TRADE DOCUMENTATION/UNIT-IV

LETTER OF CREDIT (LC)

A letter of credit (LC) is a financial document that facilitates international as well as domestic trade. It substitutes the bank credit for the credit of the customer. There are two basic types of letters of credit – commercial and standby. The commercial LC is the primary mechanism of payment while the standby LC is a secondary mechanism.

DEFINITION OF LETTER OF CREDIT

A letter of credit is a document from a bank or a financial institution on the buyer's behalf that assures the payment to the seller. The bank needs to have certain documents in possession before it issues the LC. This letter is as good as a guarantee to the seller that the payment will be cleared even if the buyer fails to do so. The risk of non-payment shifts from the seller to the bank. Generally, the entire process also involves another bank that works as an advisor to the seller. The issuing bank authorizes the advisory bank to pay the seller.

The commercial LC has been used for ages to facilitate the process of payment in domestic as well as an international trade like import and export letter of credit. In fact, its usage will increase with the development of the global economy. All the international letters of credit are governed by the regulatory body of the International Chamber of Commerce under the Uniform Customs and Practice for Documentary Credits.

FEATURES OF LETTER OF CREDIT

Since the letters of credit have been in use for centuries and there is a uniform regulatory code for the letters of credit, there are certain characteristics of letter of credit that are standard and are present uniformly in all the letters of credit:

NEGOTIABILITY

The LC is usually considered as a negotiable instrument and can be passed freely as money among various parties. It obligates the issuing bank to pay the money not only to the beneficiary but also to any other bank nominated by him. However, the LC is considered as negotiable only when it includes an unconditional promise of payment on demand or at a particular time.

REVOCABILITY

The letter of credit can be either revocable or irrevocable. The issuing bank can revoke or modify a revocable letter of credit at any time without notification. In such a scenario, the advising bank will not confirm the LC. However, the use of revocable LC is very rare. An irrevocable LC is the most commonly prevalent as it is not modifiable or revokable without the agreement of all the parties in the transaction.

TRANSFER AND ASSIGNMENT

The beneficiary of the letter of the credit can transfer or assign the LC as many times as possible. The LC will remain effective.

SIGHT AND TIME DRAFTS

The letter of credit demands payment through two features: sight or time. A sight draft is paid when the LC is presented and the time draft is paid after a certain duration of time. The bank will review the LC to be sure that it is valid in both cases.

ELEMENTS OF A LETTER OF A CREDIT

The LC is understood better if all the following elements or terms of the letter of credit are known:

- **Applicant:** The buyer in the business transaction.
- **Beneficiary:** The seller of the goods and services and the ultimate recipient of payment in the business transaction. The beneficiary needs to provide all the required documents for the letter of credit to be processed.
- **Issuing Bank:** The issuing bank provides an assurance to the beneficiary that the payment will be paid duly if all the documents presented comply with the stipulations stated in the letter of credit. The issuing bank also needs to examine the documents submitted by the beneficiary. It is absolutely liable to pay once all the terms and conditions in the LC are complete.
- **Advising Bank:** The advising bank advises the beneficiary and helps him to use the letter of credit. It pays the beneficiary once the issuing bank makes the payment. It also has the responsibility to send the required documents to the issuing bank. The advising bank has no obligation to pay if the issuing bank is unable to pay the beneficiary.
- **Confirming Bank:** The confirming bank confirms the letter of credit and assumes the same obligation as the issuing bank. The confirming bank is typically the advising bank. The conforming bank does a strict evaluation of the country and the issuing bank before confirming the LC.

DISCOUNTING OF LETTER OF CREDIT

A beneficiary can get the letter of credit discounted to be paid earlier. The advising bank advances the payment before the various sales and shipping documents are presented. The discount refers to the fees taken by the advising bank to discount the LC. The beneficiary does not receive the full payment. However, he receives the payment well in advance as compared to the issuing bank's payment terms.

UCP 600 UCPDC (UNIFORM CUSTOMS & PRACTICE FOR DOCUMENTARY CREDITS)

UCP 600 (Uniform Customs & Practice for Documentary Credits) - What is it?

The Uniform Customs & Practice for Documentary Credits (UCP 600) is a set of rules agreed by the International Chamber of Commerce, which apply to finance institutions which issue Letters of Credit – financial instruments helping companies finance trade. Many banks and lenders are subject to this regulation, which aims to standardise international trade, reduce the risks of trading goods and services, and govern trade.

The UCP 600 ("Uniform Customs & Practice for Documentary Credits") is the official publication which is issued by the International Chamber of Commerce (ICC). It is a set of 39 articles on issuing and using Letters of Credit, which applies to 175 countries around the world, constituting some $1tn USD of trade per year.

A brief history of UCP

The first version of the rules published by ICC in 1933 known as (UCP 82), it has been revised six times to keep pace with market needs and practices, in 1951 (UCP 151), 1962 (UCP 222), 1974 (UCP 290), 1983 (UCP 400), 1993 (UCP 500) and the latest version in 2007 known as (UCP 600). First published in December 2006 and implemented on 1 July 2007.

The origin of UCP 600

UCP 600 is the fruit of more than three years of work by the International Chamber of Commerce's (ICC) Commission on Banking Technique and Practice. One of the most important objectives of the UCP 600 is providing easier language and addressing the progress in various industries to unify the interpretation and application of documentary credits.

Key Sections of UCP 600

it comprises of 39 articles to cover the following:

- Scope and application of the rules (article 1)
- Definitions and interpretations (articles 2 and 3)
- Obligations and liabilities (from article 4 to 13)
- Examination and dealing with documents (from article 14 to 17)
- Documents including commercial invoice, transport documents and insurance document (from article 18 to 28)
- Miscellaneous Provisions (from article 19 to 33)

- Disclaimers (from article 34 to 37)
- Transfer and assignments (articles 38 and 39)

What's the reason for the UCP 600?

The UCP 600 replaced the UCP 500 on the 1st July 2007. It was brought about to standardise a set of rules aiming to benefit all parties during a trade finance transaction. UCP 600 was created by industry experts, and mandated by the Banking Commission, rather than through legislation. The first UCP was created in 1933 and has been revised by the ICC up to the point of the UCP 600.

The UCP 600 rules are voluntarily incorporated into contracts and have to be specifically outlined in trade finance contracts in order to apply. They also allow flexibility for the international parties involved.

An accompaniment to the UCP 600 is the International Standard Banking Practice for the Examination of Documents under Documentary Credits (ISBP), ICC Publication 745. It assists with understanding whether a document complies with the terms of Letters of Credit.

Credits that are issued and governed by UCP 600 will be interpreted in line with the entire set of 39 articles contained in UCP 600. However, exceptions to the rules can be made by express modification or exclusion.

The UCP 600 are the most successful rules ever developed in relation to trade and most Letters of Credit are subject to them. At the recent ICC UK Winter Trade Finance Conference, there was a special programme which addressed the UCP 600. This looked at recent developments in industry practice and ICC policy, as well as a review of the latest Banking Commission Opinions.

EXPORT CREDIT GUARANTEE CORPORATION (ECGC)

What is Export Credit Guarantee Corporation?

Export Credit Guarantee Corporation of India is fundamentally an export promotion organization, which seeks to enhance the competitiveness of Indian exports by offering them credit insurance covers. Over the years ECGC has considered various export credit risk insurance products suiting the needs of Indian exporters.

This corporation was set up for ensuring smooth functioning of Indian exporters by minimizing the risks associated with the payments emanating from other nations. This insurance cover which is provided by ECGC also assists the Indian exporters with better access to the credit facilities from banks and other financial institutions. ECGC is the 5th largest credit insurance company dealing with the exports of any country.

Export Credit Guarantee Corporation of India offers protection against the non-payment by an importer. Due to this insurance cover, the financial institutions are better placed for lending and providing larger credit to exporters. ECGC also offers credit ratings as well as shares the information on various countries and risks associated with doing business with/in those countries.

What does an ECGC do?

1. It offers an array of credit risk insurance covers to the Indian exporters against the loss with respect to the export of their goods and services

2. It provides Export Credit Insurance covers to the banks and other financial institutions for enabling exporters to find better services from them

3. It offers Overseas Investment Insurance to the Indian companies investing in Joint Ventures (JVs) abroad in the form of loan or equity

How does ECGC help the exporters?

ECGC provides the insurance protection to Indian exporters against the payment risks. It helps the exporters in a number of ways which include:

1. Guiding export-related activities

2. Making information available with respect to various countries with its credit ratings

3. Making it easy to get export finance from the banks and other financial institutions

4. Helping Indian exporters recover bad debts

5. Providing information on the credit-worthiness of foreign buyers

ECGC further insures exporter's credit risks against both political as well as commercial conditions and guarantees the payment to exporters. ECGC offers several types of insurance covers and these could be classified into the following groups:

a. Standard policies that protect Indian exporters against overseas credit risks

b. Construction works and services policies

c. Financial Guarantees

d. Special policies

ECGC offers following types of guarantees to the exporters:

i. Export finance guarantee

ii. Packing credit guarantee

iii. Post-shipment export credit guarantee

iv. Export production finance guarantee

v. Transfer guarantee

vi. Export performance guarantee

Over the years the Export Credit Guarantee Corporation of India has proved to be useful to Indian exporters. It pays 80 to 90 per cent of loss incurred by Indian exporters. The remaining 10 to 20 per cent of the loss alone has to be borne by the exporters.

However, it doesn't cover the risks mentioned below:

i. Exchange loss due to fluctuations in exchange rates

ii. Failure on the part of the buyer abroad to obtain the import authorization or exchange

iii. A default of the exporter or his agent

iv. Any loss which arises due to dispute in quality

v. Risk which is inherent in the nature of goods

Why do we need insurance for export credit insurance?

Insurance of the exports is important even at the best times. There can be a risk of default payments for the exports and these risks depend on political and economic changes around the world. For example, there can be blockage or delay of delivery of the exports due to a civil war. Any disturbance in the economy of the export or import company can also provide these risks. There could be restrictions imposed on either payment of the export or import of the goods due to instability in the nation. This can result in default buyers. There can be a case of the buyer going bankrupt due to political and economic uncertainties. To avoid the risk of such default payments and default buyers insurance of the exports is necessary.

Procedures with ECGC to cover insurance:

A purchase order is issued to the seller by the buyer. The purchase order contains complete details about the buyer who has to make payment. The seller (exporter) approaches ECGC to get approval on the buyer and the amount which can be shipped. The ECGC with the help of overseas network provides details regarding the creditworthiness of the buyer. ECGC collects some amount on the export and issues insurance policy.

TYPES OF RISKS IN INTERNATIONAL TRADE

The various types of risks that an international trader faces are divided into the following categories:

1. Commercial risks

2. Political risks

3. Risks arising out of foreign laws

4. Cargo Risks

5. Credit risks

6. Foreign exchange fluctuations risks.

Now, let us discuss these risks, in detail.

1. Commercial Risks

Causes of Commercial Risks: Commercial risks are caused due to the factors:

(i) Lack of knowledge about the foreign markets:

(ii) Inadaptability of the export product to change to the conditions of the foreign market requirements

(iii) Longer transit time and

(iv) Varying situations to be handled, not anticipated before export.

Nature of Risk different in International Trade

Commercial risks exist in domestic market too. But, their impact in international market: is greater, in comparison. to domestic market. The changes in international market are hazardous and difficult to anticipate. Suitability and acceptability of the product international market is rather difficult to gauge. Variations in demand and supply conditions are more unpredictable.

Most of the commercial risk s are to he borne by the exporters. Exporters cannot shift these risks to the professional risk bearers, paying insurance premium. The exporter is not, aware of the conditions in the foreign market as the way he is aware of domestic market. Long distances to travel along with cost and time implications distinguish international trade from domestic trade. Exporter cannot visit Paris with the same ease he does Mumbai from Bhopal. If goods are not sold or price realization is lower than anticipated, due to changes in demand or supply, exporter has to bring back the goods, incurring additional freight cost or opt to sell the goods at a loss.

In international. market, as in domestic market, presence of competitors influences the demand and supply conditions and entry of new competitors depresses the market more. Further, local production may bring down the prices. Introduction of substitutes to capture the market may take away the exporter's share in the market.

The price realization of the product in export market is influenced by:

(**a) Changes in Exchange Rates:** Changes in home currency or foreign currency affects the price realization. If the home currency is devalued, the competitive capacity' of the exporter is enhanced. If the foreign currency is depreciated, there is ; considerable reduction in the exporter's competitive strength.

(b) Changes in import Duties or Tariff Barriers: Changes in import duties and creation of tariff barriers disturb even an established market. In this field, through the efforts of GATT, import duties have been fairly reduced and market has become stable. On account of these impediments, exporters open manufacturing facilities in the importing countries to overcome these problems.

(C) Changes in Transport costs: Transport costs constitute, generally, a major part the invoice value and so any change in transport costs affects the competitive edge of the exporter. Change in transport costs does not affect FOB price., There, is no problem even in CIF contracts, which have escalating clause in respect of transport costs. Exports Have to worry in CIF contracts, which have escalating clause in respect of transport costs have to worry in case of CIF contracts that are net with escalation clause:

d) Change in Foreign Market Characteristics: A classical example is change in styles soon after shipment of goods in particular, when the shipment is made without letter of credit , ready made garments suffer, greatly from this problem.

Minimization of Commercial Risks: Commercial risks can be minimized by using forecasting techniques and keeping a careful watch on the changing business conditions in the concerned country, in particular, and also keeping a track of the changes in the world economy. Exporters have to be prepared to face any eventuality and wisdom lies in forecasti,44 and anticipating, of course, finally, quick responding, at the earliest hour.

2. Political Risks change in These risks arise due to change in political situations in the concerned importing and exporting countries. Following are the factors, affecting the political situation:

(i) Changes in the party in power in the concerned countries, followed by 1 head of the Government;

(ii) Coups, civil wars and rebellions:

(iii) Wars between the countries or among- many countries and

(iv) Capture of cargo by enemies during war.

Political Asks can be avoided, to a certain extent, by judicious selection of the countries to which goods are exported. Insurance companies may agree to provide cover for some of these risks, by collecting additional premium. Export Credit. Guarantee Corporation (ECGC.) also 'covers seine of the risks.

3. Risks Arising out of Foreign Laws (Legal Risks) Every country has its own commercial law. So, different laws prevail both in exporter and importer countries. Legal proceedings are complex as well as expensive. In every relationship, however cordial and long-standing may be, differences are likely to arise. Legal risks can be avoided to a great extent by incorporating the provision for appointment of an arbitrator, in case of dispute about contractual terms.