

LETTER OF CREDIT - A BEST TRADE SOLUTION TO INDIAN INDUSTRIES

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ABSTRACT

Letters of Credit have been a cornerstone of international trade dating back to the early 1900s. They continue to play a critical role in world trade today. For any company entering the international market, Letters of Credit are an important payment mechanism which helps eliminate certain risks.

Keywords: Letter of Credit, Sources of Finance

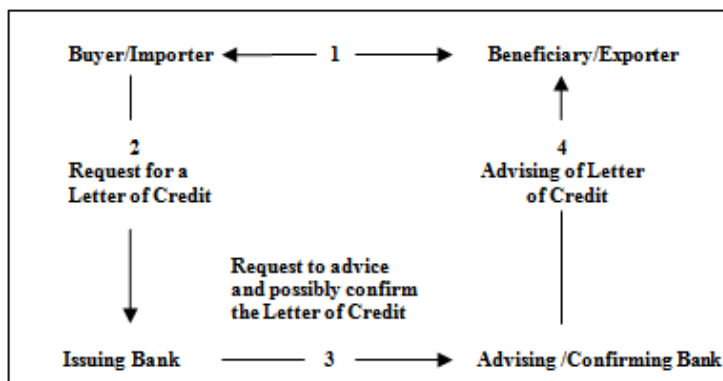
INTRODUCTION

A Letter of Credit, simply defined, is a written instrument issued by a bank at the request of its customer, the Importer (Buyer), whereby the bank promises to pay the Exporter (Beneficiary) for goods or services, provided that the Exporter presents all documents called for, exactly as stipulated in the Letter of Credit, and meet all other terms and conditions set out in the Letter of Credit. A Letter of Credit is also commonly referred to as a Documentary Credit.

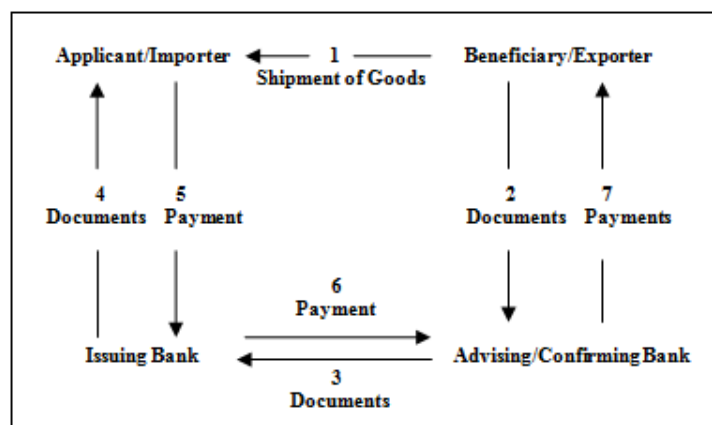
Letter of Credit (LC) is a commercial document issued by a bank in normal course of business which carries a payment guarantee obligation in case of adverse situation arises. A bank issue LC on the request of its client in favour of a third party (beneficiary). It is important instrument to the extent that it smoothens & secures the transactions ensuring to the party in whose favour the LC is opened that if any adverse situation arises and its client failed to make the payment than the issuing bank will pay subject to the terms and conditions mentioned at the time of issue of LC. This document is most important in case both the parties doing business first time. These parties can do business without any or very low risk, as bank gives a safety assurance to both the parties, involved with the transaction.

OBJECTIVES

- To understand the review of literature in the related area.
- To study the workings of Letter of Credit with suitable case study.



Issuance of Letter of Credit



Payment under Letter of Credit

Letter of Credit Lingo

To better understand letters of credit, it may help to know the following:

1. Abbreviations for 'letter of credit' include L/C, LC, and LOC
2. Applicant - the buyer in a transaction
3. Beneficiary - the seller or ultimate recipient of funds
4. Issuing bank - the bank that promises to pay
5. Advising bank - helps the beneficiary use the letter of credit

Parties to Letter of Credit

Applicant (Opener)

Applicant who is also referred to as account party is normally a Importer/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.

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. The payment has to be made to the beneficiary within seven working days from the date of receipt of documents at their end, provided the documents are in accordance with the terms and conditions of the letter of credit. If the documents are discrepant one, the rejection thereof to be communicated within seven working days from the date of receipt of documents at their end.

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 LC. If LC is a transferable one and he transfers the credit to another party, then he is referred to as the first or original beneficiary.

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.

Confirming Bank

Confirming bank adds its guarantee to the credit opened by another bank, thereby undertaking the responsibility of payment/negotiation acceptance under the credit, in addition to that of the issuing bank. Confirming bank play an important role where the exporter is not satisfied with the undertaking of only the issuing bank.

Negotiating Bank

The Negotiating Bank is the bank who negotiates the documents submitted to them by the beneficiary under the credit either advised through them or restricted to them for negotiation. On negotiation of the documents they will claim the reimbursement under the credit and makes the payment to the beneficiary provided the documents submitted are in accordance with the terms and conditions of the letters of credit.

Reimbursing Bank

Reimbursing Bank is the bank authorized to honor the reimbursement claim in settlement of negotiation/acceptance/payment lodged with it by the negotiating bank. It is normally the bank with which issuing bank has an account from which payment has to be made.

Second Beneficiary

Second Beneficiary is the person who represents the first or original Beneficiary of credit in his absence. In this case, the credits belonging to the original beneficiary is transferable. The rights of the transferee are subject to terms of transfer.

Advantages/Disadvantages of LC to Importer & Exporter

There are various advantages and disadvantages of Letter of Credit to Importer & Exporter.

Advantages to the Importer/Buyer

1. Importer is assured that the Seller will be paid only if all terms and conditions of the Letter of Credit have been met.
2. Importer is able to negotiate more favorable trade terms with the Seller when payment by Letter of Credit is offered.

Disadvantages to the Importer/Buyer

A Letter of Credit does not offer protection to the Importer against the receipt of inferior quality goods and/or a lesser quantity of goods from the Exporter. Consequently, it is important that the Importer performs the appropriate due diligence to assess the reputation of the Exporter. If the Seller acts fraudulently, the only recourse available to the Importer is through legal proceedings.

Note: Added protection to the Importer may be provided by requesting additional documentation in the Letter of Credit, e.g. a Certificate of Inspection.

Advantages to the Exporter

1. The risk of payment relies upon the creditworthiness of the issuing bank, and not on the creditworthiness of the Buyer.
2. Exporter agrees in advance to all requirements for payment under the LC. If the LC is not issued as agreed, the Exporter is not obligated to ship against it.

Disadvantages to the Exporter

1. Documents must be prepared and presented in strict compliance with the requirements stipulated in the Letter of Credit.
2. Some Importer may not be able to open LC due to the lack of credit facilities with their bank which consequently inhibits export growth.

Types of Letter of Credit

Import/Export Letter of Credit

The same credit can be termed as import and export LC depending on whose perspective it is being looked upon. For the importer it is termed as Import LC and for the Exporter of goods, it is called Export LC.

Revocable Letter of Credit

In this type of credit, buyer and the bank which has established the LC are able to manipulate the letter of credits or make any kinds of corrections without informing the seller and getting permissions from him. According to UCP 600, all LCs are Irrevocable, hence this type of LC used no more.

Irrevocable LC

In this type of LC, Any changes (amendment) or cancellation of the LC (except it is expired) is done by the Applicant through the issuing Bank. It must be authenticated by the Beneficiary of the LC. Whether to accept or reject the changes depends on the beneficiary.

Confirmed LC

An LC is said to be confirmed when another bank adds its additional confirmation (or guarantee) to honor a complying presentation at the request or authorization of the issuing bank.

Unconfirmed LC

This type of letter of credit, does not acquire the other bank's confirmation.

Transferrable LC

A Transferable Credit is the one under which the exporter has the right to make the credit available to one or more subsequent beneficiaries. Credits are made transferable when the original beneficiary is a middleman and does not supply the merchandise himself but procures goods from the suppliers and arrange them to be sent to the buyer and does not want the buyer and supplier knows each other. The middleman is entitled to substitute his own invoice for the one of the supplier and acquire the difference as his profit in transferable letter of credit mechanism.

Nontransferable LC

It is said to the credit that seller cannot give a part or completely right of assigned credit to somebody or to the persons he wants. In international commerce, it is required that the credit will be nontransferable.

Deferred / Usance LC

It is kind of credit that won't be paid and assigned immediately after checking the valid documents but paying and assigning it requires an indicated duration which is accepted by both of the buyer and seller. In reality, seller will give an opportunity to the buyer to pay the required money after taking the related goods and selling them.

At Sight LC

It is a kind of credit that the announcer bank after observing the carriage documents from the seller and checking all the documents immediately pays the required money.

Red Clause LC

In this kind of credit assignment, the seller before sending the products can take the pre-paid or part of the money from the bank. The first part of the credit is to attract the attention of the acceptor bank. The reasoning behind this is the first time this credit is established by the assigner bank, it is to gain the attention of the offered bank. The terms and conditions were written by red ink, going forward it became famous with that name.

Back to Back LC

This type of LC consists of two separated and different types of LC. First one is established in the benefit of the seller that is not able to provide the corresponding goods for any reasons. Because of that reason according to the credit which is opened for him, neither credit will be opened for another seller to provide the desired goods and sends it.

Back-to-back L/C is a type of L/C issued in case of intermediary trade. Intermediate companies such as trading houses are sometimes required to open L/Cs by supplier and receive Export L/Cs from buyer. SMBC will issue a L/C for the intermediary company which is secured by the Export L/C (Master L/C). This L/C is called "Back-to-back L/C".

Costing of Letter of Credit

Letter of Credit Charges as per State Bank of India	
Charges for opening of Letter of Credit	Yearly (approx.)
Letter of Credit Opening Charges (Above charges are inclusive of commitment fees and usance charges)	1.90%
Letter of Credit Discounting Charges (Above charges is inclusive of Interest cost only, and such cost is varies with party to party depends on the companies rating, exposure and their relation with banker's. Such cost can't go below the bank's base rate)	10.10%
Other Charges (Approx) (Above charges are inclusive of Discounted LC commission of agent, LC Handling charges and Postage charges of bank)	1.46%
Total finance cost for using LC facility	13.46%

Case Study

ABC Limited (buyer) wants to buy raw material of Rs. 1,00,000/- from XYZ Limited (seller), but the seller want Letter of Credit to guarantee payment, so how the ABC Limited will get this material? Explain?

Solution

1. First ABC Limited applies to his bank for a letter of credit in favor of the XYZ Limited for Rs. 1,00,000/-.
2. Buyer's bank approves the LC out of their sanctioned limit after keeping margin aside as applicable, then forwards the LC to its correspondent bank (advising or confirming).
3. Advising bank will authenticate the LC and forward the original LC to the seller (beneficiary)
4. Seller (beneficiary) ships the goods, then verifies and develops the documentary requirements as per the terms and conditions of LC.
5. Seller presents the required documents to the advising or confirming bank to be processed for payment.
6. Advising or confirming bank examines the documents for compliance with the terms and conditions of the LC.
7. If the documents are correct, the advising or confirming bank will claim the funds by following given below way:-

- Debiting the account of the issuing bank.
- Waiting until issuing bank remits, after receiving the documents.
- Reimburse on another bank as required in the credit.

Note:

As per RBI guideline raw material LC is valid for 1 year and capital goods LC are valid till 3 year from the date of issue.

CONCLUSION

Letters of credit is very important instruments in the field of national and international trade. They provide security for both the Importer, which he can ensure to get the goods and for the Exporter, which he can ensure to get payment when he sends the goods. Letters of credit also makes the transactions very smoothly. It gives the mechanism stability; especially from the Importer and the Exporter's perspective. For instance, there is little or no previous trading relationship among the parties; the letters of credit provide them to work with confidence and security.

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