

INTRODUCTION

A letter of credit substitutes the creditworthiness of a strong financial institution for that of an individual or a corporation. This concept has been used in financing the international shipment of merchandise for centuries. Today, letters of credit are also used in a wide variety of other commercial financing transactions, such as securing a real estate development loan, guaranteeing obligations involving the private placement of securities, and assuring payment in the event of nonperformance of an obligated party.

During the 1980s, thrifts significantly increased their issuances of letters of credit, particularly standby letters. A contributing factor to this development is that by issuing letters of credit, an institution can increase its earnings without disbursing funds, thus, not affecting its tangible and core capital requirement. (It does, however, increase its risk-based capital requirement.) The institution charges a fee for the risk of default or nonperformance by the customer. No funds are disbursed and the institution's level of assets remains virtually unchanged. However, various forms of letters of credit have different effects on risk-based capital requirements and loans-to-one-borrower limits.

It is important for regulators to look beyond the contingent liability figures that appear on the institution's records and be concerned with the risk elements present in the institution's practices regarding letters of credit issuance. Examiners should then assess the institution's system of controls that can mitigate those risks, including experienced staff, proper documentation, and the quality of underwriting. The letter of credit portfolio requires a review, both internally by the institution and also by regulators, as thorough as the lending review. A default or nonperformance by the account party of a letter of credit will have the same effect as a default on a loan, that is, a loss of capital.

To adequately evaluate the institution's portfolio, it is important for the examiner to understand the

concept of letters of credit, know how they are used, and be aware of related documentation and accounting practices. Refer to related glossary entries. There are two major types of letters of credit: the commercial letter of credit and the standby letter of credit.

Commercial Letter of Credit

The commercial letter of credit (LOC) is commonly used as a means of financing the sale of goods between a buyer and seller. Generally, a seller will contract with a buyer on an open-account basis, whereby the seller ships the goods to the buyer and submits an invoice. To avoid the risk of nonpayment, the seller may require the buyer to provide a commercial letter of credit. To satisfy the requirement, the buyer applies to an issuing institution, requesting the institution to issue a letter of credit containing specified terms and conditions in favor of the seller (beneficiary). If approved, the buyer (account party) agrees to reimburse the institution for payments drawn against the letter. The commercial letter of credit can be used to finance one shipment or multiple shipments of goods. Once documents are submitted providing evidence that the goods have been shipped in accordance with the terms of the letter of credit, the seller can draw against the issued letter of credit through a documentary draft or a documentary demand for payment. The buyer reimburses the institution (either through deposits to a deposit account or through drawing down on a line of credit previously approved by the institution). Thus, letters of credit can be secured by cash deposits, a lien on goods shipped or other inventory, accounts receivable, or other forms of collateral. Commercial letters of credit "sold for cash" (that is, secured by cash deposits) pose very little risk to an institution as long as the bank ensures that the beneficiary provides the proper documents prior to making payment on the draft. If credit is extended to pay for the goods, the subsequent loan presents the same credit risks associated with any other similar loan.

Standby Letter of Credit

The standby letter of credit (SBLOC) is an irrevocable commitment on the part of the issuing institution to make payment to a designated beneficiary if the institution's customer, the account party, defaults on an obligation. The SBLOC differs from the commercial letter of credit in that it is not dependent upon the movement of goods. Where the commercial letter of credit reduces the beneficiary's risk of nonpayment under contract for the sale of goods, the SBLOC reduces the risks of default or nonperformance under a contract. SBLOCs may be financially oriented, whereby an account party agrees to make payment to the beneficiary, or it may be service oriented, whereby a service is to be performed by the account party. SBLOCs are subject to loans-to-one-borrower limits of § 563.93 of the regulations and 12 CFR 32. Commercial letters of credit are not.

Unlike a commercial letter of credit, a demand for payment against an SBLOC is generally an indication that something is wrong. The nonperformance or default that triggers payment under the standby letter of credit often signals the financial weakness of the customer, whereas payment under a commercial letter of credit suggests that the account party is conducting its business as usual. Standby letters of credit are usually unsecured, but may be secured by a deposit or other form of collateral.

The uses of SBLOCs are practically unlimited. The more common areas of use include:

Real Estate Development: A mortgagee will condition its loan commitment upon a cash contribution to a project by the developers. Although the lender insists that the developers have some equity in the project, the developer may have funds tied up in other construction. The parties often use the letter of credit to satisfy the equity requirement without the need for a cash deposit.

Fulfilling Municipal Regulations: Most municipalities will require a standby letter of credit as security for a developer who is seeking the approval of bids on various improvement projects, such as buildings, roads, and utility services.

Securing Notes: A lender will often ask its obligor to secure the balance of a promissory note with a SBLOC.

Performance: The standby letter of credit serves in the nature of a performance bond. Often the seller of goods will have the borrower obtain a commercial letter of credit to ensure payment; simultaneously, the buyer will have the seller obtain a standby letter of credit to ensure that the goods are delivered when agreed and in acceptable condition.

Securities: The standby letter of credit serves to guarantee obligations involving the private placement of securities, such as revenue and development bonds. Industry ratings of such paper will be higher and a lower interest rate will generally be given if a SBLOC secures against default.

More recently, standby letters of credit have been used to provide credit support for credit card and auto loan securities.

Benefits

The primary reason that an institution may issue a letter of credit is to provide a financial service for a creditworthy customer. Through the use of a letter of credit, a customer can often obtain a less expensive source of funds than would be possible through direct financing from the institution. For example, the customer may be able to take advantage of a seller's credit terms with the backing of a letter of credit to substantiate creditworthiness. The institution receives a fee for providing the service. The institution also hopes to build a better working relationship with its customers who may bring in other profitable banking business.

Uniform Commercial Code

Both the issuer and the beneficiary of letter of credit contracts are obligated to conform to a uniform set of rules governed by Article 5 of the Uniform Commercial Code (UCC). These rules are addressed under the Uniform Customs and Practices for Documentary Credits. The UCC is a set of articles adopted by the domestic states, whereas the Uniform Customs and Practices involves all international guidelines for trading

goods and services. Local laws and customs vary and must be followed under advice of counsel.

Elements of a Letter of Credit

When issuing a letter of credit, federal thrifts are subject to the following requirements of § 545.48 of the regulations:

- Each letter of credit must conspicuously state that it is a letter of credit;
- The issuer's undertaking must contain a specified expiration date or be for a definite term and must be limited in amount;
- The issuer's obligation to pay must be solely dependent upon the presentation of conforming documents as specified in the letter of credit and not upon the factual performance or nonperformance by the parties to the underlying transaction; and
- The account party must have an unqualified obligation to reimburse the issuer for payments made under the letter of credit.

To the extent that funds are advanced under a letter of credit without compensation from the account party, the account shall be treated as an extension of credit subject to percentage-of-asset limitations applicable to the institution.

The letter of credit involves at least three parties and is three separate and distinct contracts:

- A contract between the account party and the beneficiary under which the account party has an obligation of payment or performance;
- A contract between the account party and the issuer of the letter of credit. The issuer is the party obligated to pay when the terms of the letter of credit are satisfied. The account party agrees to reimburse the issuer for any payments made; and
- A contract between the issuer and the beneficiary, whereby the issuer agrees to pay the beneficiary in compliance with the terms and conditions of the letter.

Revocable or Irrevocable

Letters of credit can be issued in either revocable or irrevocable form. The revocable letter of credit is rarely used, because it may be amended or canceled by either party without the consent of the other. Most letters of credit are issued as irrevocable, which stipulate that no changes may be made to the original terms of the letter of credit without the full consent of all parties.

Risks in Issuing LOCs

An institution must be aware of the credit risks that are associated with letters of credit and issue them only when its resources are adequate to cover any resultant losses. Although letters of credit are not originally made as loans, they may lead to loans if payment is made and account parties cannot meet their obligation to reimburse the institution. Therefore, the institution must implement the same underwriting guidelines for letters of credit as is prudent for other extensions of commercial credit that are recorded on the balance sheet. (Refer to Thrift Activities Regulatory Handbook, Section 214, Other Commercial Lending.)

The importance of adequate documentation cannot be overemphasized. Commercial letters of credit are part of a continuous flow of transactions evolving from letters of credit to sight drafts to acceptances. Repayment may depend upon the eventual sale of the goods involved, yet the goods may not provide adequate collateral protection. Thus, the proper handling and accuracy of the required documents is of primary concern. Letters of credit are frequently issued via tested telex, which verifies the authenticity of the sender (usually another bank). No institution should honor a letter of credit presented by a beneficiary without first confirming its authenticity.

Commercial letters of credits involving imports must be considered unsecured (by the goods being shipped from abroad) until the goods have passed customs, the security documents specified in the letter of credit have been presented, and the goods have been verified and controlled.

Letters of credit are subject to fraud risks from both customers and insiders. Standby letters of credit can be used by officers or directors as a vehicle for obtaining credit at another institution to avoid the scrutiny associated with obtaining insider loans from their institution. Consequently, the issuance of letters of credit should be subject to the same strict internal controls as the extension of credit. Such controls include: segregation of duties, the requirement of dual or multi-level authorizations and segregation of duties between the issuing, recordkeeping, acceptance, and payment functions.

Risks in Honoring LOCs

Honoring another institution's LOC or acceptance requires strict verification procedures as well as dual authorization by the honoring thrift. Reasons for strict procedures and authorizations are numerous. The issuer may be unable or unwilling to honor an LOC or SBLOC, claiming the document to be fraudulent, or a forgery, or the signer to have been unauthorized. Before honoring any other institution's LOC, a thrift should confirm in writing that the LOC is valid and will be honored under specified conditions. Agreements with issuers for accepting LOCs issued by tested telex should provide specific conditions under which they will be honored. To minimize risks of loss, compliance with the conditions must be strict-not merely substantial. Testing LOCs should involve two or more persons through dual authorization or segregation of duties to prevent fraud by employees in this process.

SBLOCs Issued As Surety For Revenue Bonds

Standby letters of credit may be issued in conjunction with the development of a property financed with tax-free revenue bonds. In these transactions, a government agency, typically a local housing authority or regional development authority, sells bonds to investors to finance the development of a specific project. Once the bonds are issued, the proceeds are placed with a trustee and then loaned at less-than-market rates to the developer of the project. The government agency has no liability; the bond investors have recourse against only the specific project. The bonds are exempt from federal taxation and generally carry below-market interest rates since they are issued

by the agency. The below-market-rate loan that is granted to the developer enables the government agency to encourage development without expending tax dollars.

Because the bonds are secured by only the project, typically an SBLOC is obtained from a thrift or a commercial bank to provide additional security to the bond holders. The SBLOC is usually for an amount above the face amount of the bonds, so that the bondholders' accrued interest between interest payment dates is also secured. Moreover, the thrift generally secures its SBLOC with a lien against the property that is junior to the authority or trustees' lien.

The trustee receives periodic payments from the developer and then pays the bondholders their periodic interest payments and the thrift its letter of credit fee. In the event of a default by the developer, the trustee will draw upon the SBLOC to repay the bondholders. If such a default occurs, the thrift is then in the position of the lender for the project.

The structure of the transaction requires the thrift issuing the SBLOC to assume virtually all of the risk. In the event any problems occur, the bondholders will be repaid by calling the SBLOC, leaving the government agency with no liability. Because of these concerns, the primary underwriting consideration is the ability of the collateral property to service the debt. Appraisals should be obtained and debt service coverage requirement calculations should include both the favorable rate obtained through the revenue bonds and market interest rates. The operations of the collateral property should also be monitored on an ongoing basis. If new construction is involved, the progress should be monitored and any cost overruns should be identified and addressed.

In reviewing these transactions, the regulator must be aware of the risk that the thrift has assumed. Pricing should be a key consideration since the thrift is vulnerable to any losses that may occur. Because the purpose of these bonds is to encourage development, marginal projects that would not be feasible under conventional financing are often financed in this manner. The collateral should be valued using market value unaffected

by the specialized financing because the specialized financing may be unavailable to a purchaser.

Without the benefit of a substantial guarantor or equity in the collateral, these SBLOCs present more-than-normal risk of loss and are likely to be substandard or worse. Protection against loss may be provided by a long-term lease from a major tenant of an industrial property, or a housing authority lease with a government funding commitment or guaranty.

Although most of the SBLOCs contain periodic renewal features, the examiner must be aware that the thrift cannot relieve itself from liability simply by choosing not to renew the SBLOC. Virtually all of the bond issues require a notice of nonrenewal prior to the expiration of the SBLOC. If such notice is received by the trustee, it is normally considered an event of default and the existing SBLOC is generally drawn upon by the trustee. As a result, the thrift should be continuously monitoring both the project and the status of the bonds. Evidence should be contained in the file regarding the property's occupancy, its cash flow position, and the status of the bonds. In addition to the current status of interest payments, any sinking fund requirements contained in the bond indenture should also be verified and compliance monitored. Instances have been reported where financial institutions found it expedient to buy the revenue bonds at a discount rather than honor an SBLOC.

Policies and Procedures

Maintaining adequate written policies and procedures and monitoring letter of credit activities are part of the fiduciary and oversight responsibilities of the board of directors. Generally, policies and procedures governing the institution's issuance of letters of credit are contained in a section of the loan policy manual.

The letter of credit policy should thoroughly explain the institution's procedures in issuing both commercial letters of credit and standby letters of credit. It should outline desirable and undesirable issuances, designate persons authorized to issue letters of credit, and define the recordkeeping and

documentation requirements, including the need to establish separate files for each issuance.

If several lending departments issue letters of credit, the policy should be explicit in charging responsibility for file maintenance and record-keeping. A separate file containing an exact copy of each outstanding letter of credit and all the supporting documentation that the underwriter used in making the decision to issue the letter should be included in the file. This documentation should be the same as the financial documentation used for originating any other form of credit, which includes current financial statements, current income statements, purpose, collateral security documentation, proof of lien position, borrowing authorization, all correspondence, and officers' memoranda.

In addition, the file must contain the documentation associated with any disbursements or payments made. For a commercial letter of credit, these documents may include:

- The draft (sometimes called the bill of exchange), which is the demand for payment;
- The commercial invoice, a document describing the goods being shipped (prepared by the seller and signed by the account party);
- The bill of lading, which documents that shipment of the goods has taken place and gives the issuer an interest in the goods in the event the account party defaults;
- The insurance certificate that provides evidence that the seller has procured insurance;
- The consular documents, stating that the shipment of goods satisfies the import/export regulations; and
- The certificates of origin and inspection, which state that the goods originated in a specified country, to guard against the substitution of second-quality merchandise.

The documents associated with standby letters of credit are far less complicated than the commercial letter of credit. Often no document is

necessary to support the beneficiary's draw upon it. This is what is referred to as a clean standby letter of credit and should be discouraged due to the possible legal expense of defending any action taken in honoring or dishonoring a draw without specific documentary requirements. At a minimum, standby letters of credit should require a copy of the contract between the account party and beneficiary, and a beneficiary's certificate asserting that the account party has not performed according to the contract or has defaulted on the obligation.

Banker's Acceptance

When the beneficiary presents a draft to the issuer in compliance with the terms of a commercial letter of credit, the method of honoring the draft is acceptance. The issuer will stamp the word "accepted" across the face of the draft, which makes the instrument negotiable. Thus, the institution upon which the draft is drawn converts what was originally an order to pay into an unconditional promise to pay. Payment terms on a letter of credit vary from sight for a sight draft (which must be paid on acceptance) to 180 days for time drafts. There is a ready market for these instruments, because they are backed by the full faith and credit of the institution. Payment must be made at maturity by the accepting institution, whether or not it is reimbursed by its customer. Because of this, acceptances are readily negotiable, and a beneficiary may "sell" accepted time drafts to other financial institutions for a discount, based on the number of days remaining until payment is to be made by the issuing institution. Acceptances are governed by Article 3 of the UCC and any rights the parties have under acceptance are subject to the rules of that article.

Accounting Issues

Statement of Financial Accounting Standards (SFAS) No. 91 stipulates that:

If the institution's experience with letters of credit indicates that the likelihood that the commitment will be exercised is remote, the commitment fee shall be recognized over the commitment period on a straight line basis as service fee income. If the commitment

is subsequently exercised during the commitment period, the remaining unamortized fee should be recognized over the life of the loan as an adjustment of yield.¹

Since letters of credit represent a contingent liability to the issuing institution, they must be disclosed in the financial statements in accordance with generally accepted accounting principles (GAAP). In accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard (SFAS) No. 5, the nature and the amount of a standby letter of credit must be disclosed in the institution's financial statement.

In addition, SFAS No. 5 requires that if a loss contingency is probable and can be reasonably estimated, a charge to income must be accrued.

Classification of SBLOCs

It may be appropriate to adversely classify an SBLOC if draws under the SBLOC are probable and a credit weakness exists. For example, deterioration of the financial standing of the account party could jeopardize performance under the letter of credit and result in the requirement of payment to the beneficiary. Such a payment would result in a loan to the account party and could result in a collection problem, especially if the SBLOC were unsecured. Thus, if payment is probable, and the account party does not have the ability to repay the institution, adverse classification is warranted. (Please refer to Handbook Section 260, Classification of Assets, for detailed procedures on asset classification.)

REFERENCES

Code of Federal Regulations (12 CFR)

Chapter I: Office of the Comptroller of the Currency

§ 32.2(d) Contractual Commitment to Advance Funds

¹ Financial Accounting Standards Board, *Statement of Financial Accounting Standards, SFAS No. 91*, "Accounting for Nonrefundable Loan Fees and costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases."

§ 32.2(e) Standby Letter of Credit

*Chapter V: Office of Thrift Supervision
Subchapter C: Regulations for Federal Savings
Associations*

§ 545.48 Letters of Credit

*Subchapter D: Regulations Applicable to All
Savings Associations*

§ 563.93 Loans-to-One-Borrower Limita-
tions

FDIC Regulations

Part 337 Unsafe and Unsound Banking
Practices

§ 337.2 Standby Letters of Credit

Comment-Rulings

FHLBB Resolution 83-241 as amended
Letters of Credit ¶ 37,362.034*

Financial Accounting Standards Board, State- ment of Financial Accounting Standards

SFAS No. 5 Accounting for Losses and Con-
tingencies

SFAS No. 91 Accounting for Nonrefundable
Loan Fees and Costs Associated
with Originating or Acquiring
Loans and Initial Direct Costs of
Leases

* The reference is to a paragraph number in the
Supervisory Service, Savings and Community
Bankers of America, Chicago, Illinois.