

MITIGATING FINANCIAL RISKS IN INTERNATIONAL TRADE THROUGH LETTERS OF CREDIT.



In Tanzania's thriving economy, the role of international trade is undeniable essential goods flow into the market, from electronics and machinery to food and pharmaceuticals, meeting the demands of the population. Yet, despite the increasing volume of imports, Tanzania remains deeply dependent on the outside world for these goods.

The private sector, which underpins the nation's economy, relies on cross-border trade to satisfy the growing demand. However, this trade is not without its risks. Exporters, from afar, fear the unsettling possibility of non-payment after they ship their goods, while Tanzanian importers are often left vulnerable to the harsh reality of paying for products that may never arrive. In the world of international trade, buyers and sellers are often strangers to each other, separated by borders, time zones, and differing regulations.

This distance breeds uncertainty and distrust, making it crucial to have a tool that guarantees the integrity of the transaction for both parties. Enter Letters of Credit (LCs) a lifeline in international trade, offering a structured, bank-backed financial guarantee.

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LCs act as a bridge of trust between unknown entities, reassuring the exporter of payment upon fulfillment of the contract and the importer that their goods will be delivered as agreed. In Tanzania's import-dependent economy, understanding how to utilize LCs effectively can unlock smoother transactions, reduce financial risk, and foster a secure trading environment.

This article explores how LCs function as a strategic tool in enhancing international trade, ensuring that both Tanzanian buyers and foreign sellers can navigate the complexities of global commerce with confidence and integrity. By embracing this mechanism, Tanzanian businesses can protect their investments, ensuring that international trade becomes a source of opportunity, not misfortune.

What is a Letter of Credit?

It is an irrevocable undertaking issued by a bank on behalf of the **buyer (importer)** to the **seller (exporter)** to pay for goods and services, provided that the seller presents documents that comply with the terms and conditions of the letter of credit.

Parties Involved in a Letter of Credit Transaction

In a transaction involving a Letter of Credit (LC), the key parties include the buyer, the seller, the issuing bank, the nominated bank, the confirming bank, the advising bank, and the negotiating bank.

After finalizing the contract for the sale of goods, the buyer and seller must mutually agree on whether payment will be made through a Letter of Credit. They must also determine the required documents, the issuing bank, and the nominated bank.

Issuing Bank and Confirming Bank.

The issuing bank is the financial institution where the buyer applies for the Letter of Credit. It is responsible for issuing the LC and setting the documentary terms and conditions that the seller must meet to receive payment. Upon fulfillment of these conditions, the issuing bank instructs the nominated bank to process the payment. While Confirming Bank serves as a guarantor for the issuing bank. If the issuing bank fails to make the required payment, the confirming bank assumes the obligation to pay the seller.

Advising Bank, Nominated Bank, and Negotiating Bank.

The advising bank, nominated bank, and negotiating bank primarily interact with the seller. In many cases, the same bank may perform all these roles:

- **Advising Bank:** This bank receives the Letter of Credit from the issuing bank, verifies its authenticity, and informs the seller of its validity and terms. The seller has the discretion to choose the advising bank, which may or may not be the same as the nominated bank.
- **Nominated Bank:** The nominated bank is selected by agreement between the buyer and the seller. It is responsible for receiving the Letter of Credit and processing the seller's payment upon submission of the required documents in compliance with the LC terms.
- **Negotiating Bank:** The negotiating bank facilitates transactions where the seller uses the Letter of Credit as a negotiable instrument to obtain payment for the goods before the final settlement.

The Transactional Cycle of a Letter of Credit.

After the sale agreement is concluded, the buyer approaches an issuing bank—typically a bank located in their place of business—and applies for a letter of credit (LC). If the seller is confident in the creditworthiness of the issuing bank, there is no need for a confirming bank.

Once the letter of credit is issued, the issuing bank transmits it to the nominated bank, which is responsible for handling the transaction on behalf of the seller. Upon receiving the LC, the nominated bank verifies its authenticity and advises the seller accordingly.

The seller then submits the required shipping and commercial documents in strict conformity with the terms of the LC. If the nominated bank finds the documents to be compliant, it proceeds with payment to the seller, thereby discharging the seller's obligations under the transaction.

The nominated bank then forwards the documents to the issuing bank and claims reimbursement. Upon verifying the documents and processing the payment, the issuing bank finalizes the transaction by paying the nominated bank. At this stage, all parties—the buyer, the seller, the issuing bank, and the nominated bank—are discharged from their respective obligations, completing the transaction cycle.

Principles that govern letters of credit.

The **Uniform Customs and Practice for Documentary Credits (UCP600)** prepared by the **International Chamber of Commerce (ICC)**, provides standard terms governing letters of credit, two principles can be emanated from these rules.

1. Autonomy of Letters of Credit

The principle of autonomy in letters of credit establishes that a letter of credit is independent of the underlying contract of sale between the buyer and the seller. This means that any breach of the sales contract does not affect the validity or enforceability of the letter of credit. Similarly, frustration with the sales contract does not alter the obligations under the letter of credit.

Once the seller submits the required documents in strict conformity with the terms outlined in the letter of credit, the issuing bank is obligated to make payment, regardless of any disputes or unforeseen events affecting the underlying transaction. This principle ensures that the letter of credit functions as a secure and reliable payment mechanism, insulating banks from the complexities of the contractual relationship between the buyer and the seller.

Illustration 1.0.

B, a buyer, orders goods from A, a seller, with payment secured through a letter of credit. A fulfills all documentary requirements in strict compliance with the terms of the letter of credit and presents them to the issuing bank. However, during transit, the goods are destroyed before reaching B. Despite this unfortunate event, A remains entitled to payment because the letter of credit is independent of the contract of sale. The destruction of the goods does not affect the bank's obligation to honor the payment, as long as the documentary conditions of the letter of credit have been met.

This autonomy ensures certainty in international trade, assuring sellers that they will receive payment upon fulfilling documentary obligations, thereby mitigating financial risks associated with buyer default or unforeseen disruptions.

1. Strict Compliance with Letters of Credit

Strict compliance with the terms of a Letter of Credit is a fundamental principle that safeguards the interests of the buyer. This principle enforces rigorous adherence to the specified conditions, ensuring that even minor deviations can relieve the buyer of the obligation to make payment.

To maximize protection, the buyer is advised to clearly define the required documentation necessary to establish confidence in the transaction. The buyer has the discretion to specify any documents deemed essential, and the seller must ensure full and precise compliance with these terms.

Illustration 2.0.

Consider a scenario where Buyer B orders goods from Seller A under a Letter of Credit that requires experts reports verifying the quality of the products before delivery.

In this case, Seller A must consult multiple experts, obtain the necessary reports, and ensure they align with the stipulated terms of the Letter of Credit. If the seller fails to meet these conditions, the buyer is not obligated to make payment, even if the goods are delivered successfully.

This principle reinforces the buyer's ability to demand comprehensive documentation, thereby enhancing transparency, ensuring the authenticity of the transaction, and compelling the seller to adhere strictly to the agreed terms.

Note; The letter of credit issued must be irrevocable as no nominated bank can accept revocable documents of credit, but also the letter of credit can be amended by the issuing bank.

Laws Governing Letters of Credit in Tanzania.

In Tanzania, there is currently no specific legislation that governs the terms and practices of Letters of Credit (LCs). However, the Uniform Customs and Practice for Documentary Credits (UCP600) Rules play a vital role in guiding transactions involving LCs. While these rules do not have an international legal binding force, they are frequently relied upon when incorporated into contracts by the parties involved. As such, the UCP600 provides a crucial framework for the conduct of such transactions, setting out the rights and obligations of the parties, particularly the buyer and the seller.

The importance of the UCP600 Rules in Tanzanian law is evident in the case ***Asif Ali Riasat T/A Ahmed Business Center (Tanzania) Limited v. CRDB Bank Plc (High Court of Tanzania, Commercial Case No. 134 of 2023)***. In this case, the court referred to the UCP600 to outline the principles governing Letters of Credit, particularly emphasizing the buyer's duty to list the documents that should be issued by the seller. His duty to specify the required documents is vital for ensuring the accuracy and completeness of the transaction. Additionally, the court underscored the paying bank's responsibility to carefully scrutinize the details of these documents before making any payments. The bank must verify that the documents meet the exact terms of the LC, failure to do so shall amount to negligence.

Moreover, the case highlighted the importance of securing marine insurance in international transactions involving shipments. The buyer must ensure that the proper documentation, including insurance coverage, is in place to protect against risks associated with marine transport. This reinforces the necessity of due diligence throughout the transaction, ensuring that all aspects, including insurance and documentation, are thoroughly examined to guarantee the smooth execution of the transaction.

Digitalizing Letters of Credit with Blockchain.

A blockchain-based Letter of Credit (LC) is a digital, de-centralized system that uses blockchain technology to automate, secure, and streamline the LC process instead of relying on paper documents and manual verification by banks. blockchain enables **real-time tracking and smart contracts for automatic approvals and tamper-proof-record bank**, this makes trade more simple by eliminating intensive paperwork and fraud as all parties are simultaneously involved in the transaction, **Blockchain has evolved as a contemporary solution that links International financial institutions with buyers, sellers, and Carriers, to promote transparency, time-effective, cost-effective, and genuine transactions.**

Key Takeaway.

letters of credit play a crucial role in ensuring the integrity of international trade, particularly in transactions where buyers and sellers may not have direct interactions. While letters of credit offer a method for mitigating risk, their effective use requires due diligence and a strategic approach. Buyers, especially in Tanzania where the legal framework surrounding these instruments is still evolving, must be cautious when selecting documents that hold merchantable value. It is essential to consider additional documentation that can confirm the genuineness of the goods and the transaction's integrity. Thus, despite letters of credit being an important safeguard, Tanzanian buyers must leverage their full potential by carefully choosing the right documents, ensuring both the authenticity and the security of their transactions.

With extensive experience and expertise in international trade and maritime transactions, SVTL Advisory provides strategic legal advisory services to businesses navigating the complexities of cross-border trade, particularly in the effective use of Letters of Credit (LCs) to mitigate payment and delivery risks. Marine insurance and other insurance services are offered through SVTL Insurance Agency, which provides tailored guidance on shipping contracts, marine insurance, and other related matters. With a strong track record in both sectors, **SVTL Advisory and SVTL Insurance Agency** are well-equipped to help clients secure and streamline their international transactions, ensuring confidence and protection throughout the process. For more updates and legal insights, these services can be accessed through the **SVTL Advisory website**.



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