

Letters of Credit: Types of Commercial Letters of Credit

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A Practice Note discussing the different commercial letters of credit most commonly used in domestic and international transactions for the sale of goods and services. This Note examines how these letter of credit transactions are structured and how they relate to the underlying sales transactions.

[Commercial letters of credit](#) (also referred to as letters of credit, commercial credits, and, simply, credits) have been a vital payment mechanism in international trade for more than a century (see [Practice Note, Commercial Letters of Credit](#)). They allow an exporter in one country to ship goods, and an importer in another to arrange payment for the goods, each confident that the other is meeting its obligations under their international sales contract.

As the use of letters of credit has become more common, international commerce has grown and trade transactions have become more complex. For example:

- Manufacturers and producers often handle international sales through independent distributors, instead of selling directly to foreign customers.
- Large importers that require a regular supply of foreign products often enter into long term supply contracts with foreign producers, under which shipments are made repeatedly at regular intervals (see [Practice Note, Supply Contracts: International Overview](#)).
- Importers with sophisticated procurement systems often assemble products using global supply chains, with components manufactured in stages in several different countries.

Letter of credit practice has adapted to meet the needs of importers, exporters, and others in these complex sales transactions. Letter of credit transactions have grown more complex, with issuing banks often specifying as many as four or more other banks to perform various tasks that are part of these transactions. When a letter of credit specifies a bank to perform a task, that bank is referred to as a nominated bank. For example, when a letter of credit specifies a particular bank to advise (notify) the credit to the [beneficiary](#), the [issuing bank](#) is nominating that bank to act as the [advising bank](#) (see [Practice Note, Commercial Letters of Credit: The Advising Bank](#)). Similarly, when an issuing bank requests that the advising bank confirm the letter of credit, it is nominating the advising bank to act as [confirming bank](#).

Although commercial letters of credit can be tailored many different ways, these variations generally fall into the following categories:

- [Confirmed letter of credit](#) (see [Confirmed Letter of Credit](#)).
- Letter of credit payable at sight or by [deferred payment](#) (see [Letter of Credit Payable at Sight or by Deferred Payment](#)).
- [Banker's acceptance](#) (see [Banker's Acceptance](#)).
- [Negotiable letter of credit](#) (see [Negotiable Letter of Credit](#)).
- [Transferable letter of credit](#) (see [Transferable Letter of Credit](#)).
- [Back-to-back letters of credit](#) (see [Back-to-Back Letters of Credit](#)).

- [Revolving letter of credit](#) (see [Revolving Letter of Credit](#)).
- Revocable letter of credit (see [Revocable Letter of Credit](#)).

Confirmed Letter of Credit

The applicant (the importer and buyer in the sales transaction) and issuing bank typically have an established banking relationship. The beneficiary (the exporter and seller in the sales transaction), however, may be unfamiliar with the issuing bank and its reliability. (For a discussion of the parties to a letter of credit, see [Practice Note, Commercial Letters of Credit: Basic Structure of a Commercial Letter of Credit](#).) The location of the issuing bank might also make it more difficult and time-consuming for the beneficiary to obtain payment. As a result, the beneficiary often requests that the letter of credit be confirmed by a local bank with which it is familiar.

In a confirmed letter of credit, the issuing bank nominates a second bank, usually the advising bank, to add its confirmation to honor a complying [presentation](#) by the beneficiary (for a discussion of presentation and honor see [Practice Note, Commercial Letters of Credit: Presentation and Honor](#)). If the beneficiary presents the required documents to the confirming bank, the confirming bank, like the issuing bank, will honor the presentation by making the required payment to the beneficiary. Confirmation is a definite undertaking, or guarantee, by the confirming bank. It typically takes the form of a declaration in the covering letter attached to the letter of credit, stating, essentially:

"We undertake that all drafts drawn . . . will be honored by us, provided that all terms and conditions of the credit have been complied with."

When the issuing bank issues a letter of credit, the credit typically authorizes or requests the second bank, the nominated bank, to add its confirmation to the letter of credit. The nominated bank is under no obligation to do so, but if it declines to confirm it must promptly notify the issuing bank. If it accepts the nomination, it adds its own irrevocable undertaking to that of the issuing bank under the letter of credit. The credit becomes a confirmed letter of credit, and the nominated bank becomes the confirming bank.

The confirming bank, also known as the confirmer, often has a customer relationship with the beneficiary or is otherwise known to it. The beneficiary of a confirmed letter of credit may look to either the confirming bank or issuing bank for payment. If the beneficiary makes a complying presentation to the confirming bank, the confirming bank must honor it, just as the issuing bank would be obligated to do.

If the confirming bank honors the presentation, typically by paying the beneficiary, it forwards the documents to the issuing bank and is entitled to reimbursement from the issuing bank. A confirming bank is also entitled to a fee for its confirmation. The letter of credit usually provides that this fee will be paid by the beneficiary, but the parties can agree to have the applicant pay the fee.

Letter of Credit Payable at Sight or by Deferred Payment

A letter of credit is typically payable at sight, that is, payable at the time the beneficiary makes a complying presentation to the issuing or confirming bank. The draft that the beneficiary presents as part of its presentation is called a [sight draft](#) (see [Practice Note, Commercial Letters of Credit: Draft and Standard Document, Sight Draft for Commercial Letter of Credit](#)).

However, the tenor of the letter of credit can be varied to defer payment. The letter of credit can provide, for example, that the beneficiary's (exporter's) draft will be payable:

- 45 days after sight.
- 30 days after the date of the bill of lading.
- On a certain future date, such as December 31, 2016.

The beneficiary's draft under such a letter of credit is known as a [time draft](#) or usance draft (see [Standard Document, Time Draft for Commercial Letter of Credit](#)). The credit is known as a time or usance letter of credit.

When a beneficiary makes a complying presentation under a time letter of credit, the issuing or confirming bank is required to accept the draft. The accepted draft is known as a banker's acceptance (see [Banker's Acceptance](#)). The bank then must pay the banker's acceptance on the specified maturity date.

A time letter of credit in effect provides the importer short-term financing. Until the time draft matures and is paid by the issuing bank, the importer (applicant) is usually not obligated to pay the issuer (see [Practice Note, Commercial Letters of Credit: Reimbursement Agreement Between the](#)

[Applicant and the Bank](#) and [Standard Document, Commercial Letter of Credit Reimbursement Agreement](#)). This extra time might, for example, allow the importer to arrange for the resale of the merchandise and then use the proceeds to reimburse the issuing bank. Without this flexibility, it might not be possible for the importer to enter into the original sales contract.

Banker's Acceptance

When a beneficiary makes a complying presentation under a time letter of credit, the issuing or confirming bank accepts the beneficiary's time draft by marking "Accepted" on the face of the draft and endorsing the draft in the name of the accepting bank. A time draft marked with the bank's acceptance is a banker's acceptance, or simply an acceptance. It is an unconditional promise to pay the holder the stated amount when the time draft matures.

Although a banker's acceptance is not payable at face value immediately, it is a [negotiable instrument](#). The drawer or any other holder can sell it at a discount. That is, the holder can sell it for an amount less than its face value based on the time value of money and the creditworthiness of the accepting bank.

After the time draft has been accepted, the drawer (beneficiary, exporter), rather than holding the acceptance until maturity, often endorses the draft back to the bank, which purchases it at a discount. It is not unusual for banks to invest in their own acceptances. If the accepting bank is a strong credit, the drawer can also sell the acceptance elsewhere, usually to another bank. If the acceptance complies with the requirements of Section 13 of the Federal Reserve Act of 1913, it is also eligible for purchase by the Federal Reserve Bank ([12 U.S.C. § 346](#)). This has created an active secondary market for eligible bankers' acceptances.

Each time an acceptance is sold, ownership is transferred by endorsement and each subsequent owner becomes a holder in due course, subject to Article 3 of the **Uniform Commercial Code** (UCC).

A banker's acceptance is tied to a specific trade transaction. It is therefore possible for the applicant (importer) to resell the goods before the acceptance matures. If it does, the issuing bank typically requires the applicant to prepay its reimbursement obligation to the issuer. But this prepayment can often be made at a discount, reducing the applicant's cost.

Negotiable Letter of Credit

In a usance (time) letter of credit, the only parties from which the beneficiary can ordinarily obtain payment are the confirming bank and the issuing bank, and only after the credit has reached maturity. This is referred to as a non-negotiable or straight letter of credit, because the payment obligation of the banks runs straight to the beneficiary. An alternative that offers the beneficiary quicker payment is a negotiable letter of credit (see [Practice Note, Commercial Letters of Credit: Negotiation](#)).

In a negotiable letter of credit, the issuing bank includes an unconditional promise to pay not only the beneficiary, but also bona fide holders and endorsers. A letter of credit is negotiable if it states that it is "available by negotiation" or that drafts "must be negotiated on or before" a specified date. It can also state that "drawers, endorsers, and bona fide holders . . . shall be paid," or similar language indicating that it is negotiable.

A negotiable letter of credit allows the beneficiary to sell its time draft before maturity to any bank nominated to negotiate by the issuing bank. The letter of credit can nominate a particular bank to negotiate, which is likely to be a bank requested by the beneficiary, or it can undertake to pay "any bank" that negotiates. By nominating "any bank," the issuing bank signals that if any bank negotiates the beneficiary's time draft, the issuing bank will pay the negotiating bank the face amount of the draft, if:

- The time draft has reached maturity.
- The negotiating bank makes a complying presentation to the issuing bank.

Any bank nominated to negotiate is under no obligation to do so. If the nominated bank chooses not to negotiate, it is under no obligation to notify the issuing bank of its refusal. But if the credit of the issuing bank is strong or the negotiating bank has a well-established relationship with the issuing bank, the nominated bank usually negotiates the beneficiary's time draft.

If the nominated bank negotiates, it purchases the time draft at a discount from the beneficiary and becomes a bona fide holder of the draft and all other documents that are part of the beneficiary's presentation. The bank negotiates for its own account and not as agent for the issuing or confirming bank. To obtain payment, it too must make a complying presentation to the issuing or confirming bank. If the documents comply with the letter of credit requirements, the issuing bank has an unconditional obligation to reimburse the negotiating bank at maturity. If the documents fail to meet these requirements, the issuing bank may refuse to honor the presentation and the negotiating bank will have recourse only against the seller (the former beneficiary), unless it purchased the time draft without recourse.

Transferable Letter of Credit

Import-export transactions often involve a trading company or other intermediary that buys the goods from an exporter and resells them for a profit to an importer. The intermediary requests a letter of credit from the importer to protect against non-payment. The exporter desires the same protection and asks for a letter of credit from the intermediary. If the intermediary is thinly capitalized or doesn't have access to credit, it may be desirable for the intermediary, as beneficiary under the letter of credit from the importer, to have the right to transfer or assign its right to draw under that letter of credit. This transfer right allows the intermediary to avoid the difficulty of applying for a letter of credit on the strength of its own credit, while providing the exporter the payment security it requires.

A letter of credit is transferable or assignable by the beneficiary only if it specifically states that it is transferable or assignable ([UCC § 5-112\(a\)](#)). This allows the beneficiary (referred to as the first beneficiary) to request that all or part of the letter of credit be made available to a second beneficiary.

For example, assume an intermediary purchases goods from a domestic manufacturer (exporter) for \$80,000. The intermediary then sells the goods to a buyer abroad (importer) for \$100,000, payable by transferable letter of credit. The intermediary can request that:

- Its right to draw \$80,000 of the letter of credit be transferred to the exporter as second beneficiary.
- The remaining \$20,000 be paid to itself as first beneficiary.

The issuing and confirming banks remain issuing and confirming banks for both the first and second beneficiary, and the transferred letter of credit mirrors the terms of the original credit, except that:

- The first beneficiary is the applicant for the transferred letter of credit.
- The commercial terms are adjusted to reflect the portion of the original letter of credit that is being transferred.

Care must be taken in arranging a transferable letter of credit. The law governing letters of credit, Article 5 of the UCC, is inconsistent with the [Uniform Customs and Practice for Documentary Credits](#) (UCP), [International Chamber of Commerce](#) (ICC) Publication No. 600 (UCP 600), the rules that are almost universally followed by letter of credit practitioners (see [Practice Note, Commercial Letters of Credit: Laws and Rules Governing Commercial Letters of Credit](#)). [UCC § 5-112](#), which permits transfers, imposes no limit on the number of times a letter of credit may be transferred and sets out no procedural requirements governing transfers. Article 38 of UCP 600, however, permits a letter of credit to be transferred only once and sets out detailed procedural requirements for transfers.

If the parties intend a letter of credit to be transferable to multiple beneficiaries (for example, to cover multiple links in a supply chain), it is important that the letter of credit be clear on this point. And the letter of credit must clearly limit the contrary provision of Article 38.

Assignment of Proceeds Distinguished

An assignment of proceeds is different from the transfer or assignment of a letter of credit. Even when a letter of credit is not transferable, both the UCC and UCP 600 permit the beneficiary to assign its right to receive all or part of the proceeds of the credit. However, this assignment may not include a delegation of its duty to perform (which would, in effect, make it a transferable letter of credit). While the beneficiary may assign its right to receive the proceeds, the beneficiary must still make the complying presentation that is necessary for the assignee to receive the proceeds of the credit.

An assignment of proceeds by a beneficiary requires the consent of the issuing bank and the confirming bank, if any, which may not be unreasonably withheld ([UCC § 5-114\(d\)](#)).

A beneficiary typically assigns its right to all or part of the proceeds of a letter of credit to:

- A supplier to pay for the cost of some or all of the goods involved in the underlying sales transaction.
- A bank as security for a financing arrangement.

Back-to-Back Letters of Credit

Back-to-back letters of credit are used in the same situation as a transferable letter of credit, that is, an export transaction involving an exporter, an intermediary, and an importer. If the letter of credit provided by the importer in favor of the intermediary is not transferable, the intermediary can obtain a second letter of credit for a lesser amount, under which it is the applicant and the exporter is the beneficiary. The two letters of credit are referred to as back-to-back letters of credit. In a true back-to-back arrangement, the first letter of credit, referred to as the primary credit, where the intermediary is

the beneficiary, serves as collateral for the second, referred to as the secondary credit, where the intermediary is the applicant and the exporter is the beneficiary.

In the example discussed under transferable letters of credit, the intermediary purchases goods from a domestic manufacturer (exporter) for \$80,000. The intermediary sells the goods to a buyer abroad (importer) for \$100,000, payable by a non-transferable primary letter of credit. The intermediary, as applicant, obtains a secondary credit for \$80,000 in favor of the exporter as beneficiary. The secondary credit is secured by an assignment of the intermediary's right to the payment under the primary credit. In this case, the issuing and confirming banks under the primary and secondary letters of credit need not be related.

A back-to-back letter of credit arrangement can also be created without using the primary letter of credit as security for the secondary credit. But the issuing bank for the secondary credit is likely to require other security from the intermediary instead.

As with a transferable letter of credit, the parties must be careful structuring a back-to-back credit arrangement to be sure the terms of the two credits are consistent. US banks are often reluctant to act as issuing bank for the secondary letter of credit because:

- The operational issues in dovetailing the terms of the secondary letter of credit with those of the primary credit are more complex.
- The risk for the issuing bank of the secondary letter of credit is inherently greater than for the issuer of the primary credit. Instead of holding a liquid asset as security for the intermediary's reimbursement obligation to it, the issuing bank in the secondary letter of credit depends on the successful completion of the primary credit, over which it has no control.
- The issuing bank for the secondary letter of credit often has no prior banking relationship with the intermediary. It depends on the cooperation of the intermediary, which must make a complying presentation under the primary credit to trigger the payment.

Revolving Letter of Credit

A letter of credit normally is for a fixed amount. The beneficiary might be able to make multiple draws under a single letter of credit, but once these amounts are drawn, they are not replenished. And once the aggregate amount of the beneficiary's draws have reached the credit's aggregate limit, the letter of credit is exhausted.

A revolving letter of credit is one that is continually replenished as it is drawn by the beneficiary. It is normally used when an importer and exporter have an ongoing supply arrangement under which the exporter makes regular shipments to the importer. For example, if a long-term sales contract requires monthly shipments of merchandise and corresponding monthly payments of up to \$1 million, the importer, rather than applying for separate letters of credit each month, can obtain a revolving letter of credit that allows the exporter as beneficiary to draw up to \$1 million each month.

The schedule of draws can vary, but a revolving letter of credit imposes an upper limit on the amount the beneficiary can draw each time. Although most letters of credit expire after a fixed period of time (usually not more than a year) revolving letters of credit often last longer. Under UCC § 5106(d), however, even a letter of credit that purports to be perpetual cannot expire more than five years after the date of issuance.

There are two kinds of revolving letters of credit:

- Cumulative, where, if the beneficiary does not draw the full amount permitted in a given period of time, the undrawn amount rolls over to the next period and increases the limit on how much can be drawn in the next period.
- Non-cumulative, where the undrawn amount does not roll over.

For example, if a revolving letter of credit permits a beneficiary to draw up to \$1 million each month:

- If the letter of credit is cumulative, and the beneficiary makes a draw of \$900,000 in one month, in the following month the beneficiary would be able to draw up to \$1.1 million.
- If the letter of credit is non-cumulative and the beneficiary makes a draw of \$900,000 in one month, in the following month the beneficiary would not be able to draw more than \$1 million.

Care must be taken in establishing a revolving letter of credit. Under UCP 600 Article 32, if an installment in a given period is not drawn, "the credit ceases to be available for that and any subsequent installment." That is, the letter of credit terminates. In a supply agreement where there might be months where no goods are shipped and no payment made, a revolving letter of credit covering these payments would need to exclude Article 32 from the provision specifying that the letter of credit is subject to UCP 600.

Revocable Letter of Credit

In principle, letters of credit can be either revocable or irrevocable. A revocable letter of credit can, without prior notice to the beneficiary, be revoked or amended by the issuing bank at any time before the beneficiary has made a complying presentation. Once the beneficiary has made a complying presentation it cannot be revoked. A revocable letter of credit cannot be confirmed.

By eliminating the seller's ironclad assurance that it will be paid once it has performed under the sales contract, revocability undermines one of the fundamental purposes of a commercial letter of credit.

Both the UCC and the UCP provide that a letter of credit is irrevocable unless it expressly states that it is revocable ([UCC § 5-106\(a\)](#); UCP 600 Art. 3). In practice, therefore, revocable letters of credit are virtually obsolete, and nearly all credits are irrevocable. An irrevocable letter of credit may not be revoked or amended without the agreement of the issuing bank, the beneficiary, and the confirming bank, if there is one.

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