SPECIAL LETTER OF CREDIT ARRANGEMENTS

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Commercial letters of credit facilitate the movement of goods into the channels of trade. A letter of credit is a written undertaking by a bank (issuing bank), acting at the request and on the instructions of its customer (applicant for the credit) to make payment to, or to the order of, a third party (the beneficiary).

For a credit to be transferable, the exporter must arrange for the importer to have a credit opened expressly stipulating that is transferable. A beneficiary may require financing in order to complete the manufacturing of merchandise or to purchase items to fill a particular order. A red clause credit helps achieve this.The applicant and beneficiary may wish to have a letter of credit structured to satisfy a long term contract requiring the constant supply of merchandise over a specific time period. This can be accomplished with a revolving letter of credit.

Key words: letter of credit, issuing bank, advising bank, payments, negotiation

Introduction

Commercial letters of credit facilitate the movement of goods into the channels of trade. They provide even more protection to the exporter than does the collection. That is why an exporter may refuse to conclude a sales contract unless it provides for shippment and payment under a letter of credit.

A letter of credit is a written undertaking by a bank (issuing bank), acting at the request and on the instructions of its customer (applicant for the credit) to make payment to, or to the order of, a third party (the beneficiary), accept and pay bills of exchange (drafts) drawn by the beneficiary, authorize another bank to effect such payment or to pay, accept or negotiate such bills of exchange (drafts).

The terms and conditions of the credit must be complied with before payment, negotiation, or acceptance can be made.

In issuing the letter of credit, the importer's bank (issuing bank) substitutes its credit standing for that of the importer, thereby assuming the credit of financial risk in full. If the beneficiary's documents comply with the terms and conditions of the letter of credit, he or she is promised payment from the issuing bank (and perhaps confirming bank), independent of the ability- or willingness – of the importer to pay.

Transferable credit

When the exporter is an intermediary between a supplier and the importer, in other words is the beneficiary, a transferable credit allows him to transfer all or part of his rights under credit to a third party (the transferee). Still, the transferee must comply with the terms and conditions of the transferred credit in order to receive payment.

For a credit to be transferable, the exporter must arrange for the importer to have a credit opened expressly stipulating that is transferable. It must be clearly stated that the credit is ''transferable''; no other terminology is accepted. Terms such as ''divisible'', ''fractionable'', ''assignable'' and ''transmissible'' do not render the credit transferable and will be disregarded.

Before transfer can be made, the exporter must send a written request to the transferring bank. The transferring bank, wheter it has confirmed the credit or not, is under no obligation to effect the transfer except to the extent and in the manner to which it has expressly consented, and until bank charges in respect of such transfers are paid.

The Uniform Customs and Practice for Documentary Credits (the U.C.P.) established the conditions under which credits may be transferred and specified the rights and obligations of the parties. The U.C.P. provide that a credit may be transferred only once. Consequently the credit cannot be transferred at the request of second beneficiary to any subsequent third beneficiary.

The terms ''assignment of proceeds'' and ''transferable'' credits sholud not be confused; they are entirely different. Unlike a transferred credit, the beneficiary maintains sole rights to the credit and it is solely

responsable for complying with its terms and conditions. With an assignment of proceeds, the beneficiary of a letter of credit assigns all or part of the proceeds under a credit to a third party (the asignee). For the asignee, an assignment means only that the paying bank, once it receives notice of the assignment, undertakes to follow the assignment instructions, if and when payment is made. An assignment of proceeds does not provide the asignee with any rights under the credit. He is dependent upon the beneficiary for compliance, and thus this arrangement is more risky for the assignee than a transferred credit.

According to the U.C.P. „the fact that a credit is not stated to be transferable does not affect the beneficiary's rights to assign any proceeds which he may become entitled to under such credit, in accordance with the provisions of the applicable law."

As an alternative to the transferable credit, the exporter, being an intermediary between a supplier and an importer, might ask the advising bank or a third bank to issue a second letter of credit in favor of the supplier ,using as collateral a letter of credit issued in the exporter's favor by the importer. When one letter of credit is used as security to obtain the issuance of a second letter of credit to cover the same transaction, that arrangement is known as ''back-to-back''- letter of credit**.**

Associated risks make most banks reluctant to enter into back-to-back credit arrangements.

Anticipated compliance and eventual payment under the first credit should provide some assurance of payment under the second, but performance under the first credit may become impossible, either through acts of the parties involved, government edict, or other causes. For example, the actual supplier (the beneficiary of the second credit) may perform under his credit covering the domestic movement of goods and thus be entitled to payment. It is possible that the shipper(the exporter of the beneficiary of the first letter of credit)will be unable to perform under his or her letter of credit because of a strike by dock personnel preventing the international movement of goods before the expiry date of the first credit.

The intermediary's bank, which opened the second credit, will still have to pay the beneficiary of this credit if documents are in order and will look to the shipper/intermediary for reimbursement. If he cannot on-ship to the ultimate importer, he will not be able to obtain payment under the first credit and may not be able to reimburse his bank. For this reason,if a bank agrees to issue a second credit with the first collateral, it will generally seek assurances that the exporter could, if necessary, make repayment from his general financial resources.

In order to protect its interest further, the bank issuing the second credit may require that the first credit be confirmed by them before considering issuance of the second. As stated earlier, for these and other reasons most banks will generally prefer their customers to utilize ,if possible, transfer or assignment of proceeds arrangements rather than back-to-back letters of credit.

Red clause

A beneficiary may require financing in order to complete the manufacturing of merchandise or to purchase items to fill a particular order. A red clause credit helps achieve this (this name is derrived from the historical practice of placing a notation in the credit in red ink to identify this option.).

Upon the instruction of the importer, the issuing bank authorizes the advising or confirming bank to make a cash advance to the beneficiary against the beneficiary's written undertaking to present documents evidencing shipment in compliance with the credit term. A red clause permits the exporter to obtain an advance of part or all of the amount of the credit, as specified in the credit.

Later, when the letter of credit is drawn under, the paying or negotiating bank deducts the amount of the advance, and any interest due as a result, from its payment to the beneficiary. Should the beneficiary fail to ship or meet the credit requirements, the paying or nagotiating bank looks to the issuing bank to obtain reimbursement for the amount of the advance plus interest. The issuing bank then changes the account of the importer. Before agreeing to an exporter's request for a red clause credit, the importer should consult his or her banker to ensure an understanding of the risk involved.

Installment credit

The applicant for an letter of credit may need to be assured of receiving the merchandise over a period of time in certain given installments. When a bank issues an installment credit or a credit stipulating shipments by installment within given periods, that credit should clearly state „Shipment must be effected in the following installments."

For example, the bank should not leave it up to the beneficiary to determine wheter a clause „Ship Style No.1 no earlier than January 1, and no later than January 31; Ship Style No.2 no earlier than February 1 and no later than February 28; and Ship Style No.3 no earlier than March 1 and no later than March 31", is to be interpreted as an installment requirement.

Revolving credit

The applicant and beneficiary may wish to have a letter of credit structured to satisfy a long term contract requiring the constant supply of merchandise over a specific time period. This can be accomplished with a revolving letter of credit.

A revolving letter of credit contains instructions which allow the beneficiary to draw for specified amounts over specified periods.

The revolving credit uses the same letter of credit to cover numerous schedules shipments over a long period without the necessity of issuing new credits or amending the existing credit; it restricts the amount available for each shipment and controls the frequency of shipments and amounts available.

There are similarities and yet major diffrences between installment and revolving credits. The diffrence can represent significant risks for all parties involved. For example, with an installment credit, should the beneficiary miss one of the installments, the credit is no longer available for future installments.

Revolving credits are either ''cumulative'' or ''non-cumulative''. These classifications control the amounts available for drawing.

For example, the consequence of non-shipment in a specified period under an installment letter of credit is that the letter of credit ceases to exist. Under a revolving non-cumulative letter of credit, the consequence is the loss of the amount for that period.

Deferred payment

Under a deferred payment credit, after shipment the exporter presents complying documents to the negotiating/paying bank. Instead of drawing a draft on the bank or applicant when the documents are presented, the exporter authorizes the bank to release documents against the bank's obligation to pay on a future date as specified in the credit.

An exporter may be called upon by the buyer to provide financing under a letter of credit for the term beyond six months. In this case, a letter of credit providing for the drawing of a time draft for acceptance by the bank (i.e., a banker's acceptance) might not be appropriate because the acceptance would be ''ineligible for discount''.

The issuing/confirming bank therefore makes a promise of future sight payment(s). For incurring this liability, the bank asseses a deferred payment comission, usually a fee proportional to its regular acceptance comission,adjusted for the longer period.

If the beneficiary requires interim financing, he or she may be able to use the issuing/confirming bank's promise of future payment to obtain credit from his or her bank. The beneficiary will not be able to ''discount'' any paper for this financing, as in this case of a banker's acceptance transaction, because a deferred payment credit does not provide for the creation of a negotiable instrument which may be sold in the secondary market. The bank would have to fund the loan from its own sources, so the interest rate would usually be higher than the cost of acceptance financing.

Bankers' acceptances

A bankers' acceptance is a time draft drawn on and accepted by a bank and payable at a fixed or determinable future date. By accepting the draft, the bank conveys its unconditional promise to pay the face amount of the draft to any holder in due course who presents it at maturity. It is a short-term, self liquidating, fixed-rate method of financing where the instrument used to evidence the debt is a draft and not a note, as is the case in coventional lending. The result:lower rates of interest or cost to the borrower.

Bankers' acceptances play a vital role in trade finance. Banks substitute their credit standing for that of their customers by accepting drafts and advancing discounted funds to the borrower.

A key feature of the bankers' acceptance is its marketability. Bankers' acceptances may be sold to investors in the open market, resulting in short-term financing for importers and exporters. For these parties,

acceptance financing is similar to issuing short-term private paper, although the administrative cost of acceptance financing is far less than issuing private paper.

Bankers' acceptances can be created either from the letter of credit transactions or from time drafts drawn independently of a letter of credit.

A typical example of a bankers' acceptance occurs when an importer draws a draft on his or her bank to finance imported merchandise arranged for under a letter of credit payable at sight, a collection, or a purchase on open account. By drawing a draft on the bank, independent of the letter of credit, the importer receives financing to pay for the imported merchandise. The revenue from the sale of the imported merchandise sholud then be used to pay the acceptance at maturity.

For example, Board of Governors of the Federal Reserve system regulates the bankers' acceptance market in the U.S. by modification of the definition of eligibility from time to time, by restrictions on the types of transactions from which eligible acceptances may arise, and by restrictions on amounts banks may create for individual customers and in the aggregate.

Acceptances are generally clasified as:

1. Eligible for discount at the Federal Reserve
2. Ineligible for discount at the Federal Reserve

Eligible for discount

Acceptances that are eligible for discount at the Federal Reserve are sold at more favorable rates in the acceptance market than ineligible acceptances, providing importers and/or exporters witk lower-cost acceptance financing. Currently, the basic criteria for eligiblity are as follows:

- the term of the draft cannot exceed six months
- the shipment must be „current", that is, the acceptance must be created within a reasonable time (usually 30 days) after shipping date of the goods
- the underlying transaction must fall into one of the following categories:
- the import or export of goods, either from the U.S. or between foreign countries.
- the domestic shipment of goods within the U.S. crossing state borders or travelling a minimum of 25 miles from point of origin.
- *the storage of readily marketable staples in the U.S. or a foreign country, provided the bank possesses a warehouse receipt or other such documents conveying the security title to the goods at time of acceptance until maturity. A readily marketable staple is defined as an article of commerce, agriculture or industry, of such use to make it the subject of constant dealing in ready markets with such frequent quotations of price to make:*

1. the price easily and definetly ascertainable
2. the staple itself easy to aquire by sale/purchase at any time.

Ineligible acceptances

Acceptances which are not eligible for discount by the Federal Reserve are defined as ''ineligible'' acceptances. The Federal Reserve requires that, unlike eligible acceptances, ineligible acceptances are not exempted from the definition of deposit and as such an ineligible acceptance is subject to reserve requirements.

The result is that the rates on ineligible acceptances generally are less favorable to importers or exporters than those on the acceptances that are eligible for discount. Despite this, ineligible acceptances can be less expensive than other short-term financing instruments and in some cases still provide attractive financing options.

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