

# Back-to-Backs vs Transferables



Some bankers' reluctance to issue back-to-back letters of credit is creating a dilemma for some exporters, according to documentary specialist *Ravi Mehta*. This reluctance is illustrative of their unprofessionalism and shortcomings. But there are solutions and methods of securing your back-to-back LCs, as he illustrates.

**“This means, the banking facility of back-to-back LCs has become a Frankenstein’s monster for the banker. It is said to boomerang against him”**

Bankers have designed the back-to-back letter of credit (LC) facility for the use of exporters for financing their supplies, which they want to export as per the requirements of export letters of credit. The exporters may opt to use a back-to-back LC or credit instead of a transferable credit, after considering the advantages and disadvantages of both kinds of LC for financing purposes.

But surprisingly, the bankers in practice may be reluctant to sell back-to-back LCs, finding such a facility risky to them. UK-based Sitpro, a trade facilitation and simplification agency, says on its website ([www.sitpro.org.uk](http://www.sitpro.org.uk)): "Many banks are reluctant to issue back-to-back letters of credit due to the level of risk to which they are exposed." DP Whiting writes in his book, 'Finance of International Trade', that instead of issuing a back-to-back letter of credit, a bank would prefer to be in a position where it can open the second credit to stand on its own. A US-based exporter and

author of *Managing Exports*, Frank Reynolds, who participated in the drafting of Incoterms 2000, agrees that bankers are reluctant. An export manager in Spain, Hector Planella, also testifies to banking reluctance. This means, the banking facility of back-to-back LCs has become a Frankenstein's monster for the banker. It is said to boomerang against him. A banker may not sell the product/service that the exporter needs if the banker finds it risky, and may advise the exporter to use an alternative facility such as a transferable credit. But the exporter may not opt to use it or he may not be able to get it. The banker's reluctance is the cause of the exporter's dilemma.

## Reluctance or not?

But are the bankers really reluctant? To test the hypothesis of this reluctance I asked some renowned bankers this question: "It is said that bankers are reluctant to issue a back-to-back LC against an export LC. Do you agree?"

The question provokes enthusiastic and illuminating debate. The views expressed by the bankers and embodied in this article, could be helpful to users, suppliers and educators of LCs.

To begin with, Gary Collyer, from ABN Amro in the UK and technical adviser for the ICC, says it is an individual bank's choice not to issue a back-to-back LC. There are no specific reasons as to why, although the main one is risk. Heinz Hertl, a retired banker

from Austria, who participated in the ICC's attempt for shaping ISBP 645, says: "I cannot say whether they are reluctant or not – it depends on the individual case. There are back-to-back credits easy to manage and there are those which are hard to manage and even risky. Therefore it is up to a bank's policy whether to do it or not. Unfortunately most of the back-to-back credits are of the second type." A banker from Canada, Helena Kwok, who works for Canadian Imperial Bank of Commerce as risk consultant in the bank's trade finance operations, also says that it is a matter of bank policy and explains that "banks do not normally take another LC as security for issuing another LC".

An export manager in Spain, Hector Planella, says from his experiences of dealing with bankers, banks consider solvency and physical assets of the exporter better than the export LC as collateral.

The views of these bankers draw us to look into the policy of a bank with regard to back-to-back LCs. For example, let us take a Swiss bank, UBS. Does it issue back-to-back LCs? Or in other words, is it reluctant to issue back-to-back LCs? UBS writes in its brochure 'Documentary Credits, Documentary Collections and Bank Guarantees: Guide to Payment and Guarantee Instruments in International Trade': "UBS is prepared to issue a back-to-back credit only if the middleman or general contractor is considered

**“Most banks do not possess necessary resources and prefer to avoid any engagement in that business”**



**Liu at Bank of Taiwan: Complexity and risks deter banks**

sufficiently reliable and capable of a faultless execution of his part of the operation... In view of the fact that the back-to-back credit transactions are exposed to risks far above the average, preference wherever possible should definitely be given to a transferable credit."

This means banks are not reluctant but selective in marketing back-to-back LC services. They supply back-to-back LCs depending upon the buyer.

**Czech reluctance**

Talking about banking practice in the Czech Republic, Pavel Andrle, secretary to the banking commission of the ICC in the Czech Republic, says: "Czech banks as a rule are very reluctant to issue back-to-back LCs (BBLCs) as they see it too much as procedural and documentary risk. They would not do it without any other supportive security."

**Taiwanese situation**

In Taiwan banks are also reluctant. Alan Liu, a retired banker who is now a visiting instructor at Taiwan Academy of Banking and Finance and Bank of Taiwan, tells **GTR**: "Almost all local banks and even foreign banks in Taiwan are reluctant to issue BBLCs because of the risks involved or because of the complexity or lack of experience in handling the documents if the



**DLA's Fung: Objective approach**

substitution of documents is required."

**Middle Eastern doubts**

A Middle Eastern LC specialist with Arab Banking Corporation in Bahrain, ND George, says: "I think that it is more right to say that the beneficiaries believe that they are automatically entitled to a back-to-back credit just because they have a master LC in their favour. So, in order to remove this misconception the banks have to spend a lot of time educating them about the independent nature of both these instruments and the need to go over the full credit review rigmarole before decisions are made to issue a back-to-back LC.

Operationally, back-to-back LCs tend to be riskier than the straight LCs but that is something skilled bankers and exporters can take care of. I think that whether banks are reluctant or not depends on who goes to them with a back-to-back request and the underlying transaction."

A certified documentary credit specialist from Al Rajhi Banking and Investment Corp in Saudi Arabia, Khalil Matar, says: "To design a back-to-back LC in a manner that adequately facilitates smooth payment under a primary LC is a task that requires special experience and skills. Most banks do not possess necessary resources and



**Andrle at Czech ICC: Procedural risks**

prefer to avoid any engagement in that business. This status is more evident in markets where competitors do not issue back-to-back LCs and clients are unable to procure the service from one or more provider."

Abdulkader Bazara, product manager at Samba Financial Group in Saudi Arabia, agrees that banks are reluctant and selective in back-to-back credit matters. They would issue only for some of their prominent customers and only for the LCs issued by prominent banks. The reason for being reluctant and selective is risk, which, he says, is of three kinds: 1) operational risk – the errors in the back-to-back LC; 2) performance risk – errors in documentation under the export or master LC and non-payment by the issuing bank of the export LC; 3) country risk faced by the original (export) LC. He therefore considers export LCs as an unsafe and unreliable security for back-to-back LCs.

A documentary credit banker with National Bank of Fujairah in Dubai, Laxmanan Sankaran, says that banks are hesitant to freely open back-to-back LCs for two reasons: 1) lack of skills for flawless documentation on the part of the trader; and 2) lack of skills on the part of a banker for issuing a back-to-back LC.

Another UAE banker, Zahoor



**Bazara at Samba Financial: Only prominent customers**

# Documentation

## Back-to-back LCs



**Reiste at Union Planters: Willing to issue back-to-back**



**Dattu at Abu Dhabi Commercial: Exporter flaws**

Dattu, head of trade finance services at Abu Dhabi Commercial Bank, expounds three reasons for the banking reluctance in back-to-back LC matters:

- Back-to-back LCs are not covered under UCP. Hence there are no governing rules and guidelines.
- Internal operational difficulties and inherent risks in back-to-back LCs.
- Flawed documentation on the part of the exporters.

### Banks who are willing

One non-reluctant bank is Export Development Bank of Iran. Its deputy head of international affairs, Mohammad Ajorloo, says: "We do agree to issue such letters of credit, making sure that the counter LC reflects a mirror image of the parent LC with the exception of curtailing the latest date of shipment, credit expiry, total LC amount and increasing the insurance coverage." Another is Union Planters Bank in the US. Its LC payment manager based at the bank's Miami office, Daniel

Reiste, says Union Planters does successfully offer a back-to-back letter of credit product. However, they discourage more than two back-to-back LCs per master LC, where necessary, he says. Their non-reluctance is the result, and indicator, of their possession of skills in issuing back-to-back credits. The general reluctance of the other banks indicates lack of skills, and lack of will or attempt to develop such skills. The non-reluctant banks are competent banks – in back-to-back credit matters. The reluctant banks are obviously incompetent banks. How to deliver safely in a situation that is not safe and get the intended results – this is banking competence. The reluctance to deliver is incompetence.

### Some don't understand

Donald Smith, a retired US banker now at Norman Technologies and chairman of the Banking Committee of the US Council for International Business, co-chair of the ICC's ISBP task force and a member of the UCP Revision Consulting Group, says: "I agree [that banks are reluctant]." Most banks do not understand what a back-to-back LC is, and therefore fail to follow precisely the outline of the first LC, and end up with an LC which does not map exactly to the first LC. A back-to-back LC is still an extension of credit and bankers fail to understand that they have a credit extension to the applicant, ie, applicant risk, and they believe instead they have the credit risk of the bank issuing the first LC. A lawyer working for UK-based international law firm DLA, Fung King Tak, however comments: "It is very difficult to generalise the statement that banks are reluctant to issue back-to-back

credits. It depends on the nature and risk exposure of each client and transaction." He further says that issuing back-to-back credits involves the assessment of various risks such as payment, product, shipment, insurance and documentary risks, and so on.

### Admittance of guilt

Banks and bankers admit their general reluctance for issuing a back-to-back LC for the following reasons:

1. Lack of skills on the part of a bank or banker for issuing a back-to-back LC.
  2. Lack of skills on the part of the exporter trader for flawless documentation under an export LC.
  3. Lack of creditworthiness of the exporter.
  4. Risk of non-payment by the issuing bank of the export LC.
  5. Absence of the ICC rules to govern back-to-back LC transactions.
- UBS says in its aforementioned brochure: "Only the transferable credit is mentioned in the UCP; the back-to-back credit is omitted.

Therefore, no specific rules for the back-to-back credit exist." Reason 1 means the back-to-back credit by nature is not risky but the banker's incompetence may make it risky. It is risky if its issuing bank does not align it properly with the export LC. Why risky? The publication of the UK-based Institute of Financial Services (IFS) 'Finance of International Trade' (6th edition) says back-to-back credits are entirely separate instruments, and thus the middleman (exporter) and his banker (issuing banker of back-to-back credit) are

responsible for paying the second credit (back-to-back credit) irrespective of whether payment is subsequently received under the first credit (export LC). The example of improper alignment between the back-to-back credit and export LC makes the back-to-back credit thus risky.

The IFS's 'Finance of International Trade' says the second credit must have an earlier expiry date than the first, otherwise the documents required to procure payment under the first credit would not be available in time. It is a good precaution to make the second credit expire in the place of issue otherwise the

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issuing bank is in the hands of the postal authorities, and delayed receipt of documents could mean non-payment under the first credit. 'Finance of International Trade' further says that "care must be taken to stipulate that the amount of insurance evidenced by the document

required by the second credit is sufficient to meet the amount of insurance required by the first credit."

The other three reasons indicate the external factors that make a back-to-back credit risky and make the bank thus reluctant. To prevent banking reluctance, exporters must take steps on their part to make their business and export LCs creditworthy. The ICC, presently, is not taking steps to frame rules for back-to-back credits, nor has it as yet any intention to do so. Bankers justify banking reluctance by saying the back-to-back credit is not the

exporter's right, but the bank's choice. The banks therefore advise exporters to use instead a transferable credit where they express reluctance to issue a back-to-back LC, fearing risk. But an exporter may be reluctant to use a transferable credit and instead may opt to use a back-to-back credit. Why? Reinhard Langerich, a retired banker from Denmark, writes in his book 'Documentary Credits in Practice' (2001 edition) that an exporter may not be able to get a transferable credit as the importer (applicant) may not want his credit to be transferable because thereby he would lose some of the control and security inherent in the credit. He further writes that the beneficiary himself may also refrain from requesting a transferable credit because he does not want to leave the impression with the applicant that he needs this security to get the goods. The IFS's 'Finance of International Trade' says that with transferable credits the ultimate buyer is aware that he is dealing with a middleman; with back-to-back credits he is not. With transferable credits the middleman and his bankers have no liability, but with back-to-back credits they are fully liable on the second credit.

In short, the banker may not sell what the exporter needs or opts for – back-to-back credits, for example. The exporter may not use what the banker advises to use – that is, transferable credits, for example.

### Lessons learned

You can overcome a banker's reluctance and make him issue a back-to-back credit. If you have flawless documentation skills and your business has a history of getting documents accepted and paid; if your business has good credit history; if the LC is

confirmed; and if the issuing bank has a good international reputation. The banker will not do banking business with you if your exporting business and your export LC both are a risk. The banker can overcome his reluctance – that is, his risk avoidance tendency – by developing risk management skills, in the interest of promoting global trade. The reluctance is a trade barrier. The banker should try to sell back-to-back LCs instead of shelving it, believing that it is risky. It is not by nature risky. It is made risky. Risk management does not mean not to take risk and therefore not to sell a product. Risk management means to control the risk and develop safety and sell the service safely with confidence. Risk avoidance indicates incompetence – lack of knowledge, skills and confidence in risk management. Risk management indicates ability to control risks and successfully market trade finance service.

For example, Union Planters Bank's Reiste tells me how his bank manages risks in back-to-back credit matters. He says: "Union Planters Bank does successfully offer a back-to-back letter of credit products. Our minimum amount is US\$100,000. We require that the import LC issued in favour of our customer [the 'master'] be confirmed by us and available with us. Likewise, the import LC [the 'back'] is restricted for presentation at our counters. We also require that our client utilise the services of a local forwarding company in Miami whom we

have worked with for many years. They ensure that the goods are properly consigned and shipped in order that proper controls are maintained over the shipment. No additional collateral is generally required for the transaction."

He further says: "We issue two types of backs. Congruent and incongruent. A congruent back will require exactly the identical documents required by the master. An incongruent back may require other documents that will necessitate being substituted in order to meet the terms of

the master LC. The type of clients that we do these transactions for usually have little operating capital and are presented with what may be considered a 'can't be refused' business opportunity that will

generate above average profits for them. Usually these are one-off transactions, although we have had clients from time to time which found the product so workable and the underlying transaction so profitable that they have encompassed up to 20 or more masters with multiple backs being issued for each. While we discourage more than two backs per master, that is occasionally modified to more depending upon the complexity of the LCs."

Banks are reluctant to issue a back-to-back credit because they lack skills to manage or prevent risks associated with the back-to-back credit. A product may not be inherently risky. But the incompetence to deliver or use it may be risky and may make the product thus risky. Where there is

incompetence for risk management there is a tendency for risk avoidance. Risk avoidance is not risk management. Risk management means the ability to manage, and not avoid, the risks. Bankers must overcome reluctance – that is, they must control the risk avoidance tendency and instead develop a tendency to control risk to sell back-to-back credits. The bankers must be well trained for back-to-back credits. They must use a checklist for issuing back-to-back credits. Without the backing of skills and knowledge the back-to-back credit may backfire. On the other hand, weaknesses in the exporter's business and in the export LC may cause banking reluctance for issuing back-to-back credits. Exporters must overcome such weaknesses. The exporters must have flawless documentation skills. They must get an export LC having such characteristics – for example irrevocability, confirmation, issuing/confirming a bank's good reputation – that can help them grab a back-to-back credit from the banking market. Good documentation expertise and a good export LC in your hand will help you get back-to-back credit where you don't want a transferable export LC. If you overcome your business weaknesses a banker may overcome his reluctance.

Back-to-back credits demand an exporter's flawless documentation ability and a banker's flawless risk management ability. These abilities are requisites for the sale or purchase of back-to-back credits. Service delivery and use demands acquisition and use of abilities. Develop and use abilities for the supply of back-to-back credits as Union Planters Bank does. Develop and use abilities for buying back-to-back credits.

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