

# Letter of Credit

Contributed by Editor  
Wednesday, 16 November 2005

A letter of credit, also referred to as an LOC or LC, is a document issued by a financial institution which essentially acts as an irrevocable guarantee of payment to a beneficiary. This means that if the applicant obtaining the LC fails to perform its obligations, the bank pays. The LC can also be the source of payment for a transaction, meaning that an exporter will get paid by redeeming the letter of credit. Letters of credit are used nowadays almost exclusively in international trade transactions of significant value, for deals between a supplier in one country and a wholesale customer in another. The parties to a letter of credit are usually an applicant who wants to send money, a beneficiary who is to receive the money, the issuing bank of whom the applicant is a client, and the advising bank of whom the beneficiary is a client. In executing a transaction, letters of credit incorporate functions common to giros and travellers cheques.

{mospagebreak title=How it works}

Let us imagine that a business called Acme Electronics from time to time imports computers from a business called Beijing Computers, which banks with the Shanghai Business Bank. Acme holds an account at Commonwealth Financial. Acme wants to buy £500,000 worth of merchandise from Beijing Computers, who agree to sell the goods and give Acme 60 days to pay for them, on the condition that they are provided with a 90-day LC for the full amount. The steps to get the letter of credit would be as follows:

- \* Acme goes to Commonwealth Financial and requests a £500,000 letter of credit, with Beijing Computers as the beneficiary.
- \* Commonwealth Financial can issue an LC either on approval of a standard loan underwriting process, or by Acme funding it directly with a deposit of £500,000 plus fees between 1% and 8%.
- \* Commonwealth Financial sends a copy of the LC to Shanghai Business Bank, which notifies Beijing Computers that payment is ready and they can ship the merchandise Acme ordered with full assurance of payment.
- \* On presentation of the stipulated documents in the letter of credit and compliance with the terms and conditions of the letter of credit, Commonwealth Financial transfers the £500,000 to Shanghai Business Bank, which then credits the account of Beijing Computers by that amount.
- \* Note that banks deal only with documents under the letter of credit and not the underlying transaction.

If the stipulated documents are presented and the terms and conditions of the letter of credit are met, then the issuing bank is obliged to pay under the letter of credit, even if the underlying transaction is not fulfilled.

Also the bank is not required to pay if the stipulated documents are not presented or the terms and conditions of the letter of credit are not met, even if the underlying transaction was fulfilled.

{mospagebreak title=Other information}

Various conditions can be placed on a letter of credit, such as to pay parts of the sum on shipment and/or arrival, or for it to be used simply as a guarantee to obtain payment on an unpaid invoice, or for a revolving credit line where there are regular shipments from a supplier to a customer.

Some letters of credit provide funding by means of drafts issued with the original, which operate like cheques. A beneficiary presented with an LC draft who has questions about it should contact the issuing bank.

The issuance and enforcement of letters of credit are normally subject to publications of the International Chamber of Commerce (ICC) such as UCP, eUCP, ISP98 or ISBP, however a letter of credit may state the conditions that govern its enforcement, including Article 5 of the Uniform Commercial Code (typically used in the United States); but the extensive use of LC's in international transactions mandates that one contemplating becoming a party to a transaction involving one be familiar with the laws of other countries which may have jurisdiction over a dispute.

The current ICC publications cover the following types of transactions.

- \* UCP - Commercial letters of credit (The most current publication is the UCP 500, however letters of credit can be subject to this publication or earlier publications if so noted in the letter of credit.)
- \* e-UCP - Commercial letters of credit that allow for electronic presentations
- \* ISP98 - Standby letters of credit (The UCP may also be used for standby letters of credit, but these practices are not as well suited for a standby letter of credit situation)
- \* ISBP - This is actually a supplement to the UCP which attempts to standardize banking practices worldwide.