

Special Letters of Credit

Red Clause Letter of Credit

Description:

A Red Clause LC allows the beneficiary (seller) to draw a certain percentage of the LC amount as an advance before the shipment of goods.

Purpose:

- Seller may insist on advance payment as the goods are packed/manufactured as per the buyer's specifications, possibly under the buyer's brand.
- Provides pre-shipment financing to sellers.

Key Features:

- Advance payment may be released against the presentation of one or more of the following documents:
 - (a) A signed receipt.
 - (b) Draft for the advance amount.
 - (c) An undertaking by the beneficiary that the amount drawn under the letter of credit will be used for the procurement/packing of the goods covered by this LC. The beneficiary also undertakes to return the funds if the shipment is not effected within the time stipulated by the credit, strictly as per LC terms.
- The LC terms specify the amount or percentage to be advanced.
- Final settlement is made upon submission of shipping documents.

Risks:

- **For the Buyer:**
 - Risk of seller default or misuse of funds.
 - At times, the seller may arrange an advance payment guarantee from their bank.

Control Point for the Issuing Bank:

The issuing bank may restrict the LC to a particular nominated bank to exercise control over **multiple payments** allowed by the credit. This ensures that the payments, such as advances and final settlements, are properly managed and eliminates the risk of duplicate payments.

Green Clause Letter of Credit

Description:

A Green Clause LC enables the beneficiary (seller) to draw a specified percentage (e.g.,

80%) of the LC amount before shipment, based on the presentation of either a trust receipt or a warehouse receipt.

Purpose:

This type of LC is typically used when the buyer is responsible for arranging freight or shipment but has not yet completed a back-to-back sale. It allows the goods to be securely stored in the seller's country, under trust, until the buyer can finalize shipment arrangements.

Key Features:

- The seller (beneficiary) may draw a specific amount, typically up to 80% of the total LC amount, upon presenting one or more of the following documents:
 - (a) A Trust receipt issued by a party appointed by the buyer, certifying that goods are held under their custody and are ready for shipment.
 - (b) A Warehouse receipt certified by an independent surveyor appointed by the buyer, indicating that the goods are ready for shipment.
- The final settlement occurs upon submission of the shipping documents, confirming the shipment of the goods.

Control Point for the Issuing Bank:

The issuing bank may restrict the LC to a specific nominated bank, ensuring proper control over the multiple payment stages (such as advance and final settlement). This control helps prevent the possibility of duplicate payments and ensures that the terms of the LC are followed precisely.

Revolving Letters of Credit

Description:

A Revolving Letter of Credit (LC) is used for repetitive transactions between a buyer and seller over an extended period. It eliminates the need to issue multiple LCs for similar goods by allowing the credit to "revolve" either in value or time, as specified in the credit terms.

Types of Revolving Credits:

1. Value-Based Revolving Credit

Mechanism:

The value of the credit is reinstated upon each drawing, either partially or fully.

Reinstatement Types:

- **Automatic:** Reinstatement occurs without requiring additional authorization or amendments, as permitted by the LC terms.
- **Non-Automatic:** Reinstatement requires explicit authorization from the issuing bank, typically through an amendment or advice.

Credit Limit Management:

- For automatic revolving credits, the issuing bank blocks the applicant's credit limit for the maximum permissible amount under the LC.
- For non-automatic revolving credits, only the face value of the credit is blocked, providing flexibility in credit usage.

2. Time-Based Revolving Credit

Mechanism:

The credit is reinstated at predefined intervals, such as monthly or quarterly.

Reinstatement Types:

- **Automatic:** Reinstatement occurs automatically at the beginning of each specified period.
- **Non-Automatic:** Reinstatement requires specific authorization for each period.

Cumulative vs Non-Cumulative:

- **Cumulative:** The unused amount, if any, is carried forward to the subsequent months. If there are no utilisations in any given month, the beneficiary is allowed to draw the full amount, including the last instalment, in a single lump sum once all instalments have been reinstated.
- **Non-Cumulative:** Limits the beneficiary to draw only the amount available for each period, with unused portions not carried forward.

Credit Limit Management:

- For automatic revolving credits, the issuing bank blocks the applicant's credit limit for the maximum permissible amount under the LC.
- For non-automatic revolving credits, only the face value of the credit is blocked.

In case of non-cumulative credits, any unused amounts from previous periods may be adjusted to free up credit limits for the beneficiary.

Connection with Article 32 of UCP 600:

Article 32 of UCP 600 automatically cancels the credit if any instalment is not shipped within the stipulated time. However, for time-based revolving credits, this provision must be excluded. The intention of a time-based revolving LC is to allow the credit to remain available even when some instalments are not shipped. Excluding Article 32 ensures that the LC remains in effect, allowing for future instalments or shipments despite non-performance of prior ones. Therefore, the LC should explicitly exclude Article 32 to maintain its validity in such cases.

Control Point for the Issuing Bank:

The issuing bank may restrict the LC to a specific nominated bank to exercise control over multiple payments and reinstatements involved in the revolving process. This ensures that the proper management of payments, whether automatic or manual, is maintained.

Standby Letter of Credit (SBLC)

An SBLC is a financial instrument used primarily as a guarantee for non-performance, ensuring the beneficiary is compensated if the applicant fails to fulfil their obligations. While commercial letters of credit are focused on payment for goods or services, SBLCs act as a safety net, invoked only in the event of non-performance or default. SBLCs are typically governed by **ISP 98**, though they may also be subject to **UCP 600**.

In most cases, SBLCs remain unused unless the applicant defaults. These credits can be issued for various scenarios, including performance guarantees, advance payment guarantees, and open account guarantees.

Types of Standby Letters of Credit

1. Performance Standby

A performance standby is issued to ensure that the applicant fulfils their contractual obligations.

- **Applicant:** The seller.
- **Beneficiary:** The buyer.
- **Purpose:** To protect the buyer if the seller fails to perform obligations such as delivering goods or services.
- If the seller defaults, the buyer can invoke the standby credit by presenting a demand for compensation as per its terms.

2. Advance Payment Standby

This standby secures the repayment of advance payments made by the buyer to the seller.

- **Applicant:** The seller.
- **Beneficiary:** The buyer.
- **Purpose:** To safeguard the buyer against the seller's non-performance after receiving an advance payment.
- If the seller fails to fulfil obligations, the buyer can recover the advance payment under the standby credit.

3. Open Account Standby

An open account standby protects the seller against non-payment by the buyer under open account terms.

- **Applicant:** The buyer.
- **Beneficiary:** The seller.
- **Purpose:** To guarantee payment if the buyer defaults.
- The standby credit allows the seller to demand payment if the buyer fails to settle dues as agreed.

Evergreen Standby Letter of Credit

An SBLC with an evergreen clause automatically extends for a specified period unless the issuing bank notifies the beneficiary of its intent not to renew. This feature is ideal for long-term contracts requiring ongoing guarantees.

- **Extension Terms:** Typically renewed for one year unless the issuing bank provides a notice of non-renewal.
- **Notice Requirement:** According to **ISP 98**, the issuing bank must notify the beneficiary at least **30 days** before the expiration date if it intends not to extend the credit.
- **Effect of Notice:** If no notice is given, the SBLC automatically extends, ensuring the beneficiary's continuous protection.

Key Characteristics of SBLCs

1. **Non-Performance Guarantee:** SBLCs are invoked only in the case of default or non-performance by the applicant.
2. **Beneficiary Demand:** The beneficiary submits a demand as per the terms of the standby credit to invoke payment.
3. **Rules Governing SBLCs:**
 - **ISP 98:** Tailored specifically for standby credits and non-performance guarantees.
 - **UCP 600:** May also apply, but ISP 98 is generally preferred for SBLCs.
4. **Low Utilization:** Most SBLCs are not drawn upon unless a failure occurs, making them a safeguard rather than a payment mechanism.

Summary

Standby Letters of Credit provide essential protection in diverse scenarios where the risk of non-performance exists. Their flexibility, combined with regulatory frameworks like ISP 98, makes them a preferred choice for guarantees in international trade and finance. For evergreen SBLCs, the inclusion of a 30-day notice period ensures clarity and allows beneficiaries to act within the specified timeframe if needed.

Back to Back Letters of Credit, Transferable Letters of Credit and Assignment of Proceeds

Background

In international trade, there are scenarios where the seller (intermediary trader) is not the actual supplier of goods but acts as a facilitator between the ultimate buyer and the actual supplier. When the intermediary receives a Letter of Credit (LC) in their favor from the ultimate buyer's bank, they may need to provide payment assurances to the actual supplier. However, if the intermediary lacks sufficient funds or financial credit facilities to support the transaction, alternative mechanisms become crucial.

Three primary options are available to the intermediary trader in such cases:

- **Back-to-Back Letter of Credit**
- **Transferable Letter of Credit**
- **Assignment of Proceeds**

Each of these options offers distinct features and considerations that facilitate trade while addressing the financial constraints of the intermediary.

Back-to-Back Letters of Credit (LCs)

A Back-to-Back LC is a financing arrangement where two separate LCs facilitate a trade transaction. This is particularly useful when an intermediary trader (the seller) receives an LC from the ultimate buyer and needs to arrange for the supply of goods from an actual supplier but lacks the financial capacity to make upfront payments or provide direct guarantees to the supplier.

Mechanism

Step 1: Receipt of Master LC (Primary LC)

- The intermediary trader (beneficiary of the master LC) receives a letter of credit from the issuing bank of the ultimate buyer.
- This LC is typically referred to as the "master LC."

Step 2: Request for Back-to-Back LC

- The intermediary trader approaches their bank (referred to as the "secondary bank") to issue a back-to-back LC in favour of the actual supplier.
- The secondary bank evaluates the master LC to assess whether it can serve as collateral for the issuance of the back-to-back LC.

- The credit limit for the intermediary trader is considered based on the master LC, ensuring that the terms and conditions of the back-to-back LC align with the master LC.

Step 3: Issuance of Back-to-Back LC

- The secondary bank issues the back-to-back LC with terms aligned to the master LC but adjusted to reflect the agreement between the intermediary trader and the supplier.
- This back-to-back LC is treated as a separate and independent undertaking.

Step 4: Supplier Ships Goods and Presents Documents

- The supplier ships the goods to the buyer (as per the terms of the back-to-back LC) and submits the documents to the secondary bank for payment under the back-to-back LC.

Step 5: Honouring Supplier's Documents

- Upon confirming that the documents comply with the terms of the back-to-back LC, the secondary bank honours the payment to the supplier.
- This payment is typically made by creating a loan account in the name of the intermediary trader, releasing the payment to the supplier.

Step 6: Submission of Documents Under Master LC

- The secondary bank forwards the documents received from the supplier to the master LC issuing bank, replacing the supplier's invoice with the intermediary trader's invoice as per the terms of the master LC.

Step 7: Reimbursement from Master LC

- Upon acceptance of the documents under the master LC, the issuing bank of the master LC releases payment to the secondary bank.
- The funds are used to offset the loan account created in the name of the intermediary trader for honouring the back-to-back LC.

Step 8: Settlement of Transactions

- The intermediary trader's obligation to the secondary bank is settled upon reimbursement from the master LC proceeds.
- The intermediary trader receives any balance amount (if applicable) after all obligations are met.

Key Notes

- **Credit Risk:**
The secondary bank assumes risk during the period between honouring the supplier's presentation under the back-to-back LC and receiving funds under the master LC. To mitigate this risk, the bank evaluates the intermediary trader's creditworthiness and may require indemnities or undertakings.

- **Compliance and Documentation:**
Alignment of terms between the master LC and back-to-back LC is critical to avoid discrepancies when forwarding documents to the master LC issuing bank.
- **Independence of LCs:**
Both the master LC and back-to-back LC are independent instruments, governed by their own terms and conditions, subject to UCP 600.

Transferable Letters of Credit

A **Transferable Letter of Credit (LC)** is a trade facilitation instrument that allows the first beneficiary (intermediary) to transfer part or all of the credit's value to one or more second beneficiaries. This arrangement is commonly used in transactions where intermediaries rely on suppliers (second beneficiaries) to fulfil their obligations to the ultimate buyer.

Step-by-Step Process

Step 1: Issuance of the Transferable LC

- The ultimate buyer requests the issuing bank to issue a transferable LC in favour of the intermediary (first beneficiary).
- The LC must explicitly state its transferability as required under **Article 38(b) of UCP 600**.
- Depending on LC availability:
 - If restricted to a nominated bank, that bank acts as the **transferring bank**.
 - If freely available, the LC should name the transferring bank.
 - If restricted to the issuing bank, the issuing bank serves as the transferring bank.

Step 2: Request for Transfer

The first beneficiary submits a written transfer request to the transferring bank. The request includes the following details:

- Terms and conditions of the transfer.
- Name and address of the second beneficiary and their banker.
- Whether amendments may be advised to the second beneficiary and the conditions under which this may occur.

To enable the LC to be transferred to multiple second beneficiaries, the LC must explicitly allow partial shipments or drawings.

It is important to note that neither the issuing bank nor the transferring bank is obligated to effect the transfer. The decision to transfer depends on their internal policies and risk considerations.

Charges associated with the transfer are typically borne by the first beneficiary, unless otherwise agreed.

Step 3: Transferred Credit

- The transferring bank issues a **transferred credit (SWIFT MT 720)** in favour of the second beneficiary through their correspondent bank.
- **Replacement of Applicant Details:** The name and address of the original applicant (ultimate buyer) are replaced with those of the first beneficiary in the transferred credit.
- **Presentation of Documents:**
 - The transferring bank may allow the second beneficiary to present documents to their own bank up to the expiry date of the credit.
- **Terms and Conditions Alignment:**
 - The transferred LC must accurately reflect the terms and conditions of the original credit, including confirmation, and may allow the following changes:
 - **Reduction in the Credit Amount:** Lowering the total value of the transferred credit.
 - **Reduction in the Unit Price of Goods:** Adjusting the price per unit as per agreement.
 - **Shortening of Deadlines:**
 - **Expiry Date:** Earlier expiration of the credit.
 - **Period for Presentation of Documents:** Reduced time frame for document submission.
 - **Latest Date of Shipment:** Earlier shipment deadlines.
 - **Insurance Terms (CIF/CIP):**
 - In cases of **CIF (Cost, Insurance, and Freight)** or **CIP (Carriage and Insurance Paid To)** terms, if the unit price is reduced, the percentage of insurance cover must be increased to meet the amount stipulated in the credit or a minimum of **110% of the goods' value** as per UCP requirements.
 - **Applicant Name on Documents:**
 - If the name of the applicant must be indicated on any document, the transferred credit must replace the word “applicant” with the name and address of the original applicant.
- **Amendment Conditions:**
 - The transferred credit must indicate if and under what conditions subsequent amendments are advised, aligning with the first beneficiary's intent.
- **Multiple Second Beneficiaries:**
 - If the credit is transferred to more than one second beneficiary, the rejection of an amendment by one or more second beneficiaries does not invalidate the acceptance by any other second beneficiary.
 - For any second beneficiary that rejects the amendment, the transferred credit remains unamended for that specific beneficiary.
- **Restrictions on Further Transfers:**
 - A transferred credit **cannot** be transferred at the request of a second beneficiary to a subsequent beneficiary.
 - However, a second beneficiary **may** transfer the credit back to the first beneficiary.

Step 4: Presentation of documents to the transferring bank

- The second beneficiary ships the goods directly to the ultimate buyer.

- Documents are presented to the transferring bank, usually through the second beneficiary's bank.

Step 5: Role of the Transferring Bank

- Upon receiving the documents from the second beneficiary, the transferring bank:
 - Notifies the first beneficiary.
 - Provides the first beneficiary an opportunity to replace the **invoice** and **draft** with their own to indicate themselves as the seller.
 - If the first beneficiary fails to replace the invoice and draft promptly, the transferring bank may forward the second beneficiary's documents directly to the issuing bank.

Step 6: Submission of Documents to the Issuing Bank

- The transferring bank forwards the documents (including the substituted invoice and draft, if applicable) to the issuing bank under the original terms of the transferable LC.

Step 7: Settlement

- The issuing bank examines the documents for compliance.
- If the documents conform, the issuing bank releases payment to the transferring bank.
- The transferring bank:
 - Pays the second beneficiary as per the transferred LC terms.
 - Credits the first beneficiary with any differential amount, after deducting charges and other obligations.

Assignment of Proceeds in Trade Transactions

When a buyer arranges a standard Letter of Credit (LC) instead of a Transferable LC in favour of the intermediary (the beneficiary), and the intermediary is unable to arrange a back-to-back LC from their bank to the actual supplier of the goods, the assignment of proceeds offers an alternative solution to manage the payment risk for the supplier.

Process of Assignment:

1. Request for Assignment:

The intermediary, who is the beneficiary of the LC, may request their bank to assign the proceeds of the LC to the supplier. If the bank agrees, it will issue an **irrevocable assignment** in the supplier's name.

2. Supplier's Rights:

The supplier receives the **right to the proceeds** under the LC, but they do **not have the right to perform** under the LC itself. This means that the supplier cannot

directly draw or present documents under the LC; they only receive the payment once the documents are presented and accepted.

3. Presentation of Documents:

The supplier ships the goods and submits the required documents to the intermediary, who is the LC beneficiary. The intermediary then forwards the documents to the nominated bank. Alternatively, the intermediary may provide the supplier with all necessary documents, such as the beneficiary's invoice, draft, and any other required documents, enabling the supplier to present the complete set of documents directly to the nominated bank on their behalf.

4. Payment Distribution:

Upon receiving the proceeds from the issuing bank, the nominated bank will disburse the assigned amount to the supplier as per the terms of the assignment. Any remaining balance, after deducting applicable charges or fees, will be transferred to the intermediary.

Key Points:

- The assignment is irrevocable.
- The assignment must be executed by a nominated bank.
- This ensures the bank retains control over the payment process and mitigates risks related to unauthorized transfers.