

## 1.LETTER OF CREDIT

**Step 1** The buyer agrees to purchase goods from the seller. This agreement may be a purchase order, an accepted pro-forma invoice, a formal contract, or an informal exchange of messages. Agreement is made as to goods being purchased, how and when they are to be shipped and insured, and how and when payment is to be affected. In this case, the agreement is to use a letter of credit as the mechanism of payment.

**Step 2** The buyer applies to his bank for a letter of credit, by 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 sends it to the seller (beneficiary), or the sellers nominated bank to assist in the transaction bank to bank.

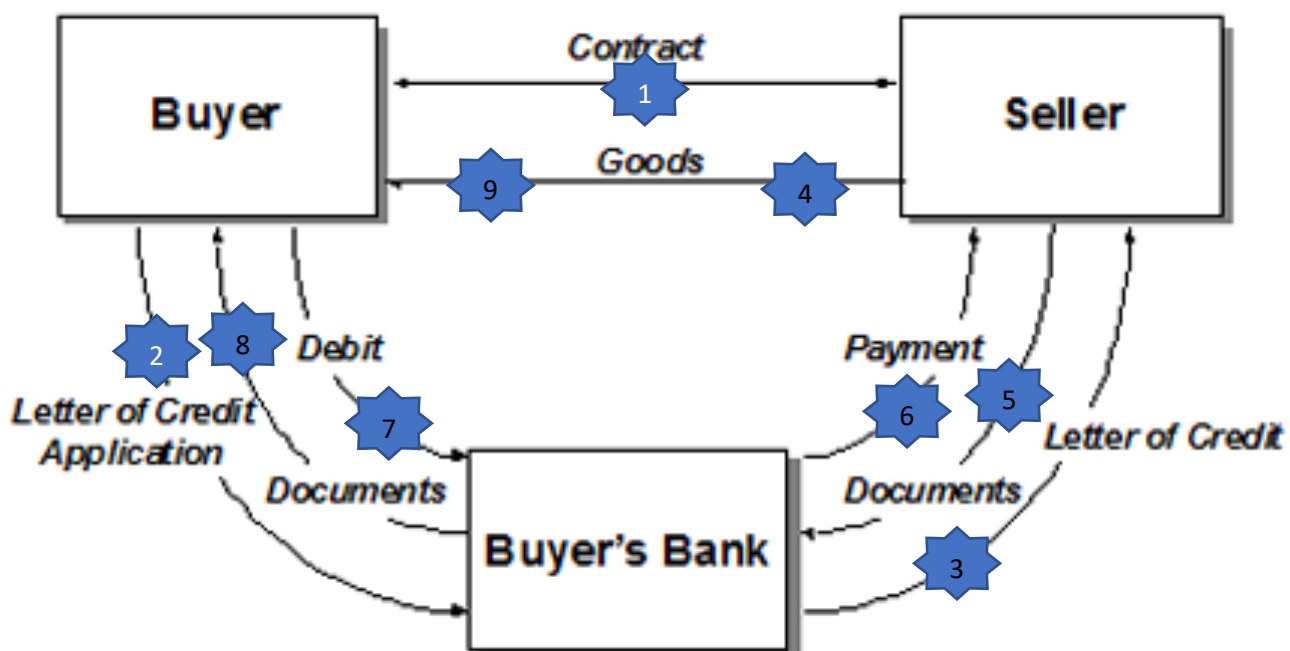
**Step 4** Having received the issuing bank's assurance of payment, the seller ships the goods to the buyer.

**Step 5** The seller prepares the documents called for in the letter of credit and presents them to the issuing bank.

**Step 6** The issuing bank examines the documents. If it determines that the documents comply with the letter of credit, the issuing bank pays the seller.

**Steps 7 & 8** 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 9** The applicant uses the documents to pick up the merchandise from the carrier, completing the letter of credit cycle.



## Benefits of a Letter of Credit

With a letter of credit, a bank can neutralize a corporate customer's country and bank risk by offering a confirmed documentary credit once the customer relies on the bank's solvency, knowledge, and professionalism. By conducting export sales transactions under an irrevocable letter of credit, the seller does not have to determine the credit standing of the foreign buyer. Letters of credit are issued in many different forms from foreign banks and financial institutions. The variations are due to differences in customs and regulations of trade and finance in the country of origin of the issuing bank or financial institution. If, for any reason, a seller cannot comply with one or more conditions of a letter of credit, it is absolutely imperative for the seller to contact the buyer to arrange for one or more amendments to the original agreement.

A letter of credit provides an irrevocable guarantee to the exporter that, provided the goods and/or services are delivered to the importer according to contractual terms and with the compliant documents, it will be paid by the bank that issued that letter of credit (the bank of the importer).

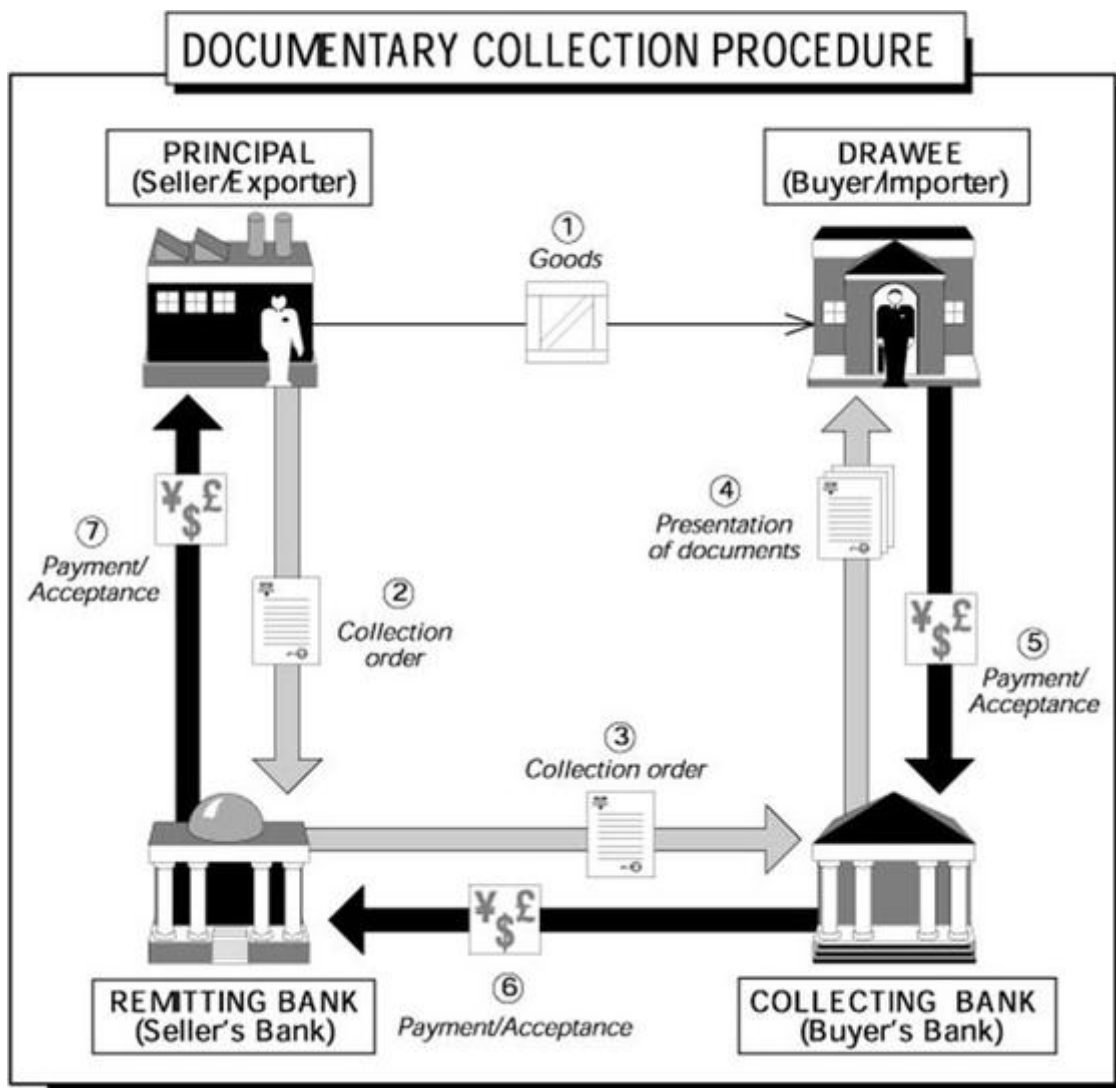
It also provides assurances to the importer that the goods and/or services ordered will be received, in line with the compliant documentation and under any contractual terms set out in the purchase agreement.

The obligation of the issuing bank to pay the beneficiary of the letter of credit, most generally the exporter, therefore depends on the exporter delivering the merchandise as detailed in the letter of credit, but also in accordance with all the other requirements specified in the documented credit.

The documentation required in a letter of credit depends on the level of complexity of the transaction and the degree of security that the two parties wish to have on the transaction: security of payment, security and transparency regarding the description of the goods, security regarding the clearance of Customs, transportation process and delivery on time, and other kinds of risks related to the transaction.

Document compliance must be verified - this is one important feature of the acceptance/endorsement process for letters of credit, in particular for the exporter's bank. The legal clauses of basic letters of credit are subject to regular standardization by the banking commission of the international chamber of commerce (ICC), which also provides for arbitration services. The existence of a strong and well identified collateral, and detailed documentation, make documented letters of credit one of the safest forms of lending. Such documentation and collateral are internationally recognized by commercial laws worldwide and are subject to arbitration in the case of default or other problems affecting the transaction.

## 2. Documentary collection is also known as Cash Against Documents (CAD)



**Step1.** The buyer and seller agree on the terms of sale of goods by:

- (a) specifying documentary collection as the means of payment;
- (b) naming a collecting/presenting bank (usually the buyer's bank); and
- (c) listing required documents.

The exporter/seller (i.e., principal) ships the goods to the importer/buyer (i.e., drawee) and obtains a negotiable transport document (i.e., bill of lading) from the shipping firm/agent.

**Step 2.** The seller prepares and presents (i.e., remits) a document package to his bank (i.e., the remitting bank) consisting of: (a) a collection order specifying the terms and conditions under which the bank is to hand over documents to the buyer and receive payment; (b) the negotiable transport document (i.e., bill of lading); and (c) other documents (e.g., insurance document, certificate of origin, inspection certificate) as required by the buyer.

**Step 3.** The remitting bank sends the documentation package by mail or by courier to the designated collecting/presenting bank in the buyer's country with instructions to present them to the buyer (i.e., drawee) and collect payment.

**Step 4.** The presenting (i.e., collecting) bank: (a) reviews the documents making certain they are in conformity with the collection order; (b) notifies the buyer about the terms and conditions of the collection order; and (c) releases the documents once the payment conditions have been met.

**Step 5.** The buyer: (a) makes a cash payment (by signing the draft), or if the collection order allows, signs an acceptance (i.e., promise to pay at a future date); and (b) receives the documents and takes possession of the shipment.

**Step 6.** The collecting bank pays the remitting bank either with an immediate payment or at the maturity date of the accepted bill of exchange.

**Step 7.** The remitting bank then pays the seller (i.e., principal).

A documentary collection (DC) is a transaction whereby an exporter entrusts collection of a payment to the remitting bank (i.e., exporter's bank), which sends documents to a collecting bank (i.e., importer's bank), along with instructions for payment.

Funds are received from the importer and remitted to the exporter through the banks involved in exchange for those documents. DCs involve using a draft that requires the importer to pay the face amount either at sight (i.e., document against payment) or on a specified date (i.e., document against acceptance). The draft gives instructions that specify the documents required for the transfer of the title to goods. Although banks do act as facilitators for their clients, DCs offer no verification process and limited recourse in the event of non-payment. Drafts are generally less expensive than letters of credit (LC).

Under a DC transaction, the importer is not legally obliged to pay for goods before shipment. The exporter retains the title to goods until the importer either pays the face amount at sight or accepts the draft to incur a legal obligation to pay at a specified later date. Although a title to goods can be controlled for ocean shipments, it cannot be controlled for air and overland shipments, which allow the foreign buyer to receive the goods with or without payment. The remitting bank (i.e., exporter's bank) and the collecting bank (i.e., importer's bank) play an essential role in DCs. Although the banks control the flow of documents, they neither verify the documents nor take any risks. They can, however, influence the mutually satisfactory settlement of a DC transaction.

## About ARDA

The Agribusiness Regional Development Association (ARDA) is a not-for-profit organisation helping Australian food and beverage producers build sustainable businesses. With decades of experience across the agriculture supply chain, we connect our members with the right people, at the right time, to achieve business growth. ARDA is funded by the Department of Agriculture, Water and the Environment to deliver the Market Diversification Program.