<u>Letter of Credit & International Trade</u>

"Globalization and free trade do spur economic growth, and they lead to lower prices on many goods."

-Robert Reich-

Undoubtedly, the international trade has a prominent impact on economic development. The rise in the international trade is essential for the growth of globalization. It has flourished over the years due to many benefits. Basically, international trade is to exchange the products, services and capital with the other countries round the globe. International trade is playing vital role for enhancing the domestic competitiveness, taking the advantage of technology, increasing sales and profits, maintaining cost competitiveness in domestic market, enhancing potential for expansion of business, gaining a global market share, reducing dependence on existing markets, stabilize seasonal market fluctuations, reduction of poverty, economic growth & development etc. It is also one of the significant sources of revenue for developing countries like Pakistan. In international dealing (import/export), many initial steps are required to start business as well as many documents/paper formalities are needed. Purchase orders, commercial invoices, CMR document, Bill of lading, Air waybill, multimodal bill of lading, certificate of origin, letter of credit etc. are the examples of general documents required. A businessman whether he is an exporter or importer must be well aware about such paper formalities.

When we talk about international dealings, payments must be systematic, and in order to eliminate risks such as unfamiliarity with the foreign country and buyer, laws and customs, transit risk, foreign exchange risk, political condition etc., "letter of credit" is a financial tool that is often used in international transactions to ensure payments. Letters of credit are typically used by importing and exporting companies particularly for large purchases. It acts as a binding document issued by the bank on the behalf of buyer and make sure that all delivery conditions have been met before making the payment to the seller. It gives the reassurance to seller that he will receive the payment for the goods. Mainly, the letter of credit verifies the credibility of buyer because it is usually issued by the banks or other financial institutions. L/C generally has three participants; the beneficiary (the person or company who will be paid), the buyer of the goods or services (sometimes called the applicant), and the issuing bank (the institution issuing the letter of credit). The beneficiary may request payment to an advising bank, which is a bank where the beneficiary is a client. For example, the advising bank financed the transaction for the beneficiary until payment was received. The same letter of credit would be termed an import letter of credit by the importer and an export letter of credit by the exporter. In most cases the importer is the buyer and the exporter is the beneficiary.

There are many types of L/C with different features and characteristics used in international market according to the need and requirements of transaction;

- Revocable L/C
- Irrevocable L/C
- Stand-by L/C
- Red Clause L/C
- Green Clause L/C
- Revolving L/C
- Back-to-back L/C
- Transferable L/C
- Confirmed L/C
- Unconfirmed L/C

Revocable letter of credit; it can be changed or cancelled by the bank that issued it, at any time and for any reason, on the contrary (does not exist as per UCP-600 w,e,f01-07-2007), **Irrevocable** letter of credit cannot be changed or cancelled unless everyone involved agrees and it provide more security than revocable L/C. whereas the **Confirmed** letter of credit is a letter that has another bank besides the issuing bank standing behind it which is called the confirming bank that ensures the payment. And **unconfirmed** letter of credit has not been guaranteed or confirmed by any other bank. For the ease of payment to more than one party, **Transferable** letter of credit can be used, because it can be passed from one 'beneficiary' (person receiving payment) to others and commonly used when intermediaries are involved in a transaction. But an **non-transferrable** letter of credit does not allow transfer of payments to third parties. A letter of credit may also be **at sight**, which is payable when the documentation has been presented and verified, or payment may be delayed (also called a usance letter of credit) until a particular time period has passed or the buyer has had the chance to inspect or even sell the goods. **Back-to-back L/C** is used in bulk orders and in trade involving an intermediary, such as a trading house. It is actually made up of two letters of credit, one issued by the buyer's bank to the intermediary and the other issued by the intermediary's bank to the seller. **Revolving L/C** is a Single L/C that covers multiple-shipments over a long period of time, Instead of opening new L/C for each separate shipment, the buyer establishes a L/C that revolves either in value (a fixed amount is available which is replenished when exhausted) or in time (an amount is available in fixed installments over a period such as week, month, or year). **Green Clause L/C** is a guarantee document that allows a purchaser to receive advances ahead of shipment against collateral property represented by warehouse receipts. Use of a green clause letter of credit is often used in the agricultural business where a company can fund the harvest of a new crop by pledging available stock as collateral. A **red clause** letter of credit allows the beneficiary to receive partial payment before shipping the products or performing the services. Originally these terms were written in red ink, hence the name. In practical use, issuing banks will rarely offer these terms unless the beneficiary is very creditworthy or an advising bank agrees to refund the money if the shipment is not made.

No doubt, many types of L/Cs create an ease for the various types of international transactions. For a businessman, it is also need of the hour to have understanding about the different types and procedure of opening a letter of credit for trading efficiently in international market. It is not as difficult as it is perceived, some following steps are included in the procedure to obtain L/C;

- The Applicant and the Beneficiary negotiate terms and conditions of the L/C as per the agreement they have made.
- The Applicant applies to the Issuing Bank to issue the L/C on an application form.
- The Issuing Bank requires some documents from the applicant; Formal contract between the importer and exporter, Pro Forma Invoice (an invoice through which the exporter informs the importer about the kind and quantities of goods to be sent, their value, time of shipment and important specifications), Buyer’s purchase order.
- After inspecting all these documents, the bank issues the L/C and forwards it to the Advising Bank. The Advising Bank checks the apparent authenticity of the L/C and advises the L/C to the Beneficiary.

Through this process, a letter of credit is easily accessible to a businessman and its benefits are not limited to one party. Seller has the security to receive the payments from the buyer’s bank, L/C reduces the risk of production. Seller has the opportunity to get financing in the period between the shipment of the goods and receipt of payment (especially, in case of deferred payment). Even the buyer will not be able to refuse to pay due to a complaint about the goods. And if we examine the buyer’s side, definitely buyer would also be benefited through the usage of L/C e.g. Cash resources of importer/buyer are not tied up, the importer can control the shipping dates for the goods being purchased, payment will only be made to the seller when the terms and conditions of the letter of credit are complied with and by a letter of credit, the buyer demonstrates his solvency etc.

In current era, every businessman wants to expand his business. International business is like a key that opens the door to the whole world for your product recognition. No doubt, there are bundle of benefits on international trade and at the same time there are many risks involved. But currently, it’s not a big issue because different documentations and institutions are involved in international dealings that allow companies to increase their working capital and accountability. Letter of credit is one of that instrument/method to provide protection to both parties in international transaction. Therefore, letter of credit is significant part and is structured according to international trade practices and regulations. It establishes what the parties are expected to do, what documents are required for the transactions, and the terms both exporter and importer agree beforehand. Thus letter of credit serves as a guarantee to strengthen the transaction and creates a link between the exporter & importer and works as a mechanism for payments that involves banks.

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