

**ARTICLE ON LETTER OF CREDIT (LC)**  
**(PART-1)**

**Introductions**

Letter of Credit (LC) is a commercial document issued by a bank/financial institution in normal course of business which carries a payment guarantee obligation in case of adverse situation arises.

A bank issue LC on the request of its client in favour of a third party (**beneficiary**). It is important instrument to the extent that it smoothens & secures the transactions ensuring to the party in whose favour the LC is opened that if any adverse situation arises and its client failed to make the payment than the issuing bank will pay subject to the terms and conditions mentioned at the time of issue of LC. This document is most important in case both the parties doing business first time. These parties can do business without any or very low risk, as bank gives a safety assurance to both the parties, involved with the transaction.

The parties to a letter of credit are usually a **beneficiary** who is to receive the money, the **issuing bank** of whom the applicant is a client, and the **advising bank** of whom the beneficiary is a client.

Normally the LC's are irrevocable, i.e., cannot be amended or canceled without prior agreement of the beneficiary, the issuing bank and the confirming bank, if any. The LCs whether revocable or irrevocable depends on the terms decided & accepted between the parties at the time of entering into agreement. But to bring the flexibility into the system, it is generally suggested that LC's should be revocable so that if any mistake happens or due to some reason a necessity arises to amend the LC, it might create panic and delay the transactions. Here it should ensure that amendment should be requested by the authorized person in the bank.

LC may be Inland Letter of Credit (ILC) or Foreign Letter of Credit (FLC). If a client purchases the goods from domestic party, it needs to give Inland LC and if it purchases the goods from overseas, FLC is issued.

The bank issues the LC subject to margin money and the prescribed/approved charges for issue of LC's. It means every time when client need to purchase the goods, it will go to the bank with a request to open LC and deposit margin money and bank charges. Further an issue of power of branches may arise that they need approvals if the overall exposure to a party falls beyond the prescribed limits. Hence they will request to its higher authorities for sanctioning the same and LC's may be issued only after getting the approvals which means unnecessary delays.

To avoid such hassle, bank gives a limit to the client after assessing the requirement of business subject to prescribed bank norms. Also to smooth the function again the bank gives an OD/CC limit so that margins and charges can be called from this account only.

Hence normally it is recommended to take LC limit if the company needs to purchase the goods (including capital goods) on regular basis from domestic and international market. The limits are secured against current assets and collaterals. Banks ask for margin in the range of 10-25% of the LC amount depending on the approval of sanctioning authority.

The margin money is kept in the form of FDR and released on completion of transaction i.e. on payment made by the company to the issuing bank.

One of the primary peculiarities of the documentary credit is that the payment obligation is abstract and independent from the underlying contract of sale or any other contract in the transaction. Thus the bank's obligation is defined by the terms of the credit alone, and the sale contract is irrelevant. The defenses of the buyer arising out of the sale contract do not concern the bank and in no way affect its liability. Banks deal with documents only, they are not concerned with the goods (facts).

Accordingly, if the documents tendered by the beneficiary, or his or her agent, *appear to be in order*, then in general the bank is obliged to pay without further qualifications.

But bank need to check the transport document and ensure that the same is in order which must indicate that the goods has reached the destination.

### **Type of Letter of Credit**

Type of LC's is as follows:

1. Sight LC means that payment is made immediately to the beneficiary/seller/exporter upon presentation of the correct documents in the required time frame. In case of sight LC there is no credit period available to the buyer/importer. The purpose is only to secure the transaction as bank involves. The transaction is completed immediately on receipt of docs in bank. This type of LC is also termed as DP LC.
2. Usance/time' LC will specify when payment will be made at a future date and upon presentation of the required documents. In case of Usance LC a credit period is extended by the exporter/seller. The LC is opened for the tenure as decided between both the parties which include the credit period. The transaction is completed on expiry of said credit period. This type of LC is also termed as DA LC.

### **Documents Called for under a Letter of Credit**

Following documents are generally submitted/transmit/issued under LC's

- Financial Documents: Bill of Exchange, Co-accepted Draft
- Commercial Documents: Invoice, Packing list
- Shipping Documents: Transport Document, Insurance Certificate, Commercial, Official or Legal Documents
- Official Documents: License, Embassy legalization, Origin Certificate, Inspection Certificate etc

- Transport Documents: Bill of Lading (ocean or multi-modal or Charter party), Airway bill, Lorry/truck receipt, railway receipt, CMC Other than Mate Receipt, Forwarder Cargo Receipt, Deliver Challan
- Insurance Document: Insurance policy, or Certificate but not a cover note.

### **Discounting of LC's**

The LC is a document which not only ensures the safety of transaction but also can be en-cashed i.e. beneficiary may discount LC from its bank subject to terms and conditions as prescribed by its bank. The beneficiary bank intimates to the issuing bank regarding this fact that beneficiary has got discounted the LC.

LC is discounted against the documents of goods which are shipped and proof of same along with other relevant documents are submitted by beneficiary to its bank. But the beneficiary must either has:

- bill Discounting Limit with its bank, in this case the seller need to intimate to the buyer
- an intimation send by the beneficiary bank to the issuing bank and the same is accepted by the buyer for each & every transaction. If the buyer do not accepts the same, discounting would not be possible.

LC discounting is possible in case of usance Letter of Credit only.

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For any query or assistance, kindly call or send a mail undersigned.

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