

The Practice of Import Letter of Credit in Commercial Bank of

Ethiopia

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1. Background of the Study

As a banker dealing with import business, one may be familiar with trade finance. Trade finance is the science that describes the management of money, banking, credit investment and assets for international trade transactions.

There are various trade finance methods by which capital can be raised for the traders, risks associated with international trade can be mitigated and payment can be effected. The other important thing to traders involved in international trade is managing their risks. These risks may be categorized as economic risks, exchange rate risks, transportation risks and political risks. Traders can mitigate such risks by utilizing the various services of insurance, companies and banks. Terms of payment are also the crucial things that buyers and sellers should agree on concluding a contract. The methods of payment are of different types with varying degree of securing payment. Therefore, banks as facilitator of international trade, knowing these various methods of payment, is equally important as for exporters and importers since having adequate knowledge on them helps the bankers to give quality services and support their customers in satisfactory manner by extending professional advice beyond mere effecting and receiving payments.

There are different methods of international trade payments of which import letter by a bank upon which payments in international trade are effected by banks through documents is one. It is issued by the bank at the request of a buyer (importer) to pay a seller (exporter) upon presentation of import documents specified in the instrument. This

study, therefore aims to evaluate the practice of import letter of credit in Commercial Bank of Ethiopia.

The history of banking in Ethiopia dates back to the turn of the last century, when in 1905 the Bank of Abyssinia was established in Addis Ababa, under the reign of Menelik II. The bank of Abyssinia was given a 50 year concession and was engaged in issuing notes, collecting deposits and granting loans, but its clients were mostly foreign business men and wealthy Ethiopians. Disappointed by the behavior of the bank, mainly devoted to profit making rather than promoting economic development, Haile selassie could not accept that the country's issuing bank was foreign owned and in agreement with National Bank of Egypt. Consequently, he decided to liquidate Bank of Abyssinia. A new bank, the Bank of Ethiopia, under government control was established in 1931 and rented management staff, premises and clings of the old bank, and the 1936 Italian occupation brought the liquidation of the Bank.

Currently, there are many private and government banks of which Commercial Bank of Ethiopia is one of them. Commercial Bank of Ethiopia is the largest bank in Ethiopia and has about 49 billion in assets, accounting for some 63.5% of deposits and 38% and above loans. The bank has 8,000 employees working in its head quarter and 205 branches positioned in the main cities and regional towns, including 45 branches in Addis Ababa. The bank recently opened new branches in the remote towns of Injibara and Humera. The bank had one branch in Djibouti which ceased operation recently. Commercial Bank of Ethiopia is chosen for this study as it is the bank with ample experience and voluminous transaction in international trade. (www.wikipedia.org)

2. Statement of the Problem

International trade is concerned with business transactions taking place between citizens of different nations. Commercial Bank of Ethiopia, being one of the biggest financial institutions, facilitates payment in the transaction.

Commercial letter of credit has been used for centuries to facilitate payment in international trade. Its use has continued to vary as the global economy changed in 1998 and on wards. New policy mechanism were introduced affecting importers to import by NBE, problems of delay by CBE to process L/C system and CBE also faces collateral evaluation problem. This study will try to investigate some of the unexploited advantages engaged in import letter of credit by Commercial Bank of Ethiopia.

3. Research Questions

In this study, the researchers will try to address the following questions:

- How are import letter of credit practiced in CBE?
- What are CBE procedures on import L/C and its impact on importers?
- What are the major effects of 100% margin import L/C handling policy?
- How are the employees involved in L/C acquainted with the activities?
- What is importers' level of satisfaction in CBE with the L/C method or system?

4. Objectives of the Study

4.1 General Objective

The general objective of the study is to investigate practices of import letter of credit and how it works at Commercial Bank of Ethiopia.

4.2 Specific Objectives

Having the fore mentioned general objectives, the researchers' aims to address the following specific objectives.

- To evaluate the CBE procedures for importers to import goods;
- To identify the effects of 100% margin import Letter of Credit handling policy ;
- To evaluate employees involvement with L/C activities; and
- To assess the satisfaction level of importers.

5. Research Methodology

The study employed descriptive research technique. Both primary and secondary data collection methods were employed. Primary and secondary data were gathered from Commercial Bank of Ethiopia, International Banking Division, National Bank of Ethiopia, and Private and Public importers. Face to face interview was conducted with selected division heads and employees of letter of credit section in IBD and NBE. In addition to this, policy manuals, office annual reports and publication were gathered from CBE branch offices.

The research considers letter of credit transaction in L/C section at Commercial Bank of Ethiopia branch office, head office-International Banking Division (IBD) and National Bank of Ethiopia (NBE) as a population. Using simple random sampling, from 45 branches of CBE, only three branches were selected, namely Joseph Branch, Mahatma Gandhi Branch and Kirkos Branch; and using judgmental sampling method, two organizations, one from public and one from private (Importers) were selected. Respondents in the IBD, NBE, ECAA and NOC are accountants, L/C clerks, L/C auditors and importers who have direct and indirect relationships with the problem under study.

6. Summary of Findings, Conclusion and Recommendations

The study was designed to examine the import letter of credit practice in CBE and intended to suggest possible recommendation to the problems identified in order to enhance the effectiveness of L/C system. This section, therefore, presents summary of findings, conclusions and possible recommendations.

6.1 Summary of Findings

Commercial Bank of Ethiopia is authorized to allow import and provide associated services against required document. If importers need to import goods, they have to first

apply for import permit after having clearance certificate from National Bank of Ethiopia. CBE receives the following from customers – L/C application signed by customer and other supporting documents required as per National Bank of Ethiopia’s directives issued in 1998 and onwards. Then, the CBE verifies the signature against the specimen maintained on the system.

Commercial Bank of Ethiopia ensures that the importers have a valid trade license along with other documents and L/C might be cancelled made by way of amendment. Amendment is accepted if there is an agreement between the two parties and if it is not contrary to National Bank of Ethiopia’s directives and International chamber of commerce rules. Handling of letter of credit is known as L/C settlement. Letter of credit can be settled in full or in part. If there is no any discrepancy with the documents and does not affect the directives the normal processing continues. Otherwise the documents should be returned and then the files closed by reversal entries. Closing is needed if the L/C remained expired for more than 45 days and the remaining balance of partially settled 5% of L/C is not expected to be shipped.

Commercial Bank of Ethiopia closely follow up by sending a reminder message to customer to settle the amount outstanding L/C every 15 days. Failure to collect documents covering shipment by air, foreign currency approval every week and settle L/C with source of fund reserve should be reported by Commercial Bank of Ethiopia (on subsidiary and general ledger of customers). There are advantages as well as risks of using L/C. The policy of 100% margin deposit, shortage of foreign currency and delayance of CBE’s approval for import permit discourage importer to import. But CBE is doing with its full potential to gain its customers’ satisfaction.

Finally the pros outweigh the cons, so importers choose letter of credit instead of any other trade settlements in Commercial Bank of Ethiopia.

6.2 Conclusion

From the preceding discussion, we have seen that the overall performance of international banking activities in the reported period was satisfactory. The continued improvement of its import foreign – transfer performance has created condition for the bank’s international banking operations. Furthermore, the IBD’s business process is being reengineered, as part of the bank’s overall BPR. However, there are certain changes in policies from 2000 on wards which are still being applied. Importers who have been enjoying L/C facility are unable to import due to 100% margin deposit. The new customers other than importers of pharmaceuticals, fertilizers, fuel, public transport vehicles, airplanes, ships, boats and investment goods exempted from custom duty of Ethiopian Investment Authority.

Commercial Bank of Ethiopia delays to approve import permit application after having clearance certificate from NBE because of the preparation for BPR. As a result, importers money is blocked for sometime and sales contract expires on CBE’s counter. Even if the banks process and procedures are getting better and the services are going more smoothly than before, there is also a problem that many banks are facing today regarding to the shortage of foreign currency which may not be improved any time soon. As a result, this will end up in affecting the customers’ satisfaction.

Finally, when the researchers looked at the performance of three branches, they found out that staffs were doing to their full potential to satisfy their customers and working to the highest standard to minimize the L/C risk exposure.

6.3 Recommendation

Based on the foregoing major findings of the study, the researchers forwarded the following recommendation.

- The bank has to develop appropriate policy so that it will bring satisfaction to customers and banks to increase interest income earned from L/C facilities.

- In order to manage L/C risk involved in the area of Foreign Service, the bank needs to develop and implement comprehensive procedures and information system to follow up the condition of its customers.
- The bank has to seek ways of dealing with the collateral valuation problems (applicant who are unable to pay). The bank could take security like cash collateral and make sure that the L/C facility limits are not exceeded. Moreover, the bank has to follow – up and ensure the strict and uniform implementation by the engineers of the existing and any forth coming procedures concerning proper valuation.
- The bank must check documents carefully against the L/C terms and conditions as well as inter – compliance to avoid from paying documents containing discrepancies.
- Consulting applicants (importers) on the outcomes of the evaluation that is made based on the information data and documents submitted should be emphasized.
- Short term training and workshops for personnel engaged in the analysis work should be organized regularly and also avail relevant reading materials should be availed.
- The bank has to establish organizational set-up for its credit management concerning L/C and deliver service to the highest standard.

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