Understanding the Risks of Standby LCs
Global Transaction Services

Cash Management  Trade Services and Finance  Securities and Fund Services

Understanding the Risks of Standby Letters of Credit and Guarantees

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Standby Letter of Credit/Guarantee Defined

For the purpose of this overview, any undertaking referred to as a Standby Letter of Credit or a Guarantee or a Bond or other similar undertaking, however named or described (including Performance or Financial) has the same meaning.
Standby Letter of Credit/Guarantee Defined

A Standby Letter of Credit or Guarantee or any other similar instrument however named or described represents an irrevocable and independent obligation of the issuer towards the beneficiary:

- To make payment upon presentation of specified documents stipulated in the Standby,

*Usually upon a certification by the beneficiary* that the account party has failed to fulfil its obligation under the Contract.
Standby / Guarantee Principles

- The bank will not investigate the underlying facts of the transaction – e.g. whether or not there was a default or contract breach.

- The Standby is separate from and independent of the underlying contract.

- The bank only reviews conditions that are evidenced by a document.

- The bank’s commitment is contingent upon the presentation of the stipulated documents in accordance with the terms and conditions of the LC.

- References to underlying purpose and references to related agreements and contracts are “for information only”.
Examples of Standby LCs/Guarantees

- Bid Standby *
- Performance Standby *
- Advance Payment Standby *
- Insurance Standby
- Credit Facility/Enhancement Standby
- Lease Support Standby
- Financial Standby favouring certain Governmental Agencies e.g. Tax office or VAT office or Customs authority etc
- Counter (Backstop or Protective) Standby *

* More explanation to follow …
Examples of Standby LCs /Guarantees

Bid Standby

To support the Supplier/Contractor bidding on a Project or Contract and assure the Buyer or Employer that the Supplier/Contractor will complete the bid conditions. Usually issued for a percentage of the Contract amount.

Performance Standby

Most common types and are issued to assure the Buyer or the Employer to support the completion of Contract or Project or to cover Warranty period etc etc. Usually issued for a percentage of the Contract amount.
Examples of Standby LCs /Guarantees

Advance Payment Standby

Supplier may ask for partial payment upfront to cover materials to be used under the Contract. The Buyer asks for this type of Standby as assurance that if the Supplier defaults under the Contract, then the Advance Payment made will be returned.

Counter Standby

Issued to support issuance of a separate Standby or Guarantee or other such undertaking by the beneficiary of the Counter Standby. Mainly issued by a Bank in one Country to request a Bank in another country to issue their local undertaking.
Special Conditions

Evergreen Standby clause

The Evergreen or automatic extension clause allows the Standby LC to be issued for a specified initial period (usually one year) with an “automatic” expiry extension.

“It is a condition of this Letter of Credit that it shall be deemed automatically extended for an additional period of one year from the present or any future date hereof unless at least 30 (60/90) days prior to any such expiration date we notify you by courier or registered mail that we elect not to extend this Letter of Credit for any such additional period.”
Evergreen Standbys: Non-Extension Notices

- Use correct language of Non Extension Notices as stated in the Standby
- If the non-extension notification period is missed, then beneficiary’s consent is required for cancellation prior to the next expiry date
- The beneficiary should not be surprised to receive a non-extension notice. The applicant and beneficiary should be in direct communication with each other
- Non Extension Notice must be forwarded to the correct address and marked for the attention parties as identified in the Standby
- Counter Standbys always contain an additional buffer period over the expiry date and notice period. Any notice of Non Extension must be within the additional buffer periods.
Special Conditions ....

Also...

- Reinstatement Conditions
- Operativeness conditions
- Automatic reductions
Fundamental differences between a Standby and a Commercial Letter of Credit

- Payment under a Standby arises out of documents evidencing that the applicant has failed to fulfill its contractual obligations.

- Payment under a Commercial Letter of Credit arises out of documents evidencing that the beneficiary has performed his contractual obligations.

- Documents under a Commercial LC offer considerable control over the shipped goods.

- Documents under a Standby lack intrinsic value (usually only a simple certification).

- Commercial LC is a prime payment instrument.

- As Standby covers non-performance of the applicant, payment is seldom expected.
Potential Risks to Consider

- Stand alone and Independent instrument.

- Documents presented under a Standby/Guarantee lack any intrinsic value because they are usually a simple certification to satisfy payment.

- Integrity of the Beneficiary not to misuse the Standby.

- Lack of expertise by the applicant to negotiate favourable terms of a Standby may result in the benefit under the Standby to run on and on beyond the Contracted terms.
When is an Expiry date not an Expiry date?

Be aware that Governing Law of certain countries do not recognise expiry dates

In certain countries, a Guarantee or Standby LC only becomes “null and void” when the original Guarantee/SBLC is returned to the Issuer or when the Issuing Bank has been released by the Beneficiary……even with a stipulated expiry date in the instrument.
Potential Risks …..

When is an Expiry date not an Expiry date… continued

- In addition even with a stated expiry date, some country local laws allow the beneficiary to claim for a stated period after the expiry date….

- Be aware and investigate this point prior to establishing a Standby or agreeing to enter into a contract which requires a local Standby or a Guarantee.

- In certain such countries it may be possible to terminate the Standby by including certain clauses such as:
  - “This Guarantee will expire and will become Null and Void after the expiry date irrespective of whether the original of this Guarantee is returned back to us or not”.


Other Potential Risks to Consider

- **For Issuing Bank**
  - You have performed your usual Compliance checks on the parties and understand the underlying purpose of the Standby
  
  - You have obtained satisfactory documentation and reimbursement agreement from the obligor. Evaluate the usual Credit risk i.e. your client is capable of meeting the contract/project requirements
  
  - Clear documentary conditions are mentioned in the Standby to minimise the risk of conditions being misinterpreted by the beneficiary and possible rejection by the Applicant in the event of a dispute under the underlying contract
Potential Risks to Consider

**For Applicant**
- As documents lack intrinsic value, try to call for additional documents to support a demand certification e.g. copy of unpaid invoices or transport documents or certification issued by an independent arbitrator or copy of court judgment
- Effectiveness of Standby is against clearly defined conditions e.g. effectiveness of Advance Payment Standby after receipt of the Advance Payment etc

**For Beneficiary**
- You have evaluated Credit and Cross border risk on the Issuing Bank
- Understood the risk of automatic reduction or automatic termination against documents which the applicant can present direct to the Issuing bank
- Understand documents and/or conditions that are required in order to draw, and avoid documents which are issued and/or signed by the applicant
Standby Risk Mitigants

- Keep language of Standby clear and simple – use recognised templates wherever possible

- Beneficiary’s/Applicant’s preferred wording of the Standby should be shared with Issuer Bank as early possible

- Be aware of correspondent pricing parameters

- Obtain applicant’s completed and signed Standby LC Reimbursement Agreement.

- Specify an expiration date and be limited in amount
Standby Risk Mitigants

- Avoid non-documentary conditions

- Be aware of local country special conditions/constraints.

- Understand the automatic extension (evergreen) provision.

- Carefully review the time limitations and drawing requirements.

- Avoid presentation of documents issued and/or signed by the applicant
Standby Risk Mitigants

Always try to mention Governing Law applicable to the Standby

Governing Rules

- Examples of Governing Rules (as published by ICC)
  - Uniform Customs & Practice (UCP500)
  - International Standby Practices (ISP98)
  - Uniform Rules for Demand Guarantees (URDG)

Above rules are published by the ICC and endorsed by the UN after consultation with the International trading community. They harmonize trade practices and help to define roles and responsibilities of all parties to the instrument and to enforce independence principle. These rules supplement the Governing Law applicable to a Standby to the extent not prohibited by that Law
Standby Risk Mitigants

- **UCP500**
  - Although specifically designed for commercial LCs, can be applied to a Standby or other similar instrument however named, to the extent to which these rules may be applicable
  - UCP600 on the way – a major overhaul
  - Most common, well-established
Standby Risk Mitigants

- **ISP98**
  - Use this set of rules where ever possible
  - Designed for Standbys or other similar instruments however named or described
  - Drafted by Bankers and Lawyers and incorporates precision terminology applicable to Standby types of instruments
  - No hidden traps for beneficiaries

  Force majeure rule: Beneficiary has 30 days to present after the bank reopens
Few of many advantages of ISP over UCP

- Unfair Force Majeure rule has been addressed
- Does not contain trap for installment payments
- Simple and readable language for professionals who are not LC experts
- Transfer by operation of law clearly defined
- Eliminates the requirement of documents to be consistent with each other
- Extend or pay provision defined
- Provides clear and balanced rules for situations where the Original Standby has been Lost or Mutilated or Destroyed
- Can be used for Independent Guarantees
Conclusion

Standby Letters of Credit can be challenging and complex.

We are here to assist with a dedicated team of Specialists, including the Trade Advisory team to find solutions and expedite your transactions while helping you to mitigate risks.
Q&A

ANY QUESTIONS?

Our Technical Trade Specialists are happy to answer your technical LC questions. Please contact your local Relationship Manager or CitiService representative and mention that you attended our Document Examination Webinar!