LETTER OF CREDIT: WHAT IS IT AND HOW ONE IS USED

Small and Medium Enterprises Development Authority

Ministry of Industries & Production

Government of Pakistan

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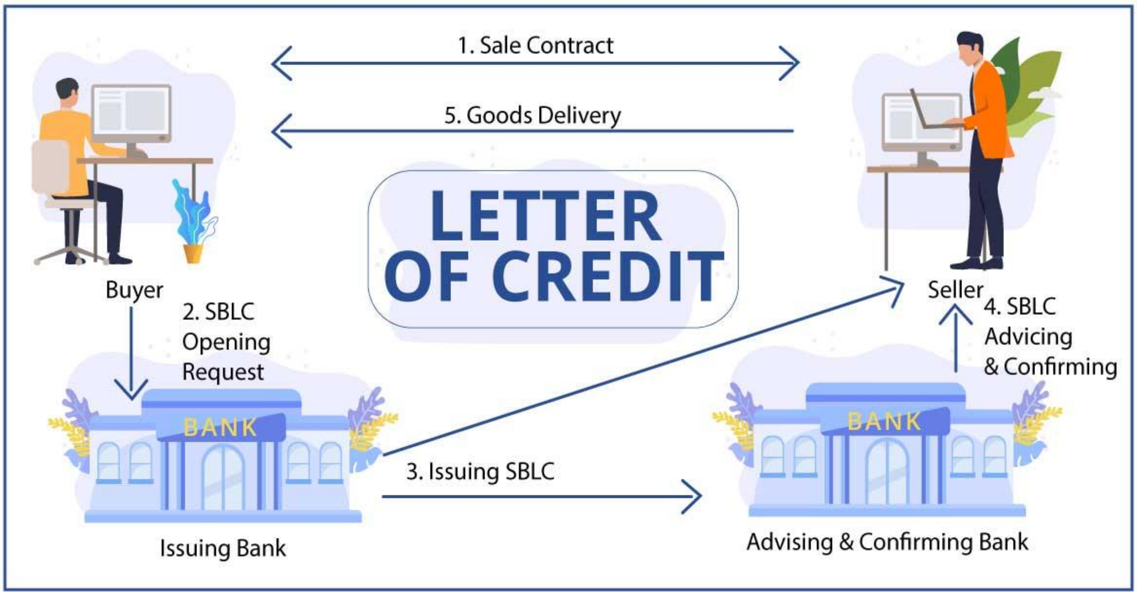

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1. Introduction to SMEDA

The Small and Medium Enterprises Development Authority (SMEDA) was established in October 1998 with an objective to provide fresh impetus to the economy through development of Small and Medium Enterprises (SMEs).

With a mission "to assist in employment generation and value addition to the national income, through development of the SME sector, by helping increase the number, scale and competitiveness of SMEs", SMEDA has carried out 'sectoral research' to identify policy, access to finance, business development services, strategic initiatives and institutional collaboration and networking initiatives.

2. Disclaimer

This information memorandum is to introduce the subject matter and provide a general idea and information on the said matter. Although, the material included in this document is based on data/information gathered from various reliable sources; however, it is based upon certain assumptions, which may differ from case to case. The information has been provided on as is where is basis without any warranties or assertions as to the correctness or soundness thereof. Although, due care and diligence has been taken to compile this document, the contained information may vary due to any change in any of the concerned factors, and the actual results may differ substantially from the presented information. SMEDA, its employees or agents do not assume any liability for any financial or other loss resulting from this memorandum in consequence of undertaking this activity. The contained information does not preclude any further professional advice. The prospective user of this memorandum is encouraged to carry out additional diligence and gather any information which is necessary for making an informed decision; including taking professional advice from a qualified consultant/technical expert before taking any decision to act upon the information.

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3. What is letter of credit

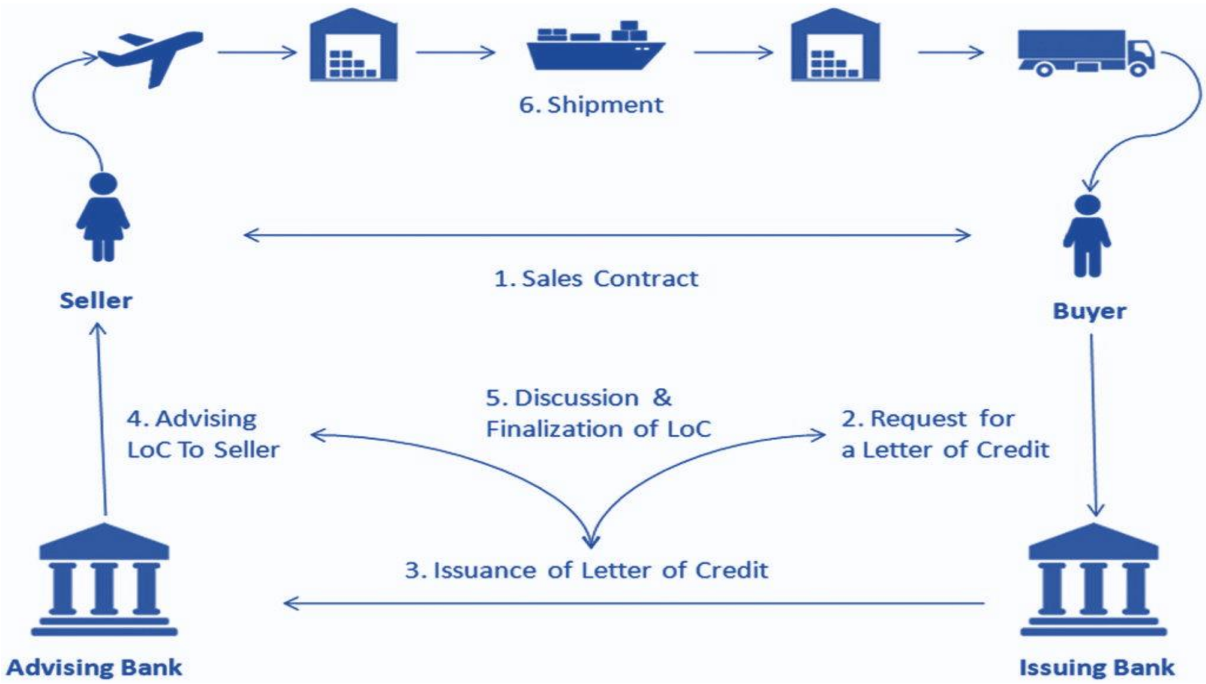
A letter of credit, or a credit letter, is a letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount. If the buyer is unable to make a payment on the purchase, the bank will be required to cover the full or remaining amount of the purchase. It may be offered as a facility (financial assistance that is essentially a loan).

Due to the nature of international dealings, including factors such as distance, differing laws in each country, and difficulty in knowing each party personally, the use of letters of credit has become a very important aspect of international trade.

4. How a letter of credit works

Buyers of major purchases may need a letter of credit to assure the seller that the payment will be made. A bank issues a letter of credit to guarantee the payment to the seller, essentially taking responsibility that the seller will be paid. A buyer must prove to the bank that they have enough assets or a sufficient line of credit to pay before the bank will guarantee the payment to the seller. Because a letter of credit is typically a negotiable instrument, the issuing bank pays the beneficiary or any bank nominated by the beneficiary. If a letter of credit is transferable, the beneficiary may assign another entity, such as a corporate parent or a third party, the right to draw.

The International Chamber of Commerce’s Uniform Customs and Practice for Documentary Credits oversees letters of credit used in international transactions.



5. Types of letter of Credit.

The types of letters of credit include a commercial letter of credit, a revolving letter of credit, a traveler’s letter of credit, and a confirmed letter of credit. International trade will also sometimes use an unsecured red clause letter of credit.

Commercial Letter of Credit

This is a direct payment method in which the issuing bank makes the payments to the beneficiary. In contrast, a standby letter of credit is a secondary payment method in which the bank pays the beneficiary only when the holder cannot.

Revolving Letter of Credit

This kind of letter allows a customer to make any number of draws within a certain limit during a specific time period. It can be useful if there are frequent shipments of merchandise, for example, and you don't want to redraft or edit letters of credit each time.

Traveler's Letter of Credit

For those going abroad, this letter will guarantee that issuing banks will honor drafts made at certain foreign banks.

Confirmed Letter of Credit

A confirmed letter of credit involves a bank other than the issuing bank guaranteeing the letter of credit. The second bank is the confirming bank, typically the seller's bank. The confirming bank ensures payment under the letter of credit if the holder and the issuing bank default. The issuing bank in international transactions typically requests this arrangement.

6. How to apply for letter of credit

Letters of Credit are best prepared by trained professionals, as mistakes in the detailed documents required can lead to payment delays and fees. Due to industry variations and types of letters of credit, each may be approached differently.

Here's an import-export example.

a) The importer's bank credit must satisfy the exporter and their bank. The exporter and importer complete a sales agreement.
b) Using the sales agreement's terms and conditions, the importers bank drafts the letter of credit; this letter is sent to the exporter's bank. The exporter's bank reviews the letter of credit and sends it to the exporter after approval.
c) The exporter ships the goods as the letter of credit describes. Any required documentation is submitted to the exporter's bank.
d) The exporter's bank reviews documentation to ensure letter of credit terms and conditions were met. If approved, the exporter's bank submits documents to the Importer's bank.
e) The importer's bank sends payment to the exporter's bank. The importer can now claim the goods sent.

7. Advantages and disadvantages of a letter of credit

Obtaining letters of credit may be necessary in certain situations. However, like anything else related to banking, trade, and business there are some pros and cons to acknowledge.

Advantages

- Can create security and build mutual trust for buyers and sellers in trade transactions.
- Makes it easier to define the specifics of when and how transactions are to be completed between involved parties.
- Letters of credit can be personalized with terms that are tailored to the circumstances of each transaction.
- Can make the transfer of funds more efficient and streamlined.

Disadvantages

- Buyers typically bear the costs of obtaining a letter of credit.
- Letters of credit may not cover every detail of the transaction, potentially leaving room for error.
- Establishing a letter of credit may be tedious or time-consuming for all parties involved.
- The terms of a letter of credit may not account for unexpected changes in the political or economic landscape.

8. How does a letter of credit works

Often in international trade, a letter of credit is used to signify that a payment will be made to the seller on time, and in full, as guaranteed by a bank or financial institution. After sending a letter of credit, the bank will charge a fee, typically a percentage of the letter of credit, in addition to requiring collateral from the buyer. Among the various forms of letters of credit are a revolving letter of credit, a commercial letter of credit, and a confirmed letter of credit.

9. What Is an Example of a Letter of Credit

Consider an exporter in an unstable economic climate, where credit may be more difficult to obtain. A bank could offer a buyer a letter of credit, available within two business days, in which the purchase would be guaranteed by the bank's branch. Because the bank and the exporter have an existing relationship, the bank is knowledgeable of the buyer's creditworthiness, assets, and financial status.

10. Difference between a Commercial Letter of Credit and a Revolving Letter of Credit

As one of the most common forms of letters of credit, commercial letters of credit are when the bank makes payment directly to the beneficiary or seller. Revolving letters of credit, by contrast, can be used for multiple payments within a specific time frame. Typically, these are used for businesses that have an ongoing relationship, with the time limit of the arrangement usually spanning one year.

11. The Bottom Line

Letters of credit can play an important part in trade transactions. There are different types of letters of credit that may be used, depending on the circumstances. If you need to obtain a letter of credit for a business transaction, your current bank may be the best place to begin your search. You may, however, need to expand the net wider to include larger banks if you maintain accounts at a smaller financial institution.