Standby Letter of Credit

There is a growing trend amongst banks to issue a *standby letter of credit* (SBLC) due to overwhelming response from their clientele as all constituents feel that the issuance of an SBLC is a simple and cost-effective procedure, and they need not repeatedly go around the bank for issuing an ordinary commercial *letter of credit* every time for a trade transaction. There is no hassle in submission of a host of documents and discrepancies pointed out for smaller mistakes, thus, avoiding or delaying the payments. The International Chamber of Commerce (ICC) has also observed that the amounts outstanding under *standbys* have far exceeded the amounts under regular commercial letters of credit. SBLCs are now used all over the world including India. Read on to know more…

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International Standby Practices (ISP 98)

Bankers often get confused between *International Standby Practices* (ISP 98) and *International Standard Banking Practices* (ISBP–Publication 681). While the former governs the rules and regulations relating to issuance of standby letter of credit, the latter deals with explanations to certain terms used while examining

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documents presented under *Uniform Customs and Practices for Documentary Credits* (UCPDC 600). While auditing branches dealing with foreign exchange business and/or any commercial business, there is a need for chartered accountants to scrutinise this portfolio vigilantly to find out if all set guidelines governing this type of business have been properly followed.

In many countries across the world, guarantees are issued by banks for securing payment for non-performance of an underlying contract by the applicant customer and/or non-repayment of debt/installments. A guarantee is protection to the beneficiary for the acts of non-performance by the other party resulting in financial losses to the beneficiary of such actions committed by the applicant. The banking legislation of the United States forbids US credit institutions from assuming guarantee obligations of third parties. To subvert such a situation, a substitute for performance guarantee or for securing repayment of loans/advances entered into by the constituents/banks in the US, *standby letter of credit*, has been designed, which is being used by the US bankers. Now, SBLCs are used all over the world including India. While they are also covered under UCPDC, the significant variance of the ruling guidelines of *standby credit* prompted the ICC to come out with a separate set of rules for SBLCs. In view of the popularity of this product, a new set of rules were approved by the ICC Commission on banking technique and practice on 6th April, 1998, and were issued as an ICC publication 590 and termed as ISP 98.

The US Comptroller of Currency defines an SBLC as: *A standby letter of credit is any letter of credit, or similar arrangement however named or described, which represents an obligation to the beneficiary on the part of the issuer:*

(i) to repay money borrowed by or advanced to for the account of the party; or

(ii) to make payment on account of any indebtedness undertaken by the account party; or

(iii) to make payment on account of any default by the account party in performance of obligation" .

Bankers can issue SBLCs under the provisions of UCPDC 600 as per Article 1 which states that the Uniform Customs and Practice for Documentary Credits, 2007 Revision, ICC Publication no. 600 ("UCP") are rules that apply to any documentary credit ("credit") (including, to the extent to which they may be applicable, any standby letter of credit) when the text of the credit expressly indicates that it is subject to these rules or under the provisions of ISP 98 (publication 590). They have to specifically mention the same in the standby issued by them as in the case of any dispute/clarification, articles, rules and regulations of that particular provision only apply. Banks must take an undertaking from the customer to this effect.

Unlike in a commercial *letter of credit* where huge set of documents are called for such as bill of lading, invoices, documents evidencing insurance, proof of dispatch of goods, etc., to enable an applicant of credit to make the payment, in standby credit a simple statement of claim, proof of non-delivery of goods or certificate of non-performance is a sufficient claim on the applicant, and the applicant bank is required to honour the payment. In simple words, a commercial *letter of credit* is a payment for performance of a contract and standby is a payment for non-performance.

Given below are some illustrative examples, how a particular action is treated under various articles of UCPDC 600 and under the rules of ISP 98:

UCPDC 600	**ISP 98**
ARTICLE – 1 Credits are binding on all parties unless expressly modified or excluded by the Credit	RULE 1.01 © An undertaking subject to the rules may expressly modify or exclude their application.
ARTICLE – 3 Branches of a Bank operating in different jurisdictions are considered to be separate entities.	RULE 2.02 If a branch is acting on its own capacity other than issuer is a different bank without relevance to jurisdiction
ARTICLE – 7 (B) The credit is enforceable against the issuer "as of time it issues the credit".	RULE 2.03 The credit is binding on the issuer when it leaves the issuer's control.

ARTICLE – 16 © Notice of dishonour to be given within five business days.	RULE 5.01 (a) The notice of dishonour to be given which is not unreasonable. Three days are not unreasonable but seven days are unreasonable.
ARTICLE – 36 – *FORCE MAJEURE* The issuer will not accept any presentation if the credit expired during the period of *force majeure*.	RULE – 3.14 (A) In this case, it extends to 30 calendar days after business reopens.
No such condition	ISP 98 – RULE 3.12 (A) If an original standby is lost, stolen, mutilated or destroyed the issuer need not replace it or waive any requirement that the original be presented under the standby.

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Types of Standby Letter of Credit

(1) *Performance Standby*: This instrument supports an obligation to perform other than to pay money including the purpose of covering losses arising from a default of the applicant in completion of the underlying transaction.

(2) *Advance Payment Standby*: This instrument supports an obligation to account for an advance payment made by the beneficiary to the applicant.

(3) *Bid Bond/Tender Standby*: This standby supports an obligation of the applicant to execute a contract if the applicant is awarded a bid.

(4) *Counter Standby*: This instrument supports the issuance of a separate standby or other undertaking by the beneficiary of the counter standby.

(5) *Direct Pay Standby*: This instrument serves to support payment when due of an underlying payment obligation typically in connection with a financial standby without regard to default. This standby is also used to directly pay an obligation where the only conditions of payment are the passage of the term and presentment of payment.

(6) *Insurance Standby*: This instrument is an insurance or reinsurance obligation of the applicant.

(7) *Commercial Standby*: This is the most used standby and it supports the obligations of an applicant to pay for goods or services in the event of non-payment by a business debtor.

Parties to a Standby Letter of Credit

(1) The Applicant.
(2) The Issuing Bank.
(3) The Beneficiary.
(4) Confirming Bank.
(5) Advising Bank.

(1) *The applicant* is the customer of the bank who requested the *issuing bank* to issue an SBLC on his behalf to guaranteeing payment in the case of default by him to meet the obligations under the contract. A written application supported by documents should be obtained by the bank from him.

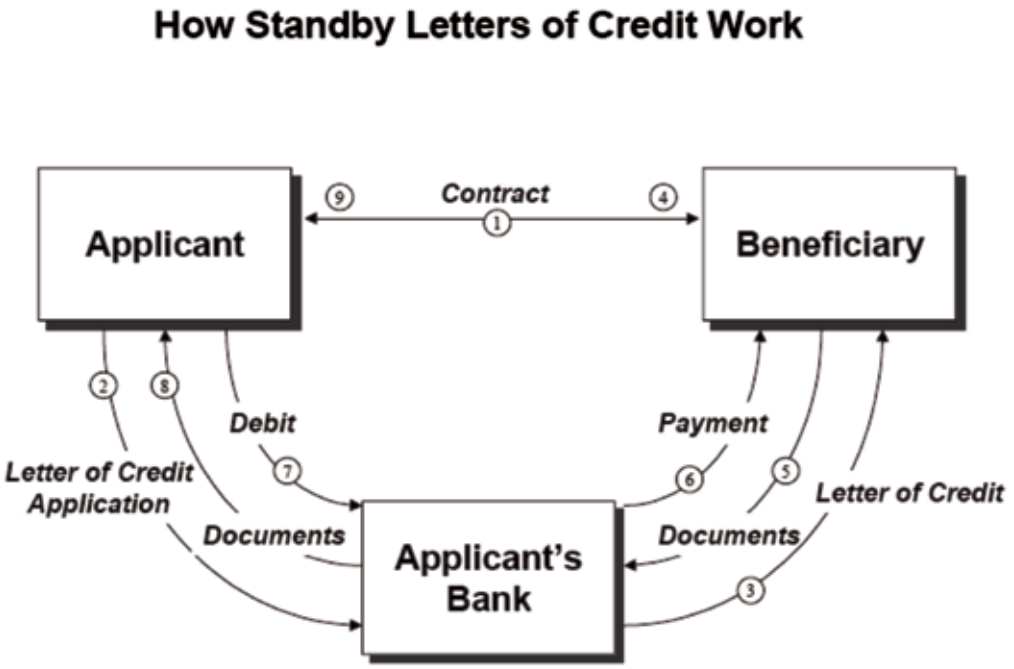
(2) *The issuing bank* is the applicant's bank that issues the standby letter of credit on his behalf undertaking the liability to honour the claim from the beneficiary.

(3) *The beneficiary* is the customer in whose favour an SBLC has been issued.

(4) *The confirming bank* is a bank normally in the beneficiary's country which undertakes to pay the beneficiary instead of the beneficiary directly approaching the issuing bank located in a different location/country.

(5) *The advising bank* is the bank that represents the beneficiary. It may accept the letter of credit on behalf of the beneficiary and will collect on behalf of the beneficiary. The advising bank may also act as the *confirming bank* sometimes.

Given above is a diagrammatical presentation of how an SBLC works (*confirming bank* and *advising bank* are not shown in the diagram):



FEDAI /RBI Guidelines on Issuance of SBLC

An SBLC facility can be extended to the following types of importers on a selective basis:

(1) If advance remittance made by an importer exceeds $200,000, SBLC from a reputed international bank and/or from an Authorised Dealer (AD) Category-1 bank in India against counter guarantee of a reputed international bank may be accepted.

(2) AD bank can open an SBLC for import of gold on loan basis as per the FEDAI guidelines dated 1st April, 2003, with a condition that the tenor of the SBLC should be in line with the gold loan. The entities permitted to import gold on loan basis, viz. nominated agencies and 100% EOUs/ units in SEZs, which are in the gem and jewellery sector and SBLC, should be in favour of the internationally-renowned bullion banks only.

(3) An SBLC can also be issued covering import of goods.

(4) In the case of independent power producers/ importers of crude oil and petroleum products, an SBLC should be issued on selective basis.

(5) An SBLC can be issued for export houses/trading houses, 100 % EOUs/star trading houses.

(6) Satisfactory credit report on the overseas supplier should be obtained.

(7) Invocation of a commercial SBLC should be supported by proper evidence and the following documents should be obtained:

i. Copy of invoice;

ii. Non-negotiable set of documents;

iii. A copy of Lloyds/SGS inspection certificate wherever provided as per underlying contract;

iv. Evidence of imports in respect of all payments made under standby LC; and

v. ADs should follow up evidence of import as provided under FEMA, in all cases of payments made under such standby LC.

(8) The applicant for the commercial SBLC shall undertake to provide evidence of imports in respect of all payments made under standby.

(9) In case the item (b) and (c) in para 7 are to be waived, the FEDAI advises that such decisions should be at the highest level of controlling offices of SBLC *issuing bank.*

(10) Issuance of SBLC for financial institutions and NBFCs relating to ECB is not normally permitted. In the case of an SME, it will be considered on merit subject to prudential norms.

(11) With a view to facilitating capacity expansion

With a view to facilitating capacity expansion and technological upgradation in the Indian textile industry, SBLC by banks in respect of ECB by textile companies for modernisation or expansion of textile units will be considered under the approval route subject to prudential norms.

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(12) Authorised dealers to issue/receive standby LC in respect of any debt, obligation, or other liability incurred by
   i. An exporter on account of exports from India.
   ii. Owed to a person resident in India by a person resident outside India for a *bona fide* trade transaction duly covered by a counter guarantee of a bank of international repute resident abroad.
   iii. Exporters may opt to receive an SBLC in respect of exports from India.

Precautions to be Taken by Banks for Issuance of SBLC

1) An SBLC should be issued on behalf of customers whose creditworthiness has been properly assessed by the bank.
2) An application from the customer should be obtained for issuance of an SBLC including the *proforma* of an SBLC issued. The applicant should also confirm that he is aware of the provisions under which SBLC has been issued and that he will not enter into any disputes when the bank is required to make the payment under an SBLC.
3) Since it is a not a fund-based limit, many banks may not undertake a full-fledged assessment of the limits. It should be assessed as if it is a fund-based limit.
4) The implications of invocation of an SBLC and the resultant payment by the customer should be properly explained and recorded.
5) The FEMA/RBI guidelines in respect of SBLC should be made known to the customers.
6) Due diligence including KYC/status reports on the applicant and on the counter-party should be obtained, scrutinised and kept on record.

7) The branch has to assess whether a regular limit is required for issuance of an SBLC and accordingly the limits should be sanctioned.
8) Proper documentation to indemnify the bank of losses and collaterals in the form of additional security other than cash margins should be obtained depending upon the standing of the customer. Depending upon the bank's practices, a contingent liability should be created in the books of the bank while issuing an SBLC.
9) It should be clearly mentioned in an SBLC whether the same is subject to the UCPDC 600 or ISP 98.
10) It should be ensured that intermediary banks such as advising bank, confirming bank, etc., also contributed/accepted the ISP 98 for issuance of an SBLC, and such bank should be of international repute preferably having correspondent banking relationship with the issuing bank.
11) The permission/authority to issue an SBLC should be kept restricted to certain branches/offices only in order to have proper monitoring and control.
12) In case invocation of an SBLC takes place, the RBI should be informed with full details.
13) In case any clarification is required, branch officials should contact their controlling offices/RBI before issuing an SBLC.

Conclusion

Auditors should check if the guidelines governing an SBLC given by FEDAI, RBI and ISP 98 and internal guidelines given by their banks have been properly followed. Any deviation in issuance of an SBLC and making payments under invocation of an SBLC should be carefully scrutinised.■