

# Letters of Credit – Revealing its advantages and disadvantages

Exporting is always associated with several risks among which non-payment of foreign buyer is the most common one. To mitigate these payment risks, letters of credit are moderated by a bank in the form of a contract where the foreign buyer pays to their bank and the bank holds the amount unless the terms and conditions mentioned in the contract of sales are met. Letters of credit have always been the standard for handling risks though there are several other payment methods which are now in use for dealing with foreign transactions. Read on to know the advantages and disadvantages of letters of credit.

## THE ADVANTAGES

- ***Safe expansion of your international business:*** The trade partners gain the ability to make further transactions with even unknown partners or set new trade relationships with foreign clients. Letters of credit help in business expansion regardless of geographical differences.
- ***Can be customized:*** Both the trade partners have the discretion of customizing a letter of credit. They can include terms and conditions that tailor to their requirements and then conclude with a common list of clauses. Letters of credit can also be personalized from one payment to another with the same trade partner.
- ***A buyer's credit certificate:*** A [letter of credit](#) passes on the credit-worthiness from the buyer or the importer to the issuing bank. When the importer is backed by a reputable institution like a bank, he can carry on several transactions with ease.
- ***No credit risk on part of the seller:*** From the perspective of the exporter or seller, a letter of credit is a mark of safety in case the importer or buyer suddenly goes broke. As the credit-worthiness of the importer is passed on to the issuing bank, the bank becomes liable to pay the amount as per the letter of credit. Hence, an LC works as credit insulation.
- ***Seller gets money after term completion:*** The issuing bank becomes independent of the obligations of the trading partner and any consequential obligations through a letter of credit. The bank needs to check whether or not the documents given by the beneficiary satiate the terms specified in the letter.
- ***Timely payments & better cash flow:*** A letter of credit offers surety to the timing and amount of the cash flow of the exporter. The exporter can thereafter plan his financing needs ahead of time and also diminish his risk level.
- ***Sellers get pre-shipment financing:*** The exporter can easily access pre-shipment financing against an LC as this lets him bridge the financing gaps.

## THE DISADVANTAGES

- ***Bank fee is an additional cost:*** A letter of credit unnecessarily increases the cost of business as the banks charge a fee for offering this kind of service. In case the parties wish to add extra features, the fees can increase steeply.
- ***Formalities are time-taking:*** The formalities and documentation that are required can be more in case of a letter of credit. This can even add to the total cost of running a business.
- ***Fraud risks increase:*** There are few complicated governing rules that bind a letter of credit and several infamous sellers and buyers can misuse them to take undue advantage

of it. Moreover, an LC also poses a fraud risk to the importer. Disputes can arise in case the quality differs from what has been agreed upon.

- **Risk of currency:** A letter of credit has forex risk as there is a currency agreed-upon in the letter of credit. Since one of the parties might have a variation in currency, they can face a risk because of fluctuations in currency. However, this might even work in your favor.
- **Expiry date:** There is an expiry date to a letter of credit and hence the exporter will be bound by time to deliver the goods at any cost. Hurrying might lead to a mess.
- **Default risk by issuing bank:** As the credit-worthiness is transferred to the issuing bank, in case the bank defaults, the exporter still has a payment risk. The exporter may avoid this when the issuing bank guarantees payment but this has a cost attached to it.

Therefore, letters of credit are of utmost importance for securing international trade transactions. Seek help of them in order to insulate your payments.