

## PADHY LEATHER: MINIMIZING COMMERCIAL RISK THROUGH A LETTER OF CREDIT

*D. N. Panigrahi wrote this case solely to provide material for class discussion. The author does not intend to illustrate either effective or ineffective handling of a managerial situation. The author may have disguised certain names and other identifying information to protect confidentiality.*

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In September 2017, Puja Mohanty moved to New Town, India, to work as business development manager for M/S Padhy Leather Ltd., a start-up manufacturing company exporting leather garments. Mohanty's main responsibility was to expand the company's business into new markets and acquire new clients. Her specific role was to negotiate trade contracts with overseas buyers and suppliers of raw materials and machines. She needed to expand business volumes and improve profitability, but at the same time minimize the risks of international trade.

Mohanty initially concentrated on exploring new clients from the United States. Subsequently, she tried to expand the business into Canada. By March 31, 2018, six months into her new job, she had acquired a high number of new clients from both countries. However, she was wary of mitigating commercial risks in the form of default risk or non-payment risk arising out of export transactions with these new and untested overseas buyers. Anxious to minimize the commercial risks, Mohanty stipulated 100 per cent advance payment for almost all export orders. However, many new customers were not willing to provide 100 per cent advance payment; as a consequence, Mohanty was not able to firm up many contracts. What could she do to balance her goals of developing business and minimizing commercial risk?

### COMPANY BACKGROUND

M/S Padhy Leather Ltd. was established in March 2016 by two young, first generation entrepreneurs. The company manufactured leather garments as winter clothing for men, women, and children. Around 90 per cent of the turnover came from exports and the remaining 10 per cent from domestic sales. The company's turnover for the two full years of its existence was ₹3 million<sup>1</sup> and ₹5 million for fiscal years 2016–17 and 2017–18 respectively. Leather was the main input, and the company sourced most of this leather through imports from different countries.

The company raised its fixed (block) capital and working capital needs through a mix of equity and bank loans. There were many competitors who exported garments to different countries. However, the company

<sup>1</sup> ₹ = INR = Indian rupee; ₹1 = US\$0.02 on March 31, 2018; all currency amounts are in ₹ unless otherwise specified.

wanted to target a niche market of special leather garments meant for winter wear. In this segment, the company felt that competition was not severe.

### **SEMINAR ON PROMOTING EXPORTS FROM INDIA**

The Directorate General of Foreign Trade (DGFT), under the Ministry of Commerce, organized a seminar in March 2018 on “Promoting Exports from India.” The seminar was held in New Delhi, as a part of the government of India’s “Make in India” drive. The objective was to educate the new generation of exporters about various techniques of international trade and export promotion facilities provided by the government through financing banks and agencies. Mohanty attended the seminar to upgrade her knowledge and skills relating to international trade.

There were many technical sessions where experts from export financing banks and export promotion organizations discussed important topics on international trade transactions. The sessions covered various risks encountered in international trade and different payment mechanisms, as well as strategies to mitigate those risks. The seminar also covered topics such as marine insurance, transport documents, exchange control, and trade control regulations.

### **RISKS ASSOCIATED WITH INTERNATIONAL TRADE**

International trade was the set of activities by which buyers and sellers exchanged goods and services for payment of money or for other goods and services across national borders. When goods and services were exchanged for other goods and services, it was known as counter-trade. International trade could be both visible and invisible. Visible trade was the export and import of goods. Services such as logistics, insurance, consultancy, travel, and tourism formed part of invisible trade.

Risk was inherent in any business. Recognizing and managing risk was the key to sustainable growth of any business. Any domestic trade carried risk elements such as carriage (transport) risk and commercial (contract and credit) risk.

#### **Carriage (Transport) Risk**

This was the risk that the goods shipped to the buyer could be damaged or lost in transit. Thus, this risk involved the physical movement of goods from the seller’s place until it was delivered at the buyer’s place.

#### **Commercial (Contract and Credit) Risk**

This was the risk that the buyer might not accept the goods or fail to pay on the due date for the goods received. It included the risk that the buyer might go bankrupt and be unable to pay for the goods received according to the commitment. It was also known as non-payment risk, default risk, or counterparty risk.

#### **Special Risk Factors in International Trade**

Apart from the two normal trading risks, two more special risk factors were present in any international trade transaction: currency (foreign exchange rate fluctuation) risk and country risk, with its four components of political stability, economic environment, legal infrastructure, and foreign exchange restrictions.

### Currency Risk

Settling a trade transaction in a foreign currency at a future date always held out the risk of adverse currency movement between the foreign currency and the home currency, which could result in an uncertain or unpredictable value of the future payments for the exporters and the importers in their home currencies. The value of payments received for exports could be reduced, or the value of payments needed to be made for imports could be increased, depending on the direction of movement of the currency of invoicing with regard to the home currency of the exporter or importer.

This risk was also known as exchange rate risk or foreign exchange rate fluctuation risk. Unfavourable exchange rate movements could have a huge negative impact on the earnings, profitability, and market value of the equity for the firms involved in exports and imports. Hence, it was imperative for exporters and importers to appreciate the nature, consequences, and management techniques of currency risk.<sup>2</sup>

### Country Risk

Country risk, also known as sovereign risk, was the risk that the government of a particular country would fail in its payment commitments to exporters or overseas suppliers of goods and services. It included the risk that even when buyers were able and willing to meet their obligations, economic and political factors might prevent settlement with the seller. For example, there could be an adverse economic environment in the importer's country, which could result in poor paying capacity for importing companies. Adverse economic situations in the exporters' and importers' countries could also result in an unstable and volatile currency in these countries, exposing trading partners to adverse foreign currency risks.

There could also be political instability, leading to delayed payment or default, and poor legal infrastructure, which could result in delayed payment from a trade dispute. Finally, foreign exchange restrictions, caused by an unfavourable balance of payment situation or shortage of foreign exchange in an importer's country, could limit an importer's ability to make payments for its international purchases.

## **METHODS OF PAYMENT IN INTERNATIONAL TRADE**

At the time of negotiating any international trade contract, one of the critical issues the importer and exporter had to agree on was the manner of settlement of dues against the goods or services traded—that is, when and how the payment would be made by the importer to the exporter. The method of settlement that the seller/exporter and the buyer/importer agreed on between themselves depended on a combination of factors such as the track record and experience in dealing with the counterparty; the level of mutual trust, confidence, and comfort; external risk factors such as country risk and currency risk; the relative bargaining power of the importer and the exporter to secure the most favourable terms; and requirements of exchange control and trade control regulations.

There were three major recognized methods of making payments globally in international trade.

### **Clean Payments**

In the case of clean payment transactions, all shipping and commercial documents, including documents of title to goods (such as a bill of lading, airway bill, post parcel receipt, or railway receipt as the case may

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<sup>2</sup> Rupnarayan Bose, *A Complete Guide to Letters of Credit and the UCP* (New Delhi: Trinity Press, 2015), 10.

have been), commercial invoices, and insurance documents, were handled directly by the trading parties. In other words, the documents were dispatched directly by the exporter to the importer, and goods were also consigned directly by the exporter to the importer. The role of the banks was limited to the remittance of funds, as required. There were four types of clean payments.

### Advance Payment/Remittance

Advance payment was a type of remittance in which the exporter stipulated that the importer should make full payment to the exporter before the purchased goods were provided. The exporter would first receive the full payment consideration from the importer, then procure and manufacture the goods and make arrangement for shipment. This was the safest payment term that the exporter could negotiate with the importer where there was no commercial or default risk. The importer remitted money directly to the exporter and relied solely on the honesty and integrity of the exporter to ship the goods (in the right quantity and quality) and commercial documents on time.<sup>3</sup> The importer bore all the risks of non-performance by the exporter. Advance payments were usually adopted when the trading parties did not yet have a long-term relationship or where the goods enjoyed a seller's market. This payment mechanism was skewed in favour of the exporter.

### Cash on Delivery

For items of nominal value such as books and personal care products, the trade term could be cash on delivery. The exporter first dispatched the goods or items without receiving any payment from the importer, and the importer paid the postal or courier authority only on receiving the goods. This was not a prevalent method of payment for regular trade.<sup>4</sup> Here, the exporter bore the highest risk, while the importer assumed the least risk.

### Open Account Sale

In an open account sale, the exporter agreed to dispatch the goods and shipping and commercial documents directly to the importer without involving the banking channel.<sup>5</sup> The importer took delivery of the goods without making payment, and according to agreed trade terms, was expected to make payment at a previously specified future date.<sup>6</sup> This method of payment was adopted when the trading parties had a long-term relationship and shared a high level of mutual trust, or where the commodity commanded a buyer's market. The exporter bore the entire risk, and the importer assumed lowest risk. In many countries, the exporter's commercial or credit risk that the overseas buyers would not pay under this payment method was minimized to some extent, provided the exporters bought export credit risk insurance policies offered by designated export credit risk insurance companies.

In India, the Export Credit Guarantee Corporation of India Limited (ECGC) offered export credit risk insurance policies to exporters at reasonable rates. The ECGC also provided export credit guarantee covers to export financing banks. However, India's exchange control regulations imposed many restrictions and safeguards on open account export transactions.<sup>7</sup>

<sup>3</sup> C. Jeevanandam, *Foreign Exchange: Practice, Concepts & Control* (New Delhi: Sultan Chand & Sons, 2016), 18.12.

<sup>4</sup> Ibid.

<sup>5</sup> Indian Institute of Banking and Finance, *International Trade Finance* (Mumbai: Taxmann Publications Pte. Ltd., 2017), 33.

<sup>6</sup> Jeevanandam, op. cit., 18.13.

<sup>7</sup> Ibid.

### Consignment Sale

A consignment sale was distinct from an outright sale. In a consignment sale, the exporter dispatched the goods to overseas selling agents. These agents took delivery of the goods without any payment upfront. The agents made their best efforts to sell the goods on behalf of the exporter and remitted the sale proceeds to the exporter when they were collected. The goods remained with the agents at the risk of the exporter. With an open account sale—an outright sale to the importer—the importer bore the risk of bad debts, but with a consignment sale, the importer carried out the sale on behalf of the exporter and the bad debt risk was borne only by the exporter.<sup>8</sup> The importer incurred no risk. Consignment sales were not popular.

### **Bills for Collection or Documentary Collection**

In all types of trade transactions except clean payment methods described earlier, a bill of exchange was drawn by the seller (exporter) on the buyer (importer). A bill of exchange (bill in short) was also known as ‘draft’ in international trade parlance. Depending on the payment instruction mentioned on the bill (also known as the tenor of the bill), there could be two types of bills: a demand bill (also called a sight bill), which was payable on demand or at sight or on presentation of documents; and a usance bill (also called a time or term bill), which was payable at a specified future date after a certain time period mentioned in the bill.

With bills for collection, exporters and importers used the services of their bankers to move documents and funds. The exporter shipped the goods to the overseas importer using various modes of transport such as ship or air, but routed the financial, commercial, and transport documents through banking channels for collection.<sup>9</sup> The transport documents, also known as the documents of title to goods, such as a bill of lading or airway bill, were consigned either to the collecting banker or the exporter. The exporter also gave the collecting banks instructions regarding the delivery of the documents to the importer, also known as a drawee in this situation.<sup>10</sup>

There were two types of documentary collection transactions: documents against payment and documents against acceptance.

### Documents against Payment

With documents against payment, the documents were released by the collecting banker to the importer when the importer paid for the shipment. If the export documents included the document of title to goods such as a bill of lading or airway bill, the exporter retained constructive control over the goods until payment was made. A demand (sight) bill used to accompany this payment method.

### Documents against Acceptance

With documents against acceptance, the documents were released by the collecting banker to the importer on obtaining the importer’s acceptance of the term for payment, known as the usance, specified in a bill of exchange. The importer’s acceptance was a commitment to pay for the shipment on the due date. This form of collection did not allow the exporter to have constructive control over the goods after the documents were released; however, the accepted bill of exchange gave the exporter legal recourse against the importer

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<sup>8</sup> Ibid.

<sup>9</sup> Ibid.

<sup>10</sup> Indian Institute of Banking and Finance, op. cit., 34.

in the event the importer did not pay on the due date. The exporter could also obtain post-shipment finance against the accepted bill of exchange. A usance (time or term) bill used to accompany this payment method.

## DOCUMENTARY CREDIT OR LETTER OF CREDIT

In any conventional domestic or international trade transaction, the exporter drew a bill of exchange (also known as a draft) on the importer, and the importer was obliged to make payment on the due date according to the agreed payment term. In the process, many uncertainties could occur. The biggest risk faced by the exporter was the risk that the importer would repudiate the contract—known as a commercial risk (or contract and credit risk).<sup>11</sup> There were many dimensions to this risk. The exporter was exposed to the risk that the importer might not accept the goods or might fail to make payment for the goods received. Alternatively, the importer might go bankrupt and be unable to pay for the goods received.

In international trade, exporters and importers were thousands of miles apart and did not know each other. Both parties wanted to avoid risk. Exporters were wary of the risk that importers would not pay, so they liked to receive payment before parting with the goods. Importers worried about the risk that exporters would not perform, so wanted to receive the goods before parting with their money. However, both of these ideal conditions could not be achieved simultaneously.

In order to resolve the impasse and facilitate international trade, a secure and safer method of debt settlement and contract performance was devised, with commercial banks as intermediaries. It was known as a letter of credit (LC). The LC method attempted to fulfil the needs of both parties to a large extent. The LC would assure exporters that if they exported the goods or commodities according to the contract terms with the importers and produced documentary evidence to that effect, the exporters would receive payment without default. The LC was “opened” (created) by the importer’s bank at the request of the importer.

The LC was a conditional undertaking of payment by the importer’s bank in favour of the exporter, stating that if the exporter exported the goods and submitted documents as specified in the LC, and if the exporter complied with the terms and conditions covered in the LC, the bank would pay the exporter. Thus, in any trade transaction accompanied by an LC, the primary obligation to pay was that of the importer’s bank, not the importer. The exporter, under such LC-based trade transactions, was taking a risk on the bank that opened the LC, rather than a risk on the importer. A risk on a bank was definitely a better risk than a risk on the importer. In other words, in any LC-based trade transaction, the obligation of the importer under the contract was supplemented by a superior obligation of a bank, which opened the LC, to make payment.<sup>12</sup>

An LC, which called for shipping and commercial documents, including documents of title to goods (such as a bill of lading, airway bill, post parcel receipt, or railway receipt, as the case may have been), commercial invoices, and insurance documents, was called a documentary letter of credit (DLC) or simply a documentary credit (DC).

### Types of Letters of Credit

There were various types of LCs, depending on the nature and the function of the credit.

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<sup>11</sup> Jeevanandam, op. cit., 18.14.

<sup>12</sup> Ibid.

### Sight and Term Letter of Credit

If the payment was to be made at the time documents were presented by the exporter (who was the beneficiary of the credit), a sight letter of credit (sight LC) was used. If there was a provision to make payment at a specified future date after the presentation and delivery of documents, the credit was called a term or usance letter of credit (usance LC).<sup>13</sup> A sight LC required a sight bill of exchange (also recognized as draft), and a usance LC required a usance bill of exchange (also recognized as draft).

### Confirmed Letter of Credit

A confirmed letter of credit (LC) was an irrevocable documentary credit confirmed by a second bank, known as the confirming bank and usually situated in the exporter's country. Generally, the bank issuing the LC requested that the bank receiving the LC in the exporter's country add its confirmation to the LC while advising the exporter. In some cases, the LC-issuing bank would request that a third bank (other than the LC-advicing bank) add its confirmation. This situation would arise when the LC-advicing bank would not have counter party credit limits on the LC-issuing bank and/or country risk limits of the LC-issuing bank.

Usually, there was an arrangement between the LC-issuing bank and the correspondent bank in the exporter's country that added its confirmation, also known as a commitment. Confirmation of an LC was stipulated in the trade and payment terms the exporter and the importer agreed on. Under such an arrangement, the advising bank became a confirming bank and guaranteed payment to the beneficiary of the credit (the exporter in this situation), provided the beneficiary fulfilled all the terms and conditions of the LC and submitted all stipulated documents. Hence, when a request for confirming an LC was received by a confirming bank from an LC-issuing bank, the confirming bank would assess the risk of the LC-issuing bank and availability of credit limit on it as well as the country risk of the LC-issuing bank and availability of country limit.

The primary obligation under the confirmed credit rested with the confirming bank, and the bill of exchange (or draft) was drawn on it. The beneficiary of a confirmed LC enjoyed the payment guarantee from two banks. The credit risk was localized on the confirming bank, which the beneficiary could deal with conveniently, if needed, rather than dealing with the LC-issuing bank abroad.<sup>14</sup>

### Transferable Credit

A transferable credit was an LC that was marked "transferable" at its origin when it was issued. The benefits under the LC could be transferred by the original or first beneficiary in whole or in part in favour of one or more second beneficiaries.<sup>15</sup> The exporter could be only an intermediary who procured goods from the suppliers and arranged for them to be shipped to the importer. The exporter was the first beneficiary and could request that the negotiating bank (the intermediary bank) transfer the benefits of the LC, in full or in part, in favour of one or more second beneficiaries.<sup>16</sup> The credits could not then be transferred by the second beneficiary or beneficiaries to one or more third beneficiaries. Under the transfer, the original terms and conditions of the credit remained the same.<sup>17</sup>

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<sup>13</sup> Indian Institute of Banking and Finance, op. cit., 34.

<sup>14</sup> Indian Institute of Banking and Finance, op. cit., 35.

<sup>15</sup> Indian Institute of Banking and Finance, op. cit., 58.

<sup>16</sup> Jeevanandam, op. cit., 19.15.

<sup>17</sup> Indian Institute of Banking & Finance, op. cit., 58.

### Back-to-Back Credit

A back-to-back credit was a standalone LC established on the strength of the credit received by the seller/exporter and original beneficiary of the LC from the overseas buyer/importer. A back-to-back credit was also called a countervailing credit. The original credit on the back of which this back-to-back credit was opened was called the overriding or principal credit.<sup>18</sup> The terms of the second credit would be similar in certain, but not all, aspects to the original credit. A back-to-back credit was often an inland LC.<sup>19</sup>

A back-to-back credit had certain features in common with a transferable credit. With both types, the benefits under the credit were transferred to a third party. Also, the documents were substituted by the first beneficiary. The possibility of the importer knowing the real supplier (or the supplier knowing the importer) was avoided in both cases.

However, a back-to-back credit differed from a transferable credit in the following aspects: With a transferable credit, there was an authority from the issuing bank for the transfer of benefit under the credit. Under a back-to-back credit, there was no such authority. Also, in the case of a transferable credit, the second credit was only an extension of the first or original credit; it had no existence outside the original credit. In contrast, a back-to-back credit existed on its own, independent of the original credit.<sup>20</sup>

### Standby Letter of Credit or Guarantee Credit

A standby letter of credit was also known as a guarantee credit. A standby LC was a contingency payment mechanism that became active in the event of default or non-payment under a payment obligation or non- or under-performance in a contract.<sup>21</sup> The beneficiary of a standby LC could invoke or enforce the provisions of the LC only if the principal party (the buyer and applicant for credit) failed to meet a payment obligation, or if a contract was not performed to the satisfaction of the beneficiary under a performance contract. When this happened, the seller or the supplier (the beneficiary under the standby LC) invoked the credit and lodged a claim on the standby LC-issuing bank according to the terms of the credit. If the invocation was found in order, the standby LC-issuing bank paid the beneficiary. In contrast to standby LCs, all other types of LCs were used in trade and commerce in goods or services, which were usually issued to ensure payment for performance under a supply contract. Hence, all other LCs were often referred to as commercial LCs in order to distinguish them from the standby LCs.

A standby LC operated just like a bank guarantee. It was payable on the first demand or claim of the beneficiary against a simple declaration of non-performance by the principal party, sometimes accompanied by minimum supporting documents, as stated in the standby LC. Supporting documents could be proof of delivery of goods, a certificate of non-performance, or a simple statement of claim or claim certificate.

Thus, a standby LC was used as a substitute for performance guarantee or for securing a debt obligation.<sup>22</sup> A standby LC was a substitute for a bank guarantee. It was used in countries where the issuing of bank guarantees was not allowed (for example, in Japan and the United States).

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<sup>18</sup> Indian Institute of Banking & Finance, op. cit., 57.

<sup>19</sup> "Inland" is domestic. Back-to-back LC was an inland (or domestic) LC as opposed to a foreign LC which may have been opened and/or operated outside the domestic territory of a country.

<sup>20</sup> Jeevanandam, op. cit., 19.17.

<sup>21</sup> Jeevanandam, op. cit., 19.18.

<sup>22</sup> Indian Institute of Banking and Finance, op. cit, 58.

## MITIGATING INTERNATIONAL TRADE RISKS

Keeping all the risks of international trade transactions in mind, various payment mechanisms and international trade instruments were developed over time. These payment methods and instruments were designed to minimize risk for each of the parties involved. Depending on the level of trust between the various parties and the international reputation of each party, different modes of settling payment and other suitable devices and business strategies were adopted.

### Mitigating Transport (Carriage) Risk

An exporter could minimize the carriage or transport risk in different ways. For example, the exporter could ensure proper packaging and storage, and carefully decide on the choice of transport and route. The exporter could also take out cargo insurance or marine cargo insurance to cover the loss or damage to the goods in transit, including loss or damage during delivery to the port or airport. Selecting the right shipment terms—as defined by Incoterms Rules<sup>23</sup>—could help with apportioning responsibilities and costs, and help with passing risks incidental to delivery.

### Mitigating Country (Sovereign) Risk

Exporters could minimize country risk by obtaining political risk cover from export credit risk insurance companies such as the ECGC. They could also obtain a country risk rating from the ECGC, or from credit-rating agencies such as Dun & Bradstreet, before taking an exposure to any country.

Exporters could also stipulate a confirmed LC by a bank outside the importer's country—preferably a bank in the exporter's own country. This was done in cases where the buyer's country risk was high, such as was the case with importing companies that operated in countries with economic sanctions or embargoes, or when countries were rated below investment grade or even worse by international credit-rating agencies.

### Mitigating Currency (Exchange Rate) Risk

Exporters and importers could minimize currency risk by using hedging techniques such as purchasing or selling forward exchange contracts, options, and futures contracts. They could also take exchange rate fluctuation risk cover from export credit risk insurance companies such as the ECGC.

### Mitigating Commercial (Default or Non-Payment) Risk

Finally, exporters could mitigate credit or commercial risk from overseas buyers/importers using various methods:

- *Advance payment obtained from the buyer*—The exporter could ask the buyer to pay for the goods before they were shipped. Depending on the situation, an advance payment could be made for a portion of the amount or for the full amount.

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<sup>23</sup> The Incoterms or International Commercial Terms were a series of pre-defined commercial terms published by the International Chamber of Commerce (ICC) interpreting the costs, risks, and responsibilities of buyers and sellers in international trade. The eighth version—"Incoterms 2010," released in January 2011—listed 11 terms classified into two categories. The second group of four terms that applied to sea and inland waterway transport only were Free Alongside Ship; Free on Board; Cost and Freight; and Cost, Insurance, and Freight. (Indian Institute of Banking & Finance, op. cit., 24–29).

- *Credit report on the buyer, which provided the buyer's purchase and payment history*—This report was usually obtained from the buyer's bank or from market investigation agencies like Dun & Bradstreet.
- *Documents sent on a collection basis*—The documents of title to the goods (transport documents) and other commercial documents were forwarded through the bank and handed over to the importer only on payment.
- *LC*—The buyer established an LC issued by the bank in favour of the supplier, whereby the bank undertook to pay the supplier if documents were in order and conditions of the credit had been met.
- *Confirmed LC*—Another bank in the exporter's country confirmed or guaranteed the credit issued by the importer's bank. As a result, the bank risk was shifted from the importer's country to the exporter's country, helping the exporter localize the risk.
- *Credit risk insurance*—The exporter obtained cover for commercial risks from export credit risk insurance companies such as the ECGC.

## OTHER SEMINAR TOPICS

The seminar also briefly dealt with the regulatory framework relating to DLCs.

### Regulatory Requirements

International trade transactions, both exports and imports, were subject to regulatory requirements prescribed by the government. There were two dimensions to the regulatory framework for foreign trade: trade control regulations and exchange control regulations. Any domestic or foreign trade transaction could be broadly divided into three activities: (1) movement of goods, (2) movement of documents, and (3) movement of funds. Entities involved in international business, including dealing with an LC, needed to have fair knowledge of these regulations.

### Trade Control Requirements

Trade control regulation in India was the responsibility of the DGFT, which established the policies and regulations relating to the physical movement of goods into and out of India. The Government of India formulated foreign trade policy, also known as export–import (EXIM) policy, for a five-year period. The policy indicated (a) what goods could be imported into or exported from the country, (b) the conditions, if any, attached to such imports or exports, and (c) various schemes for export promotion and import facilitation. Some goods were freely importable or exportable, while some goods required a licence for import and export. A few items were totally banned from imports and exports. The DGFT was the implementing agency for the foreign trade policy. Therefore, while opening an import LC, it was obligatory for both the importer/LC applicant and the LC-issuing bank to ensure compliance with the current EXIM policy, and to ensure that the goods being imported were either freely importable or could be imported with a valid import licence.<sup>24</sup>

### Exchange Control Regulations

Exchange control regulations dealt with the movement of funds and documents into and out of India. The Reserve Bank of India was the exchange control authority in India. Traditionally, banks played their roles in the movement of funds and documents. Banks in India opened LCs for their import customers for importing goods

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<sup>24</sup> Indian Institute of Banking and Finance, op. cit., 64.

and services into India. They also dealt with export LCs in many capacities, as advising bank, confirming bank, reimbursing bank, and so on, with respect to LCs opened in favour of Indian exporters by overseas buyers.<sup>25</sup>

### **Uniform Customs and Practice for Documentary Credits**

The LC was recognized as the best payment mechanism for international trade transactions. It dealt with the presentation of credit compliant documents by the beneficiary and the scrutiny of documents by the banks for compliance with the terms and conditions of credit. Every bank and every party might have different interpretations with respect to the application of an LC and its terms and conditions. These differences could result in discrepancies in documents and eventually delay or deny payment to the beneficiary. Hence, in order to achieve a uniform and common interpretation and application of DCs, the International Chamber of Commerce developed and published a standard set of rules known as Uniform Customs and Practice for Documentary Credits (UCPDC). The current edition was UCP 600 (2007 revision), which came into force on July 1, 2007. It dealt only with documentary credit; hence, the LC was popularly known as a documentary letter of credit or documentary credit.<sup>26</sup>

The objective of the UCPDC was to standardize the rules governing the operation of the DLC. There were two cardinal principles for working or operating with an LC. The first was the principle of independence of the LC, which meant that the payment undertaking of the LC-issuing bank was independent of the rights and the liabilities of the trading parties (that is, the importer and the exporter under the underlying contract of sale). The LC-issuing bank or the negotiating bank was required to pay against credit-complying documents submitted by the exporter (the beneficiary of the credit), even though the importer alleged that the exporter committed a breach of the contract of sale.

The second principle was that banks dealt in documents, not with goods to which the documents related. Hence, if the documents submitted by the exporter/beneficiary complied with the requirements of the credit, the LC-issuing bank or negotiating bank was obligated to make payment, even though the buyer complained that the goods were not up to the specified quality, standards, or quantity of the sale contract. By virtue of the independent nature of the bank's commitment and obligation to pay, the exporter was assured of payment.

### **FINAL CONSIDERATIONS**

After attending the seminar, Mohanty was feeling reasonably confident in solving her immediate business problems. She needed to balance her goals of developing business, minimizing commercial risk, and improving profitability. She realized that if she insisted on 100 per cent advance payment from her new buyers and customers, she might not firm up the contracts and, in the current competitive business environment, would lose her business to her competitors. The seminar came at an opportune time and expanded her vision. She believed that the "moment of truth" had come for her: it was time to weigh the various modes of payment in international trade open to her and make the optimal choice.

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<sup>25</sup> Indian Institute of Banking and Finance, op. cit., 65.

<sup>26</sup> Jeevanandam, op. cit., 19.1.