LETTERS OF CREDIT DEFINITIONS

Standby Letter of Credit – SLOC/SBLC

A standby letter of credit (SLOC) is a guarantee of payment issued by a bank on behalf of a client that is used as "payment of last resort" should the client fail to fulfill a contractual commitment with a third party. Standby letters of credit are created as a sign of good faith in business transactions and are proof of a buyer's credit quality and repayment abilities. The bank issuing the SLOC performs brief underwriting duties to ensure the credit quality of the party seeking the letter of credit, then sends notification to the bank of the party requesting the letter of credit (typically a seller or creditor).

A standby letter of credit shows a company's credit quality and ability to repay loans. Although a SLOC is not intended for use, it helps fulfill business obligations in case the business stops operations, cannot pay its vendors or becomes insolvent.

Small businesses often face difficulty when securing financing. For this reason, standby letters of credit may be especially beneficial for encouraging investors to lend money to a company. In case of default, investors are assured they will be paid principal and interest from the bank through which the SLOC is secured.

Obtaining a Standby Letter of Credit

When requesting a SLOC, a business owner proves to the bank he is capable of repaying the loan. Collateral may be required to protect the bank in case of default. The bank typically provides a letter to the business owner within one week of receiving documentation. The business owner must pay a SLOC fee for each year that the letter is valid. The fee is typically 1-10% of the SLOC value. If the business owner meets the criteria outlined in the contract before the due date, the business owner can cancel the SLOC without further charges.

Examples of Standby Letters of Credit

A financial SLOC, the most common type, is typically used in international trade or other high-value purchase contracts where litigation or other non-payment actions may not be feasible. A financial SLOC guarantees payment to the beneficiary if criteria outlined in the contract are left unfulfilled. For example, an exporter sells goods to an overseas buyer who guarantees payment in 30 days. When the payment does not appear by the deadline, the exporter presents the SLOC to the importer's bank and receives the payment.

A performance SLOC ensures the time, cost, amount, quality of work and other criteria are fulfilled in a manner acceptable to the client. The bank pays the beneficiary if any of the written obligations are unmet. For example, a contractor guarantees a construction project will be finished in 90 days. If work remains incomplete after the 90-day period, the client can present the SLOC to the contractor's bank and receive the payment due.

Letter Of Credit

A letter of credit is a letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount. In the event that the buyer is unable to make payment on the purchase, the bank will be required to cover the full or remaining amount of the purchase. Due to the nature of international dealings, including factors such as distance, differing laws in each country, and difficulty in knowing each party personally, the use of letters of credit has become a very important aspect of international trade.

Because a letter of credit is typically a negotiable instrument, the issuing bank pays the beneficiary or any bank nominated by the beneficiary. If a letter of credit is transferrable, the beneficiary may assign another entity, such as a corporate parent or a third party, the right to draw.

Funding a Letter of Credit

Banks typically require a pledge of securities or cash as collateral for issuing a letter of credit. Banks also collect a fee for service, typically a percentage of the size of the letter of credit. The International Chamber of Commerce Uniform Customs and Practice for Documentary Credits oversees letters of credit used in international transactions.

Straight Credit

A type of letter of credit. A straight credit can only be paid at the counters of the paying bank or a named drawee bank that has been authorized to make payment. Payment can only be made to the beneficiary named in the letter of credit, and not to an intermediary or negotiating bank. The beneficiary named in a straight credit must present documents at the paying bank or named drawee bank on or before the expiration date stipulated in the letter of credit. The term is derived from the fact that payment is made straight or directly to the beneficiary.

A straight credit differs from a negotiable credit because payment in the latter can be made to a negotiating bank. A straight credit contains clauses such as "we engage with you" that all drafts drawn in compliance with the credit terms will be duly honored upon presentation, which basically highlight the restriction of payment to the beneficiary only.

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Red Clause Letter Of Credit

The red clause letter of credit is a specific type of letter of credit in which a buyer extends an unsecured loan to a seller. Red Clause Letters of Credit permit documentary credit beneficiaries to receive funds for any merchandise outlined in the letter of credit. These letters are commonly used by beneficiaries who act as purchasing agents for buyers in another country.

The funds provided in a Red Clause Letter of Credit are known as advances. These advances are then deducted from the face amount of the credit when it is presented for payment. Red Clause Letters are usually employed to facilitate international exports and trade.

Standby Underwriting (Standby)

A type of agreement to sell shares in an initial public offering (IPO) in which the underwriting investment bank agrees to purchase whatever shares remain after it has sold all of the shares it can to the public. In an underwriting standby (standby) agreement, the underwriter agrees to purchase any remaining shares at the subscription price, which is lower than the stock's market price. This underwriting method guarantees the issuing company that its IPO will raise a certain amount of money.

Although the ability to buy shares below the market price may appear to be an advantage of standby underwriting, the fact that there are shares left over for the underwriter to purchase indicates a lack of demand. Standby underwriting thus transfers risk from the company that is going public (the issuer) to the investment bank (the underwriter). Because of this additional risk, the underwriter's fee may be higher. Other options for underwriting an IPO include a firm commitment and a best efforts agreement.

Bank Confirmation Letter – BCL

A bank confirmation letter (BCL) is a letter from a bank or another financial institution confirming the existence of a loan or a line of credit that has been extended to a borrower. The letter officially vouches for the fact that the borrower – whether an individual, company or organization – is eligible to borrow a specified amount of funds for a specified purpose.

The purpose of a bank confirmation letter, sometimes referred to as a comfort letter, is to assure a third party, generally a seller, that the borrower has access to sufficient financial resources to complete a transaction, such as the purchase of goods. The confirmation letter is not a guarantee of payment, only an assurance of the borrower's financial resources to make payment.

A bank confirmation letter serves to assure all concerned parties to a given business deal or transaction that the bank's customer, the borrower, has, or has available, the necessary financial resources to conclude a specified transaction. Such letters typically require the signature of representatives of the bank or the financial institution who are specifically authorized to issue such correspondence. Since a letter of confirmation is issued in regard to a specific transaction or project, it is not transferable to a different transaction or project. If the bank's customer decides to enter into a different deal or purchase, such as a prospective homebuyer deciding to purchase a different home than the one specified in a bank confirmation letter, the customer is usually required to obtain a new letter of confirmation.

Governmental regulations vary from country to country in terms of whether and to what extent a letter of confirmation must state the specific purpose for which a loan or line of credit is being extended to the borrower.

Common Uses of a Bank Confirmation Letter

Bank confirmation letters are most commonly prepared for a business customer of the bank, vouching for the existence of a specified line of credit. Confirmation letters often serve to reassure sellers of a large quantity of goods. They may also be issued for a company that is entering into a joint venture project with another company. While the bank confirmation letter does not absolutely guarantee payment or provision of funds, it does provide an assurance of a high probability of receiving payment.

The most common use of a bank confirmation letter by an individual is in the purchase of a home or land. In such a case, the letter provides confirmation to a seller or realtor that the bank's customer is approved for a mortgage up to a specified amount for a proposed purchase. The letter is not a commitment to buy; it is merely a reassurance that the bank's customer has access to funds to complete a purchase.

Credit Reference

A credit reference can be a report from a credit agency for either a business or an individual. The term can also be used to mean a letter from a bank or other financial institution with whom a company has done business, confirming to third party that the company or individual is known to the financial firm as a good client.

Credit references are generally used to determine the creditworthiness of a person or individual. Credit agencies are used most often for this purpose, although individual letters of reference are sometimes necessary. For example, an overseas business wishing to establish its credentials in the United States may obtain a number of credit references from other businesses, banks, vendors and customers.

Interpretive Letter

A letter issued by banking regulators that interprets the banking law for a specific issue or party. Interpretive letters become effective immediately upon issuance. These letters are similar to IRS letter rulings that interpret the application of tax law. An example is the 1989 ruling that allowed banks to begin underwriting corporate bonds.

Even though they don't technically have the force of law, banks pay close attention to interpretive letters for several reasons. They can illuminate new ways to market products and services, as well as provide approval for banks to increase their association with investment and insurance services.

Letter Of Comfort

A letter of comfort is a letter issued to a lending institution by a parent company acknowledging support of a subsidiary company's attempt for financing. A letter of comfort does not imply that the parent company guarantees repayment of the loan being sought by the subsidiary company. It merely gives reassurance to the lending institution that the parent company is aware of the credit facility being sought by the subsidiary company, and supports its decision.

A letter of comfort is typically couched in vague wording, in order to prevent the parent company from being saddled with a legally enforceable obligation. As such, a letter of comfort creates a moral obligation for the parent company rather than a legal one. Companies generally do not furnish letters of comfort unless absolutely necessary. This is because in the worst-case scenario, where the subsidiary is unable to repay the debt, the parent company may either be on the hook for the full amount if the letter of comfort was poorly worded, or may have to incur expensive legal fees to prove that its letter of comfort was not a tacit guarantee of its subsidiary's loan.

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Synthetic Letter Of Credit

A letter of credit that has been pre-funded by the bank on the closing date, instead of when the funds are drawn as needed. The funds accessible through a synthetic letter of credit are typically held in a credit-linked deposit account until required.

Since the funds borrowed through a synthetic letter of credit are given immediately, they are a more liquid source of funds to the borrower than a standard letter of credit. The proceeds are therefore considered more secure, as there is no counterparty risk which could result in the funds becoming unavailable.