Essex
Energy Marketing LLC
Refined Oil Products, Crude Oil, LNG
Spirit Bank Building, 4815 South Harvard, Suite 490, Tulsa, Oklahoma 74135
Telephone: (918) 481-1308 Fax: (918) 481-7426 www.essexenergymkt.com

Financial Instruments

There are two basic forms of Letters of Credit:

Standby (SBLC) and Documentary (DLC).

Documentary Letters of Credit can be either Revocable or Irrevocable, although the first is extremely rare. Irrevocable Letters of Credit can be Confirmed or Not Confirmed. Each type of Credit has advantages and disadvantages for the Buyer and for the Seller, which this information will review. Charges for each type will also vary. However, the more the banks assume risk by guaranteeing payment, the more they will charge for providing the service.

DOCUMENTARY LETTER OF CREDIT (DLC)

A Letter of Credit is a document issued typically by a financial institution that provides an irrevocable payment undertaking to a Beneficiary against complying documents as stated in the Credit. Letter of Credit is abbreviated as an LC or L/C, and often is referred to as a documentary Credit, abbreviated as DC or D/C, documentary Letter of Credit, or simply as Credit (governed by UCP-600 and eUCP).

Once the Beneficiary, or a presenting bank acting on its behalf, makes a presentation to the issuing bank or confirming bank, if any, within the expiry date of the LC (providing the documents complying with the terms and conditions of the LC as well as the applicable UCP and international standard banking practice), the issuing bank or confirming bank, if any, is obliged to honor the LC, irrespective of any instructions from the Applicant to the contrary.

In other words, the obligation to honor (usually payment) shifts from the Applicant to the issuing bank or confirming bank, if any. Non-banks can also issue Letters of Credit, however, parties must balance potential risks. The LC can also be the source of payment for a transaction, meaning that an exporter will be paid by redeeming the Letter of Credit. Letters of Credit are used currently primarily in international trade transactions of significant value, for deals between a supplier in one country and a wholesale customer in another. The parties to a Letter of Credit are usually a Beneficiary who is to receive the money, the issuing bank of whom the Applicant is a client, and the advising bank of whom the Beneficiary is a client. Today almost all Letters of Credit are irrevocable, (i.e. cannot be amended or cancelled without prior agreement of the Beneficiary, the issuing bank and the confirming bank, if any).

IRREVOCABLE DOCUMENTARY LETTER OF CREDIT (ILOC)

This is the most common form of Credit used in international trade. Irrevocable Credits may not be modified or canceled by the Buyer. The Buyer's issuing bank must follow through with payment to the Seller as long as the Seller complies with the conditions listed in the Letter of Credit. Both the Buyer and the Seller must approve changes in the Credit. If the documentary Letter of Credit does not mention whether it is revocable or irrevocable, it automatically defaults to irrevocable. This is often used in international transactions.

REVOCABLE DOCUMENTARY LETTER OF CREDIT

Revocable Credits may be modified or even canceled by the Buyer without notice to the Seller. Therefore, they are generally unacceptable to the Seller.

STANDBY LETTER OF CREDIT (SBLC)

A stipulation that states a Letter of Credit will be called back if the payer defaults. Standby Letters of Credit are issued by banks to stand behind monetary obligations, to insure the refund of advance payment, to support performance and bid obligations, and to insure the completion of a sales contract. The Credit has an expiration date. The Standby Letter of Credit is often used to guarantee performance or to strengthen the credit-worthiness of a customer. A bank will issue a Standby Letter of Credit on behalf of a customer to provide assurances of his ability to perform under the terms of a contract between the Beneficiaries. The parties involved with the transaction do not expect that the Letter of Credit will ever be drawn upon.

TRANSFERABLE LETTER OF CREDIT

This type of Credit allows the Seller to transfer all or part of the proceeds of the original Letter of Credit to a second Beneficiary, usually the ultimate supplier of the goods. The Letter of Credit must clearly state that it is transferable for it to be considered as such. This is a common financing tactic for reseller, intermediaries, and is common in East Asia.

REVOLVING LETTER OF CREDIT

With a Revolving Letter of Credit, the issuing bank restores the Credit to its original amount once it has been used or drawn down. Usually, these arrangements limit the number of times the Buyer may draw down its line over a predetermined period.

RED CLAUSE LETTER OF CREDIT

Red Clause Letters of Credit provide the Seller with cash prior to shipment to finance production of the goods. The Buyer's issuing bank may advance some or all of the funds. The Buyer, in essence, extends financing to the Seller and incurs the risk for all advanced credits.

DEFERRED PAYMENT (Usance) LETTER OF CREDIT

In Deferred Payment Letters of Credit, the Buyer accepts the documents related to the Letter of Credit and agrees to pay the issuing bank after a fixed period. This Credit gives the Buyer a grace period for payment.

BACK-TO-BACK LETTER OF CREDIT

This is a new Letter of Credit opened based on an already existing, nontransferable Credit used as collateral. Traders often use back-to-back arrangements to pay the ultimate supplier. A trader receives a Letter of Credit from the Buyer, and then opens another Letter of Credit in favor of the supplier. The first Letter of Credit serves as collateral for the second Credit.

ASSIGNMENT OF PROCEEDS

The Beneficiary of a Letter of Credit may assign all or part of the proceeds under a Credit to a third party (the assignee). However, unlike a transferred Credit, the Beneficiary maintains sole rights to the Credit and is solely responsible for complying with its terms and conditions. For the assignee, an assignment only means that the paying bank, once it receives notice of the assignment, undertakes to follow the assignment instructions, if and when payment is made. The assignee is dependent upon the Beneficiary for compliance, and thus this arrangement is riskier than a transferred Credit. Before agreeing to an assignment of proceeds arrangement, the assignee should carefully review the original Letter of Credit.

SPECIAL LETTERS OF CREDIT

The following is a brief description of some special Letters of Credit:

There are two forms of irrevocable Letter of Credits:

Unconfirmed Credit (the irrevocable Credit not confirmed by the advising bank). In an unconfirmed Credit, the Buyer's bank issuing the Credit is the only party responsible for payment to the Seller. The Seller's advising bank pays only after receiving payment from the issuing bank. The Seller's advising bank merely acts on behalf of the issuing bank and, therefore, incurs no risk.

Confirmed Credit (the irrevocable confirmed Credit). In a confirmed Credit, the advising bank adds its guarantee to pay the Seller to that of the Buyer's issuing bank. Once the advising bank reviews and confirms that all documentary requirements are met, it will pay the Seller. The advising bank will then look to the issuing bank for payment. Confirmed Irrevocable Letters of Credit are used when trading in a high-risk area where war or social, political, or financial instability are real threats. Also common when the Seller is unfamiliar with the bank issuing the Letter of Credit or when the Seller needs to use the confirmed Letter of Credit to obtain financing from its bank to fill the order. A confirmed Credit is more expensive because the bank has added liability.

BANK GUARANTEE (BG)

A guarantee from a lending institution ensuring that the liabilities of a debtor will be met. In other words, if the debtor fails to settle a debt, the bank will cover it. A Bank Guarantee enables the customer (debtor) to acquire goods, buy equipment, or draw down loans, and thereby expand business activity.

What is the difference between a Bank Guarantee and a Letter of Credit?

A Bank Guarantee and a Letter of Credit are similar in many ways, but they are two different things. The main difference between the two Credit security instruments is the position of the bank relative to the Buyer and Seller of a good, service or basket of goods or services in the event of the Buyer's default of payment.

These financial instruments are often used in trade financing when suppliers, or vendors, are purchasing and selling goods to and from overseas customers with whom they do not have established business relationships.

A Bank Guarantee is a guarantee made by a bank on behalf of a customer (usually an established corporate customer) should it fail to deliver the payment, essentially making the bank a co-signer for one of its customer's purchases. Should the bank accept that its customer has sufficient funds or Credit to authorize the guarantee, it will approve it.

A guarantee is a written contract stating that in the event of the borrower being unable or unwilling to pay the debt with a merchant, the bank will act as a guarantor and pay its client's debt to the merchant. The initial claim is still settled primarily against the bank's client, and not the bank itself. Should the client default, then the bank agrees in the Bank Guarantee to pay for its client's debts.

This is a type of contingent guarantee. A Bank Guarantee is more risky for the merchant and less risky for the bank. However, this is not the case with a Letter of Credit. While a Letter of Credit is a similar, the principal difference is that it is a potential claim against the bank, rather than a bank's client.

For example, a Seller may request that a Buyer be provided with a Letter of Credit, which must be obtained from a bank and which substitutes the bank's Credit for that of its client. In the event that the borrower defaults, the Seller would go the Buyer's bank for the payment. The Seller's risk is mitigated because it is unlikely that the bank will be unable to pay the debt.

A Letter of Credit is less risky for the merchant, but more risky for a bank. Banks accept full liability in both cases. With a Bank Guarantee, a client can default and the bank assumes the liability. With a line of Credit, liability rests solely with the bank, which then collects the money from its client.

BASIC PROCEDURES FOR ESTABLISHING A LETTER OF CREDIT

The Letter of Credit process has been standardized by a set of rules published by the International Chamber of Commerce (ICC). These rules are called the Uniform Customs and Practice for Documentary Credits (UCP), UCP-600 and eUCP.

The following is the basic set of steps used in a Letter of Credit transaction. Specific Letter of Credit transactions may follow somewhat different procedures.

1. After the Buyer and Seller agree on the terms of a sale, the Buyer arranges for his bank to open a Letter of Credit in favor of the Seller. Note: The Buyer will need to have a line of Credit established at the bank or provide cash collateral for the amount of the Letter of Credit.
2. The Buyer's issuing bank prepares the Letter of Credit, including all of the Buyer's instructions to the Seller concerning shipment and required documentation.
3. The Buyer's bank sends the Letter of Credit to the Seller's advising bank.
4. The Seller's advising bank forwards the Letter of Credit to the Seller.
5. The Seller carefully reviews all conditions stipulated in the Letter of Credit. If the Seller cannot comply with any of the provisions, it will ask the Buyer to amend the Letter of Credit.
6. After final terms are agreed upon, the Seller both executes the following steps and is paid upon the goods being loaded and the Buyer obtaining title documents, or the Seller ships the goods to the appropriate port or location.
7. If payment is expected after shipping the goods, the Seller then obtains the required documents. Please note that the Seller may have to obtain some documents prior to shipment.
8. The Seller presents the documents to its advising bank along with a draft for payment.
9. The Seller's advising bank reviews the documents. If they are in order, it will forward them to the Buyer's issuing bank. If a confirmed Letter of Credit, the advising bank will pay the Seller (cash or a bankers' acceptance).
10. Once the Buyer's issuing bank receives and reviews the documents, it either (1) pays if there are no discrepancies; or (2) forwards the documents to the Buyer if there are discrepancies for its review and approval.

Opening a Letter of Credit

Level of Detail
The wording in a Letter of Credit should be simple, but specific. The more detailed an L/C is, the more likely the Seller will reject it as too difficult to fulfill. At the same time, the Buyer will wish to define in detail what it is paying for.

Type of Credit
Letters of Credit used in trade are usually either irrevocable unconfirmed Credits, or irrevocable confirmed Credits. In choosing which type to open, both the Seller and the Buyer should consider the generally accepted payment processes in each country, the value and demand for the goods, and the reputation of the Buyer and Seller.

Documents
In specifying required documents, it is very important to include those required for customs and those reflecting the agreement reached between the Buyer and the Seller. Required documents usually include the bill of lading, a commercial and/or consular invoice, the bill of exchange, the certificate of origin, and the insurance document. Other documents required may be an inspection certificate, copies of a cable sent to the Buyer with shipping information, a confirmation from the shipping company of the state of its ship, and a confirmation from the forwarder that a certificate of origin accompanies the goods. Prices should be stated in the currency of the Letter of Credit and documents should in the same language as the Letter of Credit.

The Letter of Credit Application

The following information should be addressed when establishing a Letter of Credit.

1. Beneficiary
   The Seller should provide to the Buyer its full corporate name and correct address. A simple mistake here may translate to inconsistent or improper documentation at the other end.
2. Amount
   The Seller should state the actual amount of the Letter of Credit. One can request a maximum amount when there is doubt as to the actual count or quantity of the goods. Another option is to use words like approximate", "circa", or "about" to indicate an acceptable 10 % plus or minus from the stated amount. For consistency, if one uses this wording it will need to be used also in connection with the quantity.
3. Validity
   The Seller will need time to load the goods or ship, and to prepare all the necessary documents. Therefore, the Seller should ensure that the validity and period for document presentation after the loading or shipment of the goods is long enough.
4. Seller's Bank
   The Seller should list its advising bank as well as a reimbursing bank if applicable. The reimbursing bank is the local bank appointed by the issuing bank as the disbursing bank.
5. Type of Payment Availability
   The Buyer and Seller may agree to use sight drafts, time drafts, or some sort of deferred payment mechanism.
6. Desired Documents
   The Buyer specifies the necessary documents. Buyers can list, for example, a bill of lading, a commercial invoice, a certificate of origin, certificates of analysis, etc. The Seller must agree to all documentary requirements or suggest an amendment to the Letter of Credit.
7. Notify Address
   This is the address to notify upon the imminent arrival of goods at the port for loading or at the destination. A notification listing damaged goods is also sent to this address, if applicable.
8. Description of Goods
   The Seller should provide a short and precise description of the goods as well as the quantity involved. Note the comments in step #2 above concerning approximate amounts.
9. Confirmation Order
   With international arrangements, the Seller may wish to confirm the Letter of Credit with a bank in its country.

Amendment of a Letter of Credit

For the Seller to change the terms noted on an irrevocable Letter of Credit, it must request an amendment from the Buyer. The amendment process is as follows:

1. The Seller requests a modification or amendment of questionable terms in the Letter of Credit;
2. If the Buyer and issuing bank agree to the changes, the issuing bank will change the Letter of Credit;
3. The Buyer's issuing bank notifies the Seller's advising bank of the amendment; and,
4. The Seller's advising bank notifies the Seller of the amendment. Tips for Buyers and Sellers

Seller

1. Before signing a sales contract, the Seller should make inquiries about the Buyer's Creditworthiness and business practices. The Seller's bank will generally assist in this investigation.
2. In many cases, the issuing bank will specify the advising and/or confirming bank. These designations are usually based on the issuing bank's established correspondent relationships. The Seller should ensure that the advising/confirming bank is a financially sound institution.
3. The Seller should confirm the good standing of the Buyer's issuing bank if the Letter of Credit is unconfirmed.
4. For confirmed Letters of Credit, the Seller's advising bank should be willing to confirm the Letter of Credit issued by the Buyer's bank. If the advising bank refuses to do so, the Seller should request another issuing bank as the current bank may be or is in the process of becoming insolvent.
5. The Seller should carefully review the Letter of Credit to ensure its conditions can be met. All documents must conform to the terms of the Letter of Credit. The Seller must comply with every detail of the Letter of Credit specifications; otherwise the security given by the Credit is lost.
6. The Seller should ensure that the Letter of Credit is irrevocable.

7. If amendments are necessary, the Seller should contact the Buyer immediately so that the Buyer can instruct the issuing bank to make the necessary changes quickly. The Seller should keep the Letter of Credit's expiration date in mind throughout the amendment process.
8. The Seller should confirm with the insurance company that it can provide the coverage specified in the Letter of Credit, and that insurance charges listed in the Letter of Credit are correct. Typical insurance coverage is for CIF (cost, insurance and freight); often the value of the goods plus about 10 percent.
9. The Seller must ensure that the goods match the description in the Letter of Credit and the invoice description.
10. The Seller should be familiar with foreign exchange limitations in the Buyer's country that could hinder payment procedures.

Buyer

1. When choosing the type of Letter of Credit, the Buyer should consider the standard payment methods in the Seller's country.
2. The Buyer should keep the details of the purchase short and concise.
3. The Buyer should be prepared to amend or re-negotiate terms of the Letter of Credit with the Seller. This is a common procedure in international trade. With irrevocable Letters of Credit, the most common type, all parties must agree to amend the document.
4. The Buyer can reduce the foreign exchange risk by buying forward currency contracts.
5. The Buyer should use a bank experienced in foreign trade as its issuing bank.
6. The validation time stated on the Letter of Credit should give the Seller ample time to produce the goods, or to pull them out of stock.
7. A Letter of Credit is not fail-safe. Banks are only responsible for the documents exchanged and not the goods shipped. Documents in conformity with the Letter of Credit specifications cannot be rejected on grounds that the goods were not delivered as specified in the contract. The goods shipped may not in fact be the goods ordered and paid for.
8. Purchase contracts and other agreements pertaining to the sale between the Buyer and Seller are not the concern of the issuing bank. Only the Letter of Credit terms are binding on the bank.
9. Documents specified in the Letter of Credit should include those the Buyer requires for customs clearance.

COMMON PROBLEMS WITH LETTERS OF CREDIT

Most problems result from the Seller's inability to fulfill obligations stated in the Letter of Credit. The Seller may find these terms difficult or impossible to fulfill, and either tries to fulfill them and fails, or asks the Buyer to amend to the Letter of Credit. As most Letters of Credit are irrevocable, amendments may at times be difficult since both the Buyer and the Seller must agree. Sellers may have one or more of the following problems:

- The shipment schedule cannot be met;
- The stipulations concerning freight costs are unacceptable;
- The price becomes too low due to exchange rates fluctuations;
- The quantity of product ordered is not the expected amount;
- The description of product is either insufficient or too detailed; and,
- The stipulated documents are difficult or impossible to obtain.

Even when Sellers accept the terms of a Letter of Credit, problems often arise late in the process. When this occurs, the Buyer's and Seller's banks will try to negotiate any differences. In some cases, the Seller can correct the documents and present them within the time specified in the Letter of Credit. If the documents cannot be corrected, the advising bank will ask the issuing bank to accept the documents despite the discrepancies found. It is important to note that if the documents are not in accord with the specifications of the Letter of Credit, the Buyer's issuing bank is no longer obligated to pay.