Understanding Letter of Credit

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What is Letter of Credit (LC):

- Letters of credit (LCs) are essential financial instruments used in international/Domestic trade to facilitate secure transactions between buyers and sellers. Different types of LCs cater to various needs and circumstances, offering flexibility and assurance in global commerce.

Types of LC’s

- **Documentary Letter of Credit (DLC):**
- **Sight LC:**
- **Usance LC**
- **UPAS LC (Usance Payable at Sight):**
- **Standby Letter of Credit (SBLC):**
- **Revocable and Irrevocable LC:**
- **Confirmed and Unconfirmed LC:**
- **Back-to-Back LC:**

Documentary Letter of Credit (DLC):

- A documentary letter of credit is one of the most common types. It ensures that payment will be made to the seller upon presentation of specified documents, such as shipping documents, commercial invoices, and certificates of origin. DLCs provide security to both parties by guaranteeing payment against compliance with the terms and conditions outlined.

It can be further bifurcated into Sight LC and Usance LC

- **Sight LC:** A Sight LC, also known as a Documentary Credit at Sight, is a type of letter of credit where payment is made to the beneficiary (seller) immediately upon presentation of compliant documents.
- **Usance LC:** A Usance LC, also known as a Deferred Payment LC, involves a credit period where payment to the seller is deferred to a future date after the presentation of compliant documents. Basically a credit period is allowed to buyer of goods for payment.

UPAS LC (Usance Payable at Sight):

- UPAS LC stands for Usance Payable at Sight Letter of Credit. It combines elements of both sight and usance (deferred) payment terms within a single letter of credit structure.
- In UPAS LC the seller received payment upon presentation of compliant documents to the nominated bank and the bank immediately releases payment to the seller just like sight LC.
- Whereas the buyer (applicant) is granted a credit period or usance period just like Usance LC.
- The buyer's obligation to pay the issuing bank is deferred to a future specified date after the sight payment to the seller.
- The nominated bank facilitates the transaction and earns fees and charges for its services in the LC transaction and in addition to that interest income on the amount extended to the buyer as credit for the usance period.

Standby Letter of Credit (SBLC):

- SBLC serves as a secondary payment mechanism. It acts as a guarantee to the seller that if the buyer fails to fulfill their payment obligations, the bank will step in and make the payment. In simple words it is one time LC, issued for a certain period, in favour of a particular supplier, with a cap of limit for regular transactions.

Revocable and Irrevocable LC:

- A revocable LC can be modified or cancelled/revoked by the issuing bank without prior notice to the beneficiary. Conversely, an irrevocable LC cannot be changed or cancelled without the agreement of all parties involved, providing greater assurance to the beneficiary.

Confirmed and Unconfirmed LC:

- A confirmed LC involves two banks – the issuing bank and a confirming bank. The confirming bank adds its confirmation to the LC, promising to honour the payment obligations. In contrast, an unconfirmed LC relies solely on the credit of the issuing bank.

Back-to-Back LC:

- This type of LC is used when an intermediary needs to establish an LC in favour of a supplier using another LC received from the buyer. It facilitates transactions where the intermediary acts as a middleman between the buyer and the supplier.

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