



August 2025

STRUCTURED LETTERS OF CREDIT: CONSIDERATIONS FOR TRADERS AND TRADE FINANCE BANKS

INTRODUCTION

The use of structured letters of credit (also known as prepaid or synthetic letters of credit, "**Structured L/Cs**") has become increasingly common in trade finance transactions. While Structured L/Cs offer unique opportunities for liquidity and risk management, they also present specific issues and risks which traders and trade finance banks must carefully consider.

OVERVIEW OF STRUCTURED L/Cs

Structured L/Cs are often used where the applicant and the beneficiary are within the same trader group, such that the group could make profits and enhanced returns from the agreed financing structure based on existing physical trades. This is different from the conventional purpose of traditional letters of credit ("**L/Cs**"), which are normally used to facilitate sale and purchase of goods between unrelated parties.

Similar to L/Cs, Structured L/Cs contain payment undertakings from issuing banks that the beneficiaries will receive payment upon fulfilment of their obligations. However, applicants of Structured L/Cs, unlike those of L/Cs, would typically fulfil their deferred payment obligations under the Structured L/Cs upfront by, for example:

- + prepaying the issuing banks; or
- + providing security or guarantees (such as cash cover and standby letters of credit),

and in each case, coupled with settlement arrangements, and potentially agreed interest rates and foreign exchange arrangements with the issuing banks, depending on the applicants' commercial needs.

To obtain the cash for such arrangements, beneficiaries of Structured L/Cs would typically request that their banks confirm and discount the Structured L/Cs, so that the discounting proceeds could, directly or indirectly, be used to finance the applicants' prepayment, security or guarantee arrangements as described above.

Because of the unique financing purpose of Structured L/Cs, they generally contain more relaxed requirements than those of L/Cs, including but not limited to the acceptance of copy documents and discrepancies, high transaction amounts, deferred payment terms and inconsistencies between the L/C parties' and the financing banks' locations.



CONSIDERATIONS FOR TRADERS

+ **Off-balance sheet treatment**

From the applicants' perspective, one of the potential benefits of using Structured L/Cs is that their contingent obligations to make payment under the Structured L/Cs, if structured properly, would not be reported as liabilities in their financial statements, which would in turn improve their balance sheet debt-to-equity ratios and help with compliance with debt covenants.

If this is the intention, then it would be crucial for applicants to seek both legal advice and auditors' confirmations to ensure that the relevant arrangements are properly documented to reflect the off-balance sheet structures.

+ **Profit maximisation**

For the trader groups to maximise their profits under the Structured L/C arrangements, the following considerations should generally be taken into account:

- (i) the relative benefit of prepaying or placing cash cover in any interest-bearing accounts with the issuing banks by the applicants against the cost of confirming and discounting the Structured L/Cs by the beneficiaries for arbitrage opportunities; and
- (ii) whether any foreign exchange transactions would be commercially beneficial to the traders to hedge their positions under the Structured L/Cs.

CONSIDERATIONS FOR TRADE FINANCE BANKS

+ **Proper documentation**

Like traders, banks should be reminded to ensure the Structured L/Cs and all relevant documents are properly documented to comply with the provisions of UCP 600 and to accurately structure the financing, prepayment, security, guarantee, foreign exchange and settlement arrangements.

For instance, as copy documents are typically acceptable under Structured L/Cs, there is a higher risk that beneficiaries may present the same copy documents to other financial institutions to obtain financing. In order to mitigate such multiple financing risk, it is advisable to only name one confirming bank in each Structured L/C and to make sure such confirming bank is aware of the synthetic arrangement under the Structured L/C.

+ **Fraud and compliance risks**

Banks should take extra care to mitigate fraud risks by requiring traders to provide the underlying contracts which evidence genuine arms-length underlying trade transactions and the passing of title in the relevant physical goods.

All relevant banks (especially confirming banks which bear the main financial risk) should have full knowledge of the synthetic nature of the underlying transactions and ensure the relevant arrangements are sensible with reference to the trader groups' businesses.

In order to mitigate potential money laundering, terrorist financing and sanctions risks, banks are also reminded to adopt a risk-based approach and conduct appropriate due diligence in respect of their customers, their customers' businesses, the relevant goods, parties, transportation routes, as well as the nature and purpose of the underlying trade transactions. This is essential as such risks may potentially trigger bigger consequences than the amount of the Structured L/Cs.



+ **Hedging needs**

From a commercial perspective, issuing banks may consider adopting different hedging strategies including but not limited to the following:

- (i) ensuring that the amount of the relevant Structured L/Cs shall not exceed the amount of the prepayments, security or guarantees (together with the amount of any expected accrued interest); and
- (ii) where the currency of the prepayments, security or guarantees is different from that of the relevant Structured L/Cs, entering into foreign exchange arrangements with the relevant applicants and/or third-party banks for hedging purposes.

CONCLUSION

While Structured L/Cs offer significant opportunities for improving liquidity and enhancing returns in international trade transactions, traders and trade finance banks should be mindful of specific issues and risks associated with them. It is therefore of paramount importance to ensure the Structured L/C arrangements are properly and accurately documented to ensure all parties could benefit from the relevant transactions.

We regularly assist our clients in structuring and documenting trade finance transactions. Please get in touch if you are interested in discussing any of the above.

CONTACT US



ANNA KWONG

Partner

+852 2533 2854
anna.kwong
@stephensonharwood.com



PHOEBE CHENG

Associate

+852 2533 2810
phoebe.cheng
@stephensonharwood.com
