

Letter of Credits

FIBA-FELABAN

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U.S. CENTURY BANK



As old as time...

Gelesen von ...
Leopold Mozart, verglichen mit heutigen Banknoten,
Hagenauer gegen Bargeld eintauschen.

The Traveller's Purse

The most important item on a journey was a well filled purse. Hence Leopold Mozart had his salary from Prince Archbishop Scharnbatz paid in advance, while further finance for the voyage had to come from the proceeds of the concerts given on the way.

In addition his friend Johann Lorenz Hagenauer, who as a merchant had business contacts throughout Europe, provided him with letters of credit. Leopold Mozart could cash these, in the same way as a present day cheque, with Hagenauer's business associates.

Letters of Credit low default and loss rates

- Recent reports show low default and loss rates in datasets obtain from banks around the world for letter of credit

Product	Transactions	\$ in 000s	Default %	Loss %
Import L/Cs (2007-2010)	1,438,291	727,012,390	0.0673	0.0061
Export Confirmed L/Cs (2008-2010)	389,129	195,664,331	0.0907	0.0349
Performance Guarantees/ Standby L/Cs (2009-2010)	396,059	347,828,425	0.0135	0.0007

Exploring payment options

💧 Open Account :

- 💧 Seller provides open account to the buyer provides product or service and awaits for payment.
 - 💧 Benefits buyer, risk to the seller due to possibility of non-payment.

💧 Cash-in-Advance (Pre-Payment):

- 💧 Buyer prepays product to seller
 - 💧 Benefits seller, risk to buyer of not receiving products.

Other payment options

- ◆ **Documentary Collection:**

- ◆ Seller uses financial institutions as intermediary to act as a presenting bank “collecting bank” to present shipping document to the buyer in exchange for payment or to obtain buyers “promise” to pay on a determined date.

- ◆ **RISKS:**

- ◆ **Seller:**

- ◆ Payment is contingent on Buyer authorizing payment
- ◆ Payment is contingent on Buyer having funds available
- ◆ No undertaking provided by Financial Institution

Letter of Credits

- ◆ **IMPORT LETTER OF CREDIT:**

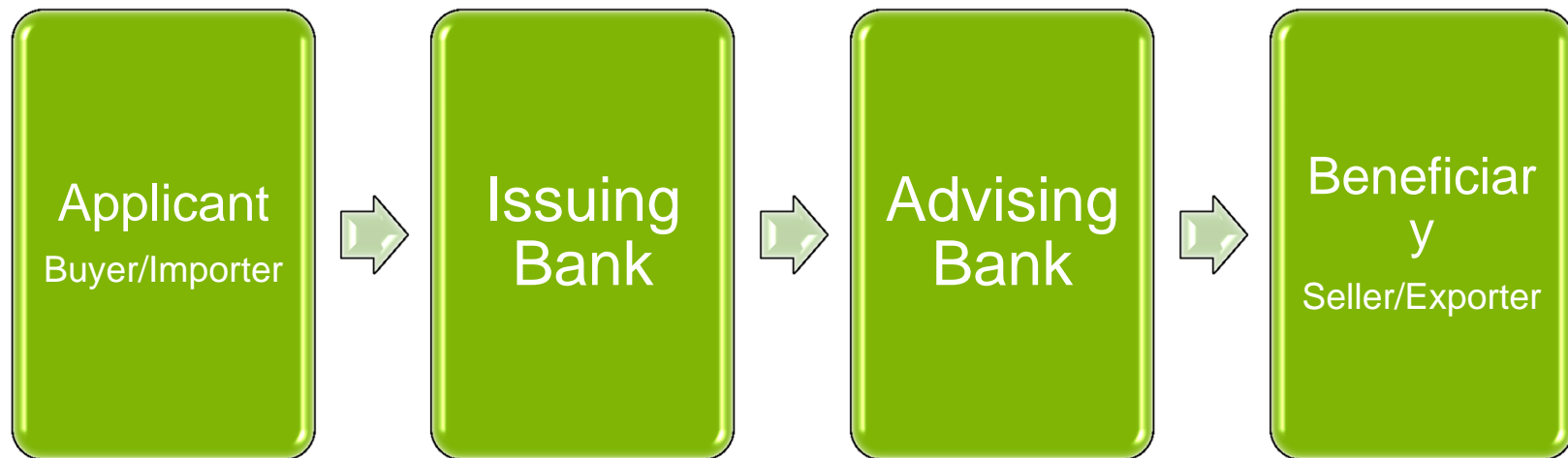
- ◆ An irrevocable undertaking usually issued by financial institutions on behalf of the buyer (importer) to pay the beneficiary (seller) for product or services. Beneficiary has control over obtaining payment if they present the required shipping documents to the financial institution in accordance with the terms and conditions of the letter of credit. Typical documents: commercial invoice, packing list, insurance policy or certificate, transport document (i.e. Ocean Bill of Lading, Multimodal Bill of Lading, Air-Waybill), etc.
- ◆ Letter of credit terms will normally indicate they are subject to the Uniform Customs and Practices for Documentary Credits (current revision is 2007 ICC Publication No. 600).

Typical Characters involved:

- ◆ Issuing bank: Financial institution issuing the letter of credit and providing it's undertaking replacing the applicant credit risk with that of the financial institution
- ◆ Applicant: Buyer/Importer
- ◆ Beneficiary: Seller/Exporter
- ◆ Advising Bank: Correspondent bank used to convey the letter of credit to the beneficiary for authentication purposes without undertaking on their part
- ◆ Confirming Bank: If confirmation is requested, a second financial institution may add their undertaking to the letter of credit assuming responsibility for payment. Their confirmation which comes at an additional cost provides an assumption of credit risk and country risk of the Issuing Bank which may be beneficial to the beneficiary.

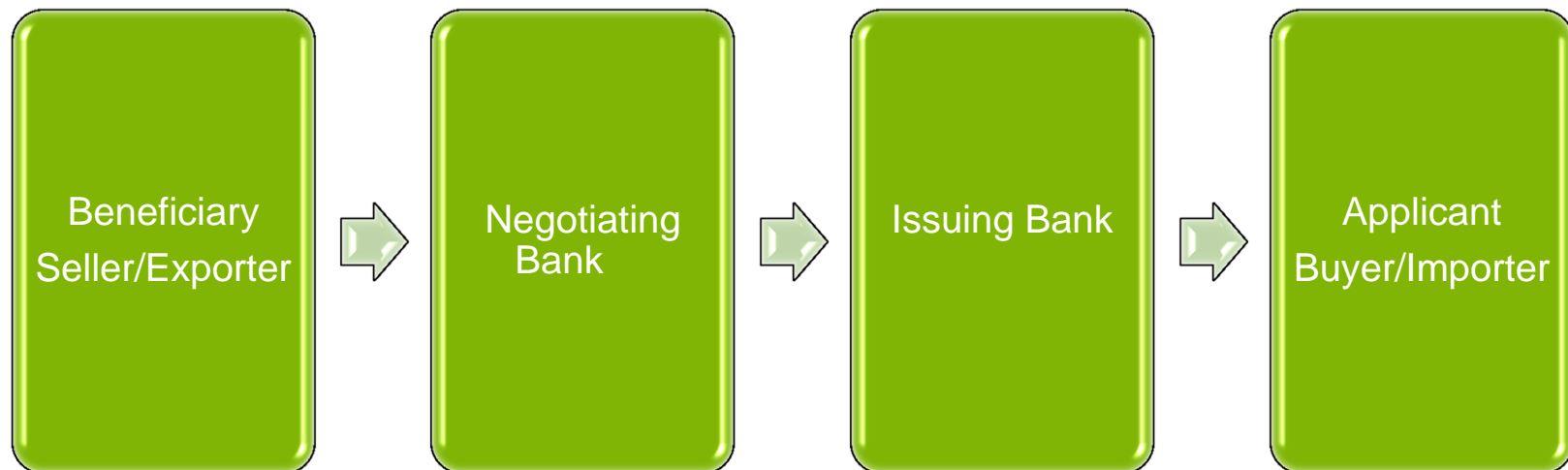
Flowchart

Application and Letter of credit advising



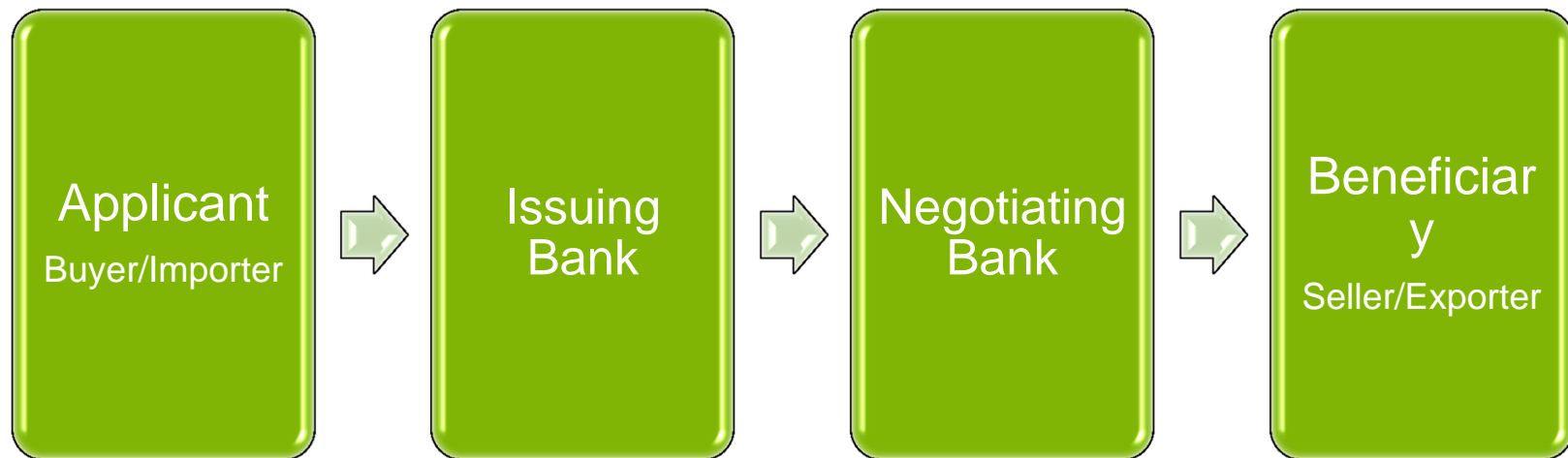
Flowchart

Documentary presentation



Flowchart

Payment



Benefits:

💧 Seller -

- 💧 Payment assurance from buyer is replaced by that of a financial institution.
- 💧 Seller has control over receipt of payment if he complies with the terms of the letter of credit.
- 💧 It is irrevocable in nature and payment will be honored upon compliance
- 💧 provides needed financing for pre-export and post export financing by financial institutions which assists seller with cash-flow issues

Benefits:

- ◆ Buyer -

- ◆ Does not have to prepay the goods and is assured by the financial institution that they would not pay unless the seller complies with the terms and conditions set forth in the letter of credit.

Risks

- ◆ Buyer:

- ◆ Letters of credit, however only deals with documents and not with goods, services or performance to which the documents may relate.
- ◆ A bank also does not assume liability or responsibility for the genuineness, falsification of any document; therefore it is important for the buyer to ensure credibility of the seller well.

Risks

- ◆ Seller:
- ◆ Payment is contingent on beneficiary compliance of terms.
- ◆ Loss of Financial Institution's undertaking due to their non-compliance of terms results in payment being subject to applicant's approval of discrepancies

Considerations

- ◆ Credit facility or single approval
- ◆ Collateral or no collateral
- ◆ Perform due diligence on your customer know their product lines and vendors
- ◆ Controlling title of goods by consigning goods to the bank

Red Flags

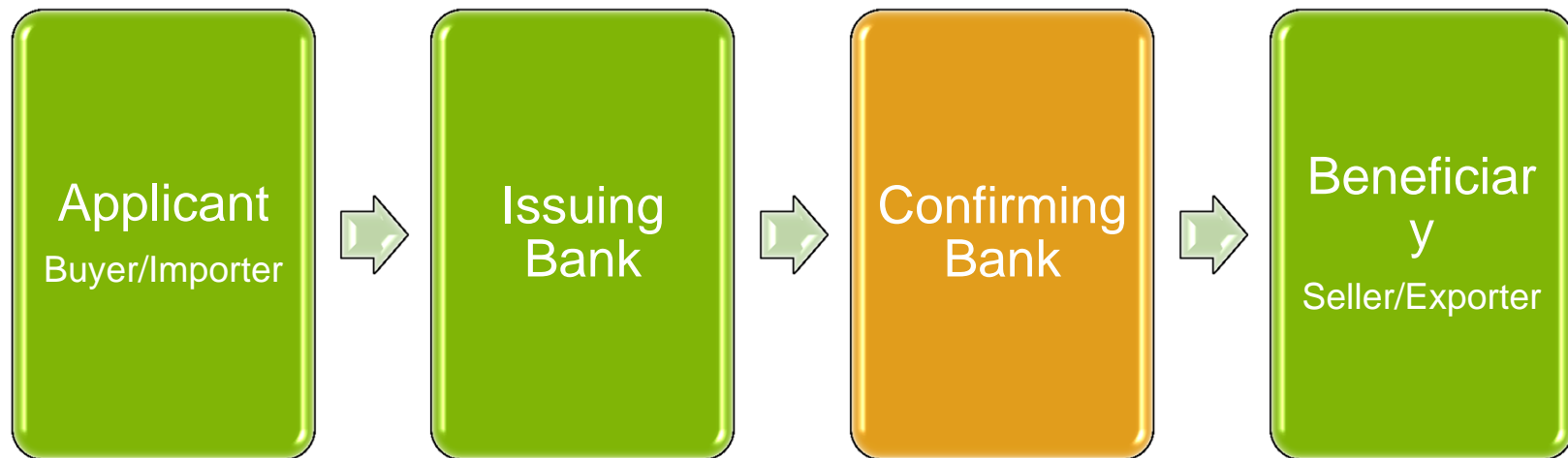
- ◆ Some examples of Red Flags:
 - ◆ Items shipped that are inconsistent with the nature of the customer's business
 - ◆ Customers involved in potentially high-risk activities, including activities that may be subject to export/import restrictions (e.g., equipment for military or police organizations of foreign governments, weapons, ammunition, chemical mixtures, classified defense articles, sensitive technical data, nuclear materials, precious gems, or certain natural resources such as metals, ore, and crude oil).
 - ◆ Obvious over- or under-pricing of goods and services
 - ◆ Customers shipping items through high-risk jurisdictions, including transit through non-cooperative countries identified by Financial Action Task Force list perceived non-cooperative in global fight against money laundering and terrorist financing.

Exports Confirmed

- ◆ An issuing bank may request a letter of credit to be confirmed by a second bank (confirming bank), usually in the country of the exporter. This would provide a second undertaking to the exporter who may be concerned with the issuing bank's credit risk and country risk.
- ◆ Confirmations became essential during the 2009 due to the economic instability almost doubling from the previous year.

Flowchart

Confirmed Letter of Credit



Considerations

- ◆ Credit facility or single approval
- ◆ Collateral or no collateral
- ◆ Perform due diligence on issuing bank
- ◆ Red Flags previously mentioned

Payment Terms

◆ AT “SIGHT”

- ◆ At sight (payment available when documents are presented in order)

◆ AFTER A SPECIFIED TERM (“USUANCE”)

- ◆ payment available XX days after sight or shipment date
 - ◆ BUYER:
 - ◆ Provides the buyer a cash flow period (XX days) which allows the buyer the ability to retrieve the goods, sell and attempt to collect before having to effect payment.
 - ◆ SELLER:
 - ◆ Present a cash flow problem to the seller, as payment is normally made at maturity.

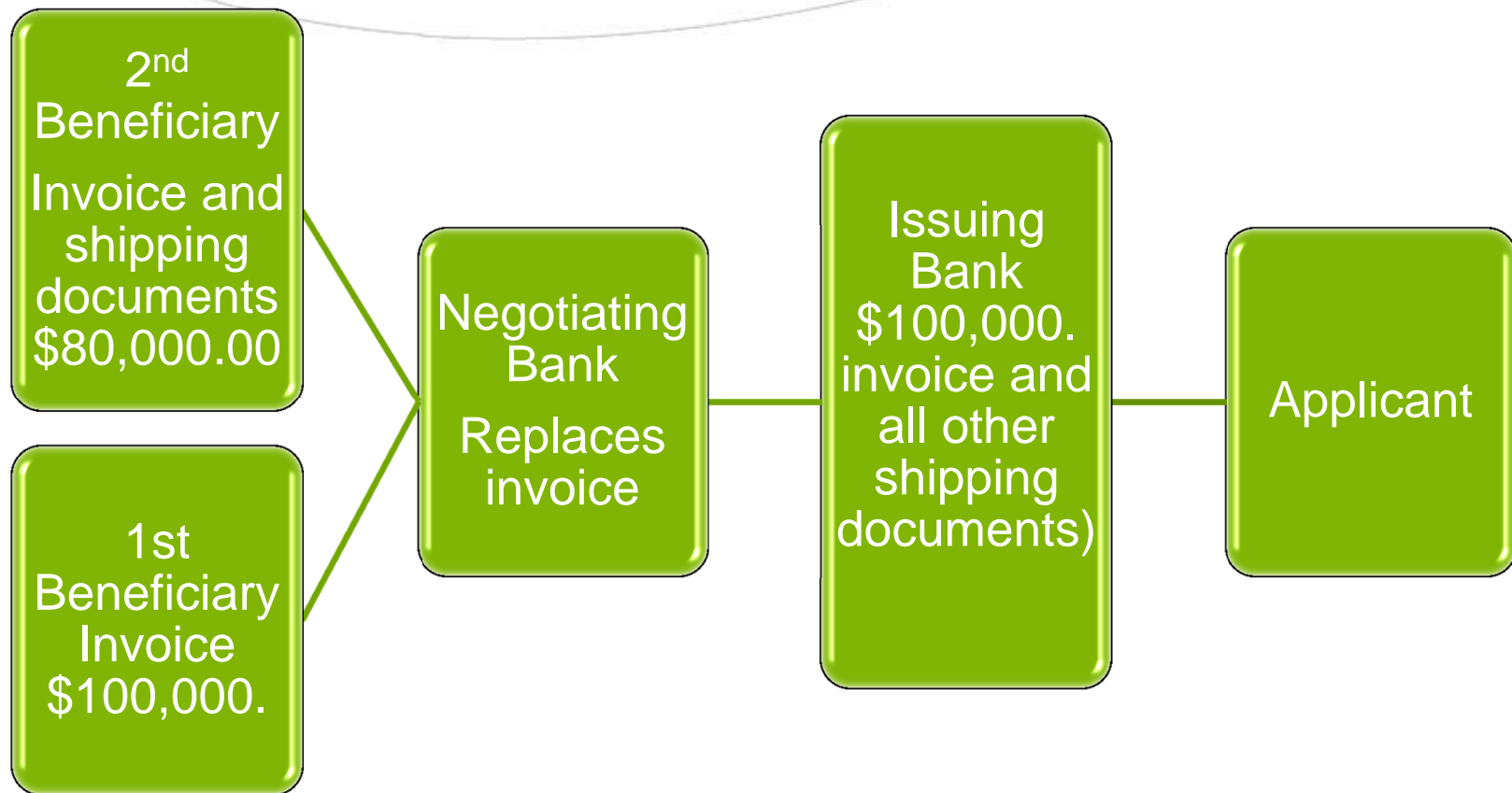
Some Cash Flow solutions

- ◆ **DISCOUNTING PAYMENT**
- ◆ **PRE-EXPORT FINANCING**
- ◆ **POST-EXPORTING FINANCING**

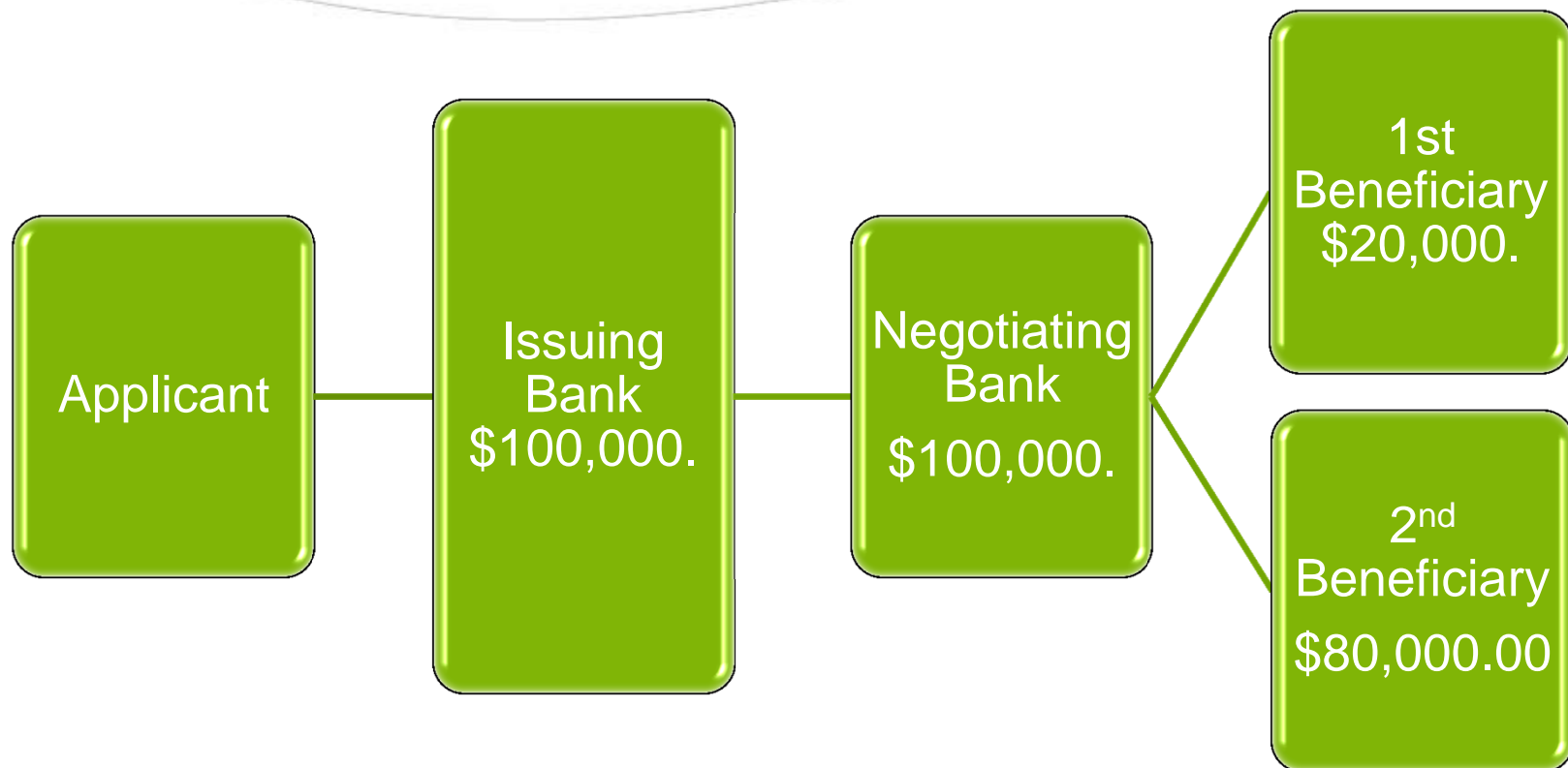
Transferable letter of credits

- ◆ An Exporter may receive a letter of credit in his favor and transfer partial or full amount of the letter of credit to the ultimate supplier or producer of goods. As the rights are transferred to a second beneficiary, the supplier would have control over payment upon complying with terms.

Document flow sample



Payment flow sample



Transferable letter of credits

- ◆ Benefits:

- ◆ Exporter: The exporter in essence has used the credit of the Importer/Buyer to fund the purchase of goods

Transferable letter of credits

◆ Possible Risks:

- ◆ Exporter: Possibility of disclosure of ultimate buyer and supplier on shipping documents
- ◆ Importer/Buyer: may be transferred to a supplier, importer may not feel comfortable with performance or integrity.

Assignment of proceeds

- ◆ An Exporter may receive a letter of credit in his favor and assign the proceeds for partial or full amount of the letter of credit to the ultimate supplier or producer of goods. As the rights not transferred to the assignee, therefore the Exporter (beneficiary of the letter of credit would retain rights and control over shipment and payment upon complying with terms.
- ◆ The assignee would receive a letter of assignment of proceeds from the bank for the amount assigned. The assignee would then release the goods to the beneficiary who would effect shipment and make documentary presentation for payment.
- ◆ The negotiating bank upon effecting payment would pay the assignee their portion assigned and the net amount due to the beneficiary.

Assignment of proceeds

- ◆ **Benefits:**

- ◆ Exporter: The exporter in essence has used the credit of the Importer/Buyer to fund the purchase of goods

Assignment of proceeds

◆ RISKS:

◆ Assignee:

- ◆ As the assignee is not transferred the rights of the letter of credit, they have no control over payment since the letter of credit remains in favor of the beneficiary.
- ◆ Release the goods to the beneficiary and rely on the beneficiary's integrity and ability to present documents in compliance with the letter of credit in order to get paid.

Standby Letter of Credit

- ◆ **Performance** - An instrument that provides undertaking from an issuing bank to the beneficiary to provide payment in the event of default on performance on the part of the applicant of the letter of credit.
- ◆ Examples include
 - ◆ Performance bond –
 - ◆ Performance in complying with delivery of services or work completed under contracted terms for construction.
 - ◆ performance in complying with a completion of a project within the contracted agreement
 - ◆ Bid bond –
 - ◆ when bidding on projects of an Electrical Plant
 - ◆ bidding on product or service contracts by vendors

Standby Letter of Credit

- ◆ **Financial** - An instrument that provides undertaking from an issuing bank to the beneficiary to provide payment in the event of default or as a financial support on financial obligation on the part of the applicant of the letter of credit.
- ◆ Sample uses:
 - ◆ as collateral in favor of a financial institution to use as collateral for a line of credit
 - ◆ Project requiring incremental payments for an Electrical plant over 10 years
 - ◆ To secure a Lease of property
 - ◆ To secure an Advance payment made for a project or contract
 - ◆ Judicial bonds (to ensure arbitral awards are carried out)
 - ◆ Commercial standbys (involves commercial trading transactions)
 - ◆ Back local guarantees (functionally similar to counter-guarantees; local bank beneficiary of LC)

Standby Letter of Credit

- ◆ Standbys are typically available for payment against statements of default or compliance along with any other supported documents which may be required.
- ◆ **Standby Rules:**
 - ◆ Uniform Customs and Practices for Documentary Credits (current revision is 2007 ICC Publication No. 600)
 - ◆ International Standby Practices (current revision is 1999 ISP98 ICC Publication No. 590)

Standby Letter of Credits

💧 **RISKS:**

- 💧 Banks: Has been used in money laundering.
- 💧 Applicant: non-genuine or unwarranted drawdown.
- 💧 Beneficiary:
 - 💧 Issuing Bank becoming insolvent and regulators repudiated the LC.
 - 💧 Court ordered injunction to stop the payment due to:
 - 💧 Applicant becoming insolvent
 - 💧 Applicant claiming you do not have right to claim

Standby Letter of Credits

- ◆ **RISKS:**

- ◆ Beneficiary:

- ◆ Foreign currency letter of credit

Standbys

UCP600 vs. ISP98

Some benefits of using ISP98 vs. UCP600 in standbys :

- ◆ Presentation of documents during a Force Majeure:
 - ◆ UCP600 Article 36 –Force Majeure due to Acts of God, Riots, War, Civil commotion, Terrorism, etc. (The bank will not upon resumption of its business honor or negotiate under a credit that expired during such interruption of its business)
 - ◆ ISP Rule 3.14 (Allows automatic extension for presentation of 30 days after the place for presentation re-opens for business).
- ◆ Non-applicable to Standby clauses in UCP600
 - ◆ UCP600 - Non-Applicable Articles such as 19-27 covering transport documents
 - ◆ Installment drawings:
 - ◆ UCP600 Article 32 – subsequent installment drawings would cease to be available if any installment not drawn within period allowed for that installment
 - ◆ ISP98 Rule 3.07 – Failure to make any one of a number of scheduled presentations does not waive the right to make another timely presentation.

Standby Letter of Credits

- ◆ It is independent of underlying transaction.

Guarantees

- ◆ Similar instruments to that of a Standby Letter of credit, however, commonly issued by Foreign Banks and not being issued in the US until recently in 2010. Still only a couple of banks issuing them in the U.S. and is subject to a different set of rules:
- ◆ Uniform Rules for Demand Guarantees (Revision 2010) URDG758.

Counter-Guarantees

- ◆ Some governments, major buyers of products requires a local bank to issue a guarantee or a standby letter of credit.
- ◆ Solution:
 - ◆ Banks in this scenario could issue a standby or guarantee in favor of the local bank to issue a counter standby or guarantee in favor of the beneficiary.

Syndication

- ◆ Problem: Letter of Credit facility or country risk is too large for one issuing bank.
- ◆ Solution: Banks can group together to “syndicate” and issue letter of credit(s). The letter of credit(s) in this scenario has more than one issuer.
- ◆ Benefit: Each bank would take a portion of the risk of credit by the obligor/applicant therefore able to work within their framework.
- ◆ Note:
 - ◆ The obligor/applicant is aware of the syndication.
 - ◆ Usually one bank becomes the administrator or “agent bank” and assumes the responsibility of issuing the L/C and examining documents.

Participation

- ◆ Problem: Sometimes a bank is asked to issue a letter of credit or provide a facility for letters of credit for an amount that exceeds the amount of credit that bank can or want to grant the obligor/applicant.
- ◆ Solution: The bank may sell portion(s) of its risk to other banks
- ◆ Benefit: The bank would take a portion of the risk of credit by the obligor/applicant therefore able to work within their framework.
- ◆ Note:
 - ◆ Usually, the obligor/applicant and beneficiary are unaware of the participation .
 - ◆ In participations, there is only one issuing bank.

Thank you

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