**LETTER OF CREDIT**

A letter of credit is a document issued by a third party that guarantees payment for goods or services when the seller provides acceptable documentation. Letters of credit are usually issued by banks or other financial institutions, but some creditworthy financial services companies, like insurance companies or mutual funds, might issue letters of credit under certain circumstances.

A letter of credit generally has **three** participants.

* First, there is the **beneficiary**, the person or company who will be paid.
* Next, there is the **buyer or applicant**of the goods or services. This is the one who needs the letter of credit.
* Finally, there is the **issuing bank**, the institution issuing the letter of credit.

**TYPES AND FEATURES OF LETTERS OF CREDIT**

Most letters of credit are import/export letters of credit, which, as the name implies, are letters of credit that are used in international trade. The same letter of credit would be termed an import letter of credit by the importer and an export letter of credit by the exporter. In most cases, the importer is the buyer and the exporter is the beneficiary.

1. **Revocable letters of credit**

A revocable letter of credit can be changed or cancelled by the bank that issued it at any time and for any reason by either the buyer or the issuing bank with no notification to the beneficiary,

1. **Irrevocable letters of credit**

An irrevocable letter of credit cannot be changed or cancelled unless everyone involved agrees irrevocable letters of credit provide more security than revocable ones.

1. **Confirmed letters of credit**

A confirmed letter of credit is one where a second bank agrees to pay the letter of credit at the request of the issuing bank. While not usually required by law, an issuing bank might be required by court order to only issue confirmed letters of credit if they are in receivership.

1. **Unconfirmed letters of credit**

A letter of credit that is assured only by the issuing bank and does not need a guarantee by the second bank. Mostly the letters of credit are an unconfirmed letter of credit.

1. **Deferred payment letters of credit**

**Under such letter of credit the importer has the facility to make payments in instalments.**

1. **With resource letters of credit**

Under such letter of credit the drawer of the draft is liable to the holder in due course if the draft is not honored by the paying bank

1. **Without resource letters of credit**

Under this the drawer is not liable if the draft gets dishonored.

1. **Commercial letters of credit**

This is a standard letter of credit that’s commonly used in international trade, and may also be referred to as a documentary credit. Letters of credit provide security to buyers and sellers: the bank guarantees payment as long as documents are produced by the seller.

1. **Clean letters of credit**

Under such letter of credit no conditions are attached to the draft and the issuing bank makes payments up to the amount of the credit.

1. **Fixed letters of credit**

A fixed letter of credit issued for a specified period of time and for fixed amount. Such lc may be written for a short time period, covering one shipment of gods and one single payments.

1. **Revolving letters of credit**

Under this type of letter of credit the amount of credit is automatically renewed or reinvested once the credit conditions have been fulfilled. This is useful if the shipments are to be made periodically, as contracted between the buyer and seller, a single revolving letter of credit can cover several transactions between the same buyer and seller.

1. **Back-to-back letters of credit**

A letter of credit which is commonly used in a transaction including an intermediary. There are two letters of credit, the first issued by the bank of the buyer to the intermediary and the second issued by the bank of an intermediary to the seller.

1. **Red clause letter of credit**

Under such letter of credit the opening bank authorities the negotiating bank to provide finance to the exporter so the he can purchase goods for the shipments. Such type of advances are called pre-shipment advances. The terms and conditions were typically written in red ink.

1. **Green clause letters of credit**

A letter of credit that pays advance to the seller just not against the written undertaking a receipt, but also a proof of warehousing the goods.

1. **Standby letters of credit**

A standby letter of credit is an assurance from a bank that a buyer is able to pay a seller. The seller doesn't expect to have to draw on the letter of credit to get paid.

1. **Transferable letters of credit**

A transferable letter of credit can be passed from one 'beneficiary' (person receiving payment) to others. They're commonly used when intermediaries are involved in a transaction.

1. **Un-transferable letters of credit**

A letter of credit that doesn’t allow transfer of money to any third parties. The beneficiary is the only recipient of the money and cannot further use the letter of credit to pay anyone.

1. **Direct pay letters of credit**

A letter of credit where the issuing bank directly pays the beneficiary and then asks the buyer to repay the amount. The beneficiary may not interact with the buyer.

1. **At sight letters of credit**

A credit that the announcer bank immediately pays after inspecting the carriage documents from the seller

1. **Export/import letters of credit**

The same letter of credit can be called export or import depending on who uses it. The exporter will term it as an exporter letter of credit whereas an importer will term it as an importer letter of credit

**PROCEDURE OF OPERATING LETTER OF CREDIT:**

**Agreements:**

Commercial letters of credit have been used for centuries to facilitate payment in international trade. Their use will continue to increase as the global economy evolves.

Letters of credit used in international transactions are governed by the International Chamber of Commerce Uniform Customs and Practice for Documentary Credits. The general provisions and definitions of the International Chamber of Commerce are binding on all parties. Domestic collections in the United States are governed by the Uniform Commercial Code.

A commercial letter of credit is a contractual agreement between a bank, known as the issuing bank, on behalf of one of its customers, authorizing another bank, known as the advising or confirming bank, to make payment to the beneficiary. The issuing bank, on the request of its customer, opens the letter of credit. The issuing bank makes a commitment to honor drawings made under the credit. The beneficiary is normally the provider of goods and/or services. Essentially, the issuing bank replaces the bank's customer as the payer.

**Performa invoice:**

The billing for the goods and services. It includes a description of merchandise, price, FOB origin, and name and address of buyer and seller. The buyer and seller information must correspond exactly to the description in the letter of credit. Unless the letter of credit specifically states otherwise, a generic description of the merchandise is usually acceptable in the other accompanying documents.

**L.C Margin:**

 LC Margin is the deposit that you keep, in liquid form, with a bank against the LC that the bank has or is going to open. LC Margin is normally some percentage of total LC limit (In Pakistan it is 25% - 30% of total LC Limit). It is treated as an asset by the name of 'LC Margin' and recognized in the balance sheet. I hope this will resolve your problem.

As I have explained to you, bank is guaranteeing the payment. In turn, what guarantee are you providing to bank against the amount of LC? So a margin amount is blocked in your bank account to make the payment under the said letter of credit. Certainly you may ask, what would be the ‘margin’, bank blocks. This amount is determined, purely based on your financial relationship with your bank.

Let us discuss about your creditworthiness with your bank while keeping ‘margin amount to open LC’. If you are a new account holder for your bank and bank does not know your other financial status, you cannot expect any financial support from your Bank. You need to keep 100% margin amount with your bank. If the LC amount is for USD 10000, your amount of USD 10000 is blocked from your account to pay LC amount to your overseas seller on maturity date. You may have a good relationship with your banker for the past many years, and your banker knows your fixed assets, your fixed investments with bank, other financial transactions and are happy with the credit worthiness, bank decides the amount of margin to be collected from you to open the Letter of Credit. It can be from 1% to 100%, as explained.

**Opening of LC:**

You (buyer) entered in to a contract with your overseas supplier to import machinery for production at your factory. As per your contract each other, you (buyer) need to open a Letter of credit (LC). In this case, Letter of credit is opened by your bank (or other opening bank) and beneficiary of letter of credit is your overseas seller of machinery. Letter of credit is a guarantee given by your bank (not you) to your buyer’s bank on account of your buyer. The amount under LC is transferred as per the terms and conditions mentioned in Letter of credit. Please also read other articles about Letter of Credit in same website to know more about Letter of Credit

You can approach your bank to open a Letter of credit. The concerned officer at bank helps you in filling up necessary application to open an LC. Since the LC is opened on the basis of your purchase contract, a copy purchase order / export contract has to be produced with along with other required documents. Your bank may ask you to keep certain percentage of ‘margin amount’ with bank

**Exporters Jobs:**

* Communicate with your customers in detail before they apply for letters of credit.
* Consider whether a confirmed letter of credit is needed.
* Ask for a copy of the application to be fax to you, so you can check for terms or conditions that may cause you problems in compliance.
* Upon first advice of the letter of credit, check that all its terms and conditions can be complied with within the prescribed time limits.
* Many presentations of documents run into problems with time-limits. You must be aware of at least three time constraints - the expiration date of the credit, the latest shipping date and the maximum time allowed between dispatch and presentation.
* If the letter of credit calls for documents supplied by third parties, make reasonable allowance for the time this may take to complete.
* After dispatch of the goods, check all the documents both against the terms of the credit and against each other for internal consistency

**Jobs of exporter’s bank:**

* A letter of credit can be advised to an exporter via an exporter’s bank.
* According to the letter of credit rules exporter’s bank has no payment responsibility against the exporter as long as the exporter’s bank that is not a confirming bank. The exporter’s bank advises the letter of credit and any amendment without any undertaking to honour or negotiate.
* Exporter’s bank has two main responsibilities against the beneficiary of the letter of credit. First of all the exporter’s bank must signify that it has satisfied itself as to the apparent authenticity of the letter of credit or amendment. Secondly the exporter’s bank must ensure that the advice of the lc accurately reflects the terms and conditions of the letter of credit or amendment received from the issuing bank.
* It is also possible to use the services of another bank ("second exporter’s bank") to advise the letter of credit and any amendment to the beneficiary. According to the letter of credit rules first exporter’s bank's and second exporter’s bank's responsibilities are the same against to the beneficiary. By advising the credit or amendment, the second exporter’s bank signifies that it has satisfied itself as to the apparent authenticity of the advice it has received and that the advice accurately reflects the terms and conditions of the credit or amendment received.
* **Issuing banks must advise the letter of credit and subsequent amendments to the beneficiary through the same exporter’s bank.** For example if the leter of credit advised to the beneficiary by the **Exporter’s bank A** in country Y, subsequent amendments must be advised to the beneficiary **by the same bank**
* If a bank is requested to advise a credit or amendment but elects not to do so, it must so inform, without delay, the bank from which the credit, amendment or advice has been received.
* If a bank is requested to advise a credit or amendment but cannot satisfy itself as to the **apparent authenticity of the credit**, the amendment or the advice, it must so inform, without delay, the bank from which the instructions appear to have been received. If the exporter’s bank or second exporter’s bank elects nonetheless to advise the credit or amendment, it must inform the beneficiary or second exporter’s bank that it has not been able to satisfy itself as to the apparent authenticity of the credit, the amendment or the advice
* An **advising bank** (also known as a notifying bank) advises a [beneficiary](https://en.wikipedia.org/wiki/Beneficiary) (exporter) that a [letter of credit](https://en.wikipedia.org/wiki/Letter_of_credit) (L/C) opened by an [issuing bank](https://en.wikipedia.org/wiki/Letter_of_credit) for an [applicant](https://en.wikipedia.org/wiki/Letter_of_credit) (importer) is available. Advising Bank's responsibility is to authenticate the letter of credit issued by the issuer to avoid fraud. The advising bank is not necessarily responsible for the payment of the credit which it advises the beneficiary of. The advising bank is usually located in the beneficiary's country. It can be (1) a branch office of the issuing bank or a [correspondent bank](https://en.wikipedia.org/wiki/Correspondent_bank), or (2) a bank appointed by the beneficiary. Important point is the beneficiary has to be comfortable with the advising bank.
* In case (1), the issuing bank most often sends the L/C through its branch office or correspondent bank to avoid fraud. The branch office or the correspondent bank maintains specimen signature(s) on file where it may counter-check the signature(s) on the L/C, and it has a coding system (a secret test key) to distinguish a genuine L/C from a fraudulent one ([authentication](https://en.wikipedia.org/wiki/Authentication)) .
* In case (2), the beneficiary can request the applicant to specify his/her bank (the beneficiary's bank) as the advising bank in an L/C application. In many countries, this is beneficial to the beneficiary, who may avail the reduced [bank charges](https://en.wikipedia.org/wiki/Bank_charge) and fees because of special relationships with the bank. Under normal circumstances, advising charges is standard and minimal. In addition, it is more convenient to deal with the beneficiary's own bank over a bank with which the beneficiary does not maintain an account.

**BENEFITS OF THE LETTER OF CREDIT**  
  
The letter of credit is the safest, most secure and most convenient settlement method for international transactions. There are a number of advantages both for the seller/exporter and the buyer/importer.  
  
**Benefits to Sellers**  
•Assures the security of payment from an international bank once the terms of the letter of credit are met.  
•Seller can determine when payment will be satisfied and ship the goods accordingly.  
•Bank bears the responsibility of oversight.  
•Seller does not have to open an account and grant payment terms to buyer. Credit risk is nearly eliminated. The risk of exchange control created with payment delays is greatly reduced.  
•Provides seller easier access to financing once the letter of credit has been issued.  
•Once the bank confirms the letter of credit, political and economic risk and questions regarding the buyer's ability to pay are eliminated. The confirming bank is obliged to pay, even if the buyer goes bankrupt, provided the terms of the letter of credit are met.  
  
**Benefits to Buyers**  
•Facilitates financing--for example, creating banker's acceptances.  
•Buyer can confirm that the merchandise is shipped on or before the required date.  
•It is safer to deal with bank than to prepay.  
•Buyer may get better terms and prices.

•No cash is tied up in the process. Buyer does not have to pay cash up front to a foreign seller before receiving the documents of title to the goods purchased. This is particularly helpful when the buyer is unfamiliar with local suppliers and laws.  
•Protects the buyer since the bank only pays when the supplier complies with the specific terms and conditions and produces the documents required by the buyer.  
•The buyer can build safeguards into the letter of credit, including inspection of the goods and quality control, and set production and delivery times.

**OTHER ADVANTAGES OF LC:**

**Advantages of Letters of Credit**

**Instant liquidity**

* The terms of a letter of credit can specify that fax presentments are allowed and that the draw must be honored (or notice of dishonor given) within a few days or less.
* In some cases where letters of credit secure bonds, commercial paper or secure clearing obligations owed to commodities or security exchanges, the letter of credit will be payable on the same day presentation is made. – Payment is usually via wire transfer of funds by the issuer to the beneficiary’s account.

**Credit of a the Issuer Is Added**

* By use of a letter of credit, the beneficiary is assured that the payment obligation is backed by credit of a bank which is substituted for or added to the credit of a corporate or individual applicant.

**Independence of issuer**

* Except for material fraud, the issuer’s obligation to honor is independent of the obligations of the parties (applicant and beneficiary) and their disputes over the underlying contract which the letter of credit supports.
* The issuer only looks to see if the documents presented are timely and conform to the documentary conditions specified in the letter of credit.
* The issuer does not and should not involve itself in issues or investigations of whether the underlying contract has been properly performed.

**Automatic Stay and Preferences**

* A draw on a letter of credit to pay for an obligation of a bankrupt applicant is not normally regarded as transfer of the bankrupt’s assets; rather the proceeds transferred are regarded as funds of the issuing bank. – As a result, courts will not normally enjoin a draw on a letter of credit even though the applicant has filed for bankruptcy.
* Because the draw on the letter of credit is of funds of the issuing bank, a court will not normally set aside as preferential a pay down of a debt from a draw on a letter of credit. Exception: Indirect preferences when a collateralized LC is issued for an already existing debt.

**Pay now, litigate later**

* Courts have taken the view that if there is a problem with the underlying contract or its performance while a draw is being made or about to be made on a letter of credit, the beneficiary should be entitled to draw and hold or use the proceeds until the dispute or litigation is resolved.
* Courts have used the phrase – “pay now, litigate later” to describe the beneficiary’s rights against the obligation of the issuer and applicant to allow the beneficiary to draw on the letter of credit.

**Adaptability.**As is shown from the variety of uses for letters of credit enumerated above, a letter of credit can be tailored to secure almost any type of obligation. The draw conditions can require elaborate or simple certifications identifying the obligation secured and the events justifying the draw.

**Statute of Limitations**  
some courts have held that even though an underlying obligation which a letter of credit supports is no longer enforceable under a statute of limitations, the LC can still be drawn upon by the beneficiary to pay the debt owed. See Williams Service Group v. National Union Fire Ins. Co., 2012 WL 5233558 (11th Cir. Oct. 23, 2012).

**Payment against right to receive goods** Documentary credits used in international trade provide that the beneficiary must present to the issuer shipping documents, including bills of lading, to receive payment.

These documents are passed along to the applicant to enable it to receive the goods shipped which are being paid from a draw on the letter of credit.

**LETTER OF CREDIT DISCREPANCIES**

“The [issuing bank](http://www.businessdictionary.com/definition/issuing-bank.html) of a [discrepancy](http://www.businessdictionary.com/definition/discrepancy.html) L/C is not obliged to [pay](http://www.businessdictionary.com/definition/pay.html) its [beneficiary](http://www.businessdictionary.com/definition/beneficiary.html) and (if it is a confirmed L/C) nor is the [confirming bank](http://www.businessdictionary.com/definition/confirming-bank.html). Such L/Cs are normally referred back to the [buyer](http://www.businessdictionary.com/definition/buyer.html) or [importer](http://www.businessdictionary.com/definition/importer.html) (the '[account party](http://www.businessdictionary.com/definition/account-party.html)') for [instructions](http://www.businessdictionary.com/definition/instructions.html).”

**Letter of credit that**

(1)Does not comply with the [terms and conditions](http://www.businessdictionary.com/definition/terms-and-conditions.html) under which it was [established](http://www.businessdictionary.com/definition/establish.html),

(2)Is without a [required](http://www.businessdictionary.com/definition/required.html) item of [information](http://www.businessdictionary.com/definition/information.html), or

(3)The information provided is inconsistent with the [associated](http://www.businessdictionary.com/definition/associated.html) [documents](http://www.businessdictionary.com/definition/documents.html).

**CHANNELS OF EXPORT TRADE**

* **Direct sales from country**

When the goods are famously known in other country, the demand originates on its own. The exporter will receive orders from the potential importer and he can decide where to export

* **Overseas agent**

Exports can also be made through overseas agent. Overseas agents are employed by thee exporters to promote their products in the foreign markets. Such agents themselves belong to that country where they are posted, they are in a better position to convince their people about the uses and advantages of imported goods.

* **Overseas sale depots:**

If exporter has to meet huge demand of goods from countries of a particular region then it is beneficial to have one sale depot in any one of the country. The demand for the countries of that region the can be met from that depot. This will result in saving of communication and transportation cost

* **Franchising:**

This mode of business is now gaining popularity almost in all parts of word. Under this the exporter instead of exporting goods to a particular country gives the license to a producer or manufacturer of that country, allowing him to produce similar products under a similar brand name .the exporter recovers a franchising fee and royalty based on the sales made by license holder.

**SOME IMPORTANT TERMS:**

**C & F**

The term **C. & F**. or C.F. means that the price so includes **cost and freight** to the named destination.

**C. I .F:**

The term C.I.F. means that the price includes in a lump sum the **cost of the goods** and the **insurance** and **freight** to the named destination.

**C. I .F & C. I:**

CIF means cost, insurance, freight and CI stands for commission and interest of brokers, middlemen, agent etc. when goods are imported on C. I. F & C.I basis this means that price stated included cost of insurance, freight, commission and interest.

**F. O .B:**

Indicating "**FOB** port" means that the seller pays for transportation of the goods to the port of shipment, plus loading costs. The buyer pays cost of marine **freight** transport, insurance, unloading, and transportation from the arrival port to the final destination

**PROBLEMS FACED BY THE PAKISTANI EXPORTERS:**

Pakistan is facing huge trade deficit and severe imbalance of payments due to low exports. Pakistani exporters have been consistently facing many problems.

Following are the causes of our low exports and the problems that our exporters face:

* **Lengthy Documentary Procedures:**

First of all our exporters have to pass through a lengthy and tedious documentary procedure. This is wastage of time.

* **Limited Market:**

Pakistani exporters face a limited and narrow market for their exports. Thus they are not in a better bargaining position and often have to sell their products at low profit margin.

* **Fierce Competition:**

Evan in that limited market, our exporters face fierce competition from the traders of others countries. This deteriorates the bargaining position of our exporters.

* **Low Priced Goods:**

Pakistan’s exporters most of the time exports such which are of primary nature and low price. Such goods are produced in other countries also. So in order to sell our products, we have to decrease the price by reducing profit margin.

* **Delay in Rebate:**

According to Government policy, exporters are entitled to rebate in certain circumstances .However, it is the usual practice that payment of rebate is delayed by Government agencies and exporters feel discomfort and disappointment.

* **Standardized Goods:**

The developed countries of the world have specified standard of quality. So in order to trade with them, our exporters have to ensure that such standards are duly observed by producers. However, due to lack of proper quality control over production process, our exporters face difficulties in meeting these standards.

* **Foreign Exchange Fluctuation:**

Foreign change fluctuation affects the exporters badly. As exporters are going to sell the products abroad,

Their receipts have to pass through the conversion from foreign currency to the local currency.

* **Risk of Export Trade:**

There are numerous risks attached to exports trade. There may damage or loss during the journey of port of destination.

* **Imports Quotas/Cartels:**

Different countries of the world had formed cartels and imposed trade quotas. These countries have specified quota for the import of the particular goods from Pakistan. These mean that that our exporters either cannot make any export to these countries or they can only export a particular amount of goods. Such quotas and trade restrictions also add to the problems of our exporters.

**Pakistan’s Exports Threats:**

Pakistan’s image as an exporter of low quality, low prices of selected goods and services, restricting demand for high quality products from Pakistan, a Catch-22 position Law and order/security situation deterring the importers to visit Pakistan or participate in our trade exhibitions Energy crises creating crises of confidence among the importers about the certainty of timely delivery of exports orders. Emergence of strong competitors in the region in the same groups where Pakistan has the comparative edge Increasing concerns of the importing countries about social and environmental issues- the green technologies, child labor, gender balance, bonded labor etc Shifting of Pakistani industrialists to other countries due to push/pull factors Pakistan’s major export markets the United States, the European Union, China and the Middle East are experiencing an economic slowdown.

**CONCLUSION:**

These are the problems faced by the Pakistani exporters during the trade with other countries. There is need that Government takes measures to minimize such risks by providing insurances facilities.

Also international market surveys can help exporters in locating new markets for their products.