DEFINITION OF 'LETTER OF CREDIT'

A letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount. In the event that the buyer is unable to make payment on the purchase, the bank will be required to cover the full or remaining amount of the purchase.

INVESTOPEDIA EXPLAINS 'LETTER OF CREDIT'

Letters of credit are often used in international transactions to ensure that payment will be received. Due to the nature of international dealings including factors such as distance, differing laws in each country and difficulty in knowing each party personally, the use of letters of credit has become a very important aspect of international trade. The bank also acts on behalf of the buyer (holder of letter of credit) by ensuring that the supplier will not be paid until the bank receives a confirmation that the goods have been shipped.

Letters of credit are a financial tool that can be very useful in some situations. Find out exactly what they are, what types of letters of credit there are, and how they work.

Letter of Credit -- Definition

When you hear the phrase **letter of credit**, it might be natural to think it would refer to a document verifying that you are creditworthy, but that isn't the case. A letter of credit is a document issued by a third party that guarantees payment for goods or services when the seller provides acceptable documentation. Letters of credit are usually issued by banks or other financial institutions, but some creditworthy financial services companies, like insurance companies or mutual funds, *might* issue letters of credit under certain circumstances.

A letter of credit generally has three participants: the **beneficiary** (the person or company who will be paid), the **buyer** of the goods or services (sometimes called the **applicant**), and the **issuing bank** (the institution issuing the letter of credit). The beneficiary may request payment to an **advising bank**, which is a bank where the beneficiary is a client, rather than directly to the beneficiary: this might be done, for example, if the advising bank financed the transaction for the beneficiary until payment was received.

Letters of credit are most often used in international trade, where they are governed by the **Uniform Customs and Practice for Documentary Credits (UCP)** rules of the International Chamber of Commerce. However, they *can* be used in other situations, as we shall see.

Types and Features of Letters of Credit

Most letters of credit are **import/export letters of credit** which, as the name implies, are used in international trade. The same letter of credit would be termed an import letter of credit by the importer and an export letter of credit by the exporter. In most cases the importer is the buyer and the exporter is the beneficiary.

The **revocable letter of credit** can be changed at any time by either the buyer or the issuing bank with no notification to the beneficiary. The most recent version of the UCP, UCP 600, did away with this form of letter of credit for any transaction under their jurisdiction. Conversely, the **irrevocable letter of credit** only allows change or cancellation of the letter of credit by the issuing bank *after* application by the buyer and approval by the beneficiary. All letters of credit governed by the current UCP are irrevocable letters of credit.

A **confirmed letter of credit** is one where a second bank agrees to pay the letter of credit at the request of the issuing bank. While not usually required by law, an issuing bank might be required by court order to only issue confirmed letters of credit if they are in receivership. As you might guess, an **unconfirmed letter of credit** is guaranteed only by the issuing bank. This is the most common form with regard to confirmation.

A letter of credit may also be a **transferrable letter of credit**. These are commonly used when the beneficiary is simply an intermediary for the *real* supplier(s) of the goods and services or is one of a group of suppliers. It allows the named beneficiary to present its own documentation but transfer all or part of the payment to the actual supplier(s). As you might guess, an **un-transferrable letter of credit** does not allow transfer of payments to third parties.

A letter of credit may also be **at sight**, which is payable as soon as documentation has been presented and verified, or payment may be **deferred** (also called a **usance letter of credit**) until a certain time period has passed or the buyer has had the opportunity to inspect or even sell the related goods.

A **red clause** letter of credit allows the beneficiary to receive partial payment before shipping the products or performing the services. Originally these terms were written in red ink, hence the name. In practical use, issuing banks will rarely offer these terms unless the beneficiary is *very* creditworthy or an advising bank agrees to refund the money if the shipment is not made.

Finally, a **back to back letter of credit** is used in a trade involving an intermediary, such as a trading house. It is actually made up of two letters of credit, one issued by the buyer's bank to the intermediary and the other issued by the intermediary's bank to the seller.

Documentation

In order to receive payment, the beneficiary must present documentation of completion of their part in the transaction to the issuing bank. The documents that the issuing bank will accept are specified in the letter of credit, but may often include:

- Bills of Exchange

- Invoices
- Government Documents such as licenses, certificates of origin, inspection certificates, embassy legalizations, and phytosanitary certificates
- Shipping and Transport Documents such as bills of lading, airway bills, etc.
- Insurance policies or certificates (but *not* cover notes)

Risks in Letter of Credit Transactions

Letter of credit transactions are not without risks. The risks inherent in these types of transactions include:

- **Fraud risk**, in which the payment is obtained through the use of falsified or forged documents for worthless or nonexistent merchandise.
- **Regulatory risk**, in which government action may prevent completion of the transaction.
- **Legal risk**, in which legal action prevents completion of the transaction.
- **Force majeure risk**, in which completion of the transaction is prevented by an external force such as war or natural disasters
- Failure of the issuing or collecting bank

What is Letter of Credit

Letter of credit, in a broad perspective, is one of the payment methods in international trade.

Some of the other payment methods in international trade are Cash-in-Advance, Documentary Collections and Open Account. All of these payment methods inherit different risk levels for exporters and importers. Letters of credit is the only payment method, which has a balanced risk structure for both parties.

Definition of Letter of Credit:

"*Credit means any arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation.*" *(UCP 600, article 2)*

This letter of credit definition is taken from the UCP 600 (ICC Uniform Customs and Practice for Documentary Credits) which is the latest version of the rules published by ICC (International Chamber of Commerce) regulating the letters of credit operations all around the world.

Role of the ICC and UCP in Letters of Credit

International trade is exchange of capital, goods, and services across international borders between people whom belong to different languages, cultures and laws. As letters of credit are a payment method of international trade it is obvious that standardized rules are needed to govern letters of credit in a global scale to make sure that letters of credit transactions run smoothly. ICC, International Chamber of Commerce, is the organization that publishes the standardized rules. The rules, which are called UCP, Uniform Customs and Practice for Documentary Credits, are revised regularly. At the time of this text is written sixth version of the UCP rules is in force.

In this first article, we have seen what letter of credit is, its definition, the rules that apply to them and the organization that publishes these rules. In the next article, we will examine types of letters of credit.

Types of Letters of Credit

Traveler's letters of credit, which were commonly used in eighteenth century, were the first financial instrument contains very similar characteristics with the contemporary letters of credit.

Commercial Letters of Credit

Commercial letters of credit are mainly used as a primary payment tool in international trade such as exporting and importing transactions. Majority of commercial letters of credit are issued subject to the latest version of UCP (Uniform Customs and Practice for Documentary Credits). The ICC publishes UCP, which are the set of rules that governs the commercial letters of credit procedures.

Standby Letters of Credit

Commercial letters of credit are a means of payment to be utilized when the principal perform its duties. As an example, let us consider an exporter who ships the goods according to the sales contract and apply to the nominated bank for the payment. If the nominated bank decides that the presentation is conforming to the terms and conditions of the credit and the UCP rules then exporter will be paid. This situation is just contrary in standby letters of credit.

A payment is made to the beneficiary of a standby letter of credit when there is a breach of the principal's obligation. As an example, let us consider a construction company that has been awarded with a tender. If this construction company cannot fulfill its obligations under the project contract beneficiary of the standby letter of credit can apply to the nominated bank for the payment. However, the nominated bank considers only the terms and the conditions of the standby letter of credit and the rules governing the credit when deciding a complying presentation. One point that needs to be stressed is that standby letters of credit have their own rules, which are called The International Standby Practices 1998 (ISP98). They are also published by ICC. However, a standby letter of credit can be issued subject to either the UCP or the ISP.

Revocable Letters of Credit

Revocable letters of credit give issuer the amendment or cancellation right of the credit any time without prior notice to the beneficiary. Since revocable letters of credit do not provide any protection to the beneficiary, they are not used frequently. In addition, UCP 600 has no reference to revocable letters of credit. All credits issued subject to UCP 600 are irrevocable unless otherwise agreed between the parties.

Irrevocable Letters of Credit

Irrevocable Letters of Credit cannot be amended or cancelled without the agreement of the credit parties. Unconfirmed irrevocable letters of credit cannot be modified without the written consent of both the issuing bank and the beneficiary. Confirmed irrevocable letters of credit need also confirming bank's written consent in order any modification or cancellation to be effective.

Unconfirmed Letters of Credit

Unconfirmed Letters of Credit can be described as a letter of credit, which has not been guaranteed or confirmed by any bank other than the bank that opened it. In these types of credits, the only bank that undertakes to honor a complying presentation is the issuing bank

Confirmed Letters of Credit

It would be easier to understand the confirmed letters of credit if we start from the definition of the confirmation.

Confirmation means a definite undertaking of the confirming bank, in addition to that of the issuing bank, to honor or negotiate a complying presentation.

If a letter of credit's payment undertaking is guaranteed by a second bank, in addition to the bank originally issuing the credit this kind of credit is called confirmed letter of credit. The confirming bank agrees to pay or accept drafts against the credit even if the issuer refuses to do so. Only irrevocable credits can be confirmed.

Clean Letters of Credit :

Below two different definitions of clean letters of credit are given.

A letter of credit payable upon presentation of the draft, without any supporting document being required.(www.businessdictionary.com)

L/C that does not require any document other than a written demand for payment by its beneficiary. In effect, a draft.(www.intracen.org)

Clean letters of credit are issued only by the request of the highest credit standing companies. It is suitable for variety commercial situations where no movement of goods is expected. Historically these types of credits have been used in traveler's letters of credit. Today direct pay standby letter of credit can be given as an example of clean letters of credit.

There are also some other form of letters of credits which deserve special attention. We will discuss them by one by more in detail however; you can find short description of each of them below.

Transferable Letters of Credit

Transferable letter of credit is a documentary credit that is issued with the option to allow a trader to transfer its rights and obligations to the supplier.

Back-to-Back Letters of Credit

Arrangement in which one irrevocable letter of credit serves as the collateral for another; the advising bank of the first letter of credit becomes the issuing bank of the second L/C. Unlike transferable letters of credit, there are two separate letter of credits exist in back-to-back letter of credit transactions.

Advance Payment (Red Clause) Letters of Credit

Letter of credit that carries a provision (traditionally written or typed in red ink) which allows a seller to draw up to a fixed sum from the advising or paying-bank, in advance of the shipment or before presenting the prescribed documents.

Parties to Letters of Credit

Main parties of Letter of Credit transaction such as

applicant,

beneficiary,

issuing bank,

confirming bank,

nominated bank

Applicant

Applicant is the buyer of the goods or services supplied by the seller. Letter of credit is opened by the issuing bank as per applicant's request. However, applicant does not belong one of the parties to a letter of credit transaction. This is because of the fact that letters of credit are separate transactions from the sale or other contract on which they may be based.

Beneficiary

Beneficiary is the seller of the goods or the provider of the services in a standard commercial letter of credit transaction. Letter of credit is opened by the issuing bank in favor of the beneficiary.

Issuing Bank

Issuing Bank is the bank that issues a letter of credit at the request of an applicant or its own behalf. Issuing bank undertakes to honor a complying presentation of the beneficiary without recourse.

Nominated Bank

Nominated bank is the bank with which the credit is available or any bank in the case of a credit available with any bank.

Advising Bank

Advising bank is the bank that advises the credit at the request of the issuing bank. An advising bank that is not a confirming bank advises the credit and any amendmend without any obligation to honor.

Confirming Bank

Confirming bank is the bank that adds its confirmation to a credit upon the issuing bank's authorization or request. Confirming bank may or may not add its confirmation to a letter of credit. This decision is up to confirming bank only. However, once it adds its confirmation to the credit confirming is irrevocably bound to honor or negotiate as of the time it adds its confirmation to the credit. Even if the issuing bank fails to honor, confirming bank must pay to the beneficiary.

Reimbursing Bank

Reimbursing Bank shall mean the bank instructed and/or authorized to provide reimbursement pursuant to a reimbursement authorization issued by the issuing bank.

Risks in Letters of Credit

Risks in letters of Credit

Although letters of credit are a balanced payment method in terms of risk issues for both exporters and importers, each letters of credit party bears some amount of risk. As we have explained before letters of credit transactions are handled by banks. This responsibility makes the banks one of the parties that bears risks in a letter of credit transaction

Risks in letters of credit can be discussed under four groups; general risks in letters of credit, risks to the applicant, risks to the beneficiary and risks to the banks.

General Risks in Letters of Credit:

Country Risk: (Political Risk)

The first risk factor that can be mentioned in the general risks group is the country risk or the political risk. Let us assume that we are an exporter located in a country X and we have a customer from the country Y. Our customer, which is from the country Y, opened a L/C in favor of us. We have checked the L/C conditions and they seem workable. We have produced and shipped the order as per the L/C and transmit the required documents to the issuing bank before the expiry date. The issuing bank found our presentation complying and informed us that they will be honoring our payment claim at the maturity date. However, before the maturity date due Country Y has changed its export regime, which makes it impossible for the issuing bank to honor our presentation. This illustrative is a good example of a country risks. Other examples of country risks are mass riots, civil war, boycott, sovereign risk and transfer risk.

Fraud Risk:

As we have described before all conditions stated in a letter of credit must be connected to a document, otherwise banks will disregard such a condition. In addition, banks deal with only documents but not goods, services or performance to which the documents may relate. This feature of the letters of credit is the source of the fraud risk at the same time. As an example, a beneficiary of a certain letter of credit transaction can prepare fake documents, which looks complying on their face, to make the presentation to the issuing bank. As the documents are complying on their face, the issuing bank may honor the presentation and in this case, the applicant must pay to the issuing bank for the goods it will never be receiving. Beneficiaries of L/Cs bear also fraud risks. This happens if an applicant issues a counterfeit letter of credit. In this case, the beneficiary never receives its payment for the goods it has shipped.

Risks to the Applicant:

In a letter of credit transaction, main risk factors for the applicants are non-delivery, goods received with inferior quality, exchange rate risk and the issuing bank's bankruptcy risk.

Risks to the Beneficiary:

In a letter of credit transaction, main risk factors for the beneficiaries are unable to comply with letter of credit conditions, counterfeit L/C, issuing bank's failure risk and issuing bank's country risk.

Risks to the Banks:

Every bank in a L/C transaction bears risks more or less. The risk amount increases as responsibility of the bank increases.

Understanding Letter of Credit Transaction

On this page I will try to explain you letter of credit process in a very simple way. After reading this article you should understand the working mechanism of letter of credit payment in general terms.

1. The starting point of the letter of credit process is the agreement upon the sales terms between the exporter and the importer. Then they sign a sales contract. It is important to stress here that letters of credit are not a sales contract. Actually, letters of credit are independent structures from the sale or other contract on which they may be based. Therefore, it should be kept in mind that a good sales contract protects the party, which behaves in goodwill against various kinds of risks.

2. After the sales contract has been signed, the importer (applicant) applies for its bank to issue a letter of credit. The letter of credit application must be in accordance with the terms of the sales agreement.

3. If the importer and its bank reach an agreement together on the working conditions the importer's bank (issuing bank) issues its letter of credit. In case the issuing bank and the exporter (beneficiary) are located at different countries, the issuing bank may use another bank's services (advising bank) to advise the credit to the beneficiary.

4. The advising bank advises the letter of credit to the beneficiary without any undertaking to honor or negotiate. The advising bank has two responsibilities against to the beneficiary. Advising bank's first responsibility is satisfy itself as to the apparent authenticity of the credit and its second responsibility is to make sure that the advice accurately reflects the terms and conditions of the credit received.

5. The beneficiary should check the conditions of the credit as soon as it is received from the advising bank. If some disparities have been detected beneficiary should inform the applicant about these points and demand an amendment. If letter of credit conditions seem reasonable to the beneficiary then beneficiary starts producing the goods in order to make the shipment on or before the latest shipment date stated in the L/C. The beneficiary ships the order according to the terms and conditions stated in the credit.

6. When the goods are loaded, the exporter collects the documents, which are requested by the credit and forwards them to the advising bank.

7. The advising bank posts the documents to the issuing bank on behalf of the beneficiary.

8&9. The issuing bank checks the documents according to the terms and conditions of the credit. In addition, the governing rules, which are mostly latest version of the UCP are taken into account. If the documents are found complying after the examination the issuing bank honors the payment claim.

10. The documents transmit to the applicant. The applicant uses these documents to clear the goods from the customs.

What does availability mean in a letter of credit transaction?

In documentary credit terminology, availability refers to the availability of the documents in exchange for the payment of the amount stated in the letter of credit. UCP 600 defines four availability options ;

Sight Payment : Sight payment refers to the payment which is made as soon as the complying presentation is seen by the issuing bank or the bank nominated in the letter of credit. The nominated bank fulfills its payment obligation with recourse basis. Nominated bank can demand the amount paid to the beneficiary back in case of documents are found noncomplying by the issuing bank. Nominated bank's payment obligation is not strict as the issuing or the confirming bank's payment obligation. UCP 600 states that a nominated bank is not obligated to accept the nomination directed to itself unless nominated bank inform its acceptance of nomination expressly to the beneficiary. Even in this situation UCP 600 assumes non payment by the nominated bank and describe the roles of the issuing and confirming banks.

Deferred Payment : Deferred payment refers to the payment which is made after a period of time that is specified also in the letter of credit. The payment period is usually determined as specific number of days after the date of presentation or the date of the transport document. Bill of exchange or draft is not required under deferred payment.

Acceptance : Acceptance refers to acceptance of a bill of exchange which is drawn on the bank mentioned in the letter of credit to be presented with the other required documents and payment at the maturity.

Negotiation : Let us check the definition of the negotiation from the UCP 600 in order to understand the term more clearly.

Negotiation means the purchase by the nominated bank of drafts (drawn on a bank other than the nominated bank) and/or documents under a complying presentation, by advancing or agreeing to advance funds to the beneficiary on or before the banking day on which reimbursement is due to the nominated bank. (UCP 600 - Article 2)

As can be seen from the above definition any letter of credit which is available by negotiation could be issued in a way so that a draft may or may not be required. Also the payment of the letter of credit may or may not be at sight. If the nominated bank advance or agreeing to advance funds to the beneficiary before it receives reimbursement from the issuing bank the negotiation condition is fulfilled. This can happen in two ways. First possibility is, in a letter of credit which is available by sight payment when the nominated bank reimburse the beneficiary before it receives funds from the issuing bank. Second possibility occurs when a letter of credit is available by negotiation requesting presentation of a time draft, while the nominated bank reimburses the beneficiary before the maturity date of the bill of exchange

Confirmation and Confirmed Letter of Credit

What is confirmation in a letter of credit transaction? What are the benefits of a confirmed lc?

Confirmation is a security tool for the exporters. Confirmation eliminates country risk and insolvensy risk of the issuing bank

As we have discussed earlier there are some risk factors exist for each party in a letter of credit transaction. When we look at the risk issue from the beneficiaries' perspective, we will observe two main risk factors that beneficiaries must bear ; the country and the insolvency risk of the issuing bank. Confirmation can be seen as a security mechanism which works in favour of the beneficiaries that eliminates these two risk factors.

Let us look at the definitions of confirmation and confirming bank from the UCP 600 ;

"Confirmation means a definite undertaking of the confirming bank , in addition to that of the issuing bank, to honour or negotiate a complying presentation."

"Confirming bank means the bank that adds its confirmation to a credit upon the issuing bank's authorization or request."

As can be seen on the above definitions confirming bank adds its undertaking to the letter of credit in addition to that of the issuing bank. In this way beneficiaries receive a second payment guarantee from another bank. Insolvency risk of the issuing bank is eliminated by addition of this second payment guarantee to the letter of credit.

Mostly confirming banks and the beneficiaries are located in the same country and when this is the case the country risk of the issuing bank is eliminated as a bank which locates in the same country with the beneficiary adds its undertaking to the letter of credit in addition to that of the issuing bank.

Confirmed Letter of Credit

After discussing the benefits of the confirmation in a letter of credit transaction, let us examine the points that need to be take into consideration regarding the confirmed letters of credit.

- Only [irrevocable letters of credit](#) can be confirmed.
- During the issuance phase of a letter of credit, the issuing bank should "authorize or request" the potential confirming bank to add its confirmation to the letter of credit.
- No bank can be forced to add its confirmation to any letter of credit.
- If a bank is authorized or requested by the issuing bank to confirm a credit but is not prepared to do so, it must inform the issuing bank without delay and may advise the credit without confirmation. (UCP 600 article 8 ii-d)
- Confirming a letter of credit does not mean that confirming bank is obligated to confirm any subsequent amendment or amendments.
- A confirming bank is irrevocably bound to honour or negotiate as of the time it adds its confirmation to the letter of credit

Letter of Credit Fees

Who pays letters of credit fees? Letters of credit have certain advantages as an international payment method. If you have enough knowledge and expertise on letters of credit field then you can use them wisely to get paid where no other payment method works. No matter how many advantages letters of credit have they have one big disadvantage. **<u>They are expensive.</u>**

Why letters of credit are expensive comparing to other payment methods?

Banks play a key role in letters of credit transactions. **<u>This is the main reason why letters of credit are so expensive comparing to other payment methods</u>**. **Issuing banks** open letters of credit for the account of applicants and in favor of the beneficiaries. Issuing banks have to bear certain amount of risks when they open letters of credit. They also let the applicants benefited from their credit worthiness. As a commercial institution issuing banks provide these services only for one reason. **To earn more money, to make more profit.** Similarly **confirming banks** collect fees from the letter of credit parties for the same reason. When confirming a letter of credit confirming banks **<u>may have to</u>**

bear substantial amount of non-payment risk. As a result confirmation fees can sometimes climb to high values. As we have learnt that in a typical letter of credit transaction there are other banks may exist in addition to issuing bank and confirming bank such as **advising bank**, **nominated bank**, **reimbursing bank**. Every additional bank means additional fees and additional cost for either applicants or beneficiaries.