



Module-B Unit-11

JAIIB PAPER-2

Principles and Practices of Banking (PPB)



JAIIB PPB Module B Unit 11: Letters Of Credit

Letters Of Credit

An Letters Of Credit can be compared to guarantee given by a **bank on behalf of its customer to the effect that the bank would make payment to the beneficiary** when the beneficiary presents the documents as it required in the LC. **They are not negotiable instrument.**

Parties to a Letter of Credit

- **Applicant-Buyer-Importer-Opener:** He is the person who applies to bank for Letter of Credit. Ex: Mr. Srivastav & Co.
- **Issuing Bank:** The bank which opens the Letter Of Credit on the request of applicant/Buyer. Ex: Bank of Baroda
- **Beneficiary-Exporter-Seller:** The person who is entitled to receive the benefit under Letter of Credit. Ex: M.s jha & Co.
- **Advising Bank / Notifying Bank:** The bank in the Beneficiary/Exporters Country through which the letter of credit is advised to the beneficiary. Ex: The UK Bank
- **Negotiating Bank:** The bank in the Beneficiary/Exporters Country which negotiate the bills (i.e. make payments on the bills drawn by the seller and accepts the documents.) If the LC specifies a bank then that bank is the Negotiating Bank and is also called the Nominated Bank / Paying Bank. If the LC however does not specify the bank, than any bank can be negotiating bank.
- **Confirming Bank:** The advising bank is only required to advise the credit to the beneficiary. If however in addition to advising the credit the advising bank were to confirm it, then the advising bank will also become confirming Bank.
- **Reimbursing Bank:** It is the bank which is appointed by the Issuing Bank to make reimbursement to the Negotiating, Paying or confirming Bank.

Types of Letters of Credit

- **Acceptance Credit:** Ordinary Letters of Credits are usually sight credits, i.e. immediate payment should be made of the bills drawn by the beneficiary. Such letters of credit under which usance bills can be drawn is an Acceptance Credit or Time Credit.
- **Revocable Credit:** A revocable LC is a credit that can be amended / cancelled by the issuing bank without prior notice to the beneficiary. However, if any negotiating bank has acted on the credit prior to receipt of the notice of amendment/cancellation then the issuing bank is bound to reimburse the negotiating bank.
- **Irrevocable Credit:** is a credit that can neither be amended nor cancelled without the consent of the beneficiary.
- **Confirmed Credit:** If a bank advising the credit to beneficiary adds its own confirmation to the credit, then the credit would be called a confirmed credit. Only irrevocable credit can be confirmed With Recourse and without Recourse Credits: when beneficiary draws a bill under a LC he is liable if the drawee fails to

make payment. These kind of bills are called recourse LCs. The beneficiary can exclude liability by adding to the bill following words “without recourse”

- **Transferable Credits:** As such the rights under an LC cannot be transferred and is vested in the beneficiary. A transferable credit is one under which the beneficiary can transfer his rights to third parties. Unless specifically stated an LC is not transferable.
- **Back-To-Back Credits:** The beneficiary in whose favour an LC is issued uses the same to obtain another credit from his (beneficiary's) bank in favor of the supplier. There are three banks involved in this type of LC. (Issuing Bank, Advising Bank, Third bank which issued an ancillary credit against the security of the original credit.
- **Anticipatory Letter of Credit**

i) Red Clause Letter of credit - In a usual LC transaction the beneficiary will be entitled to receive payment only on his handing over the documents and bills drawn under the LC to the negotiating bank. However in certain credits the beneficiary will be entitled to get an advance of the price. These credits contain a “Red Clause” which authorises an intermediary bank to make an advance to the beneficiary before shipment.

ii) Green Clause Letter Of Credits – This is a refinement of the “Red Clause”. This type of LC not only permits pre-shipment advance but also permits advances to the exporter to cover storage at the port of shipment. The Red Clause and Green Clause credit are called Anticipatory Credits.

iii) Revolving Letter of Credit: In this type of credit though amount is fixed, it can be renewed as soon as the earlier bills have been paid.

Documents Under a Letter Of Credit

- Bill of Exchange
- Invoice
- Transport Documents
- Bills of Lading
- Airway Bill
- Post Parcel Receipt and Courier Receipt
- Insurance Document
- **Other Documents:** Certificate of origin, Certificate of Weight or quality or analysis, Health authorities certificate etc.

Uniform Customs and Practices for Documentary Credits- UCPDC

600

The **ICC Banking Commission approved the UCP 600**, ICC's new on documentary credits, on **25 October 2006**. **UCP 600, which come into effect in 1 July 2007**, contains significant changes, including:

- A reduction in the number of articles from 49 of UCP 500 to 39.
- New articles on “Definitions” and “Interpretations” provide more clarity and precision in the rules.
- The replacement of the phrase “reasonable time” for acceptance or refusal of documents by a definite period of five banking days.
- New provisions which allows for the discounting of deferred payment credits.
- A definitive description of negotiation as “purchase” of drafts of documents.

Payment Under Letter Of Credit – Primary Obligation For Banks

- **Articles 6 to 13 of UCP 600 discusses** the liabilities and responsibilities of the parties involved in a letter of credit transaction. **Articles 14 to 17** are focused on the aspects of examinations of the relevant documents for discrepancy, before initiating the payment.
- The Supreme Court had occasions to consider the obligation of a bank under LC in various cases and in all these cases, the Court has held that the obligation of a bank to pay under a LC is primary, irrespective of the underlying contract.

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