UBS

Standby letter of credit

Parties and how it works

The Standby Letter of Credit – also "Standby LC" – serves to secure payment and performance obligations.

It has its roots in American banking law and is used mainly in international business with American states, as well as in the Far East.

In contrast to a guarantee, a Standby LC may be confirmed under certain circumstances. In the following, it is treated as a guarantee.

The Standby LC is based on a contract between two business partners.

Parties
At least three parties are involved in a Standby LC:

Principal
Upon the contractual partner's request, it instructs its bank to open a Standby LC to secure its payment or performance obligation.

Beneficiary
It's entitled to draw under the Standby LC if the principal fails to provide a service or make a payment. In this case, the guaranteeing bank has to pay.

Principal's bank
It issues the Standby LC and forwards it to the beneficiary. This can be carried out via an "advising" bank – generally, the beneficiary's bank.

Advising/confirming bank
In most cases, it's located at the beneficiary's domicile. It examines the apparent authenticity of the Standby LC and advises it to the beneficiary. It takes on no obligation.

If permitted by the terms of the Standby LC, it can also be confirmed by the advising bank. In this case, it's liable for the Standby LC and assumes the credit risk and the country risk, which is a benefit for the beneficiary.

How it works

Let's have a look at how a Standby LC is opened taking the example of securing payment.

1. Underlying transaction

A Swiss supplier and a buyer in the USA conclude a contract over an underlying transaction – for example, the purchase of a gas turbine. The supplier requests a Standby LC as a payment guarantee.

2. Order

The buyer instructs its bank to open a Standby LC with the supplier as the beneficiary.

3. Opening of Standby LC

The principal's bank opens the Standby LC and transmits it to the beneficiary. It can also be sent via an advising bank.

4a. Advising Standby LC

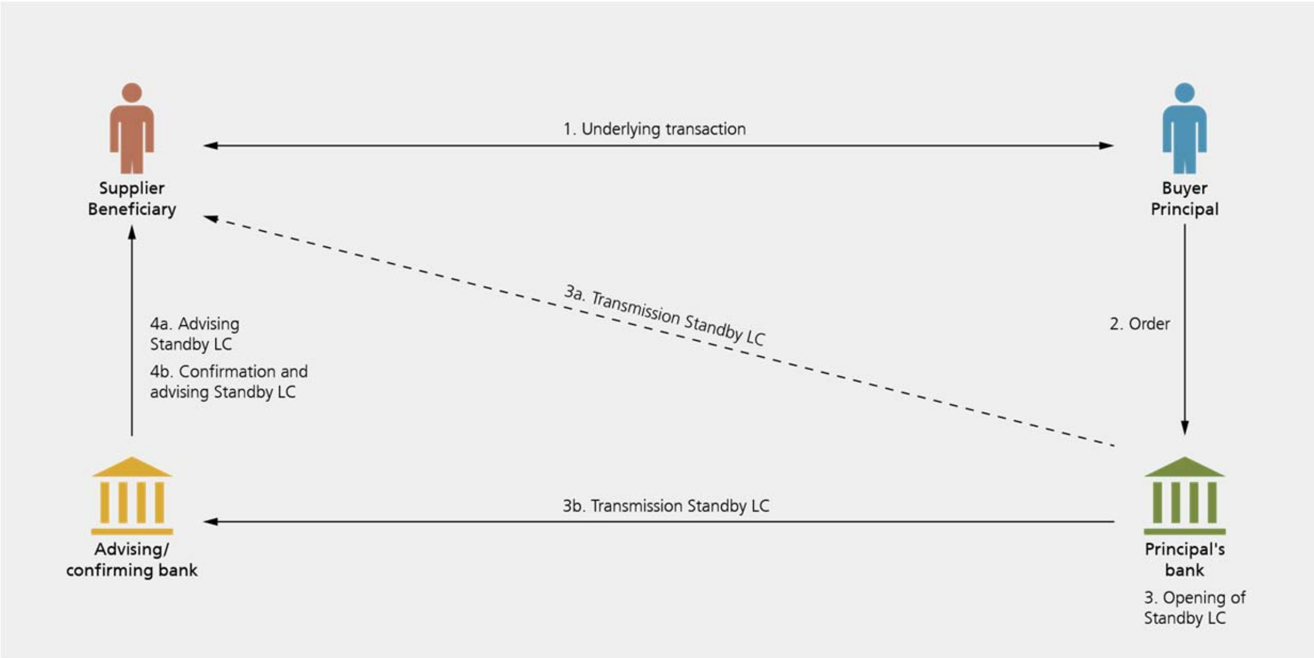
The advising bank examines the apparent authenticity of the Standby LC and forwards it to the supplier.

The underlying transaction is settled. The advising bank takes on no obligation in this case: the supplier bears the credit risk and the country risk.

4b. Confirmation and advising Standby L/C

If the supplier wants to limit these risks, it asks the buyer to open a Standby LC with confirmation from the advising bank. The confirming bank therefore takes on its own payment obligation irrespective of the opening bank's obligation. Both the credit risk of the principal's bank and the risk of the importing country are therefore covered.

The bank sends the confirmed Standby LC to the supplier. The underlying transaction is settled.



UBS Switzerland AG
Trade & Export Finance
P.O. Box, 8098 Zurich

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