LETTERS OF CREDIT

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."

Types of Letter of Credit:

According to the needs of importers and exporters, banks usually operate different types of Letter of Credit. Following are the different type of letter of Credit that is operated by banks:

1. **Red Clause L/C**

Under such Letter of Credit the opening bank authorizes the negotiating bank to provide finance to the exporter so that he can purchase goods for the shipments. Such type of advances is called pre-shipment advances.

2. Green Clause L/C:

Besides containing the provision issue pre-shipment finance, this letter of Credit also provides for storage expenses and warehouse charges.

3. Irrevocable L/C:

Such Letter of Credit cannot be modified or canceled by the opening bank. Here absolute undertaking is given by the opening bank that it will honor the draft presented by negotiating bank provided that terms and conditions of Letter of Credit are fulfilled.

4. Revocable L/C:

Such letter of credit can be revoked by the issuing bank at any time. This means it can be modified or canceled by opening bank without giving any notice.

5. Confirmed L/C:

Such type of letter of Credit is backed by the credit worthiness of both the importer and the exporter bank. Under such letter of Credit the negotiating bank gives absolute undertaken that exporter will be paid even if issuing bank fails to make payment.

This type of Letter of Credit is rarely used. Usually it is used when.

1. The issuing banks do not have sound standing.
2. The conditions in the issuing bank country are shaky and doubtful (danger of default or war etc.)
3. The issuing bank is not known.

6. Unconfirmed L/C :

Under such Letter of Credit the importer has the facility to make payment in installments.

7. With Resource L/C:

Under such Letter of Credit the drawer of the draft is liable to the holder in due course if the draft is not honored by the paying bank.

8. Without Resource L/C:

Under this the drawer is not liable if the draft gets dishonored.

9. Documentary L/C:

Under such letter of credit the exporter must make sure that the draft and invoice are supported by different required documents.

10. Revolving L/C:

Under this type of letter of credit the amount of credit is automatically renewed of reinvested once the credit conditions have been fulfilled.

11. Back to Back L/C:

Back to Back letter of credit is one where the person in whose favor it has been opened uses it to establish another credit in favor of another person. Thus one credit backs another credit.

12. Clean L/C:

Under such letter of credit no conditions are attached to the draft and the issuing bank makes payment up to amount of the credit.

Summing Up:

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.

Parties Involved in Letter of Credit:

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.

PROCEDURE OF OPENING AND FUNCTIONING OF LETTER OF CREDIT.

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. According to the article 15 of Uniform Customs and practice (44).

"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 article 47 says that 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:**

According to article 4 of Uniform Customs & practice (400).

"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.

Summing Up:
This is how the letter of credit works to complete the trade between countries.

ADVANTAGES OF LETTER OF CREDIT:
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 is in a better position to conduct his business.