LECTURE No.7

METHODS OF PAYMENT OR SETTLEMENT

Some of the inherent risks involved in the settlement process can be reduced or eliminated depending upon the method of payment selected. Therefore it is necessary for the exporter and importer to agree upon the methods of payment and incorporate the details in the contract of sale.

There are four main Terms of Settlement in the international trade[1]:

1. Advance payment;
2. Open account;
3. Bill of collection/ Documentary collections;
4. Letter of credit.

Advance payment

Under this term of settlement the importer will pay to the exporter the goods before the exporter delivers them.

Although full payment in advance is obviously most desirable for the exporter, he will only be able to obtain such terms when there is a seller’s market, or occasionally when such terms are customary in that particular trade.

In fact, this is a credit granted by the importer to the exporter. Being a credit, the importer can ask the exporter the payment of an interest. This term is very useful for the exporter.

It is quite common for a sale contract to require partial payments in advance; for example the contract could stipulate, say, 20% payable on the signing of the contract with the remaining 80% payable after dispatch of the goods under one of the other means of payment.

The *risks of the exporter*: the goods received can be specialized goods and if the importer cancels the order before the payment is made, the exporter cannot sell these goods easily.

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[1] Davies Audrey & Kearns Martin – Banking Operations, Pitman Publishing, London 1992, p.20

The *risks of the importer*:

- sometimes the exporter does not send the goods;
- the documents can be wrong;
- the goods are sent with a delay or to a wrong destination.

This method of settlement is used between old partners with a long business relationship. Another method of advance payment can be the following:

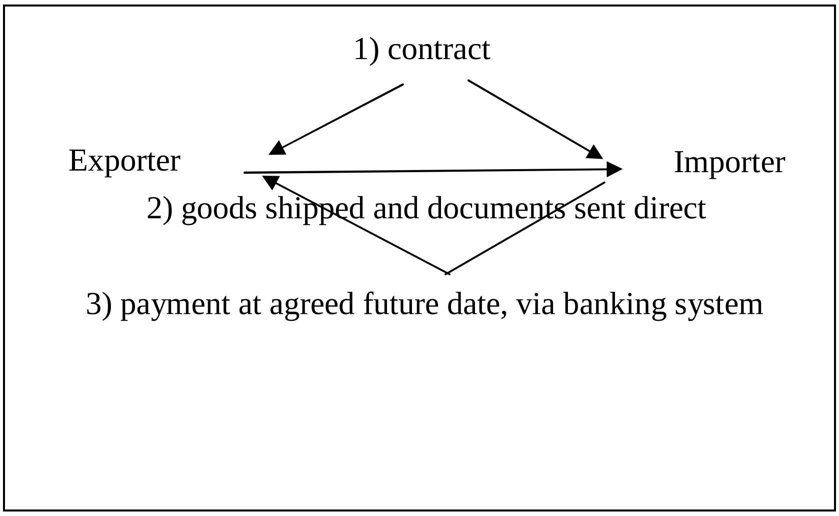
"30% of the value in advance and 70% of the value will be paid upon delivery".

Advantages to the importer:

- few arrangements have to be made other than ensuring that funds are available to meet payments when they are due;
- the importer has the control over the timing of settlement and the method by which funds are remitted;
- inspection of the goods is usually possible before payment is made.

Open account

When a buyer and a seller agree to deal an open account term, it means that the seller will dispatch his goods to the buyer and will also send an invoice requesting payment. The seller loses control of the goods as soon as he dispatches them. He trusts that the buyer will pay in accordance with the invoice.



Open account is the simplest method of settlement. However, because the exporter is delivering the goods without payment or some other absolute means of insuring that payment is received, this method presents the greatest risk.

Despite all of this, the majority of international trade transactions continue to be settled this way. Open account settlements have some advantages that make them attractive, for both the exporter and the importer, but there are disadvantages also.

The list of advantages and disadvantages that follows, for open account or other means of settlement, is not by any means exhaustive, but should be seen in the context of the needs of the two parties involved: importer and exporter.

The exporter requires payment, protection of the goods until they are paid and perhaps, financial assistance in the intervening period. The importer wants the goods to be delivered on time at the right place and of the correct quality and perhaps, with a period of credit.

Advantages to the exporter:

1. because this method of settlement tends to be used when there is a long standing relationship between the seller and the buyer, the open account balance is settled on a monthly or quarterly basis and transactions can be dealt within very much the same way as the domestic trade;

2. subject to any contract with the buyer, there are less constraints on documentation, timing of shipments and places of dispatch that make this method more feasible;

3. as only the settlement payments pass through the banking system, the exporter incurs no charges.

Disadvantages to the exporter:

1. there is no guarantee of payment and control if the goods are lost;

2. the exporter is exposed to political, economic and country risks unless other steps are taken to cover these risks;
3. because, often there is no specific constraint on the timing of the payments, it is very difficult to control the cash flow;
4. there is a possibility that delays in the banking system will delay the transfer of funds;
5. when received, payment can be in the form of a foreign cheque that will have to be negotiated or collected, causing further delay;
6. greater debtor control may be required in the form of the maintenance of a sealed ledger and sending out statements and reminders of payment due.

One method by which the exporter can reduce the risk of non-payment is relevant here and that is the use of advance payments, which involve the buyer being persuaded to provide part or the entire payment before receiving the goods.

Advantages to the importer:

1. the importer retains control over the timing of settlement and the method by which funds are remitted;

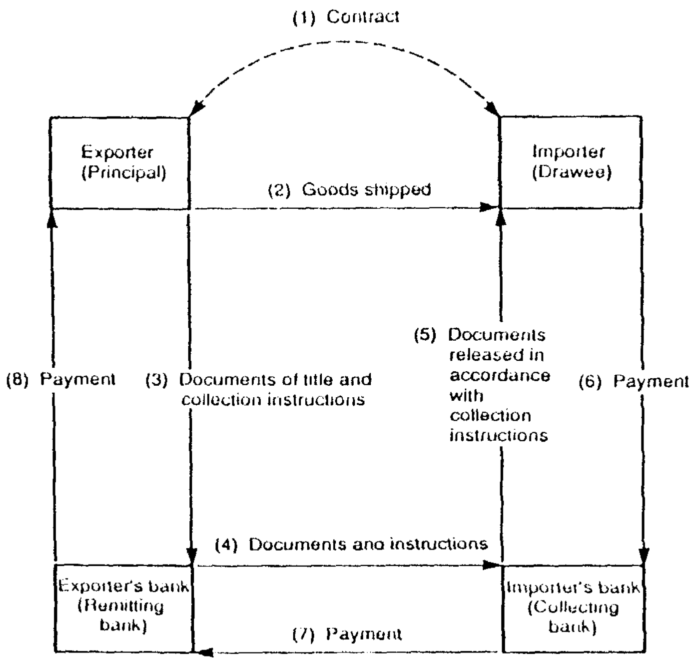
2. inspection of the goods is usually possible before payment is made.

Disadvantages to the importer:

1. the importer has little control over shipment details and the timing of the receipt of the goods;

2. there is no control over the quality of the goods. If special documents (certificates of origin) are required, there is no guarantee that these will be received.

Documentary collections



Parties to a documentary collection are:

- **the principal** (*exporter*). This is the customer who entrusts the operation of collection to his bank;
- **the remitting bank**, or the exporter's bank. This is the bank to which the principal entrusts the operation of collection;
- **the collecting bank**, or the importer's bank. This is the bank involved in processing the collection order;
- **the presenting bank** is the collecting bank which makes presentation to the drawee;
- **the drawer** (*importer*). This is the one to whom presentation the payment is to be made according to the collection order.

Under the provisions of the Uniform Rules for Collection, the handling of documents by banks or instructions received in order to:

- obtain acceptance and/or, as the case maybe, payment, or
- deliver commercial documents against acceptance and/or, as the case maybe, against payment, or
- deliver documents on the other terms and conditions.

This method of settlement[2] provides some comfort to the exporter, who will ship the goods and then arrange for the documents of title and collection instructions to be sent by the exporter's own bank (remitting bank) to a correspondent bank (the collecting bank) in the importer's country. The documents may include a bill of exchange drawn by the exporter on the importer for the amount of the invoice and payable at sight or at a fixed or future determinable time (under British law).

The documents of title are usually sent via the following route:

(a) The exporter ships the goods and obtains documents of title;

(b) The exporter sends documents of title to his bank with appropriate instructions;

(c) The exporter's bank sends documents of title to the importer's bank with the instruction that the documents can only be released:

  (i) on payment; or

  (ii) on acceptance of the bill of exchange.

(d) On payment or acceptance of the bill of exchange, the importer's bank releases the documents of title so that the importer can obtain the goods on their arrival in his country.

It can be seen that the exporter retains control over the goods under this method until either payment is made, or a legally binding undertaking to pay is given.

Where the Bill of Exchange is not accompanied by documents, these having been sent to the importer, the transaction is known as a clean collection. The collecting bank will be instructed to release the documents and, therefore, title to the goods, to the importer against payment (D/P) or acceptance (D/A) of the bill of exchange. Payment or the accepted Bill of Exchange will be sent to the remitting bank that will, in the latter case, present it for payment on the maturity date.

As a conclusion, it should be mentioned that the documentary collection is a form of making payment and ensuring payment through banks, and the documents involved in the carrying out the transactions will be delivered on certain terms and conditions.

As you have already seen, the documentary collection transactions are handled on the basis of the following documents:

[2] Negruş Mariana – Mijloace şi modalităţi de plată internaţionale, Editura Academiei, Bucureşti, 1986, p. 45

- *Documents against Payment (D/P).* The exporter takes the goods for shipment and the collecting bank may only deliver the documents to the importer in exchange of his immediate payment (at sight). **Or**
- *Documents against Acceptance (D/A).* The exporter takes the goods for shipment and the collecting bank may only deliver the documents against acceptance of a draft issued by the drawee (importer).

There is a code of practices and procedures governing the terms used and the procedures to be followed by all parties involved in documentary collections. It was drawn up by the International Chamber of Commerce and is known as Uniform Rules for Collections No. 522. The rules cover the liabilities and responsibilities of the parties, and such things as presentation, payment, acceptance, promissory note, receipts and other instruments, protest, case of need and protection of goods, advice of fate, interest charges and expenses. The Uniform Rules for Collections (URC – see Annex No.1) form an internationally accepted code of practice covering documentary collections. The Rules are not incorporated in national or international law, but become binding on all parties because all bank authorities will state that the collection is subject to the Uniform Rules for Collections.

Summary of the provisions of the Uniform Rules for Collections:

(a) The four main **parties** to a documentary collection are:

(i) the principal, i.e. the exporter;

(ii) the remitting bank. This is the bank to which the principal entrusts the collection order. This is normally the exporter's own bank.

(iii) the collecting bank. This is any bank other than the remitting bank which is involved with the collection. Normally this will be a bank in the importer's country.

(iv) the presenting bank. This is the bank which notifies the drawee of the arrival of the collection and which requests payment or acceptance from him or her. The collecting and presenting bank will normally be the same bank, but they could be different banks.

(b) **Documents** are of two types:

(i) financial documents – the instruments used for the purpose of obtaining money (e.g. bills of exchange).

(ii) commercial documents – the documents relating to goods for which the financial documents are to secure payment (e.g.: bill of lading, insurance document).

Clean collections represent financial documents which are not accompanied by commercial documents.

Documentary collections represent commercial documents which may or may not be accompanied by financial documents.

(c) **Articles 1 and 2** state that banks will act in good faith and exercise reasonable care. Banks must verify that they appear to have received the documents which are specified in the collection order.

(d) **Banks have no liability for any delay or loss caused by postal or telex failure.**

(e) **Duties of the remitting bank:**

- to check the principal's collection instructions;
- to check that the presented documents are complete;
- to pass on the principal's instructions to the collecting bank/presenting bank;
- to monitor the operation collection.

(f) **Duties of the presenting bank:**

- to confirm receipt of the documents;
- to present the documents to the drawee in strict compliance with the collection instructions (D/P or D/A);
- in the case of D/P, to effect payment to the remitting bank in accordance with the latter's instructions;
- to notify the remitting bank that the draft has been accepted at its maturity date, or, if requested, to return the bill to the remitting bank,

(g) etc.

Advantages to the exporter[3]*:*

1. the exporter has some measure of control over the documents and goods unless there is no document of title and/or the goods consigned direct to the importer or the importer's agent;

2. if the exporter has to pay charges for the collection, allowance for these, including interest, can be computed when the invoice price is calculated;

3. this method is less expensive than a documentary credit.

Disadvantages to the exporter:

1. if control is not retained through the documents of title, the exporter relies entirely on the ability and willingness of the importer to pay;
2. if documents against acceptance (D/A) terms are granted to the importer, control of goods is lost once the bill of exchange has been accepted.

Advantages to the importer[4]:

1. a period of credit can be obtained through the use of a term bill or promissory note;
2. the exporter will normally be responsible for the charges;
3. finance can be raised using the goods as security;
4. it is more convenient and less expensive than a documentary credit.

Disadvantages to the importer:

1. payment or acceptance is required on presentation when the commercial documents have arrived at the collecting bank and before the arrival of the goods;
2. if the bill is accepted the importer is legally liable despite, for example, any clauses in the contract relating to defective goods;

[3] Twells Harry – Exporters' checklist, a step-by-step guide to successful exporting, National Westminster Bank, Lloyd's of London Press LTD, 1992, p. 160
[4] Idem

3. there is no guarantee that the goods will be received as ordered or on time.

Definition, parties to the documentary credit, and the basic steps of making a payment by documentary credit

The requirement for the letter of credit will be included in the contract between the exporter and the importer, and when the letter of credit is issued it should describe the documentary requirements demanded from the exporter.

Bankers' documentary letters of credit provide a means by which an exporter can get his money safely before the goods are received by the importer. For the exporter this is, in fact, a guarantee of payment that is nearly as good as getting paid in advance.

For the importer it is better than paying in advance because by specifying the documents that the exporter must produce, the importer retains some control over the goods. For example, inspection certificates can be requested to try to make sure the quality of the goods is acceptable.

What is *a letter of credit*?

A *documentary credit*[5] can be simply defined as a conditional guarantee of payment made by a bank to a named beneficiary, guaranteeing that payment will be made, provided that the terms of the credit are met. These terms will state that the beneficiary must submit specified documents, usually to a stated bank and by a certain date.

The *letter of credit*[6] is a letter or other authenticated communication addressed by one bank (at the request of its customer) to another bank requesting the bank to whom it is addressed to make payments to (or advance payment to) or accept or negotiate bills of exchange (drafts) to or to the order of a third person (known as the beneficiary) either against stipulated documents or upon condition that all the other terms and conditions of the credit are complied with or upon the performance (or non-performance in the case of stand-by credits) of any other act by the said beneficiary.

In most banks throughout the world, documentary credits are governed by a code of practice drawn up by the International Chamber of Commerce Commission on Banking Techniques and Practice.

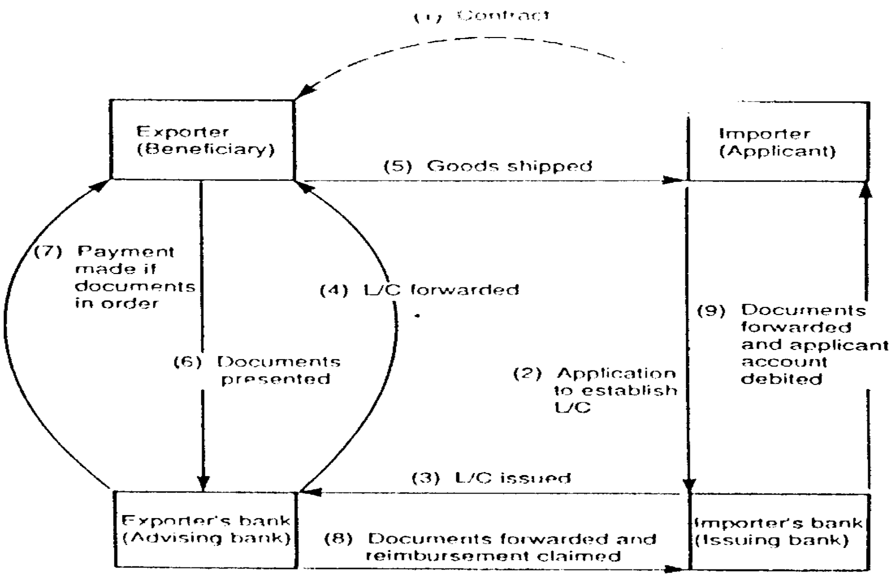
[5] Watson Alasdair – Finance of international trade, 4th edition, The Chartered Institute of Bankers, London, 1990

The code is called “The Uniform Customs and Practice for Documentary Credits” or “UCP” for short. It was last revised in 2007 ICC Publication No. 600, applicable since 2008, January 1. Under the provisions of the "UPC”, a documentary credit is defined as:

“An arrangement between a customer and a bank to make payment to, or to the order of the beneficiary,

- or to pay or accept Bills of exchange drawn by the beneficiary,
- or to authorise another bank to effect such payment, or to pay, accept, or
- negotiate such bills of exchange,
- against stipulated documents, provided that the terms and conditions are complied with”[7].

The general procedure is that the importer’s bank (issuing bank) issues at the request of the importer (applicant) a credit in favour of the exporter (beneficiary). The exporter may be advised directly but normally will be advised of the credit through a bank (advising bank) in his own country.



The basic steps of making a payment by documentary credit are as follows:

- ♦ A contract is made between an importer in one country and an exporter in another in which it is agreed that payment will be made by documentary credit.
- ♦ The exporter prepares the goods for export.

[6] Aurey Davies & Martin Kearns – Banking operations, Pitman Publishing, London, 1992, p. 55.
[7] Article 2 of UPC.

- ♦ The importer arranges the documentary credit by applying to his bank for a letter of credit to be issued.
- ♦ The importer's bank (issuing bank) draws up the letter of credit (if it considers the importer is creditworthy) including in it the details of the documents that the exporter will have to provide. The letter is sent to the exporter's bank.
- ♦ The exporter's bank (the advising bank) advises the exporter that the letter has been received and the exporter than provides the documents to show that the goods have been sent. By providing documents that comply exactly with the terms of the letter of credit the exporter can be sure of payment, guaranteed by the bank that has issued the letter of credit. In some cases the contract between exporter and importer will arrange for a bank in the exporter's country to add its guarantee or confirmation that payment will be made; such a bank is known as *a confirming bank.*
- ♦ The exporter sends the goods to the importer.
- ♦ The exporter presents the documents showing that the goods have been sent to his bank.
- ♦ The exporter's bank checks the documents and if they are:

  A) completely correct - payment is made to the exporter and the documents are sent to the importer's bank which will then pay back the exporter's bank;

  B) almost correct - payment can be made to the exporter after taking an indemnity from him by which he promises to repay if the documents are refused;

  C) incorrect - the exporter will have to get new documents or send the wrong documents for collection, which will mean a delay in getting paid.
- ♦ If the documents are correct the importer's bank will pay the exporter's bank as agreed in the letter of credit by one of the three basic methods of payment: draft, mail transfer or urgent transfer.
- ♦ The importer will receive the documents and collect the goods.

The kind of documents used in a documentary credit are generally the same kind of documents used for collections (insurance documents, invoices and transport documents) but a variety of other documents may also be requested.

As you have already seen, the parties involved in the documentary credit are:

1. ***The applicant.*** The importer or applicant is responsible for the setting up of the credit. He will complete a bank application form detailing the terms and conditions the beneficiary will have to meet to obtain payment. The terms and conditions will generally consists of:

   - how much is to be paid and when
   - a description of the goods
   - a list of shipping documents to be presented by the beneficiary
   - dates within which goods must be shipped and documents presented.

   The application is the request by the applicant for the issuing bank to undertake to pay the beneficiary on his behalf.

2. ***The issuing bank.*** This will normally be the applicant's own bank. Initially they must decide if they are prepared to issue an undertaking on behalf of their customer. Once the credit has been issued they will have to pay even if the applicant can not. The issuing bank will also verify the application to make sure:

   a) the terms and conditions are clear and concise;

   b) that its own rules, and any exchange control rules have been satisfied.

3. ***The advising bank.*** This is the bank, which receives details of the credit from the issuing bank. The advising bank will check the credit for:

   a) authenticity;

   b) feasibility;

   c) exchange control regulations.

Before passing on the beneficiary.

4. ***The beneficiary.*** This is the exporter (or seller of the goods) who probably insisted on a credit in the first place. On receipt of the credit he should verify that it agrees with the contract, and that he can comply with the conditions. The beneficiary should have in his hands an undertaking by a bank that payment will be made.

Types of credits

All types of credits should be issued as a subject matter of the Uniform Custom Regulations of the International Chamber of Commerce.

A documentary credit: It involves payment or acceptance or negotiation against stipulated documents, provided that the terms and conditions of the credit are complied with.
Since over 99% of all credits handled at branch level are documentary credits we shall talk more about these ones.

Credits are classified as either *irrevocable* or *revocable*.
A *revocable credit* may be cancelled or amended at any time without prior notice being given to the beneficiary. This type of credit is rare.

Some *characteristics of revocable credits*:

a) A revocable credit *cannot be confirmed*.

b) The advising bank should advise such revocable credits to the beneficiary with the following phrase added: "*Without engagement on the part of the advising bank*."

c) The issuing bank *can cancel such a credit* provided that, prior to receipt of advice of amendment or cancellation of the said credit, the beneficiary had not submitted the "stipulated documents" under the credit for payment, acceptance or negotiation.

An *irrevocable credit* constitutes a definite undertaking by the issuing bank to make payment without recourse. Irrevocable credits can only be amended or cancelled with the agreement of all parties. Irrevocable credits can be either *confirmed* or *unconfirmed* by the advising bank.
This is the most common form of letter of credit used in international transactions, and it is defined, as constituting in Uniform Custom: "a definite undertaking of the issuing bank provided that the stipulated documents are presented and that the terms and conditions of the credit are complied with:

A – if the credit provides for sight payment – to pay;

B – if the credit provides for deferred payment – to pay or to provide that the payment will be made on the date(s) determinable in accordance with the stipulations of the credit;

C – if the credit provides for acceptance – to accept drafts drawn by the beneficiary if the credit stipulates that they are to be drawn on the issuing bank;

D – if the credit provides for negotiation – to pay without resource the drawer and/or bona fide holders, drafts drawn by the beneficiary at sight or at a tenor, on the application for the credit or on any other drawee stipulated in the credit other than the issuing bank itself.

Characteristics of irrevocable credit:

- an irrevocable credit *can only be amended or cancelled* with the consent of all the parties to the credit;
- once *the exporter has complied with* the terms and conditions of the irrevocable credit and has submitted the "stipulated documents", *he will receive payment* (or acceptance) from the issuing bank;
- where an irrevocable credit is routed through another bank located in the country of the beneficiary (exporter/seller), the bank that notifies the terms and conditions of the credit to the beneficiary is known as the advising bank;
- where an advising bank either declines confirmation or is not asked to confirm an irrevocable credit, its role is confined to that of agent of the Issuing Bank. Its mandate is to follow the instructions given by the issuing bank.

Irrevocable confirmed credits

It is, as the title implies, a type of credit carrying "the definite undertaking" of two banks: the definite undertaking of the opening bank and the confirmation of the opening bank's commitment by another bank known as the confirming bank.

Therefore "when an issuing bank authorises or requests another bank to confirm its irrevocable credit and the latter does so, such confirmation constitutes a definite undertaking of such a bank (the confirming bank) in addition to that of the issuing bank, provided that the stipulated documents are presented and that the terms and conditions are complied with:

A – if the credit provides for sight payment – to pay;

B – if the credit provides for deferred payment – to pay or to provide that payment will be made on the date(s) determinable in accordance with the stipulations of the credit;

C – if the credit provides for acceptance – to accept drafts drawn by the beneficiary if the credit stipulates that they are to be drawn on the confirming bank, or to be responsible for their acceptance and payment at maturity if the credit stipulates that they are to be drawn on the applicant for the credit or any other drawee stipulated in the credit;

D – if the credit provides for negotiation – to negotiate without recourse to drawers and/or bona fide holders, draft(s) drawn by the beneficiary at sight or at a tenor, on the issuing bank or on the applicant for the credit or on any other drawee stipulated in the credit other than the confirming bank itself.

Characteristics of irrevocable confirmed credits:

a) when an advising bank agrees to add its confirmation to an irrevocable credit, it adds the following clause to the credit: "*This credit bears our confirmation* and we shall accordingly honour your drafts on us on due presentation if accompanied by documents as stipulated by and in compliance with the credit terms and conditions."

b) with such a confirmation, the *beneficiary* of the irrevocable confirmed credit *has the engagement* of the banking institutions in the two countries;

c) this type of credit *is most favourable to the exporter* as he is assured of payment or eventual settlement in his own country provided that he submits the stipulated documents and complies with all the other terms and conditions of the credit.

d) where an advising bank, upon being asked to add its confirmation, is unable to do so, "it must so inform the issuing bank without delay".

e) amendments or cancellations of any of the terms and conditions embodied in the irrevocable confirmed credit cannot be made "without the agreement of the issuing bank, the confirming bank and the beneficiary".

f) partial acceptance of amendments contained in one and the same advice of amendment is not effective without the agreement of all the above mentioned parties.

Sight credits. These allow for payment to be made as soon as documents are presented.

Deferred Payment Credit. This type of credit is becoming increasingly popular. It allows for payment at a future date without calling for a Bill of Exchange. The terms of such credit would state for instance: "available against presentation of the following documents….but payable only…..days after date of invoice. Bill of lading. Presentation date, etc"[8]

The provisions of UCP mention some specialised credits, such as:

Transferable credit. It is one that can be transferred by the original beneficiary to one or more second beneficiaries. It is normally used when the first beneficiary does not supply or manufacture

[8] See UCP

the goods himself, but is a middleman and thus wishes to transfer part, or all of his rights to the actual supplier or manufacturer. This type enables the middleman to give the supplier an undertaking from a bank to pay, against which they would probably be prepared to supply the goods. Without a transferable credit, a middleman of little financial standing would probably not be able to get a bank to issue such an undertaking, and so the deal would probably fall through.

This type of credit can only be transferable once, i.e. the second beneficiary does not have the right to transfer the credit to anyone else.

Back to back credits. Under the "Back to back" concept, the beneficiary of the first credit offers it as "security" to the advising bank for issuance of the second credit.

Red clause credits. The so-called "Red clause" credit incorporates a special concession to the beneficiary allowing the advising bank to advance a percentage of the total credit amount before presentation of shipping documents. The clause was originally written in red ink to draw attention to this special condition.

Revolving credit. It is one where the amount can be renewed or reinstated without specific amendments to the credit being needed. The purpose of a revolving credit is to replace a series of credits to the same beneficiary, and be able to control the size of shipments at any one time.

Standby credits. This type of credit (is referred to in Articles 1 and 2 of UCP) can be issued by a bank on behalf of a customer and in favour of an overseas party in the same manner as an ordinary credit except that it will not call for payment, acceptance or negotiation by it or an overseas advising/confirming bank; instead it is payable against a simple document (e.g. confirmation of shipment, simple receipt, etc.) and is irrevocable. This type of credit serves to act as a guarantee by the issuing bank to the overseas beneficiary against defaults by its applicant customer.

As you can see, the basic forms of documentary differ in respect of the degree of security they provide for the beneficiary. Credits are further classified into various types according to the method of settlement employed. There are also special arrangements involving combinations of separate credits or the assignment of credit proceeds.

General practice points on documentary credits

The International Chamber of Commerce, in its last issue, has warned customers to refrain from any of the following acts:

- calling for documents which the beneficiary cannot obtain;
- requiring inclusion, in a stipulated document, of particulars that are not within the issuer's knowledge;
- stipulating conditions whose observance cannot be ascertained from the face of the documents.

The *following particulars* must be adequately *provided in the application form*:

- ❑ Applicant's name, full postal address (including postal code, where this available);
- ❑ Date on which credit application form is filled in and submitted should be inserted;

- ❑ Date and place of expiry of the credit should be clearly inserted:
  - Date: "all credits must stipulate an expiry date". However "if the expiry date falls on a day on which the bank to which presentation has to be made is closed for reasons (…), the expiry date will be extended to the first following business day on which the said bank is open."
  - Place: this is interpreted to mean the city or country where the credit is to be available.
- ❑ Beneficiary: this is often, but not always, the seller of the goods. The applicant to the credit should provide his name and full postal address (together with postal code). Where the credit is to be teletransmitted; his telex number, fax number or other similar details must be indicated on the application form.

  The name of the beneficiary must be spelled accurately; his address must also be correct. (Incorrect or suspicious addresses can be a warning signal).

  Finally, the applicant would have satisfied himself as to the "reliability, standing, trustworthiness, performance ability and record of the beneficiary to be" although this is not of direct concern to the issuing bank.
- ❑ Methods of transmitting the credits:

  Is the credit to be transmitted by AIR MAIL preceded by a brief teletransmission advice?

Is the credit going to be teletransmitted by: cable, telegram, telex, facsimile, data communication network (such as SWIFT)?

Where the teletransmission is the operative credit instrument, the beneficiary can draw drafts and present documents under the credit and the nominated bank can pay or accept or negotiate drafts against the stipulated documents.

- Confirmation

  The parties to the sales contract must have agreed, in advance, whether the credit is to be irrevocable or revocable and whether the irrevocable credit should be confirmed by another bank.

- Transferable:

  In order to be transferable, a credit must have been expressly designated "transferable" by the issuing bank.

- Amount of the credit:

  Like cheques, the amount of the credit must be expressed in both words and figures.

- Bank at which the credit is to be available:

  A bank should always be nominated in every letter of credit, with authority to:

  - pay (paying bank);
  - accept drafts drawn on it (accepting bank);
  - negotiate (negotiating bank), unless the credit allows negotiation by any bank.

- Method of payment under the credit:

  A credit is to indicate clearly the way of payment. The credit applicant should therefore indicate, on the application form, whether the credit is to be available by sight payment, deferred payment, and acceptance or by negotiation.

- Are partial shipments to be allowed?

  Partial shipments are allowed unless the credit clearly indicates otherwise. In order to avoid any doubt, the credit applicant should write either "partial shipments allowed" or "partial shipments not allowed".

- Are trans-shipments allowed?

  The applicant's attention should be drawn to the question of trans-shipment.

- Documents required to be submitted under the credit.

The credit applicant should specify the types of documents, which must be submitted by the beneficiary to the paying/accepting/or-negotiating bank. The following types of documents are presented to banks in credit operations:

A. Drafts-i.e. Bills of Exchange drawn by the beneficiary at sight or at a tenor (30,60,90 or 180 days after sight);

B. Commercial invoice

"Unless otherwise stipulated in the credit, Commercial invoices must be made out in the name of applicant for the credit"; furthermore, the description of the goods in the commercial invoice must correspond with the description of the credit.

C. Transport documents required

These will depend on the mode of transportation to be used:

- By Air (Air Consignment note or Air Waybill);
- By Post (Air or Surface Mail);
- By Rail(Rail waybill or Rail Consignment Note);
- By Road;
- By inland waterway;
- By sea (marine bill of lading);
- By combined transport (by both rail and sea). A combined transport document should be called for.

A. Insurance documents to be submitted under the credit.

"Insurance documents must be as stipulated in the credit and must be issued and/or signed by insurance companies or underwriters or their agents".

"Cover notes issued by agents will not be accepted, unless specifically authorised by the credit".

B. Other documents to be submitted under the credit:

- certificate of origin;
- certificate of analysis;
- packing list;
- weight list, etc.

- Presentation period:

  The credit applicant's attention should be drawn to the provisions of Uniform Custom regulations that state that every credit which calls for a transport document should also stipulate a specified period of time after the date of issuance of the transport document within which the documents must be presented for payment, acceptance or negotiation.

  In all cases, the documents must be presented no later than the expiry date of the credit, even if the documents presentation period has not expired.

- Mode of settlement of indebtedness under the credit.

  The credit applicant should indicate how payments, acceptances and negotiations under the credit are to be settled. Usually, the applicant authorizes the issuing bank to "debit my/our account no. …" or, where forward exchange contracts has been concluded "debit my/our account no. … utilizing forward contract no. …".

- Signature of the credit application form.

  Each credit application form should be duly signed and dated by the applicant or his accredited officer. The reverse side of the form may also require signing as an acknowledgement of the Conditions under which the bank will grant the credit.

General rules

In credit operations all parties concerned deal in documents and not in goods, services and/or other performances to which the documents may relate.

Therefore, indeed the examination of "stipulated documents" is the most important function of the branch staff of a bank charged with the task of handling documentary credits.

Failure to keep in view the terms and conditions of the letter of credit can result in the following discrepancies that cause unnecessary delays in making payments under credits:

- late presentation of documents, the letter of credit having expired;
- late presentation of documents within the time scale laid down in the credit even though the credit itself may not have expired;
- late shipment;
- the description of the goods on the invoices is not the same as that one stated in the letter of credit.

Presentation of documents

Customers should always ensure that the credit documents are presented to the branch office or specified department of the bank that originally advised the credit.
Delivery of the credit documents to the wrong branch or section of the bank could result in delays in making payments.

The presenter of the credit documents must give precise instructions regarding the way of payment (by cheque, or Banks draft, by crediting an account – the number of the account and the branch and bank should be provided).

Other problems that may arise in the presentation of documents are:

- The bills of exchange (or draft) are incorrectly drawn or not endorsed.
- The documents presented do not bear any relationship one to the other and can be said to be inconsistent with one another.
- When bills of lading are presented and the "shipped on board" notation is not signed or even dated by an authorised official.
- When airway bills (Air Consignment Note) are to be presented under the credit, but they are not signed as agent for the carrier.
- When some documents called for under the credit are missing.
- When the insurance documents show an incorrect insurance value or the risks to be insured under the credit are not covered.

Settlement procedures

Once the branch has adequately completed the examination of the stipulated documents, the settlement may be by means of: payment, acceptance or negotiation.

Conclusions

The two fundamental principles of documentary credit practice are:

- the independence of the credit from the underlying contract and,

- the requirement that documents strictly comply with the terms of the credit.

A. Independence of the documentary credit from the underlying contract. The documentary credit is completely independent of the underlying contract. If the exporter fulfils the documentary obligations, payment must be effected according to the terms of the credit, regardless of disputes connected to the underlying contract.

   It is essential that all parties remain confident that issuing or confirming banks will respect their payment commitments.

B. Strict compliance. The terms of the documentary credit must be strictly adhered to as the doctrine of strict compliance. This means that documents presented under the credit must conform very precisely to the terms of the credit.

Advantages and disadvantages to the exporter and importer involved in L/C

The main advantages to the exporter are[9]*:*

- ❖ dependence on the credit worthiness of an importer is replaced by dependence on a bank.
- ❖ if the credit is confirmed by a bank in the exporter's country, the exporter is no longer subject to country risk.
- ❖ if the credit is an irrevocable form it cannot be cancelled without the exporter's express agreement, but notice of revocation can be rejected if received after shipment.
- ❖ the documents and therefore the goods will not be released until payment or a commitment to payment is made.
- ❖ when credit has been allowed, the Bill of Exchange will have been accepted by a bank and can, therefore, be used to obtain finance by discounting.

The main disadvantages to the exporter are:

- the exporter has to produce the correct document, accurate in every detail. Even small discrepancies can cause delay.
- if in revocable form the credit could be cancelled between shipment and payment.
- where the advising bank does not have immediate access to reimbursement by the issuing bank, payment may delay.

The main advantages to the importer are:

- the importer can provide for stringent documentary requirements.
- because the exporter is more reassured of receiving payment, the importer may be able to negotiate better terms on the purchase of the goods.
- the importer can control the timing of the shipment and the destination.
- there is reassurance that no funds will be paid unless documents of title are received and are correct.
- protection is provided by the Uniform Customs Practice for Documentary Credits.

The main disadvantages to the importer are:

- because the banks only deal with in the documents and not the goods, the provide no protection against poor quality, or defective or incorrect goods.
- if the credit is irrevocable, it cannot be cancelled without the consent of the exporter.
- the importer takes on the liability of the credit and remains liable regardless of any changes in circumstances.
- documentary credits can be expensive, although the importer can attempt to pass the charges on through increased prices.

Documentary collections and documentary credits

Although there are certain similarities between documentary collections and documentary credits there are also important differences. These are summarised in the following table:

Collections	*Credits*
1. The exporter (principal) requests the bank to handle the collection.	1. The importer (applicant) requests the bank to issue a letter of credit.
2. The exporter controls what banks can do by what is included in the collection order.	2. The importer controls what banks can do by specifying documents required

[9] Aurey Davies & Martin Kearns – Banking operations, Pitman Publishing, London, 1992, p.60

3. For the exporter, obtaining payment depends on the importer's ability to pay.	3. For the exporter, obtaining payment depends on producing the correct documents and on the credit worthiness of the bank which has agreed to pay.
4. For the importer, getting the documents usually depends on paying or accepting a bill of exchange.	4. For the importer, the commitment to pay arises when an application is made. Obtaining the documents requires no further formalities.

The range of methods of settlement

You need to pay special attention to collections and documentary credits because they are complicated, but they are only two of the possible choices which importers and exporters can make about the payment terms for settling a debt.

The following list shows the options, which are available. From the exporter's point of view these are shown in order of decreasing risk, the most "dangerous", first. The risk increases from an importer's point of view.

1. Consignment of goods (which means sending them abroad without having a definite sale arranged and waiting for payments as goods are sold).
2. Open account trade (which means goods are sent and payment is made at intervals).
3. Documents sent direct to the importer with payment to be made when they are received (which gives the exporter no control).
4. Collections.
5. Documentary credits.
6. Payment in advance (which means the exporter gets his money before sending goods, and may have a period of credit during which the money can be used to make or purchase the goods to be exported).