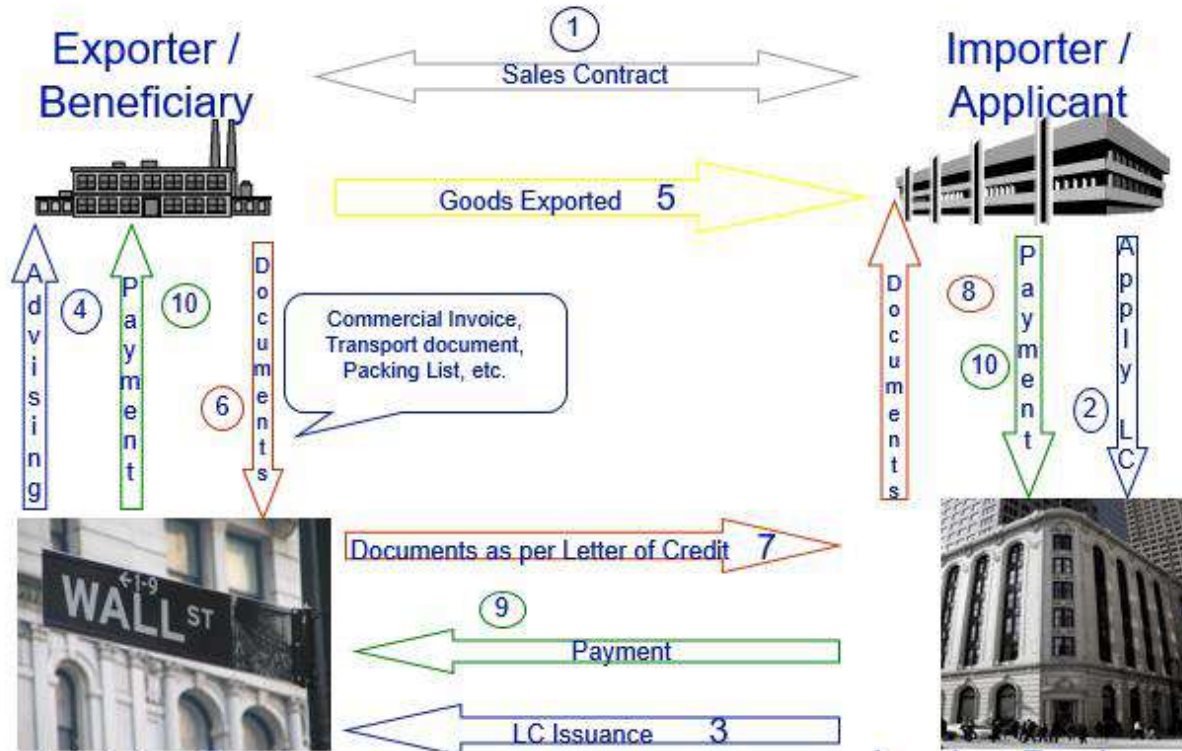




*PonSun*

AML ACADEMY

# Letters of Credit





# Types of LCs

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- Documentary vs. Clean
- Revocable vs. Irrevocable
- Red Clause
- Transferable
- Back-to-Back
- Revolving



# Documentary and Clean LCs

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- Documentary Letters of Credit
  - To draw against a documentary credit the beneficiary must submit shipping documents (i.e. bills of lading, commercial invoice, etc)
  
- Clean Letters of Credit
  - To draw under a clean credit, the beneficiary is NOT required to submit shipping documentation



# Revocable and Irrevocable LCs

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- Revocable Credit
  - May be canceled or amended by the issuing bank at any time without prior notice to the beneficiary
- Irrevocable Credit
  - May not be cancelled or amended without the consent of all parties involved



# RED CLAUSE LC

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- Customer need :
  - Exporter needs pre-export financing
- “Pre-Export”-Cash advances prior to shipment of merchandise
  - To purchase raw material
  - To manufacture and package merchandise
  - To settle upfront charges
  - To pay sub contractors



# RED CLAUSE LC

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## ➤ Risk Issues

- Exporter uses the funds for a purpose other than export shipment. (ie. does not negotiate export documents)
- Exporter negotiates the L/C with another bank
- Documents presented for negotiation have discrepancies.



# Transferable Credits

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- Customer need:
  - The beneficiary of the letter of credit not the ultimate supplier / manufacturer of the merchandise (i.e.. usually is a trading company / subcontractor / middleman)
  - The beneficiary wants to transfer part (partial assignment) or all (full assignment) of his rights and obligations to the actual supplier(s) or second beneficiary
- A transferable credit can only be issued upon the specific instructions of the applicant



# Transferable Credits

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➤ Structure:

- The transfer must be effected in accordance with the terms of the original credit, subject to the following exceptions:
  - Name and address of the first beneficiary may be substituted for that of the applicant (to hide the identity of importer/buyer)
  - Amount of credit (or unit price) may be reduced (to allow for profit of first beneficiary)



# Transferable Credits

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- Period of validity may be shortened.
  - Latest presentation date for documents may be shortened.
  - Latest shipment date may be moved earlier.
  - Percentage for insurance cover may be increased.
- The above are not considered as amendments to the original credit and may be effected without the consent of the applicant



# Back to Back LC

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- Customer need:
  - The beneficiary of the Letter of Credit is not the ultimate supplier / manufacturer of the merchandise.(i.e.. Trading Company)
  - The ultimate supplier/manufacturer requires a documentary credit to be issued in his favor.



# Back to Back LC

## ➤ Structure:

- Importer opens a documentary credit in favor of the beneficiary
- On the strength of the first documentary credit, the beneficiary applies for a second LC with his bank (which may or may not be the negotiating bank) in favor of the ultimate supplier /shipper
- The amount of the second L/C would be less than the first L/C (Difference in amount is trading profit)
  - -The expiry date is earlier
  - -Latest shipment date earlier
  - -Latest presentation date earlier
  - -Insurance for 110% of original L/C amount..

# Revolving LC

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- Customer Need :
  - If the importer buys:
    - The same merchandise
    - At a pre-determined price
    - On a very regular basis
    - From the same supplier
    - With the same terms and conditions



# Revolving LC

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- Types of Revolving Credits
  - Cumulative
    - The total potential exposure increases if exporter fails to ship during the prescribed period
  
- Non-Cumulative
  - The exposure lapses if the exporter fails to ship during the prescribed period



# Shipping Guarantees

- An issuing bank may not receive documents under its documentary credit prior to the goods arriving at their destination. This may happen quite often if the forwarding of documents by a nominated bank is delayed because they have been found discrepant on first presentation or perhaps when they were presented by the beneficiary towards the end of the applicable presentation period. This means, for example, that an applicant may not be in possession of an original bill of lading when the vessel arrives at the port of discharge. Unless the goods are cleared from the port with the minimum of delay, the port authorities may:
  - levy charges and the rate of charge may increase the longer the goods remain at the port; and
  - In a worst-case scenario, confiscate goods after the expiration of a stated statutory period.

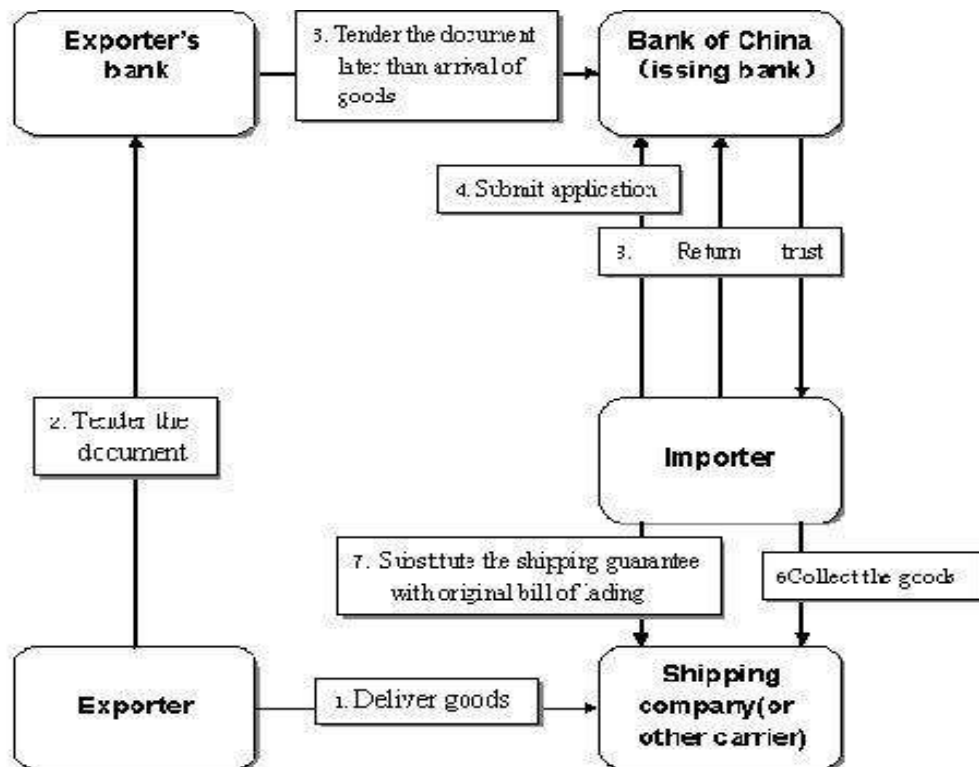


# Shipping Guarantees

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- In these circumstances, an applicant will wish to clear the goods despite the absence of an original bill of lading. To do this, it will ask the carrier for its standard indemnity form against which the carrier may be willing to release goods despite the absence of an original bill of lading. Carriers will usually not accept an indemnity directly from an applicant and will usually require the indemnity to be countersigned or issued by the issuing bank of the documentary credit or another bank. If the carrier does not maintain a standard form and is willing to accept a bank-issued indemnity, an applicant may request its bank to issue the indemnity in a format that will be satisfactory to the carrier.

# Workflow



# The form of indemnity

- Although most carriers maintain their own standard forms, its content will differ from carrier to carrier and often from country to country. There are, however, a number of common features, as follows.
- The form is pre-printed with the heading of the carrier. It will indicate that it is an indemnity containing an undertaking in connection with delivery of the described goods without production of an original bill of lading
- The applicant and issuing bank, both of which may sign the indemnity (in the case of an indemnity issued directly by the bank, only the bank will sign), will undertake:
  - –to indemnify the carrier and hold it harmless in respect of any liability, loss or damage of whatsoever nature that it may sustain by delivering the goods as requested; – to provide funds to defend any action brought against the carrier;
  - – to pay on demand any freight and / or charges due on the goods (with the bank insisting, in some cases, that the goods be released only after payment of freight or other charges); and –
  - to surrender an original bill of lading as soon as it is received and to acknowledge that each and every person is joint and severally liable, and that liability shall not be conditional upon proceeding first against any person.



# Transaction

- A carrier's indemnity form may indicate that the incorporation of an expiry date or any qualifying remarks is not acceptable. The following particulars are typically shown:
  - consignee;
  - vessel and voyage number;
  - bill of lading number;
  - quantity and description of goods / container numbers; and
  - amount.
- To countersign or issue an indemnity, an issuing bank will normally require the applicant to sign its own form of indemnity in favour of the bank. Unsurprisingly, this indemnity will usually seek to protect the bank as fully as possible. It should include the applicant's undertaking to accept the documents, when presented, irrespective of any discrepancies, and it should contain an irrevocable authority for the bank to debit the applicant's account or an undertaking that the applicant will transfer funds to the issuing bank on first demand (when no account is held with the issuing bank).



# Risk for Banks

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- The risks to an issuing bank, in addition to those already detailed, are that:
- there will most likely be no date limitation of the bank's liability; and
- the liability may, in some cases, be unlimited in amount. Accordingly, an issuing bank may insist upon a cash deposit to cover at least the invoice value plus a margin and will record the amount of liability against the customer's credit facility.
- Local bank regulations may dictate the specific procedure for establishing the bank's liability, limitation on its duration and specific accounting requirements. In most jurisdictions, the applicable statute of limitations may apply to the expiry period for the indemnity, which, for most countries, would be a minimum of six or seven years. Where an amount is to be inserted into the indemnity, it is not uncommon for carriers to insist that it be for at least 200 per cent of the invoice value.



# Airway Releases and Delivery order

- Airway releases and delivery orders usually take the form of letters, telexes, faxes or electronic messages. They are issued by the issuing bank of the documentary credit, addressed to the carrier, and will show some, or all, of: ♦ air waybill number or truck waybill number;
- consignor;
- carton detail or container numbers;
- description of goods;
- documentary credit number;
- invoice number and invoice amount; and
- an instruction to release the goods to the applicant or its nominee.
- These releases or orders do not always include an indemnity to the carrier because, in the case of air despatch, the goods are often consigned to the issuing bank. In these circumstances, the release or order serves as an instruction to deliver goods to the applicant or its nominee.



## Counter-Indemnity

- An applicant's counter-indemnity to an issuing bank to cover the issuance of an indemnity, airway release or delivery order, will usually indicate that the applicant:
  - undertakes to accept the documents, when presented, irrespective of any discrepancies;
  - indemnifies the bank against all actions, proceedings, damages or costs in relation to the issue, of the indemnity, release or order;
  - undertakes that, should the goods released form part of a larger consignment, it will accept such larger consignment and pay the full value thereof; and
  - gives the issuing bank irrevocable authority to debit its account, or an undertaking that the applicant will transfer funds to the issuing bank on first demand (when no account is held with the issuing bank).

## Risk involved

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- The issuing bank takes on a primary responsibility by instructing a carrier to release goods to the applicant;
- The issuing bank is dealing with goods, contrary to the position under UCP 600; and,
- unless the beneficiary has been paid, or a draft has been accepted or a deferred payment undertaking incurred, the issuing bank is instrumental in delivering goods of an unpaid beneficiary to the applicant.



# Letters of Indemnity

- An LOI is usually seen in commodity trades, such as oil, in which the cargo can be sold many times during its voyage. The following describes the circumstances under which an LOI could be used in a transaction covering a shipment of oil.
- Individual oil transactions typically have high values. They can be in the range of USD50m–100m or more.
- Intermediary buyers and sellers are often brokers who have no interest in the oil as end users, but who simply look to make a profit on each sale. A particular seller in the chain may well be a subsequent buyer of the same oil. ◆ Original charter party bills of lading are issued upon shipment, but the problem is that prior intervening parties may take their time to release and deliver the charter party bills of lading (duly endorsed to the next buyer), and therefore the final seller has little option but to use an LOI to fulfil its transaction.



# Letters of Indemnity

- A documentary credit covering the shipment of oil will provide a list of the documents that are required in order for the beneficiary to be paid. This list will include documents such as a commercial invoice and a full set of charter party bills of lading.
- It will also often indicate that, should the charter party bills of lading not be available at the time of presentation or payment, the beneficiary may present an LOI and a commercial invoice. The documentary credit may incorporate the wording of the LOI that is to be issued. If the beneficiary presents its invoice and LOI, settlement is made against these documents only.
- When the beneficiary has collated all of the other documents, it will present them to the nominated bank or issuing bank in exchange for the release of the LOI. These documents are not examined under the terms and conditions of the documentary credit or UCP 600.



## Form of LOI

- The LOI is generally a one-page document that: ◆ confirms the issuer's ownership rights over the goods;
- Indemnifies the party to which it is addressed against the absence of a full set of original charter party bills of lading;
- Undertakes to surrender such full set of charter party bills of lading as soon as they are received; and
- Agrees to hold the addressee harmless and indemnified against all consequences resulting from the sale and the absence of a full set of original charter party bills of lading. As previously stated, an LOI is usually issued by the beneficiary of the documentary credit and, if required, countersigned by its bankers.



# Counter-signing of LOI by Banks

- It may be the case that a bank will be asked to countersign the LOI issued by the beneficiary. There are no rules that govern the countersigning of the LOI or the level of liability that a bank will record against its client's credit facility.
- It has been known for some banks to record a nominal amount merely to track an outstanding LOI and the presentation of the shipping documents for its release. With the recording of a nominal liability will come a nominal fee for the bank adding its counter-signature.
- Other banks will record the full amount against the credit facility of the beneficiary and charge accordingly. It is for each bank to develop its own policies for the countersigning of such documents.



# Syndication and Participation

- Increasingly, the values of many transactions are becoming so large that individual banks are less willing to undertake these transactions and to retain the full liability in their own books. As a result, banks may prefer to share the risk, and arrangements are made to syndicate part or all of the risk to participating banks. These arrangements are described in general terms as ‘syndication’ and ‘participation’. The syndication of, or participation in, risk in a documentary credit is handled in different ways depending upon:
  - The banks concerned; ♦ the countries involved;
  - legal issues and advice; and ♦ the approval of each bank’s legal advisers on documentation. The most common instances in which an act of syndication and participation may occur are as follows.
  - A documentary credit may be established on behalf of an applicant (often a multinational) on a syndicated basis and to facilitate the process that follows from doing so – that is, the examination of documents and effecting payment thereunder.
  - It may concern the confirming of a large-value documentary credit. It should be noted that arrangements may take either of two forms: silent or disclosed.



# Syndication and Participation

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- Silent syndication is a one-off transaction under which the lead bank adds its confirmation and examines documents, and then honours or negotiates on behalf of the syndicate.
- The lead bank is the public voice of the syndicate, which means that third parties are unaware of the participation of the other banks.
- Syndication may be disclosed – that is, the sharing of a facility among banks in the syndicate under which each bank in turn confirms its own portion of the documentary credit and examines documents, and then honours or negotiates up to the amount for which it added its confirmation.



# Syndication Agreements

- The agreement should cover some or all of the following aspects.
- i. The total value of the documentary credit(s)
- ii. The type and nature of the goods
- iii. The length of validity for shipment and expiry
- iv. The minimum documentary requirements to be stipulated in each documentary credit and required for presentation for honour or negotiation
- v. What type of amendment will or will not be permitted
- vi. Whether the other banks wish to approve the text of each documentary credit and any amendment thereto prior to issuance
- vii. How documents are to be handled – that is, whether the lead bank’s examination of documents will be acceptable and the other banks will accept the lead bank’s decision with regard to conforming documents, and whether such acceptance will be qualified by exclusion of liability of the other banks in respect of manifest error or negligence on the part of the lead bank



# Syndication Agreements

- viii. If documents presented under the documentary credit are discrepant:
    - a. whether the other banks need to be advised of such discrepancies
    - b. whether the refusal of documents in terms of UCP 600, article 16, will end the liability of all banks
    - c. and where a waiver of the applicant has been accepted by the issuing bank, whether the other banks need to be consulted and whether they need to approve such waiver prior to reinstatement of their liability
  - ix. Whether there are any circumstances (that is, bankruptcy or liquidation) in which banks will wish to retain their rights to:
    - a. refuse documents without reference to the applicant
    - b. refuse to reinstate their liability even if the applicant has subsequently accepted the discrepant documents
  - x. The basis for sharing of commissions and fees
  - xi. The documentary requirements for any claims under the syndication agreement
  - xii. The sharing of any security that the applicant may have surrendered, including the sharing of the sale proceeds of the underlying goods
- These points illustrate some aspects that need to be considered in drafting a syndication agreement, although not all will apply in every situation and some may involve additional issues. Each syndication arrangement needs to be examined separately and an agreement relevant to each must be drafted separately.



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**Thank you**