DIRE DAWA UNIVERSITY

COLLEGE OF BUSINESS AND ECONOMICS

DEPARTMENT OF LOGISTIC AND SUPPLY CHAIN MANAGEMENT

# Factors Affecting Letters of Credit Effectiveness: Perception Survey on Trade Services and International Banking Staffs of Awash Bank East Region

BY: THEODROS FESSEHAYE

ADVISOR: ABEBAYEHU H. (ASSIST.PROF.)

Dawa University, Dire Dawa, Ethiopia

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# Factors Affecting Letters of Credit Effectiveness: Perception Survey on Trade Services and International Banking Staffs of Awash Bank East Region

THEODROS FESSEHAYE

A Thesis Submitted to the Department of College of Business and Economics, School of Graduate Studies, Dire Dawa University, Dire Dawa, Ethiopia

In Partial Fulfillment of the Requirements for Master Of Arts

Degree In Logistics And Supply Chain Management

# Declaration

I hereby declare that this MA thesis dissertation is my original work and has not been presented for a degree in any other university, and all sources of material used for this thesis / dissertation have been duly acknowledged.

Name of Student **Theodros Fessehaye**

Signature:___________________ Date _________________

# Certification

This is to certify that Theodros Fessehaye has carried out this research work on the topic entitled "Factors Affecting Letters of Credit Effectiveness: Perception Survey on Trade Services and International Banking Staffs of Awash Bank East Region" under my supervision. This work is original in nature and it can be submitted for the partial fulfilment of the requirements for the award of the degree of Masters of Art in Logistics and Supply Chain Management.

Abebayehu H. (ASSIST.PROF.)

Date___________________________

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Prepared By Theodros Fessehaye

APPROVED BY:

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| ______________________ | ______________ | __________ |
| Chair Person | Signature | Date |
| ______________________ | ______________ | __________ |
| Advisor | Signature | Date |
| ______________________ | ______________ | __________ |
| Examiner (Internal) | Signature | Date |
| ______________________ | ______________ | __________ |
| Examiner (External) | Signature | Date |

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## ABBREVIATION/ACRONYM

| | |
|---|---|
| AIB | Awash International Bank |
| NBE | National Bank of Ethiopia |
| IBD | International Banking Department |
| TS | Trade Service |
| SWIFT | Society of World Wide Inter Bank Financial Telecommunication |
| L/C | Letter(s) of Credit |
| DC | Documentary of Credit |
| ICC | The International Chamber of Commerce |
| UCP 500 | The Uniform Customs and Practice for Documentary Credits 500 |
| UCP 600 | The Uniform Customs and Practice for Documentary Credits 600 |
| UCC | Uniform Commercial Code |
| SLC | Stand by letter of Credit |
| CLC | Commercial Letter of credit |
| CAD | Cash against Document |
| TT | Telegraph Transfer |

# ABSTRACT

*Letter of credit has become widely used in international trade as the payment instrument. The purpose of this study is to assess the determining factors of letters of credit effectiveness in the process of import and export practices in AIB East Region. Employing content analysis, this study found that 51% of trade documents contained discrepancies and did not comply with terms and conditions of letter of credit, 44% of documents contained discrepancies and did not comply with the ambiguity of context of the Uniform Customs and Practice 600 and only 5% of discrepancy of trade finance documents originated from clerical errors. This study used both descriptive and explanatory research designs. Data were collected from primary sources through questionnaire and structured interview and analyzed through both descriptive and correlation analysis by using Statistical Package Social science (SPSS) program The correlation relation test showed that formation place r (90) =.680,P<.01,place of payment r (90) =.667, p<.01, language and currency r (90) =.728 p<.01 and documentary condition r (90)=.684, p<.01 had statistically significant relationship with LC effectiveness. To this end, with the support of multivariate analysis, results showed that formation place (0.00010), place of payment (0.00005), language and currency (0.00002), and documentary condition (0.00003) statistically affects LC effectiveness. Banks that facilitate international trade as a major financial institution in goods and service including payment processing for merchandise shipped and services rendered, layouts funds for buyer and seller, and give professional advice to traders specially accurately rendering foreign banking services to facilitate the country's international trade.*



**Key Words**: Letter Of Credit, International Trade, Awash Bank East Region

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# Chapter One – Introduction

## 1.1 Background of the study

International trade is a key to worldwide prosperity. It can stimulate the gross domestic product of any country. The growth of international trade and financing can offer new opportunities for buyers and sellers between two countries or more (Sut Sakchutchawan, 2009). While international trade continues to grow as a part of the global economy, more attention and emphasis have been focused on understanding the key aspects of trade finance transactions.

Nowadays, just about all companies-large or small-are affected by global trade and international competition. Moreover, common problems are a failure to present proper trade documents for payment, a failure to produce goods and services offering to the needs of foreign countries, and a failure in collecting payment and financing. Hill (2005) indicated that a typical international trade transaction may involve 30 parties, 60 original documents, and 360 documents copies, all of which have to be checked, transmitted, re-entered into various information systems, processed, and filed by quoted The United Nations report on Trade and Development. The United Nations had calculated that the time involved in preparing documentations, along with the costs of common errors in paperwork, often amounts to 10 percent of the value of goods export (Hill, 2005).

Similarly, as to any developing country, Ethiopian companies have a common problem such as failure to present proper trade documents for payment, a failure to produce goods and services offering to the needs of foreign countries, failure to participate in exhibitions in foreign countries especially exporters and a failure in collecting payment and financing. There could be any other major issues on documentary credit, payment facilitation, document handling, voluminous paperwork, complex formalities, and many potential delays and errors.

To sum up, trade transaction facilitation and exploring new opportunities through international trade financing are always a burning issue in the assessment of developing countries import and export achievement. More importantly, much work needs to be done with the course of using commercial letters of credit in the country's import and export in the Ethiopian context. It is sensible to study its potential implications and examine changes in both generally accepted accounting principles. Hence, this study assessed the determining factors of Letters of Credit effectiveness by means of the perception survey on trade services and international banking staff of AIB East Region.

## 1.2 Statement of the Problem

The major financial institutions that facilitate international trade are insurance companies and banks. Insurance companies give cover to risk of loss or damage to the goods in transit to buyer's premises while banks facilitate payment for merchandise shipped and services rendered, layouts funds for buyer and seller, documents examination and give professional advice to traders. One of these banks that are involved in rendering foreign banking services to facilitate the country's international trade is Awash Bank. A preliminary interview with trade service staff of Awash Bank East Region indicated that the practice of LC process in Awash Bank characterized as late transfer of LC documents and improperly handling and improper filing documents of letters of credit. Most exporters and importers complained to the bank on documentary collection, advance and consignment payment processing in all procedures of international trade. These all imperfection of international trading practices and associated payment faultiness has a clue to unprecedented research opportunities.

Further, import or export firms are highly obliged to fill several needless forms typed in old typing machines (Typewriter) and have been forced to offer various documents when importing and exporting in Ethiopia. The preliminary interview assured that all LC documentation has been inaccurately completed and exploited potential delay problems. The main logistics related problem is specified as firms just entering to the international market should not be forced to use freight forwarders who specialize in handling importation and exportation documents. Thus, investigating letter of credit effectiveness in the trade service process of letter of credit through intensive search of the trade service activity of Awash Bank is a must.

On the other hand, due to the importance of letters of credit in international trade law, some investigations have been conducted. For example, Hahn (2007) investigated the governing laws on letters of credit under the UCC to provide the in-depth analysis with respect to how the choice of law matters for disputes arising out of letters of credit. Hao & Xiao (2013) analyzed the two principles of “Independence” and “Strict Compliance” related to letters of credit, and studied the risks exit in letter-of-credit transactions. Sut Sakchutchawan (2009) addressed the phenomenon of document discrepancies in international trade financing and assured the problems related to letter of credit have grown in the past thirty years; no research has been undertaken to address these problems. This can be an extreme source of frustration to the variables of factors using LC and its effectiveness in finding solutions for payment and finance processes in international trade.

In general, the issue of finance is an integral one in the supply chain context; given that supply chains embody flows of information, capital, goods, and labor. The supply chain concept has traditionally tended to emphasize the tangible/material dimensions of the chain. Previously, the subject had been largely addressed in the context of operations research and economic development. As a result, the financial dimension had been relatively neglected in the literature. This changed with the 2008-2009 global financial crises. As both a potential aggravator and victim of the crisis, trade finance and supply chains became the subject of a new and rapidly growing body of literature (Hurtrez and Salvadori 2010). Thus, this study focuses on the concept of the financial dimension of supply chain and payments using letter of credit and other related concepts. This study reviewed findings from all research areas in the literature and observes significant merit in the financial and international trade concept of supply chain flows. Actually, this problem gap is growing in the field of logistics and supply chain management and seems to be an unstoppable researchable area in commercial trade.Therefore, this paper determines factors of Letters of Credit effectiveness that arranged international trade transactions payment and financing. To this effect, various factors such as formation place, place of payment, language and currency, documentary condition were independent variables and letter of credit effectiveness was treated as dependent variable.

## 1.3 Research Questions

- What are the factors that determine letters of credit effectiveness in the process of import and export practices of AIB East Region?
- Which dimensions have strong relationship to letters of credit effectiveness in the process of import and export practices of AIB East Region?
- What is the gap area that is not yet filed by AIB East Region in using letters of credit in the process of import and export practices success?

## 1.4 Research Objective

### 1.4.1 General Objective

The General objective of the study concerned, assessing the factor of import & export letter of credit effectiveness in AIB East Region.

### 1.4.2 Specific Objective:

- To investigate the factors that determine letters of credit effectiveness in the process of import and export practices of AIB East Region.
- To explore the dimensions that have strong relationship to letters of credit effectiveness in the process of import and export practices of AIB East Region.
- To assess the gap area that is not yet filed by the Awash Bank East Region in using letters of credit in the process of import and export practices success.

## 1.5 Significance of the Study

AIB East Region earns the major part of its profit from foreign banking Services.Currently AIB East Region provides low quality international payment process and special delayed and incomplete documentation and allied banking services, this kind of research outcomes will be made to serve its esteemed and valuable customers of the Bank by contain the information most useful to letters of credit effectiveness decisions. Also, it helps the bank to take corrective actions on the basis of suggested recommendations and the study will provide a starting ground to other researchers in order to undertake intensive study on the influential factors of letters of credit effectiveness. In general, the result of the study is hoped to contribute for policy makers, bank's executives and for those who need to make further studies in more details towards:

- examining the implementation of operative international trade transaction and payment system in Ethiopian business environment
- Providing feedback to banks, private and public organizations, policy makers, experts in the commercial environment because results of the study can explain the documents, payments and trade transactions quality or effectiveness.
- Gaining a better understanding of the need for a closer relationship among, letter of credit, trade facilitation, documentation, business as far as achievement tests practiced in commercial banks are concerned.

Further, the bank will revise its operational strategy through the foremost recommendations that is to be action by the AIB East Region on the drawbacks of using letters of credit in the process of import and export practices. In related to central focusing on using letters of credit, this paper helps to improve the country's most important instrument in international trade. The finding of research will smooth the flow of the document process and minimize the risk of importers and exporters as well as the involving parties in international trade such as banks, insurance & freight forwarders.

## 1.6 Limitation of the Study

This study is basically bound to examine factors of letters of credit effectiveness in the process of import and export practices success. This study emphasized that the country's biggest government owned financial institution and other private banks were overlooked due to time and money restrictions. It is targeted on the strongest financial institutions in the country that plays vital role on the economy as whole and so does in import and export business. All the commercial banks of the country were not taken as the subject of the study. It only targets the trade support and international banking division at AIB East Region. Not only this but also, the fact that the study is only conducted in letter of credit other mode of payments like TT transfer and CAD do not include which limits the generalization of the research findings. However, considering the time, budget, access to data, expected rate of return for research instruments and convenience, this research concentrated on the case of international payment terms on letters of credit effectiveness.

In short, studies need to be conducted using more variables such as letter of credit efficiency and success factors that seem to be pertinent to the study. The studies should be conducted to investigate the interaction of other variables that influence the LC effectiveness on commercial banking business. Other factors that affect the whole international trade practices may also be given an in-depth analysis through a similar study. A replication of the study needs to be done using a larger sample so as to give more insight on commercial and development banking business in Ethiopia. In regard to risk analysis of Letter of Credit, possible risks and frauds of different parties (exporter, importer, and banks) should have not been shown in this study. Unfortunately, the paper discarded various risks that affect letter-of-credit transactions even if it is the safest method of payment nowadays in international trade. Those risks may happen to each party, which is not only the exporter, but also the importers and banks.

On the other hand, conflict between clauses of credit and related laws were not included in this study. It was not checked whether or not the clauses of credit are in accordance with the law of the related country. In the real practice of international trade, some clauses in the credit are advantage to the exporter on the appearance. The noticeable point is that if the clauses are allowed according to the law of importer's country. This limitation would be more capital for further research. The other point may not consider here, the personnel involved in documentary preparation and documentary examination as they must be trained and certified to ensure they have enough skills to handle the import and export documents properly.

## 1.7 Organization of the study

This study is organized in five chapters. The first chapter consists of introduction and it includes background of study, statement of the problem, and objective of the study, significance of the study, scope and limitation. The second chapter deals with the review of the related literature the third chapter deals regarding research method chapter four treats data analysis presentation and findings. Chapter five presents conclusion and recommendations.

## 1.8 Definitions of Basic Terms

- *Letters of credit* - often described as the payment method that developed to facilitate international trade. They are especially preferred over other means of payment mostly for one - shot cross - border transactions where traders do not know each other, or in the opening stages of a potential long term relationship, before relational constraints become effective (Krazovska D., 2008).
- *Letters of credit* **-** a written undertaking by a bank (issuing bank) given to the seller (beneficiary) at the request, and in accordance with the buyer's (applicant) instructions to effect payment — that is by making a payment, or by accepting or negotiating bills of exchange (drafts) — up to a stated amount, against stipulated documents and within a prescribed time limit. (International Trade With A Practical Guide To Documentary Letters Of Credit)
- *International trade* - a key to worldwide prosperity. It can stimulate gross domestic product of the country. While international trade continues to grow as a part of global economy, more attention and emphasis have been focused on understanding the key

aspects of trade finance transactions. International trade is obviously very important for global economic growth (Sakchutchawan, 2009).

- *Trade finance* - Broadly defined, trade finance refers to “any financial arrangement connected to inter-firm commercial transactions”. It is often used in the context of international trade (import/export), in which it refers more specifically to “the funding of individual international commercial transactions by financial intermediaries” (Ellingsen and Vlachose 2009).

# CHAPTER TWO - LITERATURE REVIEW

## 2.1 Introduction

This chapter is based on the introduction given lately and the research problem presented in the introduction and the previous studies that have been done within these constructs. It provides the reader with a literature review concerning the research area. Large number of studies has been conducted in the field of letter of credit and international trade (import export transaction). There are useful contributions expressed by so many authors about the payment method that developed to facilitate international trade with payment language and currency, documentary issues, formation place and Place of payment as important factors of effective factors on using letter of credit.

## 2.2 History and Concept of Letters of Credit

The term "letter of credit" is derived from the French word "accredetif", which means "a power to do something'', which in turn derives from the Latin word "accreditiwus", which means "trust". The letter of credit is also referred to as documentary credit (Koudriachov SA, 2001). Koudriachov designated that some academics believe that the sources of letters of credit can be traced back to early Egypt and Babylon, which already had a sufficient banking structure. Rufus Trimble e.g. refers to a clay promissory note of Babylon dating from 3000 B.C., which provided for the payment of an amount and the interest on an explicit date. It is confirmed that banks in ancient Greece prepared letters of credit on correspondents with the view to obviating the actual transport of specie on payment of accounts.

As numerous disciplines of social science, there are no universal one but rather multiple definitions of the letter of credit, depending on the set of rules applicable to the letter of credit transaction. Nevertheless, a letter of credit is a written instrument employed in the event that someone ("applicant") undertakes to pay another person ("beneficiary") under a given contract ("underlying contract"), provided the terms expressly specified in the letter of credit are met (Gao X & Buckley RP., 2003).

Regardless of its long mercantile history, the letter of credit has a much shorter legal history. Pillans and Rose v Van Mierop and Hopkins is one of the first lawsuits involving a letter of credit and a landmark case in the UK's letter of credit law. Cases such as Orr & Barber v. Union Bank of Scotland13,the British Linen Company Bank v. The Caledonian Insurance Company and Re Agra & Masterman Bank v. Ex Parte Asiatic Banking Corporation demonstrate that it is only since the second half of the 19th century when transactions similar to the modern commercial credit began to appear and that banks became properly involved in the utilization of the credit arrangement (Bollen R., 2007). Bollen showed that the law of letters of credit has developed largely through customs of international trade, which mostly the International Chamber of Commerce has codified in the Uniform Customs and Practice, the Uniform Rules for Demand Guarantees, the Uniform Rules for Contract Guarantees and the International Standby Practice.

Bergami R. (2003) exhibited that letters of credit deal with these issues efficiently because, for international parties, they are issued in a transparent way, can be examined by the receiving party and lead to a reliable payment by the bank. Lord Wright described the letter of credit as a "bridge between the period of the shipment and the time of obtaining payment against documents". The letter of credit permits the beneficiary to rely on the banks instead of the importer's creditworthiness. Additionally, it gives a payment guarantee, provided the exporter produces the required documentation. Regardless of its costs and complex formal requirements the letter of credit plays a leading role in international sales transactions.

## 2.3 Types Of Letters Of Credit

There are two types of Letters of Credit: revocable and irrevocable. A revocable Letter of Credit can be revoked without the consent of the Exporter,meaning that it may be cancelled or changed up to the time the documents are presented. A revocable Letter of Credit affords the Exporter little protection; therefore,it is rarely used. An irrevocable Letter of Credit cannot be cancelled or changed without the consent of all parties,including the Exporter. Unless otherwise stipulated,all Letters of Credit are irrevocable.

The major types of letter of credits are:

## A. Revocable Or Irrevocable

Letters of credit can be revocable. This means that they can be cancelled or amended at any time by the issuing bank without notice to the beneficiary. However, drawings negotiated before notice of cancellation or amendment must be honored by the issuing bank. An irrevocable letter of credit cannot be cancelled without the consent of the beneficiary.

## B. Unconfirmed Or Confirmed

An unconfirmed letter of credit carries the obligation of the issuing bank to honour all drawings, provided that the terms and conditions of the letter of credit have been complied with. A confirmed letter of credit also carries the obligation of another bank which is normally located in the beneficiary's country, thereby giving the beneficiary the comfort of dealing with a bank known to him.

## C. Revolving Letters Of Credit

If an Applicant and a Beneficiary agree to ship goods on a continuing basis, it may be more efficient and cost effective if the Applicant establishes one Letter of Credit for all shipments, rather than one Letter of Credit for each shipment. A special Letter of Credit for handling multiple shipments, renewable over an extended period of time, is a "Revolving Letter of Credit." A Revolving Letter of Credit may operate automatically or by amendment and can be either cumulative or non-cumulative.

## D. Red Clause Letters Of Credit

If an Applicant wants to advance cash to the Beneficiary (possibly the Applicant's purchasing agent) to finance the purchase of the goods before shipment under the Letter of Credit, the Applicant may apply for a Red Clause Letter of Credit. The "red clause" in a Letter of Credit authorizes the Issuing Bank or, more typically, a Nominated Bank to make a cash advance (loan). It is referred to as a "red clause" simply because the clause is sometimes printed or typed in red ink. Letters of Credit issued with a "red clause" should restrict negotiation or payment to a specific bank. The specified bank charges interest to the Beneficiary at the local rate, unless the Letter of Credit provides otherwise. If the Beneficiary fails to pay the interest charged or principal advanced, the Nominated Bank may look to the Issuing Bank, which will look to the Applicant, for reimbursement. A "red clause" is typically used when there is a close business relationship between the Applicant and the Beneficiary.

### E. Transferable Letters Of Credit

When a Letter of Credit issued subject to the UCP is specifically designated"transferable," the Beneficiary has the right to request the named Transferring Bank to make the Letter of Credit available to one or more other parties. Transferable Letters of Credit may be transferred either in whole or in part to second Beneficiaries (Transferees). However, Transferable Letters of Credit may be transferred only once. If partial shipments are not prohibited, portions of the Transferable Letter of Credit may be transferred separately, but the total amount transferred cannot exceed the amount of the original Letter of Credit (Master Credit).

### F. Standby Letters Of Credit

The basis of a Standby Letter of Credit is that it may be drawn on by the Beneficiary when the Applicant (Buyer) has failed to perform in accordance with the underlying contract between the Applicant and Beneficiary. In simple terms,a Standby Letter of Credit is "standing by"to protect the Beneficiary in case the Applicant defaults on an agreed-upon contract. Standby Letters of Credit are either governed by the Uniforms Customs and Practice for Documentary Credit (UCP) or the International Standby Practice (ISP) rules.

## 2.4 Principles of Letters of Credit

Letters of credit are based on two principles: autonomy, and doctrine of strict compliance.

**1.Autonomy of the Letter of Credit -** According to this principle, the letter of credit is disassociated from the actual sales and other contracts and, thus, is not affected by any problems and disputes related to the contracts or dissatisfaction between the exporter and buyer. The main and only agreement that is arranged between the exporter and the bank is the letter of credit. Under a letter of credit, the bank is only concerned with one problem: to check whether the documents presented by the buyer comply with those specified in the letter of credit. Because of the autonomy of a letter of credit, the buyer's bank is therefore absolutely bound to honor the letter of credit by paying the exporter upon presentation of proper documents, notwithstanding any dissatisfaction from the buyer in relation to the sales contract or any dispute between the buyer and seller. The buyer's protest about the export cannot suspend payment of the letter of credit. This was the case with one exporter's bank. It successfully sued a buyer's bank for dishonoring drafts against a letter of credit because of complaints about the quality of the exported goods. The only case where a bank may refuse payment is in case of fraud or forgery in the transaction, referred to as "fraud exception". (Articles 3 and 4 of UCP 500 refer to the principle of autonomy of the letter of credit).

Article 4 UCP 600 defines the autonomy principle as follows *a credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honor, to negotiate or to fulfill any other obligation under the credit is not subject to claims or defenses by the applicant resulting from its relationships with the issuing bank or the beneficiary* (Leon, 2012).

**2**. **Doctrine of Strict Compliance** - According to this principle**,** the exporter must respect the written terms of the letter of credit. If any discrepancy or inconstancy occurs between the documents presented by the exporter and what is actually specified in the letter of credit, the bank can refuse payment. Therefore, with a letter of credit, the buyer has the protection of the bank strictly controlling the documents, and the seller has the protection of getting paid if all documents comply with the letter of credit. But the problem is how strict compliance should be. Some courts insist upon literal compliance, so that a misspelled name or typographical errors may be a divergence to refuse payment. Others accept payment upon substantial compliance with documentary requirements. However, one should keep in mind that the bank may insist on strict compliance with all the requirements of the letter of credit, and therefore the beneficiary must be able to provide prompt documentation. As the seller has very limited defense to protect himself, he should check with his bank whenever he has any doubts in interpreting unclear items in the letter of credit.

- **Formation place**: Generally, a contract is concluded where acceptance of an offer becomes effective, but since national laws have different approaches to determine such a place, different places can be nominated as the place of formation of the contract depending on the rules of the applicable national law.
- **Place of payment**: the place of the payment is deemed to have a strong connection in determining the governing law of the contract. In a L/C, payments are made differently in the course of the transaction, e.g. by correspondent bank or the issuing bank.
- **Language and currency**: the language and currency used in the contract are important factors which indicate the choice of law in certain situations.

Atefe etal., (2016) described the Commercial and Standby Letters of Credit as CLCs have been used for centuries to facilitate payment in international trade. It is a contractual agreement between banks, known as the issuing bank, on behalf of one of its customers, authorizing another bank, known as the advising or confirming bank, to make payment to the beneficiary. The issuing bank, on the request of its customer, opens the letter of credit. The issuing bank makes a commitment to honor drawings made under the credit. The beneficiary is normally the provider of goods and/or services. Essentially, the issuing bank replaces the bank's customer as the payer. Majority of CLCs are issued subject to Uniform Customs and Practice for Documentary Credits (UCP). SLC has a different function than the CLC. A bank will issue a SLC on behalf of a customer to provide assurances of his ability to perform under the terms of a contract between the beneficiaries.

A commercial letter of credit is a legal document from a bank or a financial institution, it represents a promise to pay the holder if the holder fulfills his obligation. Sellers in international transactions often require a guarantee of payment. This guarantee comes from the bank in the form of a letter of credit. If the buyer fails to make payment against his purchases, the bank will cover the full or remaining amount of purchase.The basis of a Standby Letter of Credit is that it may be drawn on by the Beneficiary when the Applicant (Buyer) has failed to perform in accordance with the underlying contract between the Applicant and Beneficiary. In simple terms, a Standby Letter of

Credit is "standing by" to protect the Beneficiary in case the Applicant defaults on an agreed-upon contract. Standby Letters of Credit are either governed by the Uniforms Customs and Practice for Documentary Credit (UCP) or the International Standby Practice (ISP) rules.

## 2.5 Operations of a Letter of Credit Transaction

According to the "Uniform Customs and Practice for Documentary Credits" (UCP), which are the most acknowledged set of rules and adopted in virtually every letter of credit. It fundamentally operates on at least three parties: the seller, who is also referred to as the exporter or beneficiary; the buyer, who is also referred to as the importer or applicant; and the issuing bank, which issues the letter of credit either at the request of the applicant or on its own behalf. Further the letter of credit consists of at least three different autonomous contracts: First, the underlying contract (e.g., the purchase contract) under which the seller agrees to sell the goods to the buyer and the buyer agrees to pay the seller the purchase price. Secondly, a contract between the buyer and the issuing bank under which the issuing bank agrees to issue the letter of credit for the benefit of the seller and the buyer agrees to reimburse the issuing bank for the payment made under the letter of credit plus a commission. Thirdly, the issuing banks undertaking towards the beneficiary under whom the issuing bank agrees to honor the beneficiary's draft provided it is accompanied by the required documents specified in the letter of credit (Baker B., 2003).

Baker (2003) properly opposed as in its international trade practice as the beneficiary generally does not deal directly with the issuing bank. The issuing bank regularly arranges for a bank in the beneficiary's country to advice the credit, i.e., to check the authenticity of the credit and hereafter deliver it to the beneficiary. The issuing bank in addition or alternatively may ask another bank in the beneficiary's country to make the credit available upon the presentation of complying documents.

Zhou (2002) included as the bank that advises the letter of credit to the beneficiary is referred to as the "advising bank" and the bank to which the beneficiary is to present the complying documents is referred to as the "nominated bank". The advising bank acts as an agent of the issuing bank. It advises the credit at the request of the issuing bank without any undertaking to honor the credit. The advising bank signifies that it has satisfied itself as to the apparent authenticity of the credit and that the advice accurately reflects the terms and conditions of the credit. The advising bank may offer payment to the beneficiary in addition to and independent of its advising obligation towards the issuing bank, to transmit the terms of the letter of credit to the beneficiary. Though, unless the advising bank issues its own confirmation to a letter of credit, it does not become a party to the letter of credit and is therefore not obligated to honor the promise of payment it includes. The advising bank can also take on the function of the nominated bank.

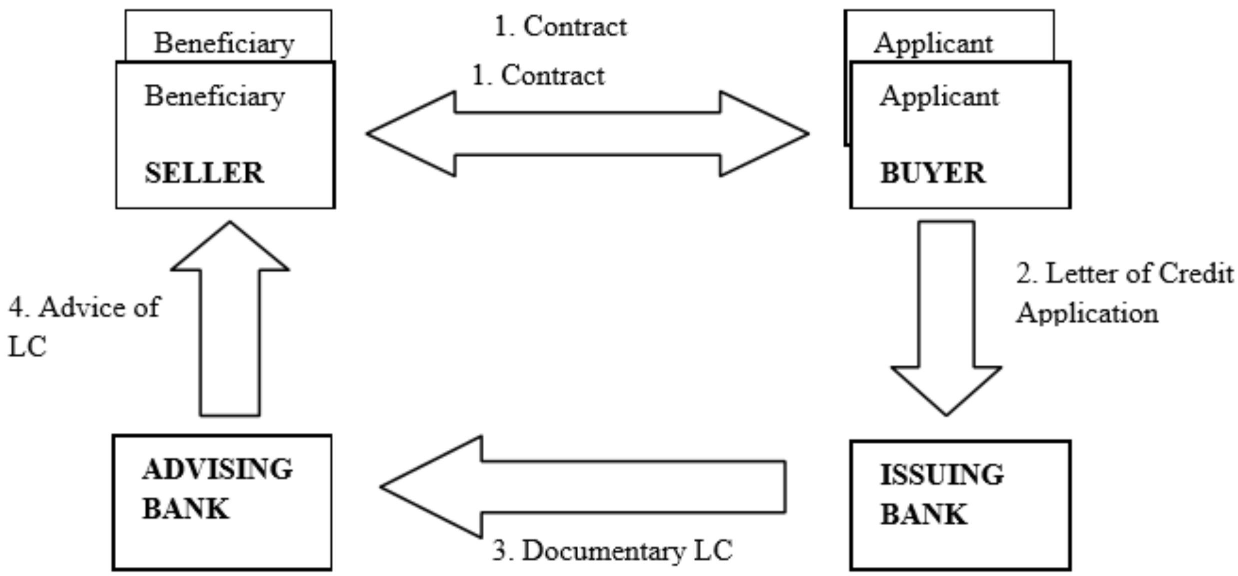


**Figure 2.1 Letter of Credit Cycle**

## 2.6 Empirical Studies related to Letter of Credit

Atefe etal. (2016) sought to investigate which kind of guarantee (commercial L/C or standby L/C) they prefer to secure the performance of their client's obligations. Studied companies were 20 international trading companies in Tehran, from which 50 experts participated in survey study. For measuring the participants and their policy in using letters of credit, a questionnaire in Persian was designed. They formulated their hypotheses as following:

- Hypothesis 1: Being a guaranteed credit can affect the preference of international trading companies in using letters of credit.

-  Hypothesis 2: Integration between CLC and SLC has a relationship with the preference of international trading companies in using letters of credit.
-  Hypothesis 3: Documentary condition is an effective factor in using letters of credit by international trading companies in Iran.
-  Hypothesis 4: Being a secondary payment tool affects the preference of International trading companies in Iran.

For analyzing data, they used statistical tests (One-sample t-test). Data showed that being a guarantee; integration, documentary conditions, and secondary payment mechanism are four important reasons for international trading companies in Iran to use letters of credit in their contracts. A statistical result showed that "being a guaranteed credit" is the most important factor with a mean of $3.660 \pm 1.135$. As well, they found significant relationship between these four factors and the L/C usage policy ($p < 0.01$, and $p < 0.05$). They concluded that they mostly prefer standby letters of credit for securing their transactions.

Basically, letters of credit are the instrument of both export and import business in that one party may request a letter of credit for a transaction involving goods or services when the other party is on the other side of the world. Sometimes called ―trade credit, the key facilitation of the export and import transaction is that the seller must ship the goods and present the documents to the bank as required by the rules and regulations of letters of credit, guaranteeing that the seller will get paid (Zodl, 2001). As indicated by Zodl, letters of credit are the most important instrument in international trade. It is the preferred form of payment because it protects both seller and buyer while they are engaged in the import and export business. In this transaction, the bank acts as a middleman to enforce the rules of the Uniform Customs and Practice 600 to both the exporter and the importer. Both must operate their business according to the 39 articles "Assignment of Proceeds" of the Uniform Customs and Practice. Neipert suggested that the letter of credit is popular because international trade transactions are complicated by the seller's trepidations regarding the difficulty of collecting funds from a foreign buyer (Neipert, 2000).

According to Zodl, the buyer will reject the payment if there is any discrepancy in the documents (Zodl, 2002, p. 62). Czinkota stated a firm must deal with numerous forms and documents when exporting to ensure that all goods meet local and foreign laws and regulations. He recommended that to ensure that all documentation required is accurately completed and to minimize potential problems, firms just entering the international market should consider using freight forwarders who specialize in handling exportation documents (Czinkota, 2004). On other hand, Daniel J. and Radebaugh, (2004) explored the problem of exporting in terms of documentary discrepancy. It was indicated that exporters often become discouraged or frustrated with the exporting process because they encounter problems, delays, and pitfalls. Based on the Uniform Customs and Practice 600 Article 14 "Discrepant document & Notice".Daniels and Ruggiero (2004) stated discrepancies in bills of exchange (draft), commercial invoices, insurance documents, and transport documents that caused problems in collection of payments for exporters. Practically, the exporter must present the documents required by the terms and conditions of the letter of credit without any discrepancies, otherwise the exporter will not get paid. Guillermo Jimenez of the International Chamber of Commerce, an expert on international commercial practices, confirmed that the bank issues a documentary credit in favor of the exporter under which the bank agrees to pay the beneficiary, provided that the beneficiary presents documents that conform to the terms and conditions of the credit. Practically, the exporter must present the documents required by the terms and conditions of the letter of credit without any discrepancies, otherwise the exporter will not get paid. Discrepancies are documents or parts of documents that do not exactly conform to terms and conditions of letters of credit.

Moon conducted a research and found that the international institutions designed to facilitate trade. His research confirmed international trade is likely to be very successful without national trade policy (Moon, 2000). Weiss found that there are a lot of restrictions on the international trade rules in exporting to foreign country (Weiss, 2002). Nelson also suggested exporters should check if their products are complying with the government rules and regulations, otherwise, the exporters will face major problems (Nelson, 2000).

DC Insight cited Del Busto and stated that the Uniform Customs and Practice is not binding law, but applies because banks voluntarily incorporate the Uniform Customs and Practice into the contracts upon which the letter of credit is based. His study confirmed the legal status of the Uniform Customs and Practice affects the international banking community and importing and exporting community worldwide. The Uniform Customs and Practice has achieved such universal effect that in some countries the Uniform Customs and Practice is recognized as having the force of law or at least that of a trade tradition or custom (DC Insight, 2005).

Fung remarked that it was not easy to understand the context of each article. As a result, the courts were often asked to interpret certain provisions from the banking commission of the International Chamber of Commerce. These interpretations and opinions are collected and published by the International Chamber of Commerce every few years (Fung, 2004). Despite these benefits, difficulty in interpretation of contextual meaning of each article in the Uniform Customs and Practice 600 often increases the risk of nonpayment for exporters. When exporters sell their goods, they expect payments. It is very important for exporters to select the proper payment in international trade.

Sut Sakchutchawan (2009) addressed the phenomenon of document discrepancies in international trade financing as a significant worldwide issue resulting in unnecessary delays, refused payments, and financial loss when banks discover discrepancies in required trade finance documents presented under the International Chamber of Commerce trade rules known as Uniform Customs and Practice. While this problem has grown in the past thirty years, no research has been undertaken to address this problem. Drawing on e-research, documentary survey, and descriptive research methodologies, the findings reveal that the unusual requirements of documentary credit and the ambiguity of the Uniform Customs and Practice 600 caused discrepancies when the required documents examined by the banks. To solve these problems, this article recommended changes include elimination of unusual requirements of documentary credit and concise articulation of the context of each article to facilitate easy understanding of contractual terms. Additionally, the personnel involved in the process must be trained to ensure they have the required skills to properly manage relevant documents for international trade financing. More companies are also looking for sources of supply to buy products. They do this to reduce their cost. International trade or business comprises a large and growing portion of the world's total business. Today, almost all companies-large or small-are affected by global trade and international competition. Additionally, many exporters have run into various problems. Common problems are a failure to present proper trade documents for payment, a failure to produce goods and services offering to the needs of foreign countries, and a failure in collecting payment and financing.

## Independent Variables

- Formation place: Generally, a contract is concluded where acceptance of an offer becomes effective, but since national laws have different approaches to determine such a place, different places can be nominated as the place of formation of the contract depending on the rules of the applicable national law.

  A commercial letter of credit is a contractual agreement between a bank, known as the issuing bank, on behalf of one of its customers, authorizing another bank, known as the advising or confirming bank, to make payment to the beneficiary. The issuing bank, on the request of its customer, opens the letter of credit. The issuing bank makes a commitment to honor drawings made under the credit. The beneficiary is normally the provider of goods and/or services. Essentially, the issuing bank replaces the bank's customer as the payee.

## Relationships Involved In A Letter Of Credit Transaction

The first one; is the contractual Relationship between the seller and the buyer, which is the underlying contract of sale. The second one: This is the contractual relationship between the applicant (normally the buyer) and the bank (the issuing bank). The third contractual relationship; the issuing bank relation with the correspondent bank usually an issuing bank employs an intermediary bank to fulfill its obligation towards the applicant. The fourth contractual relationship: this is the contractual relationship between the issuing bank and the beneficiary which represents the letter of credit. However the contract under focus here is the contract between the applicant and the issuing bank, that it contains the conditions to which the bank has to adhere strictly in honoring the credit.

## The Contract Between The Buyer (Applicant) And The Issuing Bank

According to the contract of sale, the applicant has to request his own bank (the issuing bank) to open a letter of credit in favour of the beneficiary. The issuing bank must follow the instructions given by the applicant. Those instructions must be clear, precise, and unambiguous. When he does not give clear instructions, the issuing bank has to refer back to the applicant for further instructions and clarification. The banks duty is to comply with the applicant’s instruction strictly. Furthermore, the issuing bank must also follow the instruction; when he is in the acceptance or rejection of the documents. So he has to check the documents which tendered by the beneficiary for payment, with reasonable care to ascertain that it comply with the terms and conditions of the credit. According to the UCP 600 article 14(b) "*the examination must be conducted within a reasonable time with a maximum of five banking days following the receipt of the documents*." So the issuing bank fails to follow the instructions with reasonable care, he is in a position of breach of the contract with the applicant.

On the other hand, the applicant's main duty is to reimburse to the issuing bank the amount which the bank has already paid to the beneficiary under the letter of credit. However, the right to reimbursement is not accurate. The bank's duty is only not to open the credit and also operate and complete it. If the bank failed to comply with it, he would be lost the right to reimbursement.

Moreover, the issuing bank can benefit from exempting clauses, which exempt the issuing bank from liability for matters arising to his out of control. Such as by act of god, wars, riots or any other causes. In addition, the issuing bank's duty is not to check the condition of the goods. He has to deal with documents. Important thing is to constitute a good tender of documents. If the documents are faulty, the bank cannot claim to reimbursement.

## The Contract Between The Issuing Bank And The Correspondent Bank

The other stage of the letter of credit is the contract between the issuing bank and the correspondent bank. The issuing bank instructs the corresponding bank where is employed from the beneficiary' country. The corresponding bank role has been given by the issuing bank and has to follow his instruction under the letter of credit.when the correspondent bank has received unclear instruction, he has to give primary notification to the beneficiary for information only and without responsibility. After that the correspondent bank must request to necessary information from the issuing bank. The credit will be acted only when clear instruction have been received.

According to the role of the correspondent bank given by the issuing bank, he has to work as an advising or confirming bank. If the issuing bank instructs the correspondent bank to confirm the credit, the correspondent bank is then known as the confirming bank. The confirming bank has to add his undertaking to honour the credit. On the other hand, when the correspondent bank has not added his undertaking to honour the credit, he is known as the advising bank. His role is only to accept the tendered documents and to make payment against these documents.

The difference between the advising bank and the confirming bank is that, the former works as an agent of the issuing bank, but the latter assumes the role of the principle. In addition to this that there are three different situation for the confirming bank; First one is that, when the confirming bank makes a payment to the beneficiary against to the confirming documents, he has a right to be reimbursement. However, the issuing bank fails to reimburse to the confirming bank, the former could be liable to the latter in damages between the amounts paid to the beneficiary and the amounts recovered on the sale of the goods act.

Second one is that, according to the Mance J "if the confirming bank pays on a late presentation of documents where time had not been properly extended under article 29(a) UCP 600 or by agreement, the issuing bank could clearly recover any money paid to the confirming bank as money paid under a mistake of fact.The last one is that, when the confirming bank has accepted a nonconforming documents as a result of mistake, they can take an action against the beneficiary.

## The Contract Between Issuing Bank And Seller

According to the underlying contract, the applicant has to inform the issuing bank to open a letter of credit. After that, the issuing banks' duty is to notice the beneficiary that the credit has been opened. Having received to notice, the beneficiary can obtain a payment when he tendered the documents in which must comply with the terms and conditions of the letter of credit. The credit can be either revocable or irrevocable credits. It should be stated in the contract whether revocable or irrevocable. If there was no indication a type of the credit, it presumed to be irrevocable credit.

In the case of revocable credit, the issuing bank can cancel the credit at any time and without given notice the beneficiary. On the other hand, an irrevocable credit has not been cancelled without given prior notice the beneficiary. Moreover, opening an irrevocable credit makes the contract independent between the issuing bank and the beneficiary. According to Rowlatt J."An irrevocable credit is not qualified by or subject to the terms of the contract of sale made between the buyer and the seller.

As regards to the principle of autonomy, those contracts are separate from each other. In any event a dispute between the seller and the buyer will not affect the contracts which have been made under the commercial transaction. The only exception to this rule occurs in the case of fraud. When the credit is procured by the beneficiary, the bank has a right to refuse payment. However, the fraud must be properly proved and not to be merely alleged. According to Sir John Donaldson MR said “but the evidence must be clear, both as to the fact of fraud and as to the bank's knowledge…” On the other hand, the fraud did not properly proved or it was not committed by the beneficiary, the issuing bank has to pay against confirming documents, because, in this case, the beneficiary was deemed to be innocent.

Furthermore, if the issuing bank refuses the documents as a result of the non-conformity with instructions, the issuing bank must give notice to the beneficiary without delay and no later than seventh banking days. However, the issuing banks’ decision was made wrongly about refusing the documents; the beneficiary could bring action against the bank for the value of the credit together with interest. When the beneficiary has received payment which is an indefensible delay, the bank is responsible for the loss or damage that has happened to the beneficiary as a result of the delay payment.

## The Contract Between The Confirming Bank And The Seller

Relationship between the correspondent bank and the beneficiary depends on the role of the former, which has been given to him by the issuing bank. As I mentioned before, when the correspondent bank is performed as a confirming bank, his duty is similar to the position of the issuing bank. He promises to make a payment to the beneficiary. According to Jenkins LJ, “the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as to whether the goods are up to contract or not…” In this situation, the beneficiary can by no means look at the bank for payment and he can in no circumstances look to the applicant.

On the other hand, the advising bank cannot be a party to the contractual relationship, because he does not confirm the credit. In addition, the confirming bank can accept the documents under the reserve. The documents could be tendered by faulty. On this basis, the problem only arises between the beneficiary and the confirming bank, because such a contract between the confirming bank and the beneficiary is independent. So the beneficiary would be bound to repay the amount on demand, if the faulty documents were rejected by the issuing bank or the applicant.

- Place of payment: the place of the payment is deemed to have a strong connection in determining the governing law of the contract. In a L/C, payments are made differently in the course of the transaction, e.g. by correspondent bank or the issuing bank.

A relationship between the beneficiary (seller) and the issuing bank; another relationship between the beneficiary and the applicant (buyer); and the last is between the buyer and the issuing bank.The first relationship is the LC engagement; whereas the second and the third are, respectively called as underlying contract and application agreement or cover relationship.

Under this arrangement the buyer applies for opening a LC which is to be issued in favour of the seller. The issuing bank approving the payment obligation opens a LC in favour of the seller. This is the basic mechanism of LC. However, oftentimes, the seller cannot rely on the buyer's bank (issuing bank) which is situated in the Buyer's jurisdiction. In such a case, the issuing bank requests a bank at or near the seller's business place to advise or notify the credit. The second bank is called advising bank. Here the relationship between the issuing bank and advising bank is that of principal and agent.Alternatively, the seller, who wants commitment of payment by a bank he or she knows, may arrange another bank in his or her jurisdiction. The confirming bank (seller's bank) on the assurance of reimbursement by the issuing bank undertakes to pay, accept or negotiate the seller's draft. 'The act of confirmation binds the confirming bank to the beneficiary without reducing the liability of the opening bank [issuing bank].That means in case of confirmed letter of credit the seller has rights against both the issuing bank and confirming bank.

The principle that the parties to a LC are concerned only with the documents is another important principle, which is deemed to be backed behind the success of the commercial instrument. In essence, the parties (specially the Banks) are concerned only with the documents and they do not need to see whether the goods shipped are in the right condition, quality, or not.In this regard the provision of UCP is clearer that 'banks deal with documents, and not with goods, services or other performance to which the documents may relate.'Apart from this principles there is another principle called 'strict compliance'.

By virtue of article 7 of the UCP 600 which states;

'*Provided that the stipulated documents are presented to the nominated bank or to the issuing bank and that they constitute a complying presentation, the issuing bank must honor. (…)*

The duty of an issuing bank upon receiving compliant documents is to honor the credit immediately. But Since the basic purpose of the principle of strict compliance is to confirm confidence in handling and maintaining the smooth flaw of business in order to achieve the desires and goals of the parties in practice we find cases in which the issuing bank is deprived from making payment under the credit, despite the fact that the documents are conforming. And there are other cases in which the bank is forced or allowed to make payment despite the fact that the documents are not conforming.

## Exceptions to the Principle of Strict Compliance:

**First**: Sometimes the beneficiary may provide documents with a defect or mistake which does not materially affect the underlying contract of sale, in such case the bank is forced to reject the documents, because if it accepted them, it will have no right to reimbursement, while the seller is sure that the buyer will not reject these documents, in this case the beneficiary asks the bank to accept the documents against an indemnity that covers the amount of the credit.

**Second**: If the time allows the bank to send the discrepant documents to the buyer, if the buyer approved the documents, then the bank is authorized to pay to the beneficiary.

**Third**: Sometimes the credit contract includes a provision known as, "deemed compliance agreement", states that; if the issuing bank made payment based on non complying documents, these documents are considered complying documents, accordingly the bank maintains its right in reimbursement, as long as the bank thought in a good faith that they are complying, and it has examined them with care and diligence.

**Fourth**: Article 16 of UCP600 explains how the bank should handle discrepant documents, also it states detailed requirements for rejection notice, for which the bank has to follow, if the issuing bank fails to act in accordance with the provision of this article, it shall be precluded from claiming that the documents do not constitute a complying presentation.

## Correspondent Bank

In LCs transactions,the correspondent bank is referred to by different names depending on the function it will perform under each specific transaction. These different names and the relative circumstances surrounding them are:

1. **Advising bank:** This name is given to the correspondent bank if it is acting merely as an advising bank, that is, it resembles a post office by delivering the LC instrument to the beneficiary and dispatching the documents received from it to the issuer. As such, the credit is available with the issuer who would honour the presentation value upon examining the documents and ensure that it is compliant,afterwards, it affects payment to the beneficiary.
2. **Paying bank:** If the correspondent bank is nominated by the issuer to pay the value of a credit available by sight payment or deferred payment and such nominated bank accepted the nomination per the provisions of Rule 2.04 of the ISP98.The bank paying upon receipt of documents, will check them and if these are found to be conforming to the credit stipulations, that is, do not contain any discrepancies, the paying bank will pay the beneficiary directly – either at sight or at a future deferred date – the value of the documents (less fees and charges if these are for the beneficiary's account or the full value of the documents if these are for an applicant account). Afterwards, the paying bank will claim reimbursement from a third reimbursing bank assigned by the issuer or directly from the issuer itself.
3. **Accepting bank:** When the correspondent bank is nominated by the issuer to pay the value of the credit available by acceptance (i.e., a draft must be presented with the documents), and the nominated bank has accepted its nomination per the Rule 2.04 of the ISP98, it will be referred to by the Accepting Bank.
4. **Negotiating bank:** If the correspondent bank is nominated by the issuer to negotiate the value of the credit available by Negotiation (see Rule 2.01, Section 3.1), and the negotiating bank accepted to act as such, then it will be referred to by the negotiating bank. In certain countries, a negotiating bank is also used to describe the bank that merely handles the documents without any responsibility on its part, hence, it can be said that the term negotiation could have two meanings; as such, it is essential to distinguish the term by correlating it with the responsibilities of the correspondent bank.

5. Confirming bank: If the issuer requested the correspondent bank to add its confirmation to the credit and the correspondent bank agreed to confirm the credit,then it will be called the Confirming Bank. The responsibilities of the confirming bank are consistent with the issuer's undertaking.

The correspondent bank role is the bank with which the issuer holds an agency arrangement under which both banks agree to provide services within the scope of the agreement, for example remittances, LCs guarantees … etc. and within specific limits set by both banks for each other. The correspondent bank is automatically chosen by the issuer to perform the functions under LCs. Nevertheless, the applicant may choose a bank other than the issuer's correspondent to handle the credit transaction and it may instruct the issuer to make the credit available with, confirmed or even advised by this third bank with which the issuer has no relationship whatsoever. Here the issuer may accept to route the credit through the third bank or it may elect not to do so depending on a host of factors amongst which are the credibility of the bank, its financial standing, its reputation, country risks and the volume of the transaction at hand. Hence, it is imperative to have the approval of the issuer to use a bank chosen by the applicant for the purpose of a standby letter of credit.

-  Language and currency: the language and currency used in the contract are important factors which indicate the choice of law in certain situations.

Currency of the contract is an important consideration when entering into an agreement with a business in a foreign country with a different financial system. Because issuing and receiving payments in another currency carries risk, it is often a key point in negotiation of this type of contract.

## Exchange rate risk

No matter what kind of letter of credit (insight letter of credit or deferred letter of credit), there is a time distance from issuing a letter of credit to the actual payment for importers. This long time distance may cause a big fluctuation of the exchange rate. Under the terms of the insight letter of credit, there is a time distance from the credit issuing date to consignment, and arrival of documents in the issuing bank. Then also the time for documents examination should be placed. If under the term of deferred letter of credit, the time distance will add the time from acceptant date to expiry date.

In international trade, the longer the time lasts, the more exchange rate risks exist. Once the exchange rate of paying currency increases, the importer has to pay more than the anticipative amount. There is an adage that “exchange rate is more ferocious than tiger”, which describes the big risk caused by exchange rate.

## Bank risk

Schmidt-Eisenlohr (2013) noted that some issuing banks are not standard enough to issue letters of credit, considering their nature and financial positions.They are more domestically oriented or operating with few branches.Therefore,exporters can only minimize risks by obtaining letters of credit from reputable banks that are unlikely to fail in their obligations (Hummels & Schaur,2013). According to Youssef(1998), banks have different financial ability and market strength.In essence, a letter of credit issued by a reputable bank is likely to provide more payment guarantee. It is therefore important for the exporter to set criteria for assessing a bank to trade with. This involves the habit of rejecting documents, history of payment delay and domicile in politically volatile countries that may affect foreign exchange(Yan & Xiao,2013).

Documents issued by the beneficiary of the letter of credit should be issued in the language of the credit. If the letter of credit allows for documents to be issued in two or more languages, the nominated bank has the right when advising the credit to limit the number of acceptable languages as a condition of either its engagement in the credit or its confirmation of the credit.

- Documentary condition - the phenomenon of document free from discrepancies in international trade financing as a significant worldwide issue resulting in unnecessary delays, refused payments, and financial loss when banks discover discrepancies in required trade finance documents presented under the International Chamber of Commerce trade rules known as Uniform Customs and Practice.

If a nominated bank acting on its nomination, a confirming bank or the issuing bank determines that a presentation does not comply with the credit, it may refuse to honour or negotiate. Again, when an issuing bank determines that a presentation does not comply, it may in its sole judgment approach the applicant for a waiver of the discrepancies. This option gives the purchaser an opportunity to waive discrepancies, thus promoting efficiency in a field where as many as half of the demands for payment under letters of credit are discrepant (Dole, 2006).

The second option for the bank in case of a discrepant presentation is to refuse to honour or negotiate. This would also be the course of action in case the applicant would communicate a refusal to waive the discrepancies, or if the issuer would decide not to waive even if the applicant would. Article 16(c) of the UCP 600 sets out the requirements regarding the contents of the rejection notice. Firstly, the notice must state that the bank is refusing to honour or negotiate. Secondly, it must specify each of the discrepancies in respect of which the bank has made the decision to reject. The bank must list literally "all" discrepancies, failing which it will not have a second chance to supplement or amend the relevant notice. The bank which does not state all the discrepancies upon which it subsequently seeks to rely, has failed to act in accordance with the Article 16(c) (ii) of the UCP 600 and is therefore precluded from later raising those extra discrepancies as grounds for rejection. Courts over the years in International Trade Practice have treated the rejection procedure prescribed by the UCP rules with the same degree of rigidity as the strict documentary compliance doctrine (Ellinger, 2006). Notices which do not manifest a clear intention to reject have been treated as faulty.

## Dependent Variables –Letter of Credit Effectiveness

Effectiveness is the ability of an organization to account successfully for its output and operations to its various internal and external constituencies. Effectiveness can also be defined as the achievement of goals and objectives of an activity through the factor measures provided (Ditternhofer, 2001). On other hand, managerial effectiveness as emphasized by many writers like Meharg (2009) and Bhardwaji &Punia (2013), is the achievement of a set goal of an organization. Perception is an important aspect of human behavior. Leaders and managers being human beings can significantly be influenced by their perception about leadership and managerial issues such as managerial effectiveness.

Effectiveness is also used against efficiency. Efficiency means the resources that are consumed for producing goods or delivering services. Another meaning of efficiency is that associated with performing activities as well as possible or “doing things right”. But sometimes efficiency doesn’t result in success. It may be possible that organizations present high efficiency but couldn’t achieve their objectives. Effectiveness can also be concerned with planning and controlling the three key variables associated with projects which are time, cost, and quality. They are interrelated; a change in any single variable frequently has a significant impact on the others (Daft, 2003).

Trade finance is considered critical to lowering trade frictions, and 80 to 90 percent of trade transactions involve some form of trade finance, whether as trade credit, insurance, or guarantees (Auboin 2009). The wide array of financial arrangements and instruments can be divided according to purpose in either securing and facilitating a trade transaction or in using a transaction as collateral to access credit. As securing a trade transaction, when formalizing a purchase order, the buyer and seller utilize a bank or another trade finance entity as a third party in either serving as a basic financial intermediary or as a guarantor of payment. The former refers to an “open account” setup, while the latter refers to an arrangement involving “letters of credit” (L/Cs). Letters of Guarantee serve to cap potential losses in the case of non-performance from either party. Furthermore, credit insurance can be purchased to protect against a variety of transportation, exchange rate, and political risks (Hurtrez and Salvadori 2010).Fundamentally, letters of credit are the instrument of both export and import business in that one party may request a letter of credit for a transaction involving goods or services when the other party is on the other side of the world.

- The key facilitation of the export and import transaction is that the seller must ship the goods and present the documents to the bank as required by the rules and regulations of letters of credit, guaranteeing that the seller will get paid
- As instruments in international trade, letters of credit protect both seller and buyer while they are engaged in the import and export business. In this transaction, the bank acts as a middleman to enforce the rules of the Uniform Customs and Practice 600 to both the exporter and the importer.

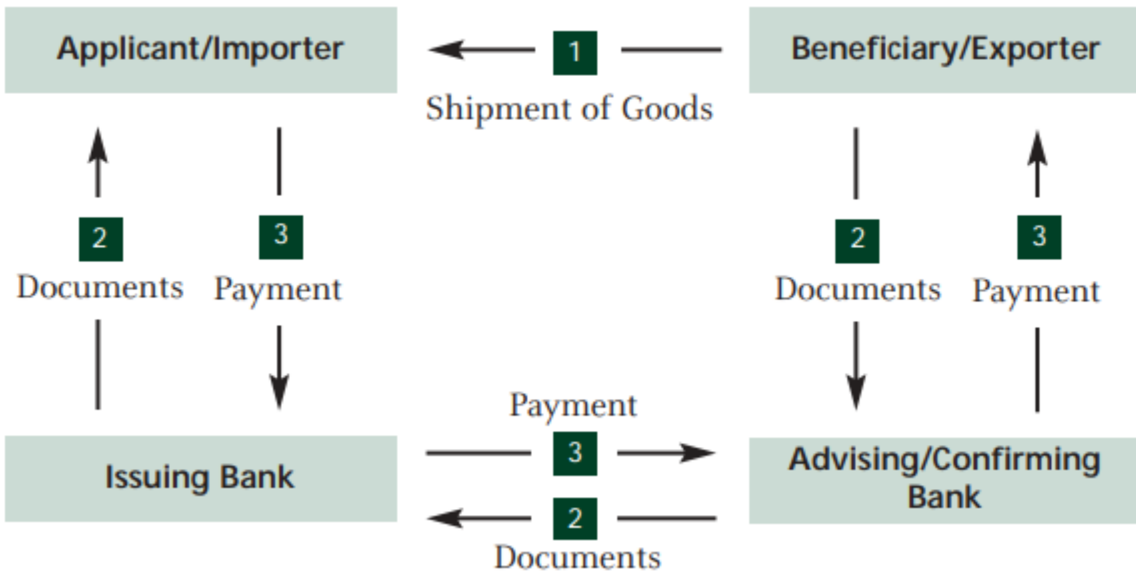


**Figure 2.2 Payment Under Letter Of Credit**

## 2.7 Conceptual Framework

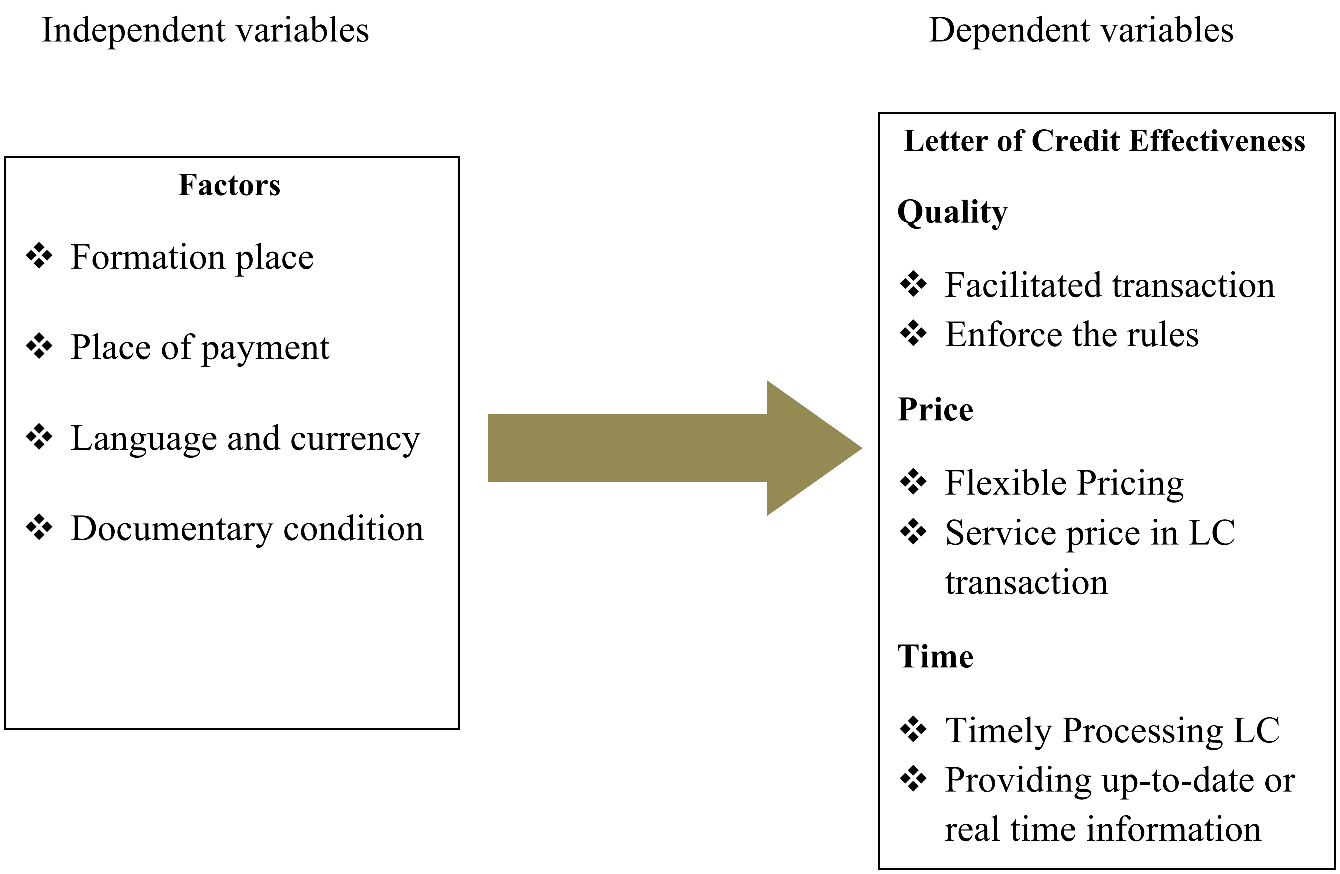


**Figure 2.3 Conceptual framework (Sakchutchawan,2009)**

# Chapter Three - Research Methodology

## 3.1 Introduction

This chapter presents details of the research design and methodology of this study. This includes the research design, sample size and sampling technique, data source and collection method questionnaire and validity and reliability test. It also includes the method of data analysis with model formulation.

## 3.2 Research Approach

Qualitative research is less formalized than quantitative research. Central in qualitative research is to reach a deeper and more complete understanding of the data collected and the problem studied. Several variables are investigated from a few numbers of entities (John, 2007). As a qualitative approach, this study tried to gain a deeper understanding and knowledge of letter of credit and its effect on international trade success.

Quantitative research is formalized and structured. It treats the research problem in a broad perspective and aims to make generalizations. The results from quantitative research are assumed to be measurable and presentable in figures. Quantitative research is very much controlled by the researcher and statistical methods have a central role in the analysis of quantitative information. In a quantitative approach, few variables are studied but on a large number of entities (Cresswell, 2009). Thus, as a quantitative approach, this study empirically investigated or tested the letter of credit effectiveness by employing statisticaltests. It also tested the relationship between effective factors that facilitate effect on international trade achievement. In general, this research used both qualitative and quantitative research and can be said that it will employ a mixed research approach.

## 3.3 Research Design

The purpose of academic research can be exploratory, descriptive, or explanatory. Exploratory studies aim for basic knowledge within the problem area. Descriptive research is appropriate when a problem is clearly structured but the intention is not to conduct research about connections between causes and symptoms. Explanatory research is useful for studying relations between causes and symptoms (Creswell, 2009). Thus, this study properly found out the problem related to formation place, place of payment, language and currency and documentary condition on international trading payment process. As explanatory research, this study examined the relations between causes and symptoms of letter of credit effectiveness. Accordingly, this study employed descriptive and explanatory research design.

## 3.4 Population

Branch managers, Business Development Managers,Relationship Officers & Trade Service staff of AIB East Region are participants in this study. The researcher took preliminary survey data about the staff who aredirectly involved in LC processing and import and export trade operation. Active participants in the LC management operation were 35 employees.

## 3.5 Data Source

To conduct this study, both primary and secondary sources of data were used.

### 3.5.1 Primary Data Source

Primary data were collected through interviews and questionnaires from trade services and international banking department of AIB East Region and managers.The questionnaire consisted of both open and closed ended questions.

### 3.5.2 Secondary Data Source

Secondary sources of data will be collected from LC directives and procedures of national banks, AIB'S specific manuals and procedures, import and export transaction files and database. The operational directive of the letter of credit of AIB were referred to and checked for more detailed information. This study exhaustively referred to international commercial banks practices and International Chamber of Commerce directives.

## 3.6 Data Collection Method

In this study, quantitative data were collected by a questionnaire and each question prepared based on the literature review on the research objective.In addition, this study will be used in interviews to collect qualitative data relevant for the purpose of the study. In order to get a true representation of data structured interviews have been conducted. To effect this, a checklist will be prepared that will contain informative questions that are focused on the problem that will be associated with letter of credit effectiveness. As qualitative data, it focused on understanding in-depth on the existing international trade and payment practices. In this regard, a face-to-face interview will be conducted.

## 3.7 Data Analysis

The data which were collected from questionnaires were coded on the Statistical Package Social science (SPSS) program. This technique were selected because it helps to summarize the sample, provides and allows describing the characteristics of the data collected and it helps to thoroughly analyze and interpret the questions one by one in order to reach meaningful results. Frequency, percentage, mean, standard deviation and graphic representation will be applied on the descriptive data analysis part. Furthermore, by using correlation analysis the interdependence between the independent and dependent variables were tested. Finally, a hypothesis test will be performed using regression analysis.

## Model specification

The statistical regression model of the study based on the theoretical regression model as indicated follows:

**Y=a+b1x1+b2x2+b3x3+b4-x4+e**

Where:

- **Y**- Letter of Credit Effectiveness

- **a**- The y intercepts.

- **x1**- Formation place

- **b1**- The regression coefficient of Formation place

- **x2**- Place of payment

- **b2**- the regression coefficient of Place of payment

- **x3**- Language and currency

- **b3**- the regression coefficient of Language and currency

- **x4**- Documentary condition

- **b4**- the regression coefficient of Documentary condition

- **e**- error term.

## 3.8 Reliability

This study used Chronbach's alpha to assess the internal consistency of variables in the research instrument. Chronbach's alpha is a coefficient of reliability used to measure the internal consistency of the scale. According to ZikmundEtla (2010), a scale with coefficient alpha between o.6 and 0.7 indicates fair reliability so for this study a Chronbach's alpha score of 0.70 or higher is considered adequate to determine reliability.

## 3.9 Validity

Validity is the extent to which differences are found with measuring instruments reflecting true differences among those being tested. In order to ensure the quality of the research design content and construct validity of the research was checked. Construct validity establishing correct operational measures for the concepts being studied (John, 2007). The literature review will be conducted and thoroughly examined to make sure that the content of measuring is relevant to the study.

# Chapter Four – Analysis and Discussion

## 4.1Respondents' Profile and Response Proportions

Every research study should include demographic data to provide information about the sample. One of the first crucial decisions made in social science research is who the study references. Using descriptive statistics, a study should include items such as gender, age, social economic status, ethnicity, employment status, income, religion, or some other category or identifier. Accordingly, this part mainly dealt with the findings of the study and its analysis. To investigate the factor of LC effectiveness, the respondents‟ profile and associated data of the participants presented in this section.

### 4.1.1 Response rate

Accordingly, the target population for this research was trade service officers, international banking staff,managers and active participants in the LC management operation of AIB East Region. During the survey a total of 35 questionnaires that prepared with english language were distributed to trade services and international banking staffs and all questionnaires were returned that are completely filled.On the other hand, as the first part of the questionnaire consisted of the demographic information of research participants, the following variables about the respondents were summarized and described in the subsequent table and diagram. These variables include age, sex, education level and working experience.

### 4.1.2 Demographic Characteristics of the Participants

Respondents were requested to indicate their age (in years), sex in terms of male and female, education level as diploma, degree, masters and above, working experience in their company (AIB East Region) in years and working experience with LC or International trade in bank system in years. Accordingly, the following information is gathered and presented on the table below.

## Table 4.1 Frequency of Participants Based on their Age

**Age**

| | | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | 25-30 | 4 | 11.4 | 11.4 | 11.4 |
| | 31-35 | 6 | 17.1 | 17.1 | 28.6 |
| | 36-40 | 8 | 22.9 | 22.9 | 51.4 |
| | >40 | 17 | 48.6 | 48.6 | 100.0 |
| | Total | 35 | 100.0 | 100.0 | |

Survey result, 2021

Table 4.1 portrays that among the total number of respondents 4 (11.4 %) were aged between 25 and 30 and 6 (17.1%) of the total respondents were between 31 and 35 years old. The majority of the respondents were aged between 36 and 40 years that consisted of 22.9% of the total participants of this study. In addition, the ages of the majority participants ranged from more than 40 to 48.6% of the total participants of this study. Hence, it can be said that most of the participants is mature and capable of managing their businesses and finding their profits.

**Table 4.2 Distribution of Participants by Sex**

**Sex**

| | | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | Female | 9 | 25.7 | 25.7 | 25.7 |
| | Male | 26 | 74.3 | 74.3 | 100.0 |
| | Total | 35 | 100.0 | 100.0 | |

Survey result, 2021

The above table displays the frequency of participants based on their sex. Accordingly, (74.3%) of the participants of this study were males and the others around 25.7% were female.According to the above figure it looks that the majority of the respondents were males.

**Table 4.3 Frequency of Participants Based on their work experience**

**Education level**

| | | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | Degree | 32 | 91.4 | 91.4 | 91.4 |
| | Masters and above | 3 | 8.6 | 8.6 | 100.0 |
| | Total | 35 | 100.0 | 100.0 | |

**Working experience in your company (AIB East Region) in years**

| | | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | 5years and below | 2 | 5.7 | 5.7 | 5.7 |
| | 6-10 | 6 | 17.1 | 17.1 | 22.9 |
| | 11-15 | 7 | 20.0 | 20.0 | 42.9 |
| | 16-20 | 11 | 31.4 | 31.4 | 74.3 |
| | More than 20 | 9 | 25.7 | 25.7 | 100.0 |
| | Total | 35 | 100.0 | 100.0 | |

**Working experience with LC or International Trade in bank system in years**

| | | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | 1 years and below | 3 | 8.6 | 8.6 | 8.6 |
| | 1-3 | 4 | 11.4 | 11.4 | 20.0 |
| | 3-5 | 9 | 25.7 | 25.7 | 45.7 |
| | 5 -10 | 12 | 34.3 | 34.3 | 80.0 |
| | More than 10 years | 7 | 20.0 | 20.0 | 100.0 |
| | Total | 35 | 100.0 | 100.0 | |

Survey result, 2021

**Respondent Working Experience**

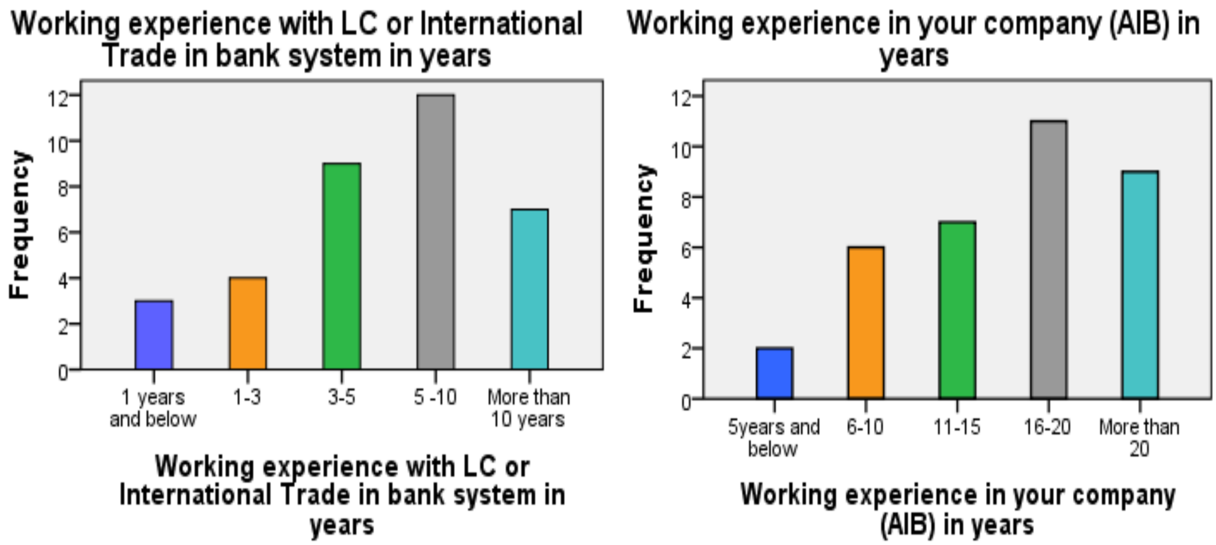


**Figure 4.1: Participants Working Experience Graphical View**

Accordingly, most of the participants, 11 (31.4%), have worked 16 to 20 years in AIB East Region and the second majority category 9 (25.7%) is found in age more than 20. The fewer respondents 2 (5.7%) indicated they have worked in AIB East Region below five years. The majority of the participants 12 (34.3%) of this study indicated that they have worked 5 to 10 years in LC processing and international banking. As the data indicate, the second majority of participants 9 (25.7%) have worked in the LC processing for 3 to 5 years and less respondents below 1 year. In regard to this, the targeted employees have pertinent and capacitated employees to include in this study. Regarding the educational level of the study 32 (91.4%) of the majority respondents are BA degree holders and the rest 3 (8.6%) are Masters.

## 4.2 Normality Test

In social science study, numerous business statistics authors indicate that Kurtosis with higher kurtosis means more of the variance is due to infrequent extreme deviations, as opposed to frequent modestly-sized deviations. Similarly, Skewness with its type of distribution is like positive skew as the right tail is longer; the mass of the distribution is concentrated on the left of the figure. The distribution is said to be right-skewed. Negative skew as the left tail is longer; the mass of the distribution is concentrated on the right of the figure. The distribution is said to be left-skewed.

**Table 4.4 The Normality Test**

| **Dimensions** | **Skewness** | | **Kurtosis** | |
|---|---|---|---|---|
| | Statistic | Std. Error | Statistic | Std. Error |
| Formation Place | 0.077 | 0.398 | -0.379 | 0.778 |
| Place of payment | 0.077 | 0.398 | -0.157 | 0.778 |
| Language and currency | -0.053 | 0.398 | -0.071 | 0.778 |
| Documentary condition | -0.350 | 0.398 | -0.319 | 0.778 |
| LC Effectiveness | -0.053 | 0.398 | -0.071 | 0.778 |

Survey result, 2021

On the above table it presented the descriptive statistic, Kurtosis and Skewness statics calculation demonstrates that the distribution is normal because Kurtosis and Skewness are in between -2 and +2, thus data is normally distributed and had a reasonable variance to use subsequent analysis (John, 2007). The detailed descriptive statistics about each variable will be discussed in the next paragraphs.

## 4.3 Reliability Test

Chronbach's alpha is mostly used and it is a coefficient of reliability used to measure the internal consistency of the scale in a reliability test. This study selected this known statistical test to assess the internal consistency of variables. According to Zikmund Etla (2010), a scale with coefficient alpha between o.6 and 0.7 indicates fair reliability so for this study a Chronbach's alpha score of 0.70 or higher is considered adequate to determine reliability.

**Table 4.5 Reliability Test by Dimension**

| **Dimenssions** | **Cronach's Alpha** | **N of Items** |
|---|---|---|
| Formation Place | 0.802 | 4 |
| Place of Payment | 0.941 | 4 |
| Language & Currency | 0.733 | 3 |
| Documentary Condition | 0.762 | 3 |
| LC Effectiveness | 0.884 | 7 |
| Overall test | 0.751 | 21 |

Survey result, 2021

## 4.4 Discrepancy Documents Analysis

This research conducted during the annual closing of July,2020/21.The discrepancy documents analysis were conducted by visiting various import and export documents and related transaction payment documents to collect data about discrepancies in LC documents. LC procedures and related international payment documents were also surveyed at trade services and international banking to ensure the validity and accuracy of the research. 18 documents that contained discrepancies in the export and import letters of credit were found. The documents were selected and classified based on the document discrepancies. Such as, do not comply with terms and conditions of letter of credit, do not comply with the ambiguity of context of the Uniform Customs and Practice 600 and discrepancy of trade finance documents originated from clerical errors

**Table 4.6: Percentages of Characteristics of Discrepancies**

| Types of Discrepancies | Characteristics | Percentages |
| --- | --- | --- |
| Excessive Requirements of Letter of Credit | there was recurrently occurrence of discrepancy | 51 |
| UniformCustoms and Practice | they were not complied with Uniform Customs and Practice 600 | 44 |
| Other Discrepancy | The discrepancies occurred because of human oversight & human carelessness.i.e Clerical Error | 5 |

The above table shows the problem directly involved with import and export documents. These data were analyzed to determine what caused the discrepancies that were posted in Table 4.6. After recognizing & identifying a problem, it is absolutely important to provide a diagnostic solution to remedy the situation. The three types of discrepancies mentioned in the above table were created in order to be able to understand and identify the results data collected as the secondary data analysis. The details of the three types of document discrepancy were further analyzed as follows.

### 4.4.1 Excessive Requirements of Letter of Credit

It shows the frequency of occurrence of each discrepancy. There was a recurrent occurrence of discrepancy in that the customers failed to provide the merchandise description exactly as required by the terms and conditions of the letter of credit. The most occurring from the requirement of the letter of credit is, the description of goods in the invoice is inconsistent with that of the credit,required signatures have been omitted on documents presented especially on the exports side.

### 4.4.2 Uniform Customs and Practice

The main discrepancy creator and it shows various reasons such as Letter of credit expired, late shipment, late presentation of documents, inconsistency indocumentsand others of the discrepancies found.Because they are not complied with Uniform Customs and Practice 600.

**Table 4.7 Most Rated Repeatedly Occurrence of Discrepancies**

| Discrepancies of Documents | Always | Sometimes | Rarely | Never |
|---|---|---|---|---|
| The description of goods in the invoice is inconsistence with that of the credit | 66% | 14% | 11% | 9% |
| Required signatures have been omitted on documents presented | 69% | 17% | 8% | 6% |
| The absence of Documents | 63% | 23% | 11% | 3% |

Survey result, 2021

**Table 4.8 Average Occurrence of Discrepancies**

| Discrepancies of Documents | Always | Sometimes | Rarely | Never |
|---|---|---|---|---|
| Letter of credit expired | 51% | 23% | 14% | 12% |
| Late Shipment | 46% | 31% | 17% | 6% |
| Late presentation of documents | 43% | 29% | 14% | 14% |
| Inconsistency in Documents | 49% | 20% | 23% | 8% |

Survey result, 2021

**Table 4.9 Rarely Occurrence of Discrepancies**

| Discrepancies of Documents | Always | Sometimes | Rarely | Never |
|---|---|---|---|---|
| Insurance certificate have different currency | 9% | 9% | 42% | 40% |
| Transport document omits name of the carrier | 6% | 17% | 49% | 28% |

| | | | | |
|---|---|---|---|---|
| Partial shipment is effected, while not allowed by the L/C | 9% | 11% | 46% | 34% |
| Copy insurance certificate presented instead of an original one | 3% | 14% | 43% | 40% |
| Shipper, Consignee, notify party's name differs for the L/C | 6% | 9% | 51% | 34% |
| Letter of credit overdrawn | 9% | 11% | 49% | 31% |
| Incorrect Endorsement / Absence of Endorsement | 11% | 23% | 37% | 29% |
| The bill of lading does not indicate that the goods are on board the vessel | 3% | 17% | 46% | 34% |
| The insurance policy or certificate does not contain the risks stipulated | 14% | 20% | 40% | 26% |
| Description of goods differs from credit by inconsistence among documents and difference in INCOTERMS | 17% | 31% | 43% | 9% |
| Under-insured | 20% | 26% | 31% | 23% |
| Bill of Lading not clean (indicating that defective goods on their package) | 3% | 6% | 48% | 43% |

Survey result, 2021

The above three tables showed the occurrence of discrepancy and the data were organized by AIB East Region employees' responses. The respondents were requested to rate the occurrence of discrepancies of documents that do not comply with UCP 600 documents in terms of the various factors. This is because there are major issues on the strict Uniform Customs and Practice and Terms and conditions of documentary credit. Traders, specifically importers and exporters often face voluminous paperwork, complex formalities, and many possible delays and errors.

Table 4.7, 4.8 and 4.9 showed 19 characteristics of the discrepancies found and represent the employees' perception in case of AIB East Region LC processing. From this analysis, the required documents were presented for payment; however, they were not complied with Uniform Customs and Practice in most cases. Specifically, table 4.7 shows that customers could not prepare the required documents in compliance with the Uniform Customs and Practice. The table indicates that there is a repeated occurrence of discrepancies such as the description of goods in the invoice is inconsistent with that of the credit. required signatures have been omitted on documents presented and the absence of documents.

Table 4.8 shows the average frequency of occurrence of discrepancy that involved LC expired, late presentation of LC, late shipment and inconsistency in documents. According to this study, the customers did not present the documents for payment on time and that result has an impact on the letter of credit to expire. This is a serious situation for the customers because the customers, especially the exporter will not get paid until the buyer agrees to accept the discrepant documents.

Table 4.9 shows rare occurrences of discrepancies. These are insurance certificate have different currency, transport document omits name of the carrier, partial shipment is effected, while not allowed by the L/C, Copy insurance certificate presented instead of an original one, shipper, Consignee, notify party's name differs for the L/C, letter of credit overdrawn, incorrect endorsement / absence of endorsement, the bill of lading does not indicate that the goods are on board the vessel, description of goods differs from credit by inconsistency among documents and difference in INCOTERMS, under-insured, bill of Lading not clean (indicating that defective goods on their package) and the insurance policy or certificate does not contain the risks stipulated

It is a reminder that the Uniform Customs and Practice is not binding law, but applies because banks voluntarily incorporate the Uniform Customs and Practice into the contracts upon which the letter of credit is based (Del Busto, 1994). Likewise, Jimenez confirmed the legal status of the Uniform Customs and Practice affects the international banking community and importing and exporting community worldwide (Jimenez, 1997). The Uniform Customs and Practice has achieved such universal effect that in some countries the Uniform Customs and Practice is recognized as having the force of law or at least that of a trade tradition or custom (DC Insight, 2005).

### 4.4.3 Others Discrepancy – Clerical Errors

They are clerical errors of exporter and importers in preparation documents for payment or for letter of credit. The discrepancies occurred because of human oversight and human carelessness. The typist can type incorrectly if the person is not detail oriented. Some documentary preparers might not be skilled enough to handle import and export documents or not have enough capacity for document examination because of the specific requirement of the letter of credit.

### 4.5 Descriptive Analysis

In this part of the study, it is tried to analyze primary data that was collected from 35 participants. Descriptive statistics is used to describe and summarize quantitative and qualitative data.

## 4.5.1 Formation place

Respondents were asked to rate the formation place as LC effective factor by applying national law on the process of LC when a contract is concluded where acceptance of an offer becomes effective. They also rated as in an offer in AIB's letters of credit, in general, takes the form of an instruction properly, in AIB practice, the applicant often communicates to the beneficiary to give notice of acceptance and the practice of AIB causes legal complexity in contract formation context even under the rule which views a contract as concluded at the place where an acceptance is dispatched.

**Table 4.10 Row Percentage Distribution of Formation Place Question Responses**

| | Strongly Agree | Agree | Neutral | Disagree | Strongly Disagree | Mean | Standard Deviation |
|---|---|---|---|---|---|---|---|
| Applying national law on the process of LC. | 0% | 12.5% | 12.2% | 46.7% | 28.6% | 1.904 | 0.942 |
| Taking the form of an instruction properly | 1.1% | 9.1% | 15.6% | 45.6% | 28.6% | 1.904 | 0.942 |
| Communication | 1.1% | 12.2% | 12.2% | 48.9% | 25.6% | 1.965 | 0.978 |
| Legal complexity in contract formation | 3.3% | 12.2% | 8.9% | 47.8% | 27.8% | 1.985 | 1.070 |
| Formation Place | **Grand Mean 1.94** | | | | | | |

In regard to the national law of LC process, the above table indicates that 46.7% of respondents preferred the category of disagree and 28.6% respondents preferred the category of strongly disagree. With the factor of formation placement instruction properly, 45.6% of the respondents rated the category of disagree and 28.6% rated the category of strongly disagree. In addition, 48.9% preferred the category of disagree and 25.6% respondents preferred the category of strongly disagree as they assured that the applicant often communicates to the beneficiary by SWIFT or other expedient means to give notice of acceptance. Further, most respondents (47.8%) choose the category of disagree and 27.8% respondents preferred the category of strongly disagree as it ensured how the legal complexity in contract formation in the LC process.

The grand mean for this factor rated is fair and 1.94 mean score. It is interpreted as a contract where acceptance of an offer becomes effective, but since national laws have different approaches to determine such a place, different places can be nominated as the place of formation of the contract depending on the rules of the applicable national law. It shows they agreed as in LC processing the application of national law is very complex. The Interpretation was made based on the following measurement scale intervals or range. Mean scores 4.51-5.00 excellent or very good, 3.51-4.50 good, 2.51-3.50 average or moderate,1.51- 2.50 fair and 1.00-1.50 is poor (Francisco M. Ebio, 2016).

### 4.5.2 Place of the Payment

Respondents of this study were requested to rate the place of the payment that is deemed to have a strong connection in determining the governing law of the contract

**Table 4.11 Row Percentage Distribution of Place of the Payment Question Responses**

| Items | Strongly Agree | Agree | Neutral | Disagree | Strongly Disagree | Mean | Standard Deviation |
|---|---|---|---|---|---|---|---|
| Payment properly transacted | 0% | 12.2% | 12.2% | 46.7% | 28.9% | 1.905 | 0.460 |
| Making reimbursement effectively | 1.1% | 8.9% | 15.6% | 45.6% | 28.9% | 1.835 | 0.732 |
| Effectively processing reimbursement of the issuing bank by the applicant | 1.1% | 12.2% | 12.2% | 48.9% | 25.6% | 1.835 | 0.816 |
| Providing secure payment method | 3.3% | 12.2% | 8.9% | 47.8% | 27.8% | 1.985 | 0. 535 |
| **Place of Payment** | **Grand Mean 1.89** | | | | | | |

The above table indicates that most respondents (46.7%) disagree and 28.9% respondents preferred the category of strongly disagree as payments are not properly transacted as expected. In the next factor, 28.9% of the respondents strongly disagreed and 45.6% disagreed as making reimbursement infectively. In addition, most respondents (48.9%) preferred the category of disagree and 25.6% respondents preferred the category of strongly disagree and the percentage indicated that ineffectively processing reimbursement of the issuing bank by the applicant. Further, this study found that most respondents (47.8%) chose to disagree and 27.8% respondents preferred the category of strongly disagree as providing an unsecured payment method to as the essence of instruments.

The grand mean rating is fair and 1.89 mean score for place of payment factor (based on the following measurement scale intervals or range of Francisco M. Ebio (2016).). The place of the payment is deemed to have a strong connection in determining the governing law of the contract. In a L/C, payments are made differently in the course of the transaction, e.g. by correspondent bank or the issuing bank.

### 4.5.3 Application of Language and currency

Respondents of this study were requested to rate the application of Language and currency. The language and currency used in the contract are important factors which indicate the choice of law in certain situations

**Table 4.12 Row Percentage Distribution of Language and currency Question Responses**

| Items | Level of Respondent agreement | | | | | Mean | Standard Deviation |
|---|---|---|---|---|---|---|---|
| | Strongly Agree | Agree | Neutral | Disagree | Strongly Disagree | | |
| Payable in an internationally accepted language | 24.4% | 34.4% | 28.9% | 11.1% | 1.1% | 3.70 | 0.999 |
| Considering language and currency as significant factor | 30.0% | 43.3% | 13.3% | 10.0% | 3.3% | 3.87 | 1.066 |
| Terms and conditions of credits and guarantees | 20.0% | 42.2% | 22.2% | 11.1% | 4.4% | 3.62 | 1.066 |
| **Language and currency** | **Grand Mean 3.73** | | | | | | |

Survey result, 2021

In this factor the study found that 34.4% respondents preferred the category of agree and 28.9% respondents preferred the category of neutral. It is shown that it is not usually to use payable in U.S. dollars as English is an internationally accepted language and U.S. dollars are commonly used in international trade. In the next factor, most respondents 43.3% preferred agree and 30.0% respondents preferred the category of strongly agreed considered language and currency as significant factors. In the next factor, the study found that 42.2% of the respondents agreed and

20.0% selected the category of strongly agree. They assured that terms and conditions of credits and guarantees to be drafted in English for formal communication and transaction to LC processing.

The grand mean rated very good and 3.73 mean score for the variable of language related issues. The interpretation was made based on the following measurement scale intervals or range of Francisco M. Ebio (2016). Overall, the language and currency used in the contract are important factors which indicate the choice of law in certain situations.

### 4.5.4 Documentary Condition of the LC processing

Respondents of this study were requested to rate documentary conditions of the LC processing in AIB East Region in terms of the following factors.

**Table 4.13 Row Percentage Distribution of documentary documentation Question Responses**

| Iems | Strongly Agree | Agree | Neutral | Disagree | Strongly Disagree | Mean | St. Dev. |
|---|---|---|---|---|---|---|---|
| Ambiguity of the Uniform Customs and Practice 600 | 21.1% | 50.% | 11.1% | 13.3% | 4.4% | 1.86 | 1.086 |
| Executing properly to manage the supply chain and quality management | 24.5% | 43.3% | 13.3% | 12.2% | 6.7% | 1.79 | 1.171 |
| Using excessive requirements of terms and conditions | 20.0% | 47.8% | 11.1% | 13.3% | 7.8% | 1.99 | 1.179 |
| **Documentary documentation** | **Grand Mean 1.83** | | | | | | |

Survey result, 2021

Most respondents (50%) preferred the category of agree and 21.1% respondents preferred the category of strongly agree as indicated that there is an ambiguity of the Uniform Customs and Practice 600 on AIB East Region LC processing AIB East Region manage properly the supply chain and quality management. It is found that 43.3% of the respondents agreed and 24.5% prefered the category of strongly agree. In addition, most respondents (47.8%) preferred the category of agree and 20% respondents preferred the category of strongly agree for the last factor. As indicated that AIB East Region used excessive requirements of terms and conditions.

The grand mean was rated as fair and1.83 mean score for this factor. The interpretation was made based on the following measurement scale intervals or range of Francisco M. Ebio (2016). In general, the condition of documentary matters is the very necessary issue in LC processing. Document free from discrepancies in international trade financing as a significant worldwide issue resulting in unnecessary delays, refused payments, and financial loss when banks discover discrepancies in required trade finance documents presented under the International Chamber of Commerce trade rules known as Uniform Customs and Practice 600.

### 4.5.5 Letter of credit Effectiveness in AIB

The dependent variable is composed of three dimensions i.e quality, time and price. Accordingly, the participants were asked to rate their opinion based on LC effectiveness in terms of quality, price and time.

**Table 4.14 Row Percentage Distribution of LC Effectiveness Question Responses**

| Items | Strongly Agree | Agree | Neutral | Disagree | Strongly Disagree | Mean | Standard Deviation |
|---|---|---|---|---|---|---|---|
| Protecting both seller and buyer | 2.2% | 3.3% | 14.4% | 41.1% | 38.9% | 1.89 | 0.929 |
| Facilitating the export and import transaction by presenting required documents | 2.2% | 4.4% | 14.4% | 43.3% | 35.6% | 1.94 | 0.940 |
| Act as a intermediary to enforce the rules | 1.1% | 10% | 7.8% | 37.8% | 43.3% | 1.88 | 0.946 |
| Providing real time information regarding documents, payments, transaction etc | 1.1% | 6.7% | 11.1% | 43.3% | 37.8% | 1.90 | 0.925 |
| Facilitating LC documents and processes timely | 1.1% | 7.8% | 8.9% | 42.2% | 40% | 1.88 | 0.946 |
| Requiring a high service price to facilitate the export and import transaction | 0% | 12.2% | 13.3% | 47.8% | 26.7% | 2.11 | 0.941 |
| Facilitate the export and import transaction within competitive and flexible price | 2.2% | 10% | 14.4% | 41.1% | 32.2% | 2.09 | 1.035 |
| **LC Effectiveness** | **Grand Mean 1.96** | | | | | | |

Survey result, 2021

Table 4.14 shows that 41.1% of the respondents preferred the category of disagree and 38.9% preferred the category of strongly disagree in protecting both seller and buyer LC transaction. With the practices of AIB East Region on facilitating the export and import transaction by presenting required documents, the respondents preferred 43.3% disagreed and 35.6% strongly disagreed. In regard to acting as an intermediary to enforce the rules, 43.3% of the respondents rated that category strongly disagree and 37.8% preferred the category of disagree. Regarding providing real time information regarding documents, payments, and transactions, 37.8% of the respondents strongly disagreed and 43.3% selected the category of disagreement. Facilitating LC documents and processes timely, 40.0% of the respondents strongly disagreed and 42.2% selected the category of disagreement. In the case of requiring a high service price to facilitate the export and import transaction, 26.7% of the respondents strongly disagreed and 47.8% 35 selected the category of disagreement. Finally, to facilitate the export and import transaction within competitive and flexible price, 32.2% of the respondents strongly disagreed and 41.1% selected the category of disagreement.

The grand mean rated is fair and score 1.96 mean for LC effectiveness factor. The interpretation was made based on the following measurement scale intervals or range of Francisco M. Ebio (2016). In general, letters of credit are the instrument of both export and import business. One party may request a letter of credit for a transaction involving goods or services when the other party is on the other side of the world. But, AIB East Region exerted fewer efforts to facilitate the export and import transaction. That is, the seller is not actively and properly shipping the goods and presenting the documents to the bank as required by the rules and regulations of letters of credit, guaranteeing that the seller will get paid. As an instrument in international trade, letters of credit protect both seller and buyer while they are engaged in the import and export business. In this transaction, the bank acts as an intermediary to enforce the rules of Uniform Customs and Practice 600 to both the exporter and the importer. In addition, the practice of document transactions is not free from discrepancies in international trade financing. It’s resulting in unnecessary delays, refused payments, and financial loss in a majority of LC processing practice. AIB East Region ability to account successfully for its LC output and operations to its various internal and external traders is less.

### 4.5.6 Summary Responses of Factors

The summary responses of factors as the average responses of four independent variables and one dependent variable as the average of the four dimensions of the LC effectiveness measurement were taken.

**Table 4.15 Summary of Question Responses**

| Average Responses in percentage (%) | Strongly Agree | Agree | Neutral | Disagree | Strongly Disagree | Mean in level Neutral |
|---|---|---|---|---|---|---|
| Formation Place | 0% | 8.9% | 18.9% | 51.1% | 21.1% | 1.94 |
| Place of Payment | 12.2% | 24.4% | 8.9% | 25.6% | 28.9% | 1.89 |
| Language & Currency | 18.9% | 47.8% | 24.4% | 6.7% | 2.2% | 1.88 |
| Documentary condition | 17.8% | 50% | 15.6% | 13.3% | 3.3% | 1.88 |
| LC Effectiveness | 0% | 4.4% | 10% | 63.3% | 22.2% | 1.96 |

Survey result, 2021

The above table shows the summary respondents of factors. The average response of formation place was selected by 51.1% of respondents as disagree. The majority of the respondents (28.9%) strongly disagree with the place of payment. With the factor of documentary condition, almost half of the respondents favored the category of agreement. In respect to language and currency, most of the respondents preferred the group of agreement. In regard to LC effectiveness, the summarized table shows that the majority of the respondents rated the category of disagreement.

## 4.6 Correlation Analysis

The data which is collected from questionnaires first give code or recording variables on Statistical package social science (SPSS) program and by using correlation analysis the interdependence between the independent and dependent variables would be tested. Accordingly, correlation analysis was used that measures the relationship between two items such as formation place, place of payment, language and currency and documentary condition as independent variables of the component of four factors and LC Effectiveness as dependent variable. The resulting value (called the "correlation coefficient") shows if changes in one item will result in changes in the other item. A pertinent interpretation was given based on this analysis. When comparing the correlation between two items, one item is called the "dependent" item and the other the "independent" item. The goal is to see if a change in the independent item will result in a change in the dependent item.

**Table 4.16 Correlation analysis**

| | | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|---|
| Formation Place (1) | Pearson Correlation | .680** | .497** | .338** | .533** | 1 |
| | Sig. (2-tailed) | .000 | .000 | .001 | .000 | |
| Place of payment (2) | Pearson Correlation | .667** | .495** | .274** | 1 | .533** |
| | Sig. (2-tailed) | .000 | .000 | .009 | | .000 |
| Language and currency (3) | Pearson Correlation | .728** | .410** | 1 | .274** | .338** |
| | Sig. (2-tailed) | .000 | .000 | | .009 | .001 |
| Documentary condition (4) | Pearson Correlation | .684** | 1 | .410** | .495** | .497** |
| | Sig. (2-tailed) | .000 | | .000 | .000 | .000 |
| LC Effectiveness (5) | Pearson Correlation | 1 | .684** | .728** | .667** | .680** |
| | Sig. (2-tailed) | | .000 | .000 | .000 | .000 |
| ****. Correlation is significant at the 0.01 level (2-tailed)** | | | | | | |

Survey result, 2021

Table 4.16shows the result of correlation analysis based on the average value of respondents" response on four independent variables and one dependent variable. According to the above table, the relationship between formation place and LC Effectiveness was a statistically significant relationship, r(35)=, .680,p<1. As the contract formation is well placed, the likelihood of LC moderately effective in terms of time, quality and price. Similarly, the relationship between place of payment and LC Effectiveness was a statistically significant relationship (35) =.667, p<.01. The descriptive statistics also showed that as the placement of payment is well organized the likelihood of LC effectiveness consumption moderately increases. Besides, there is a statistically strong relationship between language and currency and LC Effectiveness r (35) =.728 p<.01. This indicates that the LC will be effective in terms of time, quality and price with high use of language and currency properly. Finally, the relationship between documentary condition and LC Effectiveness is also tested and there is moderate relationship with statistically significant, r (35) =.684, p<.01. This indicates that LC effectiveness will be determined by appropriately handling documentary conditions.

**Table 4.17 Correlation analysis based on quality, time and price**

| | | 1 | 2 | 3 | 4 | 5 | 6 | 7 |
|---|---|---|---|---|---|---|---|---|
| Formation place (1) | Correlation | .807** | .497** | .338** | .533** | 1 | .575** | .333** |
| | Sig. @ | .000 | .000 | .001 | .000 | | .000 | .001 |
| Place of payment (2) | Correlation | .776** | .495** | .274** | 1 | .533** | .527** | .377** |
| | Sig. | .000 | .000 | .009 | | .000 | .000 | .000 |
| Language and currency (3) | Pearson Correlation | .717** | .410** | 1 | .274** | .338** | .600** | .550** |
| | Sig. | .000 | .000 | | .009 | .001 | .000 | .000 |
| Documentary condition (4) | Pearson Correlation | .609** | 1 | .410** | .495** | .497** | .847** | .346** |
| | Sig. | .000 | | .000 | .000 | .000 | .000 | .001 |
| LC Effectiveness - Quality (5) | Pearson Correlation | 1 | .609** | .717** | .776** | .807** | .742** | .553** |
| | Sig. | | .000 | .000 | .000 | .000 | .000 | .000 |
| LC Effectiveness - Time (6) | Pearson Correlation | .742** | .847** | .600** | .527** | .575** | 1 | .564** |
| | Sig. | .000 | .000 | .000 | .000 | .000 | | .000 |
| LC Effectiveness - Price (7) | Pearson Correlation | .553** | .346** | .550** | .377** | .333** | .564** | 1 |
| | Sig. | .000 | .001 | .000 | .000 | .001 | .000 | |

**. Correlation is significant at the 0.01 level (2-tailed) and @Sig. (2-tailed)

Survey result, 2021

Table 4.17 shows the correlation test of the four independent variables analysis with LC effectiveness in terms of quality, time and price. According to the above table, there were a positive relationship between formation place and LC Effectiveness in terms of quality, time and price as r (35) =.807, 0. 575 and 0.333 p<.01 respectively. Similarly, the relationship between place of payment and LC Effectiveness in terms quality, time and price were a positive and statistically significant relationship as r (35) =.776, 0. 527 and 0.377, p<.01. In addition, there were positive and statistically relationships between language and currency and LC Effectiveness in terms quality, time and price as r (35) =.717, 0.600 and 0. 550, p<.01.Finally, the relationship between documentary condition and LC Effectiveness in terms quality, time and price were tested and there were positive and statistically significant relationships as r(35) =0.609, 0.847 and 0.346 p<.01 respectively.

The above tables were analyzed based on The Pearson's Product Moment Correlation Coefficient (r) as it is a measure of the degree of association between variables. It takes a value between –1 and 1. A value of r near to 1 indicates strong positive association, where as a value of r near to –1 indicates a strong negative linear association and r of 0 indicates no linear relationship between variables, when r = ±1 this indicates that the two variables are perfectly correlated, i.e., all the points are on a straight line (John et al, 2007).

## 4.7 Regression Analysis

Data collection from the respondent's first, the questioners give code or recording variables on Statistical package social science (SPSS) program. In this study, it is attempted to test that was performed using regression analysis based on model specification. The statistical regression model of the study was based on the theoretical regression model as indicated in chapter three.

**Table 4.18 Multiple Regression Test Results**

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|---|---|---|---|---|
| **1** | **.928[a]** | **.862** | **.855** | **.262** |

a. Predictors: (Constant), formation place, place of payment, language and currency and documentary condition

**ANOVA[a]**

| Model | | Sum of Squares | df | Mean Square | F | Sig. |
|---|---|---|---|---|---|---|
| | Regression | 36.392 | 4 | 9.098 | 132.466 | .000[b] |
| 1 | Residual | 5.838 | 85 | ..069 | | |
| | Total | 42.230 | 89 | | | |

a. Dependent Variable: LC Effectiveness

b. Predictors: (Constant), formation place, place of payment, language and currency and documentary condition.

Coefficients[a]

| Model | | Unstandardized Coefficients | | Standardized Coefficients | T | Sig. |
|---|---|---|---|---|---|---|
| | | B | Sd. Error | Beta | | |
| | (Constant) | .275 | .079 | | 3. 502 | .001 |
| | Formation Place | .188 | .037 | .256 | 5.045 | .00010 |
| 1 | Place of payment | .217 | .037 | .293 | 5.831 | .00005 |
| | Language and currency | .324 | .031 | .472 | 10.513 | .00002 |
| | Documentary condition | .158 | .037 | .218 | 4.274 | .00003 |

a. Dependent Variable: LC Effectiveness Survey result, 2021

$$Y=0.275+0.188x1+0.217x2+0.324x3+0.158X4+e$$

**Where:**

- Y= Letter of Credit Effectiveness
- a= the y intercept.
- x1= Formation place
- b1= the regression coefficient of Formation place
- x2= Place of payment.
- b2= the regression coefficient of Place of payment.
- x3= Language and currency
- b3= the regression coefficient of Language and currency
- x4= Documentary condition
- b4= the regression coefficient of Documentary condition
- e= error term.

Linear regression estimates the coefficients of the linear equation, involving one or more independent variables that best predict the value of the dependent variable. In this study, the regression analysis is used on four independent variables indicated on the model to measure the LC effectiveness in terms of time, quality and price. The significance level of 0.05 is used with 95% confidence interval. As indicated in the above table the independent variables predict the dependent variable R square = 86.2 % with adjusted R square around 85.5 the remaining less than 14% other extraneous variable that can affect the LC effectiveness. This result also indicates that the four independent variables had an effect on LC effectiveness in terms of time, quality and price.

Table 4.18 the ANOVA test, it is noticed that F value of 132.46 is significant at 0.000 levels. Therefore, from the result, it is concluded that with 86.2% of the variance (R-Square) in the factors of four independent variables are significant effects on the dependent variable and the model adopted appropriately measures the construct. Using the regression result it shows that formation place (0.00010), place of payment (0.00005), language and currency (0.00002), and documentary condition (0.00003) statistically affects LC effectiveness.

In theoretical principle of the Doctrine of Strict Compliance, the exporter must respect the written terms "to the letter" of L/C. If any discrepancy or inconsistency occurs between the documents presented by the exporter and what is actually specified in the L/C, the bank can refuse payment. Therefore, with a L/C, the buyer has the protection of the bank strictly controlling the documents, and the seller has the protection of getting paid if all documents comply with the letter of credit. Hahn (2007) stated that a contract is concluded where acceptance of an offer becomes effective, but since national laws have different approaches to determine such a place, different places can be nominated as the place of formation of the contract depending on the rules of the applicable national law.

Thus, formation place is a determinant factor for LC effectiveness as well as place of payment. It is deemed to have a strong connection in determining the governing law of the contract. In L/C, payments are made differently in the course of the transaction, e.g. by correspondent bank or the issuing bank. . Hahn (2007) stated the language and currency used in the contract are important factors which indicate the choice of law in certain situations. Constructive results were found here that documentary conditions affected the LC effectiveness. The phenomenon of document free from discrepancies in international trade financing as a significant worldwide issue resulting in unnecessary delays, refused payments, and financial loss when banks discover discrepancies in required trade finance documents presented under the International Chamber of Commerce trade rules known as Uniform Customs and Practice.

**Table 4.19 Multiple Regression Test Results of LC Effectiveness of Quality, Time and Price**

| **Independent Variable** | **Dependent value and their sig. value** | | | |
|---|---|---|---|---|
| | LC Effectiveness | Quality | Time | Price |
| Formation place | .00010 | .00003 | .031 | .639 |
| Place of payment | .00005 | .00002 | .252 | 0.005 |
| Language and currency | 0.00002 | 0.00002 | 0.00001 | 0.0001 |
| Documentary condition | 0.00003 | 0.875 | .00001 | .818 |

Survey result, 2021

In this study, further regression analysis is used to observe the individual independent variable effect to measure the LC effectiveness in terms of time, quality and price. The significance level of 0.05 is used with 95% confidence interval. The regression test result showed that the independent variables predict the dependent variable as indicated as LC effectiveness in terms of time, quality and price. This result also indicates that the four independent variables had an effect on LC effectiveness in terms of time, quality and price.

Using the coefficient table of the regression result, formation place (0.00003), place of payment (0.00005), and language and currency (0.00002), statistically affects LC effectiveness in terms of quality but documentary condition (0.00003) insignificantly affects this dependent variable as P > 0.05 (.875). In theoretical and legal aspects of LC, the fact that banks are concerned only with documents and not with goods makes it easier for the dishonest to abuse this system. A fraudster can easily fabricate documents required by the letter of credit, discount them in a bank and then vanish. In another scenario, he can ship containerized, valueless goods instead of contract goods, safe in the knowledge that the goods will arrive after he obtains payment. Even after shipping goods different from contractual quality, he/she can make alterations in necessary shipping documents and demand payment from the bank with these documents. Therefore, a letter of credit will be facilitated or enforced by the rules by contract formation place, place of payment, and language and currency but documentary condition will not be the determining factor.

Using the same regression test, formation place (0.031) and place of payment (0.252) had insignificant effect of LC effectiveness in terms of time but language and currency (0.00001) and documentary condition (0.00001) significantly affected this dependent variable as $P < 0.05$. Normally, in accordance with the article of the UCP 600, a bank will have a reasonable time, not to exceed five banking days following receipt of the documents, to examine the documents and determine whether to take up or to refuse the documents and inform the party from which it received the documents accordingly. Therefore, a letter of credit will be timely processed or provided up-to-date or real time information by clearly indicated language and currency and proper documentation.

With the analysis of LC effectiveness in terms of price, formation place (0.639) and documentary condition (0.818) had insignificant effect but place of payment (0.005) and language and currency (0.0001) significantly affect the dependent variable as $P < 0.05$. In international sales, as the seller and the buyer are in different countries, there is a common problem of payment due to the difference of time between dispatch and delivery. Obviously, the seller would like to receive payment for the goods when delivering them to the carrier and the buyer would prefer to delay the payment of the price until receipt of the goods. Therefore, a letter of credit solves this problem between the seller and the buyer in terms of place of payment and language and currency.

### 4.7.1 Model Testing

Multicollinearity refers to a situation in which there is exact (or nearly exact) linear relation among two or more of the input variables (Uma, 2003). The VIF (Variance Inflation Factor) for each term in the model measures the combined effect of dependence among the regression on the variance of that term. One or more large VIF indicate multicollinearity. Practical experience indicates that if any of the VIF results exceeds 5 or 10, it is an indication that the associated regression coefficients are poorly estimated because of multicollinearity (Uma, 2003). Collinearity Statistics shows that the VIF value of all the factors are less than 5 or 10 and no collinearity is observed on this data. The independent variables that contribute to variance of the dependent variable are explained by standardized Beta coefficient. In multiple regressions, it Should have independence of observations, which can be easily checked using the DurbinWatson statistic. It is a simple test to run using SPSS Statistics. In this study the test indicates that the result of the Durbin-Watson statistic is below 2.

**Table 4.20 Summary of Research Questions Results**

| Research Questions | Sig. | Statistically Significant Level | Correlation Result | Relation Indicator |
|---|---|---|---|---|
| To what extent formation place affects LC effectiveness? | .00010 | Significant | 0.680 | Related |
| To what extent place of payment affects LC effectiveness? | .00005 | Significant | 0.667 | Related |
| To what extent language and currency affects LC effectiveness? | .00002 | Significant | 0.728 | Related |
| To what extent documentary condition affects LC effectiveness? | .00003 | Significant | 0.684 | Related |

Survey result, 2021

Table 4.16 indicates the summary of this study's research questions results. The investigation of the study employed correlation relation testing and it showed that formation place, place of payment, language and currency, and documentary condition had a significant relation with LC effectiveness. In the same way, the study found that formation place (0.00010), place of payment (0.00005), language and currency (0.00002), and documentary condition (0.00003) statistically affects LC effectiveness using multivariate analysis. It can be supposed that the four independent variables had an effect on LC effectiveness in terms of time, quality and price.

## 4.8 Qualitative Data Analysis

It is a reminder that this study allowed in-depth qualitative analysis for answering the questions of what the main problems are associated with LC processing in terms of quality, time and price and to identify the main gaps in LC processing and requirements. In addition, according to international trade and finance transactions, this study tried to get answers on the main requirements and shortcomings of letters of credit processing as the most engaged instrument in global trade in Ethiopia context. Moreover, it was requested to indicate the main problems and the key facilitation of the export and import transaction as required by the rules and regulations of letters of credit and on guaranteeing that the seller will get paid. Further, it asked to indicate the mechanisms that AIB applies and the national law that governs to protect both seller and buyer while they are engaged in the import and export business. It requests to specify the national law that applied in the processing of LC in Ethiopia and considering how AIB is effective in acting as an intermediary to enforce the rules of the Uniform Customs and Practice 600 to both the exporter and the importer.

The interview analysis assured that most problems result from the seller's incapability to fulfill obligations stated in the letter of credit. The seller may find these terms difficult to fulfill and, either tries to fulfill them and fails, or asks the buyer to amend the letter of credit. As most letters of credit are irrevocable, amendments may at times be difficult since both the buyer and the seller must agree.This study also confirmed that sellers have several problems such as un-meet the shipment schedule, providing the stipulations concerning unacceptable freight costs, having too low price due to exchange rates fluctuations, presenting incompatible quantity of products (the quantity ordered is not the expected amount in the commercial invoice), and offering unrelated documents.Even when sellers accept the terms of a letter of credit, problems often arise late in the process. When this occurs, the buyer's and seller's banks will try to negotiate any differences. In some cases, the seller can correct the documents and present them within the time specified in the letter of credit. If the documents cannot be corrected, the advising bank will ask the issuing bank to accept the documents despite the discrepancies found. It is important to note that, if the documents are not in accordance with the specifications of the letter of credit, the buyer's issuing bank is no longer obligated to pay. As of international trade and finance transactions, letters of credit are the most engaged instrument in global trade. However, it was found that there are several problems related to doing business agreement in global business practices by Ethiopian traders. Even if Letters of credit are the instrument of both export and import business, a lot of problems are created by requesting one party for a transaction involving goods or services when the other party is on the other side of the world. The main challenge is rotated on the key facilitation of the export and import transaction. That is on shipping the goods by seller and presenting the documents to the bank as required by the rules and regulations of letters of credit with guaranteeing that the seller will get paid. As saying letters of credit are the most important instrument in international trade, it cannot fully protect both seller and buyer while they are engaged in the import and export business. In this transaction, the bank expected to act as a middleman to enforce the rules of the Uniform Customs and Practice 600 to both the exporter and the importer. This study assured that international trade transactions are complicated by the seller's fears regarding the difficulty of collecting funds from a foreign buyer. Consequently, the sellers unsuccessfully pushed to facilitate the payment process without properly handing over the required documents.

# CHAPTER 5 - SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATION

## 5.1 Summary Of Findings

This study aimed to investigate the factors that determine letters of credit effectiveness in the process of import and export practices of AIB East Region. The study distributed questionnaires to 35 respondents and all of the respondents filled the questionnaires. Using correlation analysis, the interdependence between the independent and dependent variables were tested and hypothesis tests were performed using regression analysis. The result indicated that:-

- Out of the 20-discrepancy document investigation of secondary data analysis, 51% of trade documents (export and import documents) contain discrepancies and do not comply with terms and conditions of letter of credit. 44% of documents (export and import documents) contain discrepancies and do not comply with the ambiguity of context of the UCP 600 and only 5% of discrepancy of trade finance documents originated from clerical errors.
- Using the correlation analysis, it was found that the relationship between formation place and LC Effectiveness was a statistically significant relationship, r (90) =.680, p.01. This indicates that LC effectiveness will be determined by appropriately handling documentary conditions.
- By means of multivariate analysis, results showed that formation place, place of payment, language and currency, and documentary condition statistically affects LC effectiveness. This result also indicates that the four independent variables had an effect on LC effectiveness in terms of time, quality and price; noticed that F value was high (132.46) and $P < 0.05$. By means of the model testing, no co-linearity is observed on this data since collinearity Statistics showed that the VIF value of all the factors are less than 5 or 10 and. The independent variables that contribute to variance of the dependent variable are explained by standardized Beta coefficient. In this test, the result of the Durbin-Watson statistic was below 2 for the independence of observations, which can be easily checked using the Durbin-Watson statistic.

## 5.2 Conclusions

Employing multivariate analysis, the result of this study revealed that formation place, place of payment, language and currency, and documentary condition statistically affects LC effectiveness. It was found that formation place, place of payment and language and currency statistically will facilitate and enforce the role as they affect LC effectiveness in terms of quality but documentary condition is not a determinant factor in this regard. In addition, formation place and place of payment are not the causes for timely LC dealing out but language and currency and documentary conditions are the determinant factor for timely realization of LC process. With the analysis of LC effectiveness in terms of price, formation place and documentary condition are not creating price flexibility and the achievement of service pricing but place of payment and language and currency are the causes to gain price flexibility and service price of LC to be paid within the LC procedure at low service charge.

Overall, as a payment instrument, letter of credit has become widely used in international trade. Letter of credit is the life-blood of international commerce. Letter of credit takes care of the interests of both the exporter and importer, so it is considered to be the most effective and safest method to secure the payment in an international trade transaction. As the international convention for the letter-of-credit transaction, UCP 600 holds the most important doctrines for the use of letter of credit of the two principles such as principle of independence and strict compliance.

## 5.3 Recommendation

Banks should facilitate international trade as a major financial institution in goods and service including payment processing for merchandise shipped and services rendered, layouts funds for buyer and seller, and give professional advice to traders specially accurately rendering foreign banking services to facilitate the country's international trade. Altogether, on the basis of the findings of the study, the following recommendations are made:

- The practice of LC process in AIB East Region should be characterized as fast transfer of LC documents and handling filing documents of letters of credit properly. Most exporters and importers should raise any complain about the bank on documentary collection, advance and consignment payment processing, and treatment of guarantee and permit in all procedure of international trade and all imperfection of international banking practices and associated payment faultiness should be corrected accordingly

- Marketers should be forced to use freight forwarders who specialize in handling importation and exportation documents. This study recommends changes include elimination of unusual requirements of documentary credit and concise articulation of the context of each article to facilitate easy understanding of contractual terms
- Letter of credit should be issued after signing the sales contract but before shipment. It is to the advantage of the exporter to have the importer arrange for the issuance of a letter of credit as soon as after the signing of the sales contract as possible but before the sales contract importers should communicate with the bank and get advice on the contract of sale.
- AIB East Region must ensure that all documentation required is accurately completed and to minimize potential problems, firms just entering the international market should consider using freight forwarders who specialize in handling import/export documents.
- . The banks are providing a service of financing the transaction and they expect to be protected from getting involved in disputes between the parties as to the terms of the contract of sale. For this reason "the independence principle" is a very important concept in LC transactions. This means that the LC, and the documents required under the LC for payment, are completely independent from the underlying transaction between buyer and seller.
- Banks specially AIB voluntarily incorporate the Uniform Customs and Practice into the contracts upon which the letter of credit is based and likewise AIB should know that legal status of the Uniform Customs and Practice affects the international banking community and importing and exporting community worldwide and as the Uniform Customs and Practice has achieved such universal effect that in some countries the Uniform Customs and Practice is recognized as having the force of law or at least that of a trade tradition or custom
- Both the importers & especially the exporters participate or join expo/exhibition to get sales,to do effective marketing and widen the network.
- AIB East Region employees will know what they do and what is expected from them. In Particular, the bank could try to share experience with foreign banks. This will broaden

the employee's idea about foreign banks. And they will know with whom they are making business. It will also have a positive effect on customer service and the relationship with correspondent banks. In addition to this, AIB East Region would prepare seminars to its customers which would enlighten them about international trade. If the customers have the knowledge of foreign banking process of import/export, the letter of credit will be smooth and fast.

- AIB East Region would try to equip its IBD section with modern technological facilities (therefore, computers and electronic typewriters) providing this section with modern facilities should not be seen as an expenditure rather it is an investment. Since this section contributes a lot to the bank's profit, the modern facilities will improve the quality & time of the work very much because they have high speed and errors in typing can easily be corrected.

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Appendix Questionnaire-A

**Dire Dawa University**

**College Of Business And Economics**

**Department Of Logistics And Supply Chain Management**

Dear Respondents,

First of all I would like to forward my heartfelt gratitude and respect to you for administering this questionnaire honestly and responsibly. The questionnaire is designed to collect the necessary information to undertake a research title "Factors Affecting of Letters of Credit Effectiveness"for the partial fulfillment of Master of degree in Logistics and Supply Chain Management at Dire Dawa University.

The objective of the study is to investigate the factors that determines letters of credit effectiveness and also to explore the dimensions that has strong relationship to letters of credit effectiveness in the process of import and export practices at Awash Bank East Region. As a result the outcome of this study will depend upon your response. Therefore, I would like to request you to fill the questionnaire as per the instruction.

**Part One**: **Respondents - Demographic Profile**

**Instruction:** Please choose the correct information about yourself for the following questions among response categories by putting "√" mark in the box.

1. Age: 25 – 30 ☐  31 – 35 ☐  36- 40 ☐  More than 40 ☐
2. Sex: Male ☐  Female ☐

3. Education level: Diploma ☐  Degree ☐  Masters and above ☐

Other (Please specify) ______________________________

4. Working experience in your company (AIB) in years:

5years and below ☐  Between 6 and 10 ☐  between 11 and 15 ☐

Between 16 and 20 ☐  More than 20 ☐

5. Working experience with LC or International Trade in bank system in years

1 years and below ☐  Between 1 and 3 ☐

Between 3 and 5 ☐  Between 5 and 10 ☐

Morethan 10 years ☐

**Part Two:** For each of the following questions put "√" markto the correct answer.

**Question 1** - How do you rate the Formation **Place** of the contract in the process of LC on import and export goods? Please "√" mark in the table with the answer you choose.

| **Question Item** | **Strongly Agree** | **Agree** | **Neutral** | **Disagree** | **Strongly Disagree** |
|---|---|---|---|---|---|
| AIB applies national law on the process of LC as a contract is concluded where acceptance of an offer becomes effective. | | | | | |
| An offer in AIB's letters of credit, in general, takes the form of an instruction properly | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| With respect to an acceptance, in AIB practice, the applicant often communicates to the beneficiary by telex, SWIFT or other expedient means to give notice of acceptance. | | | | | |
| The practice of AIB causes legal complexity in contract formation context even under the rule which views a contract as concluded at the place where an acceptance is dispatched. | | | | | |

**Question 2** - How do you rate the **place of the payment** that is deemed to have a strong connection in determining the governing law of the contract? Please "√" mark in the table with the answer you choose.

| Question Item | Strongly Agree | Agree | Neutral | Disagre e | Strongly Disagree |
|---|---|---|---|---|---|
| AIB provides a secure payment method to the beneficiary; the performance of the payment obligation can be regarded as the essence of these instruments | | | | | |
| AIB is making reimbursement of the correspondent bank by the issuing bank effectively. | | | | | |
| AIB is effectively processing reimbursement of the issuing bank by the applicant | | | | | |
| AIB provides a secure payment method to the beneficiary; the performance of the payment obligation can be regarded as the essence of these instruments | | | | | |

**Question 3** - How do you ratethe application of **Language and currency**: the language and currency used in the contract are important factors which indicate the choice of law in certain situations? Please "√" mark in the table with the answer you choose.

| Question Item | Strongly Agree | Agree | Neutral | Disagree | Strongly Disagree |
|---|---|---|---|---|---|
| The practice of LC in AIB is to be normally payable & commonly used an international trade in U.S. dollars and English is an internationally accepted language. | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| AIB considers language and currency as significant factors which provide an indication of the choice of law in certain situations. | | | | | |
| In processing LC in AIB, it is quite normal for the terms and conditions of credits and guarantees to be drafted in English. | | | | | |

**Question 4** - How do you rate **documentary documentation** of the LC processing in AIBin terms of the following factors? Please "√" mark in the table with the answer you choose

| Question Item | Strongly Agree | Agree | Neutral | Disagree | Strongly Disagree |
|---|---|---|---|---|---|
| There is an ambiguity of the Uniform Customs and Practice 600 imposed by the International Chamber of Commerce generates documentary discrepancies in international trade transaction resulting unnecessary delays, refused payments and financial loss. | | | | | |
| AIB executes properly or manage the Supply chain and Quality management practices in the import/export supply chain | | | | | |
| AIB uses excessive requirements of terms and conditions on the letters of credit to generate documentary discrepancies in international trade transactions resulting unnecessary delays, refused payments and financial loss. | | | | | |

**Letter of credit Effectiveness in AIB East Region**

**Question 5** - How do you rate LC effectiveness in terms of **quality** as the following factors? Please "√" mark in the table with the answer you choose

| Question Item | Strongly Agree | Agree | Neutral | Disagree | Strongly Disagree |
|---|---|---|---|---|---|
| AIB properly protects both seller and buyer while they are engaged in the import and export business. | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| AIB tries to facilitate the export and import transaction by presenting the documents to the bank as required by the rules and regulations of letters of credit. | | | | | |
| In business transaction, AIB effectively acts as an intermediary to enforce the rules of the UCP 600 to both the exporter and the importer. | | | | | |

**Question 6** - How do you rate LC effectiveness in terms of **time** as the following factors? Please "√" mark in the table with the answer you choose.

| Question Item | Strongly Agree | Agree | Neutral | Disagree | Strongly Disagree |
|---|---|---|---|---|---|
| AIB provides real time information for exporters and importers regarding their LC documents, payments, transaction etc. | | | | | |
| AIB tries to facilitate LC documents and processes timely. | | | | | |

**Question 7** - How do you rate LC effectiveness in terms of **price** as the following factors? Please "√" mark in the table with the answer you choose.

| Question Item | Strongly Disagree | Disagree | Neutral | Agree | Strongly Agree |
|---|---|---|---|---|---|
| AIB requires a high service price to facilitate the export and import transaction. | | | | | |
| AIB tries to facilitate the export and import transaction within competitive and flexible price. | | | | | |

**Part Three**: Regarding **Document Discrepancy**

**Question 7 -** How do you rate the occurrence of **discrepancies of documents** that do not comply with uniform customs and practice document in terms of the following factors? Please "√" mark in the table with the answer you choose.

| **Discrepancies of Documents Do Not Comply with Uniform Customs and Practice** | **Always** | **Sometimes** | **Rarely** | **Never** |
|---|---|---|---|---|
| 1. Letter of credit expired | | | | |
| 2. late Shipment | | | | |
| 3. Description of goods differs from credit by inconsistence among documents and difference in INCOTERMS | | | | |
| 4. Insurance certificate have different currency | | | | |
| 5.Transport document omits name of the carrier | | | | |
| 6. Partial shipment is effected, while not allowed by the L/C | | | | |
| 7.Late presentation of documents | | | | |
| 8. Required signatures have been omitted on documents presented | | | | |
| 9. Copy insurance certificate presented instead of an original one | | | | |
| 10. Under-insured | | | | |
| 11. The insurance policy or certificate does not contain the risks stipulated | | | | |
| 12. Shipper, Consignee, notify party's name differs for the L/C | | | | |
| 13.The bill of lading does not indicate that the goods are on board the vessel | | | | |
| **14. The absence of Documents** | | | | |
| **15.Inconsistency in Documents** | | | | |
| **16. Incorrect Endorsement / Absence of Endorsement** | | | | |
| **17. Letter of credit overdrawn** | | | | |
| **18.Bill of Lading not clean (indicating that defective goods on their package)** | | | | |
| **19. The description of goods in the invoice is inconsistence with that of the credit** | | | | |

20. Share your opinion about the occurrence of discrepancies of import & export documents during examination at your bank

______________________________________________________________________________

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______________________________________________________________________________

21. If there is anything you would like to add regarding the company's strength and weakness in its letter of credit processing and factors affecting the effectiveness of the LC in terms of time, quality and price:

______________________________________________________________________________

______________________________________________________________________________

**Subject: Interview Check List**

1. What are the main problems associated with LC processing in terms of quality, time and price? Please identify the main gaps in LC processing and requirements.

______________________________________________________________________

______________________________________________________________________

2. According to National Bank of Ethiopia, please indicate the main requirements in processing letters of credit at AIB East Region

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______________________________________________________________________

3. Please indicate the main problems and the key facilitation of the export and import transaction as required by the rules and regulations of letters of credit and on guaranteeing that the seller will get paid.

______________________________________________________________________

______________________________________________________________________

4. Please indicate the mechanisms that AIB East Region applies and the national law that governs to protect both seller and buyer while they are engaged in the import and export business. Please indicate the national law that applied in the processing of LC in Ethiopia.

______________________________________________________________________

______________________________________________________________________

5. Do you think AIB East Region is effective in acting as an intermediary to enforce the rules of the Uniform Customs and Practice 600 to both the exporter and the importer?

______________________________________________________________________

______________________________________________________________________