

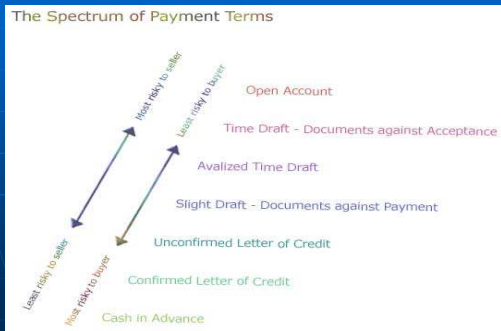
Commercial Letters of Credit

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Definition

A letter of credit is a written undertaking by a bank (issuing bank), acting at the request and on the instructions of its customer (applicant for the credit)

Risk Spectrum



Documentary Letters of Credit

Commercial (documentary) letters of credit (LC) are a written undertaking by a bank (issuing bank) acting at the request and on the instructions of its customer (applicant for the credit) to:

- Make payment to (the order of) a third party (beneficiary)
- Accept and pay bills of exchange (drafts) drawn by the beneficiary
- Authorize another bank to effect such payment or to pay, accept or negotiate such bills of exchange (drafts)

Credit terms and conditions must be met before payment, negotiation or acceptance can be made

May include a variety of documents

- Draft, bill of lading, commercial invoices, certificate of origin and insurance policies or certificates

Generally governed by the Uniform Customs and Practice for Documentary Credits (UCP)

Participants Under a Letter of Credit

- Applicant or account party (buyer/importer)
- Beneficiary (seller/exporter)
- Issuing Bank (the importer's bank)
- Advising Bank (usually a bank located in the exporter's locale and through which the credit has been advised)

Issuing Bank

The issuing bank, upon instruction of the applicant, opens or "issues" the letter of credit.

Advising Bank

The advising bank is usually a branch or correspondent of the issuing bank, located in the beneficiary's locale.

Additional Banks

Other banks may become involved as well, in order to facilitate a letter of credit transaction.

Paying Bank/Accepting Bank

This is the bank on which the draft is drawn. It can be the issuing bank, the advising bank, or yet another nominated bank.

Negotiating Bank

The term "negotiating bank" applies to a bank, usually in the locale of the beneficiary, that gives value for drafts and/or documents under the credit.

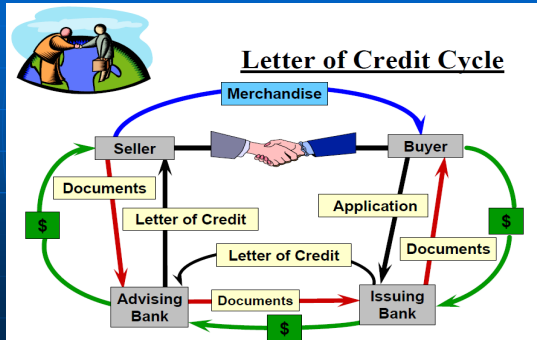
Confirming Bank

The term "confirming bank" applies to the bank, usually in the locale of the beneficiary, who, at the request of the issuing bank, may "confirm" or obligate itself to the beneficiary to insure payment/acceptance of a draft under the letter of credit.

Steps in Letter of Credit Cycle

- STEP 1 - The buyer agrees to purchase goods from the seller using a letter of credit as the mechanism of payment.
- STEP 2 - The buyer applies to his bank for a letter of credit, signing the bank's letter of credit application/agreement form.
- STEP 3 - After approving the application, the issuing bank issues the actual letter of credit instrument and forwards it to the advising bank via a SWIFT message.
- STEP 4 - The advising bank authenticates the letter of credit and delivers it to the beneficiary (the seller).
- STEP 5 - Having received the issuing bank's assurance of payment, the beneficiary (seller) ships the merchandise to the applicant (buyer).
- STEP 6 - The beneficiary (seller) prepares the documents called for in the letter of credit and presents them to the negotiating bank. The letter of credit may specify a negotiating bank or it may say it is "available with any bank," giving the beneficiary the freedom to choose.
- STEP 7 - The negotiating bank examines the documents and, if they comply, obtains funds for payment to the beneficiary in accordance with the terms of the letter of credit.
- STEP 8 - The negotiating bank transfers payment to the beneficiary (seller) and forwards the documents to the issuing bank.
- STEP 9 - The issuing bank examines the documents. If it agrees with the negotiating bank that the documents comply with the letter of credit, the issuing bank obtains payment from the applicant (buyer) in accordance with the terms of the applicant's letter of credit agreement and forwards the documents to the applicant.
- STEP 10 - The applicant (buyer) uses the documents to pick up the merchandise from the carrier, completing the letter of credit cycle.

Letter of Credit Cycle



Types of Letter of Credit

Revocable vs. Irrevocable

- Revocable-under this type of credit, the issuing bank is allowed the right to cancel (revoke) or modify the terms of the credit without the consent of the beneficiary.
- Irrevocable-this type constitutes a definite undertaking by the issuing bank to pay or accept drafts drawn under the letter of credit provided that the terms and conditions of the credit are complied with.

Types of Letter of Credit

Unconfirmed vs. Confirmed

- An unconfirmed letter of credit is one which has solely been advised to the beneficiary by the advising bank without adding its confirmation.
- A letter of credit is "confirmed" when the second bank, usually in the locale of the exporter, has added its confirmation (obligation of assurance of payment) to that of the issuing bank.

Types of Letter of Credit

Straight vs. Negotiation

- The term 'straight' is used when the obligation of the issuing bank to pay/accept drafts, or to incur a deferred payment obligation extends only to the beneficiary of the credit.
- Negotiation is used when the obligation of the issuing bank to pay/accept drafts or incur a deferred payment obligation extends not only to the beneficiary, but also to the nominating bank in the credit.

Types of Drafts

- Sight Draft: if a letter of credit requires the beneficiary to draw a draft "at sight", it is expected that the beneficiary will receive payment as soon as the documents are presented and the negotiating (paying) bank has had a reasonable time to examine the documents to determine if they are in compliance with the credit terms.

Types of Drafts

- Time draft (also referred to as acceptance draft or usance draft) – if a letter of credit requires the beneficiary to draw a time draft for acceptance with payment at some determinable future date, it is expected that the bank on which the draft is drawn (drawee) will accept the draft as soon as the documents complying with the credit terms are at the nominating bank and such nominated bank has had a reasonable time to examine those documents.

Special Letter of Credit Arrangements

Transferable Credits

- Exporter may wish to transfer rights under a credit to another party
- Often used when the exporter is not the supplier of merchandise but is an intermediary between a supplier and an importer
- Allows the beneficiary (the exporter) to transfer all or part of the rights under the credit to a third party (transferee)
- The respective rights are passed to the transferee who must comply with the terms and conditions of the transferred credit in order to receive payment
- Exporter must arrange for the importer to have a credit opened expressly stipulating that it is 'transferable'
- Before transfer can be made, exporter must send a written request to the transferring bank
- Transferring bank, whether it has confirmed the credit or not, is under no obligation to effect the transfer except to the extent and in the manner to which it has expressly consented and until bank charges for such transfer are paid
- UCP sets forth the conditions under which credits may be transferred and specifies the rights and obligations of the various parties
- UCP provides that a credit may be transferred only once

Special Letter of Credit Arrangements

Assignment of Proceeds

- Assignment of proceeds should not be confused with 'transferable' credit
- The terms are entirely different
- For a letter of credit to be transferable, it must clearly state that it is 'transferable'; no other terminology is acceptable
- However according to the UCP, 'the fact that a credit is not stated to be transferable does not affect the beneficiary's rights to assign any proceeds which he may become entitled to under such credit, in accordance with the provisions of the applicable law'
- With an assignment of proceeds, the beneficiary of a letter or credit assigns all or part of the proceeds under a credit to a third party (the assignee)
- Unlike a transferred credit, the beneficiary maintains sole rights to the credit and is solely responsible for complying with its terms and conditions
- For the assignee, assignment means only that the paying bank, once it receives notice of the assignment, undertakes to follow the assignment instructions, if and when payment is made
- An assignment of proceeds does not provide the assignee with any rights under the credit.
- The assignee is dependent upon the beneficiary for compliance
- Arrangement is more risky for the assignee than a transferred credit

Special Letter of Credit Arrangements

Back-to-Back

- An exporter may, as in the situation described under transferable credits, be an intermediary between a supplier and an importer
- Exporter might ask the advising bank or a third bank to issue a second letter of credit in favor of the supplier, using as collateral a letter of credit issued in the exporter's favor
- Banks are reluctant to enter into back-to-back arrangements because of the associated risks
- Anticipated compliance and eventual payment under the first credit should provide some assurance of payment under the second, but performance under the first credit may become impossible, either through acts of the parties involved, government edict, or other causes
- Most banks will generally prefer their customers to utilize transfer or assignment of proceeds arrangements rather than back-to-back letters of credit

Special Letter of Credit Arrangements

Red Clause

- A beneficiary may require financing in order to complete the manufacturing of merchandise or to purchase items to fill a particular order
- A Red clause credit helps achieve this
- Name is derived from the historical practice of placing a notation in the credit in red ink to identify this option
- Issuing bank authorizes the advising or confirming bank to make a cash advance to the beneficiary against the beneficiary's written undertaking to present documents evidencing shipment in compliance with the credit term
- Red clause permits the exporter to obtain an advance on part or all of the amount of the credit, as specified in the credit
- When the letter of credit is drawn under, the paying or negotiating bank deducts the amount of the advance and any interest due
- Should the beneficiary fail to ship or meet the credit requirements, the paying or negotiating bank looks to the issuing bank to obtain reimbursement for the amount of the advance plus interest
- Issuing bank then charges the account of the importer

Special Letter of Credit Arrangements

Installment Credit

- Installment credit – applicant for a letter of credit may need to be assured of receiving the merchandise over a period of time in certain given installments
- When a bank issues an installment credit or a credit stipulating shipments by installment within given periods, that credit should clearly state 'shipments must be effected in the following installments'
- Failure to meet the conditions of any installment causes the credit to be null and void for future drawings

Revolving credit

- There are similarities and major differences between installment and revolving credits with differences representing major risks for all parties involved
- Revolving letters of credit contain instructions which allow the beneficiary to draw for specified amounts over specified periods
- It uses the same letter of credit to cover numerous shipments over a long period without the necessity of issuing new credits or amending the existing credits
- It restricts the amount available for each shipment
- It controls the frequency of shipments and amounts available
- Revolving credits are either 'cumulative' or 'non-cumulative' – controlling the amount available for drawing

Special Letter of Credit Arrangements

Deferred Payment

- Exporter may be asked by the buyer to provide financing under a letter of credit for a term beyond six months
- A letter of credit providing for the drawing of a time draft for acceptance by the bank (i.e. banker's acceptance) might not be appropriate because the acceptance would be ineligible for discount
- Under a deferred payment credit, after shipment the exporter presents complying documents to the negotiating/paying bank
- Instead of drawing a draft on the bank or applicant when the documents are presented, the exporter authorizes the bank to release documents against the bank's obligation to pay on a future date as specified in the credit
- The issuing/confirming bank therefore makes a promise of future sight payment(s)
- For incurring the liability, the bank assesses a deferred payment commission, usually a fee proportionate to its regular acceptance commission, adjusted for the longer period
- If the beneficiary requires interim financing, it may be able to use the issuing/confirming bank's promise of future payment to obtain credit from its bank
- Beneficiary cannot discount any paper for this financing, because a deferred payment credit does not provide for the creation of a negotiable instrument which may be sold in the secondary market

Important Points to be Checked by Beneficiary

Upon Receipt of an Export Letter of Credit

- Whether the credit is irrevocable or revocable
- Whether the credit is confirmed or unconfirmed
- When the credit expires (expiration date-be aware of the date format)
- Where the credit expires (at the seller's bank counters or offshore counters)
- Correctness of beneficiary's (seller's) title and address [check L/C]
- Correctness of applicant's (buyer's) title and address [check L/C]
- Amount (consider terms of sales-possible additional charges)
- Does it say "about" so much, "up to" so much - if so, an amount may vary a percentage more or less
- Tenor of draft(s) [at sight, 30, 60 days]
- Location of paying bank (where credit is available; i.e., London, New York)
- Is the credit negotiable?
- Documents required to be presented by the beneficiary
- Description and unit price of merchandise
- Point of shipment and destination
- Stipulations on partial shipments and transshipments
- Special instructions
- Shipping terms/terms of sale
- Whether subject to uniform customs and practice for documentary credits (U.C.P. 600)

Effective Use of Letters of Credit

To facilitate the speed, accuracy and ease of handling, letters of credit documents must conform in all aspects to the terms and conditions of the credit.

This review is not meant to cover all situations; each credit has its own peculiarities. It is important to remember in all cases, however, that problems can be avoided by meeting the terms of the credit exactly.

All Documents

- Properly signed
- Sufficient number of originals and copies provided (one extra for bank)
- Marks, numbers, and other information are in accordance with all other documents
- Corrections are properly authenticated
- Presentation must be on or before expiration date of the credit at the given location and within the presentment period specified within the credit

Commercial Invoice

- Issued by beneficiary, unless otherwise stated in credit
- Made out to the account party, unless otherwise stated in credit
- Amount not in excess of the credit amount or available balance of the credit (i.e. 10%+/-)
- Covers full shipment, if partial shipments not permitted
- Quantity shipped, weight and measures agree with bills of lading and other documents
- Description of goods is **identical** to that shown in credit
- Unit price agrees with credit
- Marks, numbers and other information are in accordance with related documents
- Shipping terms agree with credit
- Calculations, extensions and additions are correct
- Does not contain charges or other merchandise not specified in the credit
- Does not state "used," "rebuilt," or "secondhand" unless so authorized in credit
- Signed, certified

Commercial Invoice

- Insurance documents as required in the credit have to be presented. An insurance certificate is not acceptable when the credit requires an insurance policy. Brokers' cover notes are not acceptable, unless so specified in the credit
- Amount is sufficient; at least equal CIF value of shipment or greater than the draft amount of the invoice value
- Properly signed and countersigned if required
- Endorsed by party to whom loss is payable (sign co. name on back of policy or certificate)
- Date not later than that of bill of lading or other shipping documents
- Issued in the same currency as credit, unless otherwise specified
- Correctly shows scope of entire voyage in compliance with terms of credit
- Packing, shipping marks, etc. agree with information shown in other documents
- Covers specific risks as required by credit (institute clause A, war risks and strike risks)

Common Documentation Discrepancies

- Drafts are presented after Letter of Credit has expired or after time for shipment has expired
- Invoice value or draft exceeds amount available under Letter of Credit
- Charges included in invoice are not authorized in Letter of Credit
- Amount of insurance coverage is inadequate or coverage does not include risks required by Letter of Credit
- Insurance document is not endorsed and/or countersigned
- Date of insurance policy or certificate is later than date on bills of lading
- Bills of lading are not clean—that is, they bear notations that qualify good order and condition of merchandise or its packing
- Bills of lading are not marked "on board" when so required by Letter of Credit
- "On board" endorsement or changes on bills of lading are not signed by carrier or its agent or initiated by party who signed bills of lading
- "On board" endorsement is not dated

Common Documentation Discrepancies

- Bills of lading are not endorsed
- Bills of lading are made out "to order" (shipper's order, blank endorsed) where Letter of Credit stipulates "straight" (direct to consignee) bills of lading or vice versa. (In some countries, "to order" bills of lading are prohibited and heavy penalties or additional duties are assessed for failure to ship on a "straight" bill of lading.)
- Bills of lading do not indicate "freight prepaid" or "freight collect" as stipulated in the Letter of Credit
- Bills of lading are marked "freight prepaid" and freight charges are not included in invoice
- Descriptions, marks and numbers of merchandise are not the same on all documents presented or are not as required by Letter of Credit
- Not all documents required by Letter of Credit are presented
- Documents are "stale dated" that is, not presented within a reasonable time after issuance (i.e. within the presentment period)
- Invoice does not specify shipment terms (C&F, CIF, FOB, etc.) as stated in Letter of Credit
- Invoice is not signed as Letter of Credit requires

Consequences

Documents with Discrepancies

The negotiating bank will notify the beneficiary that the documents presented contain discrepancies. If the beneficiary cannot correct such documents, within the limits of the Letter of Credit, the beneficiary will instruct the negotiating bank to either:

1. Telex the issuing bank to request approval from the applicant (customer) to pay with the mentioned discrepancies.
2. Send the documents to the issuing bank on a collection basis
3. Post a guarantee in favor of the paying bank to secure release of funds

Even if the beneficiary can correct the documents, payment will definitely be delayed and additional charges will be incurred.

When documents cannot be corrected the resulting consequences are:

1. Confirmation, if any, is voided.
2. Issuing bank is under no obligation to pay.

RESULT: YOU HAVE LOST THE ASSURANCE OF PAYMENT UNDER THE LETTER OF CREDIT

Letters of Credit and the Exporter

Advantages:

- Affords greatest protection against nonpayment (except for cash in advance)
- Minimal risk of nonpayment
 - Commercial (issuing or confirming bank) now responsible for payment; not dependent on importer's ability to pay
 - A bank cannot refuse payment for documents that are in order if it has incurred an irrevocable obligation to do so
- Prompt and convenient payment
 - Generally more so than collection from the importer
- Access to financing

Disadvantages:

- Arranging LC - greater cost, paperwork for the importer
- Thus, exporters who insist on letters of credit may limit their market reach and have trouble finding buyers

Letters of Credit and the Importer

Advantages:

- **Availability of credit and financing**
 - No need for immediate payment on a sight time draft
 - Possible to obtain acceptance, other kinds of financing from the issuing bank
- **Security**
 - Assures that exporter must meet all LC terms and conditions before payment is made
 - Assures that documents on their face comply with credit
 - Importer still depends on exporter's integrity since the bank assumes no responsibility for document accuracy or genuineness

Disadvantages:

- **Increased cost and less convenience**
 - Importer must make LC issuance arrangements
 - LC's usually cost more money and time than collections
- **No guarantee of receiving proper merchandise**

UCP 600

- UCP is the acronym for Uniform Customs and Practice for Documentary Credits used by letter of credit practitioners worldwide
- It is not a law but rather the most successful private rules for trade ever developed
- They were first issued in 1933 when the ICC, to overcome conflicting laws on letters of credit in different countries, created the UCP to bring uniformity to the field
- Firmly established after 77 years, the UCP are the rules used to govern billions of dollars in trade transactions each year

UCP 600

- For the record the laws that govern letters of credit transactions in the United States are found in Article Five of the Uniform Commercial Code
- These laws are not necessarily recognized outside the United States, similar to LC laws established in other countries, and thus the reason for the formation of the UCP
- While the UCP is not law, if the letter of credit makes itself subject to the UCP600 that means this set of rules is incorporated into the LC and the parties have agreed to be bound by them

Thank You!

DANKE SCHÖN

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THANK YOU

*G*RACIAS

MERCI

ありがとうございます

GRAZIE
