**Chapter Seven**

**Letter Of Credit (LC)**

Learning Objectives: After studying this lesson, students will be able to:

* Describe the letter of credit
* Differentiate the travelers’ letter of credit from commercial letter of credit
* Identify the advantages of letter of credit
* Describe parties to the letter of credit
* Explain the procedures in opening the letter of credit

**7.1 Introduction**

As the world’s economy expanded, international trade started. In the beginning, there were serious problems of fraud, mismanagement and malpractices. Importers were unwilling to make payment to the exporters in other countries unless the desired goods reached them. Similarly exporters were unwilling to ship the goods unless the payments reached the. In order to solve this, letter of credit was devised.

**Definition:**

A letter of credit is just a guarantee given by one bank to a third party i.e., exporter. The guarantee ensured that he will receive payments of his goods provided he performs certain obligations. It also ensures to the importer that payment to the exporter will only be made when goods have been received.

In words of Pritchard:

“Letter of credit is a commitment on the art of buyer’s bank to pay o accept draft drawn upon it provided draft do not exceed a specified amount”.

According to uniform customs and practices for documentary credit:

“It is a written undertaken by a bank given to the seller at request and in accordance with the instructions of the buyer to affect payment up to a stated sum of money within a prescribed time-limit and against stipulated documents.”

According to H.P. Sheldon.

“ A letter addressed by one banker to another requesting the banker to whom it is addressed to hold, at the deposit of a named third party a specified amount of money and to charge the issuing banker with the total amount of all cheques honored or payments made on the authority of letter.”

* 1. **Types of LC**

The Letter of Credit can be divided into two broad categories:

**I. Travelers’ Letter of Credit**

Such types of Letters of Credit are issued by the banks for the convenience of the travelers. The travelers are saved from the risk of travelling with heavy cash with them. The facility of such Letters of Credit can be available both for travelling in and outside the country. The characteristics of such Letters of Credit are as under:

(a) A Travelers’ Letter of Credit is issued by a bank on its own branch/ branches or correspondent bank/banks situated anywhere in the world.

(b) It contains a request by the issuing bank to make payment up to the amount to the person named therein.

(c) The issuing banker may issue a Letter of Identification to the holder of the Letter of Credit. The signature of the holder must be attested therein.

Types of Travelers’ Letter of Credit: The Travelers’ Letter of Credit can be divided into the following forms:

1. **Travelers Cheque:** It is issued and drawn by a bank upon its own branch or another bank. It is a request by the issuing bank to the paying bank to pay a specified amount to the holder. It also contains the specimen signature of the holder for the purpose of identification.

2. **Circular Letter of Credit:** It is addressed to more than one banker. Details of the amount paid by the various bankers are entered in the proforma, printed on the back of the letter of credit. The holder is to deposit the required amount for which he wants a letter of credit with the issuing bank. The issuing bank charges its commission for the service.

In case of a letter of credit, the banker issues an identification slip which bears the signature of the holder attested by the issuing banker. In a travelers cheque these signatures are on the travelers cheque itself.

3. **Circular Note:** It is like a traveler’s cheque. Unlike a letter of credit it is of specified denomination. In a letter of credit the banker has to make and entry at the time of the making payment. However, in a circular note, payment is made by the bank on surrender of the circular note.

4. **Circular Cheques:** These are like travelers cheques. However, these are not of specified denominations. The maximum amount payable is indicated on the circular

cheque. No separate identification slip or letter is issued along with it. The holder’s signatures are on the circular cheques like those on the travelers cheques.

5. **Guarantee Letter of Credit:** In case of other letters of credit the holder has to pay in advance the required amount of the credit to the banker who issues letter of credit. In case of guarantee letter of credit, the holder is not required to deposit any amount in advance; he/she is only required to give guarantee of the amount required.

6. **Bank Draft or Demand Draft:** A bank draft or a demand draft is a bill of exchange drawn by one bank on its own branch or any other bank. The essential features of a bank draft are:

(a) It is always drawn by a bank upon its own branch or another bank.

(b) It is always payable on demand and it cannot be made payable to bearer.

(c) Ordinarily, payment of a demand draft cannot be stopped or countermanded. It is because of this reason payment is demanded through a bank draft.

**II. Commercial Letter of Credit**

Such letters of credit are issued to facilitate trade and commerce particularly the international trade. An exporter is reluctant to send goods to the importer because he wants to minimize the risk for the payment. Similarly, the importer is also reluctant to send the payment in advance to the exporter. He is afraid that the exporter may not send the goods even after receiving payment in advance. The bank comes to the rescue (help) of both the parties. The documents of goods are sent through the bank with the instructions that the bank should deliver the documents viz., Bill of Lading or Freight Bill to the importer against payment or acceptance of the bill. The importer can get the delivery of the goods by surrendering the bill of lading to the shipping company and the exporter will get the payment from the bank.

However, in the above case a risk is involved. The importer may not pay or accept the bill. The exporter will have to spend unnecessary money in getting the goods back. Such risks can be avoided if a letter of credit is opened by the importer.

A letter of credit issued by the importer’s bank guarantees the exporter that the bank will pay or accept the bill accompanying the documents sent through the bank. The letter of credit specifies what goods have to be dispatched and also the date by which the goods must be dispatched. The exporter should strictly comply with the terms and conditions of the letter of credit. In case he fails to do so, the bank issuing the letter of credit will not liable to pay or accept the bill drawn by the exporter.

**Types of Letters of Commercial Credit**

1. **Documentary Letter of Credit:** When a clause is inserted in the letter of credit that the document of title to goods viz., bill of lading, insurance policy, invoice etc., must be attached to the bill of exchange drawn under the letter of credit. It is called a documentary letter of credit.

2. **Clean Letter of Credit:** If no such clause (as in documentary letter of credit) is inserted in the letter of credit, it is called a clean letter of credit. The documents of title in that case are sent directly to the importer. In a clean letter of credit there is greater risk for the banker. As such a banker issues clean letter of credit only to those customers, who have good reputation and credit in the market.

3. **Fixed Letter of Credit:** If the banker specifies in the letter of credit the amount of the bill to be drawn within the time fixed, it is called a fixed letter of credit. Such a letter remains valid until the specified amount is utilized within the specified time.

4. **Revolving Letter of Credit:** In case of revolving letter of credit, the banker specifies the total amount up to which the bills drawn may remain outstanding at a time. For example, X opens a letter of credit with City Bank for a total sum of $1000 valid for a period of 3 months. The beneficiary (exporter) can draw bills under the letter of credit with the condition that the value of such outstanding bills should not exceed $1000at any given time.

The main advantage of revolving credit is that the beneficiary may draw a bill for an amount higher, than the one specified in the letter of credit. Again there is no need of renewal again and again. However, it is complicated. It is difficult to ascertain how much amount is outstanding at a particular time.

5. **Revocable Letter of Credit:** Unless specified otherwise, a letter of credit will be deemed revocable.

In case of revocable letter of credit, the issuing banker resumes the right to cancel or modify the credit at any time without notice. Therefore, such a letter of credit is hardly of any use. However, in the above case modification or cancellation will become effective only on receipt of the notice by the negotiating banker.

6. **Irrevocable Letter of Credit:** Such a letter cannot be modified or cancelled without the consent of the applicant and the beneficiary. The issuing banker will be liable in case of irrevocable letter of credit if the exporter strictly complies with the terms and conditions of the letter of credit.

7. **Confirmed Letter of Credit:** When the banker issuing the letter of credit requests the advising bank in the exporter’s country to signify his confirmation to an irrevocable credit and the advising bank accepts the request, it is called irrevocable and confirmed letter of credit. The advising banker is called confirming banker. He cannot cancel or modify his undertaking without the consent of the parties concerned.

8. **Unconfirmed Letter of Credit:** In case the issuing banker does not ask the advising banker to confirm the letter of credit, it remains unconfirmed letter of credit.

9. **With Recourse Letter of Credit:** You might recall that a bill of exchange may be drawn with recourse to the drawer. If such a bill is drawn under a letter of credit, it is called ‘with recourse letter of credit’. In case of such a bill, if the drawee does not honour the bill, the banker as a holder can recover the payment of the bill from the drawer.

10. **Without Recourse Letter of Credit:** If an exporter wants to avoid his liability (as in the case of with recourse letter of credit) he can ask the importer to open a ‘letter of credit without recourse to the drawer’. If the importer fails to honour the bill, the issuing banker cannot hold the drawer liable. He can hold only the drawee liable in such a case. The banker may realize the amount by selling the goods if the documents of title have not been given to the importer.

11. **Transferable Letter of Credit:** Where the goods are exported through middle men, the exporter may ask the importer to open a transferable letter of credit. Under a transferable letter of credit, the beneficiary will be able to transfer his right to draw a bill to a third party.

12. **Non-transferable Letter of Credit:** Every letter of credit unless stated otherwise is non-transferable. Hence the beneficiary cannot transfer such a letter of credit to a third party.

13. **Back to Back Letter of Credit:** A beneficiary of a non-transferable letter of credit may request the bank to open a new letter of credit in favour of some third party on the security of letter of credit issued in his favour, it is called a back to back letter of credit.

14. **Red Clause Letter of Credit:** If the exporter wants financial assistance in advance against his export for purchase of materials, packing etc., he can ask the importer to arrange a “Packing Credit”. This packing credit is made available through the letter of credit by inserting a clause in red ink. Such a clause is called Red Clause. The negotiating banker can advance specified money to the exporter. Such accommodation is of temporary nature and is adjusted at the time of final payment.

In general, these are different types of letter of credit. You can see that from exporter point of view, the best form of letter of credit is confirmed, irrevocable letter of credit. This is because the interest of exporters is best saved in this form of credit.

**7.3 Parties to LC**

Where are four parties involved in a letter of credit?

**1. Importer:**

Importer is the person on whose request bank opens letter of credit called an account party, buyer or opener**.**

**2. Issuing Bank:**

It is the bank which opens letter of credit on the request of importer.

**3. Exporter:**

Exporter is the person in whose favor letter of credit is opened by importer. Exporter is also the seller of goods.

**4. Paying Bank:**

Paying bank is a bank in the exporter’s country which honors the draft drawn by exporter, when issuing bank has no branch in exporter’s country then it requests any other bank of the exporter’s country to complete the letter of credit operations. Such bank is called the negotiating bank or paying bank.

**7.4 Advantages of LC**

Letter of Credit has numerous advantages for importer and exporter and for banks. Those are explaining below:

**Advantages to Bankers:**

**1. Source of Income:**

First of all the Letter of Credit is a source of income for the bank. The bank charges commission for the operation of Letter of Credit. This commission constitutes bank earnings.

**2. Increase Balances:**

The depositing of Letter of Credit Margin by numerous importers increases the bank’s deposits.

**3. New Relations:**

By providing Letter of Credit operation the banks come across new businessmen and parties. This helps in capturing new customers.

4. During Letter of Credit operation the banks has to maintain contact with different foreign banks. If the bank provides its services efficiently other foreign banks will take goods impression of it and banks reputation will improve.

**Advantages to Importers:**

1. **Increase Credit Standings:**

Due to the opening of Letter of Credit, the importer’s credit standing increases and he/she is in a better position to conduct his business.

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| ***Activity 7.1***  *Demonstrate the LC process in class or lab.* |
| *Discuss the benefits that banks can get from LC.* |

**7.5 Procedure in Opening of LC**

Let us see how letter of credit is opened and operated.

**1. Mutual Agreement.**  First of all importer and exporter enters into a mutual agreement. The importer who is in need of something approaches an appropriate an appropriate exporter by way of cable, mail or internet. Both the parties come to an agreement.

**2. Proforma Invoice:** Exporter then prepares an important document known as preformed invoice. In proforma invoice all details about the counteract regarding name of product, its type, quality, quantity brand, name, color, etc. are all stated specifically. This proforma invoice is sent to importer by the exporter.

**3. Application of Letter of Credit:**  After receiving the proforma invoice the importer studies it. If he finds all terms and conditions satisfactory, he approaches his bank and requests to open letter of credit in favor of the exporter. This application is made on the prescribed form which is issued by the bank.

4. **Processing of Application**: In letter of credit, the importer’s bank lends its reputation and credit worthiness to the importer. The exporter in the other country is satisfied that the credit of an unknown ordinary man is replaced by a well-known bank. So while granting the letter of credit the bank observes all standards of care and cautions which it observes while granting credit. Further the bank follow the guide line given by the central bank regarding he export and import of different goods. Bank also checks the rates of international market of the goods which are being imported and compares then with hose stated in the proforma invoice, if there is any material difference in the rates, the bank may refuse to open letter of credit, Further the bank will examine the domestic market rates of the same imported goods in order to detect any over invoicing.

**5. ICC 500:** ICC stands for International Chamber Commerce. ICC 500 is a document which is essential for every letter of credit. It is a document which is final authority in deciding the dispute arising in the matter of letter of credit.

6. **Opening of the letters of Credit:** After complete processing of the application, if the banker find that every document is correct. It opens the letter of credit in favor of export on behalf of importer.

7. **Letter of Credit Margin:** After opening of the letter of credit, Importer is directed by bank to deposit L/C Margin. As in case of granting loan the bank demands securities, so in case of granting credit worthiness in letter of credit this margin is demanded. Further the L/C margin is used by Central Bank as an import control weapon. When Central Bank wants to imports rate of L/C margin are increased. On the other hand, when Central Bank wants to increase imports, rate of L/C margin are decreased.

8. **Copies of Letter of Credit:** After opening of the letter of credit, the importer’s bank sends one original copy and two carbon copies to importer. The original copy is mailed to the exporter and one other is return to bank after being signed by importer. One copy is retained by importer. One copy is retained by importer for his personal record.

9**. Exporter’s Job:** When letter of credit is received by the exporter, he makes necessary arrangement for the shipment of goods. After shipping he presents the letter of credit, shipping documents and drafts in his bank. Following documents prepared by the exporter are of great importance.

a) **Bill of Landing:** Bill of lading is the receipt issued by the shipping company to the exporter. This receipt contains information about the goods shipped, port of shipment, port of delivery etc.

b) **Certificate of Origin**: This document issued by the Chamber of commerce of the exporter’s country and it states that whole of the goods or major parts of the goods that has been shipped is prepared or manufactured within the country.

c) **Airway Note**: In case the goods are sent by Air Cargo then airway note is presented by the exporter as evidence.

10. **Duties of Exporter’s Bank or Negotiating Bank:** The relationship between importer’s bank and exporter’s bank is that of principle agent. The exporter’s bank must follow all the guidelines given by the importer’s bank regarding payment of amount to the exporter.

“Bank must examine all documents with reasonable care to ascertain that they appear on their face to be in accordance with the terms and conditions of credit.

So from this it is clear that it is the banker’s duty to refuse any such documents which is not in accordance with the conditions of letter of credit. Further the documents should be presented in bank within 21 days from the day of issuance of Landing. A Bill of Landing if presented by exporter at his bank so late that it cannot reach importer before the arrival of consignment, then it is called stale bill of lading. The bank in case of stale bill of lading can refuse to accept documents.

11. **Payment to Exporter:** “In credit operation all parties concerned deal in documents and not in goods services and / or other performances to which the documents may relate.”

So the banker’s job is to analyze that the document on the face appears to be sound and free of errors. If they are so, the bank will accept them. After accepting the draft and other document from the exporter, the bank will negotiate the draft with the importer’s bank and the exporter will be aid in his home currency by his bank.

12. **Jobs of Importer’s Bank:** The importer’s bank will also analyze all the documents forwarded by the exporter’s bank. While analyzing the documents the bank will consider the following points.

1. Documents have been submitted within a specified time period.

2. All the documents are in accordance with terms and conditions of Letter of Credit.

3. The related documents such as Bill of Lading Insurance Policies, Invoices, Drafts are in proper form and consistent with each other.

4. The Bill of Lading is not stale. After analyze if the bank is satisfied it makes payment by debiting the importer account and crediting the exporter’s bank account.

13. **Refusal to Accept Documents:** In case the importer’s bank finds that the documents are not in proper orders, he may decide to refuse such documents. In such a case the bank will give notice about refusal to the exporter’s bank. The notice should bear the details of defects on the basis of which bank has refused documents.

14. **Payment by Importer:**  At the time of opening of letter of credit the bank enters in a deal with the customer that when draft would be presented by the negotiating bank, the importer will make payment to the bank before the date of maturity of draft. In case of sight letter of credit, the importer has to make payment before the draft becomes due.

15. **Receiving the Consignment:** The bank hands over the necessary documents to the importer after payment are made by him. The importer then pays the custom duties and tariff and takes its consignment. However, usually clearing agents are hired for these services.

Summary

A letter of credit is just a guarantee given by one bank to a third party i.e., exporter. The guarantee ensured that he will receive payments of his goods provided he performs certain obligations. It also ensures to the importer that payment to the exporter will only be made when goods have been received.

Letter of credit can be broadly classified as Travelers’ Letter of Credit and Commercial Letter of Credit. The travelers’ Letters of Credit are issued by the banks for the convenience of the travelers where as the commercial letter of credit are issued to facilitate trade and commerce particularly the international trade in simple terms.

First of all the Letter of Credit is a source of income for the bank. The bank charges commission for the operation of Letter of Credit. This commission constitutes bank earnings. Due to the opening of Letter of Credit, the importer’s credit standing increases and he/she is in a better position to conduct his business.

***Review Questions***

* + 1. *Define the letter of credit*

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* + 1. *Describe the types of commercial letter of credit*

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* + 1. *Who are the parties to letter of credit?*

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* + 1. *What are the procedures in opening LC?*

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* + 1. *List the advantages of LC to the banker as well as to the importer.*

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***Self check table for students assessment***

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| --- | --- | --- | --- |
| ***No.*** | ***Do students grasp objectives/competencies*** | ***Yes*** | ***No.*** |
| *1* | *Describe the letter of credit* |  |  |
| *2* | *Differentiate the travelers’ letter of credit from commercial letter of credit* |  |  |
| *3* | *Identify the advantages of letter of credit* |  |  |
| *4* | *Describe parties to the letter of credit* |  |  |
| *5* | *Explain the procedures in opening the letter of credit* |  |  |