Chapter 3 - Letter Of Credit (L/c)

Introduction

Letter of Credit L/c also known as Documentary Credit is a widely used term to make payment secure in domestic and international trade. The document is issued by a financial organization at the buyer request. Buyer also provide the necessary instructions in preparing the document.

The International Chamber of Commerce (ICC) in the Uniform Custom and Practice for Documentary Credit (UCPDC) defines L/C as:

"An arrangement, however named or described, whereby a bank (the Issuing bank) acting at the request and on the instructions of a customer (the Applicant) or on its own behalf :

1.Is to make a payment to or to the order third party (the beneficiary) or is to accept bills of exchange (drafts) drawn by the beneficiary.
2.Authorised another bank to effect such payments or to accept and pay such bills of exchange (draft).
3.Authorised another bank to negotiate against stipulated documents provided that the terms are complied with.
A key principle underlying letter of credit (L/C) is that banks deal only in documents and not in goods. The decision to pay under a letter of credit will be based entirely on whether the documents presented to the bank appear on their face to be in accordance with the terms and conditions of the letter of credit.

Parties to Letters of Credit

- Applicant (Opener): Applicant which is also referred to as account party is normally a buyer or customer of the goods, who has to make payment to beneficiary. LC is initiated and issued at his request and on the basis of his instructions.

- Issuing Bank (Opening Bank) : The issuing bank is the one which create a letter of credit and takes the responsibility to make the payments on receipt of the documents from the beneficiary or through their banker. The payments has to be made to the beneficiary within seven working days from the date of receipt of documents at their end, provided the documents are in accordance with the terms and conditions of the letter of credit. If the documents are discrepant one, the rejection thereof to be communicated within seven working days from the date of of receipt of documents at their end.

- Beneficiary : Beneficiary is normally stands for a seller of the goods, who has to receive payment from the applicant. A credit is issued in his favour to enable him or his agent to obtain payment on surrender of stipulated document and comply with the term and conditions of the L/c.
If L/c is a transferable one and he transfers the credit to another party, then he is referred to as the first or original beneficiary.

- Advising Bank : An Advising Bank provides advice to the beneficiary and takes the responsibility for sending the documents to the issuing bank and is normally located in the country of the beneficiary.

- Confirming Bank : Confirming bank adds its guarantee to the credit opened by another bank, thereby undertaking the responsibility of payment/negotiation acceptance under the credit, in additional to that of the issuing bank. Confirming bank play an important role where the exporter is not satisfied with the undertaking of only the issuing bank.

- Negotiating Bank: The Negotiating Bank is the bank who negotiates the documents submitted to them by the beneficiary under the credit either advised through them or restricted to them for negotiation. On negotiation of the documents they will claim the reimbursement under the credit and makes the payment to the beneficiary provided the documents submitted are in accordance with the terms and conditions of the letters of credit.

- Reimbursing Bank : Reimbursing Bank is the bank authorized to honor the reimbursement claim in settlement of negotiation/acceptance/payment lodged with it by the negotiating bank. It is normally the bank with which issuing bank has an account from which payment has to be made.

- Second Beneficiary : Second Beneficiary is the person who represent the first or original Beneficiary of credit in his absence. In this case, the credits belonging to the original beneficiary is transferable. The rights of the transferee are subject to terms of transfer.

Types of Letter of Credit

1. Revocable Letter of Credit L/c

A revocable letter of credit may be revoked or modified for any reason, at any time by the issuing bank without notification. It is rarely used in international trade and not considered satisfactory for the exporters but has an advantage over that of the importers and the issuing bank.

There is no provision for confirming revocable credits as per terms of UCPDC, Hence they cannot be confirmed. It should be indicated in LC that the credit is revocable. if there is no such indication the credit will be deemed as irrevocable.

2. Irrevocable Letter of CreditL/c

In this case it is not possible to revoked or amended a credit without the agreement of the issuing bank, the confirming bank, and the beneficiary. Form an exporters point of view it is believed to be more beneficial. An irrevocable letter of credit from the issuing bank insures the beneficiary that if the required documents are presented and the terms and conditions are complied with, payment will be made.

3. Confirmed Letter of Credit L/c

Confirmed Letter of Credit is a special type of L/c in which another bank apart from the issuing bank has added its guarantee. Although, the cost of confirming by two banks makes it costlier, this type of L/c is more beneficial for the beneficiary as it doubles the guarantee.

4. Sight Credit and Usance Credit L/c

Sight credit states that the payments would be made by the issuing bank at sight, on demand or on presentation. In case of usance credit, draft are drawn on the issuing bank or the correspondent bank at specified usance period. The credit will indicate whether the usance draft are to be drawn on the issuing bank or in the case of confirmed credit on the confirming bank.

5. Back to Back Letter of Credit L/c

Back to Back Letter of Credit is also termed as Countervailing Credit. A credit is known as backtoback credit when a L/c is opened with security of another L/c.

A backtoback credit which can also be referred as credit and countercredit is actually a method of financing both sides of a transaction in which a middleman buys goods from one customer and sells them to another.

The parties to a BacktoBack Letter of Credit are:
1. The buyer and his bank as the issuer of the original Letter of Credit.
2. The seller/manufacturer and his bank,
3. The manufacturer's subcontractor and his bank.

The practical use of this Credit is seen when L/c is opened by the ultimate buyer in favour of a particular beneficiary, who may not be the actual supplier/ manufacturer offering the main credit with near identical terms in favour as security and will be able to obtain reimbursement by presenting the documents received under back to back credit under the main L/c.

The need for such credits arise mainly when :

1.The ultimate buyer not ready for a transferable credit
2.The Beneficiary do not want to disclose the source of supply to the openers.
3.The manufacturer demands on payment against documents for goods but the beneficiary of credit is short of the funds

6. Transferable Letter of Credit L/c

A transferable documentary credit is a type of credit under which the first beneficiary which is usually a middleman may request the nominated bank to transfer credit in whole or in part to the second beneficiary.

The L/c does state clearly mentions the margins of the first beneficiary and unless it is specified the L/c cannot be treated as transferable. It can only be used when the company is selling the product of a third party and the proper care has to be taken about the exit policy for the money transactions that take place.

This type of L/c is used in the companies that act as a middle man during the transaction but donâ€™t have large limit. In the transferable L/c there is a right to substitute the invoice and the whole value can be transferred to a second beneficiary.

The first beneficiary or middleman has rights to change the following terms and conditions of the letter of credit:

1.Reduce the amount of the credit.
2.Reduce unit price if it is stated
3.Make shorter the expiry date of the letter of credit.
4.Make shorter the last date for presentation of documents.
5.Make shorter the period for shipment of goods.
6.Increase the amount of the cover or percentage for which insurance cover must be effected.
7.Substitute the name of the applicant (the middleman) for that of the first beneficiary (the buyer).

Standby Letter of Credit L/c

Initially used by the banks in the United States, the standby letter of credit is very much similar in nature to a bank guarantee. The main objective of issuing such a credit is to secure bank loans. Standby credits are usually issued by the applicantâ€™s bank in the applicantâ€™s country and advised to the beneficiary by a bank in the beneficiaryâ€™s country.

Unlike a traditional letter of credit where the beneficiary obtains payment against documents evidencing performance, the standby letter of credit allow a beneficiary to obtains payment from a bank even when the applicant for the credit has failed to perform as per bond.

A standby letter of credit is subject to "Uniform Customs and Practice for Documentary Credit" (UCP), International Chamber of Commerce Publication No 500, 1993 Revision, or "International Standby Practices" (ISP), International Chamber of Commerce Publication No 590, 1998.

Import Operations Under L/c

The Import Letter of Credit guarantees an exporter payment for goods or services, provided the terms of the letter of credit have been met.

A bank issue an import letter of credit on the behalf of an importer or buyer under the following Circumstances

- When a importer is importing goods within its own country.
- When a trader is buying good from his own country and sell it to the another country for the purpose of merchandizing trade.
- When an Indian exporter who is executing a contract outside his own country requires importing goods from a third country to the country where he is executing the contract.

The first category of the most common in the day to day banking

Fees And Reimbursements

The different charges/fees payable under import L/c is briefly as follows

1. The issuing bank charges the applicant fees for opening the letter of credit. The fee charged depends on the credit of the applicant, and primarily comprises of :

(a) Opening Charges This would comprise commitment charges and usance charged to be charged upfront for the period of the L/c.

The fee charged by the L/c opening bank during the commitment period is referred to as commitment fees. Commitment period is the period from the opening of the letter of credit until the last date of negotiation of documents under the L/c or the expiry of the L/c, whichever is later.

Usance is the credit period agreed between the buyer and the seller under the letter of credit. This may vary from 7 days usance (sight) to 90/180 days. The fee charged by bank for the usance period is referred to as usance charges

(b)Retirement Charges

1. This would be payable at the time of retirement of LCs. LC opening bank scrutinizes the bills under the LCs according to UCPDC guidelines , and levies charges based on value of goods.

2. The advising bank charges an advising fee to the beneficiary unless stated otherwise The fees could vary depending on the country of the beneficiary. The advising bank charges may be eventually borne by the issuing bank or reimbursed from the applicant.

3. The applicant is bounded and liable to indemnify banks against all obligations and responsibilities imposed by foreign laws and usage.

4. The confirming bank's fee depends on the credit of the issuing bank and would be borne by the beneficiary or the issuing bank (applicant eventually) depending on the terms of contract.

5. The reimbursing bank charges are to the account of the issuing bank.

Risk Associated with Opening Imports L/cs

The basic risk associated with an issuing bank while opening an import L/c are :

1.The financial standing of the importer
As the bank is responsible to pay the money on the behalf of the importer, thereby the bank should make sure that it has the proper funds to pay.
2.The goods
Bankers need to do a detail analysis against the risks associated with perishability of the goods, possible obsolescence, import regulations packing and storage, etc. Price risk is the another crucial factor associated with all modes of international trade.
3.Exporter Risk
There is always the risk of exporting inferior quality goods. Banks need to be protective by finding out as much possible about the exporter using status report and other confidential information.
4.Country Risk
These types of risks are mainly associated with the political and economic scenario of a country. To solve this issue, most banks have specialized unit which control the level of exposure that that the bank will assumes for each country.
5.Foreign exchange risk
Foreign exchange risk is another most sensitive risk associated with the banks. As the transaction is done in foreign currency, the traders depend a lot on exchange rate fluctuations.

Export Operations Under L/c

Export Letter of Credit is issued in for a trader for his native country for the purchase of goods and services. Such letters of credit may be received for following purpose:

1.For physical export of goods and services from India to a Foreign Country.
2.For execution of projects outside India by Indian exporters by supply of goods and services from Indian or partly from India and partly from outside India.
3.Towards deemed exports where there is no physical movements of goods from outside India But the supplies are being made to a project financed in foreign exchange by multilateral agencies, organization or project being executed in India with the aid of external agencies.
4.For sale of goods by Indian exporters with total procurement and supply from outside India. In all the above cases there would be earning of Foreign Exchange or conservation of Foreign Exchange.
Banks in India associated themselves with the export letters of credit in various capacities such as advising bank, confirming bank, transferring bank and reimbursing bank.

In every cases the bank will be rendering services not only to the Issuing Bank as its agent correspondent bank but also to the exporter in advising and financing his export activity.

1.Advising an Export L/c
The basic responsibility of an advising bank is to advise the credit received from its overseas branch after checking the apparent genuineness of the credit recognized by the issuing bank.

It is also necessary for the advising bank to go through the letter of credit, try to understand the underlying transaction, terms and conditions of the credit and advice the beneficiary in the matter.

The main features of advising export LCs are:

1. There are no credit risks as the bank receives a onetime commission for the advising service.
2. There are no capital adequacy needs for the advising function.

2.Advising of Amendments to L/Cs
Amendment of LCs is done for various reasons and it is necessary to fallow all the necessary the procedures outlined for advising. In the process of advising the amendments the Issuing bank serializes the amendment number and also ensures that no previous amendment is missing from the list. Only on receipt of satisfactory information/ clarification the amendment may be advised.

3.Confirmation of Export Letters of Credit
It constitutes a definite undertaking of the confirming bank, in addition to that of the issuing bank, which undertakes the sight payment, deferred payment, acceptance or negotiation.

Banks in India have the facility of covering the credit confirmation risks with ECGC under their â€œTransfer Guaranteeâ€ scheme and include both the commercial and political risk involved.
4.Discounting/Negotiation of Export LCs
When the exporter requires funds before due date then he can discount or negotiate the LCs with the negotiating bank. Once the issuing bank nominates the negotiating bank, it can take the credit risk on the issuing bank or confirming bank.

However, in such a situation, the negotiating bank bears the risk associated with the document that sometimes arises when the issuing bank discover discrepancies in the documents and refuses to honor its commitment on the due date.

5.Reimbursement of Export LCs
Sometimes reimbursing bank, on the recommendation of issuing bank allows the negotiating bank to collect the money from the reimbursing bank once the goods have been shipped. It is quite similar to a cheque facility provided by a bank.

In return, the reimbursement bank earns a commission per transaction and enjoys float income without getting involve in the checking the transaction documents.

reimbursement bank play an important role in payment on the due date (for usance LCs) or the days on which the negotiating bank demands the same (for sight LCs)

Regulatory Requirements

Opening of imports LCs in India involve compliance of the following main regulation:

Trade Control Requirements

The movement of good in India is guided by a predefined se of rules and regulation. So, the banker needs to assure that make certain is whether the goods concerned can be physically brought in to India or not as per the current EXIM policy.

Exchange Control Requirements

The main objective of a bank to open an Import LC is to effect settlement of payment due by the Indian importer to the overseas supplier, so opening of LC automatically comes under the policies of exchange control regulations.

UCPDC Guidelines

Uniform Customs and Practice for Documentary Credit (UCPDC) is a set of predefined rules established by the International Chamber of Commerce (ICC) on Letters of Credit. The UCPDC is used by bankers and commercial parties in more than 200 countries including India to facilitate trade and payment through LC.

UCPDC was first published in 1933 and subsequently updating it throughout the years. In 1994, UCPDC 500 was released with only 7 chapters containing in all 49 articles .

The latest revision was approved by the Banking Commission of the ICC at its meeting in Paris on 25 October 2006. This latest version, called the UCPDC600, formally commenced on 1 July 2007. It contain a total of about 39 articles covering the following areas, which can be classified as 8 sections according to their functions and operational procedures.

ISBP 2002

The widely acclaimed International Standard Banking Practice(ISBP) for the Examination of Documents under Documentary Credits was selected in 2007 by the ICCs Banking Commission.

First introduced in 2002, the ISBP contains a list of guidelines that an examiner needs to check the documents presented under the Letter of Credit. Its main objective is to reduce the number of documentary credits rejected by banks.

FEDAI Guidelines

Foreign Exchange Dealer's Association of India (FEDAI) was established in 1958 under the Section 25 of the Companies Act (1956). It is an association of banks that deals in Indian foreign exchange and work in coordination with the Reserve Bank of India, other organizations like FIMMDA, the Forex Association of India and various market participants.
FEDAI has issued rules for import LCs which is one of the important area of foreign currency

exchanges. It has an advantage over that of the authorized dealers who are now allowed by the RBI to issue stand by letter of credits towards import of goods.

As the issuance of stand by of letter of Credit including imports of goods is susceptible to some risk in the absence of evidence of shipment, therefore the importer should be advised that documentary credit under UCP 500/600 should be the preferred route for importers of goods.

Below mention are some of the necessary precaution that should be taken by authorised dealers While issuing a stands by letter of credits:

1. The facility of issuing Commercial Standby shall be extended on a selective basis and to the following category of importers
1. Where such standby are required by applicant who are independent power producers/importers of crude oil and petroleum products
2. Special category of importers namely export houses, trading houses, star trading houses, super star trading houses or 100% Export Oriented Units.
2. Satisfactory credit report on the overseas supplier should be obtained by the issuing banks before issuing Stands by Letter of Credit.
3. Invocation of the Commercial standby by the beneficiary is to be supported by proper evidence. The beneficiary of the Credit should furnish a declaration to the effect that the claim is made on account of failure of the importers to abide by his contractual obligation along with the following documents.
1. A copy of invoice.
2. Nonnegotiable set of documents including a copy of non negotiable bill of lading/transport document.
3. A copy of Lloyds /SGS inspection certificate wherever provided for as per the underlying contract.
4. Incorporation of a suitable clauses to the effect that in the event of such invoice /shipping documents has been paid by the authorised dealers earlier, Provisions to dishonor the claim quoting the date / manner of earlier payments of such documents may be considered.
5. The applicant of a commercial stand by letter of credit shall undertake to provide evidence of imports in respect of all payments made under standby. (Bill of Entry)

Fixing limits for Commercial Stand by Letter of Credit L/c

1. Banks must assess the credit risk in relation to stand by letter of credit and explain to the importer about the inherent risk in stand by covering import of goods.
2. Discretionary powers for sanctioning standby letter of credit for import of goods should be delegated to controlling office or zonal office only.
3. A separate limit for establishing stand by letter of credit is desirable rather than permitting it under the regular documentary limit.
4. Due diligence of the importer as well as on the beneficiary is essential .
5. Unlike documentary credit, banks do not hold original negotiable documents of titles to gods. Hence while assessing and fixing credit limits for standby letter of credits banks shall treat such limits as clean for the purpose of discretionary lending powers and compliance with various Reserve Bank of India's regulations.
6. Application cum guarantee for stand by letter of credit should be obtained from the applicant.
7. Banks can consider obtaining a suitable indemnity/undertaking from the importer that all remittances towards their import of goods as per the underlying contracts for which stand by letter of credit is issued will be made only through the same branch which has issued the credit.
8. The importer should give an undertaking that he shall not raise any dispute regarding the payments made by the bank in standby letter of credit at any point of time howsoever, and will be liable to the bank for all the amount paid therein. He importer should also indemnify the bank from any loss, claim,

counter claims, damages, etc. which the bank may incur on account of making payment under the stand by letter of credit.

9. Presently, when the documentary letter of credit is established through swift, it is assumed that the documentary letter of credit is subject to the provisions of UCPDC 500/600 Accordingly whenever standby letter of credit under ISP 98 is established through SWIFT, a specific clause must appear that standby letter of credit is subject to the provision of ISP 98.
10. It should be ensured that the issuing bank, advising bank, nominated bank. etc, have all subscribed to SP 98 in case stand by letter of credit is issued under ISP 98.
11. When payment under a stand by letter of credit is effected, the issuing bank to report such invocation / payment to Reserve Bank of India.