

# STANDBY LETTERS OF CREDIT

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## I. What Is a Standby Letter of Credit?

- A. Definition and meanings of 'letter of credit'  
**letter of credit** undertaking, usually on the part of a bank and at the request of one of the bank's customers, to pay a named beneficiary a specified amount of money (or to deliver an item of value) if the beneficiary presents documents in accordance with the terms and conditions specified in the letter of credit.
- B. Definition of 'standby letter of credit'  
**standby letter of credit** as opposed to a commercial letter of credit, a letter of credit that does not cover the direct purchase of merchandise, so called because it is often intended to be drawn on only when the applicant for whom it is issued fails to perform an obligation. Standby letters of credit are based on the underlying principle of letters of credit that payment is made against presentation of documents—whatever documents the applicant, beneficiary, and issuing bank may agree to, not necessarily documents showing shipment of goods.
- C. Characteristics of standby letters of credit
  1. independent
  2. documentary
  3. not meant to be drawn on (generally)

## II. How Standby Letters of Credit Work

- A. The underlying contract between applicant and beneficiary
- B. Submission of standby letter of credit application
- C. Typical terms of standby letters of credit
  1. not available by negotiation
  2. payable against draft and statement of default or other reason payment is due
  3. payable at sight
- D. Purview of the issuing bank
  1. review workability of clauses and documents specified in the application, and recommend changes
  2. determine pricing and billing schedule, i.e., in arrears, end of calendar quarter, etc.
  3. determine method of advising

- E. Beneficiary's responsibilities
  - 1. review of the terms of standby
  - 2. request any amendments that are needed both when the L/C is established and as time passes and changes take place in the underlying contract
  - 3. retain the original in safekeeping until utilized, expired, or no longer needed
- F. Presentation of documents
- G. Examination of documents and payment
- H. Disputes about the beneficiary's right to draw should be settled outside the letter of credit transaction

### **III. Standby L/Cs vs. Commercial L/Cs**

### **IV. Standby L/Cs vs. Guarantees & Bonds**

- A. Ancillary/contract guarantees, surety bonds
- B. Independent/demand guarantees
- C. The misunderstood prohibition against U.S. banks issuing guarantees
- D. Confirmation vs. counter & local guarantees

### **V. Uses of Standby Letters of Credit**

- A. Some creative uses of standby letters of credit
  - 1. alimony payments
  - 2. employment contract
  - 3. earnest money
  - 4. wedding receptionist caterer's deposit
  - 5. winner of prize fight
  - 6. transfer of stock in a company
- B. Using standby letters of credit in trade transactions
  - 1. credit line back-up (instead of multiple commercial L/Cs)
  - 2. bid bonds
  - 3. performance bonds
  - 4. warrantee/retention money
  - 5. advance payment guarantees
- C. Specialized adaptations of standby letters of credit
  - 1. loan repayment default
  - 2. direct loan repayment (bond enhancement)
  - 3. evergreen L/Cs

## **VI. Rules that Govern Standby Letters of Credit**

- A. Uniform Customs and Practice for documentary credits (UCP 500)
- B. The International Standby Practices (ISP 98)
- C. Uniform Rules for Demand Guarantees (URDG 458)
- D. U.N. Convention on Independent Guarantees and Stand-by Letters of Credit
- E. Local law in the country(ies) of the issuer (and confirmer)

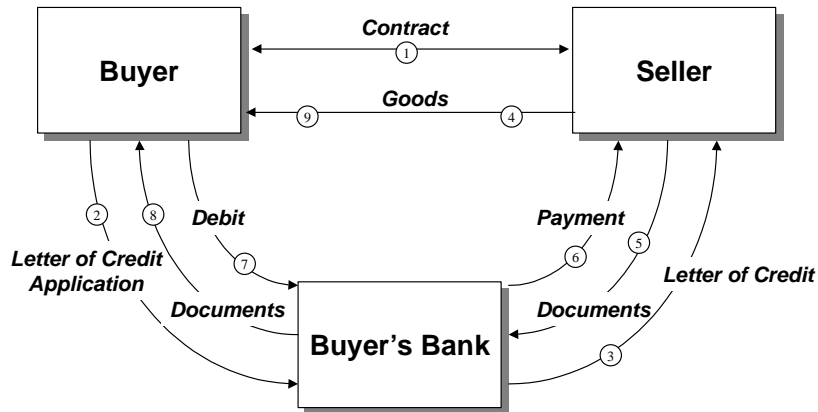
## **VII. Areas of Concern...**

- A. ...to the applicant: court injunctions
- B. ...to the beneficiary
  - 1. bankruptcy of the applicant
    - a) before receiving payment/performance from applicant
    - b) soon after receiving payment
    - c) soon after receiving L/C
      - (1) *bank secured or unsecured when the L/C was issued?*
      - (2) *did the debt exist at the time the L/C was issued?*
  - 2. insolvency of the issuing bank

## **VIII. Recap**

- A. When might a standby L/C drawing not be paid?
  - 1. expired L/C
  - 2. discrepancies
  - 3. political or economic event in the country of the issuing bank
  - 4. fraud/injunction
  - 5. L/C issued during bankruptcy preference period, covering pre-existing debt
  - 6. insolvent bank, liquidated
- B. What are the differences between commercial letters of credit, standby letters of credit, and demand guarantees?

## Letter of Credit Principles and Theory



### Step 1.

The buyer agrees to purchase goods from the seller. This agreement may be a purchase order, an accepted pro-forma invoice, a formal contract, or an informal exchange of messages, but agreement is made as to goods being purchased, how and when they are to be shipped and insured, and how and when payment is to be effected. In this case, the agreement is to use a letter of credit as the mechanism of payment.

### Step 2.

The buyer applies to his bank for a letter of credit, signing the bank's letter of credit application/agreement form.

### **1<sup>st</sup> Principle of Letters of Credit: Letters of Credit are documentary.**

### Step 3.

After approving the application, the issuing bank issues the actual letter of credit instrument and sends it to the beneficiary (the seller).

### **Note: There are 3 separate contracts in a letter of credit transaction:**

- 1. The contract of sale**
- 2. The L/C application/agreement**
- 3. The L/C itself.**

### Step 4.

Having received the issuing bank's assurance of payment, the seller ships the goods to the buyer.

### Step 5.

The seller prepares the documents called for in the letter of credit and presents them to the issuing bank.

### Step 6.

The issuing bank examines the documents. If it determines that the documents comply with the letter of credit, the issuing bank pays the beneficiary (seller).

### **2<sup>nd</sup> Principle of Letters of Credit: Letters of Credit are independent of any other contract or obligation.**

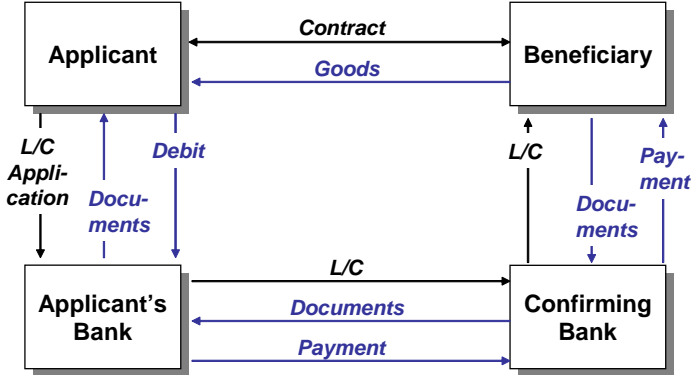
### Steps 7 & 8.

The issuing bank obtains payment from the applicant (buyer) in accordance with the terms of the applicant's letter of credit agreement and forwards the documents to the applicant.

### Step 9.

The applicant (buyer) uses the documents to pick up the merchandise from the carrier, completing the letter of credit cycle.

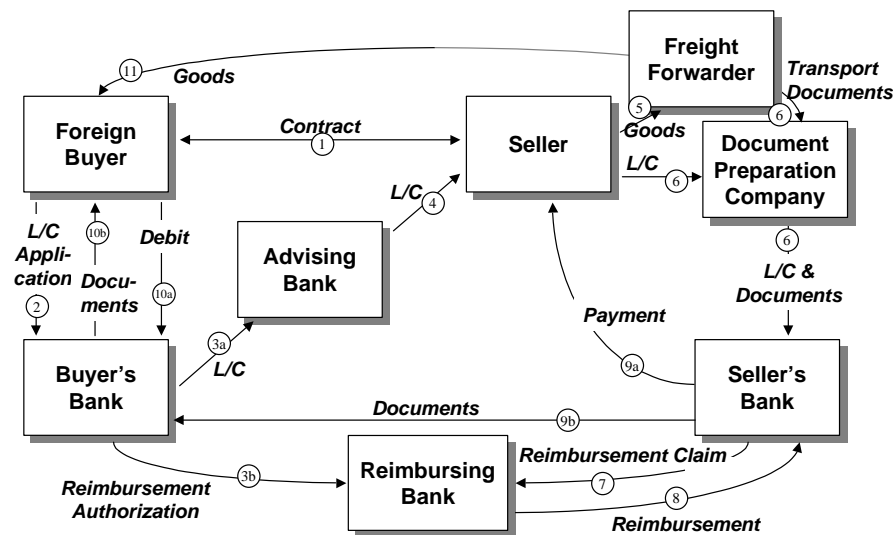
# Confirmed Letters of Credit



When a bank adds their confirmation to a letter of credit, they are engaging to treat the letter of credit as if they issued it themselves. If and when the beneficiary presents compliant documents to the confirming bank, the confirming bank must pay. The confirming bank takes the risks of being able to then collect payment from the issuing bank. The major effect is to shift country risks to the confirming bank.

The confirming bank must be invited by the issuing bank to add their confirmation. They become a third party to the letter of credit "contract" and have the right to refuse amendments.

## Letter of Credit Reality



### Step 1.

The buyer agrees to purchase goods from the seller using a letter of credit as the mechanism of payment.

### Step 2.

The buyer applies to his bank for a letter of credit, signing the bank's letter of credit application/agreement form.

### Step 3a.

After approving the application, the issuing bank issues the actual letter of credit instrument and forwards it to their chosen advising bank.

### Step 3b.

At the time the L/C is sent, the issuing bank also sends a reimbursement authorization to their chosen reimbursing bank. This bank is the clearing bank the issuing bank uses when making payments in the currency of the L/C and will play a role when the time comes to pay the L/C.

### Step 4.

The advising bank authenticates the letter of credit and delivers it to the beneficiary (the seller). If the issuing bank has requested them to do so, the advising bank may add their confirmation to the L/C (and thereby become the confirming bank).

### Step 5.

Having received the issuing bank's assurance of payment (and that of the confirming bank if the L/C has been confirmed), the seller delivers goods to a freight forwarder, who ships the merchandise to the buyer.

### Step 6.

The seller, the freight forwarder, and/or a document preparation company prepares the documents called for in the letter of credit and presents them to the seller's negotiating bank. The letter of credit may specify a negotiating bank the seller must use or it may say it is "available with any bank," giving the seller the freedom to choose where to present documents. If the L/C has been confirmed, documents must be presented to the advising/confirming bank.

### Step 7.

The negotiating bank examines the documents and, if they comply, obtains funds for payment to the beneficiary in accordance with the terms of the letter of credit, generally by sending a reimbursement claim to the reimbursing bank.

### Step 8.

The reimbursing bank matches the negotiating bank's claim against the reimbursement authorizations they are holding, charges the issuing bank's account, and transfers funds to the negotiating bank.

### Step 9a & b.

The negotiating bank transfers payment to the beneficiary (seller) and forwards the documents to the issuing bank.

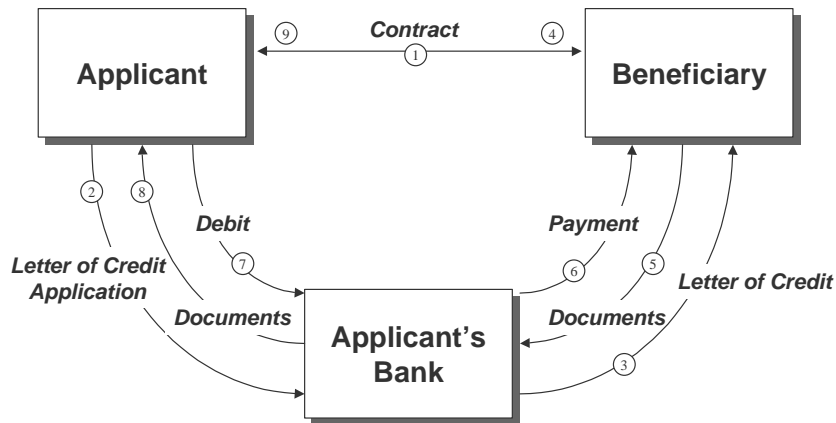
### Step 10a & b.

The issuing bank examines the documents. If it agrees with the negotiating bank that the documents comply with the letter of credit, the issuing bank obtains payment from the applicant (buyer) in accordance with the terms of the applicant's letter of credit agreement and forwards the documents to the applicant.

### Step 11.

The applicant (buyer) uses the documents to pick up the merchandise from the carrier, completing the letter of credit cycle.

## How Standby Letters of Credit Work



### Step 1.

Two parties enter into a contract that calls for one party to arrange a letter of credit in favor of the other. With a standby letter of credit, the agreement is that the L/C will not be drawn unless the applicant defaults on the contract. Standby letters of credit can be used as bid bonds, performance bonds, advance payment guarantees, and for many other purposes.

### Step 2.

The first party applies to his bank for a letter of credit, signing the bank's letter of credit application/agreement form, and indicating what documents the beneficiary will be required to present in order to be paid.

### **1<sup>st</sup> Principle of Letters of Credit: Letters of Credit are documentary.**

### Step 3.

After approving the application, the issuing bank issues the actual letter of credit instrument and sends it to the beneficiary.

### **Note: There are 3 separate contracts in a letter of credit transaction:**

- 1. The underlying contract**
- 2. The L/C application/agreement**
- 3. The L/C itself.**

### Step 4.

Having received the issuing bank's assurance that the applicant will perform (or the L/C can be drawn), the beneficiary performs his end of the contract.

### Step 5.

In the event the beneficiary feels the applicant has defaulted, he prepares the documents called for in the letter of credit and presents them to the issuing bank.

### Step 6.

The issuing bank examines the documents. If it determines that the documents comply with the letter of credit, the issuing bank pays the beneficiary. Note that there is no inquiry into the truth of the documents and permission to pay is not sought from the applicant, who is likely to not want the bank to pay and to insist he is not in default on the contract.

### **2<sup>nd</sup> Principle of Letters of Credit: Letters of Credit are independent of any other contract or obligation.**

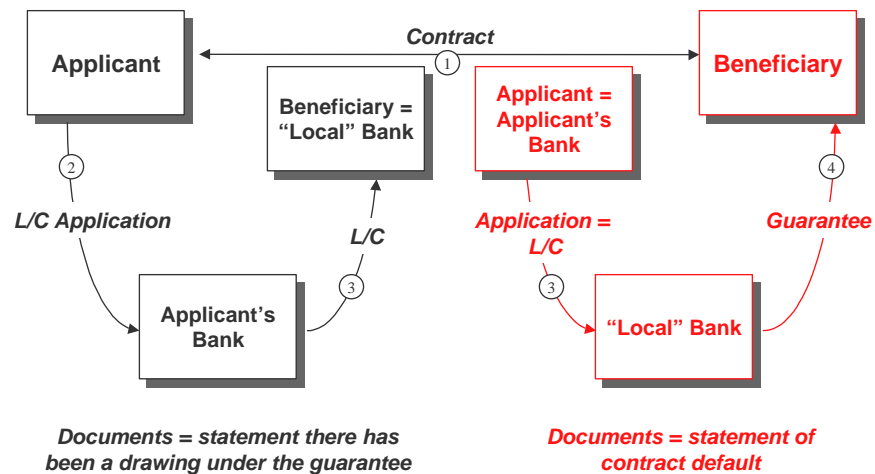
### Steps 7 & 8.

The issuing bank obtains reimbursement for the payment from the applicant and forwards the documents to the applicant.

### Step 9.

If the applicant feels the drawing was not justified, he can seek to get the funds returned under the terms of the contract.

## How Counter-Guarantees Work



### Step 1.

Two parties enter into a contract that calls for one party to arrange a local bank guarantee in favor of the other. The guarantee will be subject to local laws in the country of the second party.

### Step 2.

The first party applies to his bank for a counter-guarantee, in this case in the form of a letter of credit application/agreement form, and also providing wording for the guarantee to be issued. The letter of credit will be subject to the laws of the country of the applicant and also either the ISP or the UCP.

### Step 3.

After approving the application, the issuing bank issues the counter-guarantee letter of credit in favor of a bank in the beneficiary's country and transmits it with a request that they issue the local guarantee using the wording provided.

### Step 4.

Having received the issuing bank's assurance that they will be reimbursed for any drawings made under the guarantee, the foreign bank issues the local guarantee.

**Note: There are 4 separate contracts in a guarantee/counter-guarantee transaction:**

- 1. The underlying contract (applicant-beneficiary)**
- 2. The L/C application/agreement (applicant-L/C issuing bank)**
- 3. The L/C itself (L/C issuing bank-guarantor bank)**
- 4. The guarantee (guarantor bank-beneficiary)**

**There is no contract between the applicant and the guarantor bank.**