NON-FUND BASED CREDIT FACILITIES

CCP CHAPTER 14C PART 1

NON-FUND BASED CREDIT FACILITIES

- These are credit facilities are financial instruments provided by banks where **no direct cash outflow occurs from the bank to the borrower.**
- Instead, the bank provides a **guarantee or commitment on behalf of the customer,** ensuring payment to a third party if the customer defaults.

📌 **Common Types of Non-Fund Based Limits:**

✓ **Letters of Credit (LC)**

✓ **Bank Guarantees (BG)**

✓ **Cash Acceptances**

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📌 Advantages for Banks

Advantage 📜	Benefit to Bank 🏦
1 No Immediate Fund Outflow 💰	Banks do not disburse funds upfront, so liquidity is preserved.
2 Margin Money Collected 🏦	Borrowers deposit a **margin**, reducing risk for banks.
3 Fee-Based Income 💸	Banks charge a **commission** on LC/BG issuance.
4 More Business Opportunities 📈	Helps banks expand **client relationships**.
5 Operational Convenience ⚙️	Less complex compared to loans or cash credit facilities.

📌 Advantages for Borrowers

Advantage 📜	Benefit to Borrower 🧑‍💼
1 Lower Cost 💲	**Cheaper than fund-based facilities** (e.g., loans).

2 Simplified Process 📄	Less documentation & operational burden.
3 Alternative to Cash/Loan 💰	Reduces need for **fund-based borrowing**.
4 Operational Flexibility 🔄	**Supports trade & contract execution** smoothly.
5 Bank's Certification ☑	Acts as **a trust signal** for financial stability.

📌 Risks in Non-Fund Based Facilities

Risk Type ⚠	Description 🔍
1 Credit Risk 💳	**If LC devolves** or **BG is invoked**, it converts into a **fund-based exposure**.
2 Counterparty Risk 🤝	Buyer or seller **may default**, affecting the bank's liability.
3 Market Risk 📉	Economic or currency fluctuations **impact international transactions**.

4 Compliance Risk 📜	**Failure to adhere** to banking & international trade regulations.

LETTERS OF CREDIT (LCs)

- It is a financial instrument issued by a bank that **guarantees payment to a seller (beneficiary)** on behalf of a buyer (applicant) if the seller meets specific conditions.
- It is commonly used in **international trade** to ensure payment security between parties who may not fully trust each other.

✓ **Governing Rules:** LC transactions are governed by **Uniform Customs & Practice for Documentary Credits (UCPDC) – ICC Brochure 600**.

📌 Why are LCs Used?

✔ **Sellers want payment assurance before shipping goods.**

✔ **Buyers want confirmation that goods are delivered as per specifications before paying.**

✔ **LCs ensure security for both parties.**

📌 Key Features of an LC:

✔ **Irrevocable** – Cannot be **canceled or altered** without mutual consent.

✔ **Document-based** – Bank deals **only in documents, not goods**.

📌 PROCESS OF LC TRANSACTIONS

Step 🔄	Process 📑
1 Buyer Requests LC 📜	Buyer requests their bank (Issuing Bank) to issue an LC.
2 LC is Sent to Seller's Bank 🏦	Issuing Bank sends LC to the seller's bank (Advising Bank).

3 Seller Ships Goods 🚢	Seller ships goods and submits required documents (e.g., bill of lading).
4 Documents Verified ☑️	Negotiating Bank checks if the documents comply with LC terms.
5 Payment is Made 💰	If documents are correct, bank **pays the seller** & claims reimbursement from the issuing bank.
6 Buyer Pays Bank 🏦	Buyer pays the issuing bank & receives shipping documents to claim goods.

📌 PARTIES INVOLVED IN LETTERS OF CREDIT

Party 🏦	Role & Function 📜
1 Applicant (Buyer) 🏭	The buyer who requests an LC from their bank.
2 Beneficiary (Seller) 📦	The seller who will receive payment under the LC.
3 Issuing Bank 🏦	The bank that issues the LC on behalf of the applicant.

4 Advising Bank 📩	The bank that notifies the beneficiary about the LC.
5 Negotiating Bank 💵	The bank that checks and negotiates the documents presented by the seller.
6 Accepting Bank ☑️	The bank that accepts a **Bill of Exchange (draft)** under the LC.
7 Confirming Bank 🔒	A second bank that guarantees payment in case the issuing bank defaults.
8 Reimbursing Bank 🔁	The bank that pays the negotiating bank on behalf of the issuing bank.

📌 TYPES OF LETTERS OF CREDIT

Type of LC 📜	Description 🏦
1 Revocable LC ❌	Can be **canceled/modified** without consent (rarely used).
2 Irrevocable LC 🔒	cannot be canceled **without mutual agreement** (most common).

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3 Confirmed LC ☑	A **second bank guarantees payment** if the issuing bank defaults.
4 Revolving LC 🔄	Used for **multiple transactions** over a period.
5 Standby LC ⚠	**Works like a guarantee** – only paid if buyer defaults.
6 Transferable LC 🔁	Beneficiary can **transfer rights** to another party.
7 Red Clause LC 📩	Allows sellers to receive **advance payment**.

📌 1 Inland LC vs. Foreign LC 🌍

Type 📜	Description 🔍
🛒 Inland LC	Used for **domestic trade** within the same country.
🚢 Foreign LC	Used for **international trade** when either buyer or seller is in a different country.

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📌 2 Sight LC vs. Usance LC ⌛

Type 📜	**Description** 🔍
👀 **Sight LC (DP LC)**	**Immediate payment** to the seller upon document submission.
🕰 **Usance LC (DA LC)**	**Payment is deferred** and made at a future date after acceptance.

📌 3 Revocable LC vs. Irrevocable LC ❌ ☑

Type 📜	Description 🔍
✖ Revocable LC	**Can be canceled/modified** by the issuing bank without prior notice.
☑ Irrevocable LC	**Cannot be canceled/modified** without consent from all parties.

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📌 4 Confirmed LC 🏦 ✅

✔ A **second bank guarantees** payment in case the **issuing bank defaults**.

✔ **Used when exporters don't fully trust the issuing bank's creditworthiness**.

📌 5 Back-to-Back LC 🔄

A **Back-to-Back LC** is a financial arrangement where two **separate but linked Letters of Credit** are issued to facilitate trade involving an **intermediary (middleman or trader)** between the buyer and the final supplier.

How It Works?

- The **intermediary (middleman/trader)** receives an **LC from the buyer** (Master LC).
- The intermediary **uses this LC to issue a second LC** in favor of the actual supplier (Back-to-Back LC).
- The second LC is backed by the first LC, ensuring that the supplier gets paid once goods are delivered.

📌 6 Transferable LC 🔄

✓ Allows the **beneficiary (exporter) to transfer part/all of the credit to a second beneficiary** (supplier).

✓ **Common in international trade when a trader doesn't manufacture goods but buys from suppliers.**

📌 7 Red Clause LC 🔴

✓ Provides **pre-shipment finance** to exporters.

✓ **Advising bank** gives an **advance payment** to the seller before shipment.

✓ **"Red Clause" was traditionally written in red ink.**

📌 8 Green Clause LC 🔴

📌 ✓ **Similar to Red Clause LC but also covers warehousing & storage costs.**

✓ **Beneficiary provides warehouse receipts as collateral.**

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📌 Credit Implications of Letters of Credit for Bankers 🏦

📌 Why should banks carefully assess LC requests?

✔ **LCs create unconditional liabilities for the issuing bank.**

✔ **Banks must honour LCs if documents are compliant,** irrespective of disputes between buyer & seller.

✔ **Fraud cases are difficult to prove**, as banks deal **only in documents, not goods**.

✔ **Lack of due diligence can lead to financial exposure & reputation risk**.

📌 🔍 Steps to Safeguard Banks Against LC Defaults

Safeguard Method 🏦	Description 📜
1 Obtain Margin Money 💰	Take **25% deposit upfront** from the applicant to reduce risk.
2 Verify Cash Flows 🔎	Assess if the applicant can **repay the balance when due**.

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3 Secure LC Against Stocks 📦	LC-backed goods can serve as **security**.
4 Market Valuation of Goods 📊	Compare LC **value** with **prevailing market price** to avoid over-financing.
5 Verify Beneficiary Credentials 🏢	Obtain **status reports on sellers** for high-value LCs.

📌 Usance Letter of Credit (DA LC) ⏰

📌 What is a Usance LC?

✔ **Payment is deferred** – buyer pays after a set **credit period** (e.g., 30/60/90 days).

✔ **Used in India to enable businesses to buy on credit & manage cash flow efficiently**.

📌 How it Works:

1 **Seller ships goods & submits documents to the bank.**

2 **Buyer accepts the bill of exchange (promising future payment).**

3 **Bank releases goods to the buyer.**

4 **Buyer pays the amount at maturity (e.g., 90 days).**

📌 Risk to Banks:

✓ **Fully unsecured once goods are released** – hence **strong credit assessment is crucial**.

✓ **Mismatch in credit terms** (buyer gets extended time but may misuse surplus funds for speculative activities).

📌 Risk Associated with Opening Import LCs 🚢 📄

🏦 Key Risks Faced by Issuing Banks in Import LCs

Risk Type 🚨	Description 🔍
1 Financial Risk of Importer 💰	The **importer's financial condition may deteriorate**, affecting their ability to pay when the LC matures.
2 Quality Risk of Goods 📦 ❌	Exporters may **ship substandard or defective goods**, impacting the importer and, eventually, the financing bank.

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3 Country Risk 🌍⚠	Political & economic instability in the exporter's country may **delay or disrupt payments & shipments**.
4 Exchange Control Risk 💱	Import LCs must **comply with FEMA (Foreign Exchange Management Act)** to avoid legal issues.

📌 Assessment of Letter of Credit Limit 💳

🔎 Factors to Consider in LC Limit Assessment

Factor 📜	**Description** 🔍
1 Type of LC (DP/DA) 🏦	**DP (Documents Against Payment)** requires **immediate payment**, while **DA (Documents Against Acceptance)** allows **deferred payment**.
2 Average LC Amount 📊	Based on **monthly purchase needs & Economic Order Quantity (EOQ)**.

3 Frequency of LC Opening 🔄	Calculated as **Annual Purchases ÷ EOQ** to determine how often LCs are required.
4 Credit Period (Usance) ⏳	Determines **when payments will be due** after goods are received.
5 Lead Time 🚛	The **time required to receive goods after opening the LC**.
6 Outstanding LCs 📈	Determines how many LCs **remain open at a given time** based on lead time & credit terms.
7 Storage & Logistics Considerations 🚢	Includes **minimum stock levels, freight & insurance costs, and quota allotment**.

📌 **Example Calculation of LC Requirement:**

✓ If total lead time is 30 days & usance is 6 months → Total LC outstanding period = 7 months.

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✓ **If annual purchase is ₹6 crore & EOQ is ₹1 crore → LCs will be opened every 2 months.**

✓ **At any point, 4 LCs of ₹1 crore each will remain outstanding → Total LC limit = ₹4 crore.**

📌 Buyer's Credit 🏦

It is a short-term **loan provided by an overseas lender** (such as a foreign bank or financial institution) **to an importer** (buyer) for financing the purchase of goods and services.

✓ The loan is disbursed to the **Indian importer's Nostro account**, which is then used to **settle the import bill on due date**.

✓ **Who arranges it?**

- Generally **initiated by the foreign supplier** or a **financial institution** in the supplier's country.
- Indian banks with **overseas branches** are major players in **offering Buyer's Credit** to Indian importers.

  ✓ **Commonly used for DA (Deferred Payment) LCs** –

where the buyer delays payment & arranges financing later.

📌 ✸ Benefits of Buyer's Credit

Benefit ☑	Description 🔍
1 Immediate Payment to Exporter 📅	The exporter gets paid on time, ensuring **smooth international trade**.
2 Flexible Payment for Importer 💰	The importer gets extended time for payments, easing cash flow constraints.
3 Negotiation Power 🏷	The importer can **negotiate better discounts** with the exporter & make deals on **sight basis**.
4 Multi-Currency Advantage 💱	Importers can choose funding in **any currency** (USD, GBP, EUR, JPY, etc.), optimizing exchange rates.

5 Currency Diversification 🌍	The import currency & loan currency **can be different**, enabling better forex management.

📌 Supplier's Credit 🚢

🔍 What is Supplier's Credit?

✔ **Supplier's Credit** is **credit extended directly by the overseas supplier** or **foreign financial institutions** to the importer.

✔ It allows the importer to **pay for goods over an agreed period** (deferred payment).

✔ **Usance Bills under LCs** are often discounted by **foreign banks or Indian banks' overseas branches**.

✔ The supplier **arranges their own financing** so that they can **offer deferred payment** to the importer.

📌 ✸ Benefits of Supplier's Credit

Benefit ☑	Description 🔍

1 Cheaper Funding 💰	Helps importers **secure cost-effective financing** for raw materials & capital goods.
2 Eases Cash Flow Pressure 🏦	Importers can **spread payments over time**, reducing the burden on working capital.
3 Better Price Negotiation 🤝	Importers can **negotiate discounts** by offering a structured payment plan.
4 Ensures Sight Payment for Suppliers 📜	Suppliers receive **immediate payment**, improving their liquidity.
5 Lower Credit Risk 🔍	Payments are often backed by **LCs**, reducing the **risk of default** for suppliers.