

Letter of Credit: its importance and difficulties

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Abstract

Bangladesh has improved its economy tremendously through exporting its product to outside global market. Readymade garments, frozen food, raw leather, etc. are the topmost export items of this country and we achieve fabulous foreign response through our business policy. Letter of Credit (L/C) is a very important issue of foreign exchange management because without L/C import and export cannot be possible. Importer and Exporter do not know each other. For this reason settlement of payment cannot be possible without the arrangement of Bank particularly in foreign trade. Therefore import/Export also cannot be possible if no L/C can be made through Bank. So L/C is a very important issue in foreign trade. of credit is revocable; that is, it can be canceled by the bank without notifying the beneficiary. Bangladesh has a number of renowned banks to open L/C for their customers and these banks play a vital role in our country's export import business. But recently some awkward situations happen in case of foreign trade of our country. Some bankers seem to breach the contract of Letter of Credit. Sometimes these people are untrained and inexperienced to handle this procedure properly. Also in some cases traders are dishonest and want to take the advantage of L/C procedure. So there should be strict rules and regulation to implement the laws of opening a L/C account and handle the total procedure. The government people interfering in opening a L/C should be restricted strictly. To find out the solution some methods are selected. Interview method will be used to have a clear view about the bankers' expertise and traders' knowledge on Documentary Credit operations. Dealing Officers of foreign trade divisions of the selected banks are selected to take interview. After considering the entire situation we should find that restructure of legal enforcement against defaulter importers and exporters in Bangladesh. The personnel of the export-import department of the banks should be well trained, and should know the latest technology and laws of Letter of Credit. Government should be stricter against the corrupted people who create obstacle to open L/C for the client of the banks. The well recognizes business organization of Bangladesh, especially in garments sector should be conscious about their reputation as well as the reputation of this country. Otherwise the goodwill of our business policy and also our foreign income will be threatened in near future.

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Introduction

Letter of Credit (L/C) or the Documentary Letter of Credit is the most popular international trade payment method in Bangladesh, which covers the issues like potential risk that the parties in international trade namely the importers and exporters wish to face or share between them. Bangladesh is basically a seller's market since it is an import-based country. Therefore, on the basis of our traders' credibility, relative bargaining power, banks and regulatory requirements Documentary Letter of Credit is considered to be the best fitted as the international trade payment method. The government of a developing country like Bangladesh tends to retain severe control on foreign trade operations and thus Documentary Credit has a widespread use in our country as it provides useful additional instrument in the government's control and supervisory mechanism. The country's image in the financial world is now at stake, the heading of the renowned news paper remind us about our past glory of international business and recent crisis of the country toward doing business with global world. After shedding light on real situation in Bangladesh some recommendations are placed, such as restructuring legal enforcement against defaulter importers and exporters. The personnel of the export-import department of the banks should be well trained, and should know the latest technology and laws of Letter of Credit. The well recognized business organization of Bangladesh, especially in garments sector should be conscious about their reputation as well as the reputation of this country. Finally it is concluded that to encourage the business, to attract foreign buyers as well as to earn huge amount of foreign currency we need to make the method easier and must follow the rules and regulation strictly. If we could have done this then there would be a bright future of our country's image to the global world.

Objective of the study:

After discussing the total background, several objectives have been taken to learn more about L/C:

1. To discuss the operational procedures of Letter of Credit operation
2. To discuss the Letter of Credit operation in the context of Bangladesh
3. To identify some problems regarding perfect execution of Letter of Credit method in Bangladeshi export-import business process.
4. Recent scenario of Bangladeshi local bank in case of open L/C for importer and the solution of this crisis.

Methodology

For attaining the objectives, both primary and secondary data should be collected.

Primary Data: A questionnaire survey will be conducted for collecting primary data. The survey area is the AD branch of some selected commercial banks. Furthermore, interview method will be used to have a clear view about the bankers' expertise and traders' knowledge on Documentary Credit operations.

Dealing Officers of foreign trade divisions of the selected banks are selected to take interview. Six major AD branches of three commercial banks are also selected on the basis of convenience. All the branches are located within Dhaka city.

Secondary data: Secondary data sources are related to practices of Letter of Credit operation, various documents of ICC and domestic laws and provisions over book or various websites.

Limitation of the study:

Time limitation is a great factor for conducting research on such a vast topic. As this study has been accomplished on the basis of the data collected from only 3 commercial banks which may not reveal the real scenario of the operations and practices of L/C in Bangladesh.

A General overview of Letter of credit:

We can identify Letter of Credit (LC) in various ways, in general a letter of credit is a document issued by a bank which provides a guarantee of funding for a business. Letters of credit are used particularly in overseas transactions, where a company in one country wishes to purchase goods or services from a company in another country. The bank reviews the buyer's credit and provides a guarantee of payment in case of default by the buyer. The person receiving the letter of credit is considered the "beneficiary."

While a letter of credit is issued for a guarantee in a specific transaction, a standby letter of credit is a general letter providing a guarantee for a specific period of time.

Most letters of credit are irrevocable, but occasionally a letter of credit is revocable; that is, it can be canceled by the bank without notifying the beneficiary.

Types of Letter of Credit:

An Import/Export Letter of Credit (popularly called Master LC) is used in international trade between buyers and sellers of different countries but Back to Back letter of credit can be used in both local and international trade. Let us get introduced with different types of letters of credit used in apparel export business:

Import/Export Letter of Credit : The same credit is termed as Import Letter of Credit or Export Letter of Credit. It depends on whose perspective it is being considered. For the importer it is termed as Import Letter of Credit and for the exporter it is termed Export Letter of Credit.

Revolving Letter of Credit (L/C): Revolving letters of credit were a tool created to allow companies conducting regular business to issue a letter of credit that could "roll-over" without the company having to reapply, thus enabling business flow to continue without interruption as long as the terms and conditions, quantities, and other transaction details did not change.

Revocable Letter of Credit: Without the authentication of the seller/exporter (beneficiary), buyer/importer (applicant) can cancel or make any amendment of this type of Letter of Credit through the issuing Bank. This type of letter of credit is totally manipulated by the buyer. None accepts this type of letter of credit these days.

Irrevocable Letter of Credit: Without the authentication of the seller/exporter (beneficiary), buyer/importer (applicant) cannot cancel or make any amendment of this type of Letter of Credit through the issuing Bank. It can only be cancelled without the authentication of the seller/exporter (beneficiary) if it is expired. Exporters always prefer this type of letter of credit.

Transferable Letter of Credit : Transferable Letter of Credit is required when the exporter is middleman or agent (not the actual supplier) of the goods but buyer finds it valuable to work with this type of agent/middleman. This is also fact that sometimes agent/middleman does not want the buyer and supplier knows each other. In this type of Credit, the exporter has the right to transfer the credit to one or more subsequent beneficiaries to procure the goods and arrange them to be sent to the buyer. Usually buying houses prefer this type of letter of credit.

Nontransferable Letter of Credit: The credit cannot be transferred to anyone by the exporter/beneficiary.

Confirmed Letter of Credit: An additional confirmation or guarantee that commits to payment of the letter of credit. A confirmed letter of credit is typically used when the issuing bank of the letter of credit may have questionable creditworthiness and the seller seeks to get a second guarantee to assure payment.

Unconfirmed Letter of Credit: This type of letter of credit, does not acquire the other bank's confirmation.

Sight Credit and Usance Credit (L/C): Sight credit states that the payments would be made by the issuing bank at sight, on demand or on presentation. In case of usance credit, as per agreement by both of the exporter/beneficiary and importer/applicant this type of letter of credit requires an indicated duration for payment instead of getting paid immediately after the valid documents are checked. By this time importer/buyer can take the opportunity to arrange money selling the goods.

At Sight Letter of Credit: As mentioned in this type of letter of credit, payment is made to the exporter/beneficiary immediately upon presentation of the correct document. Apparel exporter prefers this type of letter of credit.

Red Clause Letter of Credit: This is the specific type of letter of credit that carries a provision (traditionally written or typed in red ink) which allows a exporter/beneficiary to draw up to a fixed sum from the advising or paying-bank, in advance of the shipment or before presenting the prescribed documents.

Back to Back Letter of Credit : The Back to Back Letter of Credit (sometimes referred to as the Baby or Slave Letter of Credit) is issued on the strength of the Master Letter of Credit (Master LC). Back to Back Letter of Credit is issued by the exporter's bank (advising bank) to the supplier to procure raw materials. Permission of the ultimate buyer or that of the issuing bank is not required to issue a back to back letter of credit.

Standby Letter of Credit (L/C): The standby letter of credit is very much similar in nature to a bank guarantee. The main objective of issuing such a credit is to secure bank loans. Standby credits are usually issued by the applicant's bank in the applicant's country and advised to the beneficiary by a bank in the beneficiary's country.

Common Documents under Documentary Letter of Credit

Bill of exchange/Draft:

- The draft must bear the correct Documentary reference number.
- The draft must be valid until expiry of the L/C and within the stipulated period for negotiation.
- It must be drawn or endorsed to the order of the bank.
- It is drawn by the party indicated as the beneficiary of the credit.
- It is drawn on the party indicated as the draw of the credit.
- It is market as drawn under the proper L/C of the bank quoting the L/C number.
- The tenor is in conformity with that stipulated in the L/C.
- The amount is identical with the amount mentioned in terms of the credit.

Bill of Lading (B/L)

- The full set of B/L is submitted including original copy.
- It is marked "Shipped on Board"
- It is drawn in favor of the bank endorsed to the order off the bank and dated after issuance of the L/C
- The B/L is clean
- If the terms of sale are C& F, B/L is to be marked "Freight Prepaid".
- Short from B/L is not acceptable
- Charter party B/L is not allowed unless specified in the L/C
- B/L is not stale
- Other (if any) as per L/C terms.

Commercial invoice

- The invoice is signed by the exporter / beneficiary
- The required numbers of copies of the invoice are placed as per L/C terms.
- Description of the goods with measurement / weight is mentioned in full.
- The value and price of the goods to be tallied with L/C terms
- The L/C number, name of the ship with shipping mark, shipments date L.C.A.F/ license numbers of the importer, indent number etc. are to be quoted in the invoice properly.
- The quality and quantity of the goods as mentioned in the invoice must agree with that of L/C terms.
- The name of the importer and the L/C issuing bank is mentioned in the invoice.

Certificate of origin

- The certificate of origin may be issued by the chamber of commerce & Industry of exporter's locality or by the supplier as stipulated in the L/C.
- The goods must be originated from the country as per indication included in the L/C.

Inspection Certificate

- The certificate must comply with the inspection requirements of the Documentary Credit.
- It contains no detrimental statement as to the goods, specifications, quality, packing etc. unless authorized by the documentary credit.

Packing List

- A detailed packing list requires a listing of the contents of each package, carton, etc. and other relevant information. It corresponds with the requirements of the Documentary Credit.

Insurance Document

- It is the policy/ certificate/declaration under cover note, as required by the Documentary Credit.
- It covers the specified risks as stated in the Documentary Credit and that the risks are clearly defined.

Parties to Letters of Credit

Applicant (Opener): Applicant which is also referred to as account party is normally a buyer or customer of the goods, who has to make payment to beneficiary. LC is initiated and issued at his request and on the basis of his instructions.

Issuing Bank (Opening Bank): The issuing bank is the one which create a letter of credit and takes the responsibility to make the payments on receipt of the documents from the beneficiary or through their banker. The payments have to be made to the beneficiary within seven working days from the date of receipt of documents at their end, provided the documents are in accordance with the terms and conditions of the letter of credit. If the documents are discrepant one, the rejection thereof to be communicated within seven working days from the date of receipt of documents at their end.

Beneficiary: Beneficiary is normally stands for a seller of the goods, who has to receive payment from the applicant. A credit is issued in his favour to enable him or his agent to obtain payment on surrender of stipulated document and comply with the term and conditions of the L/C.

If L/C is a transferable one and he transfers the credit to another party, then he is referred to as the first or original beneficiary.

Advising Bank: An advising bank provides advice to the beneficiary and takes the responsibility for sending the documents to the issuing bank and is normally located in the country of the beneficiary.

Confirming Bank: Confirming bank adds its guarantee to the credit opened by another bank, thereby undertaking the responsibility of payment/negotiation acceptance under the credit, in addition to that of the issuing bank. Confirming bank play an important role where the exporter is not satisfied with the undertaking of only the issuing bank.

Negotiating Bank: The Negotiating Bank is the bank who negotiates the documents submitted to them by the beneficiary under the credit either advised through them or restricted to them for negotiation. On negotiation of the documents they will claim the reimbursement under the credit and makes the payment to the beneficiary provided the documents submitted are in accordance with the terms and conditions of the letters of credit.

Reimbursing Bank: Reimbursing Bank is the bank authorized to honor the reimbursement claim in settlement of negotiation/acceptance/payment lodged with it by the negotiating bank. It is normally the bank with which issuing bank has an account from which payment has to be made.

Second Beneficiary: Second Beneficiary is the person who represents the first or original Beneficiary of credit in his absence. In this case, the credits belonging to the original beneficiary is transferable. The rights of the transferee are subject to terms of transfer.

Letter of Credit Operation in Bangladesh:

One of the important functions of the commercial banks in the world is to undertake import of merchandise into the country and payment of foreign exchange towards the cost of the merchandise to foreign suppliers. In almost all the countries of the world there is import trade control in one form or the other which supervises the import into the country and controls certain items of exports depending upon national exigencies. The main object of the import trade control is to conserve the scarce foreign exchange resources of the country with a view to meeting the needs of development of its expanding economy. In Bangladesh, the import of goods is regulated by the Ministry of Commerce in terms of the Import and Export (Control) act, 1950; with Import Policy Orders, and Public Notices issued from time to time by the Chief Controller of Imports and Exports (C.C.I.& E), while payments for these imports are regulated by Central Bank, i.e. Bangladesh Bank, through its Exchange Control Department.

According to the Imports and Exports Act, 1950 as adopted in Bangladesh, anyone willing to carry import business needs registration with the licensing authority, i.e., Chief Controller of Imports Exports and its offices at the important trade centers of the country.

The following documents are required to be submitted to the licensing authority for registration as importers.

- i) Questionnaire form duly filled in and signed
- ii) Income tax registration certificate
- ii) Trade License from the Municipal or Local Authority
- iv) Bank certificate
- v) Nationality certificate
- vi) Partnership deed where applicable
- vii) Certificate of Registration with the Register of Joint Stock Companies and Memorandum and Articles of Association in case of Private and Public Limited Company.
- viii) Certificate from the Chamber of Commerce / registered Trade Association
- ix) Ownership documents or rent receipts of the place of business
- x) Any other documents required under the relevant import policy

On receipt of the application along with relative documents, the Chief Controller of Imports and Exports and its regional offices scrutinizes the documents and conducts physical verification (if considered necessary) and on being satisfied, requests the applicant to pay fees towards registration through treasury challan.

After submission of the above documents and payment of requisite fees, if the documents are found in order and the C.C.I & E is satisfied, the Import Registration Certificate (IRC) is issued to the applicant-importer.

The IRC is a security document issued under embossing seal and duly signed by authorized officials of C.C.I & E and to be kept safe custody. The IRC is required to be renewed every year on payment of usual fees.

Import in Bangladesh can take place in two ways

- (1) By way of opening L/C
- (2) Without opening L/C.

1. Import by way of opening L/C: It requires fulfilling following criteria of private sector importer;

- a) Registered importer having valid IRC
- b) Trade license (valid)
- c) Membership certificate from local chamber of commerce of related association (valid).
- d) Income tax clearance/ declaration in case of new comer.
- e) VAT registration certificate.

If a private sector importer fulfils above requirements, a banker can process an L/C for import of goods & services from abroad but following papers/documents are to be obtained before opening of LC in addition it the above mentioned papers/documents:

1. L/C application.
2. Indent / Performa invoice / purchase order / contract / agreement.
3. Charge documents duly & properly executed.
4. Letter of Credit Authorization Form (LCAF) duly sealed & signed.
5. Insurance cover note.

The importer must be a customer of the L/C issuing bank / branch & the L/C may be opened after sanction by the competent authority.

2. Import into Bangladesh without opening L/C: It may be made in the following cases against LCAF:

- a) Books, journals, magazines, periodicals against sight draft or usance bills. Any imported item which requires payment from Bangladesh to the maximum of US \$. 2500/-in a year
- b) The items allowed by the credit, Loan, Grant.
- c) International chemical reference by registered allopathic industrial unit with the approval of Director, Drug Administration.

Risk situations in letter-of-credit transactions**Fraud Risks**

- The payment will be obtained for nonexistent or worthless merchandise against presentation by the beneficiary of forged or falsified documents.
- Only the credit itself may be funded.

Sovereign and Regulatory Risks

- Performance of the Documentary Credit may be prevented by government action outside the control of the parties.

Legal Risks

- Possibility that performance of a Documentary Credit may be disturbed by legal action relating directly to the parties and their rights and obligations under the Documentary Credit

Force Majeure and Frustration of Contract

- Performance of a contract – including an obligation under a Documentary Credit relationship – is prevented by external factors such as natural disasters or armed conflicts

A real life case study over breaking the trust of L/C by Bangladeshi Local Bank:

In recent days people of other countries' face a lot of harass to doing business with Bangladeshi people through opening a L/C. After considering different case study we found that some local banks break the confidence and faith of the people outside Bangladesh as they do not give their payment in right time. After few months ago a reputed local bank of our country; National Bank had committed this type of rules breaking activities. A HK exporter exports a container on L/C 90 days B/L date in last June to Bangladesh. Apparently this L/C was opened to them following a back-t-back structure (this is not mentioned in their L/C text though). Issuing bank was a local bank in Bangladesh. The L/C was not confirmed.

After a few days the issuing bank confirmed reception of documents. The buyer raised no discrepancies, the documents were handed over to the buyer and he took the goods from port. At the same time the bank agreed payment to mature end of October (they sent SWIFT message for this payment confirmation). Everything was consistent with the B/L shipping date and looked ok.

After the maturity date 10 days passed but the bank did not pay. Bank in HK sent several messages to issuing bank to ask for immediate payment but the HK bank did not receive any reply. Not only this, they did not reply any swift message to HK bank that they had been sent earlier.

After that the foreign bank sent some strict messages to Bangladeshi bank. They were talking to the bank in Bangladesh and explaining the serious consequences of this non-payment. The local bank promised they had already paid and they showed the HK bank a fake swift MT202 (payment order). They identified it as a message still pendent to be sent to the system, it was just in "standby" (They showed HK people a copy paper of a swift message where the 'status' field in the message was "fuzzy", they just made the paper unreadable but they said the message had been already released, something that was not true).

After this explanation and more strong position of HK bank finally the local bank released the message to the swift system and in HK the exporter bank advised to get the money in the account.

The local bank kept the money for 3 weeks, either Pay the bill amount along with interest amount or get ready for some legal actions.

The reasons behind the default payment of local bank of Bangladesh:

Most of the local banks are in real financial trouble due to the political deadlock ahead of the general election. Local commercial banks are now unable to repay the loans against local and foreign LCs due to stagnated business activities amid political deadlock and prolonged violence.

Some specialized bank like Islami Bank Bangladesh might face a setback for their high dependence on readymade garments exports if the political unrest prolongs.

In our country bankers who are involved to handle foreign export department some times are not enough qualified or experience to identify the financial condition of the importer. As a result importer in some cases does not have enough funds to make payment in time and banks have to bear the consequences.

There is always the risk of exporting inferior quality goods. Banks need to be protective by finding out as much possible about the exporter using status report and other confidential information. In our country most of the banks do not have these types of expert hands to identify and analyze confidential information of exporters.

The corruption of the bankers as well as the political people is one of the main reasons of refusing to open a L/C. Now a day's government has taken a huge loan from banks and these banks do not have proper fund to open L/C for the importer. Again some political persons threaten the officials of banks to open L/C for some industry because of their rivalry.

Some solution to overcome this situation:

Even at this real time communication world, letter of credit is considered to be the one of the safest way to remit and get proceeds. But still there are some factors to be re-considered like:

- 1) Restructure of legal enforcement against defaulter importers and exporters in Bangladesh.
- 2) Necessary changes in import policy to permit imports to be made without LC to reduce import cost and subsequently reduce prices on essential and consumable goods.
- 3) Financing in the garments sector by the banks should be made more secure etc.
- 4) The personnel of the export-import department of the banks should be well trained, and should know the latest technology and laws of Letter of Credit.

- 5) Government should be stricter against the corrupted people who create obstacle to open L/C for the client of the banks.
- 6) The well recognize business organization of Bangladesh, especially in garments sector should be conscious about their reputation as well as the reputation of this country and should make the payment in time so that other countries can agree to do business with us in near future.
- 7) Carefully review all requirements for the letter of credit before moving forward with a deal, understand all the documents required .Can get all the documents required for the letter of credit and also understand the time limits associated with the letter of credit, and whether they are reasonable
- 8) Local banks should regularly repay the loans of foreign financial institutions and banks to protect the image of local banks and the country as well.

Conclusion:

The Export Import business of Bangladesh in some cases entirely depends upon the Letter of Credit method. The Import and Export policy of the country and Foreign Exchange Guideline provided by the Central Bank are also encourage this Documentary Credit system. For example import without LC is restricted for upto \$35000/per year and to some restricted items like books, journals etc. (Import Policy Order 2006-2009) and import against advanced payment is comparatively complex (Foreign Exchange Guideline Vol – 1). So to encourage our business, to attract foreign buyers as well as to earn huge amount of foreign currency we need to make this method easier and must follow the rules and regulation strictly. If we could have done this then there would be a bright future of our country's image to the global world.

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