

# Documentary Credits

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In international trade, documentary credits, commonly known as letters of credit (LC), provide a secure payment method where the buyer's bank guarantees payment to the seller upon presentation of compliant documents that meet specified terms and conditions. This is the most ideal arrangement between buyer and seller to protect their credit risks.

In this method, buyer arranges a documentary credit from their bank in favour of the seller payable against documents evidencing compliance of terms and conditions. The seller effects the shipment and presents the documents to the buyer's bank usually through their bank. If the presented documents are in compliance with the terms & conditions of the LC, the buyer's bank shall effect the payment to the seller and release the documents to the buyer.

## Basic definitions:

Buyer who makes an application to open the documentary credit with their bank is known as APPLICANT.

The bank that opens the documentary credit at the request of the applicant is known as ISSUING BANK

The party in whose favour the documentary credit is issued is known as BENEFICIARY

The bank that advises the credit to the beneficiary is known as ADVISING BANK

The bank that is designated in the LC to receive the documents from the beneficiary is known as NOMINATED BANK

The DOCUMENTARY CREDIT is an irrevocable undertaking of the issuing bank to honour a complying presentation

Documents are in accordance with terms & conditions of the LC and applicable provisions of UCPDC600 (Uniform Customs and Practice for Documentary Credits) and ISBP (International Standard Banking Practice) is known as COMPLYING PRESENTATION

## LC Cycle:

- The buyer (Applicant) makes an application with their bank (Issuing Bank) to issue the LC in favour of the seller (Beneficiary)
- The buyer's bank (issuing bank) must block the available credit limits of the applicant and to perform compliance checks as per bank policies before issuance of the LC. LC is usually advised to the seller (Beneficiary) through their correspondent bank in beneficiary's country (Advising Bank)
- The Advising Bank advises the LC to the beneficiary after ascertaining the apparent authenticity of the LC and ensuring terms and conditions are properly reflected in the advise
- The beneficiary must carefully review the terms and conditions of the LC with the underlying sales contract and must satisfy whether all the terms and conditions of

the LC and documentary requirements can be complied with. If not, beneficiary may request the applicant to arrange necessary amendments to the LC from the issuing bank

- The beneficiary effects the shipment and presents the documents to the nominated bank stated in the LC
- The nominated bank despatches the documents to the issuing bank with or without examination of documents
- The issuing bank checks the documents to ascertain whether the presentation is complying and releases the documents to the applicant while settlement is made as per LC terms.
- In case of non complying presentation, as the issuing banking is no more obligated to pay to the beneficiary, must send notice of refusal to the presenter of the documents within 5 banking days following the day of receipt of the documents and may also seek a waiver from the applicant for discrepancies observed.
- If applicant agrees to waive the discrepancies and issuing bank also accept the waiver, the issuing releases the documents and settlement is made to the beneficiary as per LC terms

ADVANTAGES TO BUYER	ADVANTAGES TO SELLER
<ul style="list-style-type: none"> <li>• No credit risk – Bank pays against complying documents only.</li> </ul>	<ul style="list-style-type: none"> <li>• No credit risk – there is an independent undertaking of the buyers bank.</li> <li>• Seller may get easy finance under L/c for supply of goods, though it is expensive mechanism as compared to other payment methods.</li> </ul>

RISKS TO BUYER	RISKS TO SELLER
<ul style="list-style-type: none"> <li>• Buyer is not sure whether goods are shipped as per contractual specifications. However, he may require independent inspection agency certificate under the L/C to ensure quality of the goods.</li> <li>• Possible delay in receiving documents which may be required to clear the goods that have already arrived</li> </ul>	<ul style="list-style-type: none"> <li>• Documentary risk – Seller may fail to present documents strictly in accordance with terms and conditions of L/c and applicable ICC rules.</li> <li>• Creditworthiness of the issuing bank</li> <li>• Country risk (Commercial &amp; Political)</li> </ul>