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Letters of Credit: A Strategic Tool for Community and Regional Banks

For community and regional banks, letters of credit remain one of the most valuable and often underappreciated tools for supporting local businesses engaged in domestic and international trade. Even as technology reshapes how documents move and how payments are processed, the fundamentals of the law governing letters of credit continue to shape risk, compliance, and client expectations. This article examines why letters of credit are essential and the key considerations for bank teams.

A Letter of Credit in Plain Terms

A letter of credit is a bank's independent promise to pay a beneficiary once the required transactional documents are presented, regardless of what might be happening in the underlying commercial transaction between counterparties. For the beneficiary of the letter of credit, this function delivers several important benefits. Chief among them is that it allows the beneficiary to trade confidently with unfamiliar counterparties by shifting the commercial credit risk from the counterparty to the issuing bank's controlled, rules-based review process. In other words, the beneficiary's repayment exposure is tied to the issuing bank's financial strength, rather than the counterparty's financial wherewithal.

For the issuing bank, offering letters of credit provides a valuable service that strengthens client relationships and also provides fee income for banks. For many small and midsize businesses, access to a letter of credit may be the difference between winning and losing a contract.

Why Businesses Rely on Letters of Credit

Businesses typically rely on letters of credit for several reasons, particularly when operating outside their usual network of partners. These businesses may request a letter of credit when they are working with a new supplier or buyer, when they need assurance of payment before producing or shipping goods, when they want payment tied to documentary proof rather than promises, or when they want to avoid potential performance disputes. In each case, the business (or beneficiary of the letter of credit) wants to limit third-party risk. For community and regional banks, offering letters of credit means enabling economic activity that might otherwise be too risky.

The Legal Rules You Can't Ignore

Letters of credit operate within a well-established legal and regulatory framework, and bank teams must understand the rules that govern how these instruments are issued, honored, and examined. These standards include:

- Uniform Customs and Practice for Documentary Credits (UCP 600) for commercial letters of credit
- International Standby Practices (ISP98) for standby letters of credit
- Uniform Commercial Code (UCC) Article 5, the primary U.S. legal framework
- Sanctions and compliance requirements, including those enforced by the Office of Foreign Assets Control (OFAC), as well as anti-money laundering (AML) and Know Your Customer (KYC) obligations

Together, these rules define the obligations of the issuing bank, the rights of the beneficiary, and the scope of the bank's examination duties. They also highlight why legal and compliance teams play an essential role in the letter-of-credit process. For example, even a routine standby letter of credit can trigger sanctions or AML considerations that require heightened review. A strong understanding of these requirements allows banks to support their customers while maintaining compliance with the legal framework for every letter-of-credit transaction.

The Independence Principle: Protecting the System

The most important legal concept governing letters of credit for bankers to understand is the independence principle, meaning that the letter of credit is separate from the underlying commercial transaction between the counterparties. This matters for the following reasons:

- Issuing banks perform on the letter of credit, provided that the terms of presentment are complied with, even if there is some dispute between the counterparties regarding the commercial transaction. In other words, it is not the issuing bank's responsibility to resolve any legal or business discrepancy.
- Beneficiaries cannot be required to hold letter-of-credit proceeds in escrow simply because there is a dispute.

This principle is the foundation of global trust in letters of credit, and it underscores why precise drafting and a strong review process are critical for issuing banks.

Strict Compliance: Small Errors Create Big Problems

Community and regional banks know this well: Letters of credit are a documentary obligation, and strict compliance is a necessity. "Close enough" is not compliant. Some of the most common issues to watch out for include:

- **Misspelled names:** The names of all parties must match those stated in the letter of credit precisely. Even a small deviation can raise questions about identity and authority.
- **Incorrect dates:** Shipment, invoice, or presentation dates that are inconsistent with the letter of credit, even by one day, create discrepancies that may lead to dishonor.
- **Conflicting or ambiguous terms:** Consistency is a must. Ambiguity increases the risk of the beneficiary presenting documents that do not appear compliant, and any mismatch in terms provides legal justification for refusal.
- **Late presentations:** Documents must be presented within the time frame stated in the letter of credit. Failure to do so

can mean invalid presentation.

- **Formatting or content errors in transport documents:** Errors can force banks to honor documents that do not meet expectations.

Strict compliance is key. Even small discrepancies can justify refusal. When in doubt, proper review by a legal team can help minimize risk and ensure enforceability by standardizing language and preventing ambiguity.

Modern Risks Every Bank Should Prepare For

Today’s environment presents new operational challenges to letters of credit: fraud schemes, especially involving forged documents, have become increasingly sophisticated and pose real exposure for institutions relying on traditional paperwork flows. At the same time, digital presentations have introduced new questions about how to verify authenticity checks. Compressed examination timelines leave banks with little room for error, and a missed deadline could force the bank to honor discrepant documents. Adding to these operational pressures, banks face heightened regulatory scrutiny, particularly around sanctions and AML compliance.

For community and regional banks operating with leaner teams, strong coordination across credit, operations, and legal is more important than ever for managing risk.

Why Letters of Credit Remain a Strategic Advantage

Despite these evolving modern risks, letters of credit remain one of the most effective tools available to banks serving business clients. They continue to offer a predictable, rules-based payment mechanism that brings structure and certainty to commercial transactions among counterparties. When offered by community and regional banks, letters of credit deliver a valuable service that supports local businesses and also generates fee income for the bank.

FBT Gibbons

For many community and regional banks, an effective program for letters of credit isn't just a product; it is an asset in building client relationships and provides a competitive edge.

FBT Gibbons has a long history of representing and collaborating with community and regional banks. We are available to help you launch or modernize programs for letters of credit and other valuable offerings to meet the needs of your organization and your customers. For further guidance, contact the authors or any attorney with our Regional and Community Banks team.

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