How can Letters of Credit provide working capital?

The London Institute of Banking & Finance’s Relationship Director, David Morrish, explains how even when the cost of the discount is factored in, this trade finance tool is a good solution.

Letters of credit (LCs) provide sellers with some certainty of payment and, used imaginatively, they can also facilitate release of much-needed working capital. In some instances this will depend on how sympathetic the seller’s bankers are, an issue discussed further in this article.

Firm order

At its simplest, the receipt of a firm order for the supply of goods or services in the form of a letter of credit, confirmed by a bank in the seller’s country if appropriate, may give the seller’s bankers confidence to increase credit facilities with them. However, if not the bank, or other banks or specialist export finance providers, may be prepared to look at the letter of credit on a stand-alone basis.

The key questions banks will want answering include:

- Does the seller have the ability to fulfil the terms of the LC? Are the terms straightforward or unduly complex?
- Is this the seller’s normal business activity?
- What is known of the buyers? Are they reputable?
- What is the standing of the issuing bank? If the LC has been confirmed what is the standing of the confirming bank?
- Is there a potential market for the goods in the event that the terms of the LC cannot be met and the original buyer walks away?

This is not an exhaustive list, there are no doubt other factors that will need to be considered, but it should give an indication of what level of comfort lenders are looking for. It is worth adding that, while there are exceptions, when buyers request their bankers to issue an LC this will usually be at their expense and will use up some of their credit line. In other words if buyers apply for an LC to be issued on their behalf then it is reasonable to assume that they want the goods. So even if the seller fails to meet all of the terms and conditions of an LC, as long as the underlying goods or services are delivered, in the vast majority of cases payment will still be forthcoming. What has been lost is the certainty of payment that a complying presentation provides.

Transfer, assignment and back-to-back LCs

For transactions in favour of sellers that are sourcing some, or all, of the goods or services from third parties then there are other options available. Asking for an LC to be ‘transferable’ (under LC Uniform Rules UCP 600) allows the beneficiary of an LC to transfer all, or part of, the LC to one or more suppliers. The terms of the LC are, for the most part, replicated but the amount and unit price of the goods may be reduced so that the beneficiary of the original LC can make its turn.

Importantly the beneficiary of a transferrable LC needs no additional credit facilities although it will need to pay the bank’s transfer fees. On the down side the buyer will almost certainly learn the identity of the ultimate supplier and may subsequently deal direct.

Back-to-back LCs are not recognised by UCP 600 but work in a similar way to transferrable credits, i.e. with the terms and conditions in favour of a seller being replicated in LCs issued ‘on the back’ of LCs issued to third party suppliers. These need very close monitoring by the bank if risks are to be minimised which is why not every bank will offer this facility. However, as with transferrable LCs it does allow the original beneficiary to use an LC received in its favour effectively as security, in whole or in part, to source goods or services.

As another variation, the beneficiary of an LC may assign the proceeds of successful presentations of documents to third parties (as defined in UCP 600). Third party suppliers may therefore be sufficiently confident of a beneficiary’s ability to present complying documents, to accept an assignment of a given percentage of proceeds under LC presentations, in lieu of payment in advance for goods supplied.

Where it is recognised by a buyer that the beneficiary of an LC may require working capital to allow a contract to be fulfilled, an advance payment or red clause may be inserted into the terms of the LC. This allows the beneficiary to draw down a given percentage ahead of shipment of the underlying goods, with the amount drawn being deducted from the amount due on presentation of complying documents.
Buyer support

Of course it is not only sellers that may need finance; buyers may also need support. In a new relationship it would be not unusual for the seller to call for an LC with payment at sight, i.e. on presentation of complying documents. That will often put pressure on the buyer’s cash flow as there will be a funding gap pending delivery of the goods and their subsequent sale. If the seller can be convinced to accept, say 60-day terms, this will give the buyer breathing space before payment is due. However the seller will either have to wait for payment as a consequence, or obtain finance against the deferred payment at cost to them.

However by changing the wording of the LC it is still possible to give the seller payment ‘at sight’ while obtaining credit from them. The case study illustrates how this could work in practice.

There is not necessarily a finance solution for every situation, but with a little thought there are ways in which buyers and sellers can help each other and if necessary can obtain support from their banks. If however that support is not forthcoming then companies should not hesitate to look elsewhere. Potentially this could be other banks with connections in the countries where those companies operate, or increasingly to specialist export finance houses.

In turn banks need to look more imaginatively at the way they assess credit risk regarding international trade transactions. Analysis undertaken by the ICC suggests that financing trade is considerably less risky than traditional lending against security or the strength of the balance sheet. With particular reference to LCs some of the associated risks have already been removed.

The message, therefore, for both potential buyers, sellers and also their banks is to look at the options, understand and mitigate the risks and reap the rewards.

Case study: Seafood import/exports

Seafood Importers (UK) are a fast expanding business in the south of England, specialising in supplying seafood imported from Hong Kong to wholesalers. Typically sales from Seafood Importers (UK) to the wholesalers are on 90-day terms allowing the wholesalers to then sell to supermarkets and restaurants before payment is due.

Eastern Seafood Exporters (Hong Kong), their principal supplier, would like to increase sales. However, pressure for payment from the predominantly small fishing fleets in Hong Kong, where crews are paid in cash at the end of each voyage, means that Eastern Seafood Exporters must insist on documentary LCs to provide certainty with payment in full at sight.

The current requirement for Seafood Importers (UK) to pay their suppliers at sight while granting their buyers 90 days credit has created strong pressure on their cash flow, which has slowed the company’s growth significantly as a consequence.

Seafood Importers (UK) needed to find a mechanism that would allow them to grow the business but maintain existing arrangements with their suppliers.

The answer was to change the payment terms to Eastern Seafood Exporters from sight to 120 days sight, but include a clause in the LC that would allow the face value of documents presented to be paid immediately against complying documents, with the cost of discount over 120 days to be met by Seafood Importers (UK).

The benefits of this were twofold:

• Eastern Seafood Exporters would continue to receive payment in full on presentation of documents at no additional cost to them.

• Seafood Importers (UK) would gain 120 days credit (at cost of discount) giving them a positive cash flow of 30 days.