

# Documentary Credits

## Security of settlement through documentary credit

With the exporter's interest in optimising security for the payments he is to receive, especially those from the faraway markets, interest in using documentary credits is still increasing.

By using a documentary credit, an exporter is certain of receiving payment at the agreed time, and of having a source of finance.

The importer, who is the party arranging for the issue of the documentary credit, will often obtain advantages such as a reduction in price, a source of finance and prompt delivery.

## What is a documentary credit?

In international trade, the following methods of settling payment are the most common:

- by cheque
- by transfer
- by collection
- by documentary credit (D/C), which is known also as a letter of credit (L/C)

Settlement by cheque or by transfer are the methods used where payment for trade transactions is arranged by open account. Settlement by collection or documentary credit are the methods used, where an exporter wishes to satisfy himself that payment is made for the goods supplied, before the importer receives them.

### **A documentary credit is a method of payment**

A documentary credit ensures that the exporter trading on a cash basis receives payment upon shipment of the goods.

### **A documentary credit is a source of finance**

The terms of a documentary credit may stipulate payment at a fixed future date, at which time the exporter is certain of payment

### **A documentary credit is a kind of "guarantee"**

The issuing bank undertakes to pay the exporter when he meets the terms of the documentary credit, as stipulated by the importer.

By issuing a documentary credit, a bank (the issuing bank) takes over the payment obligation of the importer. By meeting the terms of the documentary credit, the exporter changes his claim from a claim on the importer to a claim on the issuing bank. The common procedure is for the documents and the payment to be handled through the exporter's bank (the advising bank). The payment is made to the exporter, when he presents the required documents to his bank.

## The advantages of a documentary credit

### **Why use a documentary credit?**

In bygone days, when foreign trade was merely the buying and selling of goods by the masters of the vessels of the big trading houses, there was no need for documentary credits.

As foreign trade grew in complexity, the documentary credit became a useful and increasingly popular method of payment. Today, it is used extensively and employed, in particular, when the exporter is unfamiliar with the importer, and therefore reluctant to dispatch the goods without being certain of receiving payment.

In many countries, a documentary credit is the only method by which payment for imports is permitted. This may be because import licences are administered by the central banks of the countries concerned.

The advantages of a documentary credit, as a method of settling payment, clearly favour the exporter.

### **Advantages to the exporter**

- His claim changes from being a claim on the importer to being a claim on the issuing bank
- He is certain of payment at the time agreed upon
- He receives payment at his own bank or at a bank in his own country
- His liquidity improves
- He can use the documentary credit as collateral with his suppliers
- He has a source of finance
- He can have funds immediately available, in addition to an existing credit line by having his claim discounted

Conversely, the Importer has the following advantages:

### **Advantages of the importer**

- He may obtain credit
- He may obtain a price reduction because of the certainty and promptness of payment
- He has the near certainty of delivery on the agreed date

## International code

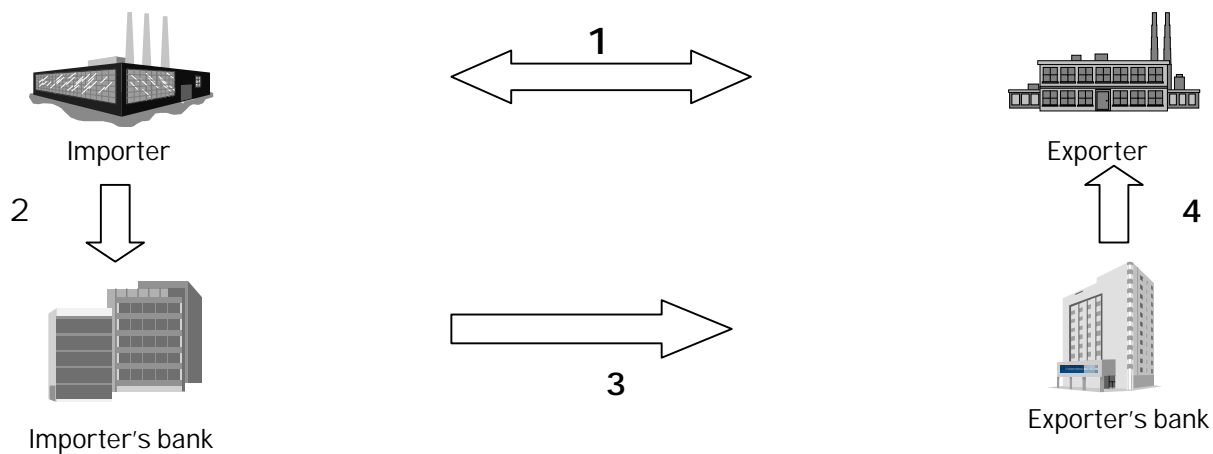
The International Chamber of Commerce (ICC) in Paris has drawn up the Uniform Customs and Practice for Documentary Credits. Documentary credits, which are subject to this code, are alone among international payment and guarantee transactions in being subject to a code of practice that includes a definition of the payment obligations of banks and is recognised worldwide.

As said, the code stipulates the obligation of a bank to make payment under a documentary credit, and it stipulates a bank's obligations in relation to the processing of the documents under the documentary credit.

Note should be taken that a bank is solely concerned with the documents, and not with the goods, or the project, referred to in the documents. Furthermore, its concern with the documents is limited to the terms of the documentary credit. No sales contract or agreement, even if referred to in the documentary credit, will entail or imply liability on the part of the bank.

## How to issue a documentary credit

There are different types of documentary credits. The exporter and importer should consider and agree on the type to be used, and on its terms. They would be well advised to seek the advice of their bankers when they draw up the sales contract.



1. The exporter and the importer conclude the sales contract with payment to be arranged by documentary credit
2. The importer instructs his bank (the issuing bank) to issue a documentary credit in favour of the exporter (the beneficiary) to be advised through the exporter's bank (the advising bank)
3. The importer's bank sends the documentary credit to the exporter's bank
4. The exporter's bank advises the exporter of the issue of the documentary credit

## **Summary of procedure**

The importer (the applicant) sends an application to his bank for the issue of a documentary credit. The information he gives on the application form must specify the total amount for which the documentary credit is to be issued, and the pre-arranged terms. The importer's bank issues the documentary credit and sends it - generally by electronic means - to the exporter's bank.

The exporter's bank checks that the documentary credit conforms with the code (Uniform Customs and Practice for Documentary Credits), and sends the documentary credit to the exporter.

The exporter checks that the terms of the documentary credit conform with those of the sales contract and that they can be met. If there are any discrepancies, the importer must immediately be asked to instruct the issuing bank to make such amendments to the documentaty credit as are necessary.

## Types of documentary credit

### **Irrevocable credits**

The vast majority of documentary credits is issued as irrevocable credits. According to the Uniform Customs and Practice for Documentary Credits, a credit will be revocable only if it is explicitly defined as revocable.

An irrevocable credit cannot be revoked or amended without the consent of all the parties to it.

It follows that the importer's bank cannot singlehandedly request the documentary credit to be amended, but must make payment against presentation of the documents required under the terms of the original documentary credit.

### **Confirmed irrevocable documentary credits**

A confirmed irrevocable documentary credit is a documentary credit to which the advising bank has added its confirmation.

By adding its confirmation to the credit the exporter's bank incurs an irrevocable obligation to pay against presentation of conforming documents.

A confirmed irrevocable credit gives the exporter who presents conforming documents protection against political and financial risks arising from conditions in the importer's country, and assurance of payment for the goods supplied.

Even though the terms of the documentary credit do not request its confirmation, the exporter's bank in most cases offers the exporter risk cover, which is tantamount to a confirmation.

## Place and time of payment

### **Place of payment**

A documentary credit will always state the place at which final payment will be made.

### **Payable/negotiable with exporter's bank**

The issuing bank has authorised the exporter's bank to pay/negotiate against conforming documents.

If the credit has not been confirmed by the exporter's bank, this bank, will only take a position upon presentation of the documents by the exporter, as to whether it will pay/negotiate forthwith or await receipt of cover from the issuing bank.

If effecting payment under a negotiable documentary credit immediately upon presentation, the exporter's bank will normally reserve recourse against the exporter.

### **Payable with the issuing bank**

In this case, the importer's bank must be satisfied with the documents before payment can be transferred to the exporter.

### **Time of payment**

The common procedure is for the payment under a documentary credit to be made upon the presentation of documents, however, a documentary credit is a flexible method of settlement, providing the option of immediate or deferred payment.

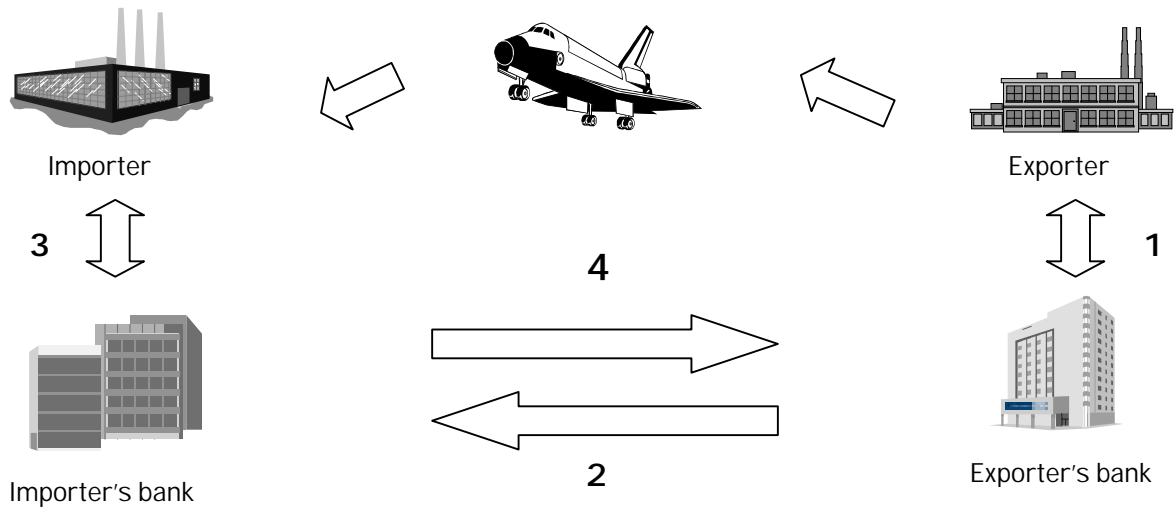
### **Payment at sight**

In the case of a sight documentary credit, the bank makes payment to the exporter, when he presents conforming documents.

### **Deferred payment**

Where the terms of a documentary credit stipulate that payment will be made at a fixed future date, the documentary credit is said to be settled by "deferred payment". The bank will undertake against presentation of documents to pay on the fixed deferred date of payment.

## Documentation



1. When the goods have been shipped, the exporter will compile all the documents required under the documentary credit and present them to his bank for processing. If satisfied with the documents, the bank will make payment to the exporter
2. The exporter's bank sends the documents to the importer's bank
3. The importer's bank releases the documents to the importer against payment and the importer can take delivery of the goods
4. The importer's bank makes payment to the exporter's bank

## Cover of the supplier's risk

### **Payment orders and transfer of title under a documentary credit**

If a supplier requests security for payment in step with the payment made under the documentary credit, the exporter can ask the bank to record an irrevocable payment order in favour of the supplier.

An irrevocable payment order does not, however, protect the supplier's claim, against other creditors, in the event that the exporter is declared bankrupt. If the supplier wishes to have such protection, he must request the exporter to assign (transfer the title to) the proceeds of the documentary credit to him.

### **A transferable documentary credit**

The exporter may also give his supplier assurance of payment by way of a transferable documentary credit. By having transferred to him the documentary credit which the exporter has received from the importer's bank, the supplier obtains the same degree of certainty of payment as the exporter.

## Information

This booklet highlights some of the many factors that need to be considered by exporters and importers wishing to settle their transactions by documentary credit.

However, you should not be deterred by their number, for we at Danske Bank can help you. We are at your disposal with advice and assistance from the very beginning to the very end of the documentary credit process.

Danske Bank has considerable know-how and longstanding experience in handling documentary credits. With our global network of correspondents we are capable of transacting documentary credits with any country in any part of the world.

Danske Bank is always at your service offering advice and information