

Letter of credit essay



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INTRODUCTION Letter of credit is a commercial device involving three parties: the issuer (usually a bank), the customer and the beneficiary. The customer, in essence, buys the letter of credit from the issuer.

That is, the customer pays a fee for the issuance of the letter of credit and agrees to be responsible to the issuer for reimbursement of any funds which the issuer pays to the beneficiary. The issuer is then bound to honor the demand of the beneficiary for payment of the letter of credit, as long as the demand is in compliance with the conditions of the letter of credit, including presentation of appropriate documents. (D. Brinkman. , 1997) Letters of credit have increasingly become the first and last resort for many credit executives attempting to eliminate transaction risks, and they are essential to both domestic and international trade.

Letters of credit are particularly important to international commerce. A letter of credit is a commercial device involving 3 parties: 1. the issuer, 2. the customer, and 3. the beneficiary. The strict compliance doctrine requires the seller/beneficiary to present documents that conform to a strict reading of the letter of credit. Letters of credit are always conditioned upon the submission of documents, not extrinsic facts. An issuer may dishonor a letter of credit if the documents are fraudulent or if there is fraud in the transaction. (D. Brinkman, 1997)

METHODOLOGY The methodology for this paper is from reading and Internet research. The scope for this project centers on Letter of Credit and the cases involves with Letter of Credit. Materials from research from the internet as well as online Journals, articles through the internet were also conducted.

LITERATURE REVIEW Based on www.wikipedia.org, Letter of Credit derives from the French word ‘accreditif’, a power to do something which in turn is derivative of the Latin Word ‘accreditivus’, meaning trust.

But the simple definition of Letter of Credit is an undertaking by a bank to make payment to a named beneficiary within a specified time against the presentation of documents which comply strictly with the terms of the letter of credit. (SITPRO International Guide) In the www.investorwords.com, Letter of Credit is a binding document that a buyer can request from his bank in order to guarantee that the payment for goods will be transferred to the seller. Basically, a letter of credit gives the seller reassurance that he will receive the payment for the goods.

In order for the payment to occur, the seller has to present the bank with the necessary shipping documents confirming the delivery of goods within a

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given time frame. It is often used in international trade to eliminate risks such as unfamiliarity with the foreign country, customs or political instability.

FINDINGS Introduction – What is Letter of Credit Letters of Credit are commonly used in international trade. They are issued by larger banks and contain a promise to pay a seller upon receipt of goods by a buyer if certain conditions outlined in the letter of credit have been met.

Not only that, it is basically an arrangement whereby the applicant (the importer) requests and instructs the issuing bank (the importer) or the issuing bank acting on its own behalf. In Allen. N (1996), there are generally three principals which govern the use of letter of credit: 1) The banks' responsibility to deal in documents only; 2) the rule of strict constructions, which dictates that the terms and conditions of the letter of credit are to strictly adhered to; and 3) the rule of independence, which mandates that the letter of credit is to be considered independent from the sales contract or any other agreement between the parties.

Parties to Letter of Credit When an exporter asks for payment by letter of credit, he is transferring the risk of non-payment by the buyer to the issuing Bank – and the Confirming Bank if the letter of credit is confirmed – providing the exporter presents the required documents in strict compliance with the credit, with the exception of cash in advance. For the exporter a letter of credit is the most secure method of payment in international trade provided the terms of the credit are met. All parties in the letter of credit transaction deal with documents, not goods.

The following diagram shows those involved in a letter of credit transaction:

_ Figure 1: Parties to Letter of Credit _ _ Figure 3: Letter of Credit – Process

Types of Letter of Credit There are few types of Letter of Credit in the market. They are: Irrevocable Unconfirmed Confirmed Standby Letter of Credit Revolving Letter of Credit Transferable Letter of Credit Back to Back Letter of Credit Irrevocable It can be neither amended nor cancelled without the agreement of all the parties to the credit.

The Issuing bank gives a binding undertaking to the Beneficiary provided all the credit terms and conditions are fulfilled. Under UCP 600 all letters of credit are irrevocable. Unconfirmed A letter of credit forwarded by the Advising bank directly to the exporter without adding its own undertaking to make payment or accept responsibility for payment at a future date, but confirming its authenticity Confirmed Where a bank usually in the Beneficiary's country, adds its own undertaking confirming that payment will be made as long as compliant documents are presented.

This commitment holds even if the Issuing bank or the Applicant fails to make payment. Confirmation gives the exporter added security, particularly if the standing of the Issuing bank is unknown or the current political and economic state of the importer's country is uncertain. A bank will make an additional charge for confirming a letter of credit. Confirmation costs will vary according to the country involved, but for many countries considered a high risk it will be between 2%-8% Standby Letter of Credit

A secondary payment mechanism used as support where an alternative, less secure, method of payment has been agreed The parties involved with the

transaction do not expect that the letter of credit will ever be drawn upon. They are also used in the United States of America in place of bank guarantees. Often used to guarantee performance or to strengthen the credit-worthiness of a customer. Should the exporter fail to receive payment from the importer he may claim under the standby letter of credit. Certain documents are likely to be required to obtain payment including: The standby letter of credit itself;

Sight draft for the amount due; Copy of the unpaid invoice; Proof of dispatch; and A signed declaration from the Beneficiary stating that payment has not been received by the due date and therefore reimbursement is claimed by letter of credit. The International Chamber of Commerce rules for operating standby letters of credit are UCP600 and ISP98 International Standby Practices. Revolving Letter of Credit Used for regular shipments of the same commodity between the same exporter and importer. The credit must state that it is a revolving letter of credit.

It may revolve either automatically or subject to certain provisions. Avoids the need for repetitious arrangements for opening or amending letters of credit which can revolve in relation to time or value. If the credit is time revolving once utilized it is re-instated for further regular shipments until the credit is fully drawn. If the credit revolves in relation to value once utilized and paid the value can be reinstated for further drawings. Transferable Letter of Credit The exporter has the right to request the paying or negotiating bank to make part (or all) of the credit value available to third parties.

Useful for those acting as middlemen, especially where there is a need to finance purchases from third party suppliers. At the request of the (first) Beneficiary, it may be made available in whole or in part to another (second) Beneficiary. A credit may be transferred in part to more than one second Beneficiary. Back to Back Letter of Credit Can be used as an alternative to the transferable letter of credit. A letter of credit is used as security to establish a second letter of credit issued by the Advising Bank in favor of the exporter's merchandise supplier –rather than transferring the original letter of credit to the supplier.

Many banks are reluctant to issue back to back letters of credit due to the level of risk to which they are exposed, whereas a transferable credit will not expose them to risk higher than that under the original credit Documents Required By Letter of Credit All documents must conform to the Letter of Credit and be consistent with each other. There are basically three forms of documents which are the financial claim, transport document and lastly other documents. Governing Rules under Letter of Credit

In practice, a letter of credit obtained from a bank will usually state that the transaction is governed by both sets of rules. Both the Uniform Commercial Code (UCC) and Uniform Customs and Practice for Documentary Credits (UCP) have codified the rule of independence. Uniform Commercial Code (UCC) The Uniform Commercial Code (UCC or the Code) is one of a number of uniform acts that have been promulgated in conjunction with efforts to harmonize the law of sales and other commercial transactions in all 50 states within the United States of America.

This objective is deemed important because of the prevalence today of commercial transactions that extend beyond one state (for example, where the goods are manufactured in state A, warehoused in state B, sold from state C and delivered in state D). The UCC deals primarily with transactions involving personal property (moveable property), not real property (immovable property). (Wikipedia. com) Uniform Custom and Practice for Documentary Credits (UCP) The Uniform Customs and Practice for Documentary Credits (UCP) is a set of rules on the issuance and use of letters of credit.

Historically, the commercial parties, particularly banks, have developed the techniques and methods for handling letters of credit in international trade finance. This practice has been standardized by the ICC (International Chamber of Commerce) by publishing the UCP in 1933 and subsequently updating it throughout the years. The ICC has developed and moulded the UCP by regular revisions, the current version being the UCP500. The result is the most successful international attempt at unifying rules ever, as the UCP has substantially universal effect.

The latest revision was approved by the Banking Commission of the ICC at its meeting in Paris on 25 October 2006. This latest version, called the UCP600, formally commenced on 1 July 2007. ICC and the UCP Function of the ICC is the preparation and promotion of its uniform rules of practice. The ICC's aim is to provide a codification of international practice occasionally selecting the best practice after ample debate and consideration. The ICC rules of practice are designed by bankers and merchants and not by legislatures with political and local considerations.

The rules accordingly demonstrate the needs, customs and practices of business. Because the rules are incorporated voluntarily into contracts, the rules are flexible while providing a stable base for international review, including judicial scrutiny. International revision is thus facilitated permitting the incorporation of the changing practices of the commercial parties. ICC, which was established in 1919, had as its primary objective facilitating the flow of international trade at a time when nationalism and protectionism threatened the easing of world trade.

It was in that spirit that the UCP were first introduced – to alleviate the confusion caused by individual countries' promoting their own national rules on letter of credit practice. The aim was to create a set of contractual rules that would establish uniformity in practice, so that there would be less need to cope with often conflicting national regulations. The universal acceptance of the UCP by practitioners in countries with widely divergent economic and judicial systems is a testament to the rules' success. Who can become a member of ICC? Corporations and companies in all sectors; National professional and sectoral associations;

Business and employers federations; Law firms and consultancies; Chambers of commerce; Individuals involved in international business. Autonomy of Letter of Credit The autonomy of the letter of credit governs the rule that the paying bank, as the agent of the bank which issues the letter of credit, will have to pay without conditions if the beneficiary of the letter of credit complies with the requirements for payment under the letter of credit. This means that the terms and conditions under the sales and purchase contract

between the seller and buyer will cause no effect to the payment by the bank under the letter of credit.

For example, if the letter of credit requires a documentary check, and the seller obtaining benefits from such letter of credit provides to the bank the full and complete documents as demanded by such letter of credit, the bank will have to absolutely make the payment to the seller, except in the case of non-compliance with the documents or fraud. This point was strongly expressed in an international case law in New York (*O'Meara (Maurice) Co v National Park Bank* 146 NE 636 (1925)), which involved a paper trading and it was said: The bank ... was under no obligation to ascertain, either by a personal examination or otherwise, whether the paper conformed to the contract between the buyer and the seller. The bank was concerned only in the drafts and the documents accompanying them ... If the drafts, when presented, were accompanied by proper documents, then, it was absolutely bound to make the payment under the letter of credit, irrespective of whether it knew, or had reason to believe, that the paper was not of the tensile strength contracted for".

It could be concluded that the bank does not care whether the seller has committed a breach under the contract of sale or not, at the time of the seller submitting the documents. The bank will have a duty to pay under the conditions of the letter of credit even though the bank knows that the seller has breached the sales contract. This is based on the autonomy principle that makes the letter of credit seem independent and severable from the sales contract, which is an underlining contract between the seller and buyer.

The autonomy of the letter of credit will be an advantage in international sales because it leads to successful agreed terms of goods delivery and price payment between the seller and the buyer, so that the seller will have to present documents of delivery in order to conform with the terms of the letter of credit, and the buyer will have to reimburse the bank upon the bank's payment to the seller in compliance with the terms of the letter of credit. Doctrine of Strict Compliance

According to the contract between applicant and issuing bank, the bank is obliged to observe the borders of the commission given to it and fulfils that request by observe the doctrine of strict compliance. But the doctrine of strict compliance prevails in all the contracts which occur in a letter of credit transaction: the contract between buyer and banker, the contract between banker and seller and between issuing and correspondent banks. Definition – Doctrine of Strict Compliance “ There is no room for documents which are almost the same, or which will do just as well... f the bank does as it is told, it is safe; if it declines to do anything else, it is safe; if it departs from the conditions laid down, it acts at own risk. ”. This short definition of strict compliance was developed in 1927 by an English court. The rule “ de minimis non curat lex” (rule of insignificance) does not apply in letter of credit transactions. Although the bank? s duty is limited to check the documents “ on their face”, they have to fulfill that obligation strictly so that the buyer can enjoy the protection of the documents which he has instructed the bank to collect.

On their face means that a bank need not ask itself whether the documents may perhaps be false, or whether the goods declared to have been shipped

have in fact been shipped, or whether the document may have become worthless after the moment at which it was issued: The actual situation does not concern the bank, except in some cases like. Problem with Doctrine of Strict Compliance Different interpretation of strict compliance Strict compliance is interpreted by courts and in different countries. Literal compliance

Literal compliance generally means that the terms and conditions of the letter of credit must be fulfilled “ literal” letter by letter. The bank is obliged to act within the frontiers of the given, formal and precise banking commission because the underlying sale contract between applicant and beneficiary lies outside knowledge and judgment of the bank. Where a bank receives the documents with a request for payment, it pays at its peril against documents which do not comply exactly with the terms of the credit.

Reasons for strict compliance

Banks are no experts regarding goods and industries; they do not have the knowledge to judge about goods and they cannot overview the terms and conditions between the applicant and the beneficiary. Therefore exists the danger that even discrepancies that appear insignificant cause big damages to the beneficiary. A survey in the 1980s found out that there have been discrepancies in over 60% of the presentations of documents. But even if discrepancies are rampant and many of them can be easily remedied or waived by bankers decision and customers agreement, it is still necessary for the banks to protect themselves and their customers. 58 Even art. 15 of UCP 500 contains a disclaimer for many risks, banks can be liable for losses and damages: if a bank do not fulfill its obligation to examine the documents

in a correct way, it is not possible that it can refer to the disclaimer. Wide literal compliance Another opinion demands a wider compliance: where it can be shown that the supposed discrepancy results from a patent error, it would be unrealistic to treat the entire tender as invalid by reason only of a technical slip or mistake.

To treat any typographical error or patent mistake as a discrepancy would convert the commercial transaction covered by the letter of credit into a proof reading exercise. The kind and relevance of the mistake is therefore crucial, but not only if there is a mistake which is perhaps irrelevant for all parties. A discrepancy may not affect the value or merchantability of the goods, and may thus appear merely technical. In such a case, a bank would nonetheless be obliged to found the documents acceptable. Case Study UNITED BANK LTD. v. BANQUE NATIONALE DE PARIS & ORS. English Scottish and Australian Bank Ltd v. Bank of South

Africa [1922] Lloyd Rep 21 Bailhache J said: “ It is elementary to say that a person who ships in reliance on a letter of credit must do so in exact compliance with its terms. It is also elementary to say that a bank is not bound or indeed entitled to honour drafts presented to it under a letter of credit unless those drafts with the accompanying documents are in strict accord with the credit as opened” Moralice (London) Ltd. V. E D & F Man [1954] 2 Loyd’s Rep 526 The Court held that the de minimis rule did not apply in a letter of credit transaction. There the goods involved was 500 metric tons of sugar. The documents showed only 499. metric tons. McNair J held that the confirming bank could not be compelled to pay on the letter of credit and neither could the bank have “ as against their principal, the Iraqi
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buyer, justified a payment of that sum against the documents in that form. ” The Court held this notwithstanding that the beneficiary offered to draw a slightly lesser amount in proportion to the shortfall. Some courts insist upon literal compliance, so that a misspelled name or typographical error voids the exporter’s/beneficiary’s/seller’s demand for payment. Other courts require payment upon substantial compliance with documentary requirements.

The bank may insist upon strict compliance with the requirements of the L/C. In the absence of conformity with the L/C, the Seller cannot force payment and the bank pays at its own risk. Sellers should be careful and remember that the bank may insist upon strict compliance with all documentary requirements in the LC. If the documents do not conform, the bank should give the seller prompt, detailed notice, specifying all discrepancies and shortfalls. Conclusion In conclusion, Letters Of Credit have become a very prominent mode of payment in the trading as compared to the other alternatives available.

The hassle free nature of Letter of Credit and the assurance attached with them have played a major role in their success. The variety Letter of Credit and the flexibility involved with it have enabled Letter of Credit to be used in all trade practices be it national or international. Various banks have also started giving these Letter of Credit services to customers thus facilitating the trade even further. Bibliography 1. <http://en.wikipedia.org> 2. www.sitpro.org.uk 3. International and Comparative Trade Law, S. Johan, University of Uppsala, 2004. 4. UCP 600 5. <http://www.iitk.ac.in/ime>