

## What is a Letter of Credit?



A letter of credit is a documentary agreement, typically from a bank (Issuing Bank), assuring that a seller (Beneficiary) will receive payment up to the amount of the letter of credit, as long as certain documentary delivery conditions have been met. In the event that the buyer (Applicant) is unable to make payment on the purchase, the Beneficiary may make a demand for payment on the bank. The bank will examine the Beneficiary's demand and if it complies with the terms of the letter of credit, will honor the demand.

*Fun fact: The name "letter of credit" derives from the French word "accréditation", a power to do something, which derives from the Latin "accreditivus", meaning trust*

The letter of credit states what documents the Beneficiary must present, what information they must contain, and the place and date it expires. Beneficiaries who sell goods and utilize a letter of credit as the method of payment have the assurance of the issuing bank that if they present the documents stated in the letter of credit, the issuing bank will honor their demand for payment.

### Types

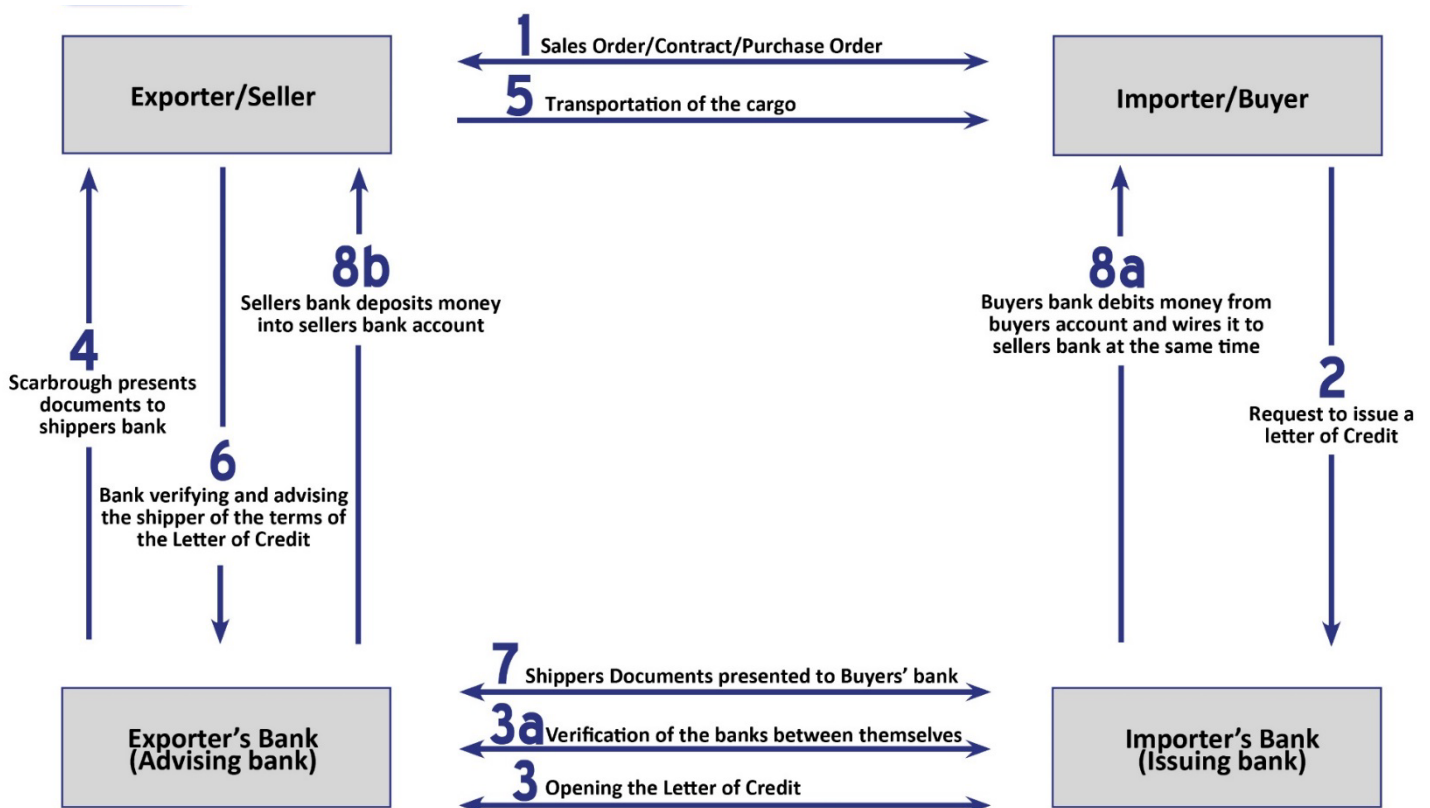
- **Import/export** — The same credit can be termed an import or export LC depending on whose perspective is considered. For the importer it is termed an Import LC and for the exporter of goods, an Export LC.
- **Revocable** — The buyer and the bank that established the LC are able to manipulate the LC or make corrections without informing or getting permissions from the seller. According to UCP 600, all LCs are irrevocable, hence this type of LC is obsolete.
- **Irrevocable** — Any changes (amendment) or cancellation of the LC (except it is expired) is done by the applicant through the issuing bank. It must be authenticated and approved by the beneficiary.
- **Confirmed** — An LC is said to be confirmed when a second bank adds its confirmation (or guarantee) to honor a complying presentation at the request or authorization of the issuing bank.
- **Unconfirmed** — This type does not acquire the other bank's confirmation.
- **Restricted** — Only one advising bank can purchase a bill of exchange from the seller in the case of a restricted LC.
- **Unrestricted** — The confirmation bank is not specified, which means that the exporter can show the bill of exchange to any bank and receive a payment on an unrestricted LC.

- **Transferrable** — The exporter has the right to make the credit available to one or more subsequent beneficiaries. Credits are made transferable when the original beneficiary is a middleman and does not supply the merchandise, but procures goods from suppliers and arranges them to be sent to the buyer and does not want the buyer and supplier know each other.
- **Untransferable** — A credit that the seller cannot assign all or part of to another party. In international commerce, all credits are untransferable.
- **Standby Letter of Credit:** – Operates like a Commercial Letter of Credit, except that typically it is retained as a “standby” instead of being the intended payment mechanism. UCP600 article 1 provides that the UCP applies to Standbys; ISP98 applies specifically to Standby letters of Credit; and the United Nations Convention on Independent Guarantees and Standby letters of Credit applies to a small number of countries that have ratified the Convention.

### Incoterms

Incoterms are a set of three-letter standard trade terms most commonly used in international contracts for the sale of goods. It is essential that you are aware of your terms of trade prior to shipment.

### Process



[Source: Wikipedia]