

DOCUMENTARY CREDITS

– protecting payments in international trade

Documentary credits are one of the most secure payment methods in international trade, offering the exporter a conditional payment guarantee from the importer's bank. Documentary Credits are often used when the parties involved are not familiar with each other and the exporter wants to ensure that he will receive payment for his goods.

What are documentary credits?

- Documentary credits are a payment method that ensures that the exporter is guaranteed payment provided all terms and conditions detailed on the documentary credit are met.
- Documentary credits can be used as a financing method. If the exporter has granted the importer extended credit (deferred payment) but the exporter would like payment immediately, Danske Bank will endeavour to discount the draft under the documentary credit at a competitive rate.
- A documentary credit is a conditional payment guarantee. The bank issuing the documentary credit guarantees that the exporter will receive payment once the terms of the documentary credit have been met.

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

The importer's bank issues the letter of credit and is referred to as the issuing bank. The issuing bank therefore assumes full responsibility in guaranteeing payment to the exporter rather than the importer. Once the required documents and 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.

In some countries, it is a statutory requirement that payment of imported goods takes place through a documentary credit. Perhaps an import licence is required and in order to access foreign currency which is managed by a central bank a documentary credit is required to support this.

Advantages to the exporter

- Payment is guaranteed by the importer's bank prior to shipment.
- The exporter receives payment through its own bank or a local bank.
- Enhanced security of payment at the agreed time.
- Enhanced security that the order received will not be cancelled or changed without the exporter's agreement.
- Improved liquidity as payment often can be made shortly after shipment.
- The possibility of financing.

Advantages to the importer

- No obligation to pay unless all the conditions of the documentary credit are fulfilled.
- Using documentary credits with extended credit terms may be an alternative to traditional forms of bank finance such as overdrafts.
- Potential for discount from the exporter because of secure and fast payment.
- Multiple payments can be made.
- Your credit reputation is enhanced.
- Prompt shipment of goods.

International rules

Documentary credits are subject to a set of international rules entitled Uniform Customs and Practice for Documentary Credits (UCP), ICC Publication No. 600.

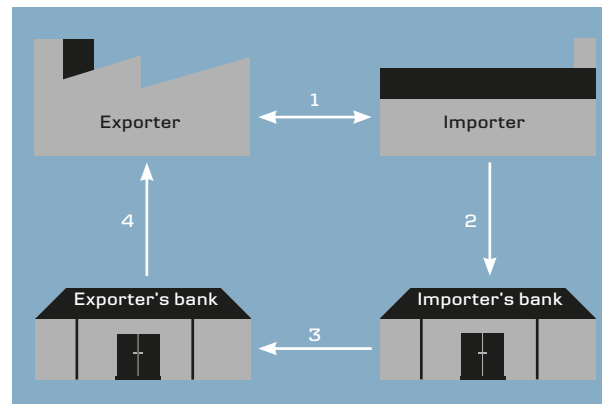
The rules are governed by the International Chamber of Commerce (ICC) in Paris and are used by most banks worldwide. They specify the payment obligations of banks and their obligations to handle documents under documentary credit.

Banks are responsible only for handling documents and assume no responsibility for the goods or the project to which the documents relate. Banks must observe the terms of the documentary credit only.

The documentary credit is legally independent of the contract, which means that any changes to the contract are not automatically valid for 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 guidance before entering into a binding agreement.



The diagram 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 the 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 those 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 them to make the necessary changes to the documentary credit.

Types of documentary credit

- **Irrevocable documentary credit**

An irrevocable documentary credit cannot be amended or cancelled unless all parties agree. It is important that all parties are in agreement to any amendments prior to the shipment of goods.

- **Confirmed documentary credit**

The exporter's bank (the advising bank) may confirm a documentary credit if it includes a request to that effect. By adding its confirmation to the documentary credit, the exporter's 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. It also 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. This is known a silent 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 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.

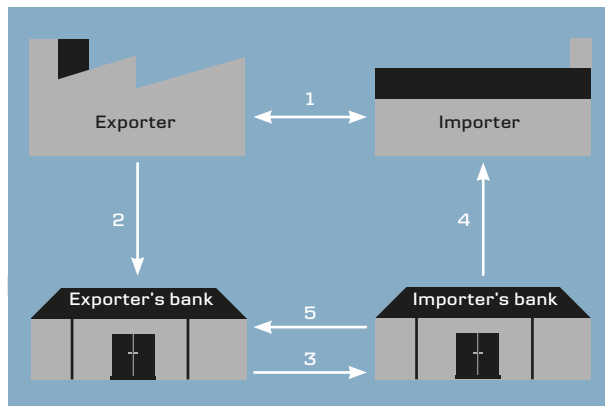
Payment Terms

Before a documentary credit is issued the exporter and importer will agree on the terms of payment.

The exporter may receive payment from its bank immediately after having submitting documents that meet the terms of the documentary credit. This is referred to as "payment at sight". When an importer has been granted credit and the importer's bank undertakes to make payment to the exporter against presentation of the required documents on a fixed future date, this is known as "deferred payment".

Documentation process

The diagram details 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 example, 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. 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 through 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 has the same degree of payment protection as the exporter.

Documentary credits in Business eBanking

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

Contact us

Danske Bank has many years of experience in handling documentary credits and through our global network of correspondent banks we are able to process documentary credits in the majority of countries worldwide.

For more advice or information, our contact information is available at www.danskebank.co.uk/tradefinance