

Understanding and Using Letters of Credit, Part I

Letters of credit accomplish their purpose by substituting the credit of the bank for that of the customer, for the purpose of facilitating trade. There are basically two types: commercial and standby. The commercial letter of credit is the primary payment mechanism for a transaction, whereas the standby letter of credit is a secondary payment mechanism.

Commercial Letter of Credit

Commercial letters of credit have been used for centuries to facilitate payment in international trade. Their use will continue to increase as the global economy evolves.

Letters of credit used in international transactions are governed by the International Chamber of Commerce Uniform Customs and Practice for Documentary Credits. The general provisions and definitions of the International Chamber of Commerce are binding on all parties. Domestic collections in the United States are governed by the Uniform Commercial Code.

A commercial letter of credit is a contractual agreement between banks, known as the issuing bank, on behalf of one of its customers, authorizing another bank, known as the advising or confirming bank, to make payment to the beneficiary. The issuing bank, on the request of its customer, opens the letter of credit. The issuing bank makes a commitment to honor drawings made under the credit. The beneficiary is normally the provider of goods and/or services. Essentially, the issuing bank replaces the bank's customer as the payee.

Elements of a Letter of Credit

- A payment undertaking given by a bank (issuing bank)
- On behalf of a buyer (applicant)
- To pay a seller (beneficiary) for a given amount of money
- On presentation of specified documents representing the supply of goods
- Within specified time limits
- Documents must conform to terms and conditions set out in the letter of credit
- Documents to be presented at a specified place

Beneficiary

The beneficiary is entitled to payment as long as he can provide the documentary evidence required by the letter of credit. The letter of credit is a distinct and separate transaction from the contract on which it is based. All parties deal in documents and not in goods. The issuing bank is not liable for performance of the underlying contract between the customer and beneficiary. The issuing bank's obligation to the buyer, is to examine all documents to insure that they meet all the terms and conditions of the credit. Upon requesting demand for payment the beneficiary warrants that all conditions of the agreement have been complied with. If the beneficiary (seller) conforms to the letter of credit, the seller must be paid by the bank.

Issuing Bank

The issuing bank's liability to pay and to be reimbursed from its customer becomes absolute upon the completion of the terms and conditions of the letter of credit. Under the provisions of the Uniform Customs and Practice for Documentary Credits, the bank is given a reasonable amount of time after receipt of the documents to honor the draft.

The issuing banks' role is to provide a guarantee to the seller that if compliant documents are presented, the bank will pay the seller the amount due and to examine the documents, and only pay if these documents comply with the terms and conditions set out in the letter of credit.

Typically the documents requested will include a commercial invoice, a transport document such as a bill of lading or airway bill and an insurance document; but there are many others. Letters of credit deal in documents, not goods.

Advising Bank

An advising bank, usually a foreign correspondent bank of the issuing bank will advise the beneficiary. Generally, the beneficiary would want to use a local bank to insure that the letter of credit is valid. In addition, the advising bank would be responsible for sending the documents to the issuing bank. The advising bank has no other obligation under the letter of credit. If the issuing bank does not pay the beneficiary, the advising bank is not obligated to pay.

Confirming Bank

The correspondent bank may confirm the letter of credit for the beneficiary. At the request of the issuing bank, the correspondent obligates itself to insure payment under the letter of credit. The confirming bank would not confirm the credit until it evaluated the country and bank where the letter of credit originates. The confirming bank is usually the advising bank.

Letter of Credit Characteristics

Negotiability

Letters of credit are usually negotiable. The issuing bank is obligated to pay not only the beneficiary, but also any bank nominated by the beneficiary. Negotiable instruments are passed freely from one party to another almost in the same way as money. To be negotiable, the letter of credit must include an unconditional promise to pay, on demand or at a definite time. The nominated bank becomes a holder in due course. As a holder in due course, the holder takes the letter of credit for value, in good faith, without notice of any claims against it. A holder in due course is treated favorably under the UCC.

The transaction is considered a straight negotiation if the issuing bank's payment obligation extends only to the beneficiary of the credit. If a letter of credit is a straight negotiation it is referenced on its face by "we engage with you" or "available with ourselves". Under these conditions the promise does not pass to a purchaser of the draft as a holder in due course.

Revocability

Letters of credit may be either revocable or irrevocable. A revocable letter of credit may be revoked or modified for any reason, at any time by the issuing bank without notification. A revocable letter of credit cannot be confirmed. If a correspondent bank is engaged in a transaction that involves a revocable letter of credit, it serves as the advising bank.

Once the documents have been presented and meet the terms and conditions in the letter of credit, and the draft is honored, the letter of credit cannot be revoked. The revocable letter of credit is not a commonly used instrument. It is generally used to provide guidelines for shipment. If a letter of credit is revocable it would be referenced on its face.

The irrevocable letter of credit may not be revoked or amended without the agreement of the issuing bank, the confirming bank, and the beneficiary. 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. If a letter of credit is irrevocable it is referenced on its face.

Transfer and Assignment

The beneficiary has the right to transfer or assign the right to draw, under a credit only when the credit states that it is transferable or assignable. Credits governed by the Uniform Commercial Code (Domestic) maybe transferred an unlimited number of times. Under the Uniform Customs Practice for Documentary Credits (International) the credit may be transferred only once. However, even if the credit specifies that it is nontransferable or non assignable, the beneficiary may transfer their rights prior to performance of conditions of the credit.

Sight and Time Drafts

All letters of credit require the beneficiary to present a draft and specified documents in order to receive payment. A draft is a written order by which the party creating it, orders another party to pay money to a third party. A draft is also called a bill of exchange.

There are two types of drafts: sight and time. A sight draft is payable as soon as it is presented for payment. The bank is allowed a reasonable time to review the documents before making payment.

A time draft is not payable until the lapse of a particular time period stated on the draft. The bank is required to accept the draft as soon as the documents comply with credit terms. The issuing bank has a reasonable time to examine those documents. The issuing bank is obligated to accept drafts and pay them at maturity.

Standby Letter of Credit

The standby letter of credit serves a different function than the commercial letter of credit. The commercial letter of credit is the primary payment mechanism for a transaction. The standby letter of credit serves as a secondary payment mechanism. A bank will issue a standby letter of credit on behalf of a customer to provide assurances of his ability to perform under the terms of a contract between the beneficiaries. The parties involved with the transaction do not expect that the letter of credit will ever be drawn upon.

The standby letter of credit assures the beneficiary of the performance of the customer's obligation. The beneficiary is able to draw under the credit by presenting a draft, copies of invoices, with evidence that the customer has not performed its obligation. The bank is obligated to make payment if the documents presented comply with the terms of the letter of credit.

Standby letters of credit are issued by banks to stand behind monetary obligations, to insure the refund of advance payment, to support performance and bid obligations, and to insure the completion of a sales contract. The credit has an expiration date.

The standby letter of credit is often used to guarantee performance or to strengthen the credit worthiness of a customer. In the above example, the letter of credit is issued by the bank and held by the supplier. The customer is provided open account terms. If payments are made in accordance with the suppliers' terms, the letter of credit would not be drawn on. The seller pursues the customer for payment directly. If the customer is unable to pay, the seller presents a draft and copies of invoices to the bank for payment.

The domestic standby letter of credit is governed by the Uniform Commercial Code. Under these provisions, the bank is given until the close of the third banking day after receipt of the documents to honor the draft.

Procedures for Using the Tool

The following procedures include a flow of events that follow the decision to use a Commercial Letter of Credit. Procedures required to execute a Standby Letter of Credit are less rigorous. The standby credit is a domestic transaction. It does not require a correspondent bank (advising or confirming). The documentation requirements are also less tedious.

Step-by-step process:

- Buyer and seller agree to conduct business. The seller wants a letter of credit to guarantee payment.
- Buyer applies to his bank for a letter of credit in favor of the seller.
- Buyer's bank approves the credit risk of the buyer, issues and forwards the credit to its correspondent bank (advising or confirming). The correspondent bank is usually located in the same geographical location as the seller (beneficiary).
- Advising bank will authenticate the credit and forward the original credit to the seller (beneficiary).
- Seller (beneficiary) ships the goods, then verifies and develops the documentary requirements to support the letter of credit. Documentary requirements may vary greatly depending on the perceived risk involved in dealing with a particular company.

- Seller presents the required documents to the advising or confirming bank to be processed for payment.
- Advising or confirming bank examines the documents for compliance with the terms and conditions of the letter of credit.
- If the documents are correct, the advising or confirming bank will claim the funds by:
 - Debiting the account of the issuing bank.
 - Waiting until the issuing bank remits, after receiving the documents.
 - Reimburse on another bank as required in the credit.
- Advising or confirming bank will forward the documents to the issuing bank.
- Issuing bank will examine the documents for compliance. If they are in order, the issuing bank will debit the buyer's account.
- Issuing bank then forwards the documents to the buyer.

Standard Forms of Documentation

When making payment for product on behalf of its customer, the issuing bank must verify that all documents and drafts conform precisely to the terms and conditions of the letter of credit. Although the credit can require an array of documents, the most common documents that must accompany the draft include:

Commercial Invoice

The billing for the goods and services. It includes a description of merchandise, price, FOB origin, and name and address of buyer and seller. The buyer and seller information must correspond exactly to the description in the letter of credit. Unless the letter of credit specifically states otherwise, a generic description of the merchandise is usually acceptable in the other accompanying documents.

Bill of Lading

A document evidencing the receipt of goods for shipment and issued by a freight carrier engaged in the business of forwarding or transporting goods. The documents evidence control of goods. They also serve as a receipt for the merchandise shipped and as evidence of the carrier's obligation to transport the goods to their proper destination.

Warranty of Title

A warranty given by a seller to a buyer of goods that states that the title being conveyed is good and that the transfer is rightful. This is a method of certifying clear title to product transfer. It is generally issued to the purchaser and issuing bank expressing an agreement to indemnify and hold both parties harmless.

Letter of Indemnity

Specifically indemnifies the purchaser against a certain stated circumstance. Indemnification is generally used to guaranty that shipping documents will be provided in good order when available.

Common Defects in Documentation

About half of all drawings presented contain discrepancies. A discrepancy is an irregularity in the documents that causes them to be in non-compliance to the letter of credit. Requirements set forth in the letter of credit cannot be waived or altered by the issuing bank without the express consent of the customer. The beneficiary should prepare and examine all documents carefully before presentation to the paying bank to avoid any delay in receipt of payment. Commonly found discrepancies between the letter of credit and supporting documents include:

- Letter of Credit has expired prior to presentation of draft.
- Bill of Lading evidences delivery prior to or after the date range stated in the credit.

- Stale dated documents.
- Changes included in the invoice not authorized in the credit.
- Inconsistent description of goods.
- Insurance document errors.
- Invoice amount not equal to draft amount.
- Ports of loading and destination not as specified in the credit.
- Description of merchandise is not as stated in credit.
- A document required by the credit is not presented.
- Documents are inconsistent as to general information such as volume, quality, etc.
- Names of documents not exact as described in the credit. Beneficiary information must be exact.
- Invoice or statement is not signed as stipulated in the letter of credit.

When a discrepancy is detected by the negotiating bank, a correction to the document may be allowed if it can be done quickly while remaining in the control of the bank. If time is not a factor, the exporter should request that the negotiating bank return the documents for corrections.

If there is not enough time to make corrections, the exporter should request that the negotiating bank send the documents to the issuing bank on an approval basis or notify the issuing bank by wire, outline the discrepancies, and request authority to pay. Payment cannot be made until all parties have agreed to jointly waive the discrepancy.

Tips for Exporters

- Communicate with your customers in detail before they apply for letters of credit.
- Consider whether a confirmed letter of credit is needed.
- Ask for a copy of the application to be fax to you, so you can check for terms or conditions that may cause you problems in compliance.
- Upon first advice of the letter of credit, check that all its terms and conditions can be complied with within the prescribed time limits.
- Many presentations of documents run into problems with time-limits. You must be aware of at least three time constraints - the expiration date of the credit, the latest shipping date and the maximum time allowed between dispatch and presentation.
- If the letter of credit calls for documents supplied by third parties, make reasonable allowance for the time this may take to complete.
- After dispatch of the goods, check all the documents both against the terms of the credit and against each other for internal consistency.

Summary

The use of the letters of credit as a tool to reduce risk has grown substantially over the past decade. Letters of credit accomplish their purpose by substituting the credit of the bank for that of the customer, for the purpose of facilitating trade.

The credit professional should be familiar with two types of letters of credit: commercial and standby. Commercial letters of credit are used primarily to facilitate foreign trade. The commercial letter of credit is the primary payment mechanism for a transaction.

The standby letter of credit serves a different function. The standby letter of credit serves as a secondary payment mechanism. The bank will issue the credit on behalf of a customer to provide assurances of his ability to perform under the terms of a contract.

Upon receipt of the letter of credit, the credit professional should review all items carefully to insure that what is expected of the seller is fully understood and that he can comply with all the terms and conditions. When compliance is in question, the buyer should be requested to amend the credit.