

# How can I use letters of credit with Chinese suppliers?

I am a buyer and realise that most transactions with China suppliers are done through bank transfers, but I would like to know how to use letters of credit, as I have heard they can better protect me

## *The specialist perspective*

**A** payment by letter of credit presents three major advantages. First, no deposit is required before production. Full payment happens only after shipment and under certain conditions. It is an excellent way of reducing risks for large orders.

Second, the buyer requires a list of documents. If the supplier does not send the right documents in the right number and by a certain date, it causes a discrepancy and suspends payment. It pushes the supplier to pay a lot of attention to documentation, so that the buyer can get the goods out of Customs smoothly.

Third, a letter of credit can reduce the buyer's risks regarding product quality and shipment delays. If the quality is acceptable, an inspection agency nominated by the buyer will issue a certificate, which should be one of the required documents. The shipment date should then take place within the letter of credit's validity period.

**From the very first communication with a potential supplier, mention your payment terms. If they push back, tell them it is your company policy. If they still refuse, look for another supplier**

If there is any discrepancy between the documents received from the supplier and the letter of credit's requirements, the buyer has two options:

1. Waive all discrepancies, release payment and get the documents (sometimes a discount is negotiated and the supplier issues a credit note)
2. Refuse the discrepancies and cancel the letter of credit. For the most common letters of credit, known as at sight, it means the buyer does not receive the documents

A minority of Chinese suppliers accepts letters of credit, so here is my advice. From the very first communication with a potential supplier, mention your payment terms. If they push back, tell them it is your company policy. If they still refuse, look for another supplier.

If you feel that a supplier might accept a payment by letter of credit, here are my tips to reassure them:

- Use a famous international bank if possible;
- Only ask for the necessary requirements (your bank's commercial department should be able to help you on this);
- Send a draft to your supplier before formally opening the LC and take their comments into account; and
- Open a letter of credit at sight. Do not try to extend the maturity, unless

you feel the supplier really wants your order.

I can see two reasons why most Chinese suppliers refuse letters of credit. First, this payment mode protects the buyer more than the supplier. In theory, the opening bank guarantees to pay and the letter of credit protects the supplier against payment risks. In reality though, there are virtually always discrepancies. In case the buyer's account is empty, it might push the bank to manufacture discrepancies in order to give the buyer an easy way out. At the very least, the discrepancies allow for a payment delay.

As a consequence, the supplier prefers the solution of bank wires. This way the supplier hooks the buyer with a 30% down payment and can avoid payment delays by refusing to ship the products before receiving the remaining 70%.

Second, most Chinese manufacturers have little cash on hand. They need money to buy the components necessary for production and they cannot always count on their bank to discount a letter of credit.

This is why a supplier accepting a payment by letter of credit is a good sign. It means they have no financial problem and are relatively stable.

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