

Letters of Credit

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I need to get a letter of credit for my international business transactions. My business is fairly new, this is the first time I've needed one, and I don't know a lot about how to do this. I used to work for a much larger company, where the finance department handled these things. What can you tell me about letters of credit? What do I need to do to get one? What do I have to watch out for? Is there a better place to go, to get one?

Starting a new business, transitioning out of a larger corporation, can pose a lot of challenges. As our reader implied, as we go from employee to business owner, we go from being specialists to generalists. Our scope of knowledge has to expand geometrically. And it's often the little things that we don't know that will stop us in our tracks.

Let's take a look at letters of credit. What are they? Who uses them, and when are they used? Where do you go to get one, and what information will you need to qualify for one? What do you need to consider when setting one up, using one? What are the alternatives, if any?

Letters of credit are usually irrevocable, although you can also get revocable LCs and revolving LCs. LCs are documents provided by the buyer's bank, given to the seller, guaranteeing payment for goods

to be shipped. LC's are very specific about goods shipped, time limits and dates, quantity shipped and amount to be paid. In the letter, the bank agrees to pay for the goods, on behalf of the buyer.

Importers and exporters use letters of credit typically to insure payment, particularly when a shipment is due long after the merchandise has been ordered. The advantage to the importer is that it allows greater buying power without tying up the equivalent amount of capital for long periods of time. In the case of international shipments, most buyers don't want to take the risk, or tie up their cash, until they know the goods have reached their country. LCs help ensure that the buyer gets what he or she ordered, within the time agreed to with the seller.

Letters of credit can also be used for domestic purchases, but are used much less often of this purpose. Domestically, LCs are useful when the customer does not have a good credit rating or has a credit line that is insufficient to cover the cost of the purchase. In such a case, the bank guarantees that the seller will get paid upon delivery of the goods. The seller must be able to assure the bank issuing the LC that they are able to pay upon delivery, usually by pledging securities or other assets, or freezing funds in a bank account.

Assuming it's an international transaction, here's how things work. The buyer goes to a bank and requests a letter of credit to purchase specific goods, which will be delivered at a future date. Once the buyer proves to the bank that funds are available to make good on the letter, the buyer's bank let's the seller's bank know that the letter of credit has been issued. The seller's bank notifies the seller, and the seller ships the goods out of their warehouse.

When the seller's goods arrive at the port of departure, the ship's captain signs a bill of lading, describing the goods shipped, noting departure and destination ports and freight costs, and promising to deliver in good order, to a specific port, at a specific time. The lading date is the date the document is signed by the shipper.

A package of documents is assembled and sent to the bank issuing the LC. The package typically includes the bill of lading, an original invoice, a packing list, a certificate of origin signed by the local chamber of commerce (if the buyer is concerned that substitutions may be made), a copy of insurance certificates, if necessary, and test certificates if products have quality issues. Recently the US government is requiring proof that wood packed around heavy freight is pest free. These documents usually must

Letters of Credit

05/29/06

be received by the bank 14-21 days from the bill of lading date.

The bank then determines whether the receiving documents match the terms and conditions laid out in the letter of credit. Most letters of credit are considered to be irrevocable, but if there are discrepancies in the documentation, for instance the material comes in late, both parties must agree to the changes. When all the documents have been approved, the issuing bank provides the funds to the seller's bank, and debits the buyer's account. All documents are then forwarded to the buyer, who awaits receipt of the goods.

Commercial banks or large lending institutions can issue letters of credit. Usually they require you to have a 2 to 3 year track record of making money and doing business on a regular basis. Once this has been established, for every dollar you have on deposit with the bank they may give you a multiple of that amount toward your LC.

Start up financing can also be secured through personal assets, such as home equity financing, personal accounts or collateral. (There may be tax advantaged options so ask your accountant.) They will also, of course, issue the LC if you have in your account the full amount of money for the value of the letter of credit. This amount is basically frozen

until the letter of credit is redeemed. If your bank refuses to confirm the letter, go to another bank. The cost generally starts at 1% of contract amount (included in the bid price) but may be for any % of the total purchase.

If you are the seller you should get your bank involved in investigating the buyer's creditworthiness. Remember that the buyer's bank must also be financially sound. It is to your best advantage that the LC is irrevocable.

If you are the buyer consider the standard payment method in the country you are buying. Keep detail of purchase short and concise. Be prepared to amend or re-negotiate terms if you can live with the changes that may be noted upon arrival. It is recommended that you use a bank experienced in foreign trade. You also should consider ample validation time on the letter. Remember, banks are only responsible for the documentation, not the condition of the goods. Don't forget, documents supplied should include those required for customs entry.

If you're looking for alternatives, you might consider a Bank Draft. This works very similar to an LC but the seller must know you well and trust that you will pay him when the goods arrive. With this agreement the seller issues a request for payment (the draft), a

contract with terms, plus all other shipping documentation once the goods have been shipped. The bank again takes the documents, reviews them, confirms with the buyer that they have reviewed the documents and asks for the green light to pay the seller and debit the buyer's account. With the Bank Draft there is no need to freeze cash or credit against a purchase ahead of delivery, but the seller must have a very good relationship with the buyer to agree to this set up.

If there are regular shipments of the same goods between buyer and seller, you may be able to set up a revolving letter of credit. This can eliminate the need to set up a separate LC for each and every shipment of goods. Your bank can help you decide if this is appropriate, once you describe the transactions you expect to conduct over the coming year.

With a standby letter of credit, the seller has recourse to demand payment from the buyer's bank, if the buyer does not make good on payment for the goods shipped. In this case, the seller must supply the buyer's bank with a copy of the open invoice and documentation similar to that required for a regular letter of credit. In such a situation, the seller probably wants to have reason to trust the buyer, such as credit rating, experience working with the buyer's bank and the buyer. Knowledge that the buyer is financially solid, and ready,

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05/29/06

willing and able to pay is important, when dealing across long distances, with multiple countries and international laws.

When using LCs, you also need to factor the cost of the LC into the equation. LC fees can run from 1% to 8% of the transaction. So, if you are buying \$50,000 worth of goods, for example, you will also be paying \$500 to \$4,500 for the LC. Some business owners shrug off this cost as necessary, but not worth factoring into the mix, and then end up making less on the transaction than they wanted or needed to make. When planning the selling price, you have to remember to mark up the goods to include the LC fee, plus the cost of your time to get the LC issued. Remember, it's all about detailed paperwork, but it is a good way to transact business across international borders and long distances.

Finally, remember that even with an LC, things can go wrong. You will have some recourse, but don't count on having the goods until they actually show up on your loading dock. After all, one of the reasons LCs we developed is because of the variables and risks involved in shipping goods, when you don't actually pick them up from the seller, and when they have to cross international borders.

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Letters of Credit and Assignments of the Proceeds by Jacob Katsman. The book provides cases, and examples of communications, which can help you build your toolkit, if you're planning on regularly using LCs.

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