Letter of Credit:

A letter of credit is a letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount. In the event that the buyer is unable to make payment on the purchase, the bank will be required to cover the full or remaining amount of the purchase. Due to the nature of international dealings, including factors such as distance, differing laws in each country, and difficulty in knowing each party personally, the use of letters of credit has become a very important aspect of international trade.

Funding a Letter of Credit

Banks typically require a pledge of securities or cash as collateral for issuing a letter of credit. Banks also collect a fee for service, typically a percentage of the size of the letter of credit. The International Chamber of Commerce Uniform Customs and Practice for Documentary Credits oversees letters of credit used in international transactions.

Basic Types of Letters of Credit

There are three basic features of letters of credit, each of which has two options. These are described below. Each letter of credit has a combination of each of the three features.

SIGHT OR TERM/USANCE

Letters of credit can permit the beneficiary to be paid immediately upon presentation of specified documents (sight letter of credit), or at a future date as established in the sales contract (term/usance letter of credit).

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.

UNCONFIRMED OR CONFIRMED

An unconfirmed letter of credit carries the obligation of the issuing bank to honor 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.

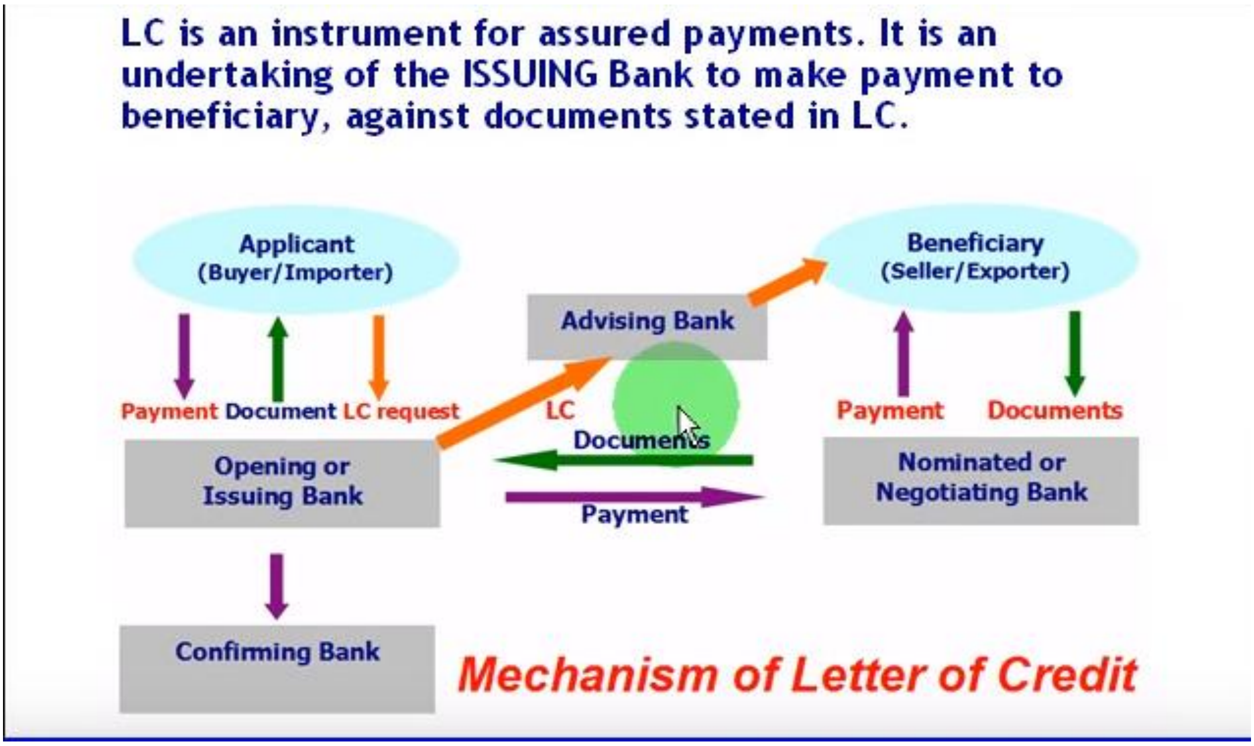
BENEFITS OF A LETTER OF CREDIT

To The Exporter/Seller

1. Letters of credit open doors to international trade by providing a secure mechanism for payment upon fulfilment of contractual obligations.
2. A bank is substituted for the buyer as the source of payment for goods or services exported.
3. The issuing bank undertakes to make payment, provided all the terms and conditions stipulated in the letter of credit are complied with.
4. Financing opportunities, such as pre-shipment finance secured by a letter of credit and/or discounting of accepted drafts drawn under letters of credit, are available in many countries.
5. Bank expertise is made available to help complete trade transactions successfully.
6. Payment for the goods shipped can be remitted to your own bank or a bank of your choice.

To the Importer/Buyer

1. Payment will only be made to the seller when the terms and conditions of the letter of credit are complied with.
2. The importer can control the shipping dates for the goods being purchased.
3. Cash resources are not tied up.



SPECIAL TYPES OF LETTERS OF CREDIT

Red Clause Letter of Credit

A red clause letter of credit incorporates a clause, traditionally written in red, which authorizes the bank acting as the negotiating or paying bank to pay the beneficiary in advance of shipment. This enables the purchase and accumulation of goods from a number of different suppliers, and the arrangement of shipment in accordance with the letter of credit terms. Such advances will be deducted from the amount due to be paid when the documents called for are presented under the letter of credit. If the beneficiary fails to ship the goods or cannot do so before the expiry of the letter of credit, the issuing bank is bound to reimburse the negotiating or paying bank, recovering its payment from the applicant. Variations of such credits may also require that any advances be secured by temporary warehouse receipts until shipment is affected. Beneficiaries of red clause letters of credit are invariably brokers/agents of buyers in a particular field.

Transferable Letter of Credit

A transferable letter of credit allows the beneficiary to act as a middleman and transfer his rights under a letter of credit to another party or parties who may be suppliers of the goods. Depending on whether the letter of credit permits partial shipments, fractional amounts may be transferred to more than one beneficiary. The letter of credit however, can be transferred only once: the secondary beneficiaries cannot transfer their rights to a third party. Transfer of a letter of credit can be made on specific application by the original beneficiary to the authorized transferring bank To be transferable, a letter of credit must be so marked by the issuing bank which can only do so on the applicant's specific instructions. The applicant should be aware that any second beneficiary, the probable supplier, is usually a party not likely known to the applicant.

The terms and conditions of the transferred letter of credit must be identical to those of the original letter of credit with the following exceptions:

• The original beneficiary may be shown as the applicant on the transferred credit.

• The amount of the letter of credit, and unit prices if any, may be less than in the original letter of credit (the difference being the original beneficiary's profit margin).

•The latest shipment date, if any, and expiry date as shown on the original letter of credit should be shortened.

• The percentage of insurance coverage, if any, should be increased to satisfy the requirements of the original letter of credit.

• When a drawing takes place, the original beneficiary normally substitutes his invoices for those of the second beneficiary for up to the amount and unit prices available under the original letter of credit, and draws the difference as profit.

Back-to-Back Letter of Credit

Although not recorded on a letter of credit, "back-to-back" is a term used in transactions involving two irrevocable letters of credit. Such transactions originate when a seller receives a letter of credit covering goods which must be obtained from a third party who in turn requires a letter of credit. The "second" issuing bank looks to the first issuing bank for reimbursement after paying under the second letter of credit. The difference between back-to-back letters of credit and transferable letters of credit, is such that in a transferable letter of credit, the rights under the existing letter of credit are transferred. In a back-to-back transaction, different letters of credit are actually issued. Because technical problems can arise in back-to-back transactions, banks tend to discourage their use.

Deferred Payment Letter of Credit
Under a deferred payment letter of credit, the applicant does not pay until a future date determined in accordance with the terms of the letter of credit. No drafts are called for, which avoids “stamp duties” charged by some countries on bills of exchange (drafts). One reason an exporter might extend credit terms to an importer could be the competitiveness of the market and the need for the exporter to finance the importer if the exporter is to make the sale.

OTHER TYPES OF LETTERS OF CREDIT

Standby Letters of Credit
Standby letters of credit may apply in general to transactions which are based on the concept of default by the applicant in performance of a contract or obligation. In the event of default, the beneficiary is permitted to draw under the letter of credit. Standby letters of credit may be used as a substitute for performance guarantees, or issued to guarantee loans granted by one firm to another, thereby securing payment to the creditor in the event the other party fails to repay its obligation on the due date. Even if the applicant claims to have performed, the bank issuing the letter of credit is obliged to make payment provided the beneficiary produces complying documents, usually a sight draft, and a written demand for payment.

Letter of Credit Charges:
Different charges required by bank in for various formalities to create and execute LC:
-Interest on issuing LC
-Advising Fees
-Examining documents charges
-Discrepancy Correction charges
-Courier and Postage
-Bank to Bank reimbursement
-Cancellation Charges

What are the Risks in Letters of Credit?

<u>Applicant's Risks in Letters of Credit:</u>
Applicant is the importer in a commercial letter of credit transaction. Applicant's risks in a letter of credit transaction can be classified under shipment risks, issuing bank's failure risk and fraud risks.

- **Risks Related to Shipments**: Short shipments, shipments of under quality goods and late shipments risks fall in this category.
- **Failure of the Issuing Bank**: Failure of the issuing bank may result a double payment risk to the applicant. In case the issuing bank failed to pay the L/C amount, applicant may have to pay the credit amount to the beneficiary outside of the letter of credit, even if the applicant already paid the credit amount to the issuing bank.

- **Fraud Risks**: Applicants are exposed to fraud risks that are commonly originated from the acts of the beneficiaries. This scenario becomes reality if the beneficiary gets his money from the confirming or issuing bank against forged documents.

<u>Beneficiary's Risks in Letters of Credit</u>:

Beneficiary means the party in whose favor a credit is opened. Beneficiary's risks in a letter of credit transaction can be classified under discrepant documents risks, fraud risks, non-payment risks (due to sanctions, political risks etc.)

- **Discrepant Documents Risks:** If the banks figure it out that the documents are discrepant, and then beneficiaries can only reach the payment upon applicant's acceptance of the documents.
- **Fraud risks**: Applicants can receive funds under letters of credit via forged documents by shipping under quality goods or even worse shipping nothing at all.
- **Non-Payment Risks (Due to Sanctions, Political Risks etc.)**: Beneficiaries make sure that they comply with the international regulations including UN, EU and US embargoes.

<u>Issuing Banks's Risks in Letters of Credit:</u>

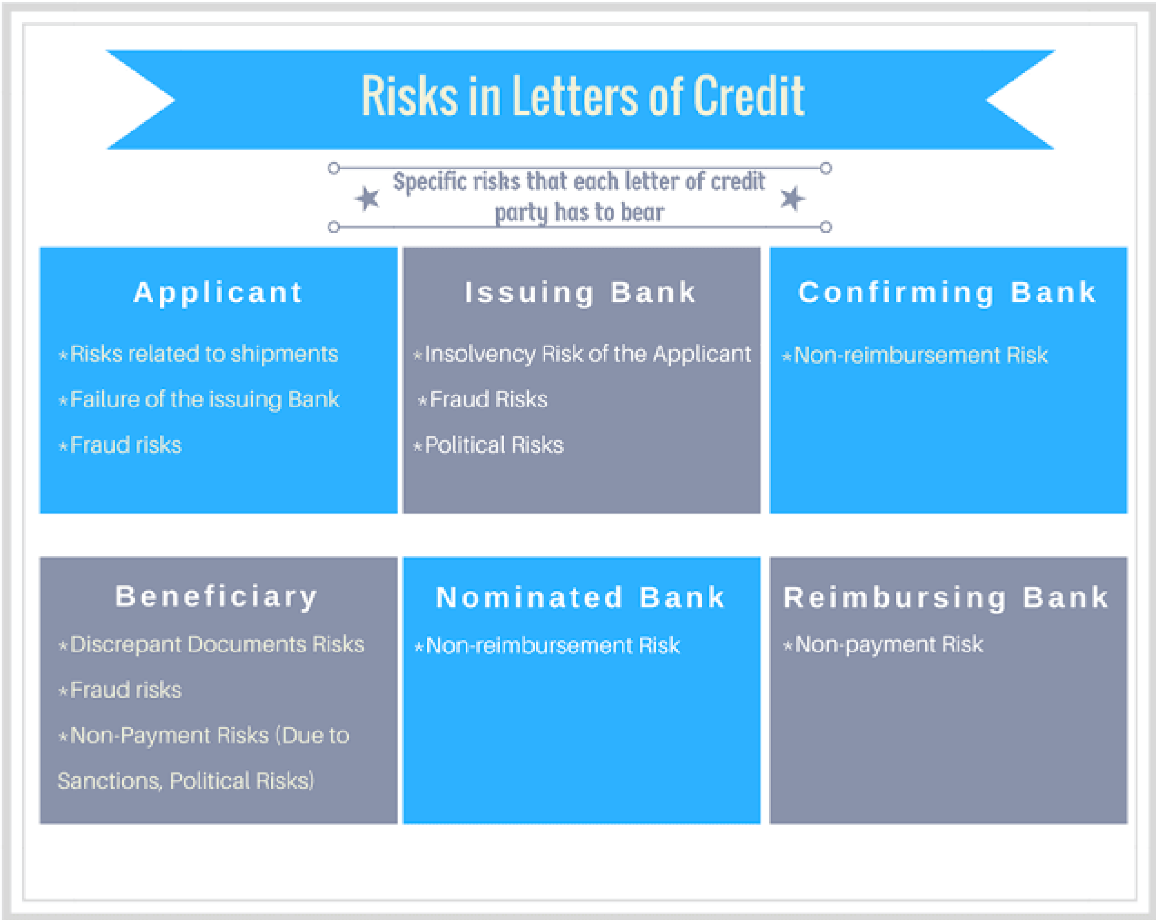
Issuing bank is the entity, which gives the main conditional payment guarantee to the beneficiary. As a result, issuing bank is more vulnerable to the risks in letters of credit transactions than any other parties involved.

- **Insolvency Risk of the Applicant:** Issuing bank may not be able to recover the credit amount that has already paid to the beneficiary, if applicant becomes insolvent after issuance of the letter of credit.
- **Fraud Risks:** Beneficiary and applicant may act together to scam issuing banks under letter of credit transactions.
- **Political Risks:** Issuing bank may not be able to honor its payment obligation due to various political risks. Most recent examples are sanction clauses inserted into letters of credit.

<u>Confirming Bank's Risks in Letters of Credit:</u>

Confirming bank means the bank that adds its confirmation to a credit upon the issuing bank's authorization or request.

- **Non-reimbursement Risks:** A confirming bank is irrevocably bound to honor or negotiate as of the time it adds its confirmation to the credit. A confirming bank's main risk is the non-reimbursement risk, which means that the confirming bank could not get the credit amount from the issuing bank, although it has already paid it to the beneficiary.



ADVANTAGES OF LETTER OF CREDIT

A letter of credit enjoys various advantages over other means to do international trade transactions. Some of the major ones are listed below:

- A letter of credit gives the trade partners an ability to transact with unknown partners or in newly established trade relationships. It helps in expanding their business quickly into new geographies.
- A letter of credit is highly customisable. Both the trading partners can put in terms and conditions as per their requirements and arrive at a mutually exclusive list of clauses. It can also be customised from one transaction to another with the same trading partners.
- A letter of credit makes the issuing bank independent of the trading partners' obligations and any disputes arising out of those obligations. The bank has to just check whether the documents submitted by the beneficiary satisfy the terms and conditions specified in the letter of credit, and pay the full amount.
- A letter of credit transfers the credit-worthiness from the importer or buyer to the issuing bank. The importer can do multiple transactions at the same time when he is backed by an established and larger institution such as a bank.
- A letter of credit is safer for the seller or exporter in case the buyer or importer goes bankrupt. Since the creditworthiness of the importer is transferred to the issuing bank, it is the bank's obligation to pay the amount as agreed in the letter of credit. Thus, a letter of credit insulates the exporter from the importer's business risk.
- A letter of credit is quick to execute. As per the initial terms and conditions, the seller or exporter has to present the proof of material type and quantity along with the shipping documents supporting his

claim that the goods have been shipped. The advising bank will verify the documents the give the full payment instantly.

- In the case of a dispute between the trading partners, the exporter can withdraw the fund as agreed upon in the letter of credit and resolve the disputes later in the court. The beneficiary's right to the full amount is described in the phrase 'pay now, litigate later' by the courts.
- The importer cannot hold or deny the payment to the exporter by raising objections on the quality of goods because the bank just needs to see the documents satisfying the shipping terms and conditions as put in the letter of credit.
- A letter of credit provides certainty to the amount and timing of the exporter's cash flows. He can plan his financing needs well in advance which reduces his risk.
- The exporter can avail pre-shipment financing against a letter of credit. This helps him in plugging the financing gaps if any.

DISADVANTAGES OF LETTER OF CREDIT

As with any financial instrument, even letter of credit has disadvantages as listed below:

- A letter of credit adds to the cost of doing business. Banks charge a fee for providing this service, and it can increase steeply if the parties want to put some additional features.
- The required documentation and formalities may be more in a letter of credit. This may also add to the cost of doing business.
- A letter of credit has complex governing rules and can be misused to take advantage of the applicant.
- A letter of credit poses a material fraud risk to the importer. The bank will pay the exporter upon looking at the shipping documents and not the actual quality of goods. Disputes can arise if the quality is different from what was agreed upon.
- A letter of credit also carries forex risk. There will be an agreed upon currency in the letter of credit. At least one of the parties will have a different currency than that, and hence they will face a risk due to currency fluctuations. It can also work in favour.
- A letter of credit has an expiration date and must be used before it.
- A letter of credit essentially transfers the credit-worthiness from the importer to the issuing bank. So, if the issuing bank defaults, there is still a payment risk to the exporter. Though this can be circumvented if the advising bank guarantees the payment, which will add to the cost of the letter of credit.

7 Common Mistakes When Preparing Letters of Credit

1. Not understanding the real purpose of a letter of credit.
2. Choosing a letter of credit when another method of payment is preferable.
3. Failing to negotiate the terms of a letter of credit during the negotiation of the contract.
4. Not making sure the proforma invoice and contract agree.
5. Improper review or lack of review of a letter of credit when it is received.
6. Not being able to meet all terms and conditions of the letter of credit.
7. Letting someone who is inexperienced or unknowledgeable prepare the documents under the letter of credit.

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