



# UNLOCKING GROWTH: HOW LETTER OF CREDIT BENEFITS INDIAN INDUSTRIES

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## Abstract

Since the early 1900s, letters of credit have been a vital component of global trade. They still have a significant impact on global trade today. Letters of credit are a crucial payment method that helps reduce some risks for any business venturing into foreign markets.

**Keywords:** Letter of Credit, Sources of Finance.

## Introduction

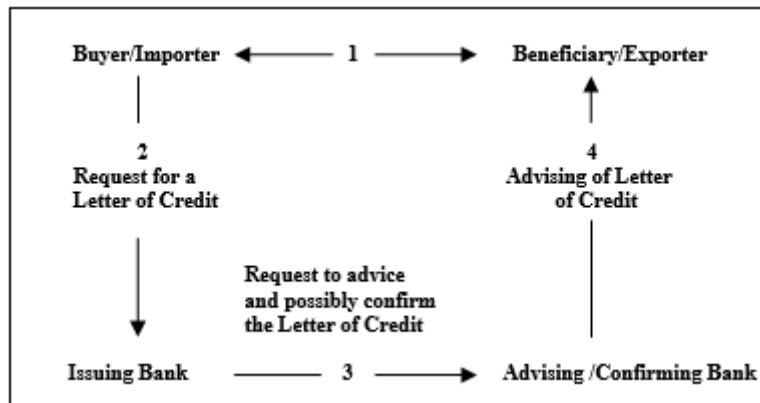
Simply put, a Letter of Credit is a written document that a bank issues at the request of its client, the Importer (Buyer), guaranteeing that the bank will pay the Exporter (Beneficiary) for goods or services, as long as the Exporter provides all required documentation, precisely as specified in the Letter of Credit, and complies with all other terms and conditions specified in the Letter of Credit. Another name for a Letter of Credit is a Documentary Credit.

In the regular course of business, a bank will issue a Letter of Credit (LC), a commercial instrument that bears a payment guarantee responsibility in the event of an unfavourable circumstance. On a client's request, a bank will issue an LC in the beneficiary's name. It is a crucial tool insofar as it streamlines and secures transactions, guaranteeing the party to whom the LC is opened that, in the event of a bad circumstance and the client fails to make the payment, the issuing bank will make the payment in accordance with the terms and conditions specified at the time the LC was issued. When both parties are conducting business for the first time, this paper is crucial.

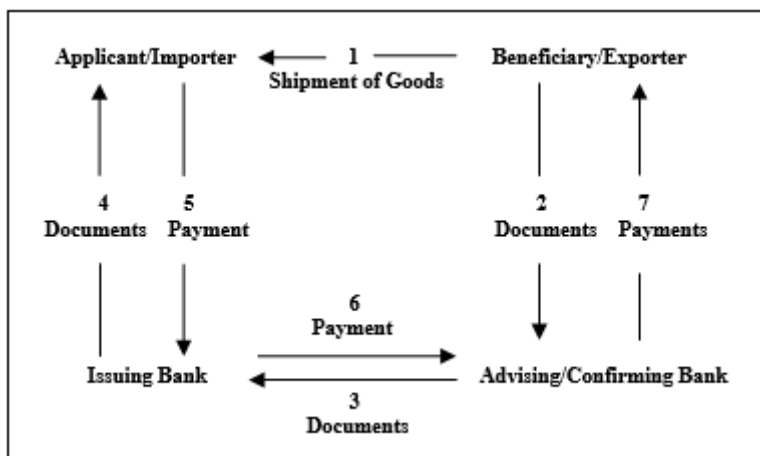
## Objectives

1. To examine how a Letter of Credit operates using an appropriate case study.

## Issuance of Letter of Credit



### Payment under Letter of Credit



### Letter of Credit Lingo

To better understand letters of credit, it may help to know the following:

1. The terms "letter of credit" can be shortened to L/C, LC, and LOC.
2. The buyer in a deal, or the applicant
3. Beneficiary: the person who sells or eventually receives money
4. The bank that guarantees payment is known as the issuing bank.
5. Advising bank: assists the recipient in utilizing the credit letter

### Parties to Letter of Credit

#### Applicant (Opener)

The applicant, also known as the account party, is typically the importer, purchaser, or consumer of the goods and is responsible for paying the beneficiary. At his request and in accordance with his directives, LC is started and issued.

#### Issuing Bank (Opening Bank)

When the beneficiary or their banker provides the necessary paperwork, the issuing bank is the one who creates the letter of credit and assumes responsibility for making the payments. If the documents are in compliance with the terms and conditions of the letter of credit, the beneficiary must receive the payment within seven working days of the day the documents were received at their end. If there are any discrepancies in the documents,

they must be rejected and disclosed within seven working days of the day they received the materials.

### **Beneficiary**

Typically, the beneficiary is a seller of the products who must be paid by the applicant. In order for him or his agent to receive payment upon surrendering the required document and adhering to the terms and conditions of the LC, a credit is granted in his favour. He is known as the first or original beneficiary if LC is transferable and he assigns the credit to someone else.

### **Advising Bank**

An advising bank, which is often based in the recipient's nation, offers advice to the beneficiary and handles the task of forwarding the paperwork to the issuing bank.

### **Confirming Bank**

By adding its guarantee to a credit that was opened by another bank, the confirming bank assumes responsibility for both payment and negotiating acceptance under the credit, on top of the issuing bank's. When an exporter is dissatisfied with the commitment made by just the issuing bank, confirming banks are essential.

### **Negotiating Bank**

The bank that negotiates the documents that the beneficiary submits to them under the credit—whether they are recommended through them or are the only ones allowed to do so—is known as the Negotiating Bank. As long as the presented papers comply with the terms and conditions of the letters of credit, they will negotiate the documents, claim the reimbursement under the credit, and pay the recipient.

### **Reimbursing Bank**

The bank designated to honor the reimbursement claim in settlement of negotiation, acceptance, or payment submitted to it by the negotiating bank is known as the Reimbursing Bank. Payment must typically be made from the bank that the issuing bank has an account with.

### **Second Beneficiary**

When the first or original Beneficiary of credit is not present, the second beneficiary acts as his representative. In this instance, the original beneficiary's credits are transferable. The terms of the transfer govern the transferee's rights.

### **Advantages/Disadvantages of LC to Importer & Exporter**

There are various advantages and disadvantages of Letter of Credit to Importer & Exporter.

#### **Advantages to the Importer/Buyer**

1. The importer is guaranteed that payment to the seller will only occur if all

requirements specified in the Letter of Credit have been fulfilled.

2. When payment by Letter of Credit is offered, the importer can bargain with the seller for better trade terms.

### **Disadvantages to the Importer/Buyer**

The importer is not protected by a letter of credit against receiving items of lower quality or in smaller quantities from the exporter. As a result, it's critical that the importer conducts the necessary due diligence to evaluate the exporter's reputation. The Importer's only option in the event that the Seller commits fraud is to take legal action. Note: Requesting further documentation, such as a Certificate of Inspection, in the Letter of Credit may give the importer more protection.

### **Advantages to the Exporter**

1. Instead of the buyer's creditworthiness, the issuing bank's creditworthiness determines the risk of payment.
2. The exporter consents in advance to all LC payment requirements. The exporter is not required to ship against the LC if it is not issued as promised.

### **Disadvantages to the Exporter**

1. The conditions outlined in the Letter of Credit must be strictly followed while preparing and presenting documents.
2. Due to a shortage of credit facilities with their bank, certain importers would not be able to open LC, which hence hinders the growth of exports.

### **Types of Letter of Credit**

#### **1. Import/Export Letter of Credit**

Depending on who is looking at it, the same credit may be referred to both import and export LC. It is referred to as import LC for the importer and export LC for the exporter.

#### **2. Revocable Letter of Credit**

With this kind of credit, the buyer and the bank that created the LC can alter the credit letter or make other changes without notifying the seller or obtaining his consent. Since all LCs are irrevocable under UCP 600, this kind of LC is no longer used.

#### **3. Irrevocable LC**

With this kind of LC, the applicant works with the issuing bank to make any necessary adjustments or cancellations (apart from when the LC has expired). It needs to be verified by the LC beneficiary. The beneficiary will decide whether to accept or reject the adjustments.

#### **4. Confirmed LC**

When another bank adds its own confirmation (or guarantee) to honour a compliant presentation at the issuing bank's request or authorization, the LC is considered confirmed.

## **5. Unconfirmed LC**

The other bank's approval is not obtained for this kind of letter of credit.

## **6. Transferrable LC**

A credit that allows the exporter to make the credit available to one or more future recipients is known as a transferable credit. When the original beneficiary acts as an intermediary and does not provide the goods directly, but instead purchases them from suppliers and arranges for their delivery to the buyer without requiring that the buyer and supplier are acquainted, credits become transferable. By using a transferable letter of credit system, the intermediary can replace the supplier's invoice with his own and keep the difference as profit.

## **7. Nontransferable LC**

The seller is said to be unable to grant someone or the people he desires a portion or the entire right of allocated credit. It is necessary for the credit to be nontransferable in international trade.

## **8. Deferred / Usance LC**

This type of credit won't be paid and issued right away after the legitimate documents have been verified; instead, it will be paid and assigned after a specified period of time that is acceptable to both the buyer and the seller. After taking the connected goods and selling them, the vendor will actually give the customer a chance to pay the necessary amount.

## **9. At Sight LC**

This type of credit occurs when the announcer bank promptly pays the necessary amount after reviewing the seller's carriage documents and verifying all of the paperwork.

## **10. Red Clause LC**

In this type of credit assignment, the seller may withdraw all or a portion of the bank's funds prior to shipping the goods. Getting the acceptor bank's attention is the first goal of the credit. This is because the assigner bank is establishing this credit for the first time in order to attract the offered bank's attention. Red ink was used to write the terms and conditions, and it gained prominence with that title.

## **11. Back to Back LC**

Two distinct and distinct types of LC make up this sort of LC. The first one is set up to help the seller who, for whatever reason, is unable to supply the matching goods. As a result, no credit will be made for another seller to supply and ship the needed products in accordance with the credit that has been opened for him.

One kind of L/C issued in the event of an intermediary trade is a back-to-back L/C. It is occasionally necessary for intermediary businesses, such trading houses, to open L/Cs with suppliers and receive export L/Cs from buyers. For the intermediary firm that is

protected by the Export L/C (Master L/C), SMBC will issue an L/C. "Back-to-back L/C" is the name given to this L/C.

### Costing of Letter of Credit

<b>Letter of Credit Charges as per State Bank of India</b>	
<b>Charges for opening of Letter of Credit</b>	<b>Yearly (approx.)</b>
Letter of Credit Opening Charges (Above charges are inclusive of commitment fees and usance charges)	1.90%
Letter of Credit Discounting Charges (Above charges is inclusive of Interest cost only, and such cost is varies with party to party depends on the companies rating, exposure and their relation with banker's. Such cost can't go below the bank's base rate)	10.10%
Other Charges (Approx) (Above charges are inclusive of Discounted LC commission of agent, LC Handling charges and Postage charges of bank)	1.46%
<b>Total finance cost for using LC facility</b>	<b>13.46%</b>

### Case Study

ABC Limited, the buyer, wishes to purchase Rs. 1,00,000 worth of raw material from XYZ Limited, the seller. However, the seller need a Letter of Credit to ensure payment. How will ABC Limited obtain this material? Describe?

### Solution

1. First, ABC Limited requests a letter of credit for Rs. 1,00,000 in favor of XYZ Limited from his bank.
  2. The buyer's bank forwards the LC to its correspondent bank (advising or confirming) after approving it out of their sanctioned limit and setting aside any appropriate margin.
  3. The advising bank will verify the LC and send the seller (beneficiary) the original LC.
  4. After shipping the products, the seller (beneficiary) confirms and develops the documentation needs in accordance with the LC's terms and conditions.
  5. The seller gives the advising or confirming bank the necessary paperwork so that payment can be processed.
  6. The advising or verifying bank checks the documents to make sure they adhere to the LC's terms and conditions.
  7. The advising or confirming bank will claim the funds by debiting the issuing bank's account in the manner described below, if the documents are accurate.
- After obtaining the documentation, waiting for the issuing bank remits.
  - Pay back at a different bank as specified in the credit.

### Note

According to RBI guidelines, capital goods LCs are valid for three years after the date of issuance, while raw material LCs are valid for one year.

### **Conclusion**

In the context of both domestic and foreign trade, letters of credit are crucial tools. They offer security to the exporter, ensuring that he will be paid when he ships the goods, as well as to the importer, ensuring that he will receive the items. Additionally, letters of credit facilitate seamless transactions. It provides stability to the mechanism, particularly from the standpoint of the importer and exporter. For example, the parties have little to no prior trading experience; the letters of credit allow them to operate with assurance and stability.

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