

Letter of Credit

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.

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:

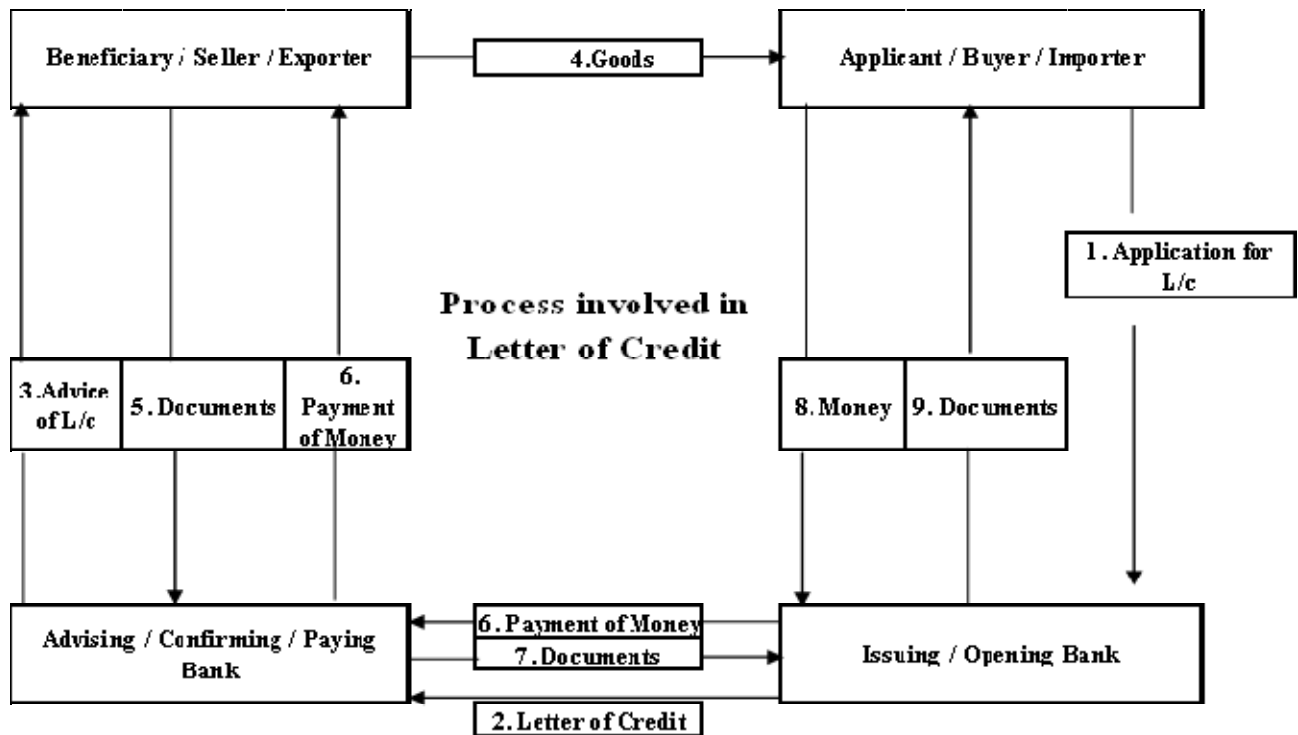
1. Is to make a payment to or to the order third party (the beneficiary) or is to accept bills of exchange (drafts) drawn by the beneficiary.
2. Authorised another bank to effect such payments or to accept and pay such bills of exchange (draft).
3. Authorised another bank to negotiate against stipulated 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 Letter 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.
- **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 and the beneficiary transfers the credit to another party, then he is referred to as the first or original beneficiary.
- **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, provided the documents are in accordance with the terms and conditions of the letter of credit.
- **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.
- **Paying Bank** is the bank nominated in the letter of credit that makes payment to the beneficiary, after determining that documents conform, and upon receipt of funds from the issuing bank or another intermediary bank nominated by the issuing bank.
- **Confirming Bank** is the bank, which, under instruction from the issuing bank, substitutes its creditworthiness for that of the issuing bank. It ultimately assumes the issuing bank's commitment to pay.

Process involved in Letter of Credit



1. Applicant / Buyer / Importer approaches Issuing/ Opening Bank with LC application form duly filled and requests Issuing Bank to issue a Letter of Credit in favor of Beneficiary / Seller / Exporter
2. An Issuing Bank / Opening Bank issue a Letter of Credit as per the application submitted by an Applicant and sends it to the Advising / Confirming / Paying Bank, which is located in Beneficiary's country, to formally advise the LC to the beneficiary.
3. Advising Bank advises the LC to the Beneficiary.
4. Once Beneficiary receives the LC and if it suits his/ her requirements, it prepares the goods and hands over them to the carrier for dispatching to the Applicant.
5. The Beneficiary then hands over the documents along with the Transport Document as per LC to the Advising Bank to be forwarded to the Issuing Bank
6. Issuing Bank reimburses the Advising Bank with the amount of the LC, post Advising Bank's confirmation that they have negotiated the documents in strict conformity of the LC terms. The Advising Bank makes the payment to the Beneficiary.
7. Simultaneously, the Advising Bank forwards the documents to the Issuing Bank to be released to the Applicant to claim the goods from the carrier.
8. Applicant reimburses the Issuing Bank for the amount, which the Issuing Bank had paid to the Advising Bank.
9. Issuing Bank releases all documents along with the titled Transport Documents to the Applicant.

Advantages & Risks of Letter of Credit

Advantages	Risks
The beneficiary is assured of payment as long as it complies with the terms and conditions of the letter of credit. The letter of credit identifies which documents must be presented along with the data content of those documents. The credit risk is transferred from the applicant to the issuing bank.	Since all the parties involved in Letter of Credit deal with the documents and not with the goods, the risk of Beneficiary not shipping goods as mentioned in the LC is still persists.
The beneficiary can enjoy the advantage of mitigating the issuing bank's country risk by requiring that a bank in its own country confirm the letter of credit. That bank then takes on the country and commercial risk of the issuing bank and protects the beneficiary.	The Beneficiary's documents must comply with the terms and conditions of the Letter of Credit for Issuing Bank to make the payment
The beneficiary minimizes collection time as the letter of credit accelerates payment of the receivables.	The Beneficiary is exposed to the Commercial risk on Issuing Bank, Political risk on the Issuing Bank's country and Foreign Exchange Risk in case of Usance Letter of Credits.
The beneficiary's foreign exchange risk is eliminated with a letter of credit issued in the currency of the beneficiary's country.	

Types of Letter of Credit :

1. Revocable Letter of Credit

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 , 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 Credit

In this case it is not possible to revoke or amend a Letter of Credit without the agreement of the issuing bank, the confirming bank, and the beneficiary. From 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

A confirmed letter of credit is one in which the advising bank, on the instructions of the issuing bank, has added a confirmation that payment will be made as long as documents mentioned in the L/c application are presented. This commitment holds even if the issuing bank or the buyer fails to make payment. A bank will make an additional charge for confirming a letter of credit.

4. Sight Credit & 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. Standby Letter of Credit

A standby letter of credit is used as support where an alternative, less secure, method of payment has been agreed. They are also used in the United States of America in place of bank guarantees. In case the exporter fail to receive payment from the importer, he may claim under the standby letter of credit. Certain documents are likely to be required to obtain payment including: the standby letter of credit itself; a sight draft for the amount due; a copy of the unpaid invoice; proof of dispatch and a signed declaration from the beneficiary stating that payment has not been received by the due date and therefore reimbursement is claimed by letter of credit. 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 Letter of Credit

6. Revolving Letter of Credit

The revolving credit is used for regular shipments of the same commodity to the same importer. It can revolve in relation to time or value. If the credit is time revolving once utilized, it is re-instated for further regular shipments until the credit is fully drawn. If the credit revolves in relation to value once utilised and paid, the value can be reinstated for further drawings. The credit must state that it is a revolving letter of credit and it may revolve either automatically or subject to certain provisions. Revolving letters of credit are useful to avoid the need for repetitious arrangements for opening or amending letters of credit.

7. Transferable Letter of Credit

A transferable documentary credit is a type of credit under which the first beneficiary which is usually a middleman may request the Advising / Confirming / Paying Bank to transfer credit in whole or in part to the second beneficiary. The L/c 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 . This type of L/c is used in the companies that act as a middle man during the transaction but don'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.

8. Back - to Back Letter of Credit

A back - to - back credit which can also be referred as credit and counter credit 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 Back - to - Back 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 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

Settlements Under a Letter of Credit

All commercial letters of credit must clearly indicate whether they are payable by sight payment, by deferred payment, by acceptance, or by negotiation. These are noted as formal demands under the terms of the commercial letter of credit.

1. In a **sight payment**, the letter of credit is payable when the beneficiary presents the complying documents and if the presentation takes place on or before the expiration of the letter of credit.
2. In a **deferred payment**, the letter of credit is payable on a specified future date. The beneficiary may present the complying documents at an earlier date, but the letter of credit is payable only on the specified future date.
3. Under a payment by **acceptance**, a time draft drawn on, and accepted by, a banking institution, which promises to honor the draft at a specified future date. The act of acceptance is without recourse as it is a commitment to pay the face amount of the accepted draft.
4. Under negotiation, the **negotiating bank**, a third party negotiator, expedites payment to the beneficiary upon the beneficiary's presentation of the complying documents to the negotiating bank. The bank pays the beneficiary, normally at a discount of the face amount of the value of the documents, and then presents the complying documents, including a sight or time draft, to the issuing bank to receive full payment at sight or at a specified future date.

Import Letter of Credit

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 issues 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.

Export Letter of Credit

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.