

**INTERNATIONAL COMMERCIAL LAW: LETTER OF CREDIT AND ITS TYPES**- Samridhi Bhatt<sup>1</sup>**ABSTRACT**

International trade is recognized to be the backbone of transactions taking place worldwide. It is vital to understand as to what is the acceptance or payment methods in the process of importing and exporting materials. With the balance of advancement method, now, there are various ways to make payments as best for the buyers at ease process. It is pertinent to mention that international trade is directly associated with marine transportation. In International trade, the nexus of various payment ways with marine transportation made it much smoother for the parties to enter into trade transactions broadly. Concerning payment accomplishment, not only physically, but with the help of the Internet, the activities can be exercised at any time & anyway. However, criticism lies in the phase of every growing track Internet holds drawback of **Trust and reliability** due to the absence of physical communication and Virtual relations. Aloof from the negative, international trade is the essence of the global economy necessitating participation from every nation.

**INTRODUCTION**

In every trading system, parties are considered to be the executors of the transaction process. It is pertinent to mention that trade must ensure a factor of guarantee to make payment and provide services. However, in the case of international transactions, parties from multiple countries enter into the trading business for importing and exporting various supplies, which in turn, constitutes the criticism of reliability issues as there are probabilities in regards to the unknowingness of the parties' background due to which many transactors daunt to be a part of the international trading system. Here comes the role of the third party, the **Bank**, which ensures the security of the payment through the **Letter of Credit**. In this article, we will be discussing the letter of credit and its kinds, followed by other relevant categories.

---

<sup>1</sup> Student at Delhi Metropolitan Education, Noida

For general queries or to submit your research for publication, kindly email us at [editorial@ijlr.in](mailto:editorial@ijlr.in)

<https://www.ijlr.in/>

### Letter of Credit

In the concept of a Letter of Credit, it is an **instrument** rendered by the Bank, on the part of the customer/buyer/importer, with the purpose of furnishing assurance/guarantee to the seller/exporter that the **consideration** will be done positively only after the **requirements**(i.e. invoices, documentary evidences, consignment associated documents, etc.)met by the seller/exporter. In the naive sense, by the buyer's (Importer) **application** to the Bank, the LOC is delivered to the seller. The institution ensures that the purchaser will make the payment guaranteed by which reliability issues of the seller are exempt but following with the conditions at first that the seller holds a **mandatory obligation** to fulfill all requisites as specified in the Letter of Credit. Hence, the LOC has the function of an **advance payment option**. Here, the duty of making payment lies on the shoulders of the respective Bank that's providing the LOC, and it is **binding**. Even in the cases where the buyer fails to pay the balance amount, the same will be given by the Bank. It is pertinent to mention that the LOC is a **negotiable instrument** where the buyer's Bank makes the payment to the seller's/beneficiary's Bank. However, instantly, here a question arises as on what basis the Bank accepts the request of the buyer to provide LOC to the beneficiary? It is an undoubted fact that banks never serve for free, they mandatorily charge some amount to provide services. Hence, the same follows in the deliverance of LOC. The Bank holds security deposits and charges a particular amount of fees in accord with the percentage of the size of the LOC from the buyer/importer.

In this case, the seller, as well as the buyer, hold the position of satisfaction of meeting their wants wholly as the Bank is the **guarantor** of the whole execution. Thus, it is considered to be the most **secured option** for making payments in international transactions.

### Parties in Letter of Credit

The main parties in the Letter of Credit are:

1. The applicant/account party (Importer)
2. The issuing authority/issuer of LOC (Bank/Financial Institution)
3. Beneficiary (Exporter/seller)

This procedure involves that firstly, the importer (Applicant) has to make an application to the Bank with a request to issue a Letter of Credit in favor of the Exporter (Beneficiary), under which all the Terms & Conditions will be specified, and the same has to be provided by

For general queries or to submit your research for publication, kindly email us at [editorial@ijalr.in](mailto:editorial@ijalr.in)

<https://www.ijalr.in/>

the beneficiary as demanded under the LOC, after which if the issuing authority and the applicant are satisfied on the documents and details delivered by the beneficiary then the payment will be delivered. It can also be said that the LOC is akin to a **Contract of sale**.

### Types of Letters of Credit

#### 1. Standard/Documentary Letter of Credit

The letter of credit as enunciated above is directly known as the Documentary Letter of Credit as defined under **Article 2(21)**.<sup>2</sup> It is an instrument requested by the buyer/importer from the Bank to deliver the LOC to the seller/exporter in view that the payment will be made guaranteed only if the requirements as stipulated in the LOC are adhered to wholly by the Exporter. This LOC holds an efficient role in the international trading business. It is likewise recognized as **Exporter/Importer Letter of Credit**, the reason being that it depends on the party who executes the LOC, in case if the importer utilizes the LOC, then it will be known as Importer's LOC, and vice versa. In this course, the credit can be mold into the following kinds:

1. After the successful completion of requirements leading to the collection of payment by the exporter/seller.
2. Deliverance of document at first and the payment at maturity.
3. Utilizing the Negotiable function and setting the place of seller.

#### 2. Standby Letter of Credit

This type of LOC ensures the duty of making payment in the case where the buyer is unable to furnish the same. Hence, it is considered to be executed on Secondary Duty. However, it is pertinent to mention that it acts as a **Bank guarantee** where banks are not the only ones to provide a guarantee. Now, this kind of LOC holds two responsibilities:

- I. That the issuing party (Issuer) has to accomplish the duty on the applicant's application,
- II. That the issuing party (Issuer) must approve all the pieces of documentary evidence as provided by the seller.

---

<sup>2</sup> Uniform Customs and Practice for Documentary Credits

For general queries or to submit your research for publication, kindly email us at [editorial@ijlr.in](mailto:editorial@ijlr.in)

<https://www.ijlr.in/>

The crucial point in this kind of LOC is that the **Burden of proof** lies on the shoulders of the seller. There are situations where the material is received by the buyer but the payment is not made, in such cases if the seller proves that:

- a) All the requirements as mentioned in the standby LOC are fulfilled by the seller, and
- b) The buyer fails to make the payment.

Henceforth, if the above two conditions are proved by the seller, then the issuer(Bank) will make the payment, on behalf, of the buyer to the seller. In a gist form, the bank acts, just in case, to provide a guarantee and not expedite transactions. The best example could be the facilitation of insurance facilities, same as that of SBLC. However, it has been observed that SBLC is not much exercised in trade transactions.

### **3. Revocable Letter of Credit**

It is perceived to be the most uncertain form of LOC where the modifications and cancellations of the LOC are made, without providing any prior notice to the beneficiary. In the concrete sense, here the control has been provided to the issuer (Bank) and the buyer to alter or modify, and cancel (only done by the Bank) the LOC whenever it wishes to do so following any of the reasons without informing the seller. Also, the issuer takes no responsibility for the guarantee of making payment even if the requirements of RLOC are met by the seller. Hence, this form of LOC **does not provide surety and security** to the seller (Beneficiary), due to which this form is not opted much by the beneficiaries for making transactions in international trade. According to the regulations, even under the Uniform Customs and Practices, there are no provisions relating to Revocable LOC. As compared to Documentary and Standby letter of Credit, the RLOC is not legally binding in nature.

Therefore, such kind of LOC is not much of use depending upon the conditions and the transactions. The RLOC holds **risk and disadvantageous factors** for the beneficiary as he won't have any kind of assurance for receiving payment on delivering the goods to the buyer.

### **4. Irrevocable Letter of Credit**

The Irrevocable LOC is the opposite of RLOC, in the sense that under ILOC the **assurance, security,** and the **binding effect** has been provided to the beneficiary. In ILOC, the alterations/ modifications and cancellations cannot be made strictly by the Bank or the

buyer/account party. In this, the essence of the **consent role** has been provided according to which without the permission of the other party members the ILOC cannot be altered and canceled. Also, further, for any of such changes, an **agreement** has to be entered upon by the parties.

The ILOC entails the **responsibility** of the Bank towards the beneficiary to make payment as agreed by the parties, and accept all the conditions as specified in the LOC. Similar to that of the Documentary LOC, in ILOC, the Bank has to make payment to the seller/beneficiary after the completion of all the terms done by the seller as per ILOC. It is a beneficial form of letter for the beneficiary where he holds an assurance against his deliverance of goods.

The ILOC has its two forms:

- I. **Confirmed LOC**: This kind of LOC comes into the picture when there arises a reliability issue. Making a transaction in an international trade where the party is way too far from each other, No reliable concrete information undoubtedly led to the concern of trustworthiness of the parties as the Bank of the seller or the buyer is the only institution that affirms all the terms and document. However, some parties still appear unsure as to the confirmation and the assurance provided by the account party's Bank. Here, another institution comes into being, the advising Bank that delivers approval/confirmation on the part of issuing Bank. The procedure under CLOC involves the following process:
  - a) That the party (either buyer or beneficiary) holds a doubt in regards to the issuing bank reliability;
  - b) After which the issuing Bank requests an advising bank to confirm the LOC on the part of issuing Bank;
  - c) It replaces the position of the responsibilities where the advising Bank becomes the issuing Bank and furnishes a guarantee that the payment will be made to the seller only if the conditions are wholly performed and abide by the beneficiary.
  - d) The advising Bank is ordinarily that institution trusted by the beneficiary.
- II. **Silent LOC**: This is the reverse of CLOC, in which, rather than the issuing bank, the request for a confirmation is made by the seller/beneficiary. As having a silent feature, the beneficiary/beneficiaries are the only ones knowing the request confirmation.

For general queries or to submit your research for publication, kindly email us at [editorial@ijalr.in](mailto:editorial@ijalr.in)

<https://www.ijalr.in/>

III. **Unconfirmed LOC**: Almost all the LOC are Unconfirmed LOC where the need to confirm or the request for confirmation does not arise. Mainly the role of the Advising bank or the second bank is excluded.

#### 5. **Transferrable and Untransferable LOC**

In the international trading system, there aren't always two-party to execute the LOC. There are high possibilities in case of having many parties, the TLOC delivers the facility to transfer payment due as a persona to the LOC. The facility can either be exercised by the issuing bank or by the beneficiaries. Crucially, these are for the beneficiaries, it applies to those cases where there is a delegate/ subsidiary beneficiary who is willing to transfer complete or remaining payment to the principal/primary beneficiary. Also, even generally, the transfer of payment can be made from one beneficiary to the other. The requirements of TLOC are as follows:

- That the transfer can be made only when the real beneficiary will provide the request's application;
- That the documents must be shown before transferring the amount to another beneficiary;
- That the documents must be of the beneficiary who is transferring the amount, and only then the transfer will be executed.

However, in **Untransferable LOC**, it is the opposite of TLOC in which there is an **absence of transferrable facility**. The beneficiary will be the only owner to hold the payment, and such LOC cannot be utilized in more ways.

#### 6. **Back-to-Back LOC**

This is recognized to be a hidden LOC where the identification is kept safe with the LOC. It too includes a middleman in the process of transactions. Under the BBLOC, two LOC are created as follows:

- 1) Released by the buyer's bank to the middlemen beneficiary's bank,
- 2) Released by the middlemen beneficiary's bank to the trader.

Here, the middlemen beneficiary is known to both identities of buyer and seller. However, this is always issued, in view, to hide the real identity of the seller and the buyer. This kind of LOC is not used much except in certain transactions.

For general queries or to submit your research for publication, kindly email us at [editorial@ijalr.in](mailto:editorial@ijalr.in)

<https://www.ijalr.in/>

## 7. Revolving LOC

According to this LOC, it is meant for **multiple transactions** in a **single LOC**. The transactions that occur constantly, where a bulk trading system is being processed with various parties, at such a moment it's laborious to issue LOC individually for every single transaction. Hence, RLOC comes into the picture that can be released at once, the amount in the LOC can be changed according to the transaction that takes place, and the single LOC can be utilized for numerous transactions.

Every trading system builds a strong relationship between buyer and seller where this relationship works for several years as the parties become well adverse of the background of each other. It led to the making of RLOC where now it's easy for the buyer to proceed with the transactions through a single released LOC. The **Expiration period** of RLOC is generally **one or three years** depending upon the conditions. The best example could be of **Construction Contract**.

## 8. Red Clause LOC

The principle under RCLOC involves '**Payment before services**'. According to this LOC, a part of the payment is rendered by the buyer, issued as an advance loan, to the beneficiary before delivering goods and services to the buyer. This advance payment amount is concluded, afterward receiving the goods and services from the seller as negotiated. This kind of transaction takes place where there is a need for arranging materials by the seller for which advance payment has to be made by the buyer to the seller. In all the other forms of LOC, there is a rule to make payment after receiving the services, but it is different from all the other LOC by holding an advance payment characteristic. However, this creates a credibility issue for the buyer as the payment will be made in advance, further, there is an uncertainty that whether the seller will be there to provide the services or not. To eliminate such risk, a written confirmation along with the receipt is delivered by the seller.

The RCLOC is demanded by the seller as he will be in **benefit** for having paid in advance. However, the risk lies for the buyer, and due to this reason, mostly, the RCLOC is not opted by the buyer.

## 9. Green Clause LOC

It is an extended version of RCLOC in which another facility has been furnished, which is the **storage port**. Earlier in the case of RCLOC, the seller has to provide receipt and written confirmation, but, in GCLOC, along with the receipt and written confirmation, the seller has been provided a storage place where the goods are to be stored.i.e., warehousing of materials. Here, the seller has to also provide evidence (warehouse receipt), that the goods have been stored or that the goods will be stored in a particular place in the name of the respective institution (Bank).

This kind of LOC is considerably safe as that of the RCLOC, but, for many buyers, this LOC still seems to hold risk as there is uncertainty for the deliverance of services.

#### **10. Slight LOC**

According to this LOC, **instant payment** is made by the issuing bank to the seller just by providing the relevant documents. Here, this LOC is dependent upon the **documents**, it is to be **in consonance with the terms and conditions** provided in the LOC. The bank has the responsibility to check all the documents provided by the seller, and once the approval is rendered, the bank will deliver instant payment to the seller. For the bank, it takes few business days to review all the documents and pass confirmation.

#### **11. Direct payment LOC**

In this LOC, a whole different scenario arises where the bank makes the payment directly to the seller without interacting with the buyer, and after making the payment, the same is to be taken from the buyer. Here, no relationship of exchange lies between buyer and seller as the payment is made by the bank directly. This kind of LOC is beneficial for the seller as well as the buyer, but the bank is the risk party where the uncertainty lies on the part of the buyer.

#### **12. Deferred payment LOC**

According to this LOC, the payment to the seller is made at a **particular period of time**. It is the opposite of that of the sight LOC. Under this, the seller is provided a reasonable period of time, which is to be agreed by the seller, only after which the payment will be delivered. It is to be noted that before the payment is made to the seller, the goods are to be received by the buyer, and this is the beneficial clause for the buyer as he will be able to review the goods before making payment to the seller. This is a high-risk LOC for the seller as he won't have anything on his hands if the buyer commits fraud. However, the bank in some way will play

its part too but, at the end of the transaction, if something wrong happens, the result of the risk will be faced by the seller. Hence, to never counter such risky LOC, the seller will never opt to be in this kind of transaction.

This LOC is also known as **Usance LOC**. This LOC assures the seller that the payment will be made but at the specified time only. The procedure to this LOC involves the inspection of documents by the bank at the first stage, after that, the goods are delivered to the buyer, and lastly, on the completion of the stipulated period, the payment will be provided to the seller. The best example of this kind of LOC could be making a payment by way of installments.

### **Benefits of Letter of Credit**

The Letter of Credit holds a significant part in the international trading system where a bank carries the responsibility for all the uncertainties. Hence, LOC becomes beneficial for the exporter as well as the importer. The following point covers the benefits acquired by the exporter and the importer by using Letters of Credit:

#### **Exporter:**

- ✓ Issuing bank holds the responsibility to make payment
- ✓ Minimizes uncertainty of the stock production
- ✓ Chance of finance
- ✓ Easy to strategy
- ✓ Mandatory to make payment by the buyer against the goods, even if the buyer is not satisfied.

#### **Importer:**

- ✓ Elimination of risk by the paper review approval from the Bank.
- ✓ Power over the terms of Contractual obligations.
- ✓ Vital party in the working of LOC (willingness)

### **Conclusion**

The international trading system is a worldwide transactional hub where different country's buyers may purchase goods from another country's sellers. It's typical to have a form of payment facilities in such a platform that can run smoothly without transmitting risks/uncertainties. The different types of letters of Credit enunciate every kind of possible dexterity to the parties so that they can choose any LOC according to their willingness, and

For general queries or to submit your research for publication, kindly email us at [editorial@ijalr.in](mailto:editorial@ijalr.in)

<https://www.ijalr.in/>

their nature of trading. The Letter of Credit has a very crucial role in the international platform for all the exporters and the importers due to which, the Letters of Credit must be utilized in the truest sense. Also, growth for every platform is vital for balancing intricacies and advancements. Hence, for the Letter of Credits, development in every minor point must still go on for better functioning at the International Levels.

### **References**

1. *Intricacies Involved in an International Transaction by 'Letter of Credit'*, available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1583826](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1583826)
2. *Advantages of Using Letter of Credit in International Transactions*, available at <https://www.mondaq.com/turkey/international-trade-investment/100456/advantages-of-using-letter-of-credit-in-international-transactions>
3. *Letter of Credit*, available at <https://www.intelligenteconomist.com/letter-of-credit/>
4. <https://efinancemanagement.com/sources-of-finance/types-of-letter-of-credit-lc>
5. <https://www.thebalance.com/types-of-letters-of-credit-315040#:~:text=Different%20Types%20of%20Letters%20of%20Credit%201%20Commercial,that%20payment%20will%20be%20made.%20More%20items...%20>
6. <https://howtoexportimport.com/-What-is-a-Letter-of-credit-in-International-Trade-10380.aspx#:~:text=Letter%20of%20credit%20is%20a,oted%20by%20importers%20and%20exporters.&text=An%20LC%20is%20a%20commitment,presentation%20of%20all%20required%20documents.>
7. <https://blog.ipleaders.in/letter-credit-regulatory-framework/>
8. <https://www.uniassignment.com/essay-samples/law/letter-of-credit-in-international-transactions-law-commercial-essay.php#ftn90>

For general queries or to submit your research for publication, kindly email us at [editorial@ijalr.in](mailto:editorial@ijalr.in)

<https://www.ijalr.in/>



For general queries or to submit your research for publication, kindly email us at [editorial@ijalr.in](mailto:editorial@ijalr.in)

<https://www.ijalr.in/>

© 2021 International Journal of Advanced Legal Research