

Letters of Credit: Negotiation Considerations and the Benefits and Pitfalls of Using Letters of Credit as Collateral

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Agenda

Methods of Payment

- Open Account
- Advance Payment
- Letters of Credit

History

- Crude Oil Avg.

Documentary Letters of Credit

- Key Points to Remember
- Documentary Conditions, Common Discrepancies and Irregular Documentation
- What Happens

Confirmation

- Considerations of a confirming bank

Standby Letters of Credit

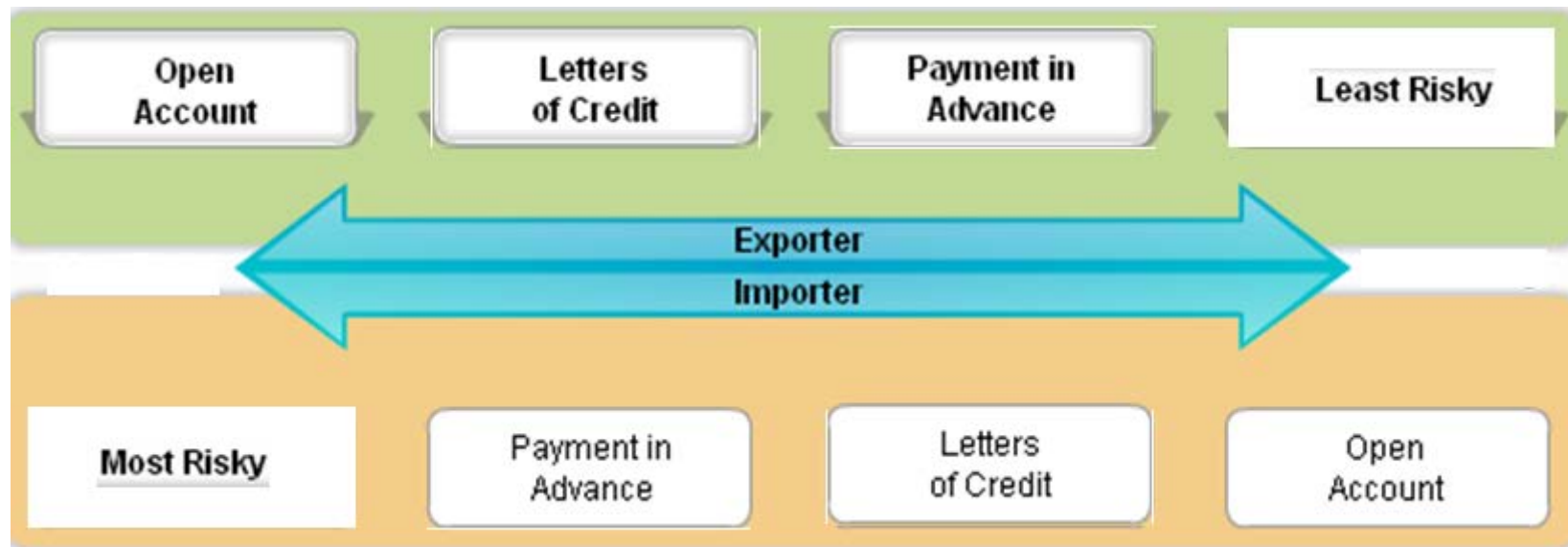
Bank Risk

Uniform Code

Sweepstakes Contest

Methods of Payment

- **Open Account**
- **Payment in Advance**
- **Letters of Credit**

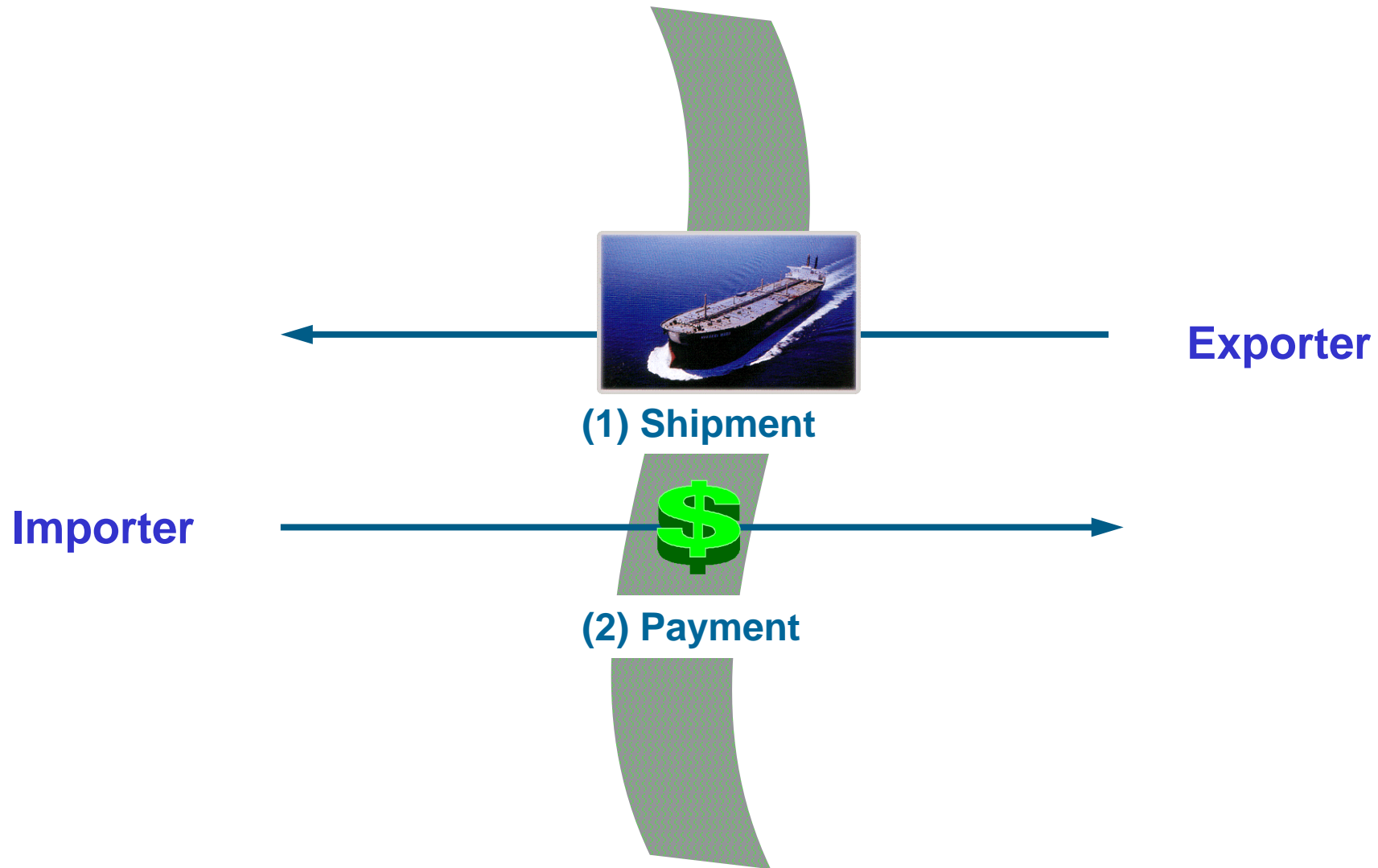


Open Account

Exporter risk (high):

- **Most popular method of payment – Around 80% of international trade is conducted on an open account basis.**
- **Importer won't pay because of disputes**
- **Importer can't pay because of**
 - **Insolvency or**
 - **Unavailability of foreign exchange**
- **Loses control of goods**

Open Account - Flows

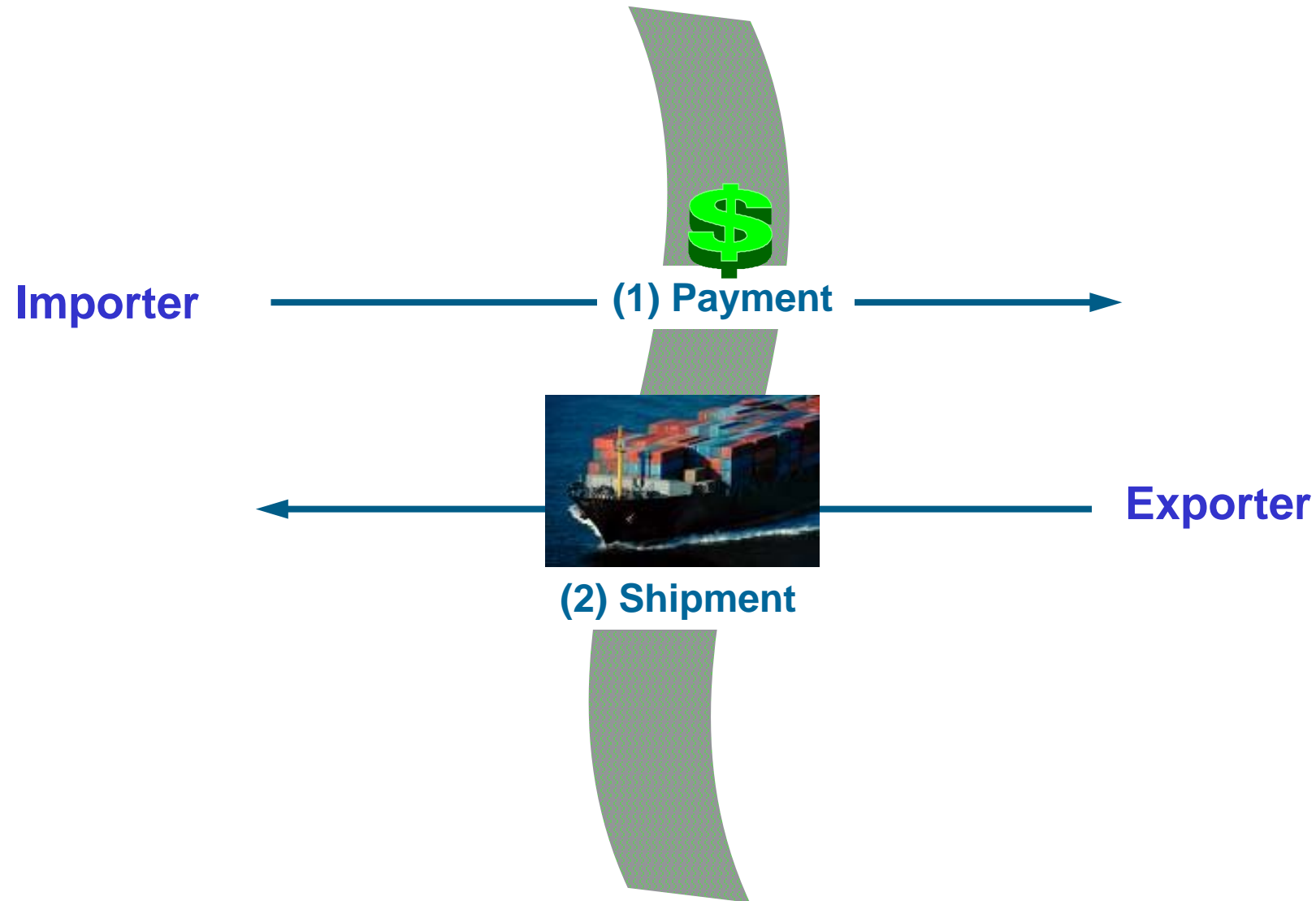


Payment in Advance

Exporter risk (lowest):

- **As name suggests, under these terms the importer pays for the goods in advance of receiving them from the exporter.**
- **Ideal from the seller's point of view.**
- **Higher risk for the buyer as they are relying on the exporter to deliver the correct goods, on time, undamaged, and to an acceptable quality standard.**
- **Also disadvantageous to the buyer from a working capital perspective and so is not very common in international trade.**

Payment in Advance



Letter of Credit - Defined

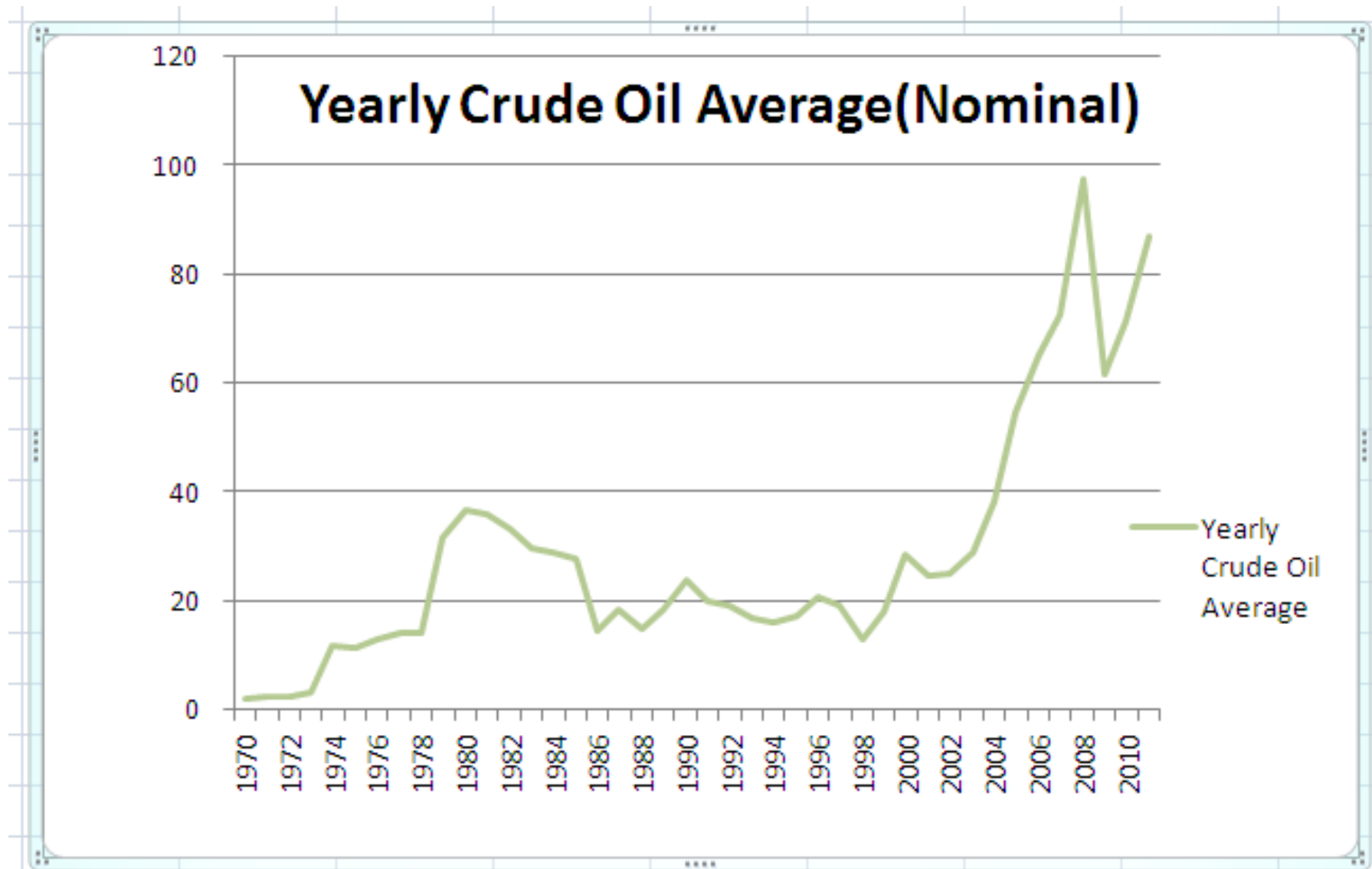
- ✓ A conditional undertaking
- ✓ Usually given by a bank (issuing bank)
- ✓ At the request of a customer (applicant)
- ✓ To pay a seller (beneficiary)
- ✓ Against stipulated documents
- ✓ Provided all terms and conditions are complied with

History

Commercial LCs became widespread after WW I with the growth of international trade.

Standby LCs were used in the 1960's for certain type of financing, such as real estate development, ship building and Mid-East infrastructure projects. The 1970's saw a widespread use and recognition of SBLCs.

Crude Oil Averages and the Start of LCs in Energy



Documentary Letters of Credit

- **Issued with the intent to pay against conforming documents**
- **Is used as the payment vehicle under the contract**
- **Documents: Bill of Lading, invoice, inspection certificates, certificate of origin, insurance certificate, etc.**

Key Points to Remember

- ✓ **Banks deal in documents, not in goods or performance**
- ✓ **The LC substitutes the credit of the issuing bank for that of the buyer**
- ✓ **The LC assures the seller of payment when the terms of the LC are met**
- ✓ **The exporter is not obliged to perform if the terms of the LC are not acceptable to him**

Documentary Conditions

- 1. Beneficiary's SIGNED COMMERCIAL INVOICE COVERING SHIPMENT OF 950,000 NET US BARRELS PLUS OR MINUS 5 PERCENT OF CRUDE OIL OF VARIOUS GRADES.**
- 2. FULL SET OF 3/3 ORIGINAL 'CLEAN ON BOARD' BILL OF LADING, PLUS 3 NON ' NEGOTIABLE COPIES ISSUED OR ENDORSED TO THE ORDER OF THE ISSUING BANK EVIDENCING A SHIPMENT OF APPROXIMATELY 950,000 NET U.S. BARRELS (PLUS OR MINUS FIVE PERCENT) OF CRUDE OIL OF VARIOUS GRADES FOR SHIPMENT FROM ___ NO LATER THAN JANUARY , 2013**
- 3. ORIGINAL CERTIFICATE OF QUALITY PLUS 5 COPIES.**
- 4. ORIGINAL CERTIFICATE OF QUANTITY PLUS 5 COPIES.**
- 5. ORIGINAL CERTIFICATE OF ORIGIN PLUS 5 COPIES.**
- 6. ORIGINAL TANKER ULLAGE REPORT PLUS 5 COPIES.**
- 7. ORIGINAL TANKER'S TIME SHEET PLUS 5 COPIES.**
- 8. ORIGINAL CARGO MANIFEST PLUS 5 COPIES.**
- 9. ORIGINAL MASTER'S RECEIPT FOR DOCUMENTS PLUS 5 COPIES.**

Common Discrepancies in Documentary LCs

- Bill of Lading not signed correctly**
- Description of goods**
- Late shipment**
- Inconsistent Documents**
- LC expired**

Irregular Documentation

- **If possible, amend the documents**
- **Seek waiver from the applicant**
- **Send documents on an approval basis**
- **Importer has no obligation to take up irregular documentation**
- **Exporter reverts to an open account sale**

What happens

Discrepancies lead to open account sales!

Confirmation

Buyer (applicant) and seller (beneficiary) enter into contract and agree to settle the transaction using an LC

LC is to be issued by an issuing bank with which the beneficiary may not be too comfortable; i.e. the credit and/or country risk

Once a bank adds its confirmation, the confirming bank takes on the obligations of the issuing bank

Considerations of Confirming Bank

- ❖ A confirmation of an irrevocable credit:

 - Constitutes a definite undertaking,

 - Provided the credit terms and conditions are strictly complied with.



Common Sense Rules

Read your Letter of Credit.

Check for details such as correct name.

Review documentary requirements.

The terms, conditions and documents called for in the Documentary Credit must be in agreement with the sales contract.

When making presentation of the documents to the bank, the Beneficiary should:

- Present the required documents exactly as called for by the Documentary Credit. They must be in accordance with the terms and conditions of the Documentary Credit and not, on their face, inconsistent with one another.
- Present the documents to the bank as quickly as possible, and in any case within the validity of the Documentary Credit and within the period of time after date of shipments specified.

Banks will refuse settlement if documents are not compliant with the terms and conditions stipulated.

Standby Letter of Credit

- **Same parties as in documentary LC but does not necessarily directly involve the movement of goods**
- **Support a direct financial obligation, such as a loan (Financial SBLC)**
- **Developed to support performance obligations under a contract or agreement (Performance SBLC)**
- **Could also be used as a form of guarantee by the exporter in open account trading transactions (Trade or Commercial SBLC)**

Usually payable on demand by presentation of draft certificate / statement of beneficiary

- **Issued under ISP 98 or UCP 600**

Bank Risk

Letters of Credit are obligations of the issuing bank independent of the obligation of the applicant to reimburse the issuer.

Bank Failures:

A receiver of an insolvent bank will reject drawings as burdensome contracts

Underscores the importance of the beneficiary evaluating the creditworthiness of the issuing bank and approving only credit worthy issuers.

Exceptions

Collateralized LCs

if the issuing bank is fully collateralized, the regulators, in special cases, may consent to an agreement with the beneficiary for the beneficiary to access the collateral.

Commercial LCs

Regulators may allow the beneficiary to complete the transaction in the interests of commerce if in turn the applicant is in a position to make payment

Banks – What makes a good bank?

Capital Base

Asset Quality

- Loan portfolio; diversification; growth; clear credit policy

Management

- Experienced; regulated; customer care; well trained staff

Earnings

- ROA; ROE; stable income stream; low cost to income ratio

Liability Management

- Stable customer base and good liquidity; ability to manage market risk.

For the purpose of jurisdiction, choice of law, and recognition of inter-branch letters of credit, but not enforcement of a judgement, all branches of a bank are considered separate juridical entities and a bank is considered to be located at the place where its relevant branch is considered to be located under this subsection.

Q&A