

# STANDBY LETTERS OF CREDIT

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A commercial letter of credit is used to effect payment for goods and services. In contrast, a standby letter of credit serves as an assurance that the applicant will fulfill its obligations defined in a contract executed with the beneficiary. In other words, the beneficiary draws under the standby letter of credit only when the applicant fails to meet the obligations, such as:

- to repay money borrowed by, advanced to, or for the account of the applicant, or
- to make payment based upon a specified default(s) by the applicant in the performance of a contract obligation.

In the first case, the bank issuing the standby letter of credit agrees to repay the funds borrowed or advanced in the event the applicant fails to do so. For example, a foreign bank may finance the local subsidiary of a U.S. corporation and require a standby letter of credit from a U.S. bank. If the local subsidiary defaults on the loan, the foreign bank is able to draw under the standby letter of credit to recover the unpaid amount of the advance.

Standby letters of credit also are used to assure timely payment of invoices for sales made on open accounts. The seller may request a standby letter of credit to assure a buyer's invoice will be paid within a specified period of time. The seller is entitled to draw under the standby letter of credit for any unpaid invoices simply by presenting a draft and statement certifying the invoices remain unpaid.

Another common use for the standby letter of credit is to assure performance under a contract. For instance, standby letters of credit may be offered by building contractors to assure compliance with local, state, or federal regulations and building codes. (Standby letters of credit may be used in lieu of cash deposits, guarantees, and bonds.) A company bidding on a contract to provide merchandise or services may be required to post a bond which is forfeited if the bidder fails to fulfill the terms of the bid award.

In all of these examples, the standby letter of credit is payable upon presentation of a draft accompanied by a statement indicating the applicant has failed to perform according to an underlying contract or agreement. Standby Letters of Credit are used in both domestic and international transactions.