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An In-Depth View of Letters of Credit

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Agenda

- Revocable vs. Irrevocable
- Roles of the banks in a Letter of Credit
- Value of Confirmation
  - Who benefits
  - Can you get the benefits of confirmation without the actual confirmation
- Banker’s Acceptances and Discounting
- Time vs. Deferred
  - Deferred Payment Undertaking
- Avoid Discrepancies
- Transfer vs. Assignment

Revocable vs Irrevocable

- Irrevocable
  - Means that parties to the letter of credit cannot act unilaterally to change the transaction
  - Everyone must consent to a change
  - Does the bank ask your consent in every case?
    - Why or Why Not?
- Revocable
  - Banks no longer issue “revocable” letters of credit

What is a Letter of Credit?

- A letter of credit is a contract
  - It is a stand-alone contract, meaning that its terms and conditions does not attach to any other contract and vice-versa
  - The contract is between:
    - The issuing bank and the beneficiary
  - The contract indicate exactly what the seller needs to do in order to be paid
    - This is the sellers end of the deal
  - If the seller upholds their side of the contract, then the bank has an obligation to pay regardless of their ability to be reimbursed by the applicant
  - A discrepancy is a breach of contract and nullifies the issuers obligation

Roles of the Banks

- Issuing bank (a/k/a applicant’s bank or importer’s bank)
  - This is the bank that issues the letter of credit on behalf of its customer
  - This bank with the ultimate payment obligation
- Advising Bank
  - This bank receives the letter of credit from the issuing bank and advises the credit to the beneficiary
- Confirming Bank
  - This bank (can be the same as the advising bank) takes on the same payment obligation and risk of the issuing bank
- Nominated Bank
  - This bank (can be the same as the advising bank) is “nominated” by the issuing bank to pay, negotiate, accept or incur a deferred payment undertaking
  - Most banks will NOT act on its nomination unless it is a confirming bank
- Negotiating Bank
  - This bank (can be the same as the advising bank) purchases the shipping documents and pays the exporter, acting on its above nomination by the issuing bank
- Accepting Bank
  - This bank (can be the same as the advising bank) accepts a draft with a term, which obligates it to make payment on the maturity date
- Reimbursing Bank
  - This bank (can be the same as the advising bank) will reimburse the negotiating or nominated bank based on instructions it receives from the issuing bank and a claim it receives from the nominated bank.

Bank Liability

- Letters of Credit are "contingent" liabilities to issuing banks
  - This means that the bank does not have a liability until relevant shipping documents are presented under the letter of credit
  - Presentation of "complying" documents triggers the conversion of that liability from a contingent to a direct liability
    - On a sight transaction, this means that the issuing bank must pay within the 5 days permitted under UCP
    - On a time transaction, this means that the issuing bank must pay on the maturity date

- Complying presentation is the presentation of documents under the letter of credit that strictly (100%) conform to the terms and conditions of the letter of credit

Drafts drawn on….

- The Letter of Credit will always indicate who required drafts should be drawn on
  - This is usually the issuing bank as they are the ones with ultimate responsibility to pay
  - However if the letter of credit is "restricted" or available with a specific bank, then the drafts would be drawn on that bank

- Issuing banks would restrict a letter of credit to a specific bank:
  - if they want that bank to act on its nomination
  - if they are requesting a bank to confirm their letter of credit

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Available with… by…

- Letters of Credit will always indicate who the letter of credit is available with
  – This is the bank that the issuing bank is nominating
- And it will indicate how it is available
  – By Payment – meaning as soon as documents in compliance are presented to the nominated bank, payment should be made to the exporter
  – By Negotiation – meaning that the nominated bank (acting on its nomination) will purchase the documents and make payment to the exporter
  – By Deferred Payment – payment will be made at a future maturity date as determined the terms of the letter of credit
  – By Acceptance – payment will be made at a future maturity date as determined by the presentation of a time draft

Role and Value of the Confirmation

- Confirming Bank
  - This bank (can be the same as the advising bank) takes on the same payment obligation and risk of the issuing bank

- So, what does this mean and how is it to the exporters advantage?
  - Rather than taking the obligation of a bank half a world away that you know nothing bank, your bank is going to take on that obligation
  - When your bank finds your documents to be in compliance with the contract, it will pay you immediately
    - This is a “go to sleep at night” provision. A bank that you know and trust is going to be the one taking on the documentation and payment risk

Confirmation cont'd

- DSO (Days Sales Outstanding)
  - Confirmation can greatly reduce your DSO

- Other advantages
  - Competitiveness – providing terms (time LC) can be the point that tips the scale in your favor in a competitive situation
  - With a confirmed letter of credit you can offer terms knowing that you will be paid prior to the maturity date through a banker's acceptance

Banker’s Acceptances

- Instruments that are typically derived from term LC’s
- Presentation of dox with a term trigger a banker’s acceptance
  - Either the issuing bank or the accepting/confirming bank “accepts” the draft, or obligates itself absolutely to make payment on the maturity date
  - In many cases the bank, having taken this obligation, will consider “discounting” the transaction
    - This means that it will agree to pay the beneficiary in advance of the maturity date
    - In such cases, it is agreeing to provide a short term loan to the beneficiary so fees and interest will apply

Confirm / Without / May Add

- Every letter of credit will include an instruction from the issuing bank to the nominated bank with regard to confirmation
  - CONFIRM instructs the nominated bank to add its confirmation
  - WITHOUT instructs the nominated bank not to confirm
  - MAY ADD leaves the decision to the nominated bank
    - Advising bank (even instructed to CONFIRM) are not obligated to do so
    - Likewise, if an issuing bank indicates WITHOUT that doesn’t mean that you cannot receive the benefits of the confirmation

    - You can ask your bank to do a “silent confirmation” where your bank will provide you the benefits of the confirmation without the issuing bank knowledge
    - Is that OK?

Can I get this benefit if the LC is available by deferred payment?

- Yes you can
- Deferred payment LC's are term LC's that do not require a draft
  - In this case there is no draft to accept so how do I get the benefits
- Deferred Payment Undertaking
  - This is where the bank will provide you with its obligation to pay you on a future date even without the presentation of a draft
  - And – the undertaking can be discounted

Tips to Avoid Discrepancies and Surprises

- Get your bank involved early
- Talk to the bank about fees
- Ask questions if there is anything in the LC that you don't understand
  - Understand the pitfalls
- Remember that the LC is not impacted by anything in your sales contract and vice-versa
- Seek help from a forwarder or a company that understands how to create shipping documents based on the LC
- Know that if the LC is not what you need or expect, you can reject it
- Understand the Incoterms
- Work with the buyer to "Keep it simple"

Things to look for…

- Merchandise Description
  - Is it accurately reflecting exactly what is being shipped
  - All the details in the merchandise description MUST be in your invoice
- Quote – Unquote statements
  - Must be exactly as per the letter of credit
- Dates
  - Expiry date and PLACE – it means something
  - Latest Ship Date
  - Presentation Period
    - This is typically 21 days
  - How many days are between the Latest Ship Date and the Expiry Date
- Fees
  - What fees apply and
  - Who is responsible for those fees

Keep it simple

- 1. Commercial Invoice in one original and one copy, manually signed, showing the date of shipment, vessel name, issuing bank letter of credit number, shipping marks, net and gross weights, number of containers and container numbers

- 1. Commercial Invoice in one original and one copy

Understand the Incoterms

- Exporters love “EXWORKS”
  - Buyer agrees to pay for all shipping charges and customs fees
  - Even arranges to have the merchandise picked up right from the sellers dock

- What can possibly be wrong with this idea?
  - What shipping document is called for in the letter of credit?
  - What is the presentation period in the letter of credit?
  - What if my documents contain discrepancies?

Transferable Letters of Credit

- What is a transferable Letter of Credit
  - Allows the beneficiary of the letter of credit to transfer all or part of a letter of credit to another party or "2nd beneficiary"
  - However, the terms and conditions of the original letter of credit must be used with only the following fields of the letter of credit which can be changed:
    - Applicant and Beneficiary
    - Amount
    - Unit Price (is applicable)
    - Expiration Date
    - Presentation Period
    - Latest Shipment Date

Transfers cont'd

- 2nd Beneficiary provides the documents required in the transferred letter or credit
- Upon presentation of the 2nd Beneficiary's documents to the transferring bank, the 1st Beneficiary may substitute its own invoices to maintain compliance with the original letter of credit

- Are LC's transferable
  - An LC must specifically state it is transferable
  - Banks may refuse to transfer a letter of credit

Transfer vs. Assignment

- A transfer provides the rights of the letter of credit to a 2nd beneficiary
- An assignment does not provide the rights of the letter of credit to another party, but does assign a portion of the proceeds of that letter of credit to the assignee

Fees

- All banks have their own fee schedules for letters of credit and several fees can come into play for any letter of credit
  - Flat fees are issuance fees, advising fees, discrepancy fees or any fees that are not based on a percentage of the transaction
  - Commission / Payment / Negotiation fees are usually based on a percentage of the transaction
    - Can be anywhere between .25% per annum to 2.5% per annum
  - Acceptance and Discount fees are at the discretion of your bank
  - Other fees may apply as well

- Thank you