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# Global Transaction Services

*Cash Management Trade Services and Finance Securities and Fund Services*

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## Standby Letters of Credit

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# Agenda

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- **Standby Letter of Credit Defined**
- **Transaction Cycle**
- **Types of Standbys/Guarantees**
- **Special Conditions**
- **Governing Rules and Laws**
- **Risk Based Capital Guidelines**
- **Pricing**
- **The Roles of the Bank, Applicant and Beneficiary**
- **Key Risks**
- **Summary/Q&A**

# Standby Letter of Credit Defined

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A Standby Letter of Credit represents an irrevocable obligation to the beneficiary on the part of the issuer:

- **To make payment on account of any indebtedness undertaken by the account party,**

**Or**

- **To make payment on account of any default by the account party in the performance of a non-financial or commercial obligation,**

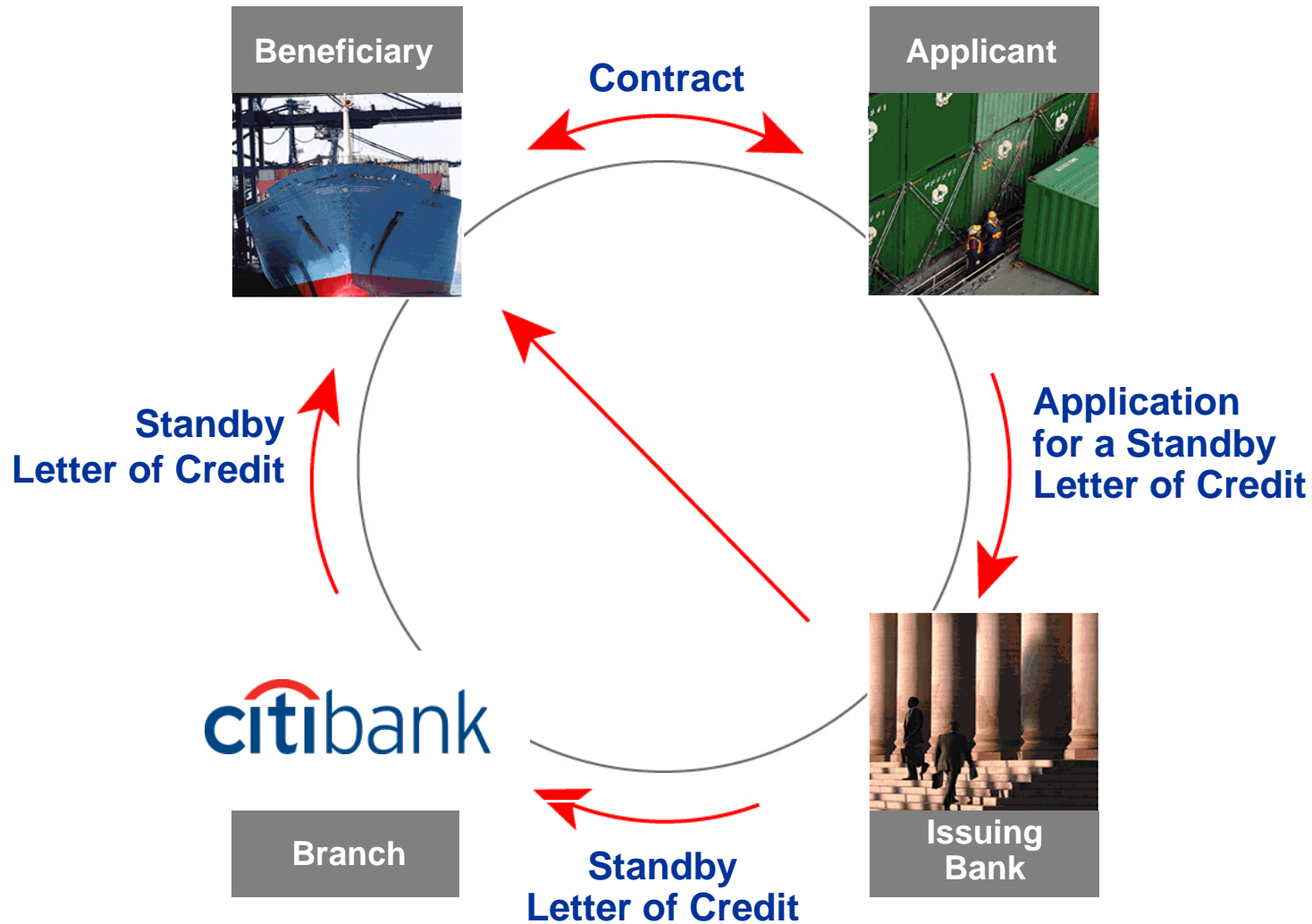
*upon certification by the beneficiary that the account party has failed to fulfill its obligation to the beneficiary.*

# Direct vs. Indirect (Protective/Counter Guarantee) Issuance

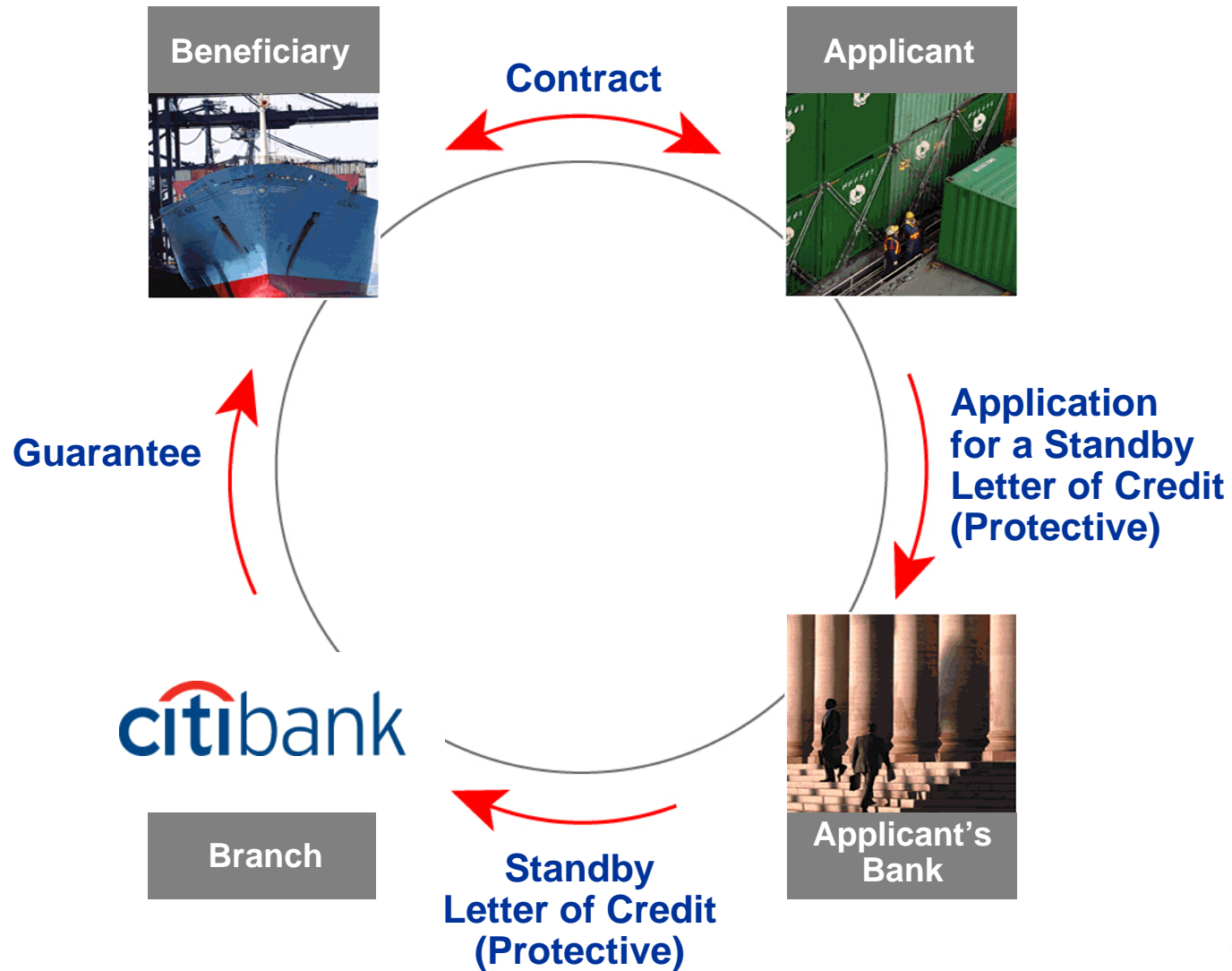
Standby LCs are issued in two ways –

- **Directly – The applicant’s bank issues the Standby LC directly to the Beneficiary (may be through an advising bank)**
  - This method is typically used when the Applicant and the Beneficiary are located in the same country
  
- **Indirectly – The applicant’s bank issues the Standby LC in favor of another Branch or Financial Institution in order to induce issuance of a local guarantee**
  - This method is typically used due to local government regulations/laws or beneficiary’s request

# Direct Standby LC Flow



# Indirect (Protective) Standby LC Flow



## Example of a Standby Letter of Credit

### Applicant Bank's Irrevocable Standby Letter of Credit #12345

Date: June 1, 2006

To: **ABC Water Company**

Red Bank Road

Red Bank, New Jersey

Gentlemen:

By order of and for the account of **XYZ Fire Corporation** we hereby issue in your favor our Irrevocable Standby Letter of Credit in an amount **not to exceed \$10,000.00**.

Funds under this Letter of Credit are **available by payment** against presentation of your draft(s) at sight accompanied by the following certification, "The undersigned, an authorized signer of ABC Water Company, hereby certifies with reference to LC 12345 issued by Applicant's Bank that XYZ Fire Corporation failed to comply with the provisions of Contract #789 dated March 1, 2006."

This Letter of Credit is effective the date hereof and shall **expire at our office on December 31, 2006**.

We hereby engage with you that drafts drawn in conformity with the terms and conditions of this Letter of Credit will be duly honored upon **presentation to our office located at (Address)**.

This Letter of Credit is **subject to The International Standby Practices-ISP98** (1998 Publication) International Chamber of Commerce Publication No.590.

# Types of Standby LCs/Guarantees

- **Bid Standby\***
- **Performance Standby\***
- **Advance Payment\***
- **Credit Enhancement**
- **Loan Guarantee**
- **Insurance Related**
- **Lease Support**

\*Examples follow...

## Bid Standby-sample text extract

**Bid Standby** – Suppliers/Contractors bidding on a project or sale-assures the buyer that the bid will be honored – usually issued for a percentage of the contract amount

*Funds under this Letter of Credit are available by payment against presentation of your draft(s) at sight drawn on us and mentioning thereon our Letter of Credit No. 123456. Each such draft must be accompanied by your signed written statement that “Construction Company was duly tendered a contract for its signature under bid invitation No. 98765 for the construction of the Century Hotel and failed to become a party thereto.”*

## Performance Standby-sample text extract

**Performance Standby** – Used to support the completion of a contract or as warranty for newly installed equipment

*Funds under this Letter of Credit are available by payment to you against presentation of your draft(s) at sight drawn on us and mentioning thereon our Letter of Credit No. 123456. Each such draft must be accompanied by your signed written statement that “Construction Company has failed to comply with the terms and conditions of contract #456, for the construction of the Century Hotel,” specifying the paragraph(s) and/or clause(s) in default.*

## Advance Payment Standby-sample text extract

**Advance Payment** – Supplier may ask for partial payment upfront to cover materials to be used under the contract. The buyer asks for this type of SBLC as assurance that if the supplier defaults on the contract the advance payment will be returned.

*Funds under this Letter of Credit are available by payment with us against presentation of the following statement:*

*“We are demanding payment in the amount of \_\_\_\_\_ because (Applicant Name) has failed to fulfill its contractual obligations for the delivery of equipment in accordance with Contract No. 123 dated March 1, 2006 and as such we are entitled to repayment for the amount being demanded.”*

# Special Conditions

## Evergreen 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.”*

# Special Conditions

## Non-Extension Notices under Evergreen LCs

- **LC should provide for explicit drawing right.**
- **If the non extension notification period is missed the only way to terminate the LC prior to the next expiry date is to ask for beneficiary's consent to cancel.**
- **The beneficiary should not be surprised by a non-extension notice – the applicant and beneficiary should be in direct communication with each other.**
- **As a beneficiary, make sure you get the notice (LC should be specific as to means and destination). Case law in the U.S. generally finds that “notice” includes the mail room.**

# Special Conditions

When is an Expiry date not an Expiry date?

- **In certain countries, a Guarantee or Standby LC only becomes “null and void” when the original Guarantee/SBLC has been returned or when the Issuing Bank has been released by the Beneficiary.....even with a stipulated expiry date in the instrument.**
  
- **Caution is advised in the following countries:**
  - India, Indonesia, Malaysia, Pakistan, Taiwan, Italy, Bulgaria/Hungary/Kenya/Ivory Coast/Tunisia for Customs Bonds, El Salvador, Venezuela, Argentina, Brazil, Turkey, Algeria/Morocco/Thailand/Lebanon for LCs in favor of a Gov't entity
  
- **You may be able to terminate the LC in these countries by including specific clauses such as:**
  - “All demands for payment must be made prior to the expiry date”

# Special Conditions

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 of this extended period in the following countries:**
  - Korea-2 months, India-120 days, El Salvador-3 years, Venezuela-60 days, Italy-10 years
- **You may be able to terminate the LC in these countries by including specific clauses such as:**
  - “The beneficiary is requested to return this Guarantee immediately after the stated expiry date ”

# Special Conditions

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## Detrimental Amendments

- **Amendments which have a detrimental impact for the beneficiary such as amount decrease or expiry curtailment are issued subject to the beneficiary's agreement. If the bank has been unable to obtain the beneficiary's consent, the LC terms will remain unchanged.**
- **Note – For applicants this usually means fees are calculated on the higher value of the LC**

# Special Conditions

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Also...

- **Reinstatement LCs**
- **Installment Credits or Variable Amount Credit**
- **Transferable LCs**

## Payments under Standby Letters of Credit

- **Most of the time the account party satisfactorily fulfills his obligations to the beneficiary and the Letter of Credit expires unutilized**
- **If and when the Beneficiary does draw in accordance with the terms and conditions of the LC, the bank is obligated to pay in accordance with either the specific conditions of the LC or within their usual processing time. (anywhere from 2 hours to seven banking days)**
- **All demands for payment must be made on or prior to the expiry date**

# Governing Rules

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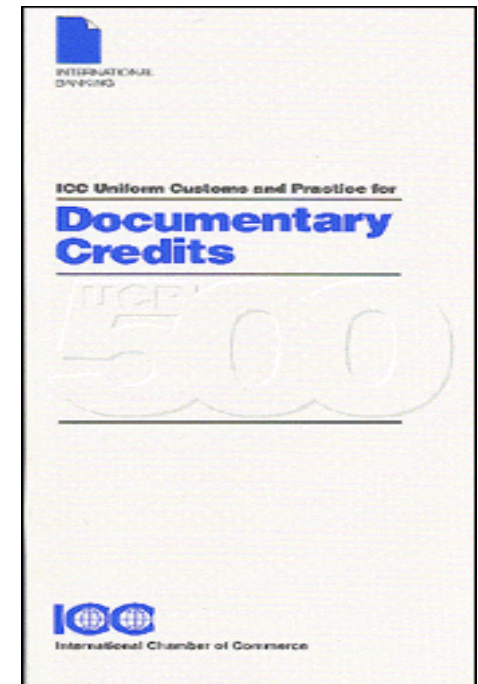
## ■ Governing Rules

- help to define the instrument as a letter of credit
- represent banking practice
- Uniform Customs & Practice (UCP500)
- International Standby Practices (ISP98)
- Uniform Rules for Demand Guarantees (URDG)

# Governing Rules.....

## ■ UCP500

- Most common, well-established
- Designed for commercial LCs
- UCP600 on the way – a major overhaul
- Pitfalls for beneficiaries



## Governing Rules *continued*

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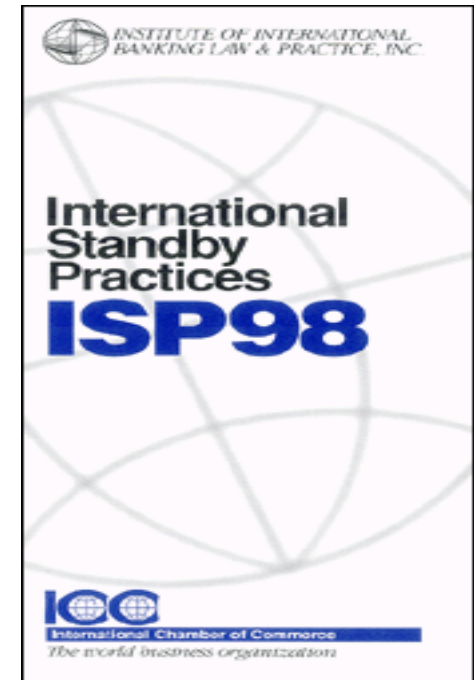
### ■ **Pitfalls/ Considerations with UCP500**

- Force majeure: Beneficiary cannot draw during a force majeure event affecting the bank, and it may expire in the meantime (Article 17)
- Inconsistency (Article 13(a))
- Installment Drawings/Shipments (Article 41)
- Transfer provisions (Article 48)

## Governing Rules *continued*

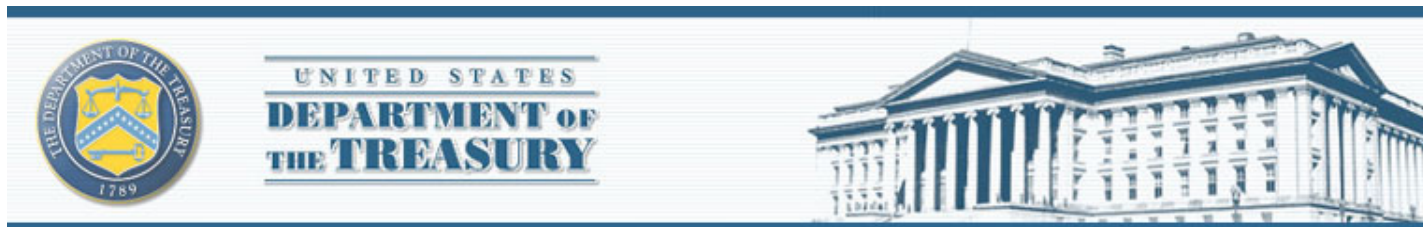
### ■ **ISP98**

- Use this set of rules!
- Designed for standbys
- Drafted by lawyers: precision of terminology, contemplation of various problematic scenarios
- No hidden traps for beneficiaries
  - Force majeure rule: Beneficiary has 30 days to present after the bank reopens



## Governing Law in the U.S.

- **OFAC** – The Office of Foreign Assets Control ("OFAC") of the US Department of the Treasury administers and enforces economic and trade sanctions based on US foreign policy and national security goals against targeted foreign countries, terrorists, international narcotics traffickers, and those engaged in activities related to the proliferation of weapons of mass destruction
- <http://www.treasury.gov/offices/enforcement/ofac/>



## Governing Law in the U.S. *continued*

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- **New York State Law – Article 5 of the Uniform Commercial Code.** The U.S. has a state-by-state statutory scheme for letters of credit. Article 5 mirrors many aspects of the practice rules (UCP and ISP), but it also addresses fraud under LCs and provides rules for when an injunction against drawing may be granted by a court

## Governing Law in the U.S. *continued*

Standby LCs issued by U.S. National Banks are subject to the regulations of the **Office of the Comptroller of the Currency (OCC Rule 12 CFR 7.1016)** must meet certain criteria.

- (i) The independent character of the undertaking should be apparent from its terms (such as terms that subject it to laws or rules providing for its independent character);
- (ii) The undertaking should be limited in amount;
- (iii) The undertaking should:
  - (A) Be limited in duration; or
  - (B) Permit the bank to terminate the undertaking either on a periodic basis (consistent with the bank's ability to make any necessary credit assessments) or at will upon either notice or payment to the beneficiary; or
  - (C) Entitle the bank to cash collateral from the applicant on demand (with a right to accelerate the applicant's obligations, as appropriate); and
- (iv) The bank either should be fully collateralized or have the post-honor right of reimbursement from the applicant or from another issuer of an independent undertaking.

## Risk Based Capital Rules

### **Financial Standby LC** – Irrevocable undertaking by a banking organization to guarantee payment of a financial obligation

- Considered a Direct Credit Substitute
- Converted to an “on balance sheet” equivalent at 100%
- Considered Financial if the event that triggers payment is financial, such as failure to pay amounts due

### **Performance Standby LC** – Irrevocable undertaking by a banking organization to make payment in the event the customer fails to perform a non-financial contractual obligation

- Considered a transaction related contingency
- Converted to an “on balance sheet” equivalent at 50%
- Considered Performance if the event that triggers payment is performance related, such as failure to ship a product or provide a service

## Risk Based Capital Rules...*continued*

- **Financial Standby LCs have a higher conversion factor because unlike Performance Standby LCs they tend to be drawn down only when the account party's financial condition has deteriorated**
- **The majority of Standby LCs are considered for Risk Based Capital purposes to be Financial**
- **Insurance related Standby LCs are classified as Financial (failure to pay premiums/deductibles, failure to pay Worker's Comp, etc.)**

# Pricing

## Factors that may contribute to your SBLC Price quote:

- Risk Based Capital Cost for the Bank
  - Client's Credit Rating
  - \$\$ of the SBLC
  - Tenor of the SBLC
  - Market Conditions
- 
- **Local guarantees in one country/region may be priced higher than other countries/regions due to local regulatory requirements or Legal Lending Limit constraints**
  - **Know your “all in cost” parameters (Indirect + Local Guarantee pricing; additional ancillary costs such as Courier fees, telex fees, etc.)**

## Key Points about your Bank's role in Standby LCs

- **The bank's commitment is contingent upon the presentation of the stipulated documents within the terms and conditions of the LC**
- **The bank will not investigate the underlying facts of the transaction – e.g. whether or not there was a default or contract breach.**
- **The SBLC is separate from and independent of the underlying contract**
- **The bank can only review conditions that are evidenced by a document called for in the SBLC-references to “other” documents will be “for information only”**

## Key Points about your role in Standby LCs

### ■ As Applicant

- Keep the LC language clear and simple
- Ask the beneficiary to provide their preferred language-subject to review by your bank
- Share proposed language with your bank early in the issuance process
- Be aware of pricing parameters
- Avoid non-documentary conditions
- Be aware of local country special conditions/constraints
- Maintain ongoing communication with the beneficiary

# Key Points about your role in Standby LCs

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## ■ **As Beneficiary**

- Understand the automatic extension (evergreen) provision
- Carefully review the time limitations and drawing requirements
- Avoid applicant issued and/or signed documents for LC drawings
- Maintain ongoing communication with the applicant

# The Key Risks of Standby LCs

## ■ As Applicant

- Drawing by beneficiary conforming to the LC terms and conditions which the applicant feels is inappropriate, stemming from a dispute in the underlying contract

## ■ As Beneficiary

- Issuing/Confirming bank insolvency or other default
- Understanding the documents and/or conditions that must be required in order to draw-discrepancies in drawings generally result in non-payment

## In Summary.....

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- **While you may find Standby Letters of Credit and Guarantees challenging due to the potential complexities, your Trade Bank is there to assist. Most major Trade Banks have expertise in Standby LC structuring.**

## Any Questions?

**Our Standby LC Trade Specialists** are happy to answer your technical Standby LC questions. Please mention that you attended our Standby LC Webinar!

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**Our Trade Bankers** are available to provide additional information about our trade services, our trade finance capabilities, and our global network. Please contact:

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Q&A

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