

## **The Mechanism of Letter of Credit**

### **Definition of Letter of Credit (LC)**

Letter of Credit (or Documentary Credit) is an undertaking issued by a bank for the account of the buyer or for its own account, to pay the seller against the value of the draft and/or other documents provided that the terms and conditions of the credit are complied with.

LC is usually subject to the Uniform Customs and Practice for Documentary Credits, International Chamber of Commerce Publication No. 600 (UCP 600).

### **Availability of Letter of Credit**

Under UCP 600, an LC can be made available with:

- Payment – Payment at sight against compliant documents.
- Negotiation – Payment with or without recourse to the beneficiary or bona fide holder against compliant documents presented under the credit.
- Acceptance by a Drawee Bank – Payment at a future determinable date against compliant documents. A tenor draft is normally required for presentation under an acceptance credit and is drawn on the acceptance bank rather than the issuing bank.

Usance Credit – Payment at a future determinable date against compliant documents. A tenor draft is normally required (but not mandatory) for presentation under a usance credit and is drawn on the Issuing Bank. Usance credit is available by Negotiation, Acceptance and Deferred Payment. A tenor draft is not required for presentation under a deferred payment credit.

### **Parties in Letter of Credit Transaction**

#### LC Applicant

LC Applicant is normally the buyer under the sales contract and the party that initiates the request to the Issuing Bank to issue an LC on its behalf. The LC Applicant normally maintains banking facilities with the Issuing Bank.

#### LC Beneficiary

LC Beneficiary is normally the seller under the sales contract and the party who will receive payment under the LC if it can fulfill all the terms and conditions of the credit.

#### Issuing Bank

An Issuing Bank (or LC opening bank) is the bank that issues the LC in favour of a seller at the request of the LC applicant. The Issuing Bank is normally located in the applicant's country with established

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banking relationship with the applicant.

By issuing an LC, the Issuing Bank undertakes to pay the beneficiary the value of the draft and/or other documents if all the terms and conditions of the LC are complied with.

### Advising Bank

An Advising Bank (or sometimes known as notifying bank) is the bank that advises the LC beneficiary that there is an LC issued in his favour. Advising Bank is normally located in the seller's country and is either appointed by the Issuing Bank or LC applicant. Its primary responsibility is to authenticate the LC to ensure that the LC comes from genuine source.

### Confirming Bank

A Confirming Bank (normally also the Advising Bank) is the bank that adds its own undertaking to pay the LC beneficiary if all terms and conditions of the credit are complied with. Such undertaking is in addition to that given by the Issuing Bank at the request of the Issuing Bank.

The Confirming Bank will only confirm an LC upon satisfactory evaluation on the conditions of the Issuing Bank and its domicile country.

### Nominated Bank

A Nominated Bank is a bank authorised by the Issuing bank in the credit to pay, negotiate, issue a deferred payment undertaking or accept drafts under the LC. If the LC does not specify a Nominated Bank, the LC is deemed as freely negotiable and any banks that receive documents from the LC beneficiary are qualified to be a Nominated Bank.

A Nominated Bank is not responsible to pay under the credit unless it has added its confirmation to the credit. In such a case, it will become a Confirming Bank.

### Negotiating Bank

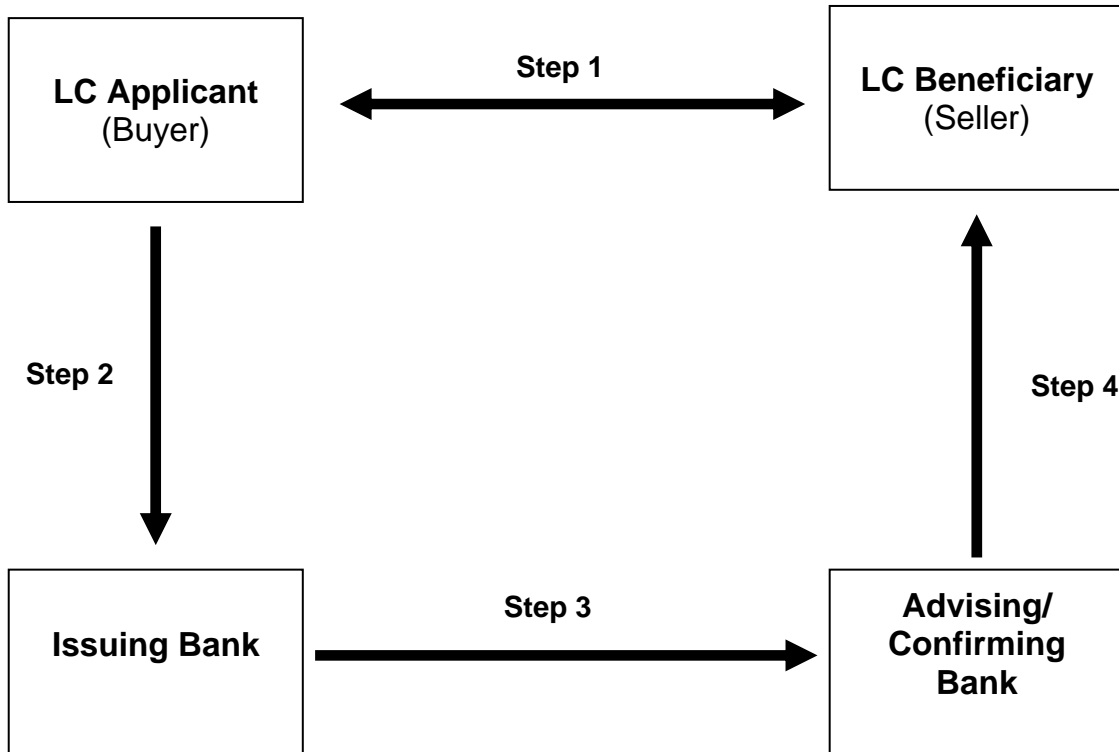
A Negotiating Bank is the bank that examines the drafts and/or documents presented by the LC beneficiary and gives values to such drafts and/or documents. Negotiation could be in the form of purchasing or agreeing to purchase the drafts and/or documents presented.

### Reimbursing Bank

A Reimbursing Bank is the paying agent appointed by the Issuing Bank to honour claims submitted by the nominated or negotiating bank.

## The Flow of Letter of Credit

### Stage 1: Letter of Credit Issuance and Advising/Confirmation



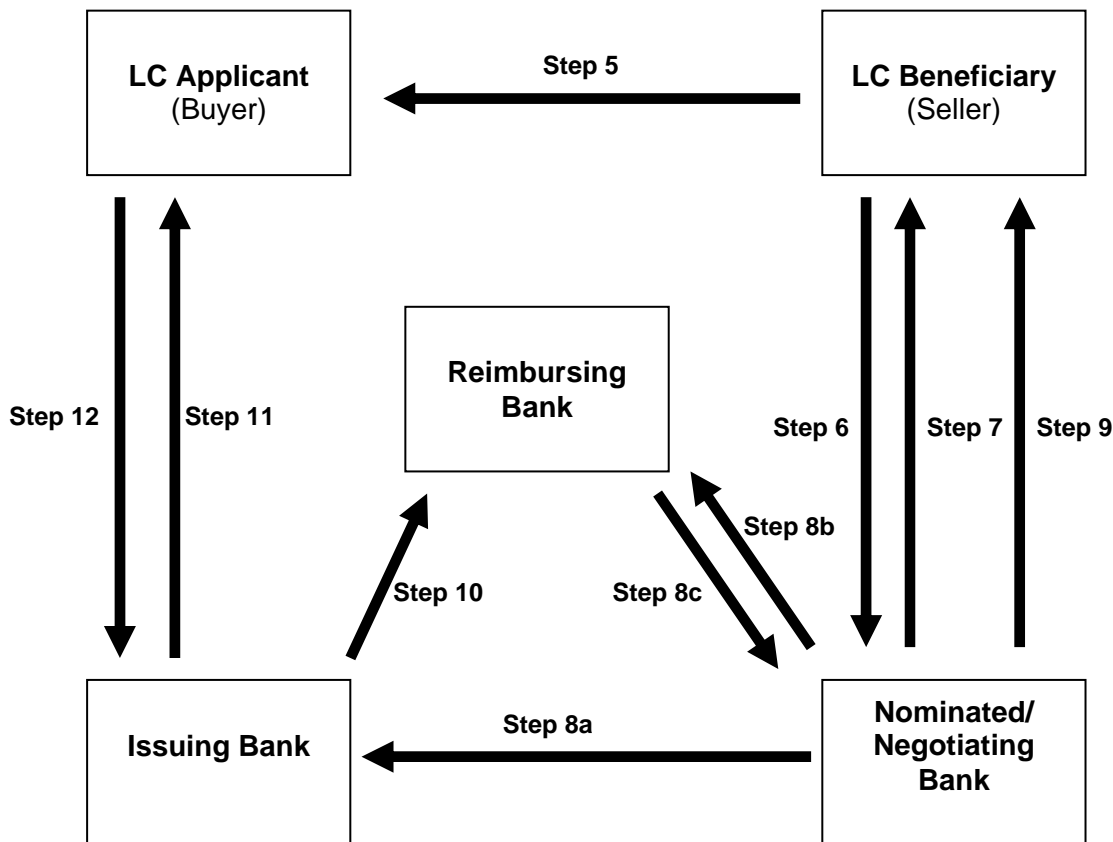
Step 1: Buyer and seller conclude the sales contract and agreed to use an LC as the method of payment.

Step 2: Buyer approaches the Issuing Bank to issue an LC on his behalf in favour of the seller with all the terms and conditions specified.

Step 3: Issuing Bank issues the LC and requests the advising bank to advise or confirm the credit to the LC beneficiary (seller).

Step 4: Advising/confirming bank authenticates the LC and sends the LC to the LC beneficiary.

## Stage 2: Presentation of Documents and Settlement (Sight LC with Reimbursing Bank)



- Step 5:** Seller prepares and despatches the goods to the buyer's country.
- Step 6:** Seller presents the drafts and/or documents to the nominated bank.
- Step 7:** Nominated (nominated as the negotiating bank) Bank checks documents presented against the LC terms and conditions and seeks instructions from seller on documentary discrepancies.
- Step 8a:** Nominated Bank forwards the drafts and/or documents to the Issuing Bank.
- Step 8b:** If documents are free from discrepancies or discrepancies are supported by seller's indemnity, nominated bank claims reimbursement from the appointed reimbursing bank.
- Step 8c:** Reimbursing Bank pays the nominated bank against a valid reimbursement authority received from the Issuing Bank and statement from negotiating bank that the documents complied with LC terms.
- Step 9:** Nominated Bank credits the net proceeds into the seller's account.
- Step 10:** Issuing Bank checks documents presented against the LC terms and conditions. If documents are free from discrepancies, Issuing Bank reimburses the reimbursing bank.
- Step 11:** Issuing Bank presents documents to the buyer for payment.
- Step 12:** Once payment is received from the buyer, Issuing Bank releases documents to the buyer for the latter to collect his goods.

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