

Regulatory Procedure

HOW TO OPEN A LETTER OF CREDIT



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1. Disclaimer

Information in this document is provided only for general information purpose and on an "as is" basis without any warranties of any kind. Use of this information is at the user's sole risk. SMEDA assumes no responsibility for the accuracy or completeness of this information and shall not be liable for any damages arising from its use.

2. Introduction of SMEDA

The Small and Medium Enterprises Development Authority (SMEDA) was established with the objective to provide fresh impetus to the economy through the launch of an aggressive SME development strategy. Since its inception in October 1998, SMEDA had adopted a sectoral SME development approach. A few priority sectors were selected on the criterion of SME presence. In depth research was conducted and comprehensive development plans were formulated after identification of impediments and retardants. The all-encompassing sectoral development strategy involved overhauling of the regulatory environment by taking into consideration other important aspects including finance, marketing, technology and human resource development.

After successfully qualifying in the first phase of sector development SMEDA reorganized its operations in January 2001 with the task of SME development at a broader scale and enhanced outreach in terms of SMEDA's areas of operation. Currently, SMEDA along with sectoral focus offers a range of services to SMEs including over the counter support systems, exclusive business development facilities, training and development and information dissemination through a wide range of publications. SMEDA's activities can now be classified into following broad areas:

***Creating a Conducive Environment;** includes collaboration with policy makers to devise facilitating mechanisms for SMEs by removing regulatory impediments across numerous policy areas*

***Cluster/Sector Development;** comprises formulation and implementation of projects for SME clusters/sectors in collaboration with industry/trade associations and chambers*

***Enhancing Access to Business Development Services** development and provision of services to meet business management, strategic and operational requirements of SMEs.*

SMEDA has so far successfully formulated strategies for sectors including fruits and vegetables, marble and granite, gems and jewelry, marine fisheries, leather and footwear, textiles, surgical instruments, transport and dairy. Whereas the task of SME development at a broader scale still requires more coverage and enhanced reach in terms of SMEDA's areas of operation.

Along with the sectoral focus a broad spectrum of services are now being offered to the SMEs by SMEDA, which are driven by factors such as enhanced interaction amongst the stakeholders, need based sectoral research, over the counter support systems, exclusive business development facilities, training and development for SMEs and information dissemination through wide range of publications.

3. Role of Legal Services Cell, SMEDA

The Legal Services Cell (LSC) is a part of Business & Sector Development Services Division of SMEDA and plays a key role in providing an overall facilitation and support to SMEs. The LSC provides guidance based on field realities pertaining to SMEs in Pakistan and other parts of the world.

LSC believes that information dissemination to SMEs on the existing regulatory environment is of paramount importance and plays a pivotal role in their sustainable development.

In order to facilitate SMEs at an individual level LSC has developed user-friendly systems, which provide them detail description of the laws and regulations including processes and steps required for compliance.

The purpose of this document is to provide SMEs either individuals or companies with information pertaining to Letter of Credit. Entrepreneurs interested in enhancing their understanding about the procedures and rights can also use the document. For convenience of the readers sample of various forms, instructions on how to fill up the forms and important addresses are also included.

1 Letter Of Credit (L/C)

A letter of credit (L/C) is a bank's promise to pay to the exporter all the agreed value of the consignment on behalf of the foreign importer, provided that the exporter has complied with all the terms and conditions of the L/C.

L/C is the most commonly used medium used for payment in international trade and is used to protect the interests of both the exporter and importer. Using L/C as a mode of payment helps to minimize the risk of transaction. L/C also adds to ensure, to both buyer and seller, that the goods will be shipped within the time stipulated and the payment shall be made on time without undue delay.

2 Parties Involved in Letter of Credit

2.1 Buyer / Importer (herein after called “The Applicant”)

The Applicant means the importer (buyer) who requests a bank to issue a Letter of Credit.

2.2 Seller / Exporter (herein after called “The Beneficiary”)

The Beneficiary means the exporter (seller) who finally ships the goods and receives the payment on fulfillment of terms and conditions laid down in the Letter of Credit.

2.3 The Issuing Bank

The issuing bank (Importer's Bank) issues the L/C and makes the payment on behalf of importer as per the terms and conditions prescribed in L/C. The exporter may negotiate with the buyer to select a particular bank (if possible) for issuance of the L/C and may ask the Advising Bank if it has a corresponding bank in the buyer's country and suggest that bank to the buyer as the issuing bank.

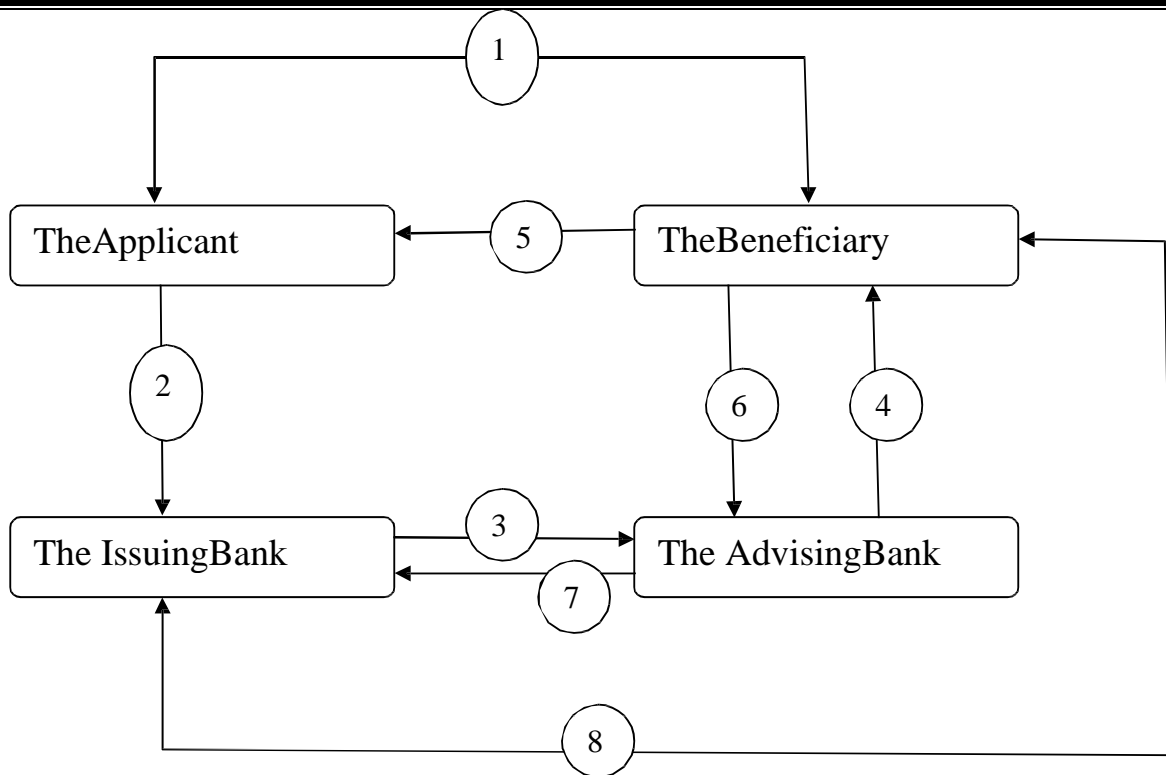
It is not necessary that the issuing bank shall be the same bank where the buyer or the seller has a commercial account; it can be any other bank, mutually agreed upon by the importer and exporter.

2.4 The Advising Bank

Advising bank is usually in the country of the seller. The Advising Bank advises the exporter / seller / beneficiary that an L/C is received from the issuing bank and provides information on terms and conditions of the L/C. The advising bank is not responsible for any payment under L/C.

3 Step by Step Procedure to Open AL/C

The chart below shows how participants are involved in the process of opening and payment of L/C:



1. The Applicant (buyer) and the Beneficiary (seller) negotiate terms and conditions of the L/C as per the agreement they have made.
2. The Applicant applies to the Issuing Bank to issue the L/C on an application form.
3. The Issuing Bank requires the following documents from the applicant:
 - a) Formal contract between the importer and exporter.
 - b) Pro Forma Invoice or Contract or Purchase Order (a document through which the exporter informs the importer about the kind and quantities of goods being sent, their value, time of shipment and important specifications).
 - c) Insurance Policy with premium paid receipt.

After inspecting all these documents the bank issues the L/C and forwards it to the Advising Bank through SWIFT (Society for Worldwide Interbank Financial Telecommunication) or Mail.

4. The Advising Bank checks the apparent authenticity of the L/C and advises the L/C to the Beneficiary.
5. The Beneficiary checks if the L/C complies with the formal contract and if all terms and conditions specified in the L/C can be satisfied. The Beneficiary ships the goods to the importer.
6. The Beneficiary assembles the documents specified in the L/C, checks the documents for discrepancies with the L/C, draws the draft (if it is Sight or Usance L/C as No Draft or Bill of Exchange is required in case of Deferred Payment L/C) and presents the draft and

- the documents to the Advising Bank
7. The Advising Bank inspects the draft and the documents against terms and conditions of the L/C and forwards them to the Issuing Bank
 8. The Issuing Bank checks if the documents comply with the L/C and makes a payment immediately (if the L/C is available by sight) or on a certain date (if L/C is available by deferred payment)

4 Forms and Types of L/C

Letter of Credit is a conditional bank guarantee of payment for supplied goods, conditional means that to get paid you have to present the documents, which should strictly comply with the terms and conditions specified in the L/C. It is important to note that banks only deal with the documents involved in L/C and not with the goods or merchandise.

Following are the most commonly used forms and types of an L/C:

4.1 Revocable L/C

A revocable L/C may be amended or cancelled by the Issuing Bank at any moment and without prior notice to the Beneficiary. This form of L/C is not much acceptable in export proceeds arrangement.

4.2 Irrevocable L/C

An irrevocable L/C cannot be amended or cancelled without prior notice to and the consent of the parties involved. Any amendment in irrevocable L/C causes delays and extra cost to the importer and exporter. It is important that an L/C indicates whether it is revocable or irrevocable, in the absence of such indication the L/C shall be deemed to be irrevocable.

4.3 Confirmed L/C

When goods are exported to a country with economical or political instability or if the exporter / seller is unfamiliar with the Issuing Bank, he may require from the importer that the L/C be confirmed by a bank of international repute. If L/C is confirmed, the confirming bank becomes liable for the payment in case the issuing bank refuses to pay against the L/C.

4.4 Transferable L/C

Transferable L/C is a perfect financial tool for middlemen to secure their margin without involving any funds. It allows dealing with more than one beneficiary. When a transferable L/C is issued in one's favor, he can transfer it to any seller and use it as a payment.

4.5 L/C payable at sight

"Payable at sight" means that exporter / seller be paid "immediately" (in fact, it may take up to 10-12 days) after presentation of the documents stipulated in the L/C to the Issuing Bank or to the Confirming Bank if it was confirmed.

4.6 L/C payable on the maturity date

If deferred payment was agreed, exporter will be paid on the maturity date indicated in the L/C after presentation of the documents stipulated in the L/C to the Issuing Bank. The date is specified on the L/C document from which the deferring period starts (e.g. 30/60/90/120 days from or after

date of receipt of documents or transport documents).

5 Information that an L/C Must Have

It is essential for the importer and exporter to be absolutely sure that the L/C was prepared correctly and there is no legitimate ground for refusal of payment under the L/C. Therefore the L/C must contain the below mentioned information correctly. It is important that the L/C should be in a language understandable to all, preferably English.

- a) Applicant's full name and address
- b) Beneficiary's full name and address
- c) Issuing Bank details
- d) Advising Bank details
- e) Form and type of credit (e.g. irrevocable, transferable etc.)
- f) Issue date
- g) Expiry date
- h) The latest date of shipment (usually with words "no later than")
- i) Expiry date for presentation of documents and Presentation Period.
- j) Amount payable under L/C
- k) Currency of payment
- l) Port of loading
- m) Port of discharge
- n) Terms of delivery
- o) Indication of the payment of the freight (Freight Prepaid/Freight Collect)
- p) Allowances for partial shipment or trans-shipment if needed
- q) Type of payment availability (e.g. at sight, on the maturity date)
- r) Description of goods (must correspond with the description given in the Pro Forma Invoice)
- s) List of documents required for the payment
- t) Accountability for bank charges

6 Confirmation of L/C

The confirmation of the L/C by another bank - the Confirming Bank - means that if the Issuing Bank refuses to make the payment, the Confirming Bank is responsible for this payment. If you are dealing with a buyer from a country with an unstable political or economical situation, always ask for the confirmation of the L/C.

The best-case scenario is when the Advising Bank confirms the L/C. If the Advising Bank does not agree to confirm the L/C, ask the bank to recommend you another bank to be the Confirming Bank.

There are additional charges for the confirmation of the L/C, which depend on the risk involved in dealing with the particular country. The responsibility to pay for the confirmation is negotiable and usually is paid by the importer. However, if it wasn't agreed prior to the issuance of the L/C, the importer is the one who will pay for this service.

7 Documents That May Be Stipulated in an L/C

Before the L/C is issued, the importer and exporter negotiate on documents which are to be included in the L/C and which are not. It is always advisable to keep the list as short as possible. It is not necessary to mention all documents required by the contract in the L/C. Usually the exporter is required to present a commercial invoice, a transport document and an insurance policy (certificate).

The list of additional documents depends on the agreement made between seller and the buyer. Usually the buyer will include documents needed for the customs clearance. The list may include:

- Certificate of origin
- Certificate of quality
- Weight certificate
- Pre-shipment inspection certificate
- Packing declaration
- Packing list
- Fumigation certificate
- Insurance certificate, etc.

8 Cash Margin Restriction on Import L/C

In Pakistan the importer needs to fulfill the cash margin requirement for issuance of Import L/C by an issuing bank. In cash margin requirement the importer (buyer) shall deposit a certain amount to the issuing bank against the total value of L/C, without being withdrawn until the realization of terms and conditions of L/C.

Cash margin percentage on import of items varies periodically in accordance with the directions of the State Bank of Pakistan as per BPRD Circulars issued at various times. For current references, please refer to annexures at the end of the document.

9 Tips To Minimize Risks

A careful attention to the following considerations, by the importer and exporter, may minimize the risks involved in L/C transactions:

- 1- Prior to the issuance of the L/C, negotiate exactly what documents must be presented to the bank.
- 2- Try to agree to present as few documents as possible and to keep the descriptions as simple as possible.
- 3- Once issued, the L/C can only be altered or cancelled by consent of all parties.
- 4- Remember that L/C is a bank-to-bank agreement and is not a substitute for the contract

- between seller and the buyer.
- 5- The importer should be sure that he is in a position to provide the bank with all documents stipulated in the L/C intime.
 - 6- Always indicate L/C as "irrevocable".
 - 7- Check the additional conditions and be sure that you are able to meet them.
 - 8- If the exporter has any doubts that the Issuing Bank may fail to make a payment, for any political or economic reason, in this case the L/C must be confirmed by the Advising Bank or by any other bank, whose confirmation will be accepted by the Advising Bank.
 - 9- If there are any discrepancies and the L/C has to be amended, do not ship goods before these amendments are made.
 - 10- Specify how many original documents and how many copies are to be presented.
 - 11- The description of goods stipulated in the L/C must correspond with the description given in the invoice. If the invoice states "100% Fruit Juice" and the L/C states – "Pakistani Fruit Juice", it is enough for the bank to refuse the payment and this decision will most likely be supported by the court.
 - 12- L/C may require a "clean" transport document. That means the document, which bears no clause or notation that expressly declares a defective condition of the goods and/or the packaging.

10 Annexures

10.1 Annexure - I

BPRD Circular Letter No. 08 of 2009	March 09, 2009
<p>The Presidents/Chief Executives, All Banks</p> <p>Dear Sir/Madam,</p> <p style="text-align: center;"><u>Minimum Margin Restriction on Import Letters of Credit</u></p> <p>Please refer to BPRD Circular Letter No.05 of 2009 dated March 03, 2009 on the captioned subject.</p> <p>It has been decided to waive the condition of cash margin requirement on HS Code 0713 (Leguminous Vegetables, Dried Shelled).</p> <p>Banks are advised to comply with the above mentioned instructions immediately. However, the other instructions on the subject will remain unchanged.</p> <p>Please acknowledge receipt.</p> <div style="text-align: right; margin-top: 20px;"><p>Yours sincerely,</p><p>Sd/-</p><p>(Syed Irfan Ali) Director</p></div>	

10.2 Annexure -II

BPRD Circular No. 12 of 2009	June 12, 2009
<p data-bbox="251 384 581 432">The Presidents/Chief Executives, All Banks</p> <p data-bbox="407 470 1240 506" style="text-align: center;"><u>Minimum Margin Restriction on Import Letters of Credit</u></p> <p data-bbox="251 537 1295 588">Please refer to BPRD Circular Nos.06 and 11 dated May 22, 2008 and August 27, 2008 respectively and subsequent Circular Letters on the captioned subject.</p> <p data-bbox="251 611 1357 661">It has been decided to withdraw cash margin restriction for opening of import letters of credit with immediate effect.</p> <p data-bbox="251 695 537 722">Please acknowledge receipt.</p> <p data-bbox="1143 1241 1300 1266" style="text-align: right;">Yours sincerely,</p> <p data-bbox="1089 1299 1357 1371" style="text-align: right;">Sd/- (Muhammad AkhtarJaved) Senior Joint Director</p>	