Stand-by Letter of Credit

The “Middle Earth” of Trade Finance

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Many people regard standby letters of credit as not being proper documentary credits, which is partly justified as they are used in the same way as a bank guarantee but, like commercial credits, they are subject to the international rules and any existing legislation pertaining to documentary credits. The main difference lies in the fact that a commercial credit is expected to be used according to its purpose, that is to act as a means of channelling documents and payment between the Buyer and the Seller. Like a guarantee, a standby is not supposed to be used, unless the parties fail to perform their obligations. That is why it can be defined as a “bank guarantee taking the shape of a documentary credit”, being subject to the UCP rules.

1. Definition and historical background.

Standby letters of credit might be regarded as improper documentary credits for they are used as a bank guarantee.
Like commercial credits, they are subject to international rules and any existing legislation pertaining to documentary credits. The main difference between a commercial credit and a standby letter of credit is that a commercial credit is expected to be used with the aim of “channelling” documents and present documents **in accordance with the stipulations** of the credit if he wants to be paid. Instead of requiring the presentation of invoices, transport documents and insurance policies , evidencing the shipment of a specific consignment payment between a Buyer and a Seller. Like a guarantee, a standby is not supposed to be used, unless the parties fail to perform their obligations: that is why it can be defined as a “bank guarantee taking the shape of a documentary credit”.
The goal of standbys is to allow the Beneficiary to of goods, the Beneficiary must present a document stating that the Applicant has not fulfilled his obligations.
The wording often stipulates that such a declaration shall be accompanied by further documents supporting the claim, either in original form or in copies.
Standbys are very flexible and can be used for all types of business. Indeed, they can cover anything ranging from an ordinary guarantee commitment to sophisticated financial tools.
If a payment risk of a single commercial transaction is to be covered, it is normally recommendable to use a commercial credit, while a standby is perfect to secure the payment of a claim in connection with a more permanent business relationship.

2. Standby Letters of Credit vs Commercial Letters of Credit.

The ICC has included standbys in its universally known and accepted Uniform Customs and Practices for Documentary Credits (‘UCP’) since its 1983 version, where they appear to be only a “special type” of letter of credit., with considerable differences between them though.
The commercial letter of credit is a “credit” in which the bank’s **undertaking to pay is primary both in form and intent**.
The standby is **primary in form,** but **secondary in intent** and cannot be invoked properly by the Beneficiary unless there was an actual default by the Principal or, at the very least, an honest belief that such default has occurred.
Both instruments have also significant features in common though.
A standby, in particular, is **independent** from the underlying contract and is **documentary in character** in that the payment obligation is **triggered solely by a written demand** and any other specified documents presented in conformity with the credit. In the case of a commercial letter of credit, the Beneficiary is the party whose duty is to perform the underlying contract. He receives payment on tendering the prescribed documentary evidence of performance. By contrast, the Beneficiary of a standby is the party **entitled to receive performance** and such entitlement to make a demand for payment arises solely because of the Principal’s failure to perform. Therefore, the distinction lies in the fact that a commercial credit **typically supports the Applicant’s obligation** as a **purchaser** in a commercial transaction involving goods. A standby **typically supports the Applicant’s obligation to pay a loan** or similar **monetary obligation**, or to **perform services**.
The commercial credit is a “payment mechanism” in which the issuer is expected to pay the Beneficiary for the goods purchased by the Applicant. In a standby, **the issuer is not expected** to pay the Beneficiary unless the Applicant **defaults** in the **underlying obligation** to the Beneficiary.
In a commercial letter of credit, documents stand as an evidence shipment of goods. They are issued by a third party, as is the case of a bill of lading, which represents an “economic value”. The promise contained in the document to deliver the goods to the holder of the bill of lading constitutes a “financial value”. The bank that issued the letter of credit accepts them and handles them to the purchaser, i.e. the Applicant. Documents will enable him to have the goods at his disposal and to transfer them to a third party to whom he sold the goods in turn.
In a standby, the Beneficiary is not obliged to provide a bill of lading, or similar documents, evidencing shipment of goods. Simply, he will make a unilateral written declaration, stating that a certain risk covered by the standby has materialised. Such declaration has no “financial value”as such. In case of unfair calling of the standby, the written demand is nothing more that a written “lie” by the Beneficiary.

3. Standby Letters of Credit and Demand Guarantees Compared.

Banks in the United States have long used standbys as a **substitute** for demand guarantees, in other words, in transactions outside the traditional scope of the application of commercial letters of credit. As they were not generally allowed to issue guarantees, the term ‘standby credit’ was adopted in order to avoid the language of guarantees. Furthermore, from a legal viewpoint, standby is simply another term for demand guarantee.
Both are undertakings for the payment of money, **independent from the underlying contract**.
Both are **documentary in character**; and both are **primary in form but secondary in intent**. The difference between them is in the practice and business use.
From a commercial point of view, standbys are a different product, for they are used to **support not only “non-money” performance,** such as sales of goods or construction, but also **an extremely diverse range of financial performances**. They are governed by banking practices and are more akin to commercial letters of credit than to demand guarantees.
Standbys have developed into an “all-purpose“ financial support instrument includng a much broader range of uses than the normal demand guarantee. Therefore, they are used to support financial, as well as non-financial, obligations of the Principal and to provide credit enhancement for the primary financial undertaking.
The major difference between demand guarantees and standbys is that the latter are usually drafted in the form of a letter of credit. As a result of this, banks tend to apply to them many of the practices in current use for commercial letters of credit.
Standbys are extremely similar to demand guarantees in terms of function and legal regime, although the form is quite different: as a matter of law, there is no distinction between these instruments.
Although both instrument feature historical and procedural differences in the development, they still serve **the same “economic function”** and should therefore be treated as **equivalent instruments**. The Guarantor of a standby/demand guarantee undertakes to pay the Beneficiary a certain amount of money because of the failure on the part of the Principal to pay or to perform some other obligation.
They differ from the traditional guarantee, i.e. the suretyship guarantee, in that the Beneficiary has the right to claim for payment, either upon simple demand without justification or upon demand accompanied by one or more specified documents,. i.e. a statement by the Beneficiary himself or a third party.
In both cases, the Guarantor of the undertaking is not interested in the performance, or failure to perform, as it acts merely upon reception of the simple demand, or the demand accompanied by the specified documents.
Even though the processing does not differ from a commercial letter of credit, the economic function is quite different as commercial letters of credit serve as a “means of payment” to the Beneficiary when the **underlying contract IS “properly” performed**, whereas the demand guarantee and the standby letter of credit serve as **means of payment to the Beneficiary when the underlying contract IS NOT “properly” performed**.

4. Many types of Standbys.

Standbys are classified by type, depending on their function and other factors not necessarily related to the terms and conditions of the standby itself. There are basically no limits to the variety of transactions that the standby credit can serve. Generally, standby credits can be used in any contract where the performance of one party is **executory**.

a) Commercial standbys

A commercial standby supports the obligations of an Applicant to pay for goods or services in the event of non-payment by other methods.
This instrument meets various needs to hedge against risks arising in a commercial transaction, just as an ordinary guarantee does. Due to the many different types of business transaction, it is not possible to outline various types of commercial standby and each of them must state exactly which documents are to be presented by the Beneficiary in order to obtain payment, by whom the documents must beissued and their contents, unless specified in the set of rules the standby is subject to.
There are several examples of the needs to be covered by a standby:

Type #1: SBLC
Purpose: settling for a payment and delivering goods-
Description: standbys are often issued upon request by a company that undertook to supplygoods and acts as a guarantee for the Buyer who wishes to have the goods delivered in conformity with the agreement. It is a security for theBuyer, effecting payment under the contract that can be issued in favour of the Seller. The credit amount will usually equal the contract amount, perhaps less the advances settled. A counter standby may support the issuance of a separate standby, or other undertaking by the Beneficiary of the counter standby. This will, for example, be found in the case where there are different banks involved in the transaction. Where an issuing bank has instructed a paying bank to pay on its behalf under a standby letter of credit that it has issued, the issuing bank will often issue a counter standby as part of the reimbursement contract between the issuing bank and the paying bank of the standby letter of credit.

Type #2: Performance SBLC
Purpose: Performing a work
Description: it is issued at the request of a company having undertaken to perform a job and serves as a guarantee for the Buyer to have a work completed in conformity with an agreement. It is also often issued for 5-10% of the total contract amount and combined with a standby pertaining to the bid. It shall also cover the expenses borne by the Buyer when having to find an alternative contractor, should the work not be performed as per agreement.

Type #3: Advance Payment SBLC
Purpose: repaying an advance
Description: it supports an obligation to account for an advance payment made by the Beneficiary, such as, for instance, employer for construction work, to the Applicant , e.g. a construction or engineering company, before the contract has been completed. It is often used **i**n connection with construction works, perhaps a supply of goods as well, the parties may agree the Contractor, or the Supplier, to receive an advance of 10% of the contract amount, for instance, in order to finance the preliminary works, or the purchase/ manufacturing of the goods. If the Contractor, or the Supplier does not perform the services agreed, the advance must be repaid: in this respect, a standby can be issued as security.
Standbys are also used for **granting a retention: i**n connection with major construction work, in particolar, the Developer may wish to retain part of the contract amount, 10% for instance, as security for the work being performed in conformity with the contract and for complaints being remedied within the warranty period. Such retention is usually agreed to last for the warranty period. In order to improve his liquidity, the Contractor may provide a standby covering the performance of his duties under the contract against payment of the entire contract amount when completing the entire construction work.
It can also “**enhancine” a warranty:** both in connection with the supply of goods and the performance of work, a warranty will usually be provided to the Buyer, or the Developer, for the general period of one year, to start from delivery or completion. To render more weight to the warranty, the Supplier or Contractor may support it by having a standby issued.

Type #4:Bond or Tender SBLC
Purpose: for participating a bid/tender
Description: It is issued upon request by company submitting a tender for the delivery of goods or services and serves as a guarantee to the company inviting bids the tenderer acknowledges the order on the terms and conditions contained therein. A standby is often issued for 5-10% of the tender value and shall cover the expenses incurred by the company inviting tenders when it is forced to find an alternative supplier, should the tenderer fail to enter into the contract.
Where tenders are invited, it is commonly a prerequisite of consideration of the tender that the tenderer undertakes to sign the contract if it is awarded to him, to procure the issue of any performance standby or other standby required by the contract and not to alter or withdraw his tender in the meantime. The purpose of the tender bond standby is to safeguard the tender-inviting party (Beneficiary) against breach of such an undertaking and to prevent frivolous bidders from submitting a tender. Should the tenderer, to whom the tender was assigned, decide not to execute the contract, the amount of the tender guarantee will be forfeited in favour of the Beneficiary, Such an indstrument provides him with a source of funds to help cover his additional unexpected costs should the successful tenderer not proceed with the contract when it is awarded to him.

Other uses:
As a result of their flexibility, standbys can also be used for **carrying out maintenance:** in connection with the building or supply of major technical plants or factories, the Supplier sometimes enters into a maintenance contract for the duration of an agreed number of years, usually much longer than the warranty. During such period, he will often ensure his own people to be trained in order to be able take over the maintenance work when the contract expires. A standby may cover the risk that the Supplier not to meet the terms of the contract.
In the world of international freight forwarding, they can **fill the absence of bill of lading:** if a consignment dispatched by sea arrives at its destination before the Buyer receives the bill of lading issued in context with shipment, he may need to get access to the goods against a declaration or a guarantee. Quite often, the shipowner will not accept the Buyer’s declaration but require a bank guarantee or a standby to be issued as security.

b) Financial Standby Letter of Credit.

A financial standby supports an obligation to pay money, including any instrument evidencing an obligation to repay borrowed money: where a performance standby becomes payable where an applicant fails to perform a non-monetary obligation, e.g., fails to complete a building, a financial standby, in contrast, becomes payable, where an Applicant, or debtor, fails to perform a monetary obligation, i.e. to repay a certain amount of money in relation to a loan agreement that Applicant has concluded with a financial institution or a bank. The financial standby is normally paid upon presentation of documents evidencing or alleging the Applicant’s default on the underlying contract or loan agreement.
In USA, a large number of standbys are used to secure financial transactions ranging from loans to mergers and acquisitions. In connection with financial transactions, the rate of interest, of a loan, for instance, is an essential factor. Therefore, standbys are also used to improve the Applicant’s creditworthiness in addition to providing the security required as this may reduce the financial costs in terms of interest.
Where the wording of both the commercial credit and the commercial standby is typically drafted jointly by the Applicant and his bank, the practice for financial standbys is to be drafted by legal experts and usually issued for very large amounts
Each standby must state the documents the Beneficiary must present in order to claim for payment, whom shall issue them and their contents as well, unless this appears from the set of rules the standby is subject to.
it is common for a standby, particularly in the U.S.A., to contain elaborate and comprehensive provisions whose wording states that certain articles of the UCP 600 do not apply to the relevant instrument.

Type#1: Insurance SBLC
Description: An insurance standby supports an insurance or reinsurance obligation of the Applicant, e.g. an insurance company. During the last decades, the reinsurance business has increasingly used letters of credit wtih the goal to secure the credit of reinsurers . Reinsurance enables an insurance company, the reinsured, to share the risk of one or more contracts with another insurance company, the reinsurer. This allows for the risks to be spread. An insurance company can effect a credit for reinsured liabilities and therefore write more insurance: the reinsurer obtains a profit opportunity without the overhead expenses associated with creating and servicing the business. In the past American state regulators required out-of-state reinsurers to deposit funds toward their obligations.

Type#2: Direct Pay SBLC

Description: It is intended to be the primary means of payment and may or may not be linked to default in performance or payment. It supports payment of an underlying obligation in connection with a financial standby without regard to a default. As a direct pay standby letter of credit is intended as the primary means of payment of a financial obligation, and not as a secondary or alternative method to be used in the event of a default, it is **closer in nature to the commercial letter of credit**.

The difference between a standby and a more traditional commercial credit is that with the standby, the parties are expected to settle the transaction themselves and, furthermore, it is payable only if disagreements arise between the parties in a default situation. Much like in a commercial credit, the purpose of a direct pay standby is to secure payment, for instance at the maturity of a draft and payment is not expected to take place outside the function of the instrument.

Under special circumstances direct pay standbys have been phrased to the effect that the bank would effect payment, even without the Beneficiary presenting any document. This variant is seldom used, and not all banks are expected to be prepared to enter into such an arrangement.