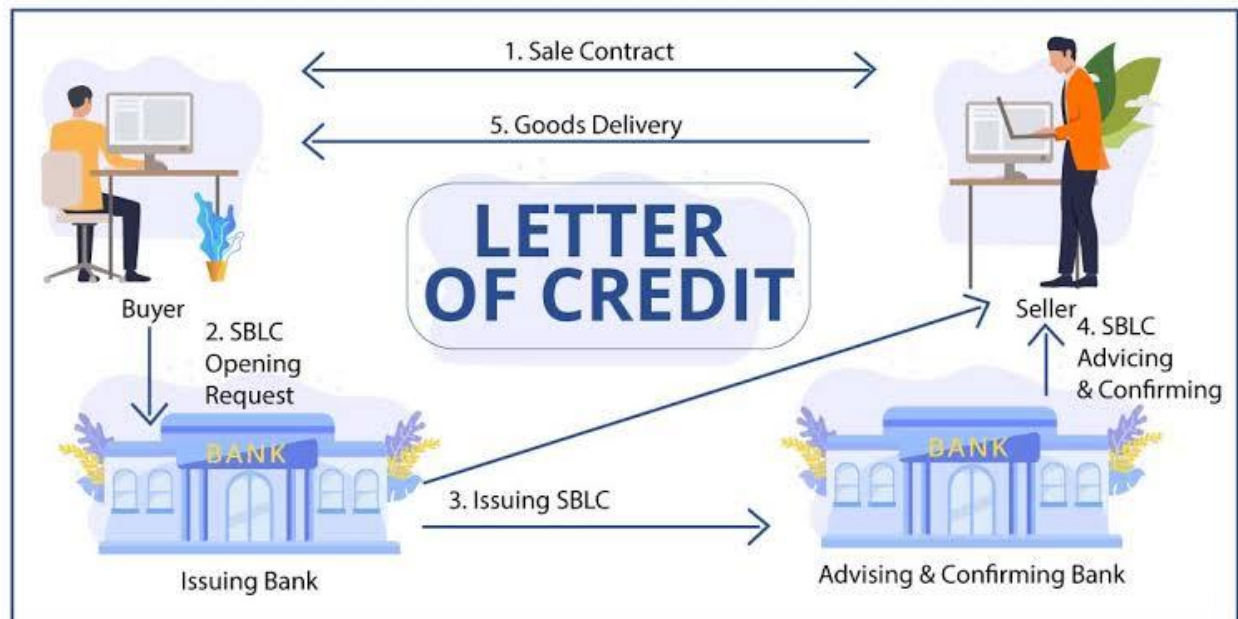


Understanding Different Types of Letters of Credit: UCP 600, Clauses, and Case Studies

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In international trade, Letters of Credit (L/C) are one of the most commonly used methods of payment, providing security to both the buyer and the seller. Governed by the Uniform Customs and Practice for Documentary Credits (UCP 600), a set of rules established by the International Chamber of Commerce (ICC), Letters of Credit help mitigate risks associated with cross-border transactions.

This article explores the various types of Letters of Credit, the significance of specific clauses and numbers under UCP 600, common discrepancies, and the importance of UCP 600 in global trade. Additionally, we will present a case study to illustrate how a Letter of Credit operates in a real-world scenario.

What is a Letter of Credit?

A Letter of Credit is a financial document issued by a bank on behalf of a buyer, guaranteeing payment to a seller upon presentation of specified documents that comply with the terms and conditions of the L/C. The L/C serves as an assurance to the seller that they will receive payment if they fulfill the contractual obligations, while also ensuring that the buyer receives the goods or services as agreed.

Types of Letters of Credit

There are several types of Letters of Credit, each designed to meet the specific needs of the parties involved in a transaction. The following are the most commonly used types:

1. Revocable Letter of Credit

A Revocable L/C can be altered or canceled by the issuing bank without prior notice to the beneficiary (seller). However, this type of L/C is rarely used in modern trade because it offers little security to the seller.

Significance:

Revocable L/Cs are typically used in transactions between parties with a high degree of trust, but they are less favorable to the seller due to the lack of guarantees.

2. Irrevocable Letter of Credit

An Irrevocable L/C cannot be changed or canceled without the consent of all parties involved, including the issuing bank, the confirming bank (if any), the beneficiary, and the applicant (buyer). This type of L/C is widely used because it provides greater security to the seller.

Significance:

Irrevocable L/Cs ensure that the terms cannot be altered once issued, providing assurance to the seller that they will receive payment if they meet the conditions specified.

3. Confirmed Letter of Credit

A Confirmed L/C involves a second bank, usually in the seller's country, which adds its own guarantee to the L/C issued by the buyer's bank. This provides additional security to the seller, especially in situations where the buyer's bank is located in a country with political or economic instability.

Significance:

Confirmed L/Cs are crucial in high-risk transactions as they ensure payment even if the buyer's bank fails to honor the L/C. This type of L/C is commonly used when the seller is unsure about the creditworthiness of the issuing bank.

4. Unconfirmed Letter of Credit

An Unconfirmed L/C is guaranteed only by the issuing bank, without any additional guarantee from another bank. The seller bears the risk of the issuing bank's ability to pay.

Significance:

Unconfirmed L/Cs are more common when the seller has confidence in the issuing bank's reliability. They are less secure than confirmed L/Cs but involve lower costs.

5. Sight Letter of Credit

A Sight L/C requires the issuing bank to pay the beneficiary immediately upon presentation of the required documents, provided that all terms and conditions are met.

Significance:

Sight L/Cs offer quick payment to the seller, reducing the time between shipment and receipt of funds, which is critical for managing cash flow in export transactions.

6. Deferred Payment Letter of Credit

A Deferred Payment L/C does not require immediate payment upon presentation of documents. Instead, payment is made at a future date as specified in the L/C.

Significance:

Deferred Payment L/Cs are useful in situations where the buyer needs time to sell the goods or generate cash flow before making payment, while still providing the seller with assurance of future payment.

7. Revolving Letter of Credit

A Revolving L/C allows for multiple payments over a specific period without the need to issue a new L/C for each transaction. The L/C “revolves” for a certain amount and timeframe, either in terms of the value or the period.

Significance:

Revolving L/Cs are beneficial in ongoing trade relationships where the same buyer and seller engage in regular transactions. It reduces administrative burden and costs associated with issuing multiple L/Cs.

8. Standby Letter of Credit

A Standby L/C acts as a secondary payment mechanism. It is similar to a guarantee, where the bank only pays the beneficiary if the buyer fails to fulfill their obligations.

Significance:

Standby L/Cs are often used as a security measure in contracts, providing a safety net for the seller in case of non-performance by the buyer.

UCP 600: Importance and Clauses

The UCP 600 (Uniform Customs and Practice for Documentary Credits) is the latest version of the rules governing Letters of Credit, published by the International Chamber of Commerce in 2007. These rules are universally applied in international trade, ensuring standardization and reducing the risk of misunderstandings in L/C transactions.

Key Clauses and Significance:

- Article 2: Definitions - This article defines key terms used in the UCP 600, such as "Credit," "Banking Day," "Negotiation," and "Honour." These definitions ensure that all parties have a common understanding of the terms used in L/C transactions.
- Article 7: Issuing Bank Undertaking - The issuing bank is obligated to honor a compliant presentation. This article emphasizes the bank's responsibility to pay the beneficiary as long as the documents presented conform to the L/C terms.
- Article 14: Standard for Examination of Documents - This article provides the standard by which banks must examine the documents presented under a Letter of Credit. The bank has up to five banking days to determine if the documents comply with the L/C terms.
- Article 16: Discrepant Documents, Waiver and Notice - If the documents do not conform to the terms of the L/C, the bank must notify the beneficiary of the discrepancies. The beneficiary can then correct the discrepancies or the buyer may waive them.

Common Discrepancies in Letters of Credit

Discrepancies occur when the documents presented do not conform to the terms and conditions of the Letter of Credit. Common discrepancies include:

- **Incorrect Description of Goods:** The goods described in the invoice do not match the description in the L/C.
- **Late Shipment:** The goods are shipped after the date specified in the L/C.
- **Missing Documents:** Required documents, such as the Bill of Lading or insurance certificate, are not included.
- **Mismatched Signatures:** The signatures on the documents do not match the authorized signatures on file.

The Importance of UCP 600 in Resolving Discrepancies

UCP 600 plays a crucial role in resolving discrepancies by providing a standardized framework for examining documents. The rules help ensure

that disputes are minimized and that both the buyer and seller understand their obligations under the L/C. Banks rely on the UCP 600 guidelines to determine whether to honor or reject a presentation based on document compliance.

Case Study: A Letter of Credit Discrepancy Resolution

Background:

An exporter in India, Mr. Kumar, was shipping textiles to a buyer in Germany under a confirmed, irrevocable Letter of Credit. The L/C stipulated that the goods must be shipped by October 10th, and the documents had to be presented within 15 days of shipment.

Issue:

The goods were shipped on time, but due to delays at the freight forwarder's office, the documents were presented to the confirming bank on October 27th, two days after the deadline.

Discrepancy:

The confirming bank notified Mr. Kumar of the discrepancy related to the late presentation of documents. The German buyer refused to waive the discrepancy, fearing a potential impact on the delivery schedule.

Resolution:

Under UCP 600 Article 16, Mr. Kumar was given the option to correct the discrepancy or provide additional documentation explaining the delay. Mr. Kumar, in collaboration with the freight forwarder, provided a detailed explanation of the delay, supported by documentation showing that the goods were indeed shipped on time and that the delay was beyond his control.

The confirming bank reviewed the additional documents and the explanation provided. They decided to honor the presentation, given that the shipment was timely and the delay in document submission did not affect the buyer's position.

The buyer, satisfied with the explanation and reassured by the bank, accepted the documents. The payment was made to Mr. Kumar, and the transaction was completed successfully.

Conclusion

Letters of Credit are vital instruments in international trade, providing security and reliability in transactions between buyers and sellers across borders. The various types of L/Cs cater to different trade scenarios, offering flexibility and protection to the parties involved. The UCP 600 rules play a pivotal role in standardizing L/C transactions, ensuring clarity, and minimizing disputes.

Understanding the types of Letters of Credit, the significance of UCP 600 clauses, and how to handle discrepancies is crucial for exporters and importers. By following the guidelines set forth in UCP 600 and being vigilant about potential discrepancies, businesses can safeguard their interests and ensure smooth international trade operations. The case study of Mr. Kumar demonstrates how an understanding of these rules can lead to the successful resolution of issues, reinforcing the importance of due diligence in handling Letters of Credit.