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Enhancing Payment Security For SMEs In Global Trade Trough Letter Of Credit: A Case Study Of Chip Producer In Batu

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Abstract

Small and medium-sized enterprises (SMEs) play a pivotal role in global trade, but they face significant challenges, particularly in managing payment risks. This study investigates the role of Letters of Credit (LCs) in enhancing payment security and financial stability for SMEs in international trade, using a case study of PT. ATN, an SME located in Batu Malang, Indonesia. The research aims to explore how LCs mitigate payment risks, improve operational stability, and facilitate participation in global markets. A qualitative research methodology was employed, utilizing semi-structured interviews and documentary analysis. Data were analyzed thematically to identify key challenges, benefits, and the broader implications of LC utilization. The study also examined the operational processes involved in LC issuance, including the critical role of banks as intermediaries. The findings reveal that LCs significantly reduce payment uncertainties and enhance cash flow stability for SMEs. By ensuring payment through third-party bank guarantees, LCs provide a financial safety net that enables SMEs to focus on market expansion and productivity improvements. However, challenges such as stringent documentation requirements and complex procedures hinder their wider adoption. Institutional support, including trade fairs and export facilitation programs, was identified as critical in connecting SMEs with international buyers and supporting LC usage. This study contributes to the existing literature by providing empirical insights into the practical applications and challenges of LCs in emerging markets. It underscores the need for targeted training and the integration of digital technologies to streamline LC processes.

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These findings have important implications for policymakers and financial institutions seeking to empower SMEs in the global trade landscape.

Keywords: Letters of Credit, Global Trade, SMEs, Trade Finance

INTRODUCTION

Micro, Small, and Medium Enterprises (MSMEs) serve as a crucial backbone of the national economy, accounting for approximately 99% of all business units in Indonesia. These enterprises contribute up to 60.51% of the national Gross Domestic Product (GDP) and employ nearly 97% of the total workforce. Despite their significant role in the domestic sector, MSMEs' contribution to national exports remains relatively low. The Ministry of Cooperatives and Small and Medium Enterprises has noted that MSME contributions to national exports were only 15.7% in 2023. This has drawn government attention, with targets set to increase MSME contributions to commodity exports to 17% by 2024. Recognizing the potential for MSMEs to further integrate into global markets (Chakravarthy et al., 2023; Harel, 2021; Rutendo, 2018), it is essential to explore mechanisms that can facilitate their participation and ensure their financial security in international trade.

Global trade represents a significant portion of economic activity for small and medium-sized enterprises (SMEs), offering them vast opportunities for growth beyond their local markets. However, engaging in international transactions introduces complex challenges, particularly in managing payment risks (Heinzova et al., 2023; Manurung & Manurung, 2019). These challenges are exacerbated for SMEs, which often lack the resources and bargaining power to mitigate risks effectively compared to larger corporations. One critical tool that has been historically important in facilitating safe and secure international trade is the Letter of Credit (LC).

The LC stands out as a pivotal financial instrument in international trade by ensuring that payment terms are strictly adhered to, providing a guarantee from the buyer's bank to the seller that payment will be made on time and for the correct amount, conditional upon the delivery of goods as per agreed terms (LEE, 2021). This mechanism not only secures payment but also aligns with regulatory and legal frameworks across different jurisdictions, reducing the risk of financial loss due to non-compliance or fraud (Istianah, 2021; Kamaluddin et al., 2021; Puneri, 2021).

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Despite its advantages, the utilization of LCs involves certain complexities. These include stringent requirements for documentation and the need for all parties to adhere precisely to terms specified in the credit letter, which can be a significant hurdle for SMEs unfamiliar with the process (LEE, 2021). Furthermore, the integration of LCs with digital technologies and compliance with international standards adds another layer of complexity(Ruslan, 2023), or using blockchain (Ermakov et al., 2018).

In light of these challenges, this study focuses on a case involving a chip producer in Batu, Indonesia, to illustrate how LCs can be leveraged to enhance payment security for SMEs in global trade. The choice of this locale and business context is particularly relevant due to Indonesia's emerging market status and its increasing integration into global trade networks. The chip producer, a small enterprise, represents a typical SME that could benefit significantly from enhanced payment security in its export activities.

The paper will explore various dimensions of LC usage in enhancing payment security. It will examine the operational intricacies of LCs, the benefits and challenges associated with their use, and the specific impacts on SMEs engaged in global trade. This examination will be underpinned by empirical data and literature that underscore the effectiveness of LCs in mitigating payment risks (Kamaluddin et al., 2021) and enhancing the economic viability of SMEs (LEE, 2021).

Moreover, the study will discuss the adaptation of traditional LC mechanisms to modern financial technologies and the implications of such adaptations for SMEs. With the advent of digitalization in banking, there are opportunities to streamline and simplify the LC process, potentially making it more accessible and less cumbersome for SMEs (Ruslan, 2023).

Finally, the paper aims to contribute to the academic discussion by providing empirical evidence from the case study, alongside a comprehensive review of the literature on international trade finance, SME performance in global markets, and the role of financial instruments in securing payments. The ultimate goal is to offer insights into how SMEs can navigate the complexities of international trade with enhanced security and efficiency, using LCs as a tool to safeguard their transactions against common financial risks. This discussion is crucial for policymakers, financial institutions, and SMEs themselves as they collectively seek to foster a more inclusive and secure global trading environment.

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RESEARCH METHODS

This section outlines the qualitative research methodology and case study approach adopted to explore the efficacy of Letters of Credit (LC) in enhancing payment security for SMEs in global trade, with a particular focus on a small enterprise named PT. ATN (PT. Arjuna Triple Nine) located in Batu, Malang, Indonesia.

Research Design

Adopting a qualitative research design, this study uses a case study approach to provide an in-depth analysis of the practical application and implications of LCs in international trade for SMEs. Case study research is appropriate for investigating contemporary phenomena within their real-life context, especially when the boundaries between phenomenon and context are not clearly evident (Hollweck, 2015). This approach allows for a comprehensive understanding of the complex issues faced by SMEs in using LCs and the strategies they employ to mitigate associated risks.

Research Location

The research was conducted in Batu, Malang, Indonesia, where the selected SME operates. This location was chosen due to its growing importance as a hub for SMEs engaged in international trade within the region. PT. ATN, a chip producer known for its export activities, provides a pertinent example of the challenges and opportunities associated with using LCs in a developing market context.

Data Collection

Data were collected through a series of semi-structured interviews and document reviews. Interviews were conducted with key stakeholders, including the SME's management team, finance officers, and external trade partners who interact with the LC process. This method facilitates the collection of detailed information and personal experiences directly related to the use of LCs (Bryman, 2012). Documentary review supplemented the interviews, involving analysis of trade documents, financial statements, and LC records provided by the SME. This helped in understanding the procedural context and the actual documentation involved in LC transactions.

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Data Analysis

Data from interviews and documents were analyzed using thematic analysis, a method for identifying, analyzing, and reporting patterns (themes) within data (Braun & Clarke, 2006). This approach is particularly suited to case study research where different types of data are integrated to provide a rich narrative. The analysis involved coding data in an iterative process, where initial codes were generated and then grouped into broader themes that describe the complexities of using LCs in enhancing payment security.

RESULTS AND DISCUSSION

This section presents the findings from the case study of a small enterprise in Batu, Malang, Indonesia, PT. ATN, specifically focusing on the use of Letters of Credit (LCs) in securing payments for international trade. The results are discussed in the context of the operational challenges and benefits identified through thematic analysis of interview and documentary data. These findings are compared with existing literature to validate the study's outcomes and discuss their broader implications for SMEs in similar contexts.

The Process of Issuing Letters of Credit

The issuance process of Letters of Credit (LCs) involves several stages, from the initial application to the final settlement of payments. Observations indicate that many SMEs face administrative challenges during the LC issuance process, particularly in ensuring the completeness of required documents and meeting stringent conditions. These difficulties are largely attributed to SMEs' limited understanding of the documentation requirements and the inherent complexity of the process (Cindawati, 2018). Additionally, limited access to credible banks with international networks presents another obstacle, especially for SMEs located in remote areas.

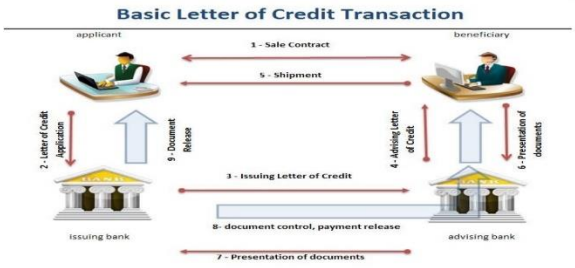


Figure 1: **Letter of Credit Issuance Process Flow**

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Figure 1 illustrates the LC issuance process, starting from the application by the importer to the final stage of payment receipt by the exporter once all document requirements are fulfilled. From this diagram, it is evident that LCs involve multiple stages of document validation by the issuing bank, which ensures that all conditions are met before the payment is made. According to interviews, exporters noted that this process provides a sense of security, as funds are transferred only after the required documents have been received and approved. However, challenges in document compliance remain a significant barrier, as highlighted in a study by Purba (2024) , which shows that any incompleteness or discrepancies in the documentation can result in delays or even rejection of payments. These findings underscore the critical need for enhanced training and capacity-building initiatives for SMEs to better understand and navigate the LC issuance process. Additionally, improving access to reliable banking partners with strong international networks is vital to facilitating smoother trade transactions for SMEs.

PT. ATN's Interview for Export Strategies

The interview with the proprietor of PT.ATN revealed detailed strategies and experiences related to their international sales and use of LCs. The enterprise began exporting in 2015 and has since established a diverse international market base, including countries such as Hong Kong, Korea, Singapore, the Philippines, Malaysia, Canada, and the UAE.

1) **Initiation of Export Operations:** The business initiated export operations following direct contact by an international buyer from Hong Kong who learned about the company through Facebook. This initial contact led to a transaction where the payment was made in full upfront, indicating a direct and immediate trust in the payment process. PT.ATN provides detailed insights into the technical strategies employed to enhance export efficiency and establish long-term relationships with international buyers. These strategies demonstrate a combination of innovative marketing, structured business engagements, and meticulous project management.
2) **Current Export Techniques: T**he technical strategies employed to enhance export efficiency and establish long-term relationships with international buyers. These strategies demonstrate a combination of innovative marketing, structured business engagements, and meticulous project management.
   (i) **Digital Marketing:** The enterprise has prioritized creating engaging and communicative digital marketing campaigns to promote its products effectively.

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This approach leverages social media platforms and other digital channels to attract international buyers and increase brand visibility.

(ii) **Participation in International Exhibitions:** PT ATN actively participates in international trade fairs as both a visitor and exhibitor. These events, often organized by the Ministry of Trade or through invitations from Indonesian embassies abroad (e.g., Singapore Embassy), provide valuable opportunities for networking with potential buyers and showcasing their product range.

(iii) **Business Matching:** The company engages in structured business matching sessions, where detailed discussions are held with potential buyers regarding product specifications, pricing, production capacity, and special services offered. These services may include private labeling, shipping and packing solutions, and handling regulatory documentation. These sessions also provide a platform for exchanging relevant business insights and sharing experiences, further building trust and rapport.

(iv) **On-Site Visits:** Inviting buyers to visit the company's facilities serves as a crucial trust-building measure. This practice allows buyers to assess the enterprise's capabilities firsthand, increasing their confidence in the quality and reliability of the business.

(v) **Establishing Terms:** PT. ATN emphasizes the importance of creating clear agreements to ensure smooth business operations. These include:

- **Non-Disclosure Agreements (NDA):** Protecting confidentiality during initial discussions.
- **Trade Agreements:** Outlining the rights and obligations of both parties, including return policies, payment terms, and sales area terms.
- **Forecast Agreements:** Establishing umbrella agreements to govern buyers' future orders.

(vi) **Project Handling:** Comprehensive project management practices are implemented to ensure seamless execution of export orders. These include:

- **Business Planning:** Preparing forecasts and arranging necessary financing.
- **Regulatory Documentation:** Obtaining essential certifications such as HACCP (Hazard Analysis and Critical Control Points), Food and Drug Administration (BPOM-Badan Pengawas Obat dan Makanan), halal, and

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Business Identification Number (NIB-Nomor Induk Berusaha) with Importer Identification Number (API-Angka Pengenal Importir).

- **Material Preparation:** Coordinating with vendors to secure materials and facilities.
- **Packing and Shipping Coordination:** Ensuring that logistics meet buyers' expectations.

These export strategies reflect the enterprise's commitment to professionalism, compliance with international standards, and the delivery of tailored services to meet the needs of diverse markets. By systematically integrating these practices, PT.ATN has established itself as a reliable partner in international trade, enhancing its competitive edge and long-term sustainability.

3) **Regular Export Schedule:** The company maintains a bi-weekly export schedule to Hong Kong, Malaysia, and Singapore. For newer markets like Paris and Dubai, contacts were made through trade fairs organized by Indonesia's Ministry of Trade, which underscores the importance of governmental support in facilitating international business connections.
4) **Payment Modalities:** PT.ATN utilizes various payment methods, including full upfront payments, 50% down payments, and Letters of Credit. Notably, the use of LCs is exclusive to customers from Dubai, driven by the complex customs and importation processes in that region which delay the final transaction completion and payments.

Benefits of Using Letters of Credit

Despite the challenges associated with their use, LCs also provided notable benefits, primarily enhancing payment security and trust with international partners. One key benefit identified was the mitigation of default risk, as the issuing bank guarantees payment upon the fulfillment of contractual obligations (Heinzova et al., 2023). This guarantee significantly reduces the financial vulnerability associated with international trade.

The utilization of LCs has proven to have a positive impact on the financial stability of SMEs engaged in international trade. LCs provide a guarantee that payment will be made once the stipulated requirements are met, contributing to improved cash flow and reducing the uncertainties faced by exporters (Utama et al., 2024; Wijaya et al., 2022) . In the context of SMEs, LCs allow them to focus on enhancing productivity and market development without worrying about the risk of payment defaults. This impact aligns with

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the views of (Cindawati, 2018), who noted that LCs offer certainty to SMEs in securing payments as per the terms of international trade agreements. Based on the findings of this research, the enhanced financial stability facilitated by the use of LCs can be seen as a crucial boost for SMEs to be more active in international markets.

To illustrate this impact more clearly, Table 2 presents data on the improvement in cash flow for SMEs before and after the use of LCs.

Table 2. Comparison of SME Cash Flow Before and After Using Letters of Credit

Condition	Average Monthly Cash Flow (Rp)
Before Using LC	200 million
After Using LC	350 million

The average increase in cash flow of 75% after using LCs demonstrates that this instrument is effective in supporting the liquidity of SMEs. These findings support previous literature which emphasizes that the payment security provided by LCs allows exporters to plan their finances more effectively (Madani et al., 2022). Participants also highlighted improved business credibility and relationships with overseas partners. By utilizing LCs, the SME was perceived as more reliable and professional, which is crucial for maintaining long-term business relationships. This finding aligns with Ruslan (2023), who suggests that the formal structure of LCs can enhance the reputation of SMEs in international trade networks.

Challenges of Using Letters of Credit

The thematic analysis identified several key challenges faced by the SME when utilizing LCs. The first major challenge relates to the complexity and stringency of documentation requirements. As noted by (LEE, 2021), LC transactions demand precise documentation that conforms strictly to the terms specified in the credit agreement, a process that many SMEs find daunting. This was echoed by the SME's finance officers, who reported difficulties in aligning internal processes with these requirements, often leading to delays and increased transaction costs.

Another significant challenge is the lack of familiarity with LC procedures among SME staff. Training for staff to manage LCs effectively is crucial, yet it represents an additional

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cost for the SME (Kamaluddin et al., 2021). This issue was particularly pronounced in situations where rapid adjustments were needed to respond to changing conditions in international markets.

Implications

The case study of PT.ATN offers significant insights into the strategic use of LCs in navigating the complexities of international trade.

1. **Governmental Role:** The initiation of export relationships facilitated by trade fairs highlights the critical role of government in supporting SMEs' entry and expansion into foreign markets. Such support is vital in connecting SMEs with potential international buyers. Support from local government, such as that provided by relevant departments in the Malang Raya area, is a critical factor affecting the success of UMKM exports in the region, as is the role of the government for MSMEs in Medan (Hidayat et al., 2024). Additionally, initiatives by Customs to facilitate export ease for UMKM, such as the KITE IKM program (KITE IKM - Kemudahan Impor Tujuan Ekspor Industri Kecil dan Menengah), strengthen the position of UMKM in the international market by providing tax exemptions and duty-free facilities for production raw materials. These steps significantly reduce production costs and improve the competitiveness of UMKM products in the global market (Seroja et al., 2023).
2. **Banks' Role in Facilitating Export Processes:** The primary role of banks in international trade is to provide payment guarantees to exporters. The issuing bank ensures that payment will be made once all required documents and conditions are met, offering exporters a sense of security throughout the transaction. Access to credible banks with international networks is particularly crucial for SMEs, especially those located in remote areas. Banks act as intermediaries, offering infrastructure and services to facilitate international trade transactions using LCs. Asah et al. (2020; Cindawati (2018) highlights the importance of banks with global connections in ensuring secure and efficient cross-border transactions. Islamic banks can use products with murabahah contracts (Novita et al., 2015).

   This partnership between banks and SMEs is integral to overcoming operational challenges in the LC process, including document validation and compliance with international trade regulations. By leveraging banking networks, SMEs like PT. ATN can enhance their capacity to participate in global markets with reduced financial risks and increased operational efficiency.

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3. **Current Export Techniques:** PT ATN actively employs a range of strategies to streamline its export processes, including digital marketing, participation in trade exhibitions, and business matching sessions with potential buyers. These methods, supported by banking services, have enabled the enterprise to expand its market reach and build robust relationships with international partners.
   These findings underscore the indispensable role of banks as facilitators of secure and efficient international trade, particularly through their involvement in LC transactions. By offering payment guarantees, credible banking networks enable SMEs to navigate complex global trade dynamics with greater confidence and stability.
4. **Payment Security:** The use of LCs specifically for the Dubai market underscores the utility of this financial instrument in managing payment risks associated with complicated customs procedures. LCs provide a guarantee that payments will be secured even when goods are delayed at customs, ensuring that the SME's cash flow is not adversely affected. The findings of this study align with existing literature on the effectiveness of Letters of Credit (LCs) as reliable instruments for mitigating payment risks in international trade. Both Purba (2024) and Utama et al. (2024) emphasize that LCs serve as robust mechanisms for risk mitigation, particularly due to the involvement of banks as trusted third parties that guarantee payment transactions. These insights reinforce the central role of LCs in reducing financial uncertainty for exporters and building trust in cross-border transactions.
5. **Market Diversification:** The variety in payment methods and the strategic choice of using LCs for specific markets illustrate the need for flexibility and adaptation to different international trade practices and regulations. Additionally, Abduraxmonovich, (2021) and Utama et al. (2024) highlight that LCs contribute significantly to maintaining the operational stability of small and medium-sized enterprises by mitigating cash flow risks and providing better financial protection. This stability allows SMEs to allocate resources more effectively, enhancing their ability to manage production, logistics, and market expansion efforts without being constrained by financial uncertainties. These findings are particularly relevant for SMEs like PT.ATN, which rely on predictable cash flows to sustain their operations and fulfill the demands of international buyers. By offering such financial safeguards, LCs not only protect SMEs from potential losses but also enhance their credibility and reliability in the eyes of global trading partners. This dual role

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of LCs as a financial safety net and a trust-building tool underscores their importance as a critical component of international trade strategies for SMEs operating in high-risk environments

6. **Training for SMEs:** From a practical perspective, these results also underline the need for targeted training and education programs for SMEs. While LCs enhance transaction security and financial stability, administrative challenges remain a significant barrier for many SMEs. Implementing specialized training programs focusing on LC procedures and documentation requirements would significantly improve SMEs' understanding of this payment instrument. Such initiatives would not only reduce errors and delays in the LC process but also empower SMEs to actively participate in international markets with greater confidence and efficiency.

By providing SMEs with the necessary knowledge and skills to navigate LC complexities, these programs could further amplify the positive impacts of LCs on financial stability and risk mitigation. This practical intervention would complement the financial and operational benefits already observed, fostering a more inclusive and competitive global trade environment for SMEs

CONCLUSION

This study examined the role of Letters of Credit (LCs) as a risk mitigation instrument and payment method in international trade, focusing on SMEs in Indonesia through a case study of PT. ATN. The findings highlight that LCs significantly enhance payment security, financial stability, and trust between SMEs and international trading partners. By mitigating the risk of payment defaults, LCs enable SMEs to improve cash flow and operational stability, allowing them to better plan and expand their business activities in global markets. The involvement of banks as trusted third parties plays a pivotal role in ensuring the reliability and success of LC transactions.

Despite these advantages, the study also identified notable administrative challenges associated with LC issuance, particularly the stringent documentation requirements and complex procedures, which can be a significant barrier for SMEs with limited resources. These challenges underline the need for targeted training programs to improve SMEs' understanding of LC processes and for stronger collaborations with banks that have extensive international networks to facilitate efficient and secure trade transactions.

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The implications of this research emphasize the importance of LCs in empowering SMEs to compete more effectively in global markets. By providing empirical evidence on the benefits and challenges of LC utilization, this study contributes to the existing body of knowledge on international trade finance, particularly in the context of SMEs in developing economies. It underscores the critical role of institutional support, such as participation in international trade fairs and export facilitation programs, in helping SMEs overcome trade barriers.

Future research should adopt a multi-case study approach covering diverse sectors and geographic regions to enhance the generalizability of findings. Additionally, exploring the integration of digital technologies, such as blockchain, into LC processes could provide further insights into how innovations can improve the efficiency and accessibility of this financial instrument for SMEs. By advancing both practical and theoretical understanding, this study lays a foundation for more effective policy interventions to support SMEs in navigating the complexities of global trade.

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