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Import Letters of Credit

Mitigating Cross-Border Trade Risks in Uncertain Times

Why import letters of credit are valuable tools for facilitating global trade, how they work, and the seven benefits of using them efficiently and effectively

In today's volatile global trade environment, businesses are grappling with disruptions caused by rising geopolitical tensions, tariff policy shifts, and resulting supply chain vulnerabilities. Companies sourcing goods and equipment from foreign suppliers increasingly face risks of non-delivery, financial losses, and quality issues. Given the importance of global trade for companies of all sizes, these trends impact not only larger firms but also mid-size and smaller companies that source from overseas.

Import letters of credit (LCs), long used to facilitate cross-border trade, remain critical yet often overlooked tools for strategically managing the impacts changing tariffs can have on global trade. They offer payment assurance and foster trust in international transactions, helping to mitigate some of the financial risks inherent in global supply chains. This paper delves into the supply-chain challenges LCs can help address; describes four main LC types, their workings, and benefits; and looks at their anticipated future role in global trade.

Import/Export Challenges in Increasingly Complex Global Supply Chains

Due to ongoing globalization and the interdependence of suppliers and manufacturers across industries, supply chains have become increasingly complex. For example, before being shipped to their retail destinations, a single product such as a smartphone may have different components and manufacturing activities sourced from multiple countries: microchips from Taiwan; batteries from South Korea; and assembly in China. This global model is particularly common in industries such as apparel, automobiles, aerospace, pharmaceuticals, and medical and industrial equipment.

According to the United Nations Conference on Trade and Development (UNCTAD), global trade in intermediate goods—components that cross multiple borders before final assembly—accounts for over 40%, or more than $10 trillion, of total world trade.[1] This level of interdependence means that disruptions in one region, whether caused by geopolitics, new tariffs, or regulatory changes, can ripple through supply chains, affecting costs and delivery times worldwide.

Emerging uncertainties. For U.S. companies importing goods, newly imposed U.S. tariffs and other nations' retaliatory actions don't just raise costs; businesses must also navigate renegotiating supplier prices, finding and qualifying alternative suppliers, and complying with new government reporting requirements.

Consider the case of a U.S. manufacturer that relies on Chinese machinery parts. The company might now face not only higher costs to purchase those parts but also delays in customs processing, increased paperwork, and the challenge of passing on costs to customers without losing to lower-priced competitors. What's more, it may need to revise its import declarations, country-of-origin documentation, and other government-mandated reporting.

[1] Key Statistics and Trends in International Trade 2023. United Nations Conference on Trade and Development. March 27, 2024.

As a result, businesses may consider moving production to countries that have reduced or no tariffs to make the intermediate components required for manufacturing their goods. But doing so can create logistical hurdles and potential quality control issues.

Such an evolving landscape underscores the importance of strategic supply chain management in mitigating risks and maintaining operational efficiency. Among the most significant concerns facing companies with international business exposure are:

- **Tariff volatility:** Changes in tariffs can disrupt business cost structures. When tariffs increase, companies may need to quickly adjust their pricing strategies, which can be challenging in competitive markets where passing higher costs onto customers might not be feasible. Conversely, abrupt tariff reductions can devalue existing inventory purchased at higher foreign exchange rates, leading to financial losses and complicating long-term procurement planning.
- **Geopolitical shifts:** The imposition or removal of sanctions, export or import controls, or realignment of political alliances can result in price increases for products from a given country or render products completely unavailable. Other events, such as government actions to limit foreign direct investments, restrict financial flows, or annul trade agreements, can destabilize global supply chains, causing disruptions in sourcing, production, and distribution. Border control time delays can also impact the delivery schedules of goods. Any of these can affect the stability of supplier relations and force importers to seek alternatives, often requiring extensive and lengthy, time-consuming supplier evaluations and validations.
- **Diminished working capital:** Increased tariffs can raise the cost of imported goods, requiring companies to allocate more cash to buying inventory and reducing working capital. This may also prolong cash conversion cycles—how long it takes to convert inventory investments back into cash. Longer cycles can lead to higher financing costs and potential supply chain disruptions, making it harder to maintain liquidity and fund operations efficiently.
- **Financial risks:** Non-delivery, delivery delays, fraudulent delivery of incorrect or substandard goods, and supplier insolvency can all pose significant threats to contract performance and the importer’s receipt of goods. This can adversely affect the cash flow of a business, even its survivability. For exporters, non-payment can threaten cash flow and survivability. On top of these risks, currency fluctuations during unexpected delays can negatively impact both parties.

Import LCs: What You Need to Know

An Import LC is an irrevocable financial instrument issued by a bank on behalf of an importer—the buyer—to guarantee payment to an exporter—the seller—upon fulfilling specific terms and conditions as defined by the underlying sales contract between the parties. Below are descriptions of four main types of LCs and how they work:

- **Import LC**: Also known as a Commercial LC, this is the most common LC type used in global trade. It ensures sellers get paid only after fulfilling contract terms, such as shipping the goods and providing

the required documentation. It reduces the need for advance payments, improves cash flow management and working capital, and builds trust between buyers and suppliers in global trade.

- **Confirmed LC**: This LC provides additional security to exporters by involving a second bank—typically in an exporter's home country—that guarantees payment should the Import LC-issuing bank default. It is used most often when an exporter is worried about the creditworthiness of the importer's bank or operates under policies that require a guarantee from a major financial institution.
- **Transferable LC**: This LC allows the original exporter (usually a trading company or intermediary) to transfer all or part of the credit to one or more secondary suppliers. It is especially useful in industries like apparel, electronics, or commodities, where distributors or trading firms often source materials from multiple manufacturers. By using a Transferable LC, suppliers down the chain are assured of payment without the intermediary needing upfront capital.
- **Standby LC (SBLC)**: As a complement to an Import LC, an SBLC provides a backup payment guarantee rather than a direct payment method. Unlike Import LCs, which facilitate trade transactions, an SBLC is only triggered if the buyer fails to meet other contractual obligations, such as making a payment or delivering a project. Often used in construction, large equipment deals, or service contracts, SBLCs protect the beneficiary from financial loss in case of non-performance.

Table 1: Summary of the Import LC types

LC Type	Relationship to Import LC	Key Function
Import LC	The core trade finance instrument for importers. Also known as a Commercial LC.	Guarantees payment for goods once LC conditions are met.
Confirmed LC	A second bank's promise to pay if the issuing bank does not pay even though L/C conditions have been satisfied.	Reduces exporter's risk if they don't trust the importer's issuing bank.
Transferable LC	An additional condition added to an Import LC that allows the primary beneficiary to pass payment rights to suppliers.	Helps exporters acting as intermediate traders to finance supply chain purchases.
Standby LC	Complementary LC type that serves as a backup performance guarantee for contracts or services.	Ensures payment in case of non-performance or non-payment.

Obtaining an Import LC. The process of obtaining an Import LC is typically straightforward. It requires the importer's bank to issue the LC, followed by the exporter shipping goods and filing necessary documents that evidence the shipment. The bank then checks if everything was done properly before making payment. Here are the specific steps:

1. **Request:** The importer requests an Import LC from their bank to ensure that the payment to the exporter will be made.
2. **Issue:** After confirming the legitimacy and creditworthiness of both the importer and exporter along with workability of the LC terms, the issuing bank forwards the Import LC to the exporter's bank, who authenticates the LC and sends to the exporter.

3. **Shipment and documentation:** The exporter ships the goods and submits required documents, such as a bill of lading and commercial invoice, to their bank.
4. **Bank verification and payment:** The exporter's bank verifies the documents and sends them to the issuing bank. After validating the documents, the issuing bank will then debit the importer's account and wire funds to the exporter's bank. If the documents do not conform to the LC, the issuing bank must request the importer's approval to pay.

Costs of an Import LC. For a standard Import LC, the fee typically totals 0.5% of the transaction value, depending on the issuing bank, the complexity of the trade, and the importer's creditworthiness.

If the exporter requires additional security through a Confirmed LC, where a second bank guarantees payment, confirmation fees may add 0.5%-4.0% of the transaction's value to the total cost, based on the perceived risk of the issuing bank risk.

Considerations in using LCs. While LCs can help provide much-needed security in global trade, businesses should consider the associated time, effort, and costs they require. For example, it takes time to produce the detailed documentation an issuing bank expects to evaluate a customer's LC request and to ensure strict compliance with contractual terms.

In addition, not all parties—importers and exporters—may be equally familiar with the use of Import LCs and their procedures, so they may need training and support.

Finally, the aforementioned costs associated with issuing, confirming, and processing LCs can be substantial, potentially deterring smaller businesses from using them. However, as these companies start to diversify their sales or sourcing into international markets, they should consider consulting a global trade professional to help consider the risk/reward ratio associated with import LCs.

In most cases, leveraging digital platforms can help streamline LC processing and reduce manual errors. Partnering with experienced financial institutions such as TD Bank, a top 10 LC-issuer in the U.S., can help companies ensure efficiency and contractual compliance to minimize the administrative burden often associated with LCs.

TD Global Trade Financing Solutions

With strong credit ratings—Moody's: Aa3; S&P: A+; Fitch: AA; DBRS: AA—TD Bank, N.A. has long ranked in the top 10 LC issuers in the U.S., most recently #7 among the other ranked banks.

TD Global Trade Financing Solutions include:

- **Import/export letters of credit**
- **Standby letters of credit**
- **Import/export documentary collections**
- **Bankers acceptances**
- **Export financing**

Plus, the TD Bank Trade online digital platform enables fast, simple, and secure issuance, tracking, and reporting of TD Global Trade Financing products, with templates available for repeated transactions.

Import LCs: Seven Key Benefits

Import LCs provide a secure and reliable payment mechanism that benefits both importers and exporters in international trade. By offering a bank-backed guarantee, LCs can reduce financial risk, improve cash flow management, and create a structured framework for trade transactions. Businesses using Import LCs can

navigate complex global supply chains with greater confidence, ensuring that payments and deliveries are protected from disruptions and uncertainty.

#1 Assures payments, mitigating supply chain risks

For importers, an Import LC provides negotiation leverage by eliminating the need for full prepayment while ensuring that funds are only released upon satisfactory shipment and documentation. For exporters, it assures them that they will receive payment once the terms and conditions of their trade agreement with the importer are met. This allows them to offer importers better payment terms because it reduces the risk of non-payment, especially if an importer is a new customer for the exporter.

#2 Protects importers from contract non-performance or substandard goods

Using an Import LC, importers are safeguarded from paying exporters before the latter has fully met their contractual terms. For example, if a North American electronics importer faced delayed delivery or sub-standard products from an overseas supplier, the company's Import LC allows payment to be withheld until the supplier meets its committed shipment dates or passes proof-of-quality product inspections. In either case, these requirements, as defined in the Import LC, would mitigate the importer's risks of financial loss.

#3 Reduces counterparty risk

International transactions come with the risk that a buyer may default on their payment, or a seller may fail to deliver as promised. Since an Import LC acts as a financial commitment from a bank, it reduces the reliance on the counterparty's creditworthiness and shifts the risk to a more secure financial institution. This is especially valuable in markets where credit ratings may be difficult to assess or where political and economic instability creates additional trade uncertainties.

#4 Provides flexibility to adapt to cost changes

In volatile environments where tariffs, exchange rates, or raw material costs fluctuate, an Import LC can provide a structured framework to help businesses manage financial exposure. LCs can include clauses that account for price adjustments or changes in duty rates, ensuring both parties remain protected against unexpected cost increases. This flexibility allows businesses to maintain stable supply chain relationships even when economic conditions shift.

Best Practices for Vetting Suppliers and Ensuring Quality

Importers should thoroughly vet new suppliers to minimize risks and ensure product quality. This begins with due diligence, including verifying a supplier's reputation, financial stability, and industry certifications.

Conducting factory visits and audits and requesting and evaluating product samples will help assess production capabilities and quality standards before placing large orders.

To safeguard shipments, importers can use pre-shipment inspections by third-party agencies and establish contractual agreements outlining quality expectations, delivery timelines, and penalties for non-compliance.

Using LCs with quality-based payment conditions ensures suppliers meet standards before funds are released. Lastly, building long-term supplier relationships helps maintain consistency and reduce risks. By following these best practices, importers can strengthen their supply chain and secure reliable, high-quality goods.

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#5 Improves cash flow, strengthens working capital

An Import LC also serves as an alternative to payments in advance (i.e., deposits), helping the buyer to secure goods without requiring immediate payment. This can free up working capital for other needs, such as inventory management, operations, or expansion. By leveraging an LC, businesses can extend payment timelines while ensuring suppliers receive guaranteed payment, creating a more efficient cash flow cycle. For foreign suppliers, LCs can help secure financing against the issuing bank's credit, reducing the pressure of waiting for direct payment from buyers.

#6 Facilitates compliance and documentation

Import LCs require strict adherence to trade documentation standards, reducing the likelihood of disputes and ensuring compliance with international trade regulations. Banks involved in the LC-backed transaction scrutinize invoices, shipping documents, and certificates to confirm all contractual obligations are met before processing payment. This structured approach minimizes the risk of fraud, administrative errors, or regulatory non-compliance, making transactions more transparent and secure.

#7 Enhances supplier relationships

Import LCs can foster trust, especially in new or high-risk supplier relationships. An importer's ability to have their bank issue an Import LC, for example, solidifies their position as a legitimate buyer, while the foreign suppliers can leverage the LCs to obtain pre-shipment financing. Because LCs reduce the need for upfront payments, exporters are better motivated to meet their obligations before being paid. The bank-backed guarantee assures suppliers they will be paid, reducing concerns about buyer default and encouraging better pricing and flexible terms. By structuring clear trade conditions, Import LCs improve transparency, minimize disputes, and ensure contract compliance. This stability enhances supplier confidence, loyalty, and supply chain efficiency, leading to stronger and more reliable trade relationships.

Conclusion: Recommendations for Businesses

In an increasingly complex and unpredictable global trade environment, an Import LC remains a valuable tool for businesses managing cross-border transactions, helping them to maximize cash flow and working capital efficiencies.

As rising geopolitical tensions and shifting tariff rules potentially disrupt existing supply chains and introduce new risks to global trade, companies must adopt proactive strategies to protect their financial stability and maintain operational flexibility and resilience. Integrating Import LCs into a supply chain risk management approach can help businesses mitigate counterparty risks, ensure payment security, and maintain liquidity in volatile trade conditions.

To maximize the benefits of Import LCs, businesses should consider leveraging technology from their banks to streamline LC issuance and processing. Digital LC platforms, AI-driven risk analysis, and supply chain finance integrations, for example, can greatly enhance efficiency and reduce administrative burdens.

Finally, strong financial partnerships are critical. Collaborating with experienced global trade finance institutions like TD Bank can provide businesses with tailored solutions that optimize LC structures, reduce

costs, and improve transaction security. By adopting these best practices, companies can enhance financial security, strengthen supplier relationships, and confidently navigate global trade uncertainties—ensuring long-term supply-chain resilience in today's evolving global marketplace. ■