

DOCUMENTARY CREDITS

– protecting payments in international trade

Documentary credits are often used when the parties to an international trade do not know each other and the exporter does not want to send goods to the importer without being sure that payment will be made.

What are documentary credits?

- Documentary credits are a payment method that ensures that the exporter receives payment immediately after the goods have been sent.
- Documentary credits can also be used as a financing method, and the terms of the individual documentary credit may stipulate that the importer be granted a credit. The exporter can be sure that payment will be made before the credit expires.
- Documentary credits are a kind of guarantee. The bank issuing the documentary credit guarantees that the exporter will receive payment once the terms of the documentary credit have been met.

By issuing the documentary credit, the importer's bank (the issuing bank) assumes the payment obligation of the importer. Once the terms of the documentary credit have been met, the exporter

has a claim against the issuing bank rather than against the importer. Usually, the documents and payment are handled by the exporter's bank (the advising bank). Payment is settled once the exporter has presented the required documents to its bank.

Documentary credits (D/Cs) are also known as letters of credit (L/Cs).

In some countries, it is a statutory requirement that payment of imported goods takes place through a documentary credit. The reason for this can be that import licences and access to foreign currency are managed by the central bank of the countries in question.

Advantages to the exporter

- The exporter's claim against the importer becomes a claim against the issuing bank.
- The exporter receives payment in due time.
- The exporter receives payment through its own bank or a bank in its home country.
- The exporter's liquidity improves immediately after the goods have been sent.
- The documentary credit can be used as security in favour of one or more sub-suppliers.

- If the importer has been granted a credit under the documentary credit, the exporter may transfer the claim to its bank and obtain immediate payment from the bank.

Advantages to the importer

- The importer may be granted a credit.
- The importer may be granted a discount because of the provision of security and promptness of payment.
- The importer can expect the goods to be delivered in due time.

International rules

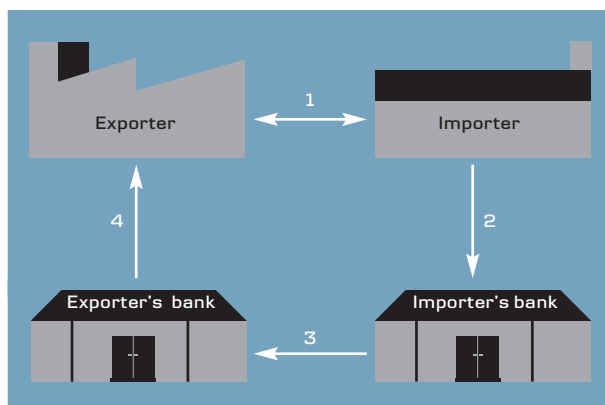
The International Chamber of Commerce (ICC) in Paris has drawn up the Uniform Customs and Practice for Documentary Credits. This set of rules is recognised worldwide and specifies the payment obligations of banks and their obligations to handle documents under documentary credits.

The banks are responsible only for handling documents and have no responsibility for the goods or the project to which the documents relate. Moreover, the banks must observe the terms of the documentary credit only. Any other contracts or

agreements will not impose any obligations on the banks irrespective of whether reference is made to such documents in the documentary credit.

How to establish a documentary credit

There are several types of documentary credit. The exporter and the importer should consider and agree on the type to be used and on the terms. They should also contact their banks for advice before entering into a binding agreement.



The figure above shows the usual process for establishing a documentary credit.

1. The exporter and the importer conclude a sales contract and agree to use a documentary credit as payment method.
2. The importer submits an application for the issuance of a documentary credit to its bank (the issuing bank). The application specifies the amount and the agreed terms of the documentary credit.
3. The importer's bank issues the documentary credit and submits it to the exporter's bank (the advising bank).
4. The exporter's bank examines whether the documentary credit complies with the ICC's rules and advises the exporter of the documentary credit.

When receiving the documentary credit, the exporter should make sure that the terms of the documentary credit match the terms agreed on and that it is possible to meet them.

If the terms differ from what was agreed, the exporter must immediately request the importer to contact the issuing bank and instruct it to make the necessary changes to the documentary credit.

Types of documentary credit

- **Irrevocable documentary credit**
An irrevocable documentary credit cannot be cancelled or changed unless all parties agree. Therefore, the importer's bank cannot require that a documentary credit be changed, and the bank is obliged to make payment against the documents required under the original documentary credit.
 - **Confirmed documentary credit**
The exporter's bank (the advising bank) may confirm a documentary credit if the documentary credit includes a request to that effect. By adding its confirmation to the documentary credit, the bank assumes an irrevocable obligation to make payment against presentation of the required documents.
- If the exporter meets the terms of the documentary credit, the confirmed documentary credit protects the exporter against any political and financial risks arising from conditions in the importer's home country and provides assurance of payment for the goods supplied.

Even if the documentary credit does not include a request for confirmation, the advising bank in most cases offers the exporter the same degree of risk protection as that provided by a confirmation.

Unconfirmed documentary credit

Under an unconfirmed documentary credit, only the issuing bank assumes a payment obligation.

The exporter's bank controls the documents required under such a documentary credit, but is under no obligation to make payment until it has received payment from the issuing bank.

When a bank pays an amount on behalf of another bank (in another country), there is always a risk that it will not receive reimbursement from the issuing bank - or that it will be reimbursed with delay.

Place of payment

The place at which final payment will be made is always stated in the documentary credit.

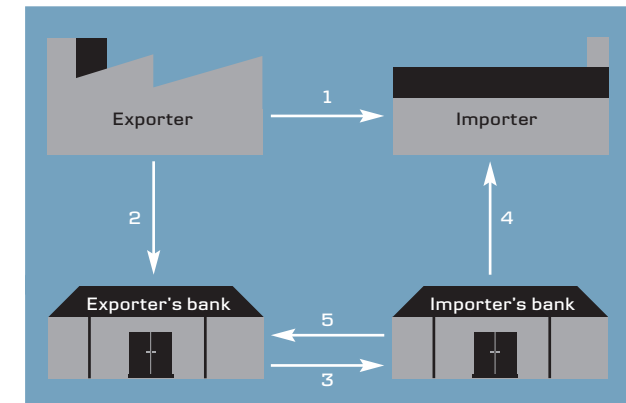
- Payable (negotiable) with the exporter's bank: The importer's bank has authorised the exporter's bank to pay/negotiate against presentation of documents meeting the terms of the documentary credit.
- Payable (negotiable) with the issuing bank: The payment will not be transferred to the exporter until the importer's bank has accepted the documents.

Time of payment

The exporter often receives payment from its bank immediately after having submitted documents that meet the terms of the documentary credit. This is referred to as "payment at sight". A documentary credit is, however, a flexible payment method under which the importer may be granted a credit. This is referred to as "deferred payment". The importer's bank undertakes to make payment against presentation of the required documents on a fixed future date.

Documentation process

The figure below shows the documentation process.



1. The exporter sends the goods to the importer in accordance with the terms of the documentary credit and arranges for the preparation of shipping documents, for instance, a bill of lading or an airway bill.
2. The exporter submits the documents required under the documentary credit to its bank. The bank checks that the documents meet the terms of the documentary credit. If this is the case, the exporter will normally be able to obtain payment.

3. The exporter's bank sends the documents to the importer's bank.
4. The importer's bank submits the documents to the importer against payment, and the importer can now take delivery of the goods.
5. The importer's bank makes payment to the exporter's bank.

Sub-suppliers' risk

If a sub-supplier requires security for receiving payment as payment is made under the documentary credit, the exporter can request its bank to issue an irrevocable payment order in favour of the sub-supplier. An irrevocable payment order means that the exporter will not receive any payment under the documentary credit until the sub-supplier's claim has been met in accordance with the payment order.

An irrevocable payment order does not, however, protect the sub-supplier's claim against any other creditors of the exporter if the exporter goes bankrupt.

If the sub-supplier wants such protection, it must request the exporter to assign its claim under the documentary credit to the sub-supplier. Such assignment also means that the exporter will not receive any payment until the claim of the sub-supplier has been met. But at the same time, it protects the sub-supplier's claim against other creditors if the exporter goes bankrupt.

The exporter can also provide security for payment to a sub-supplier by means of a transferable documentary credit. By transferring the documentary credit that the exporter has received from the importer's bank to the sub-supplier, the sub-supplier obtains the same degree of payment protection as the exporter.

Documentary credits in Business Online

Danske Bank's Business Online system enables you to handle documentary credits easily and efficiently. Read more in our Trade Finance in Business Online factsheet.

Contact us

If you require advisory services on documentary credits, please contact us.

We have many years of experience in handling documentary credits. And through our global network of correspondent banks, we are able to process documentary credits in almost any country in the world.

Our contact information is available at www.danskebank.com/tradefinance.