LETTERS OF CREDIT REPORT

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Banker's Eye View

Export L/Cs: Did You Want Your Money Now or Later?

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Letters of credit fall into two main categories: commercial and standby—the ones that are intended to be paid and the ones that aren't. This article is about the ones that are intended to be paid and an underutilized "trick of the trade" for getting them paid faster.

In earlier articles I've pointed out that 60%-80% of drawings presented under commercial letters of credit contain discrepancies, yet only about one in a thousand gets refused.[i] Discrepancies add a great deal of tension to the system. When documents have no discrepancies, the "negotiating" bank can often get funds from the issuing bank in a week or less by claiming payment from the issuing bank's clearing account with a bank in New York. This mechanism is so efficient it allows payment before the issuing bank has even seen the documents. In order to do this, the negotiating bank must take full responsibility for documentary compliance. Once the issuer receives the documents, they have the right to demand the funds be returned if they find discrepancies and wish to refuse payment.

When documents have discrepancies, however, two weeks or more can be added to the process. First the exporter must be notified of the discrepancies and given an opportunity to fix them. If they cannot be fixed, most negotiating banks in the U.S. give the exporter only two choices for proceeding, both of them time-consuming:

(1) Mail the documents to the issuing bank and see what happens, or
(2) Cable the issuing bank with a list of discrepancies identified and ask for a waiver.

In my days as a document checker, I used to hate calling exporters to tell them about discrepancies in their documents. They always wanted to argue about why something was not a discrepancy or was only a "minor discrepancy." I would try to explain that it was not up to me, as the negotiating bank, to decide what was and what was not a discrepancy; my job was to identify things the bank which *issued* the credit might call discrepancies. There is no distinction between major and minor discrepancies, as any discrepancy can be used as grounds for refusing documents. But if the exporter was so sure documents would not be refused, I invited them to bear the risk rather than trying to stick me with it. I presented them with a third alternative:

(3) Put an indemnity in place which allows the negotiating bank to proceed as though there were no discrepancies.

This would allow me to avoid the delays and expenses involved in mailing documents for approval or cabling for waiver, i.e., it's faster and cheaper.

Most banks are willing to offer this method of handling to their regular customers, they just don't bring it up. The use of such indemnities is even addressed in the UCP500[ii] and there's fairly standard language for them:

> In consideration of your honoring/negotiating this drawing, 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,

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> 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.

We bankers call these indemnities "shippers' indemnities." Although the language scares off a lot of exporters, it puts them in no worse position than they would be in if the negotiating bank mailed the documents for approval or cabled for waiver. The worst that can happen is that the issuing bank refuses the documents and asks for the money back. Without using the shipper's indemnity, the exporter wouldn't be paid in the first place. As I've already pointed out, the odds of the documents being refused are very low. Refusal is usually because the goods shipped do not meet the terms of the original contract of sale and the importer does not want them. It is obviously the exporter, not the bank, who is in the best position to judge when this might happen.

On the positive side, payment can be made quickly. Rather than the 60%-80% of drawings that have discrepancies getting exceptional processing, only the 0.1% of drawings which are refused incur the additional delays and expenses. Although payment against an indemnity is subject to reversal, there is a fairly short time limit. Under the UCP500, the issuing bank has only seven banking days after receipt of documents to refuse them.[iii] After that, payment becomes final.

Shipper's indemnities put the risk where it belongs while taking advantage of the fact commercial letters of credit are intended to be paid. Using them improves the efficiency of the letter of credit process and removes stress from the system.

Notes

[i] See "Why are We Examining Documents under All These L/Cs" in the January/February 1996 issue of *Letters of Credit Report*, Vol. 10, No. 5

[ii] UCP500 Article 14(f)

[iii] UCP500 Article 14(d)(i)