

TRADE FINANCE KNOWLEDGE HUB



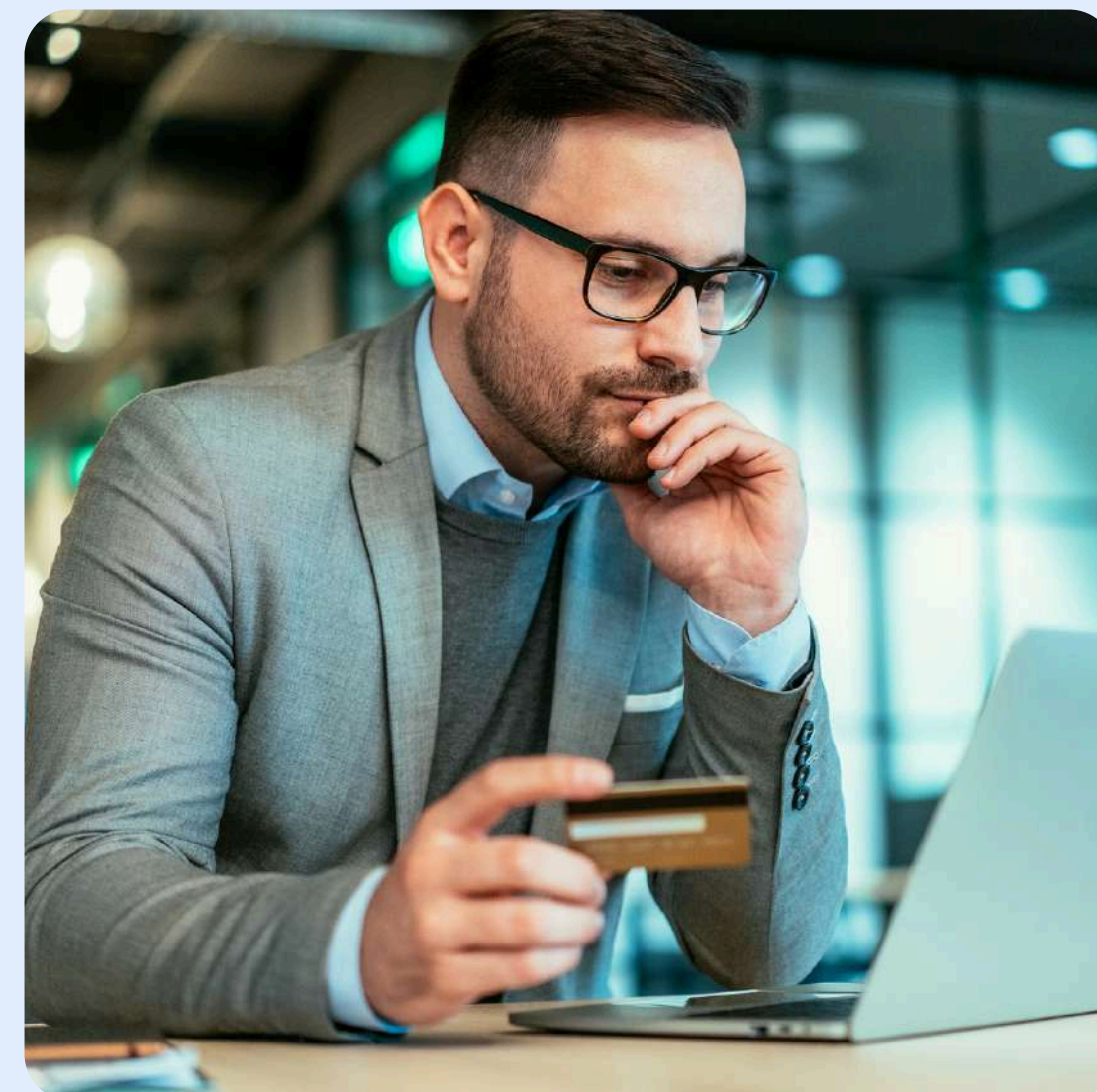
DOCUMENTARY CREDIT

What is a Credit?

Credit, in simple terms, is a time gap agreed between two parties before payment is made.

Instead of paying in advance, the buyer and seller agree on a specific period — such as 30, 60, or 90 days — within which the payment will be settled.

This agreed period allows the buyer to receive the goods or services first and pay later, while the seller extends trust for that duration. The “credit period” is essentially the time given to bridge delivery and payment.



What is a Documentary Credit?

Documentary Credit, also known as a Letter of Credit (LC), is a conditional payment method used in trade between a buyer and a seller.

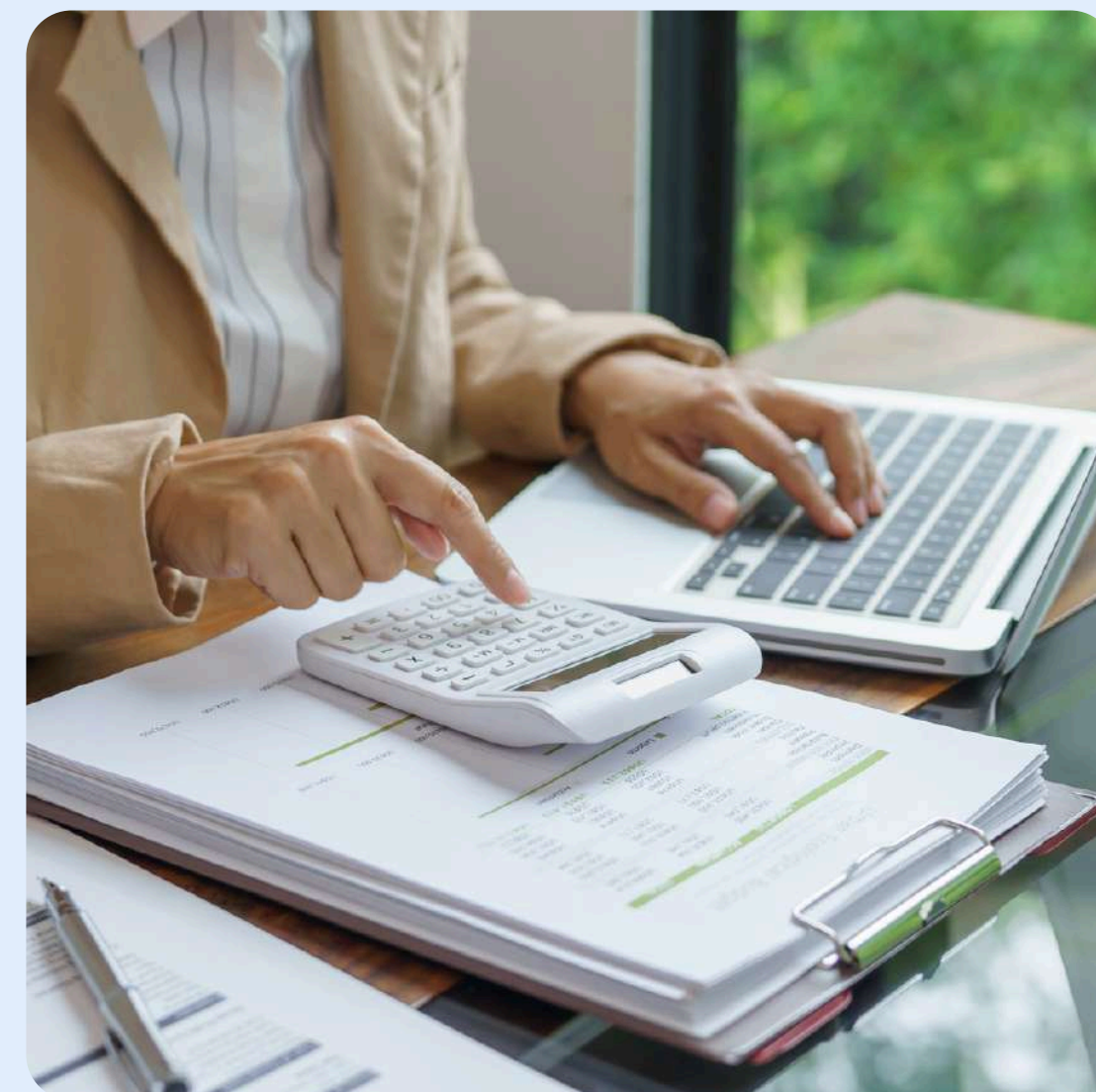
In this arrangement, the buyer's bank provides a written undertaking (guarantee) to the seller that payment will be made — provided that the seller submits the required shipping and trade documents exactly as specified in the Letter of Credit.

These documents typically include items such as the Bill of Lading, Commercial Invoice, Packing List, and other documents agreed upon in the contract.

The key principle is that payment is not based on the physical goods themselves, but strictly on the presentation of compliant documents that meet all the terms and conditions stated in the credit.

This mechanism protects both parties:

- The seller is assured of payment once documents comply.
- The buyer is assured that payment will only be released once shipment is properly documented as agreed.



Why is it called **Conditional Payment Method**?

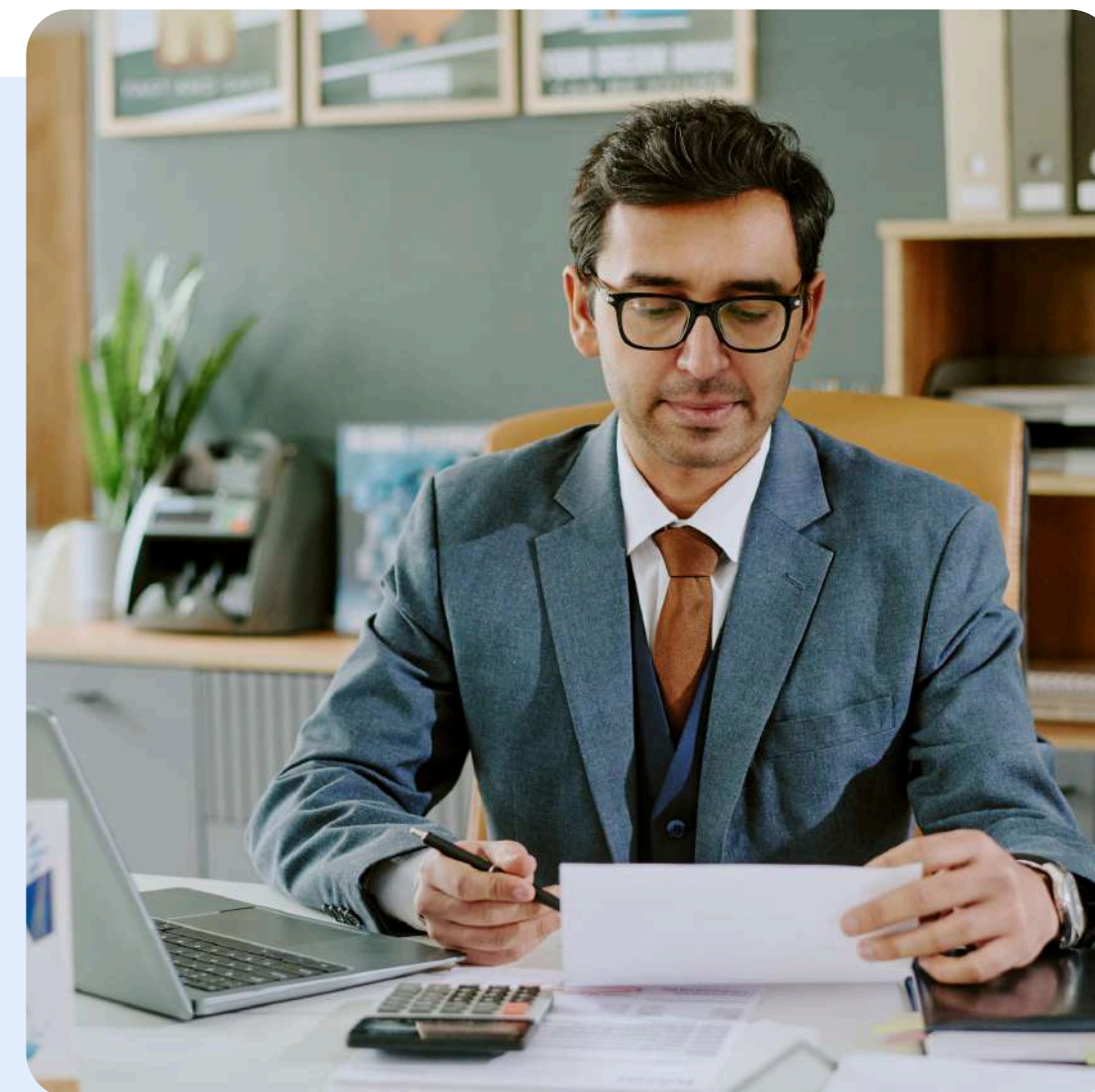
Documentary Credit (Letter of Credit) by nature is conditional.

It contains specific terms, conditions, and documentary requirements that must be strictly complied with by the beneficiary (the seller) in order to receive payment under the credit.

The issuing bank (the buyer's bank) examines only the documents presented — not the actual goods. If the documents fully comply with the terms and conditions stated in the Letter of Credit, payment will be honored.

However, if there are discrepancies or if the required conditions are not met, the issuing bank has the right to refuse payment and return the documents to the beneficiary.

This strict compliance principle ensures that the buyer is protected from non-conforming shipments, while the seller is assured payment — provided all documentary obligations are properly fulfilled.



Are all Documentary Credit Irrevocable?

All Documentary Credits (Letters of Credit) are irrevocable by default under international banking rules (UCP 600).

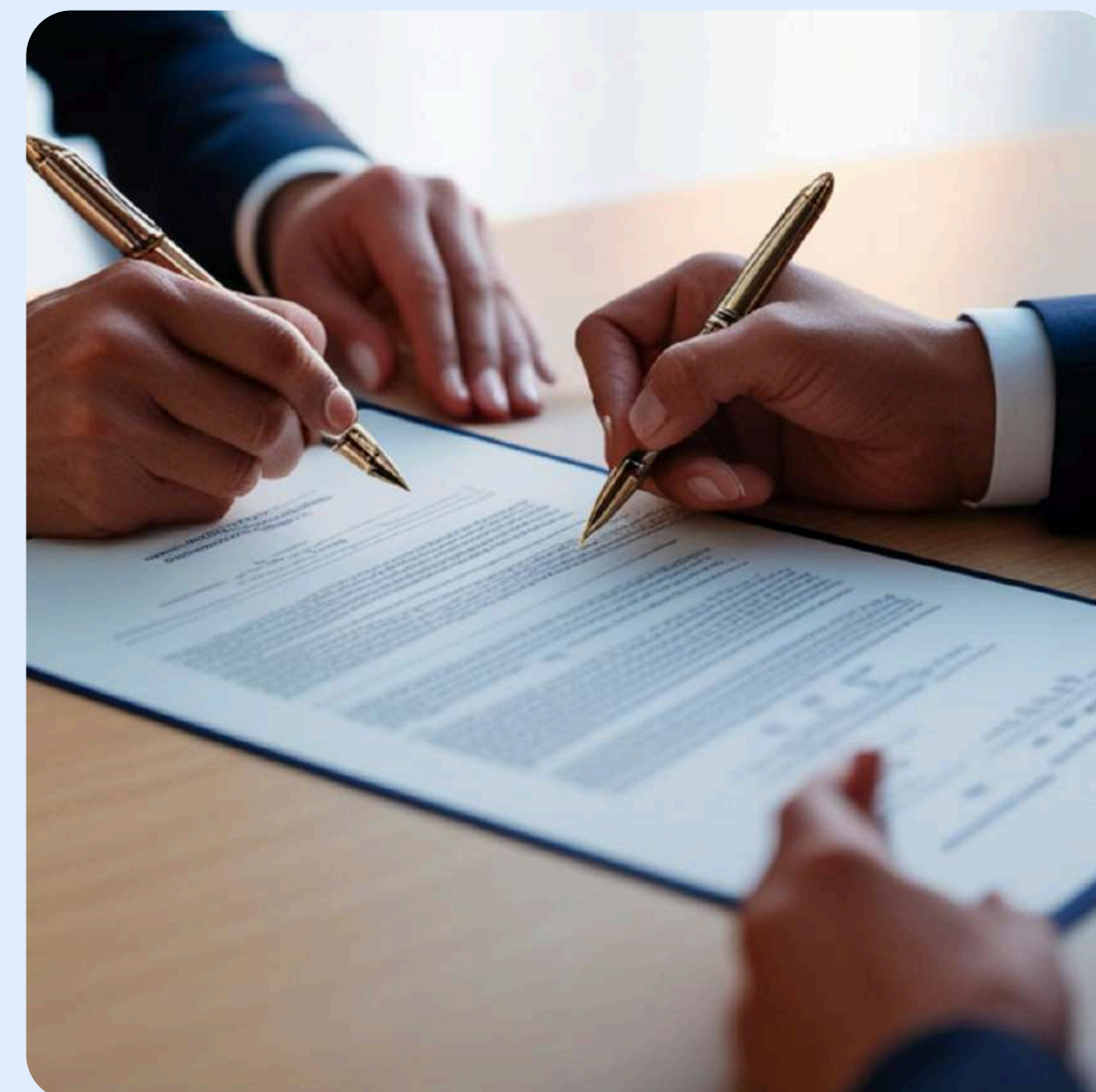
This means that once a Letter of Credit is issued, it cannot be amended or cancelled without the agreement of all concerned parties — particularly the beneficiary (the seller).

The beneficiary is the primary protected party under the credit. While the applicant (buyer) or the issuing bank may request amendments or cancellation, such changes cannot take effect unless the beneficiary formally agrees.

In simple terms:

- The buyer cannot cancel the LC unilaterally.
- The issuing bank cannot revoke it on its own.
- Any amendment or cancellation requires the beneficiary's acceptance.

This irrevocable nature strengthens trust in international trade by ensuring that once the credit is issued, the seller has a secure payment undertaking — subject only to compliance with the credit terms.



Types of Credit in Documentary Credit?

Documentary Letter of Credit at **SIGHT/USANCE**

SIGHT

This type of Documentary Credit is considered one of the most secure payment methods for the seller.

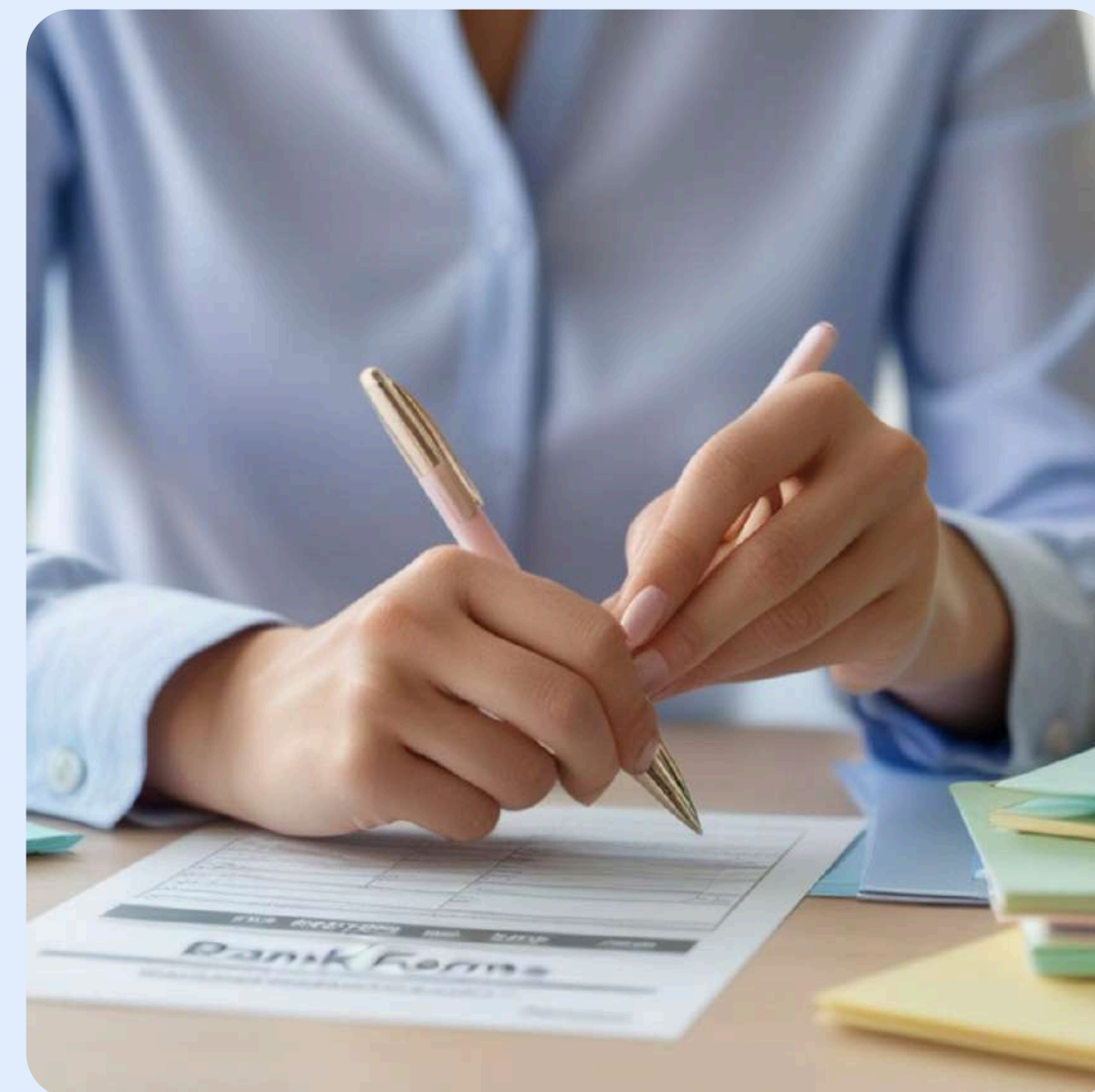
Under this structure (particularly in a sight Letter of Credit), the buyer is able to obtain the shipping documents only after payment has been made or formally accepted. In other words, the release of documents and the release of payment happen simultaneously.

Since the shipping documents — such as the Bill of Lading — represent control over the goods, the buyer cannot claim or clear the goods without first fulfilling the payment obligation under the credit.

This ensures strong protection for the seller, because:

- Payment is secured by the issuing bank.
- The buyer cannot access the goods without honoring the credit terms.
- The transaction is processed through banks under strict documentary control.

For this reason, Documentary Credit remains one of the safest and most trusted payment mechanisms in international trade.



Documentary Letter of Credit at **SIGHT/USANCE**

USANCE

In many trade transactions, buyers prefer a longer repayment period — for example, 90 days from the date of presentation or shipment.

This means that after the seller presents compliant documents under the Letter of Credit, payment will only be made after the agreed credit period (e.g., 60, 90, or 120 days). As a result, the seller must wait until maturity to receive funds.

This structure is commonly referred to as a Usance or Deferred Payment Letter of Credit. However, such arrangements typically work only when the buyer has an approved bank financing facility. In this case, the buyer's bank effectively supports or finances the transaction, allowing the buyer to pay at a later date.

It is important to understand that:

- This is not a simple cash-backed transaction.
- The buyer must have a proper credit line or trade finance facility with their bank.
- The bank evaluates the buyer's creditworthiness before approving such deferred payment terms.

Without an established financing arrangement, banks will generally require cash margin or immediate payment support rather than offering extended credit periods.

From the seller's perspective, while deferred terms may help close the deal, they must assess the waiting period and potential financing cost implications.



What are the 3 Major Types of Facilities that banks and financial institutions provide for issuing guarantees?

3 Major Types of Facilities

Cash Facility

A Cash Facility means the buyer must place a full cash margin — typically 100% to 110% of the Documentary Credit amount — with their bank before the credit is issued.

In this arrangement, the bank blocks the equivalent funds in the buyer's account for the entire validity period of the Letter of Credit, whether it is a Sight LC or a Usance (Deferred Payment) LC.

This means:

- The buyer's funds are fully secured and held by the bank.
- The bank is not extending credit, but simply issuing the LC against the buyer's own cash.
- The buyer's liquidity is tied up for as long as the credit remains active.

In simple terms, the bank is not financing the transaction — it is issuing the Documentary Credit against funds already deposited and blocked by the buyer.

Credit Facility

A Credit Facility is when a bank or financial institution finances the transaction on behalf of the buyer, instead of requiring full cash margin.

In this arrangement, the bank extends a credit line to the buyer and charges a certain percentage (%) as fees or interest for providing that facility.

The charges will vary depending on the structure of the Letter of Credit:

- Sight LC - Usually lower charges, as payment is made immediately upon compliant document presentation.
- Usance / Deferred LC - Higher charges, because the bank is effectively financing the buyer for a longer period (e.g., 60, 90, or 120 days).

The longer the credit period, the higher the cost — since the bank's funds are tied up for a longer duration and the financing risk increases.

In simple terms:

- Cash Facility = Buyer's own funds are blocked.
- Credit Facility = Bank's funds are used, and the buyer pays financing costs.

This structure helps buyers preserve liquidity and manage cash flow, but it comes with financing charges and requires approved credit limits from the bank.

Conditional Facility

A Conditional Facility is not commonly practiced by most reputable banks or financial institutions, as it carries a higher level of risk.

Under this model, an unsecured Letter of Credit is issued on behalf of the buyer to the seller without taking any cash margin from the buyer and without a fully approved credit facility in place.

In such cases:

- The bank does not block funds from the buyer.
- The bank does not independently finance the transaction.
- Payment is only made if and when the buyer provides funds at the time documents are presented.

This means that even if the seller submits fully compliant documents, settlement can only occur once the buyer makes the payment.

In this structure, both Sight and Usance transactions are effectively treated the same — documents are released strictly against actual payment.

Because there is no secured cash margin and no confirmed financing support, this model exposes the seller to higher payment risk and is therefore not widely adopted by regulated banking institutions.

For this reason, most established banks prefer either:

- A Cash Facility (secured by margin), or
- A Credit Facility (supported by approved credit lines).

How is a Documentary Credit used in Trade Transactions?

How is a Documentary Credit used in Trade Transactions?

According to various international trade studies conducted by global trade and banking associations, international trade transactions are generally categorized into four main payment methods:

Open Account

Open Account transactions account for approximately 80% of global trade.

Under an Open Account arrangement, the seller ships the goods to the buyer without receiving immediate payment. Instead, payment is made at a later agreed date (for example, 30, 60, or 90 days).

This method is typically used when there is a strong, established relationship and a high level of trust between the buyer and seller. In practice, Open Account transactions may be supported in several ways:

- **Direct Trust Basis:** The seller relies on the buyer's credibility and track record, expecting payment on the agreed due date.
- **Factoring / Invoice Discounting:** The seller sells its invoice to a factoring company or financial institution and receives advance payment (usually a percentage of the invoice value). The factor then collects payment from the buyer on the due date.
- **Import Financing / Trade Lending:** The buyer arranges import financing through its bank, which pays the seller (or the factoring company), and the buyer repays the bank according to agreed terms.

While Open Account provides flexibility and convenience, it generally exposes the seller to higher payment risk unless supported by credit insurance, factoring, or structured trade finance solutions.

Documentary Credits or Guarantees

Documentary Credits and Bank Guarantees account for approximately 10% of global trade transactions.

This category includes bank-backed payment instruments that provide security and risk mitigation for international trade. These instruments are commonly used when trading partners require stronger financial assurance, particularly in high-value or cross-border transactions.

The main instruments under this category are:

- Letter of Credit (LC)
- Standby Letter of Credit (SBLC)
- Bank Guarantee (BG)

Unlike Open Account transactions, these instruments reduce counterparty risk by involving a bank as a secure intermediary. They are commonly used in new trading relationships, large commercial contracts, government tenders, infrastructure projects, and transactions where additional financial assurance is required.

Although they represent a smaller percentage of global trade volume compared to Open Account, Documentary Credits and Guarantees play a critical role in securing complex and high-risk international transactions.

Documentary Collections

Documentary Collections account for approximately 5% of global trade transactions.

A Documentary Collection is a payment method where banks act as intermediaries to exchange shipping documents between the seller and the buyer — but without providing any payment guarantee.

Under this method:

- The seller ships the goods and submits the shipping documents to their bank.
- The seller's bank forwards the documents to the buyer's bank.
- The buyer can only obtain the documents (and therefore claim the goods) after making payment (Documents Against Payment - D/P) or accepting a draft for future payment (Documents Against Acceptance - D/A).

Unlike a Letter of Credit, the buyer's bank does not take responsibility to pay. The banks involved merely act as collecting agents and do not issue any undertaking or guarantee on behalf of the buyer.

Therefore:

- Risk is lower than Open Account, since documents are controlled by banks.
- Risk is higher than a Letter of Credit, because there is no bank payment guarantee.

Documentary Collections are typically used when trading partners have moderate trust but do not require the full security and cost of a Documentary Credit.

Advance Payment

Advance Payment accounts for the remaining portion of global trade transactions (approximately 5%).

Under an Advance Payment arrangement, the buyer pays the seller fully (or partially) before the goods are shipped or services are delivered.

In this structure:

- The seller receives funds upfront.
- The shipment is made only after payment is secured.
- There is generally no credit period, since payment is made in advance of delivery.

This method provides maximum protection for the seller, as there is no risk of non-payment. However, it carries higher risk for the buyer, since payment is made before receiving the goods.

Advance Payment is commonly used when the seller has strong market leverage, when goods are customized, or when dealing with new or high-risk buyers.

Why is there a Requirement of Documentary Credit in Trade Transactions?

As discussed earlier, international trade is generally structured under four main payment methods.

Among these four, there is only **one payment method that provides the seller with direct payment security from the buyer's bank** — and that is the **Documentary Credit (Letter of Credit)**.

Under a Documentary Credit, the issuing bank gives a formal undertaking to pay the seller, provided that compliant shipping documents are presented in accordance with the terms of the credit. This means the seller's payment security comes from the bank — not solely from the buyer's promise.

Therefore, if the buyer is not willing to make an advance payment, the seller will typically prefer a Documentary Credit structure to protect themselves. It ensures:

- Payment assurance backed by a bank
- Reduced counterparty risk
- Security tied to proper shipment documentation

In simple terms, when advance payment is not possible, a Letter of Credit becomes the safest alternative for the seller in international trade.



Who can issue the Documentary Credit?

As per international regulatory guidelines and financial frameworks, the following types of institutions are generally permitted to issue trade finance instruments. Please note that regulatory rules may vary from country to country. The list below is provided for general reference purposes only:



Commercial Banks

Micro Finance Banks

Micro Finance Institutions

Leasing Companies

Insurance Companies

Special Trade Finance
Institutions With Regulatory
Approval

It is important to understand that not only commercial banks can issue Documentary Credits. Other regulated financial institutions and insurance companies — where permitted by law and regulatory approval — may also issue such trade finance instruments.

However, for simplicity and general understanding, the term “issuing bank” is commonly used in trade finance terminology. This helps people easily understand the structure and process, even though the actual issuing party may be a different type of licensed financial institution.

What truly matters is not whether the issuer is a traditional bank, but whether the institution is properly licensed, regulated, and legally authorized to issue such instruments within its jurisdiction.

In practice, the difference can be identified directly from the wording of the instrument itself. If the issuing party is not a bank, the terminology in the Documentary Credit will reflect this. For example, instead of stating “Issuing Bank,” the document may state “Issuer” or refer specifically to the name of the issuing institution.

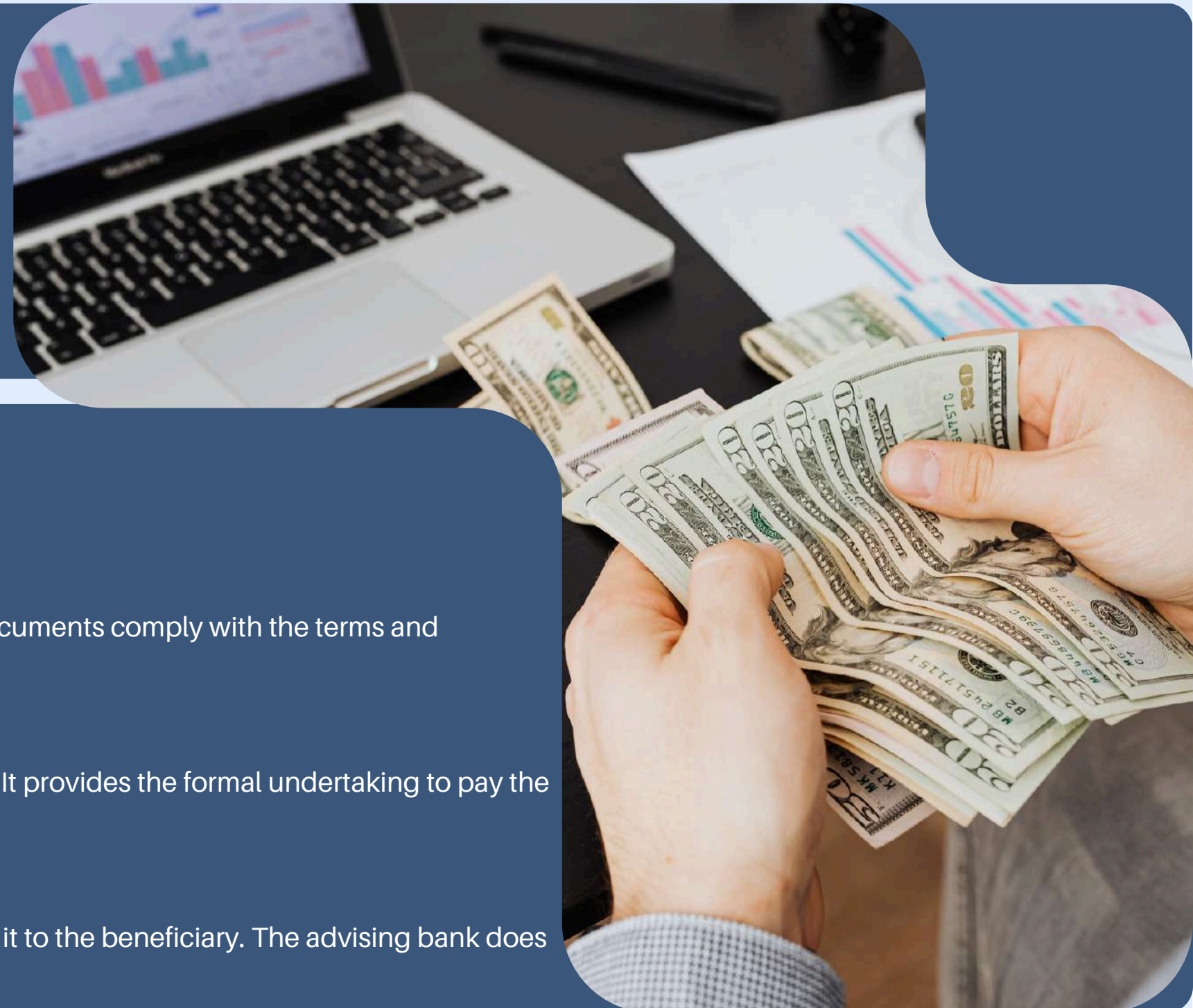
Therefore, the key focus should always be on:

- Regulatory authorization
- Legal enforceability
- Financial credibility of the issuing institution

rather than simply assuming that only banks can issue Documentary Credits.

How the Circle of Documentary Credit Works?

A Documentary Credit operates through a structured banking process involving key parties to ensure secure and conditional payment in international trade.



Important Parties Involved in a Documentary Credit

• Importer - Applicant

The buyer of the goods. The importer applies to their bank to issue the Letter of Credit in favor of the seller.

• Exporter - Beneficiary

The seller of the goods. The exporter receives payment under the Letter of Credit, provided all required documents comply with the terms and conditions stated in the credit.

• Buyer's Bank - Issuing Bank / Issuer

The bank (or authorized financial institution) that issues the Documentary Credit on behalf of the importer. It provides the formal undertaking to pay the beneficiary upon presentation of compliant documents.

• Seller's Bank - Advising Bank / Advising Through Bank

The bank that receives the Letter of Credit from the issuing bank and advises (authenticates and forwards) it to the beneficiary. The advising bank does not guarantee payment unless it adds its confirmation.

Important Factors Involved In Documentary Credit

When issuing or reviewing a Documentary Credit, several key factors must be clearly defined to ensure smooth execution of the transaction:

Amount (Transaction Value)

The total value of the trade transaction covered under the Documentary Credit. This reflects the financial commitment of the issuing bank.

Underlying Transaction (Proforma Invoice or Contract)

The LC is based on an agreed commercial transaction between buyer and seller.

The proforma invoice or sales contract outlines:

- Description of goods
- Quantity
- Price
- Delivery terms (Incoterms)
- Other commercial details

This forms the foundation of the credit.

Port of Loading and Port of Discharge

Specifies:

- Where the goods will be loaded (origin port)
- Where the goods will be discharged (destination port)

These details must match the transport documents presented under the credit.

Documents Required

The LC clearly lists all documents the seller must present to receive payment. These typically include:

- Transport Documents (e.g., Bill of Lading, Airway Bill)
- Commercial Documents (e.g., Commercial Invoice, Packing List)
- Insurance Documents (where applicable)
- Legal or Regulatory Documents (e.g., Certificate of Origin, Inspection Certificate)

Additional documents may be included upon mutual agreement between buyer and seller, subject to approval by the issuing bank.

Additional Conditions

Beyond documentary requirements, the LC may include special conditions agreed between buyer and seller.

These may relate to:

- Quality certifications
- Inspection clauses
- Special declarations
- Compliance requirements

Such conditions form an integral part of the Documentary Credit and must be carefully reviewed, as non-compliance can lead to discrepancies.

Period of Presentation

This defines the number of days within which the seller must present documents after shipment (for example, within 21 days from the date of shipment).

Failure to present documents within this period may result in refusal of payment.

Expiry Date and Latest Shipment Date

These are critical timelines agreed upon by buyer and seller:

- Latest Shipment Date: The final date by which goods must be shipped.
- Expiry Date: The last date on which documents can be presented under the credit.

If shipment occurs after the latest shipment date, or if documents are presented after expiry, the Documentary Credit becomes invalid. In such cases, the seller loses the right to claim payment under the credit — even if the goods were shipped.

Understanding these factors is essential, as Documentary Credits operate under the principle of strict compliance. Even minor discrepancies can result in delays or rejection of payment.

General Process under Documentary Credit

When structuring a Documentary Credit (Letter of Credit), several key elements must be clearly defined to ensure smooth execution and compliance:

1. Sales Agreement

The buyer and seller enter into a commercial contract outlining:

- Description of goods
- Quantity and price
- Shipment terms
- Credit period (if any)
- Payment method (via Documentary Credit)

This agreement forms the basis for issuing the LC.

2. Application for Documentary Credit

Based on the contract, the buyer (applicant) applies to their bank to issue a Documentary Credit in favor of the seller (beneficiary).

3. Bank Approval and Issuance

The buyer's bank conducts internal checks — including credit approval, risk assessment, and compliance review.

Once approved, the bank formally issues the Documentary Credit.

4. Advising the Credit

The beneficiary's bank receives the LC from the issuing bank.

The advising bank authenticates the message and decides whether to advise (forward) it to the beneficiary.

5. Shipment and Document Preparation

Upon receiving the advised LC, the beneficiary reviews the terms carefully.

If acceptable, the beneficiary ships the goods in accordance with the credit terms and prepares the required documents.

6. Submission of Documents

The beneficiary submits the required documents to their bank (advising/negotiating bank).

That bank forwards the documents to the issuing bank for examination and payment processing.

7. Examination by Issuing Bank

Upon receipt, the issuing bank examines the documents strictly according to the terms of the credit.

It is important to note:

The issuing bank examines documents only, not the actual goods or performance.

The issuing bank then informs the applicant (buyer) about the document status.

8. Applicant's Acceptance and Document Release

The beneficiary's bank receives the LC from the issuing bank.

The advising bank authenticates the message and decides whether to advise (forward) it to the beneficiary.

9. Settlement of Payment

The issuing bank remits payment to the beneficiary bank or directly to the beneficiary, according to the settlement terms (Sight or Usance).

What is Transferable Credit?

A Transferable Documentary Credit works similarly to a normal Letter of Credit, but with the involvement of an additional party.

In this structure:

- The First Beneficiary is typically a trading company or broker.
- The first beneficiary does not supply the goods directly.
- Instead, they rely on a Second Beneficiary (actual supplier) to perform under the credit in order for payment to take place.

1. Commercial Agreement

The buyer enters into a contract with the seller (who is actually a broker/trader).

The contract clearly defines:

- Description of goods
- Quantity and price
- Shipment terms
- Credit period
- Payment terms (via Documentary Credit)

3. Bank Approval and Issuance

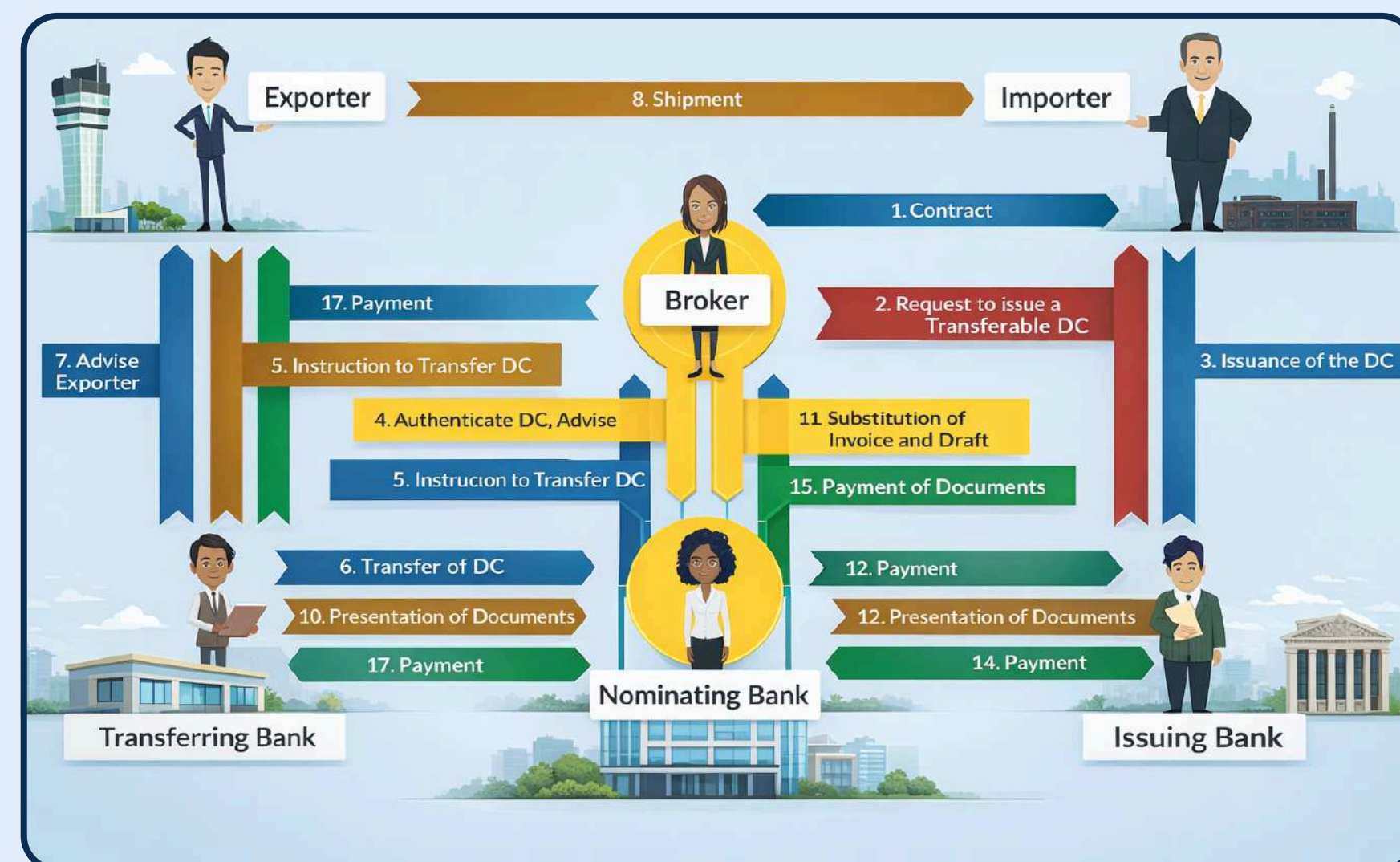
After internal approval from Credit, Risk, and Compliance departments, the buyer's bank issues the Documentary Credit marked as "Transferable."

4. Advising to First Beneficiary

The beneficiary's bank receives the credit, examines its authenticity, and decides whether to advise it to the first beneficiary (broker).

5. Request for Transfer

Once the first beneficiary receives the advised credit, they instruct their bank to transfer the LC to another beneficiary (the actual supplier).



6. Transfer of Credit

The credit is transferred to the Second Beneficiary through the transferring bank. The transfer is usually done after adjusting the value — the broker retains their margin, and the remaining value is transferred to the end supplier.

7. Advising to Second Beneficiary

The transferring bank receives and reviews the transferred credit, then advises it to the second beneficiary (actual supplier).

What is Transferable Credit?

8. Shipment and Document Submission

The second beneficiary ships the goods in accordance with the credit terms and submits the required documents to the transferring bank.

9. Documents Sent to First Beneficiary Bank

The transferring bank forwards the documents to the first beneficiary's bank for examination and processing.

10. Examination by First Beneficiary Bank

The beneficiary's bank receives the credit, examines its authenticity, and decides whether to advise it to the first beneficiary (broker).

5. Request for Transfer

The first beneficiary's bank examines the documents and informs the first beneficiary of the status.

11. Substitution of Invoice

The first beneficiary substitutes the second beneficiary's invoice with their own invoice (reflecting the full LC value). The documents are then sent to the issuing bank for final examination and payment processing

12. Examination by Issuing Bank

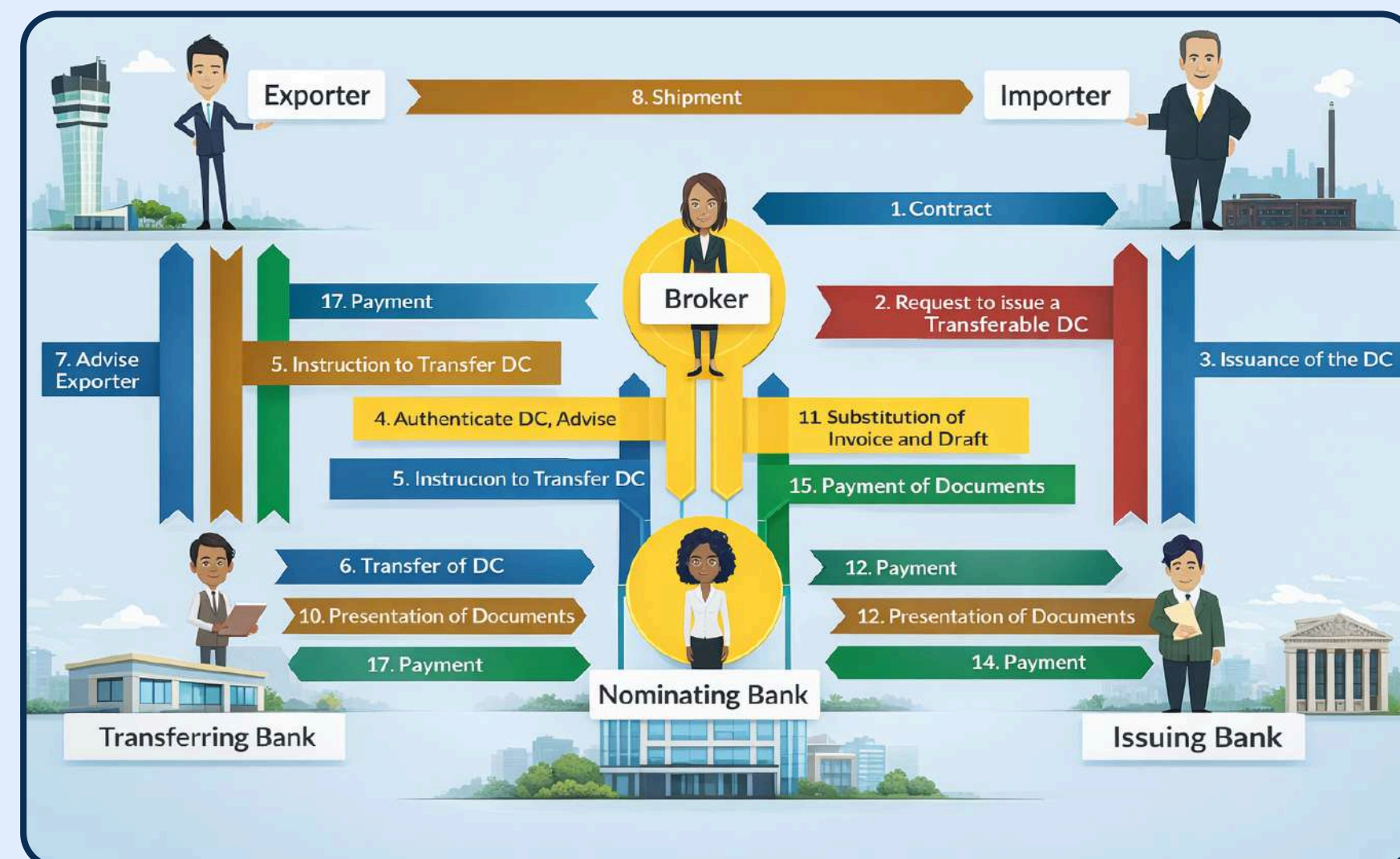
The issuing bank examines the documents strictly according to the LC terms. It is important to note: The issuing bank examines documents only, not the actual goods or performance. The issuing bank then informs the applicant (buyer) accordingly.

13. Release of Documents and Settlement

Upon approval, the issuing bank debits the buyer's account (or uses their credit facility) and releases the shipping documents to the buyer so they can clear the goods from customs. Payment is then remitted according to the LC terms.

14. Settlement by Issuing Bank

The issuing bank makes payment to the first beneficiary's bank (or directly to the beneficiary, depending on the structure) in accordance with the settlement terms of the Documentary Credit (Sight or Usance).



15. Margin Retention by First Beneficiary

The first beneficiary (broker) retains their agreed profit margin under the credit. The remaining amount — corresponding to the transferred value — is allocated for payment to the second beneficiary through the transferring bank

16. Completion of Issuing and Beneficiary Bank Role

The remaining amount — corresponding to the transferred value — is allocated for payment to the second beneficiary through the transferring bank

17. Final Payment to End Beneficiary

The transferring bank releases payment to the second beneficiary (actual supplier) according to the transferred credit terms.

Types of Documents in Documentary Credit

There are 4 Major Type of Documents

Transport Document

- Bill Of Lading
- Airway Bill
- Seaway Bill

Commercial Document

- Commercial Invoice
- Contract
- Inspection Certificate

Legal Document

- Certificate Of Origin
- Packing List
- Health Certificate or any Certificate as per the Product

Insurance Document

- Insurance Policy Certificate



What is a Red Clause?

Red Clause Documentary Credit (Historical Context)

In earlier banking practices, when Documentary Credits were issued in physical hard copy format, certain special clauses were highlighted in colored ink.

One such clause was marked in red, which is how the term "Red Clause Letter of Credit" originated.

Purpose of a Red Clause

A Red Clause allows the beneficiary (seller) to draw advance funds under the Documentary Credit before shipment and before submitting the required shipping documents.

In other words:

- The seller can receive partial or full advance payment.
- The advance is granted against a simple undertaking or receipt, rather than full documentary compliance.



While still legally possible, Red Clause structures are less common in modern trade finance due to tighter risk controls and banking regulations.

Impact on Risk Structure

This arrangement significantly alters the normal principle of a Documentary Credit, which is based on: Payment against compliant documents.

By allowing advance payment without document presentation, the risk shifts more heavily toward the buyer and issuing bank.

Therefore:

- It weakens the traditional security structure of an LC.
- It is generally used only when there is strong trust between parties.
- The buyer must be comfortable accepting the additional risk.

When Is It Used?

Red Clause credits are typically used when:

- The seller requires working capital to procure or manufacture goods.
- The buyer is willing to support the seller with advance financing.
- There is an established and trusted trading relationship.

What is a Revolving Credit?

A **Revolving Letter of Credit** is a type of Documentary Credit that can be used multiple times within its validity period, without the need to issue a new LC for each shipment.

In simple terms, once a portion of the credit is utilized, the available amount is automatically reinstated according to the terms stated in the LC.

How It Works - Example

Assume:

- A Documentary Credit is issued for USD 100,000.
- An additional clause states:
- "This Letter of Credit may be revolved 4 times until expiry, with a gap of 30 days each."

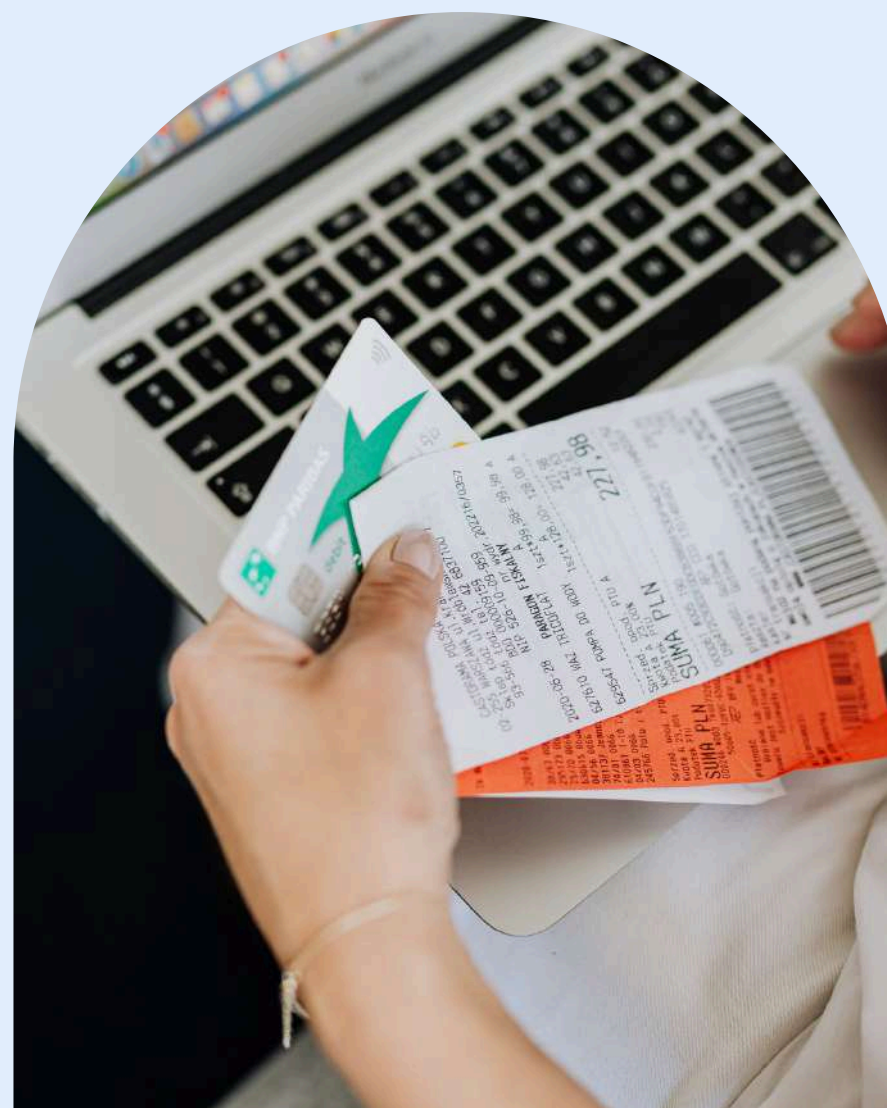
This means:

- The seller can ship goods worth USD 100,000.
- After documents are presented and settled, the credit amount is reinstated.
- This process can repeat 4 times within the validity period, with a 30-day interval between each utilization.

Effectively, although the face value of the LC is USD 100,000, the total transaction coverage becomes:

USD 100,000 × 5 cycles = USD 500,000

(Initial use + 4 additional revolvments)



Key Features of a Revolving LC

- Reduces administrative burden — no need to issue multiple LCs
- Suitable for long-term supply contracts with repeated shipments
- Can revolve by:
 - Time (monthly, quarterly, etc.)
 - Value (amount reinstated after utilization)
 - May be cumulative or non-cumulative (as specified in the LC terms)

Important Considerations

- The revolving terms must be clearly stated in the LC.
- Banks assess the buyer's credit exposure based on total potential liability.
- Risk monitoring is important since the total exposure may exceed the face value of a single shipment.

What is a Partial Shipment?

A Partial Shipment under a Documentary Credit means that the total order value can be delivered in multiple shipments instead of one single shipment.

This option must be clearly stated and allowed in the Letter of Credit.

Example

Assume:

- A Documentary Credit is issued for USD 100,000.
- The LC allows partial shipments.

In this case:

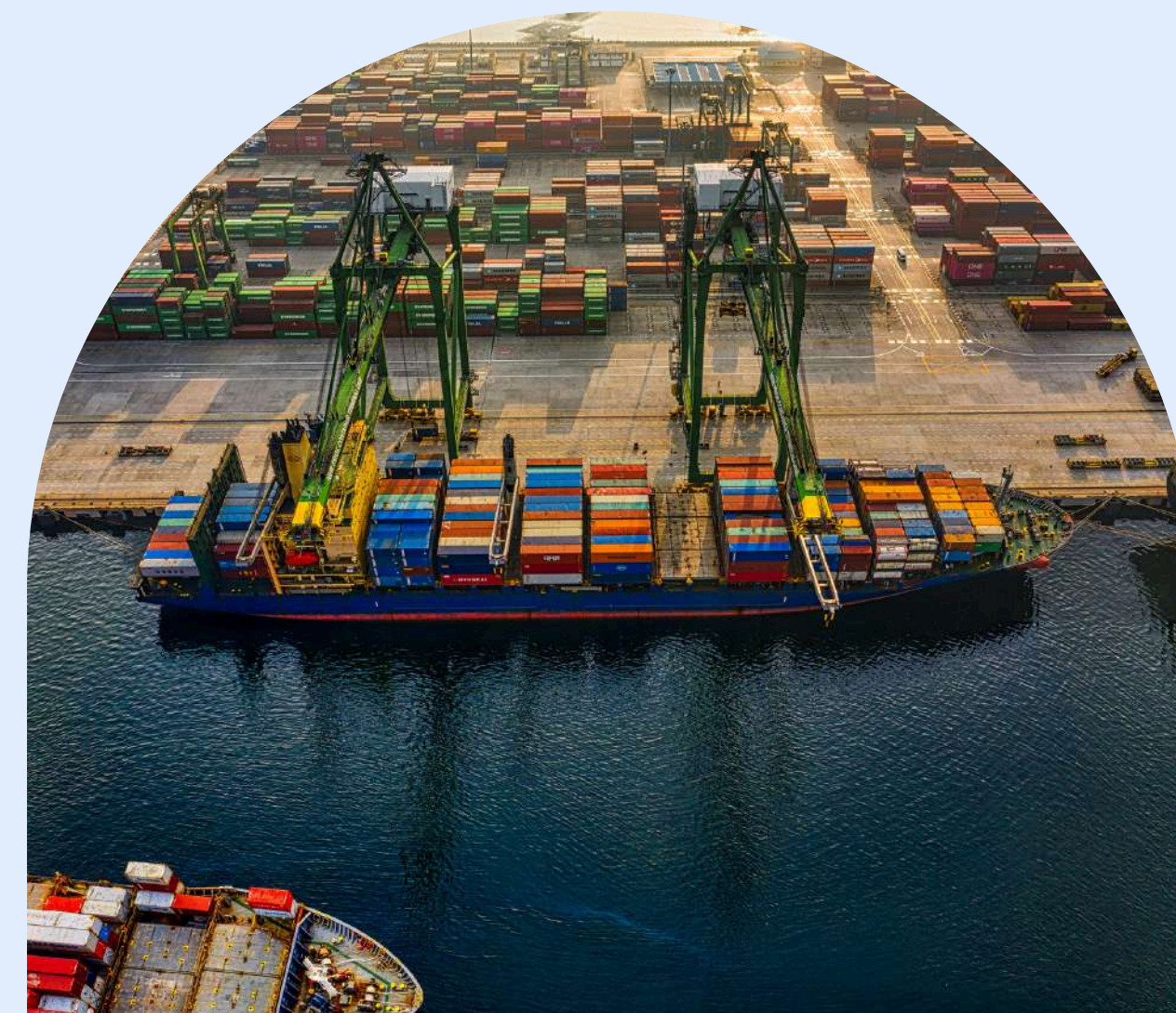
- The seller may ship goods worth USD 25,000 at a time.
- After each shipment, the seller submits documents to the bank for USD 25,000.
- This process can be repeated four times, until the full USD 100,000 order is completed.

Important Points

- Partial shipment must be explicitly allowed in the LC terms.
- If the LC states "Partial Shipment Not Allowed," the seller must ship the full quantity in one single shipment.
- If partial shipment is not initially permitted, the LC must be amended before any document submission.
- Each partial shipment requires its own compliant set of documents.

Why Partial Shipment Is Used

- When goods are produced in batches
- When logistics require staggered delivery
- When the buyer and seller agree on phased supply
- For large contracts where full shipment at once is not practical



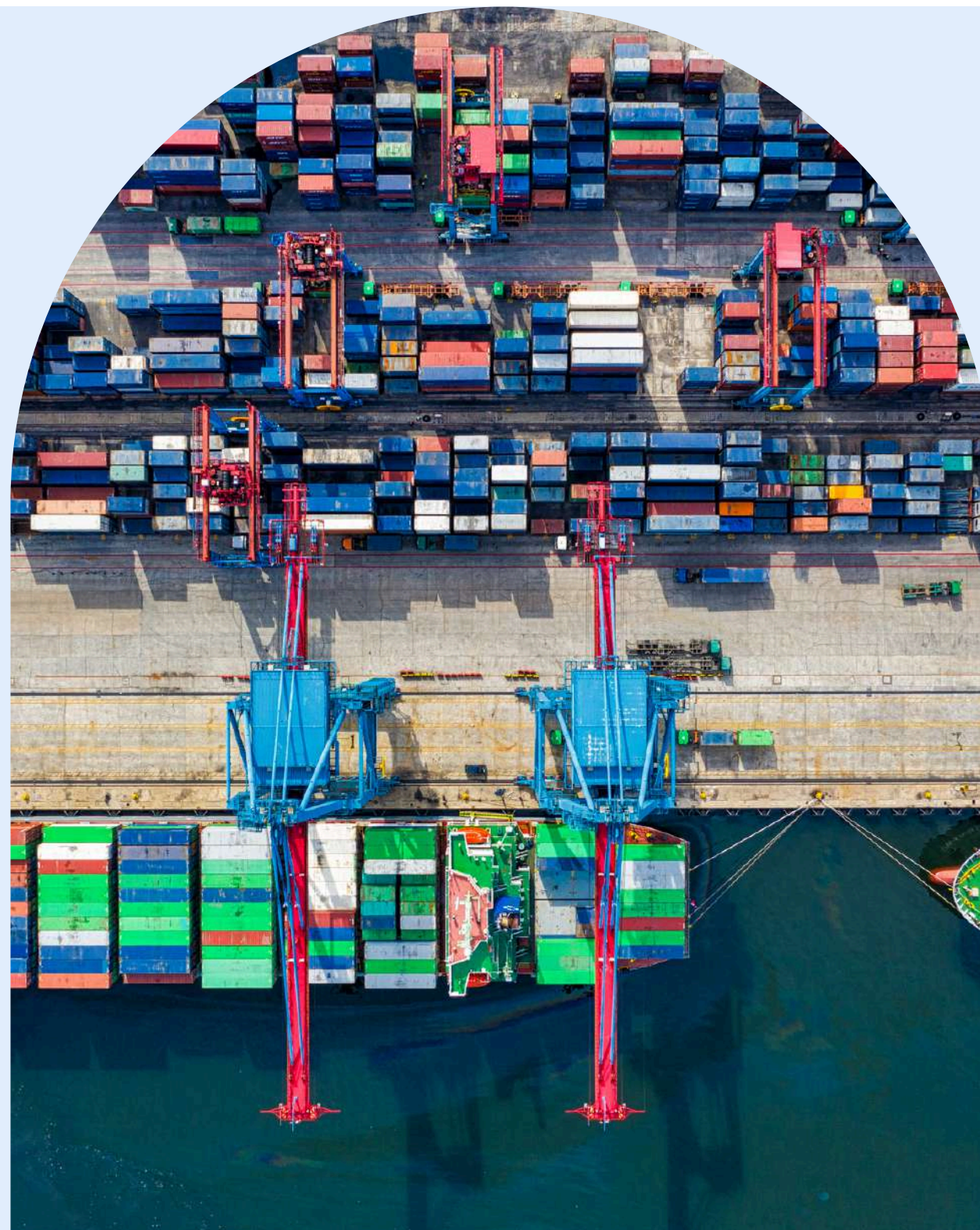
Allowing partial shipment provides flexibility but must always be aligned with the commercial contract and clearly stated in the Documentary Credit.

What is a Transshipment Shipment?

As per international regulatory guidelines and financial frameworks, the following types of institutions are generally permitted to issue trade finance instruments.

Please note that regulatory rules may vary from country to country. The list below is provided for general reference purposes only:

- Commercial Banks
- Microfinance Banks
- Microfinance Institutions
- Leasing Companies
- Insurance Companies
- Specialized Trade Finance Institutions (with proper regulatory approval)



Each of these institutions must operate under the supervision and approval of their respective financial regulatory authorities. Their ability to issue instruments such as Letters of Credit, Bank Guarantees, or Standby Letters of Credit depends on local banking regulations, capital requirements, and licensing permissions.

It is important to always verify the regulatory standing and authorization of any issuing institution before accepting a trade finance instrument.

What is Adding Confirmation under a Credit?

Adding Confirmation means that another bank — typically in the beneficiary’s country — adds its independent payment undertaking to the Documentary Credit.

When a credit is confirmed, the confirming bank becomes an additional obligated party in the transaction. It assumes the responsibility to pay the beneficiary, provided that compliant documents are presented.

Why Confirmation Is Requested

Confirmation is usually requested when:

- The beneficiary is not comfortable with the issuing bank’s credit strength.
- There are concerns about country risk or political risk in the issuing bank’s jurisdiction.
- The seller wants stronger payment security.

How It Works - Example

If the beneficiary is not satisfied with the issuing bank’s standing, they may request that a reputable correspondent bank add its confirmation to the LC.

Once confirmation is added:

- The confirming bank takes independent liability to pay under the credit.
- The beneficiary can rely on the confirming bank for payment.
- The beneficiary and their bank deal primarily with the confirming bank instead of depending solely on the issuing bank.

In simple terms:

The confirming bank’s obligation is separate and in addition to that of the issuing bank.

Benefits of Confirmation

- Eliminates issuing bank risk
- Reduces country and political risk
- Provides stronger payment assurance
- Improves confidence in high-value transactions

Important Note

Confirmation is not automatic.

It must be:

- Authorized in the LC (either “confirmation requested” or agreed separately), and
- Accepted by the confirming bank after its own risk assessment.

MAY ADD

- The issuing bank allows the beneficiary’s bank to add confirmation if requested.
- It is optional and decided by the beneficiary.
- The cost is usually borne by the beneficiary.

CONFIRM

- The issuing bank formally requests another bank (correspondent bank) to add its confirmation.
- If accepted, the confirming bank takes independent payment liability under the credit.



There are multiple ways confirmation can be structured depending on bank relationships and risk appetite.

MAY ADD

The issuing bank authorizes the beneficiary's bank to add its confirmation if requested. The addition of confirmation is optional and entirely at the discretion of the beneficiary. In most cases, the cost associated with adding confirmation is borne by the beneficiary, unless a different arrangement has been agreed between the parties.

CONFIRM

The issuing bank formally requests another bank (correspondent bank) to add its confirmation. If accepted, the confirming bank takes independent payment liability under the credit.

SILENT CONFIRMATION

Silent confirmation is similar to a "May Add Confirmation" structure, but with one key difference. In this case, the issuing bank does not instruct or authorize the addition of confirmation (no "May Add" or "Confirm" instruction is given in the credit). Instead, the beneficiary's bank independently decides to add its confirmation



How Do the Applicant and Beneficiary Secure Themselves Under a Documentary Credit?

BUYER (APPLICANT)

The buyer gains greater security when operating under a Documentary Credit compared to making advance payments.

Payment is only made once the seller submits the required documents strictly in accordance with the agreed terms and conditions. This ensures that the buyer is not obligated to release funds until contractual performance has been fulfilled.

This structure significantly reduces payment risk and enhances transactional confidence.



SELLER (BENEFICIARY)

The seller benefits from enhanced payment security under a Documentary Credit because the obligation to pay rests with the issuing bank — not solely on the buyer's financial capacity.

Once the seller complies with the documentary requirements and presents documents that meet the agreed terms, the bank is obligated to honor the payment.

This provides assurance, predictability, and protection against counterparty risk.

What are High Risk Goods?

High-risk goods refer to commodities and products that carry elevated compliance, fraud, or performance risks within international trade transactions.

These goods often trigger additional scrutiny due to:

- Higher exposure to fraud or document manipulation
- Sanctions-related concerns
- Increased risk of non-performance
- Market volatility and regulatory sensitivity

As a result, financial institutions may:

- Decline to issue trade instruments
- Require enhanced compliance checks
- Impose stricter conditions
- Request additional collateral or documentation

When underlying goods are categorized as high-risk, banks prioritize risk mitigation to protect against financial, legal, and reputational exposure.

Common Examples

Because these sectors are frequently associated with fraudulent documentation or non-performance claims, banks apply stricter due diligence standards.



GOLD



DIAMONDS



OIL PRODUCTS



PETROLEUM



OTHER HIGH-VALUE



EASILY TRANSFERABLE
COMMODITIES

What is a UCP 600?

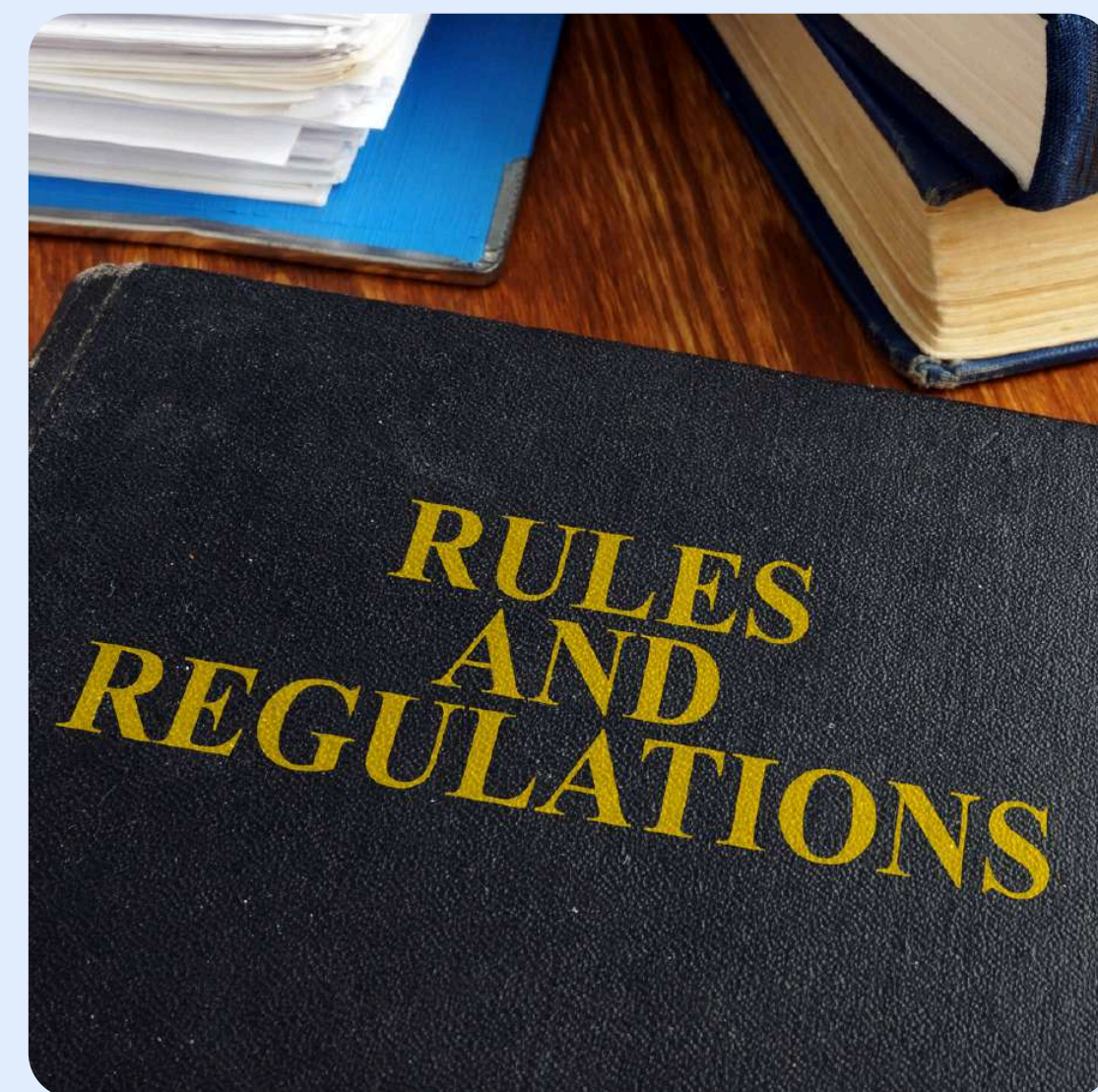
UCP 600 (Uniform Customs and Practice for Documentary Credits) is a globally recognized set of rules governing Documentary Credits (Letters of Credit) in international trade.

Issued by the International Chamber of Commerce (ICC), UCP 600 provides a standardized legal and operational framework to ensure clarity, consistency, and fairness in trade finance transactions worldwide.

These rules define and regulate:

- How a Documentary Credit operates
- The responsibilities of the Issuing Bank
- The responsibilities of the Advising/Confirming Bank
- The rights and obligations of the Beneficiary
- The rights and obligations of the Applicant
- The standards for examining documents
- The procedures for transferring a credit

UCP 600 consists of 39 articles, each outlining specific provisions to guide banks and trading parties in executing secure and compliant documentary credit transactions.



How ICC UCP 600 - is Applied in Documentary Credits

The ICC Uniform Customs and Practice for Documentary Credits (UCP 600) serves as the internationally recognized rulebook governing Documentary Credits.

UCP 600 clearly defines:

- The responsibilities of each party involved
- The procedures for issuing, advising, and confirming credits
- The standards for examination of documents
- The rights and obligations of banks and beneficiaries

By incorporating UCP 600 into a Documentary Credit, all parties understand in advance how the transaction will be conducted and how documents will be examined. This ensures consistency, transparency, and reduced disputes in international trade.

What Is a Discrepancy Notice in a Letter of Credit?

Once documents are presented under a Documentary Credit, the issuing bank is required to examine them strictly in accordance with the terms and conditions of the credit and the rules of UCP 600.

If the documents do not comply with the credit terms, they are considered **DISCREPANT**.

In such cases:

- The issuing bank must issue a Discrepancy Notice to the presenting bank (beneficiary's bank).
- This notice must be sent within a maximum of five (5) banking days following document presentation.
- The notice must clearly state all discrepancies found.

If the issuing bank fails to send a discrepancy notice within the five banking days, the documents are deemed accepted

Industry Insight:

According to industry trends, approximately 70–80% of document presentations contain discrepancies, highlighting the importance of careful document preparation and strict compliance review.

What Is a **Acceptance** under a **Documentary Credit**?

Acceptance under a Documentary Credit refers to the applicant's (buyer's) agreement to accept the presented documents and proceed with payment.

If the beneficiary submits documents that contain discrepancies, the issuing bank will notify the applicant. In such cases, the applicant has the option to:

- Waive the discrepancies, and
- Instruct the issuing bank to proceed with payment.

If the applicant confirms acceptance and the issuing bank agrees, payment may be released to the beneficiary despite the discrepancies.

In simple terms:

Acceptance means the buyer agrees to proceed with payment, even if the documents are not fully compliant with the original LC terms.

What Is Negotiation of Documents in a Documentary Credit?

Negotiation of documents refers to the process where the beneficiary submits shipping documents through a bank (usually the beneficiary's bank or a nominated bank) to obtain payment under the Documentary Credit.

Although the beneficiary has the right to submit documents directly to the issuing bank, LC documentation can be complex and highly technical. Errors or discrepancies may result in delays or non-payment.

For this reason, beneficiaries often prefer to route documents through their bank or another bank with whom they have a working relationship. The bank:

- Reviews the documents for compliance,
- Assists in managing discrepancies,
- Forwards documents to the issuing bank, and
- Facilitates collection of payment.

The beneficiary typically bears the charges for negotiation services.

Why Are Traditional Banks Losing Business to Non-Banks and Other Financial Institutions?

In recent years, traditional banks have been losing trade finance business to non-bank financial institutions and specialized trade finance providers.

This shift is largely due to:

- Faster response times and processing
- Greater flexibility in structuring transactions
- Higher risk appetite compared to traditional banks
- Less stringent regulatory constraints in certain jurisdictions

As a result, many importers and buyers are increasingly engaging with non-bank institutions and alternative trade finance providers instead of relying solely on traditional banks.

Why Are Banks More Strict in Trade Finance Today?

Trade finance is considered a **high-risk industry globally**, and banks have become increasingly cautious due to several key challenges:

1. Fraud and Sanctions Risk

Fraudulent activities and sanctions breaches are common in international trade.

In many cases, these risks are not immediately visible and may only come to light during regulatory investigations. If violations occur, banks face significant penalties and reputational damage. As a result, banks enforce strict compliance controls.

2. Unutilized or Suspicious Documentary Credits

Repeated issuance of Documentary Credits without actual shipment or document presentation can raise red flags.

Banks may view such activity as potential misuse of financial instruments or even money laundering risk, leading to stricter scrutiny and monitoring.

To avoid such risks and complications, banks often choose to be highly selective and may decline transactions or clients that present potential compliance or dispute risks.

3. Disputes and Discrepancies

Discrepancies in documents often lead to disputes between buyers and sellers.

These disputes can escalate into legal proceedings, increasing costs and operational burden for banks. To mitigate this, banks apply strict document examination standards.

4. Applicant vs Bank Disputes on Compliant Documents

Under UCP rules, if documents are compliant, the issuing bank is obligated to honor payment.

However, disputes may arise when applicants (buyers) refuse to accept or pay despite compliance. This creates legal and financial pressure on banks, as they are still required to fulfill their obligation to the beneficiary.

Key Takeaway

Banks are not being difficult — they are protecting themselves from regulatory penalties, financial loss, and legal exposure in a high-risk global trade environment.

How Do Sanctions Affect Documentary Credits?

Sanctions compliance has become one of the most critical challenges for issuing banks and financial institutions in trade finance transactions.

In many cases, sanctioned entities, restricted countries, or prohibited ports may be indirectly involved in a transaction but intentionally omitted from documentation. Detecting such hidden risks is a major concern for banks today.

Regulators frequently impose significant penalties on financial institutions for sanctions breaches. As a result, banks have strengthened their compliance frameworks and now perform enhanced due diligence on every transaction.

This increased scrutiny may lead to:

- Additional verification requirements
- Processing delays
- Requests for supporting documentation
- In some cases, rejection of transactions

Ensuring full transparency of all parties, shipment routes, and jurisdictions involved in a trade transaction is therefore essential to avoid sanctions-related risks.

BANK GUARANTEE

What is a Guarante and Bank Guarantee?

What Is a Guarantee?

A guarantee is a formal undertaking to ensure payment or performance on behalf of an individual or a corporate entity. It creates an obligation for the guarantor to fulfill the commitment if the primary party fails to meet its contractual responsibilities or defaults on its obligations.

What Is a Bank Guarantee?

A bank guarantee is a commitment issued by a bank on behalf of an individual or corporate client, assuring the beneficiary that the bank will fulfill the payment or performance obligation if the applicant fails to do so.



In simple terms, a bank guarantee provides financial security to the beneficiary by transferring the risk of default from the applicant to the issuing bank.

Is a Bank Guarantee Irrevocable and Unconditional Payment Undertaking?

A bank guarantee is generally considered irrevocable, but whether it is conditional or unconditional depends on the structure and wording of the guarantee.

Irrevocable Nature of a Bank Guarantee

Yes, a bank guarantee is typically irrevocable once issued. This means it cannot be cancelled or amended without the consent of the beneficiary. Although the applicant or issuing bank may request cancellation, the guarantee remains valid unless the beneficiary formally agrees to its release.

Conditional vs. Unconditional Nature of a Bank Guarantee

The nature of payment under a bank guarantee depends on its terms:

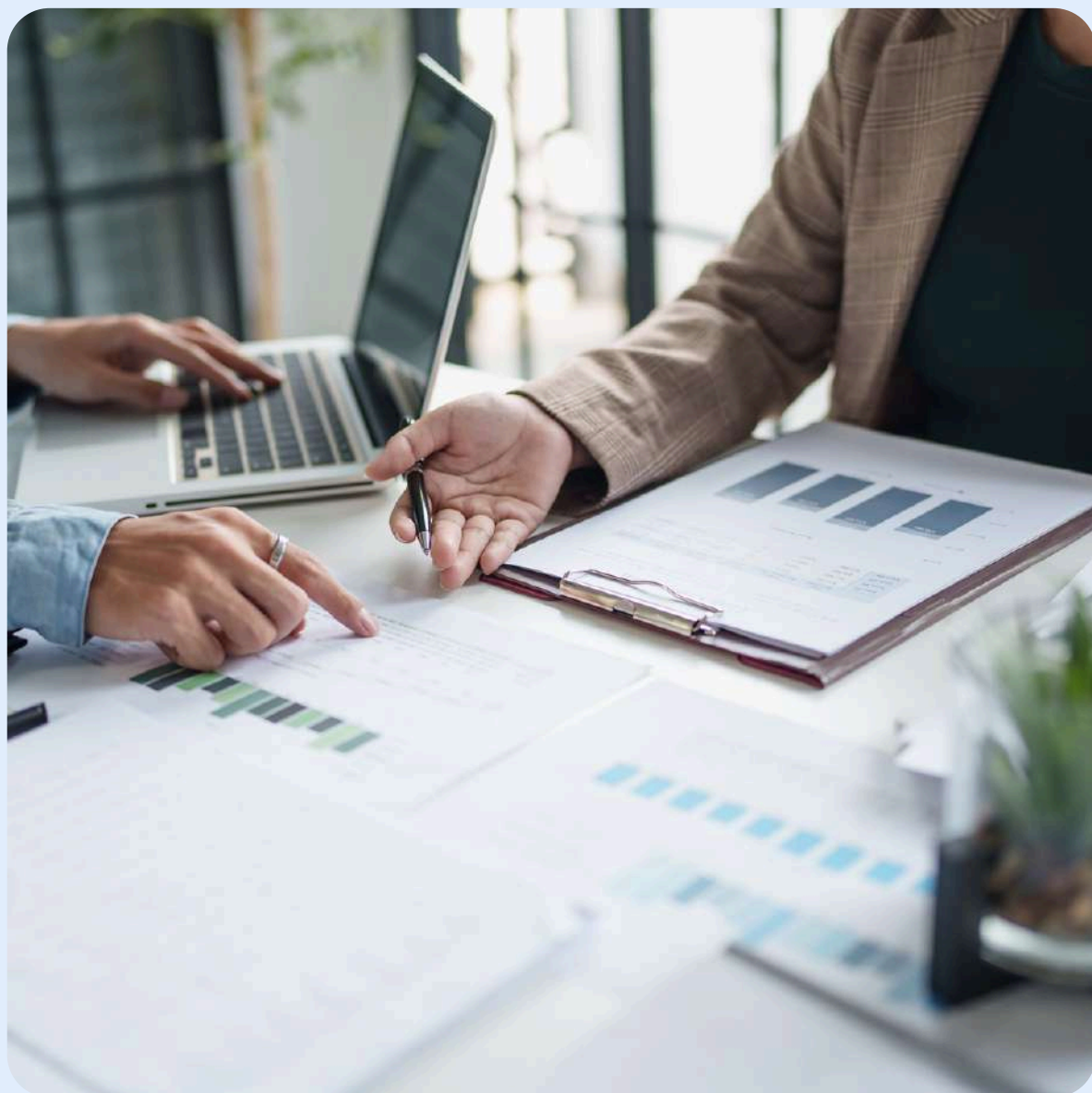
- An unconditional bank guarantee allows the beneficiary to claim payment upon simple written demand, without the need to prove default.
- A conditional bank guarantee requires the beneficiary to submit supporting documents or evidence confirming that contractual obligations were not fulfilled.

If the required conditions are not met in a conditional guarantee, the issuing bank has the right to reject the claim.



What Types of Facilities Do Banks and Financial Institutions Provide to Issue a Bank Guarantee?

Banks and financial institutions generally provide three primary types of facilities through which an applicant can obtain a bank guarantee.



1. Cash Facility

Under a cash facility, the applicant is required to maintain a 100% to 110% cash margin against the value of the guarantee. These funds remain blocked with the issuing institution for the entire validity period of the guarantee.

This structure involves minimal credit risk for the bank, as the guarantee is fully secured by the applicant's own funds.

2. Credit Facility

Under a credit facility, the bank or financial institution issues the guarantee using its approved credit line extended to the applicant. Instead of blocking full cash margin, the institution finances the obligation and charges a fee or commission based on the amount and tenure of the guarantee.

This structure helps applicants preserve liquidity while obtaining the required guarantee support.

Conditional Facility

A conditional facility is not commonly offered by most banks or financial institutions because it carries a higher level of risk. Under this structure, an unsecured guarantee is issued on behalf of the applicant without requiring any cash margin.

If a claim is made under the guarantee, payment can only be honored once the applicant provides the required funds. Due to this dependency on the applicant's payment at the time of claim, this facility is considered high risk and is therefore less widely practiced in the banking sector.



How Guarantees Are Used in Trade?

According to international trade studies conducted by various industry associations, global trade transactions are generally structured around **four primary payment methods**. These methods help parties manage risk, trust, and cash flow in international trade transactions.

Open Account

Goods are shipped before payment is received, based on trust between buyer and seller.

Documentary Collection

Banks handle shipping documents and release them against payment or acceptance.

Documentary Credit or Guarantees

Banks provide payment assurance subject to agreed conditions.

Advance Payment

The buyer makes payment before shipment of goods.

Four Primary Payment Methods

Open Account

Open account transactions represent approximately 80% of global trade. Under this arrangement, the seller ships goods based on trust that the buyer will make payment on the agreed due date.

In some cases, the seller may sell the invoice to a factoring company to receive early payment against the shipment. Alternatively, the buyer may arrange import financing, allowing the lender to pay the seller upfront while the buyer repays the financing institution later on the agreed terms.

This method supports smoother trade flows but carries higher payment risk for the seller.

Documentary Credits or Guarantees

Documentary credits and bank guarantees account for roughly 10% of global trade and are commonly used when additional payment security is required between trading parties.

These instruments include:

- Letter of Credit (LC)
- Standby Letter of Credit (SBLC)
- Bank Guarantees (BG)

They provide structured payment assurance through financial institutions, helping reduce counterparty risk and strengthen trust in international trade transactions.

Four Primary Payment Methods

Documentary Collection

Documentary collection accounts for approximately 5% of global trade transactions. Under this method, banks facilitate the exchange of shipping and commercial documents between the buyer and the seller but do not provide any payment guarantee.

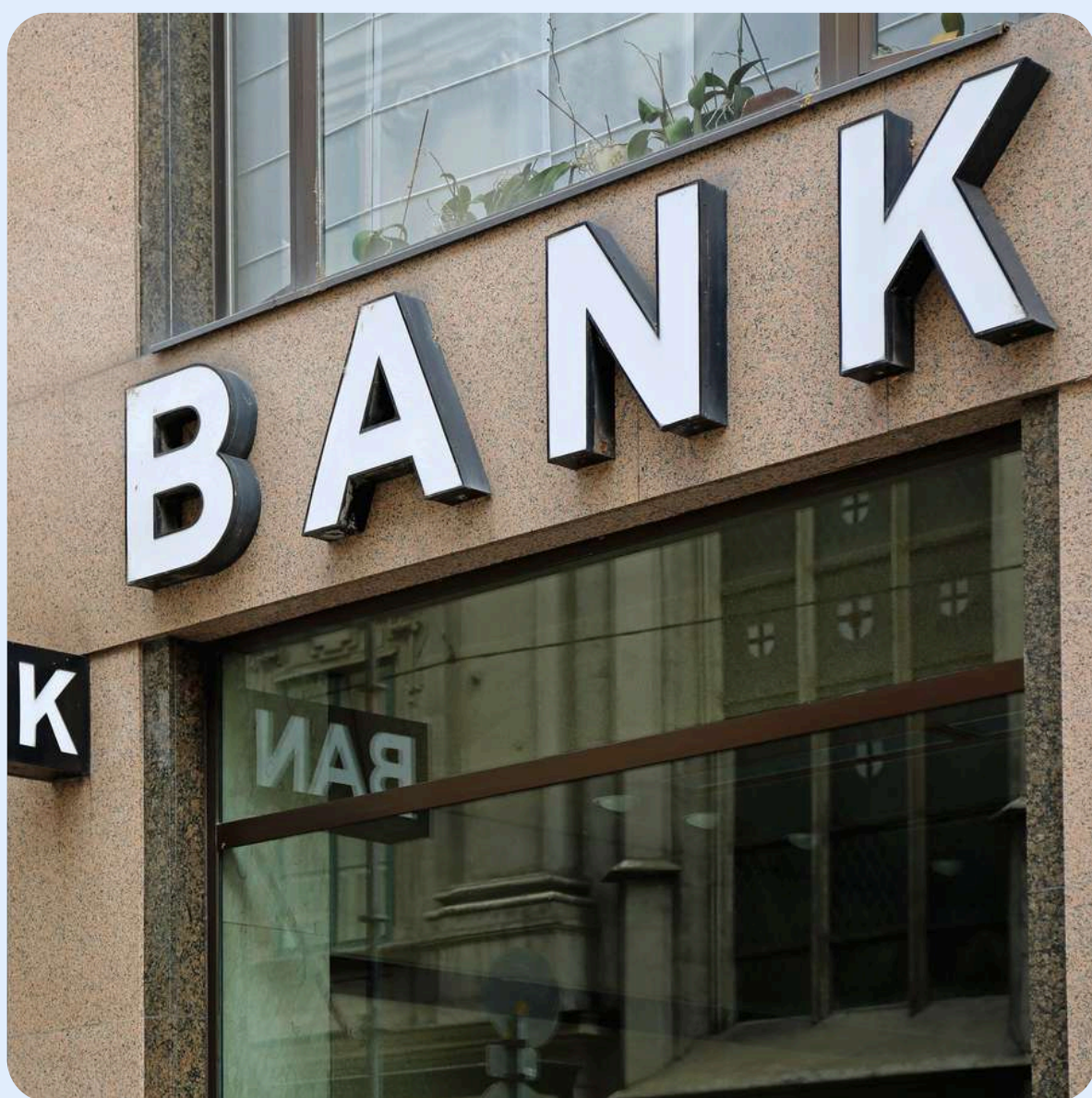
Unlike documentary credits, where the issuing bank undertakes payment responsibility subject to compliant documents, banks involved in documentary collection act only as collecting agents. They release documents to the buyer against payment or acceptance but do not assume liability on behalf of the buyer.

Advance Payment

Advance payment represents the remaining 5% of global trade transactions. Under this arrangement, the buyer pays the seller in advance before shipment of goods.

This method provides maximum security to the seller, as payment is received upfront. However, it places greater risk on the buyer and is typically used when the seller has stronger negotiating power or when there is an established relationship of trust between the parties.

Why Is a Bank Guarantee Required?



In today's business environment, corporates, government entities, and institutions often prefer to operate under the security of a bank-backed undertaking, especially for projects, contracts, and commercial transactions. A bank guarantee provides assurance that financial or performance obligations will be fulfilled as agreed.

Bank guarantees are commonly used in tenders, project execution, trade transactions, advance payments, performance commitments, and procurement agreements. They may also support obligations such as lease commitments, asset purchases, and contractual performance requirements.

These instruments are widely applicable across multiple industries and sectors, strengthening trust between parties and reducing counterparty risk in both domestic and international business activities.

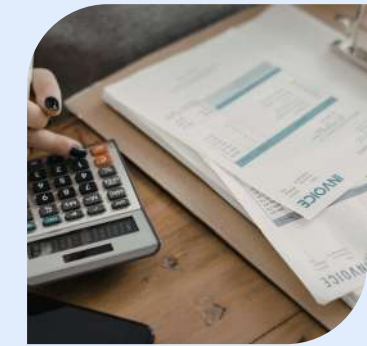
Types of Guarantees



BID BOND | TENDER GUARANTEE



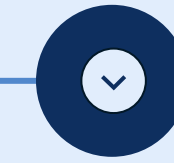
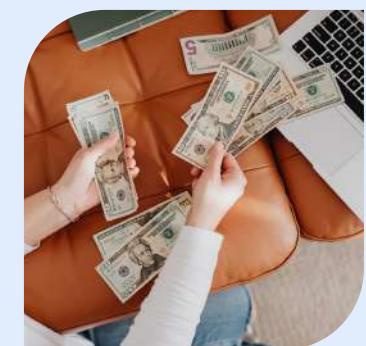
ADVANCE PAYMENT



PERFORMANCE BOND



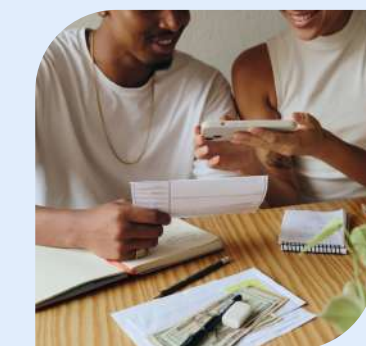
PAYMENT GUARANTEE



WARRANTY GUARANTEE



RETENTION MONEY BOND



CREDIT LINE GUARANTEE



Who can issue a Bank Guarantee?

Under general international practices and regulatory frameworks, several types of financial institutions may issue bank guarantees. However, it is important to note that regulations vary by country, and eligibility depends on local supervisory approval. Typically, bank guarantees can be issued by:



Commercial Banks

Micro Finance Banks

Micro Finance Institutions

Leasing Companies

Insurance Companies

Special Trade Finance
Institutions With Regulatory
Approval

The authority to issue guarantees always depends on the institution's licensing status and the applicable regulations within its jurisdiction. These frameworks ensure credibility, enforceability, and financial security in guarantee-backed transactions.

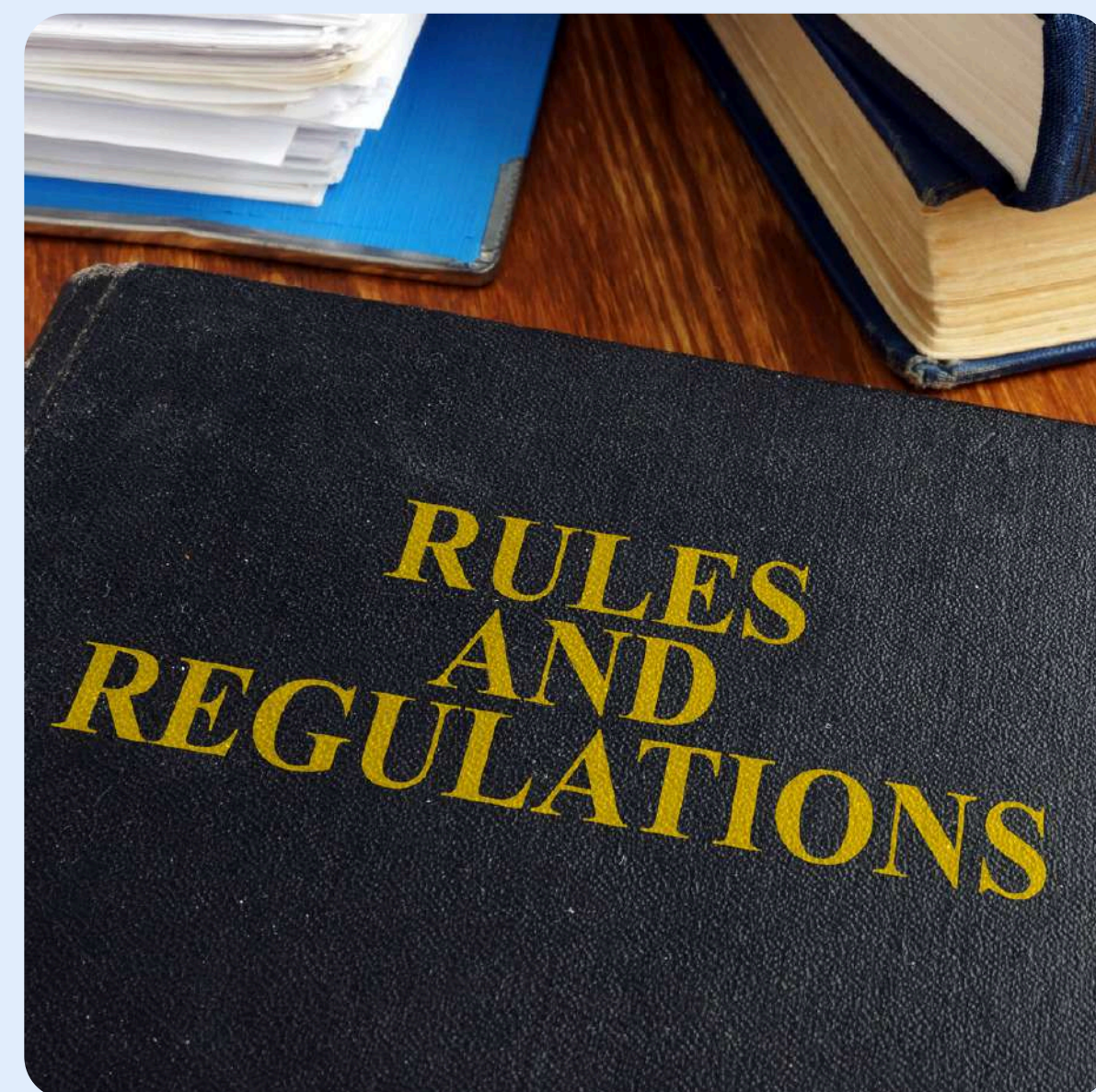
Bank guarantees are not issued exclusively by banks. In many jurisdictions, **other regulated financial institutions** and insurance companies may also issue guarantees, subject to local regulatory approval. However, the term "**bank guarantee**" is commonly used as a general industry reference because banks remain the most widely recognized issuers of such instruments.

When a guarantee is issued by a **non-bank financial institution**, the terminology in the guarantee document typically changes. Instead of referring to an "**issuing bank**", the document refers to the "**issuer**," and the instrument may simply be described as a "**guarantee**" rather than a bank guarantee. The structure and purpose of the undertaking remain the same; only the issuing entity and terminology differ.

Which Rules Apply to Bank Guarantees?

Under international practice, bank guarantees are commonly issued in accordance with URDG 758 (Uniform Rules for Demand Guarantees, ICC Publication No. 758). These rules provide a globally recognized framework governing the issuance, interpretation, and enforcement of demand guarantees.

However, in certain transactions, the beneficiary may request that the guarantee be governed by local law instead of URDG 758. The applicable governing rules are therefore typically agreed through negotiation between the applicant and the beneficiary before issuance.



What Is the **Basic Difference** Between a Bank Guarantee and a Documentary Credit / Standby Letter of Credit?

Documentary Credit (LC / SBLC)

A documentary credit primarily functions as a payment instrument used in commercial trade transactions. It is generally governed by UCP 600 (Uniform Customs and Practice for Documentary Credits) and is designed to ensure payment against compliant document presentation.

Key characteristics:

- Functions mainly as a payment mechanism
- Governed by UCP 600
- Used primarily in commercial trade transactions

Bank Guarantee

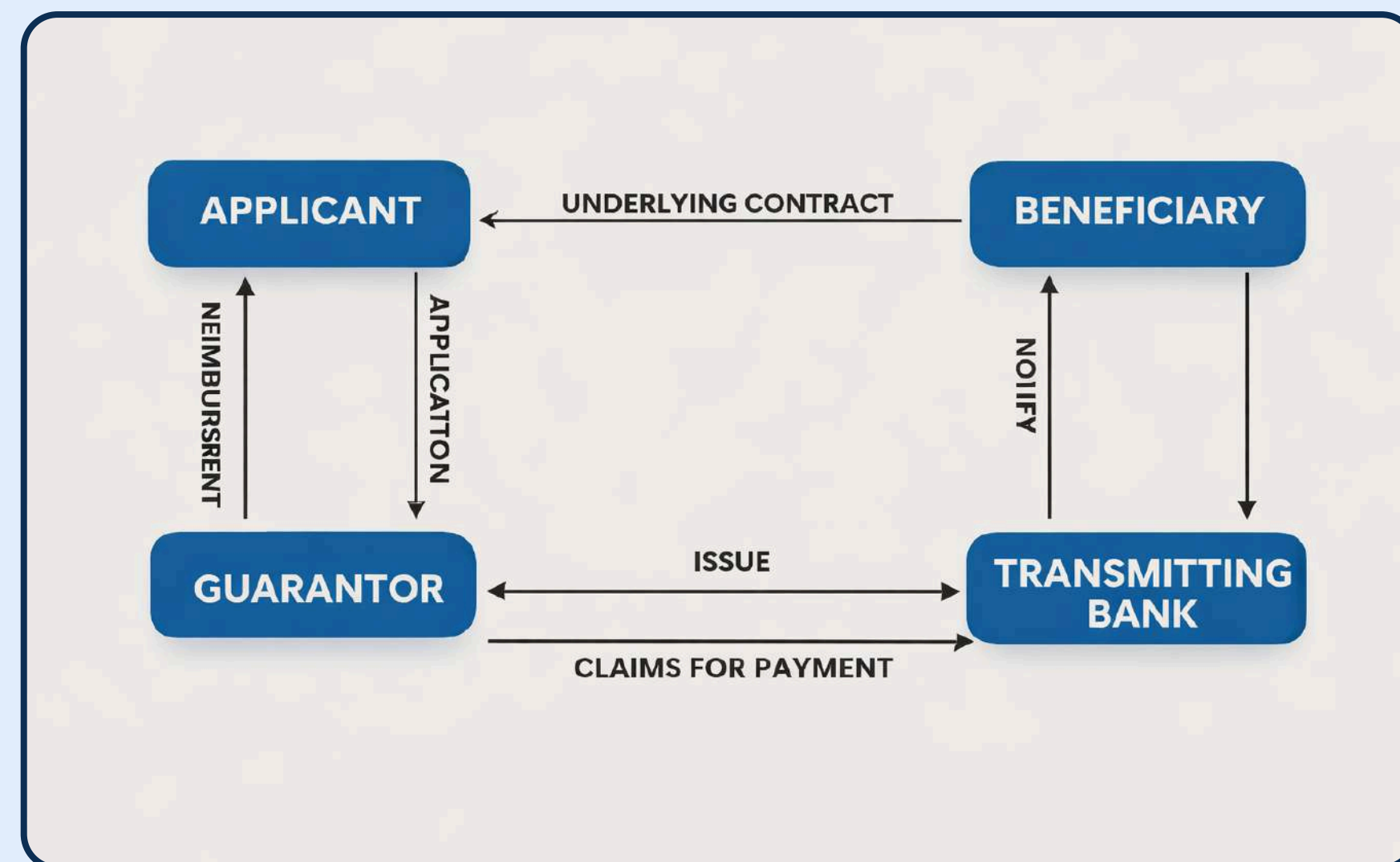
A bank guarantee primarily serves as a security instrument that protects the beneficiary in case of non-performance or default by the applicant. It is commonly governed by URDG 758 or applicable local laws, depending on the agreement between parties.

Key characteristics:

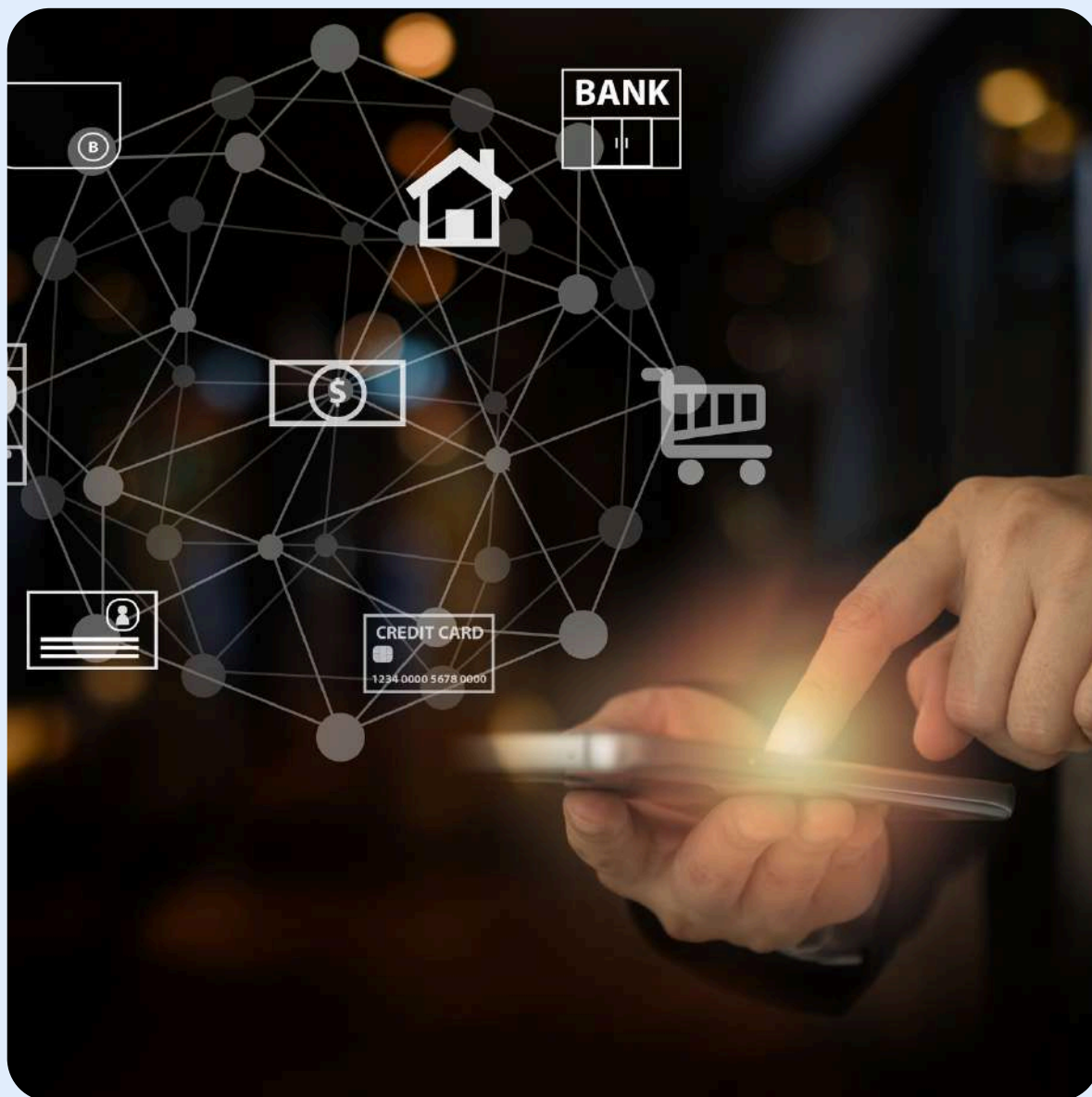
- Functions mainly as a risk mitigation and security instrument
- Governed by URDG 758 or local law
- Used across a wide range of business sectors and contractual obligations

How the Circle of Bank Guarantee Works?

1. The applicant and beneficiary first enter into an underlying contract that clearly defines the terms of the transaction.
2. Based on this agreement, the applicant applies for a bank guarantee through their issuing bank.
3. After review and approval by the bank's credit, risk, and compliance teams, the issuing bank releases the guarantee.
4. Once the guarantee is received by the beneficiary's bank, it reviews the instrument and decides whether to formally advise it to the beneficiary.
5. The bank guarantee becomes enforceable only if the applicant defaults on their contractual obligations.
6. In the event of default, the beneficiary requests their bank to lodge a claim under the guarantee with the issuing bank.
7. Upon receiving the claim, the issuing bank examines the demand strictly in accordance with the guarantee terms and applicable rules, and informs the applicant accordingly.
8. Where applicable under the agreed structure, the issuing bank debits the applicant's account to settle the claim amount.
9. The issuing bank then remits payment to the beneficiary's bank or directly to the beneficiary as per settlement instructions.
10. Finally, the beneficiary's bank credits the beneficiary's account, completing the claim settlement process.



What Is a Transferable Guarantee?



A **transferable guarantee** operates similarly to a standard guarantee but allows additional parties to participate in the transaction structure.

Typically, the **first beneficiary** is a trading or intermediary company that relies on another party—such as a supplier or subcontractor—to perform the contractual obligations. In such cases, the guarantee may be structured to support the involvement of this additional performing party, enabling execution of the underlying contract while maintaining security for all stakeholders involved.

Redundant Terms in a Bank Guarantee

Under international guarantee practice—particularly URDG 758—certain expressions are considered unnecessary because their meaning is already implied within the nature of a demand guarantee. Including them does not change the legal effect of the instrument.

A guarantee does not need to state that it is:

1. **Unconditional or abstract** – This already means payment is made against presentation of the documents specified in the guarantee.
2. **Absolute** – This simply confirms that the guarantee is irrevocable.
3. **Primary** – This indicates the issuer’s obligation is independent from the underlying contract.
4. **Payable from the issuer’s own funds** – This clarifies that payment does not depend on the applicant’s available funds.
5. **Clean or payable on demand** – This means payment is triggered upon presentation of a written demand and any required supporting documents.



Terms Without a Single Accepted Meaning

Some terms frequently appear in guarantees but do not have universally standardized interpretations. Their meaning depends on context and jurisdiction.



The following terms are generally disregarded unless clearly defined:

Typically disregarded terms:

- Callable
- Cash Back
- Divisible
- Fractionable
- Indivisible
- Transmissible

Terms that require contextual clarification:

- Assignable
- Evergreen
- Reinstate
- Revolving

To avoid ambiguity in guarantee wording, it is always recommended that such terms be clearly defined within the guarantee text or supporting agreement.

Why Are Banks More Strict Today in Trade Finance Activities?

Trade finance is considered a **high-risk sector globally**, and banks apply stricter compliance controls to manage regulatory exposure and financial risk. Some of the key reasons include:

1. Fraud and Sanctions Risks

Fraudulent transactions and sanctions violations remain major concerns in international trade.

In many cases, risks are not immediately visible and may only come to light during regulatory investigations or compliance reviews. When breaches occur, issuing banks can face significant penalties and reputational damage.

2. Discrepancies and Legal Disputes

Document discrepancies between applicants and beneficiaries can lead to contractual disputes and delayed settlements. In some situations, these disputes escalate into legal proceedings, increasing costs and operational risk for banks involved in the transaction.

Because of these factors, banks now apply enhanced due diligence, compliance screening, and document verification procedures before issuing trade finance instruments.

3. Applicant Disputes on Claim Acceptance

Fraudulent transactions and sanctions violations remain major concerns in international trade.

In many cases, risks are not immediately visible and may only come to light during regulatory investigations or compliance reviews. When breaches occur, issuing banks can face significant penalties and reputational damage.

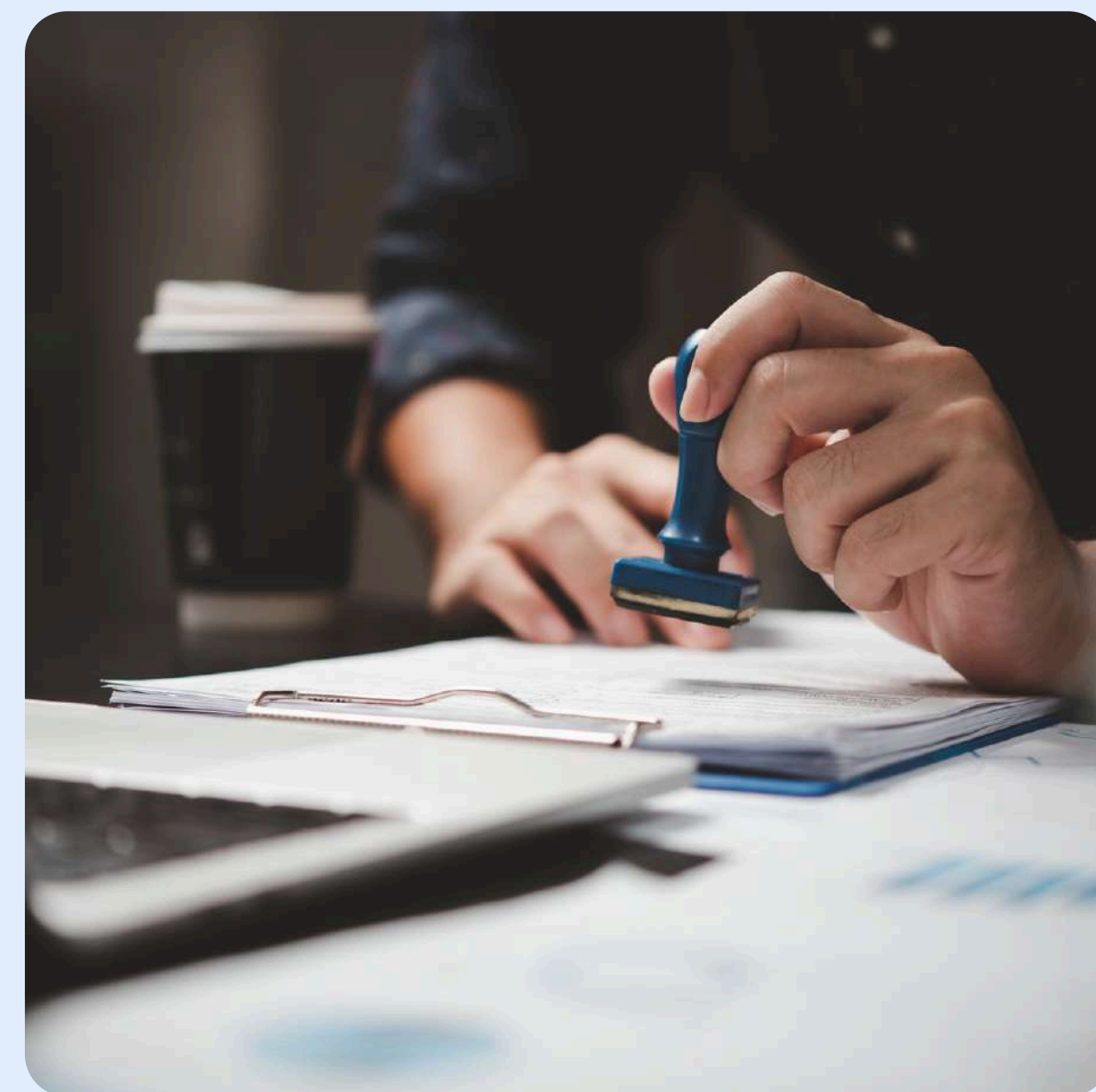
Are the Applicant and Beneficiary **100% Secure** Under a Bank Guarantee?

The practical answer is **NO**.

A bank guarantee provides financial security, but it does not eliminate all risks associated with contractual performance.

An issuing bank cannot guarantee that the beneficiary will perform its obligations correctly or honestly. Similarly, the beneficiary's bank cannot guarantee payment if a claim does not meet the conditions specified in the guarantee. The issuing bank retains the right to examine the claim and reject it if it does not comply with the agreed terms.

Therefore, bank guarantees primarily serve as risk mitigation tools designed to support contractual performance between parties rather than absolute assurances of payment or performance.



STANDBY LETTER OF CREDIT

What is a Credit?

In simple terms, **credit** refers to an agreed time period between two parties during which payment is deferred. Instead of making payment in advance, the parties agree on a **credit period**—a defined number of days after delivery or invoice date—within which the payment will be settled.

This arrangement helps improve cash flow flexibility while supporting ongoing business transactions.

What is a Standby Letter of Credit (SBLC)?

A **Standby Letter of Credit (SBLC)** is a bank's undertaking to pay the beneficiary on behalf of the applicant in the event that the applicant fails to fulfill their payment or contractual obligation.

In essence, an SBLC acts as a **financial safety mechanism**, ensuring that the beneficiary receives payment if the applicant defaults on their commitment.



Why Is It Called a Conditional Payment Method?



A **Standby Letter of Credit (SBLC)** is considered a **conditional payment instrument** because payment is made only when the beneficiary submits the required documents and fulfills the conditions specified in the credit.

If these conditions are not met, the issuing bank has the right to reject the claim and return it to the beneficiary without making payment. This ensures that payment is released strictly in accordance with the agreed terms of the SBLC

Are All Standby Letters of Credit Irrevocable?

Yes, all Standby Letters of Credit (SBLCs) are considered **irrevocable** under standard banking practice. This means that once issued, the credit cannot be cancelled or amended without the consent of the beneficiary.

Only the beneficiary has the authority to agree to any cancellation or modification. Other parties, including the applicant or issuing bank, may request changes, but no action can be taken without the beneficiary's approval.



What Types of Facilities Do Banks Provide to Issue a Standby Letter of Credit?

Banks and financial institutions generally provide three types of facilities through which an applicant can obtain a **Standby Letter of Credit (SBLC)**.

1. Cash Facility

Under a cash facility, the applicant is required to maintain a cash margin of approximately 100%-110% of the SBLC value with the issuing bank. These funds remain blocked for the entire validity period of the SBLC and serve as full security for the bank's undertaking.

2. Credit Facility

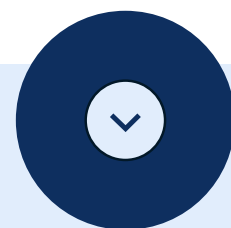
Under a credit facility, the bank finances the SBLC issuance based on the applicant's creditworthiness. Instead of blocking full cash collateral, the bank extends a credit line and charges a facility fee or percentage-based commission depending on the risk profile and tenor of the transaction.

3. Conditional Facility

A conditional facility is less commonly offered by banks due to its higher risk nature. In this structure, the SBLC may be issued without requiring full cash collateral from the applicant. However, if a claim is made under the SBLC, payment is typically processed only after the applicant settles the obligation. Because of this dependency, many banks avoid operating under this model.

How Is a Standby Letter of Credit Used in Trade?

According to international trade studies conducted by various industry associations, global trade transactions are generally structured using four main payment methods:



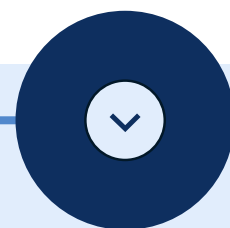
OPEN ACCOUNT

Open account transactions represent the largest share of global trade. Under this arrangement, the seller ships goods to the buyer based on mutual trust, expecting payment on an agreed future date.

In some cases:

- the seller may sell the invoice to a factoring company to receive early payment, or
- the buyer may arrange import financing through a lender that pays the seller and recovers payment later from the buyer.

This method offers flexibility but carries higher risk for the seller.



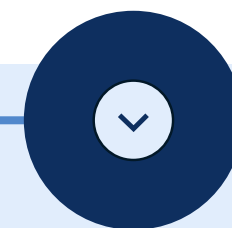
DOCUMENTARY CREDITS AND BANK GUARANTEES

Documentary credit and guarantee instruments provide additional security in trade transactions.

These include:

- Letters of Credit (LC)
- Standby Letters of Credit (SBLC)
- Bank Guarantees (BG)

In these structures, banks play an active role in reducing payment risk by supporting the transaction with conditional payment commitments.



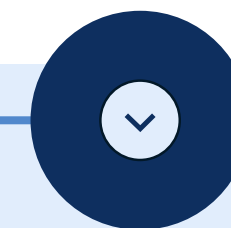
DOCUMENTARY COLLECTION

Documentary collection involves the exchange of shipping and commercial documents through banks acting as intermediaries between buyer and seller.

Unlike Letters of Credit:

- banks do not guarantee payment
- they act only as collecting agents
- payment responsibility remains with the buyer

This makes documentary collection less secure than LC-based transactions but simpler and more cost-efficient.



ADVANCE PAYMENT

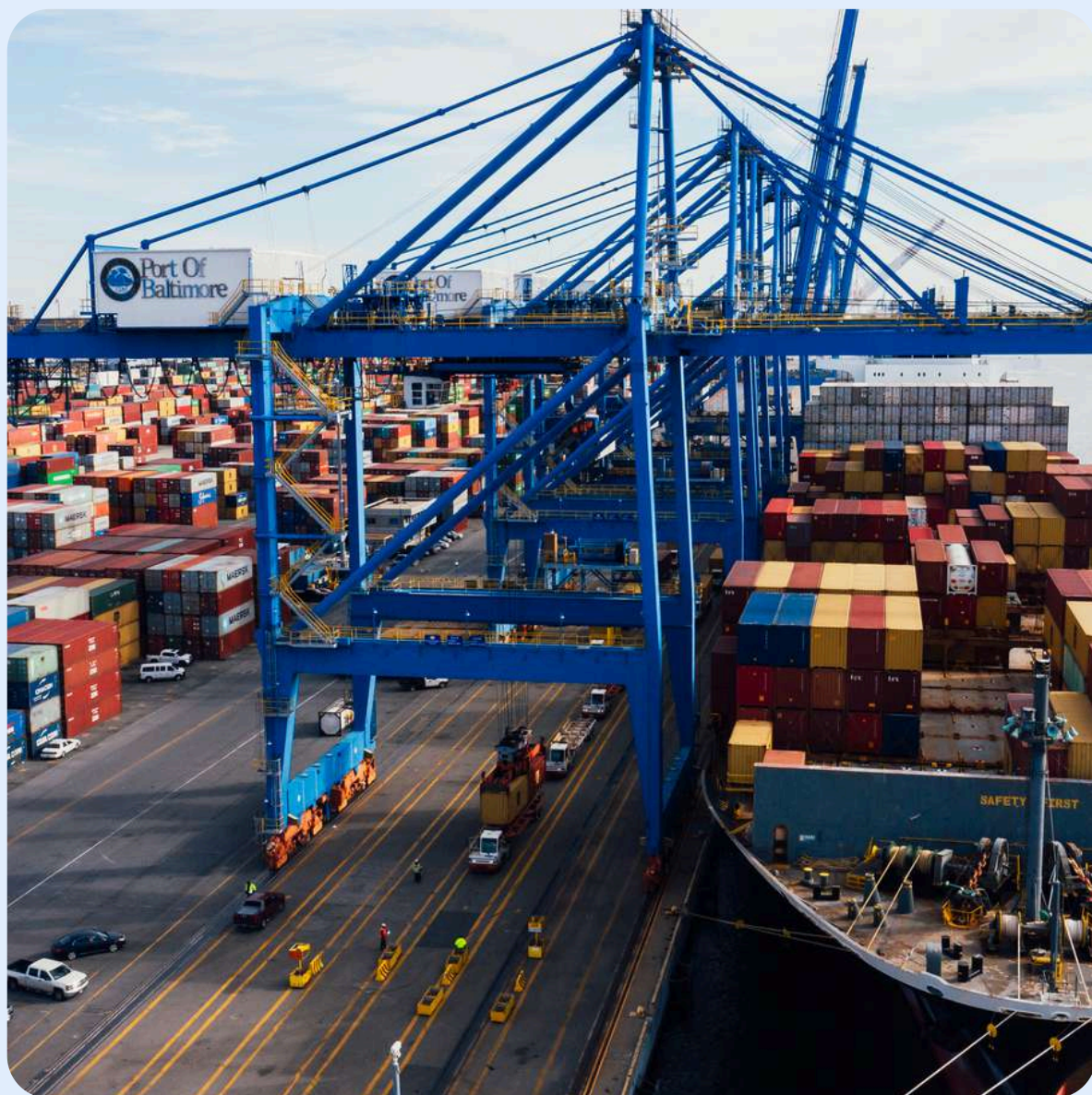
Under advance payment terms, the buyer pays the seller before shipment takes place. This structure provides maximum security to the seller but increases risk exposure for the buyer.

Advance payment is commonly used when:

- the seller has strong negotiating power
- the goods are customized
- or the buyer-seller relationship is new

It ensures the seller receives funds before dispatching the shipment.

Why Is a Standby Letter of Credit Required in Trade?



As discussed earlier, international trade transactions generally follow four main payment methods. Among these, only documentary credit and guarantee instruments provide the seller with security of payment backed by a bank.

Therefore, when advance payment is not made by the buyer, sellers often request a Standby Letter of Credit (SBLC) to protect themselves against the risk of non-payment. An SBLC serves as a reliable financial safeguard, ensuring that the seller receives payment if the buyer fails to meet their contractual obligations.

Who can issue a Standby Letter of Credit?

Under general international practices and regulatory frameworks, several types of financial institutions may issue bank guarantees. However, it is important to note that regulations vary by country, and eligibility depends on local supervisory approval. Typically, bank guarantees can be issued by:



Commercial Banks

Micro Finance Banks

Micro Finance Institutions

Leasing Companies

Insurance Companies

Special Trade Finance
Institutions With Regulatory
Approval

The authority to issue guarantees always depends on the institution's licensing status and the applicable regulations within its jurisdiction. These frameworks ensure credibility, enforceability, and financial security in guarantee-backed transactions.

Bank guarantees are not issued exclusively by banks. In many jurisdictions, **other regulated financial institutions** and insurance companies may also issue guarantees, subject to local regulatory approval. However, the term "**standby letter of credit**" is commonly used as a general industry reference because banks remain the most widely recognized issuers of such instruments.

When a guarantee is issued by a **non-bank financial institution**, the terminology in the guarantee document typically changes. Instead of referring to an "**issuing bank**", the document refers to the "**issuer**," and the instrument may simply be described as a "**guarantee**" rather than a bank guarantee. The structure and purpose of the undertaking remain the same; only the issuing entity and terminology differ.

Can Only Banks Issue a Standby Letter of Credit?

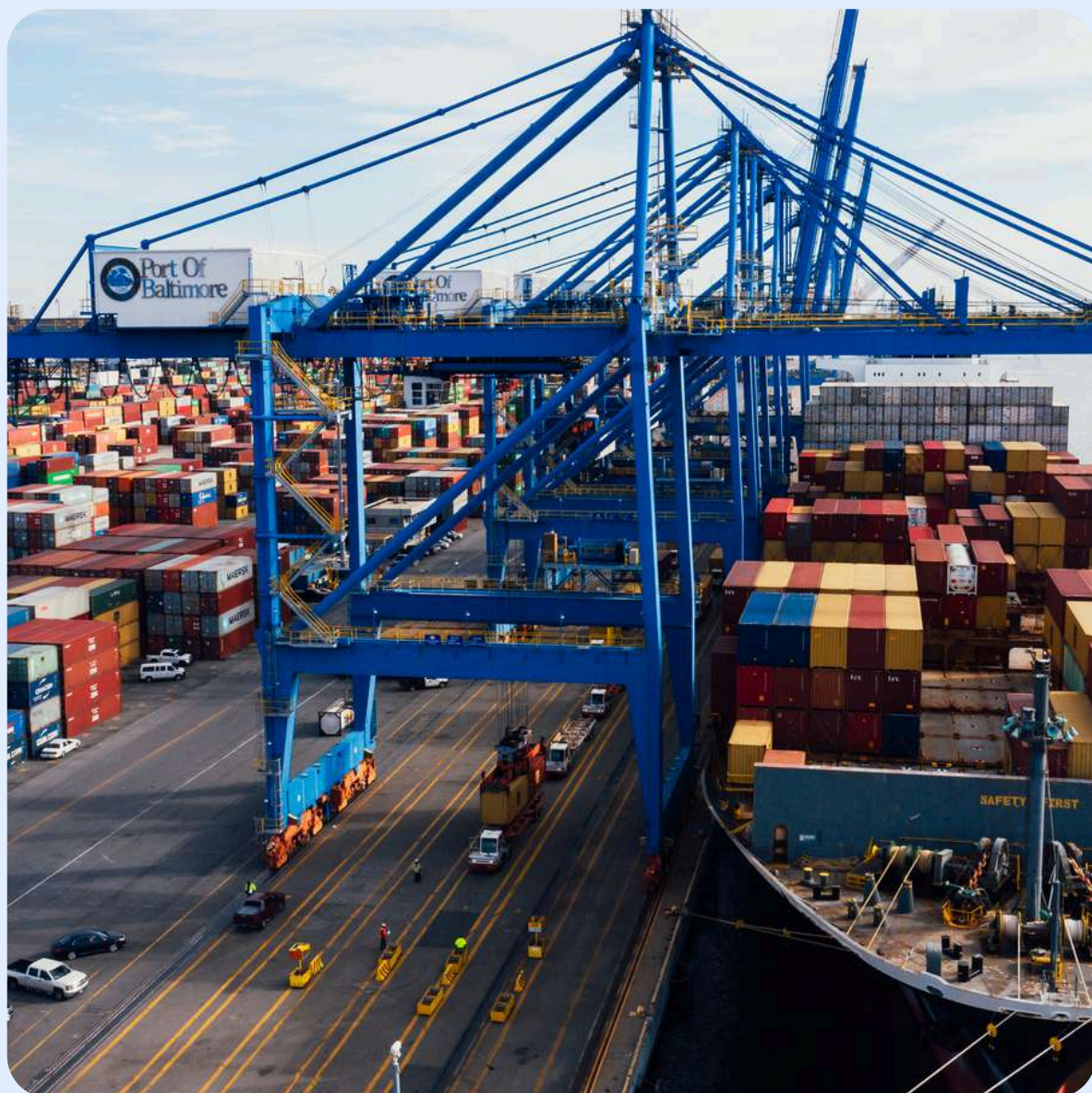
No. Standby Letters of Credit (SBLCs) are not issued exclusively by banks. Other authorized financial institutions and, in some jurisdictions, insurance companies may also issue SBLC-type guarantees, subject to regulatory approval.

However, the term “issuing bank” is commonly used in standard trade finance terminology for simplicity and general understanding. In practice, when a non-bank financial institution issues the instrument, the terminology is typically adjusted from “issuing bank” to “issuer” in the SBLC message or documentation.

The key consideration is not the type of institution, but whether the issuer is properly licensed and authorized under the applicable regulatory framework.



What Is the Basic Difference Between a Standby Letter of Credit and a Documentary Credit?



A Documentary Credit (Letter of Credit) primarily focuses on the documents specified in the credit and the transaction terms stated within it. The issuing bank examines only the required documents presented under the credit and does not consider external factors beyond those conditions.

Documentary Credits are generally issued subject to the rules of UCP 600 (Uniform Customs and Practice for Documentary Credits), which govern how banks review documents and process payment obligations.

In contrast, a Standby Letter of Credit (SBLC) functions mainly as a guarantee of payment in case of default, rather than as a primary payment mechanism in routine trade transactions.

Which Applicable Rules Apply to a Standby Letter of Credit (SBLC)?

Standby Letters of Credit are typically issued under one of the following internationally recognized rule frameworks:

- UCP 600 (ICC Publication No. 600) – Uniform Customs and Practice for Documentary Credits
- ISP98 (ICC Publication No. 590) – International Standby Practices

While both frameworks can govern SBLCs, ISP98 is specifically designed for standby letters of credit and is therefore more commonly preferred in SBLC transactions.

UCP 600

UCP 600 (Uniform Customs and Practice for Documentary Credits) is an ICC framework that governs how banks handle documents presented under documentary credits. It defines the roles, responsibilities, and rights of the applicant, beneficiary, and issuing bank.

Under UCP 600, payment is made based strictly on the presentation of compliant documents related to trade transactions, making it primarily suitable for **commercial Letters of Credit used in international trade.**

ISP98

ISP98 (International Standby Practices) is an ICC rule set specifically designed for Standby Letters of Credit. Unlike UCP 600, ISP98 is not limited to traditional trade transactions and can also support obligations related to **performance guarantees, financial commitments, and service contracts.**

Under ISP98, a claim is typically submitted only when the applicant fails to perform contractual obligations or fails to make payment as agreed, which triggers the standby undertaking by the issuing institution.

What Are the Major Differences Between ICC 590 (ISP98) and UCP 600?

UCP 600 assumes that applicants intend to pay beneficiaries upon presentation of compliant documents because those documents represent ownership of goods and are essential for completing trade transactions.

In contrast, ISP98 (ICC Publication No. 590) assumes that applicants generally do not expect payment to occur unless there is a default. This is because standby letters of credit function primarily as a backup payment guarantee, rather than a primary payment method.



Document Examination Requirements

UCP 600 contains stricter rules regarding document examination and presentation timelines. ISP98 applies more flexible standards suitable for standby transactions.



Control Over Goods

Under UCP 600, documents may represent title to goods and are often required for customs clearance. Under ISP98, documents typically do not control goods and serve mainly as evidence of default.



Standby-Specific Provisions

ISP98 includes provisions specifically designed for standby letters of credit that are not covered under UCP 600.



Importance of Original Documents

UCP 600 places strong emphasis on original shipping and commercial documents. ISP98 is less concerned with document originality because standby claims usually involve simple demand statements rather than trade documentation.

Practical Interpretation

In simple terms, ISP98 is structured around credit assurance, where payment occurs only if the applicant fails to perform contractual obligations. The documents presented under a standby letter of credit usually have limited intrinsic value and serve primarily to support a claim of default rather than facilitate trade settlement.

	UCP600	ISP98
INTENDED USE:	LETTERS OF CREDIT WHOSE PRIMARY PURPOSE IS EXCHANGE CONTROL OF GOODS FOR PAYMENT.	LETTERS OF CREDIT WHOSE PRIMARY PURPOSE IS TO PROVIDE CREDIT ASSURANCE.
ASSUMPTION 1:	THE DOCUMENTS HAVE A TIME VALUE.	THE DOCUMENTS HAVE NO INTRINSIC
ASSUMPTION 2:	APPLICANTS WANT TO PAY.	APPLICANTS DON'T WANT TO PAY.

- **UCP600:**

Letters of credit whose primary purpose is exchange control of goods for payment.

▶ Letters of credit whose primary purpose is to provide credit assurance.

- **ASSUMPTION 1:**

Applicants want to pay.

▶ The documents have no intrinsic value.

▶ Applicants don't want to pay.

Key Operational Differences Between UCP 600 and ISP98

The following table highlights several practical differences between UCP 600 (commercial documentary credits) and ISP98 (standby letters of credit):



TOPIC	UCP 600	ISP98
Force Majeure	Credit expiry continues even during force majeure events	Expiry may be automatically extended (typically up to 30 days after bank reopens)
Consistency of Documents	Data across documents must not conflict	Expiry may be automatically extended (typically up to 30 days after bank reopens)
Time Allowed for Dishonour	Up to 5 banking days for examination	Determined by reasonableness standards (generally <4 days reasonable; >7 days unreasonable)
Original Documents	“In copies” interpreted as at least one original of each document	“Copies” may include copies or originals unless otherwise specified
Transport Documents	Subject to detailed and strict requirements	Treated as ordinary documents unless specifically required
Disposition of Documents	Strict handling and control requirements apply	No specific disposition requirements

How a Standby Letter of Credit (SBLC) Works – Step-by-Step

1. Agreement Between Parties

The applicant and beneficiary first enter into a contract that clearly defines the terms of the transaction.

2. SBLC Application Submission

Based on the agreement, the applicant requests issuance of a Standby Letter of Credit from their bank.

3. Bank Review and Issuance

The issuing bank evaluates the request through its credit, risk, and compliance procedures before issuing the SBLC.

4. Advising the Beneficiary

The beneficiary's bank receives the SBLC, reviews its authenticity and terms, and then advises it to the beneficiary.

5. Use of the SBLC (Only in Case of Default)

The SBLC is utilized only if the applicant fails to meet contractual obligations under the transaction.

Issuance Stage

HOW A STANDBY LETTER OF CREDIT (SBLC) WORKS – STEP-BY-STEP



How a Standby Letter of Credit (SBLC) Works – Step-by-Step

6. Claim Submission by Beneficiary

In case of default, the beneficiary requests their bank to lodge a claim under the SBLC with the issuing bank.

7. Examination by Issuing Bank

The issuing bank reviews the claim strictly according to the SBLC terms and applicable rules (UCP600 or ISP98).

8. Applicant Notification

The issuing bank informs the applicant after receiving the claim.

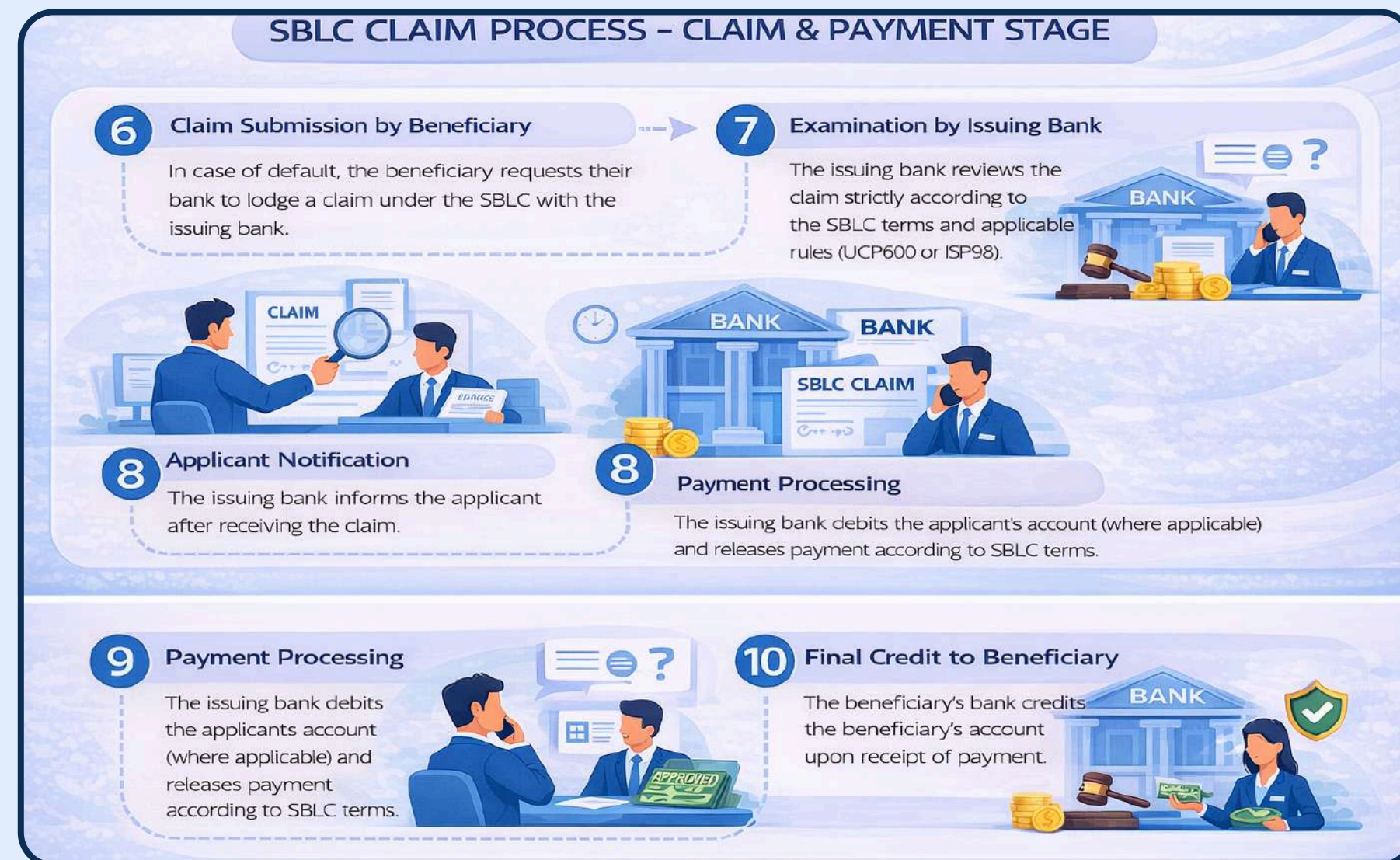
9. Payment Processing

The issuing bank debits the applicant's account (where applicable) and releases payment according to SBLC terms.

10. Final Credit to Beneficiary

The beneficiary's bank credits the beneficiary's account upon receipt of payment.

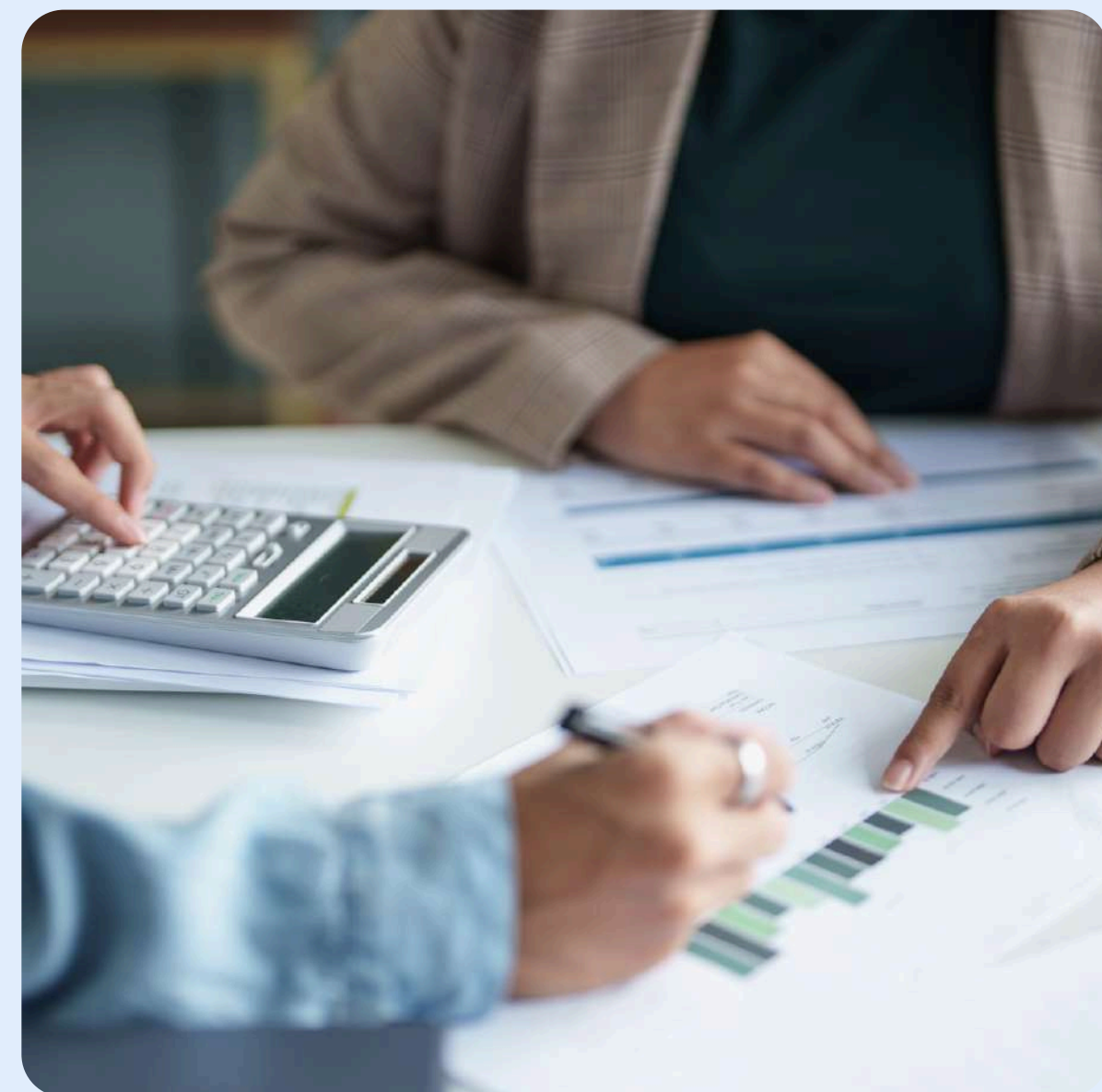
Claim & Payment Stage



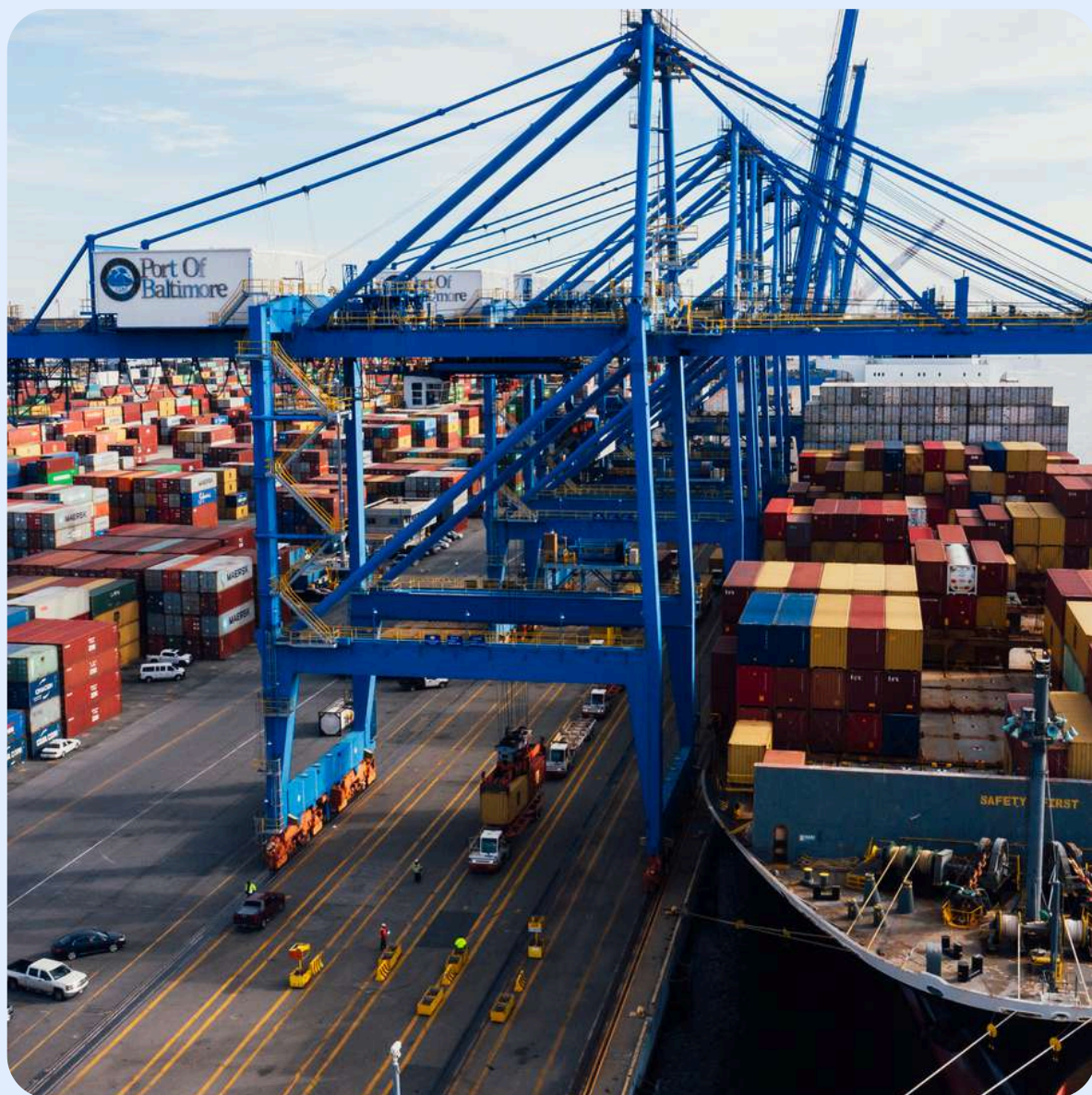
What Is a Transferable Standby Letter of Credit?

A **transferable Standby Letter of Credit (SBLC)** functions similarly to a standard SBLC but allows additional parties to participate in the transaction.

Typically, the **first beneficiary is a trading company** that relies on a second party (such as a supplier or subcontractor) to fulfill contractual obligations. A transferable SBLC enables the first beneficiary to transfer part or all of the credit to another party involved in executing the contract.



What Is Adding Confirmation Under a Standby Letter of Credit?



Adding confirmation means a second bank (the confirming bank) provides its **independent payment guarantee** in addition to that of the issuing bank. This is commonly requested when the beneficiary prefers additional security beyond the issuing bank's obligation.

Once confirmation is added:

- The confirming bank assumes payment responsibility under the SBLC
- The beneficiary may rely on the confirming bank instead of the issuing bank
- Payment risk related to the issuing bank's country or credit profile is reduced

There are different types of confirmation structures.

“May Add” Confirmation

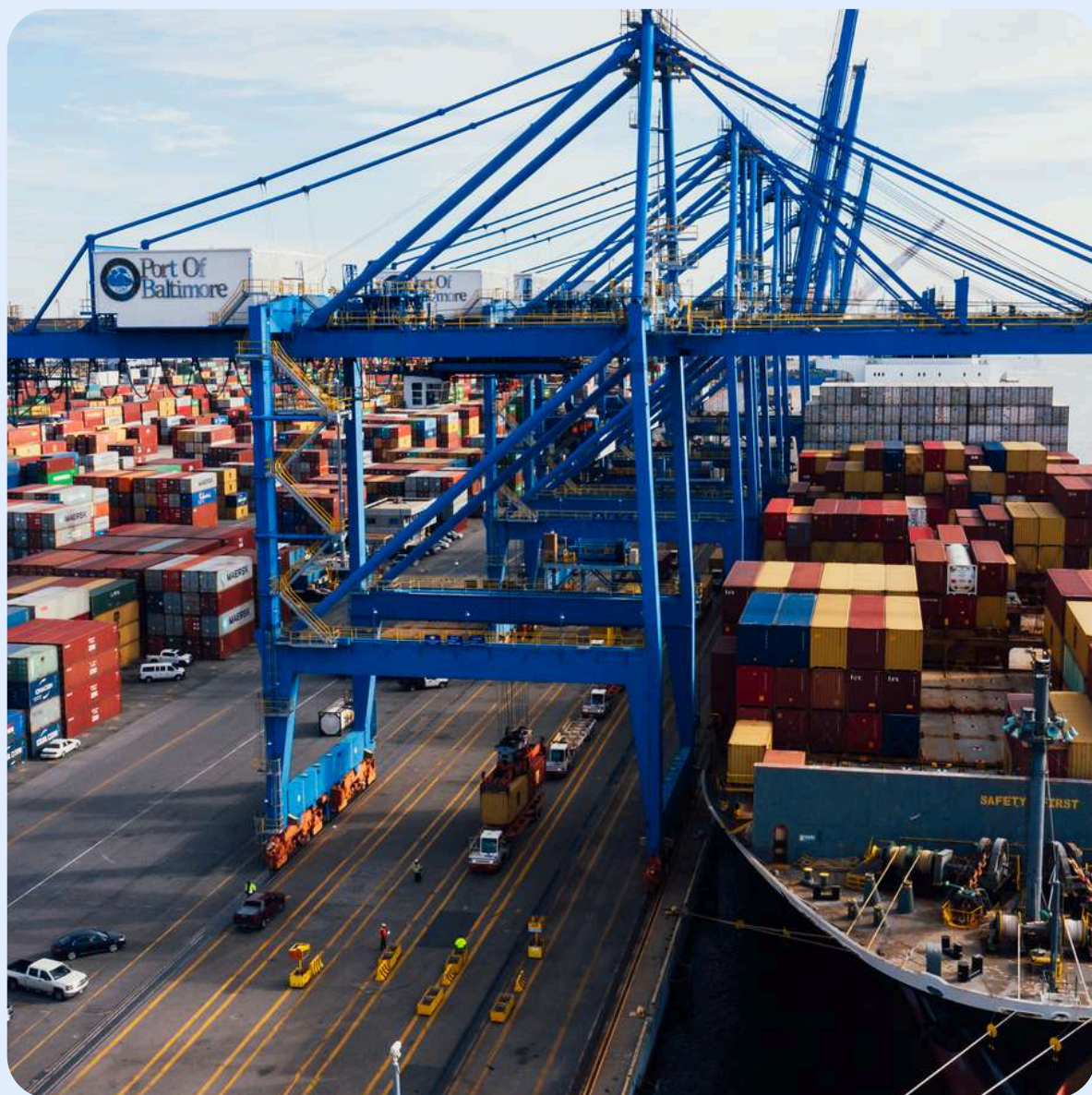
“May Add” confirmation means the issuing bank authorizes the advising bank to add its confirmation if requested by the beneficiary.

Key points:

- Confirmation is optional
- The beneficiary decides whether confirmation is required
- Costs are typically borne by the beneficiary



“Confirm” Instruction



“Confirm” confirmation means the issuing bank formally instructs another bank (usually a correspondent bank) to add its confirmation to the SBLC.

In this structure:

- Confirmation becomes part of the credit arrangement
- The confirming bank assumes payment liability
- The beneficiary benefits from an additional layer of payment security

Redundant Terms in a Standby Letter of Credit (SBLC)

A standby letter of credit does not need to explicitly state the following terms, as they are already implied under standard standby practice:

A guarantee does not need to state that it is:

1. **Unconditional or abstract** – This already means payment is made against presentation of the documents specified in the guarantee.
2. **Absolute** – This simply confirms that the guarantee is irrevocable.
3. **Primary** – This indicates the issuer's obligation is independent from the underlying contract.
4. **Payable from the issuer's own funds** – This clarifies that payment does not depend on the applicant's available funds.
5. **Clean or payable on demand** – This means payment is triggered upon presentation of a written demand and any required supporting documents.



Terms Without a Single Accepted Meaning

Some terms frequently appear in guarantees but do not have universally standardized interpretations. Their meaning depends on context and jurisdiction.



The following terms are generally disregarded unless clearly defined:

Typically disregarded terms:

- Callable
- Cash Back
- Divisible
- Fractionable
- Indivisible
- Transmissible

Terms that require contextual clarification:

- Assignable
- Evergreen
- Reinstate
- Revolving

To avoid ambiguity in guarantee wording, it is always recommended that such terms be clearly defined within the guarantee text or supporting agreement.

How Sanctions Affect a Standby Letter of Credit (SBLC)

Sanctions compliance has become increasingly complex for issuing banks and financial institutions in day-to-day operations.

Even when sanctioned parties are not directly named in transaction documents, indirect involvement—such as links through counterparties, ports, vessels, ownership structures, or jurisdictions—can create serious compliance risks.

As a result:

- Banks face frequent regulatory penalties for sanctions violations
- Financial institutions must perform deeper transaction screening
- Documentation reviews have become more stringent
- Enhanced due diligence (EDD) is now a standard requirement in many transactions

Because of these risks, banks and financial institutions are becoming more vigilant and are strengthening their compliance frameworks before issuing or honoring standby letters of credit.



Why Are Banks More Strict Today in Trade Finance Activities?

Trade finance is considered a **high-risk sector globally**, and banks apply stricter compliance controls to manage regulatory exposure and financial risk. Some of the key reasons include:

1. Fraud and Sanctions Risks

Fraudulent transactions and sanctions violations remain major concerns in international trade.

In many cases, risks are not immediately visible and may only come to light during regulatory investigations or compliance reviews. When breaches occur, issuing banks can face significant penalties and reputational damage.

2. Discrepancies and Legal Disputes

Document discrepancies between applicants and beneficiaries can lead to contractual disputes and delayed settlements. In some situations, these disputes escalate into legal proceedings, increasing costs and operational risk for banks involved in the transaction.

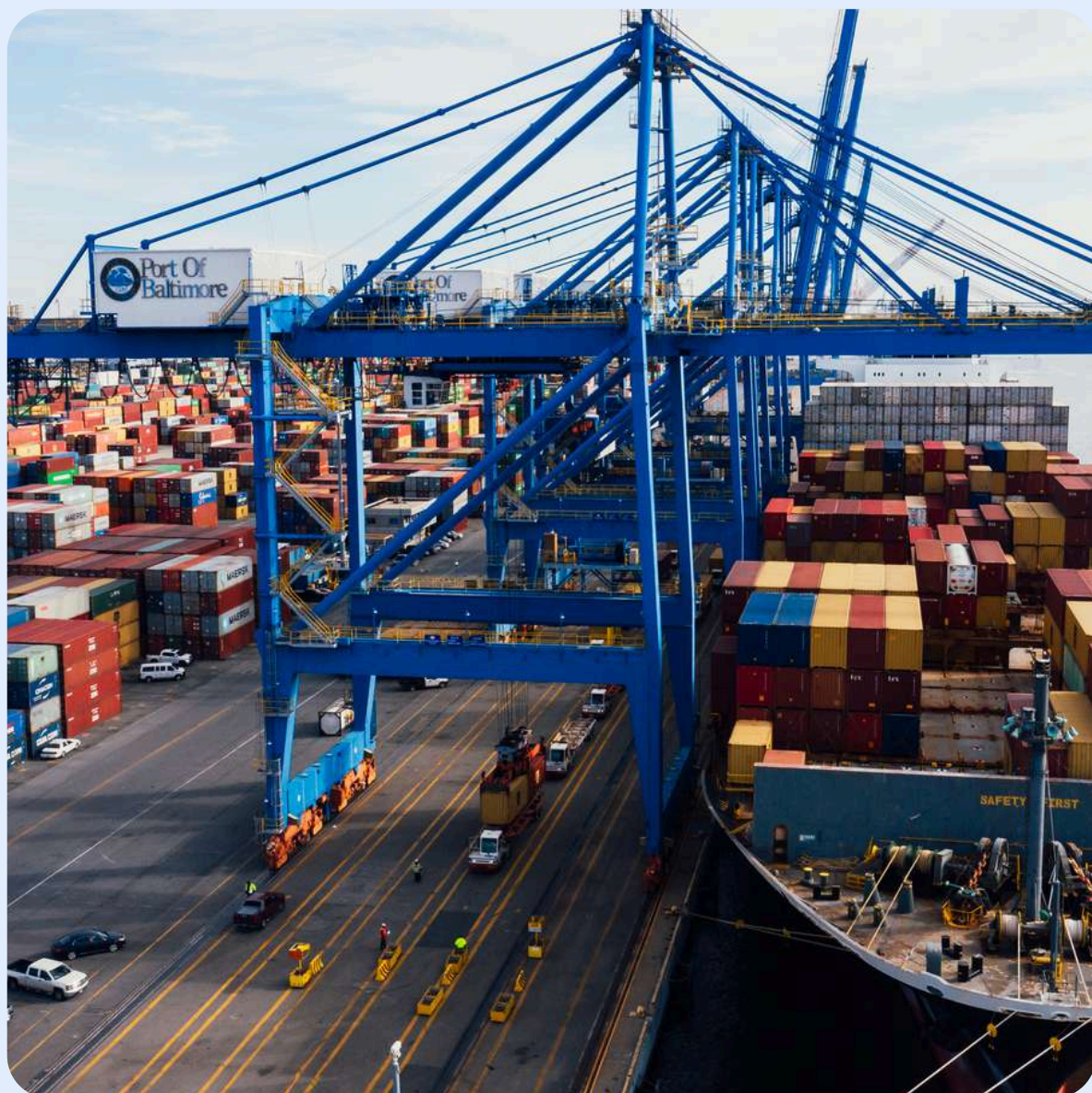
Because of these factors, banks now apply enhanced due diligence, compliance screening, and document verification procedures before issuing trade finance instruments.

3. Applicant Disputes on Claim Acceptance

Fraudulent transactions and sanctions violations remain major concerns in international trade.

In many cases, risks are not immediately visible and may only come to light during regulatory investigations or compliance reviews. When breaches occur, issuing banks can face significant penalties and reputational damage.

Purpose of a Standby Letter of Credit (SBLC)



A Standby Letter of Credit (SBLC) is primarily used to **reduce payment risk and avoid advance payments** in commercial transactions.

Under an SBLC structure:

- The beneficiary receives assurance of payment if the applicant fails to perform
- The applicant can include specific claim conditions that must be satisfied before payment is made
- Payment is released only upon compliant document presentation
- The issuing bank retains the right to reject claims that do not meet SBLC terms and applicable rules (such as ISP98 or UCP600)
- Transaction risk is shifted from upfront payment exposure to structured documentary compliance

As a result, SBLCs provide **security for the beneficiary while protecting the applicant's cash flow and contractual position.**

S.W.I.F.T AND ADVISING TRADE MESSAGES

WHAT IS S.W.I.F.T?

S.W.I.F.T Stands for the society for worldwide interbank financial telecommunication. It is a messaging network that facilitates communication between financial institutions, enabling them to securely exchange information and financial transactions globally, such as money transfers, foreign currency exchanges, and securities trading.

WHAT IS TRADE MESSAGES IN S.W.I.F.T

Trade messages in S.W.I.F.T. are standardized messages that facilitate the exchange of information related to trade finance between financial institutions or banks. These messages contain structured data and provide a common language for communication between banks, which can help to reduce errors and increase efficiency in trade finance transactions.



WHAT IS ADVISING

Advising refers to the process of informing a beneficiary or seller that a Financial instrument has been issued in their favor. The advising bank is responsible for transmitting that instrument to the beneficiary and verifying its authenticity. The advising bank is not necessarily the issuing bank or the confirming bank, but it acts as an intermediary between the two parties and provides a level of assurance that the instrument is genuine.

WHAT IS S.W.I.F.T ADVISING

Swift advising refers to the process of transmitting a swift message, such as a letter of credit, to the beneficiary or seller through an intermediary bank. The intermediary bank, also known as the advising bank, receives the swift message from the issuing bank and verifies its authenticity before forwarding it to the beneficiary or seller.

The swift advising process helps to ensure that the beneficiary or seller receives timely and accurate information about the letter of credit or other financial instrument. It provides a level of assurance that the financial instrument is genuine and helps to minimize the risk of fraud or other errors in the transaction.



How S.W.I.F.T Advising Works

The SWIFT advising process involves the following steps:

Issuing bank initiates the SWIFT message

The first step in the SWIFT advising process is for the issuing bank/Issuer to initiate the SWIFT message, such as a letter of credit or payment instruction, on behalf of the buyer.

Message transmission to intermediary bank

The SWIFT message is then transmitted to an intermediary bank, also known as the advising bank, which serves as an intermediary between the issuing bank and the beneficiary or seller.

Verification of message authenticity

The advising bank verifies the authenticity of the SWIFT message and ensures that it is consistent with the terms and conditions of the underlying transaction.

Notification to beneficiary

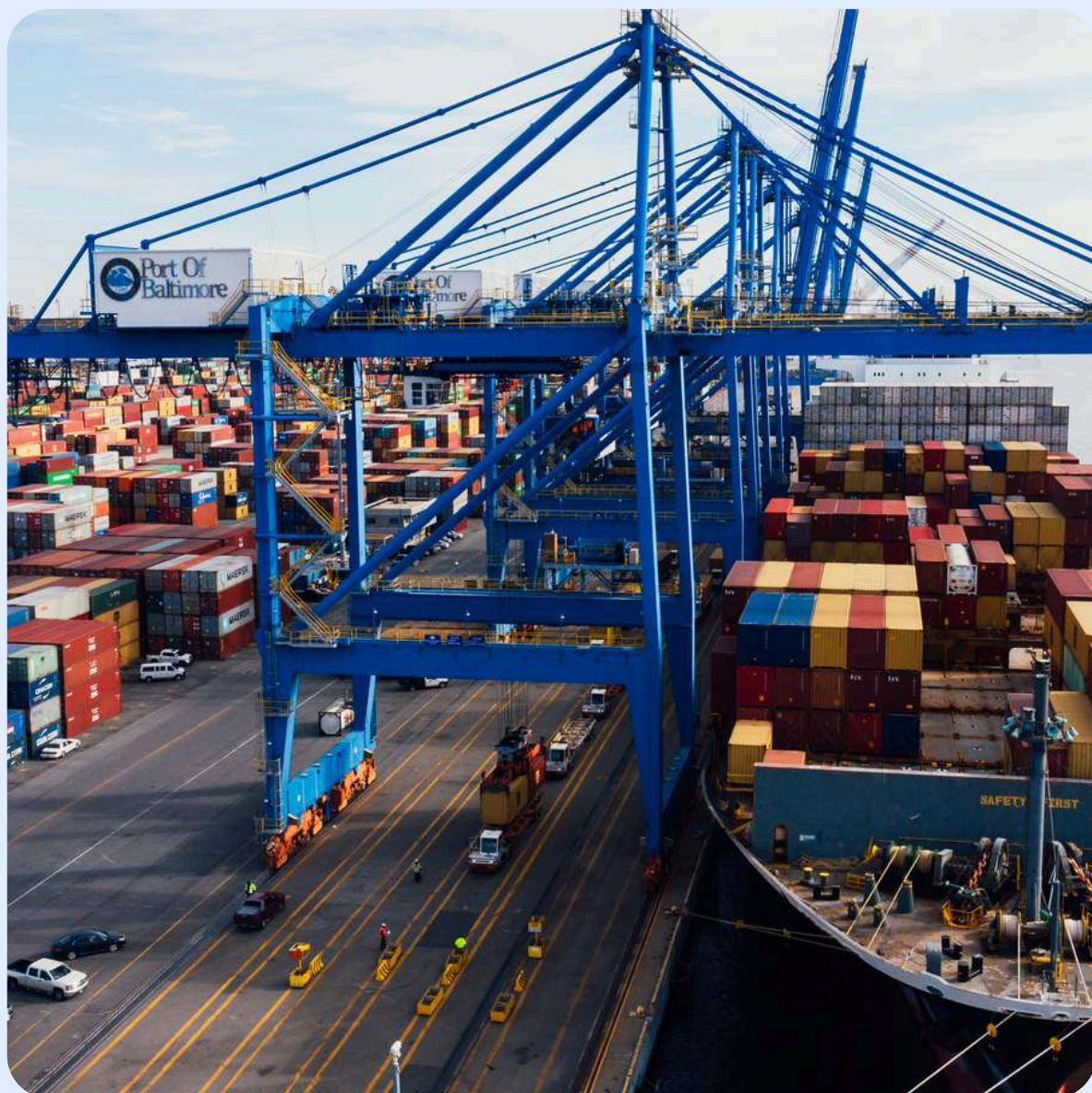
Once the advising bank has verified the authenticity of the SWIFT message, it notifies the beneficiary or seller of its contents, usually through an electronic message or letter.

SWIFT Advising

HOW A STANDBY LETTER OF CREDIT (SBLC) WORKS – STEP-BY-STEP



What is RMA (Relationship Management Application)?



The Relationship Management Application (RMA) is a SWIFT authorization system that enables banks to manage their messaging relationships securely with other SWIFT users.

Through RMA, banks can:

- Control which counterparties they are permitted to exchange SWIFT messages with
- Define the types of messages that can be exchanged (e.g., MT700, MT760, MT103)
- Authorize and authenticate communication between institutions
- Ensure compliance with SWIFT security standards and protocols

In practice, RMA acts as a permission framework that protects banks from unauthorized or unexpected SWIFT communications while maintaining secure interbank connectivity.

What is Digitisation of SWIFT Messages?

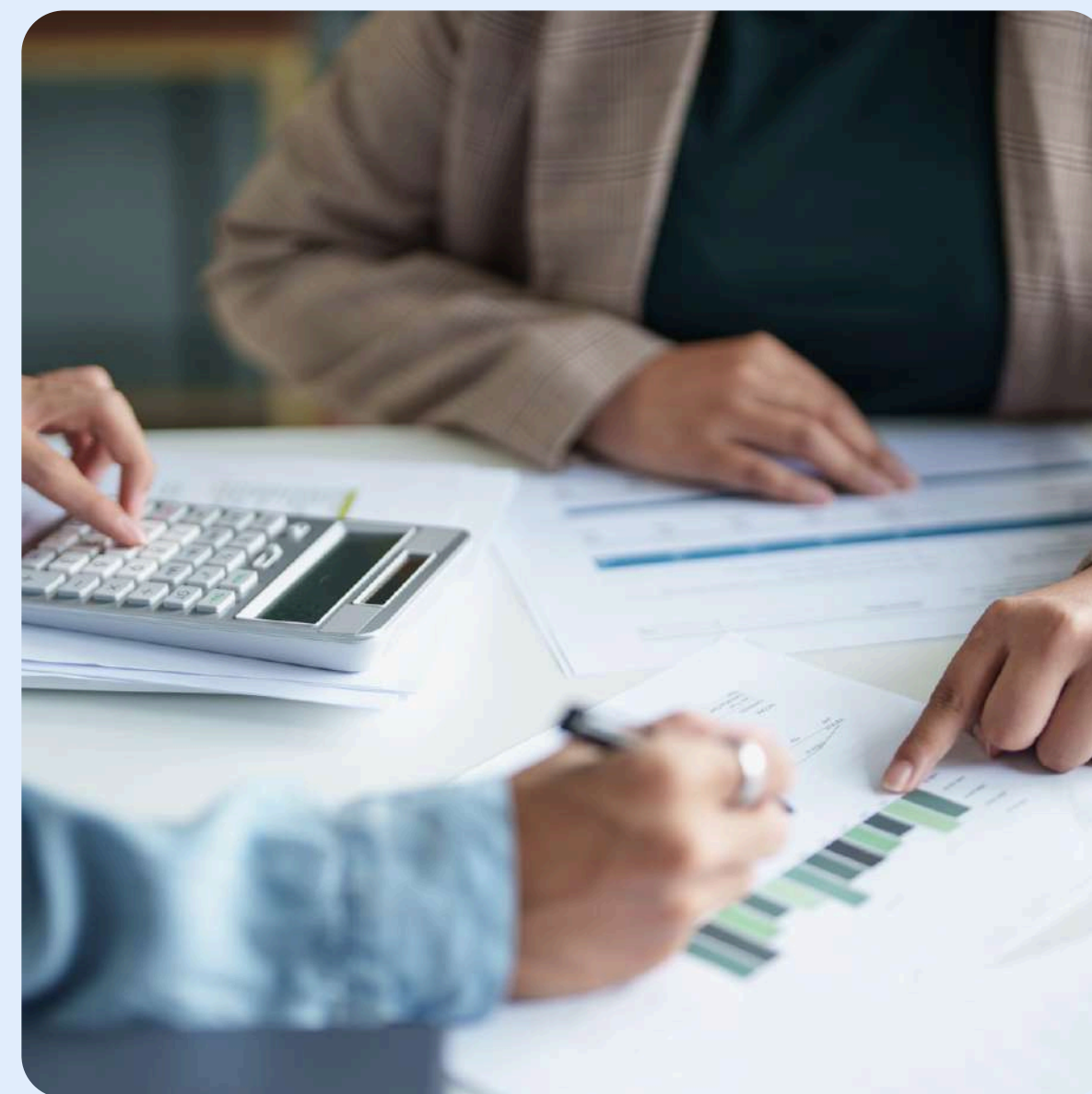
Not all financial institutions have direct access to the SWIFT messaging network, even though they actively participate in international trade transactions.

In such cases, these institutions work through a partner bank that has SWIFT access. The partner bank can generate and transmit the SWIFT message on their behalf.

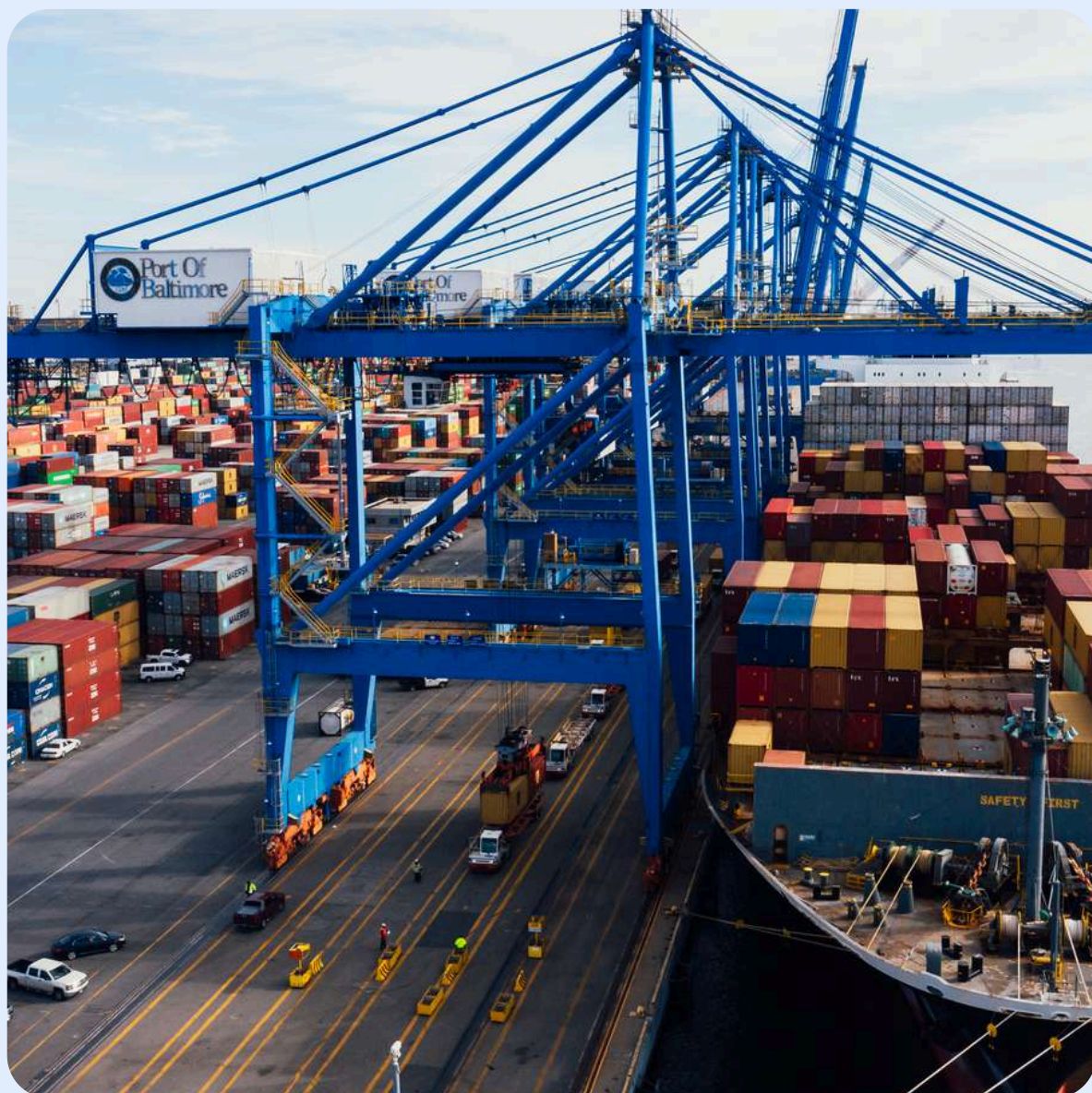
Under this arrangement:

- The original issuing institution remains clearly identified as the issuer
- The partner bank acts only as the sending or relaying bank
- The message is transmitted through the partner bank's SWIFT infrastructure
- This process is commonly referred to as advising or relaying SWIFT messages
- It is a standard and widely accepted practice in global trade finance

This structure allows institutions without direct SWIFT connectivity to participate efficiently in international banking transactions while maintaining transparency regarding the issuing party.



How should a SWIFT Operator Digitise the Message



For a bank to digitise the message they will a soft copy of the SWIFT message the ordering institution is asking to create in the system.

Purpose of soft is for easily copy the message and just inputting it in the system than rewriting the complete message.

Below should be message type files of each message:

- 1.Documentary Credit should be in the form of 710
- 2.Standby Letter of Credit or any form of Guarantee should in the form of 760
- 3.For a RWA or any non-format message should be in the form of 799

What is Process Flow From Request to Generating SWIFT Copy of any Digitisation?

It starts with the issuer initiating the request. They send this via email, and importantly, they attach the Word file containing the exact SWIFT message that needs to be advised. This document serves as the base content that the bank will work with.

Once the request is received, the bank's first step is to check the RMA, or the relationship management authorization, with the receiving bank mentioned in the SWIFT message. This is a critical step because it confirms whether there is an established and authorized communication line between both banks within the SWIFT network.

After confirming that the RMA is in place, the bank proceeds by taking the content provided by the issuer and inputting it into the SWIFT system. At this stage, the message is essentially digitized—meaning the exact details from the file are structured and transmitted in proper SWIFT format.

Once the message has been successfully created and transmitted, an acknowledgment copy, or ACK, is generated. This ACK serves as confirmation that the message has been sent through the system, and this is then shared back with the issuer as a reply to their original email.

Following that, the bank will apply the advising charges by debiting the issuer's account, as per the agreed terms for handling and transmitting the message.

And finally, the process doesn't stop there—any incoming messages or responses related to that SWIFT are monitored closely, and the bank ensures that these are shared promptly with the issuer so they are always updated in real time.



Onboarding of an Institution For Digitisation Of Swift Message

ONBOARDING AN INSTITUTION

— The Foundation of a Trusted Banking Relationship —



From a banking and compliance perspective, onboarding is absolutely critical. A bank should only work with institutions that are properly regulated by recognized authorities. These institutions must first be onboarded as Financial Institution (FI) clients before any services, including digitisation or SWIFT advising, can even be considered.

As part of this onboarding, the bank will also open or designate an FI account for the institution. This is necessary so that all service-related charges—such as advising or processing fees—can be properly and transparently debited.

The main purpose of onboarding is regulatory compliance. It ensures that the bank has a complete and verified KYC profile of the issuer. This includes understanding the institution's background, ownership, regulatory standing, and overall risk profile. Only after this due diligence is completed, and once both parties are aligned, does the bank proceed with formal agreements.

So before any digitisation or SWIFT activity happens, onboarding ensures that everything is structured, compliant, and aligned with regulatory standards. It's not just a formality—it's a foundational step that protects both the bank and the institution.

What is Service Level Agreement (SLA)?

A Service Level Agreement (SLA) in the context of SWIFT digitisation services is a formal agreement between the bank and the issuer that clearly defines the roles, responsibilities, and expectations of both parties throughout the process. The purpose of the SLA is to ensure smooth execution, minimize risks, and avoid delays by setting clear guidelines on what each party is accountable for.

Issuer Responsibilities

From the issuer's side, the SLA outlines key requirements to ensure the bank can process the transaction without issues. These typically include:

- Ensuring proper compliance of the transaction
- Providing complete and accurate KYC of the applicant
- Submitting all relevant underlying transaction documents

These elements are critical, as any gaps can delay or impact the successful transmission of the SWIFT message.

Bank Responsibilities

On the other hand, the SLA also defines what the bank must deliver to ensure a seamless experience for the issuer. For example:

- Since trade transactions are highly time-sensitive, the bank should ensure that the SWIFT copy (ACK) is generated and shared within 24-48 hours
- If any issue arises during the process—such as an RMA being unavailable or revoked with the receiving bank—the bank must immediately inform the issuer

This allows the issuer to take timely action, such as exploring an alternative routing or second bank for the transaction.



INCOTERMS

What is Incoterms?

INCOTERMS, or International Commercial Terms, are globally recognized trade terms used in international business transactions. They were developed by the International Chamber of Commerce (ICC) to establish a common set of rules that clearly define the responsibilities, obligations, costs, and risks between the buyer and seller in cross-border trade.

These terms are widely used in international contracts to ensure that all parties involved understand their roles throughout the shipment and delivery process.

What is Main Purpose of Incoterms?

The main purpose of INCOTERMS is to create clarity and transparency in international trade transactions. They help define who is responsible for key aspects such as transportation, insurance, customs clearance, delivery obligations, and related costs.

INCOTERMS also help businesses understand at what point the risk transfers from the seller to the buyer during the movement of goods.

By providing a globally accepted trade language, INCOTERMS minimize misunderstandings, reduce disputes, and create smoother transactions between companies operating in different countries, legal systems, and business environments.



INCOTERMS 2020



INCOTERMS 2020 is the latest version of the International Commercial Terms published by the International Chamber of Commerce (ICC). Released in 2019 and officially implemented on January 1, 2020, it replaced the previous INCOTERMS 2010 framework.

The updated version consists of 11 internationally recognized trade terms that clearly define the responsibilities of buyers and sellers in global trade transactions. These terms outline key areas such as delivery obligations, transfer of risk, transportation responsibilities, and allocation of costs throughout the shipment process.

INCOTERMS 2020 was introduced to reflect the evolving practices of international trade and to provide greater clarity and efficiency for businesses operating across different countries and jurisdictions.

List of INCOTERMS?

There are currently 11 INCOTERMS that are used in international trade transactions, each of which outlines the responsibilities of the buyer and seller with regard to the delivery of goods, the transfer of risk, and the payment of costs associated with an international trade transaction.



INCOTERMS IN INTERNATIONAL TRADE

There are 11 INCOTERMS that define the responsibilities of buyers and sellers in international trade.

	EXW (Ex Works)	 Clear Responsibilities Define obligations of buyers and sellers  Transfer of Risk Identify the point where risk is transferred  Allocation of Costs Clarify which party bears the costs
	FCA (Free Carrier)	
	CPT (Carriage Paid To)	
	CIP (Carriage and Insurance Paid To)	
	DAP (Delivered at Place)	
	DPU (Delivered at Place Unloaded)	
	DDP (Delivered Duty Paid)	
	FAS (Free Alongside Ship)	
	FOB (Free on Board)	
	CFR (Cost and Freight)	
	CIF (Cost, Insurance, and Freight)	

 Understanding and using the right Incoterm ensures a fair contract, reduces risks, and supports smooth international trade operations.

It is essential for both buyers and sellers to have a clear understanding of each INCOTERM, as this directly impacts their obligations, risk exposure, and cost responsibilities. A well-informed choice of INCOTERM ensures that the contract is balanced, transparent, and protects the interests of both parties involved in the transaction.

11 INCOTERMS

The key INCOTERMS and how responsibilities are typically divided between the buyer and the seller.

EXW (Ex Works)

Under EXW, the seller's responsibility is minimal—they simply make the goods available at their premises or a named location. From that point onward, the buyer takes full responsibility for transportation, insurance, and all associated costs and risks until the goods reach their final destination.

FCA (Free Carrier)

With FCA, the seller delivers the goods to a carrier or a specified location. Once delivered, the risk transfers to the buyer. The buyer then takes over the responsibility for transportation and related costs from that point forward.

CPT (Carriage Paid To)

In CPT, the seller arranges and pays for transportation to a named destination. However, the risk transfers to the buyer once the goods are handed over to the carrier—not when they arrive at the destination.

11 INCOTERMS

The key INCOTERMS and how responsibilities are typically divided between the buyer and the seller.

CIP

(Carriage and Insurance Paid To)

CIP is similar to CPT, but with an added layer of protection—the seller is also responsible for arranging and paying for insurance during transit. This makes it suitable for higher-value or sensitive goods.

DAP

(Delivered at Place)

Under DAP, the seller is responsible for delivering the goods to a named destination, ready for unloading. The buyer takes responsibility for unloading, as well as any import duties, taxes, and customs clearance.

DPU

(Delivered at Place Unloaded)

DPU goes a step further—here, the seller is responsible not only for delivering the goods but also for unloading them at the destination. The buyer handles customs clearance and any additional charges thereafter.

11 INCOTERMS

The key INCOTERMS and how responsibilities are typically divided between the buyer and the seller.

DDP (Delivered Duty Paid)

DDP places the maximum responsibility on the seller. The seller handles everything — from transportation to customs duties and taxes—delivering the goods fully cleared for import at the buyer's location.

FAS (Free Alongside Ship)

Under FAS, the seller delivers the goods alongside the vessel at the port of shipment. From that point, the buyer takes over all risks and costs, including loading, freight, and onward transportation.

FOB (Free on Board)

FOB requires the seller to load the goods onto the vessel at the port of shipment. Once the goods are onboard, the risk transfers to the buyer, who then handles all subsequent transportation and costs.

11 INCOTERMS

The key INCOTERMS and how responsibilities are typically divided between the buyer and the seller.

CFR (Cost and Freight)

With CFR, the seller pays for transportation to the destination port. However, the risk transfers to the buyer once the goods are loaded onto the vessel—not upon arrival.

CIF (Cost, Insurance and Freight)

CIF is similar to CFR, but the seller also provides insurance coverage for the goods during transit. This offers additional protection to the buyer while still transferring risk at the point of shipment.

Role of INCOTERMS

INCOTERMS (International Commercial Terms) play a critical role in international trade by clearly defining the responsibilities of buyers and sellers. They establish who is responsible for transportation, costs, and—most importantly—the point at which risk transfers from one party to another.

Understanding these roles is essential, as different INCOTERMS allocate risks in different ways.



Key Risks Defined by INCOTERMS

• Risk of Loss or Damage to Goods

One of the most important aspects of INCOTERMS is determining when the risk of loss or damage transfers from the seller to the buyer.

For example, under FOB (Free on Board), the risk transfers once the goods are loaded onto the vessel. In contrast, under CIF (Cost, Insurance and Freight), the seller arranges transport and insurance, but the risk still transfers once the goods are shipped.

• Risk of Delay in Delivery

Delays can occur due to customs clearance, logistical issues, or transport disruptions. INCOTERMS define which party bears the responsibility for such delays.

For instance, under EXW (Ex Works), the buyer takes full control of transportation and therefore bears the risk of delays. On the other hand, under DDP (Delivered Duty Paid), the seller is responsible for the entire delivery process, including any delays along the way.

• Risk Related to Insurance and Protection

INCOTERMS also influence who is responsible for arranging insurance to protect the goods during transit.

For example, under CIP (Carriage and Insurance Paid To), the seller is required to arrange insurance coverage. In contrast, under DAP (Delivered at Place), the buyer typically takes responsibility for insurance once the goods are in transit.



Incoterms® 2020

by the International Chamber of Commerce (ICC)

WHAT INCOTERMS DEFINE



Transport Obligations



Cost Allocation



Risk Transfer

LEGEND

- Seller's obligation
- Buyer's obligation
- Shared / Mixed

RULES FOR ANY MODE OR MODES OF TRANSPORT

EXW

Ex Works
(named place)



SELLER

BUYER



FCA

Free Carrier
(named place)



CPT

Carriage Paid To
(named place of destination)



CIP

Carriage and Insurance Paid To
(named place of destination)



DAP

Delivered at Place
(named place of destination)



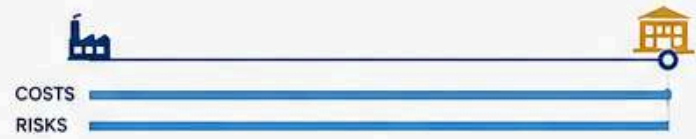
DPU

Delivered at Place Unloaded
(named place of destination)



DDP

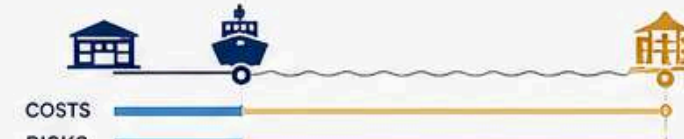
Delivered Duty Paid
(named place of destination)



RULES FOR SEA AND INLAND WATERWAY TRANSPORT

FAS

Free Alongside Ship
(named port of shipment)



FOB

Free on Board
(named port of shipment)



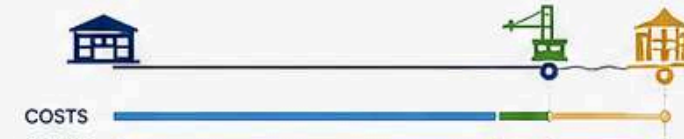
CFR

Cost and Freight
(named port of destination)



CIF

Cost, Insurance and Freight
(named port of destination)



KEY TAKEAWAY

Incoterms® 2020 help businesses clearly define who does what, who pays what, and when the risk transfers—supporting smoother transactions and reducing the potential for disputes.



IMPORTANT

Always specify the Incoterm® in your contract along with the named place or port.



Applicable to global trade



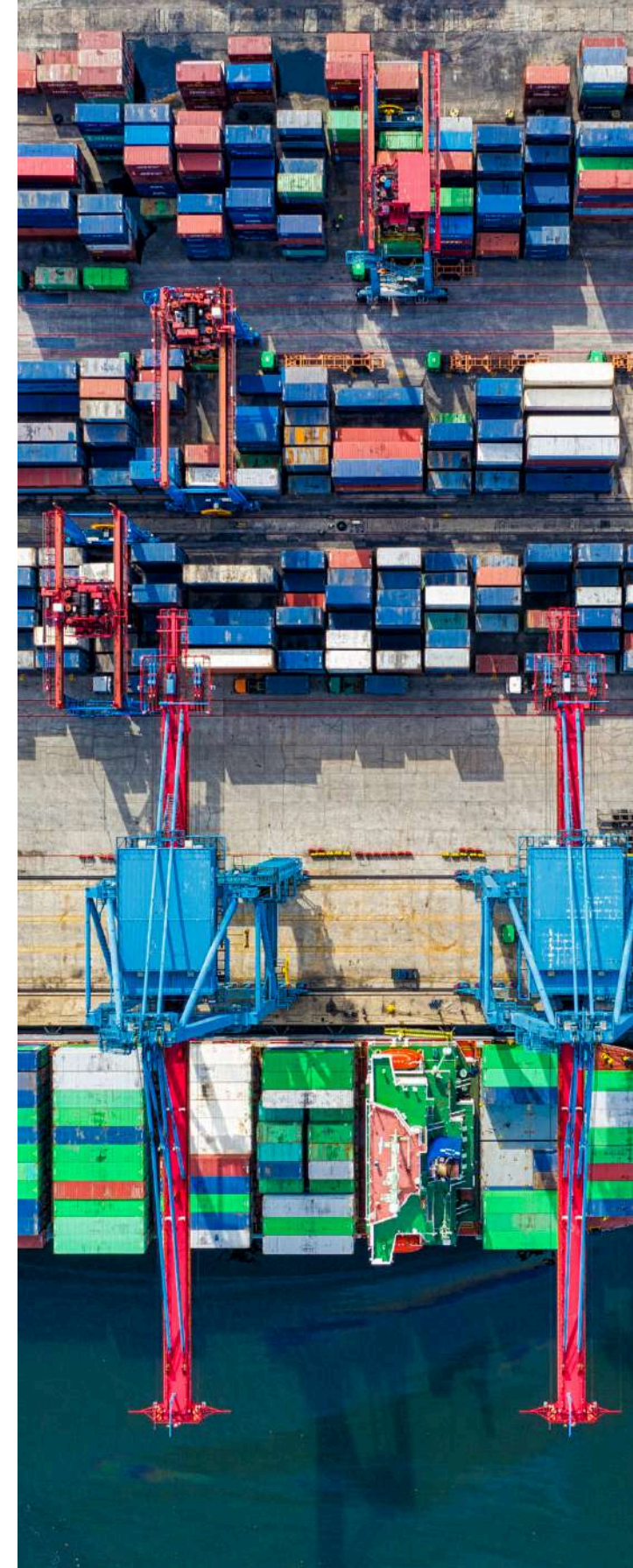
Recognized by courts worldwide



Reduce risk and uncertainty



Facilitate smooth international trade



LIMITATIONS OF INCOTERMS

While INCOTERMS are widely used and helpful, it is important to understand their limitations.



1. LIMITED SCOPE

INCOTERMS only cover the physical movement of goods and do not address financing, intellectual property, dispute resolution, or other key areas.



2. POTENTIAL AMBIGUITY

Terms like FCA or DAP can be interpreted differently depending on the context, leading to possible misunderstandings or disputes.



3. DOCUMENTATION COMPLEXITY

Depending on the INCOTERM, additional documents may be required, increasing administrative workload, time, and costs.



4. LIMITED BUYER PROTECTION

INCOTERMS define seller obligations but may not fully protect buyers in cases of non-delivery, defective goods, or other issues.



5. CULTURAL AND INTERPRETATION DIFFERENCES

Differences in business practices and cultural perspectives can lead to varying interpretations and application of certain INCOTERMS.



INCOTERMS are a powerful framework, but not a complete solution. Combine them with clear contracts, communication, and risk management to ensure successful international trade.



**THANK
YOU!**