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Dealing with *Letter of Credit* Discrepancies

By Walter (Buddy) Baker

Letters of credit (L/Cs) are a popular tool for credit managers. They provide a fairly simple way to place credit risk with another party—in this case a bank—who may be in a better position to evaluate and assume the credit risk of a particular buyer. After all, companies are in business to sell goods and services, not to take credit risks and provide financing. L/Cs are especially popular in managing export transactions, where the risks are particularly difficult to assess. Credit information is harder to obtain for foreign companies and not always reliable, laws the buyer is subject to are unfamiliar, and there is country risk to deal with: balance of payments issues, exchange controls, government stability, etc. Letters of credit can shift all of these risks to a bank, either in the buyer's home country or in North America. Banks are in the business of evaluating credit risks, including country risks, and providing financing. When a letter of credit is used, the bank issuing the L/C becomes obligated to pay the exporter. If there is a "confirming bank," what you have is a second bank, probably in North America, who is adding *their* engagement to pay.

Payment Against Documents

But not everything about letters of credit is popular. In order to obtain payment from the bank, the exporter must provide the bank with documentation the bank can themselves use to obtain payment from the buyer. Up front, the buyer agrees with the bank what this documentation will be and signs a legal agreement with the bank to reimburse the bank if and when they receive this documentation. The bank then writes the letter of credit to the exporter and lists this documentation. Ideally, this should all be documentation the exporter can easily produce. Usually it is just the documentation the exporter prepares anyway, like an invoice and maybe a packing list, plus a copy of the transport document demonstrating the goods were shipped, and, maybe, evidence the goods were insured. These documents should reflect the agreement between the buyer and seller as to what goods were to be shipped; how, when, and where they were to be shipped; and who was to cover transportation and insurance costs. Nonetheless, creating this documentation and presenting it to the bank for payment seems like a hassle to most North American exporters. And no wonder, once you realize that 60 to 80% of the documents presented to the banks do not comply with the letter of credit requirements, at least according to the banks. Why do exporters have such a problem presenting compliant documents? Are the banks overly picky? This is what I will attempt to explain in this article, as well as how

to avoid discrepancies and, ultimately, how to get paid notwithstanding discrepancies.

Letter of Credit Mechanics

The first thing to understand is that standard practice with an export letter of credit is not to present the documents called for directly to the bank that issued the letter of credit, who is probably in another country, but to a "negotiating bank" in the country of the exporter. (If there is a confirming bank, documents must be presented to them.) The negotiating bank will generally provide the service of examining the documents for compliance with the letter of credit and then obtaining payment from the issuing bank.

The negotiating bank can often effect payment to the exporter by obtaining funds from the issuing bank's account at a bank where they keep U.S. dollars on deposit. (Authorization to charge this account must be contained in the L/C.) The bank where the funds are on deposit is called the "reimbursing bank." The system for clearing reimbursement is efficient enough—usually taking 5 days or less—that the beneficiary can be, and often is, paid before the issuing bank even sees the documents. Nonetheless, upon receipt of documents, the issuing bank will still examine them and, if they do not conform strictly with the terms of the credit, the bank has no right to obtain payment from the buyer. The bank therefore has the right to refuse the documents and demand a refund of the amount paid

(plus interest). It follows, therefore, that a negotiating bank will pay an exporter only upon the presentation of documents that it feels certain will not be refused by the issuing bank. Because any discrepancy is grounds for refusal, the negotiating bank will insist the documents strictly comply with the terms of the letter of credit. As I've already mentioned, over 60% of all documents are found to contain discrepancies upon presentation to the negotiating bank. About half of these discrepancies can still be corrected (or "cured"), while the other half cannot. Obviously, the preferred course of action would be to avoid discrepancies to begin with.

Avoiding Discrepancies

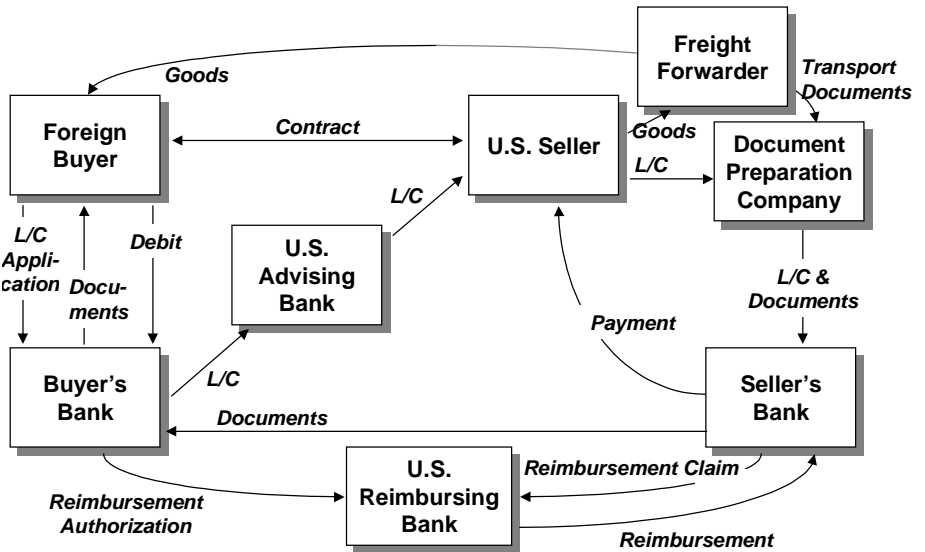
A large portion of the discrepancies found in letter of credit documents occur with a great deal of frequency. Three common problems can be avoided if the exporter carefully checks the following *before shipping*:

1. The credit amount is sufficient to cover the shipment (particularly if the shipping terms are CIF or CIP).
2. Documents will be available and can be presented before the expiry date of the credit.
3. The latest shipment date (if there is one) specified in the letter of credit can be met.

After shipping, documents must be properly prepared and presented on a timely basis. The most common discrepancies encountered by banks examining documents under letters of credit represent errors or misunderstandings in how to prepare documents. They include the following:

1. Documents are inconsistent with each other.*
2. Documents were presented more than 21 days after the date of shipment (or other presentation period specified in the L/C).*
3. Full set of bills of lading was not presented or other required documents are missing.

How Letters of Credit Work



- Step 1.**
The buyer agrees to purchase goods from the seller using a letter of credit as the mechanism of payment.
- Step 2.**
The buyer applies to his bank for a letter of credit, signing the bank's letter of credit application/agreement form.
- Step 3.**
After approving the application, the issuing bank issues the actual letter of credit instrument and forwards it to the advising bank.
- Step 4.**
The advising bank authenticates the letter of credit and delivers it to the beneficiary (the seller).
- Step 5.**
Having received the issuing bank's assurance of payment, the beneficiary (seller) delivers goods to a freight forwarder, who ships the merchandise to the applicant (buyer).
- Step 6.**
The beneficiary (seller), the freight forwarder, and/or a document preparation company prepares the documents called for in the letter of credit and presents them to the negotiating bank. The letter of credit may specify a negotiating bank or it may say it is "available with any bank," giving the beneficiary the freedom to choose where to present documents.
- Step 7.**
The negotiating bank examines the documents and, if they comply, obtains funds for payment to the beneficiary in accordance with the terms of the letter of credit.
- Step 8.**
The negotiating bank transfers payment to the beneficiary (seller) and forwards the documents to the issuing bank.
- Step 9.**
The issuing bank examines the documents. If it agrees with the negotiating bank that the documents comply with the letter of credit, the issuing bank obtains payment from the applicant (buyer) in accordance with the terms of the applicant's letter of credit agreement and forwards the documents to the applicant.
- Step 10.**
The applicant (buyer) uses the documents to pick up the merchandise from the carrier, completing the letter of credit cycle.

Using an L/C Document Preparation Service

If preparing letter of credit documents seems arcane and laborious, why not outsource the process? For years, many freight forwarders have offered the service of preparing all export documentation for their customers, including the documents to be presented under letters of credit, and many exporters take advantage of this service. But freight forwarders are experts in booking freight; preparing documentation is not necessarily a core competency for them. Discrepancy rates continue to be in the 60% to 80% range.

In the last few years, a specialization has sprung up of companies that are experts in preparing letter of credit documents. Some of these companies, like Quality Letters of Credit, Inc. (<http://www.qualitylc.com/>), *guarantee* that documents will comply with the letter of credit or your money back. The benefit of having compliant documents presented the first time is two-fold: faster payment and lower costs, not to mention the fact that the payment protection of the letter of credit is preserved. No time is lost in discussing discrepancies with the negotiating bank, correcting documents, or cabling the issuing bank for permission to pay. The cumulative effect of such discrepancy-resolution processes can easily be a delay of 2 to 4 weeks in getting paid. Furthermore, cable expenses are reduced and the banks will stop charging discrepancy fees. As if these 2 benefits didn't pay for the cost of hiring someone to prepare error-free documents, it is also quite likely that the average cost of preparing a set of documents is lower for one of these companies than for an exporter or a forwarder. A document preparation company can justify the cost of investing in export document preparation software and spread that cost across more sets of documents, making them much more efficient than a company that prepares documents using a word processor.

And, if that weren't enough justification to outsource document preparation to one of these specialists, some of these companies have co-located their employees with employees of partner banks to further speed up the process. Whether the document preparation company employees are located at a bank or bank employees are located at the document preparation company's facilities, the result is faster approval of documents and elimination of "mail float" and courier charges.

Combined with a shipper's indemnity program, a document preparation service can result in immediate payment on all of a company's letters of credit, with no danger of having to return funds due to discrepancies. Isn't that what everyone expected to begin with?

4. Draft is drawn incorrectly or for the wrong amount.

5. Draft is not signed or not endorsed.

6. Invoice does not describe merchandise in exact accordance with the letter of credit. *Note:* If the letter of credit describes merchandise in a foreign language, then the exporter must describe the merchandise in that language in the invoice; translations are not acceptable.

7. Invoice does not show the same shipping terms as specified in the L/C.

8. Invoice includes charges inconsistent with the shipping terms in the L/C.

9. Invoice is not made out in the name of the applicant shown in the L/C.

10. Insurance coverage is insufficient or does not include the risks specified by the L/C.

11. Insurance certificate or policy is not endorsed.

12. Insurance certificate is dated later than the shipment date.*

13. Bill of lading is not clean (defective condition of goods or packaging indicated).

14. Bill of lading does not clearly indicate the name and capacity of the signer and who the carrier is (must be signed "ABC Co. as carrier" or "XYZ Co. as agent for ABC Co., the carrier").*

15. Bill of lading is not consigned correctly or is not endorsed (if endorsement is required).

16. Multimodal bill of lading was presented when L/C calls for port-to-port, or simply "ocean," bill of lading. (Acceptable if "on board" notation includes the name of the vessel and the port of loading.)*

17. Multimodal bill of lading was presented when shipping terms are

FOB (*i.e.*, port to port) and does not indicate inland freight has been prepaid or otherwise fails to meet requirements for port-to-port shipment.*

18. Bill of lading is not marked "freight prepaid" or "freight collect" as required under the credit or in agreement with the invoice and shipping terms.

19. Not all documents show license numbers, letter of credit numbers, or other identification required in the credit.

* Requirement found in *The Uniform Customs and Practice for Documentary Credits*, a set of rules almost every letter of credit in the world indicates it is subject to; it may or may not be spelled out in the L/C. If you are not familiar with the UCP, you should ask your banker for a copy. It is only 7 pages long and forms the basis for how banks examine documents.

20. Documents are not signed in accordance with L/C terms (any document called a “certificate” must be signed).

Discrepancies like these can generally be avoided by reviewing the terms and conditions of the letter of credit and preparing documents that follow the instructions found there. [See sidebars: “A Document Examination Checklist” and “Using an L/C Document Preparation Service.”] Keep in mind that banks deal only in documents and have no business getting involved in the underlying contract between the exporter and the buyer. The bank’s reimbursement from the buyer depends on the documents complying.

Obtaining Waiver of Discrepancies

After examining the documents, the negotiating bank will notify the exporter of any discrepancies found and work with the exporter to “cure” as many discrepancies as possible. If the exporter’s documents cannot be corrected to fully comply with the credit terms, he has various alternatives available to still collect payment. *It should be noted, however, that he has lost a key element of the letter of credit: the issuing bank’s obligation to pay.* Even if the issuing bank waives discrepancies, the confirming bank, if there is one, may choose *not* to extend its confirmation to cover the waiver, which is, in essence, an amendment to the credit.

The most common course of action, despite the fact that it is expensive and time consuming, is that the exporter asks the negotiating bank to cable the issuing bank indicating the discrepancies and requesting authority to pay. The issuing bank will then contact the buyer and, if the buyer agrees to pay despite the discrepancies, the issuing bank will then cable the negotiating bank giving the authority to make payment. Alternately,

if the exporter is comfortable with his relationship with the buyer and thinks that there is no real danger the buyer will refuse to pay, the exporter can direct the negotiating bank to forward the documents with the discrepancies to the issuing bank “for approval.”

Using Shippers’ Indemnities to Obtain Immediate Payment Despite Discrepancies

If documents are being sent for approval, the exporter may further request that the negotiating bank go ahead and pay against his indemnity. Under such an arrangement, the exporter agrees to return payment to the negotiating bank in the unlikely event such payment is not approved by the issuing bank.

Although the use of such “shippers’ indemnities” is infrequent in North America, banks are generally willing to accept such indemnities from their own customers so long as the credit standing of the customer is satisfactory. Despite a high discrepancy rate (30% even after fixing curable discrepancies), the actual incidence of issuing banks refusing documents is very low (on the order of 3 out of 10,000 sets of documents). This is due to the facts that buyers who can obtain letters of credit to begin with are normally good credit risks, they want the merchandise that was shipped and will therefore agree to pay even though documents do not comply, they wish to remain on good terms with their suppliers, and, unless the underlying contract of sale has been violated, they are legally obligated to pay anyway. The use of shippers’ indemnities is highly recommended as a way to obtain payment days or weeks sooner as well as to avoid cable expenses. Indeed, *with a blanket indemnity in place, the negotiating bank may be willing to pay before even checking the documents.* Because indemnities will be accepted only by banks with whom

the exporter has credit lines, beneficiaries wishing to make use of such arrangements should present documents to their own banks for negotiation rather than follow the common, but often unfavorable, practice of submitting documents to the advising banks. [See the diagram “How Letters of Credit Work”]

When All Else Fails

If your documents get refused by the issuing bank, it does not mean you will not be paid. Although you have lost the credit protection of the letter of credit, you still have the contract of sale to fall back on and the buyer’s own obligation to pay. The bank can assist you in determining the whereabouts of the goods and will not release the documents to the buyer until they receive your instructions for disposing of the documents. If the buyer has taken possession of the goods (presumably because possession did not depend on having the documents), the bank may even pressure them to pay. It will certainly damage the buyer’s reputation with their bank if the bank knows the buyer is taking advantage of the letter-of-credit system to obtain goods they don’t pay for. Unfortunately, beyond this, collection proceedings will be subject to local laws in the buyer’s country—one of the main problems you were trying to avoid by getting a letter of credit in the first place.

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A Document Examination Checklist

The Draft: *Check that...*

- the Draft bears the correct Letter of Credit reference number,
- the signature and/or the name of the Drawer corresponds with the name of the Beneficiary,
- the tenor is in accordance with the Letter of Credit,
- the payee is the bank documents are being presented to or the Beneficiary,
- if the payee is the Beneficiary, it is duly endorsed and bears no restrictions or conditions in the endorsement (e.g., "without recourse"),
- the amounts in figures and words correspond and the currency is that in which the L/C is issued,
- it is drawn on the Drawee specified in the L/C,
- the amount drawn does not exceed the balance available in the Letter of Credit,
- the values of the draft and the invoice correspond,
- it has a current date—specifically, the shipment date if the Letter of Credit calls for the maturity of the Draft to be based on the bill of lading date,
- any apparent alterations have been properly stamped and/or initialed,
- it contains any necessary clauses required by the Letter of Credit.

The Invoice: *Check that...*

- the correct number of original(s) and copy(ies) is presented,
- it is issued by the Beneficiary named by the Letter of Credit and, if an address is shown, it is the same address as that indicated in the L/C,
- the Applicant (the buyer) is indicated as the invoiced party, and, if an address is shown, it is the same address as that indicated in the L/C,
- the description of the goods is in exact accordance with the merchandise description in, and includes the shipping terms indicated in, the Letter of Credit, and no extra goods are included,
- no additional detrimental description of the goods appears that may question their condition or value (e.g., "re-conditioned"),
- any other information supplied in the invoice, such as marks, numbers, transportation information, packaging, weight, freight charges or other related insurance and transport charges etc., is consistent with that in the other documents,
- the currency of the invoice is the same as that in the Letter of Credit,
- the invoice amount is at least the amount of the Draft,
- if partial shipments are prohibited, the invoice covers the complete shipment as required by the L/C or is within the 5% tolerance allowed by the UCP,
- if required by the Letter of Credit, the invoice is signed, notarized, legalized, certified, etc.

Transport Documents: *Check that...*

- the full set of originals issued is presented, unless otherwise allowed by the Letter of Credit (for air waybills, the original Shipper's Copy constitutes the "full set"),
- it clearly indicates who the carrier is,
- it clearly indicates the name and capacity of the signer (e.g., "ABC Co. as carrier" or "XYZ Co. as agent for ABC Co., the carrier"),
- if an "ocean" or "port-to-port" bill of lading is required, it clearly indicates that the goods are on board a named vessel at a named port on a given date,

- the place of receipt/origination/taking in charge, port of loading, port of discharge, place of delivery/destination, etc. are as specified in the L/C,
- it is not a "charter party" transport document, unless authorized in the L/C,
- the name of the consignee is as stipulated in the Letter of Credit,
- if the transport document requires endorsement, it is appropriately endorsed,
- there are no clauses on the transport document that may render it "unclean" (See UCP 500 sub-Article 32(a)),
- the description of the goods is not inconsistent with the description of the goods as stated in the invoice, and that the marks and numbers as well as other specifications, if any, are identical to those appearing on the other documents,
- any apparent alterations have been properly stamped and/or initialed,
- the name and address, if any, of the notify party are as stipulated in the Letter of Credit,
- the indication of "freight prepaid" or "freight collect," as required by the terms of the Letter of Credit, appears on it and is consistent with the shipping terms shown in the invoice,
- all other conditions stipulated in the appropriate transport articles of UCP 500 are complied with.

The Insurance Document: *Check that...*

- the policy/certificate/declaration/cover note, as required by the Letter of Credit, is presented,
- the full set of the insurance document issued (all signed originals) is presented,
- if specified in the L/C, the correct number of original(s) and copy(ies) is presented,
- it is issued and signed by the insurance company or underwriter or their agents, or countersigned by the assured if so required by the insurance document itself,
- the date of issuance or date from which cover is effective is no later than the date of loading on board or dispatch or taking in charge of the goods, as the case may be,
- if the assured named is other than the Confirming Bank, Issuing Bank or buyer, it bears the appropriate endorsement,
- it is issued in the same currency as the Letter of Credit, unless otherwise allowed in the Letter of Credit,
- the insured value of the goods is as required by the Letter of Credit or as defined in UCP 500 sub-Article 34(f),
- the goods description is not inconsistent with and relates to that of the invoice,
- the marks and numbers, etc. are identical to those of the transport document and all other information appearing on the document is consistent with that of the other documents,
- it covers the specified risks as stated in the Letter of Credit and that the risks are clearly defined,
- it covers the merchandise from the port of loading or place of taking in charge to port of discharge or place of delivery designated in the L/C,
- any apparent alterations have been properly stamped and/or initialed.

A more extensive checklist can be found in the book *ICC Guide to Documentary Credit Operations for the UCP500*, International Chamber of Commerce Publication No. 515, available from ICC Publishing at <http://www.iccbooks.com/>. The actual checklist used by many banks is called *Standard Banking Practice for the Examination of Letter of Credit Documents*, published by the International Financial Services Association at <http://www.intlbanking.org/>.

Sample Shippers' Indemnities

Shippers' indemnities should be addressed to the bank to which you are presenting documents and follow one of the following formats:

BLANKET INDEMNITY

A blanket indemnity should be on company letterhead, signed by an authorized signatory, and should read as follows:

In consideration of your honoring/negotiating our drawings presented to you under any and all letters of credit issued in our favor notwithstanding any discrepancies which might exist therein, we hereby agree to pay you on demand the amount of each such drawing (with interest at the per annum rate of ___% from demand until paid in full) and to indemnify and hold you harmless for any other losses, costs, and expenses (including, without limitation, reasonable attorneys' fees and court costs) incurred in connection therewith or the enforcement hereof, in the event that the documents included in the drawing are refused by the issuing bank or the issuing bank fails, for any reason, to pay a drawing honored or negotiated by you. This agreement does not preclude any other rights you might have against us by reason of such drawings.

TRANSACTIONAL INDEMNITY

A transactional indemnity should appear on the company's transmittal cover letter or be on separate company letterhead, signed by an authorized signatory, and read as follows:

Re: Our reference _____ dated _____ for
(amount) _____ drawn under letter of credit number _____ issued by
_____, ABN AMRO reference _____.

In consideration of your honoring/negotiating the above described drawing under the cited letter of credit, notwithstanding the following:

(list of discrepancies or the words "any discrepancies which might exist therein")

we hereby agree to pay you on demand the amount of such drawing (with interest at the per annum rate of ___% from demand until paid in full) and to indemnify and hold you harmless for any other losses, costs, and expenses (including, without limitation, reasonable attorneys' fees and court costs) incurred in connection therewith or the enforcement hereof, in the event that the documents included in the drawing are refused by the issuing bank or the issuing bank fails, for any reason, to pay the drawing. This agreement does not preclude any other rights you might have against us by reason of such drawings.