for your buyer on their financing costs

Assumptions

- Draft amount: $300,000
- Payment terms: 180 days
- Local working capital loan rate: 7.5% p.a.
- Costs associated with UPAS L/C
  - Discount rate LIBOR (2%) + 0.50% per annum
  - Note possibility of additional charges from issuing bank
- L/C verbiage specifies that applicant (buyer) assumes responsibility for the discount charges

Zero cost impact to exporters

Under this scenario, the buyer's extended payment terms have no cost impact to the U.S. exporter. The buyer pays its issuing bank at the end of the payment term. Payment is made "at sight" without recourse to the exporter.

Letter of Credit - Exporter pays discount interest

Letter of Credit Discounting - Offer your buyer a price "menu"

Current "at sight" sale

Units sold: 3
Unit price: $100,000 per unit
Total sale: $300,000.00

Financing cost for 180 days

LIBOR (London Interbank Offered Rate) = 2.00% + 0.50% % per annum = all in rate 2.50% per annum
($100,000 per unit x 0.025 x 180 days / 360 days = $1,250 per unit)

Sale offering 180 day discount terms

Units sold: 3
Unit price $101,250.00 per unit
Total sale: $303,750.00

- **Your buyer may find these rates attractive versus their in country borrowing rates**
- **Opportunity to build in spread to increase profit**
- **Rates and availability are subject to change**
- **Issuing bank unlikely to add additional spread**

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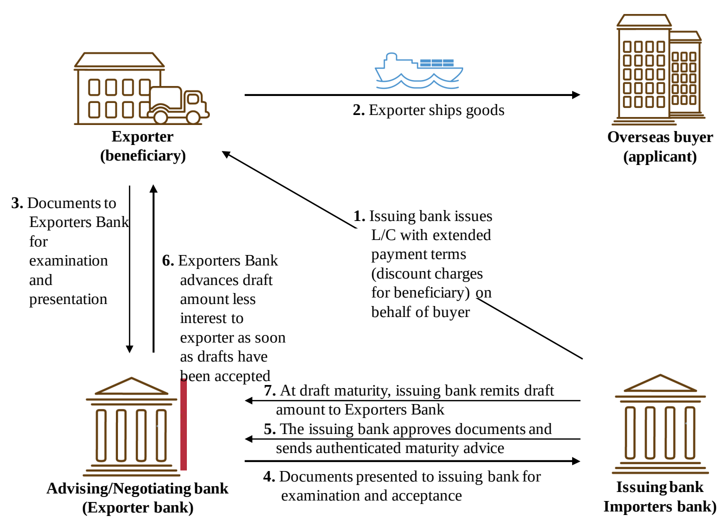
How discounted L/Cs work (Tenor terms – interest charges for EXPORTER)



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Documentary Collections

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Documentary Collections

- What is it?
  - Payment based upon the presentation and acceptance (by the buyer) of documents that convey title
  - Like an international COD with seller maintaining control of shipment
- Best Used When There Is….
  - An established, proven relationship
  - Low to moderate political risk
  - Low to moderate economic risk
  - Ocean shipment

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Documentary Collections

- AKA – Documents against payment / Cash Against Documents (CAD)/ Collections / DP or DA
- Less secure to exporter than Letter of Credit / more secure than open account
- Shipping documents (Bills of Lading) are sent to buyers bank and cannot be released to buyer until payment or acceptance.
- Recommended for ocean shipments where full set of ocean bills of lading are included with document presentation.
- Seller controls cargo for "sight" transactions, but not "tenor" transactions.
- Buyer or bank are under no obligation to make payment, so exporter may be stuck with product at overseas port.
- Can be used as financing tool for exports (Aval Drafts)

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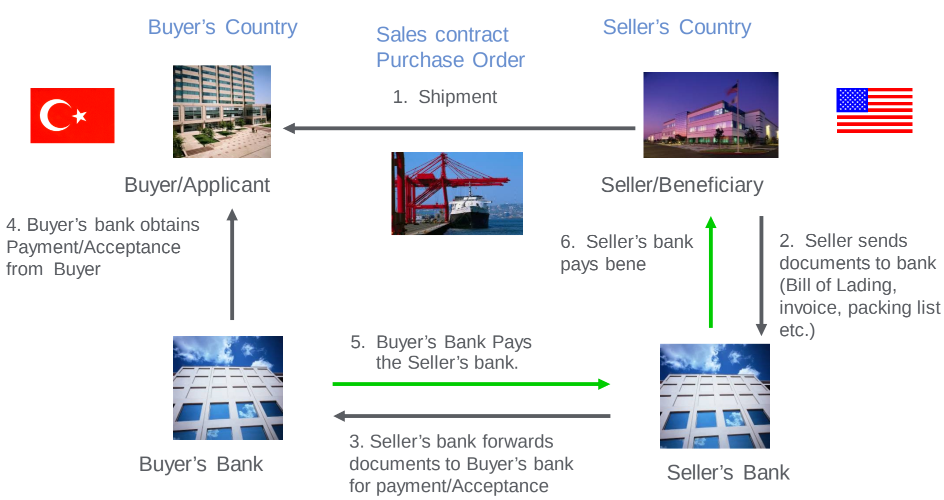
Documentary Collection Process



Includes incoming, outgoing and direct collections.

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Standby Letters of Credit

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Standby Letters of Credit

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- What Is It?
- A written obligation by a bank given to the beneficiary at the request, and on the instructions of the applicant to pay a stated sum of money within a prescribed time limit and against stipulated documents.
- A substitution of the bank's credit for the applicant's.
- Independent of underlying transaction, issuer's direct obligation.
  - Contract indicates under what conditions a draw can be made, default, non-performance or breach of contract.
  - LC indicates how the drawing is made, it is essentially an accommodation to the beneficiary to obtain funds.
  - Issuing or confirming bank must pay against presentation of complying documents.
  - Standbys can be confirmed

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Types of Standby Letters of Credit

- **Performance**
  - Supports obligation to perform under contract
- **Advance Payment**
  - Supports obligation under advance payment
- **Bid Bond / Tender Bond**
  - Supports obligation to execute Bid
- **Counter Standby / Counter Guarantee**
  - Supports issuance of separate standby or guarantee, usually for purposes of Bid performance bond
- **Financial**
  - Supports obligation to pay or re-pay money, such as a loan or debt obligation
- **Insurance**
  - Supports insurance or reinsurance obligation
- **Commercial**
  - Supports obligation of buyer to pay for goods under open account commercial transaction
- **Direct Pay**
  - Instrument intended to be primary means of payment for IRBs, used to support industrial revenue bonds

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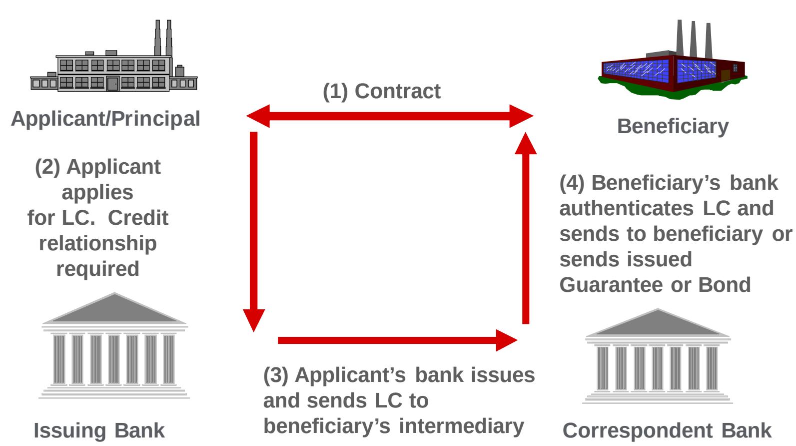
SBLC Issuance Process with Advising Bank



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Standby LC Used to Support Open Account

- For instance: open account sale - 30 days after shipment
- Buyer's Bank issues standby LC allowing seller to draw if payment not received by day 31 or later
  - LC requires draft and beneficiary's certificate of non-payment
- If payment *is* received within 30 days, LC is not used and expires
- If payment *is not* received, seller can draw under the LC and receive funds from bank
  - Documentation must comply with LC terms

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Guarantee vs. Standby LCs

- **What is the difference between guarantees and standby LCs?**
  1. The main difference between guarantees and standby LCs is the governing rule for the instrument. Guarantees are issued under local law, or the URDG758; LCs are issued under the UCP600 or ISP98.
  2. Guarantees have been in use worldwide for decades and beneficiaries have gained confidence in accepting instruments issued locally, subject to local law and local presentation.
- **What are some things to consider when issuing LCs and guarantees?**
  1. Whenever possible the customer should try and persuade the beneficiary to accept a standby L/C for their business purposes.
  2. As guarantees are subject to local law and are normally required to be issued by a local bank in the country of the beneficiary, it is more difficult to accommodate the request due to local rules and law. There may be a requirement that the applicant maintains legal representation in the beneficiary's country, for instance.
- **Are there additional risks associated with a guarantee?**
  1. A counter- guarantee standby is issued by your bank in favor of the guarantee issuing bank. This obligates to the guarantee-issuing bank, but your bank does not monitor the guarantee they issue. The guarantee is coordinated by the guarantee-issuing bank directly with the beneficiary.

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Bank Guarantees and US Law

- Guarantees, by their nature, are dependent instruments and are directly tied to the underlying transaction they support. They are most often governed by local the issuer's local law and considered as contracts. LCs offer greater independence from the underlying contract.
- In the United States a guarantee is more closely related to a surety bond than a standby LC.
- There are several characteristics of guarantees that are not allowed by the Office of the Comptroller of the Currency (OCC), and rules issued by the International Chamber of Commerce (ICC). For example, a guarantee may be open-ended without expiry, or the laws in the country of issuance do not consider a guarantee cancelled until it is returned to the issuer's counter, irrespective of the expiry date. The OCC and all ICC governing publications state that an LC (or guarantee) must have a stated place and date when the issuer's obligation ceases. Local law may not have such requirements.

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Questions ?

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