USE A 'STANDBY LETTER OF CREDIT'

In many common business circumstances, letters of credit are better than direct loans

Many businesses use bank loans to fill a gap in their cash flow, finance an equipment purchase, or other beneficial business purposes. But few know a bank's "standby letter of credit" is also useful in several common business circumstances.

The letter is the bank's guarantee the customer will honor a specified financial obligation as agreed. Should the customer fail to honor the obligation, the bank must make payment.

To illustrate the process, consider a contractor that has a long-term relationship with a bank. The bank has extended many loans to the contractor, and the contractor has repaid them all as scheduled. So, the bank views the contractor as a reliable, creditworthy enterprise.

The contractor then places a $15,000 order with a new supplier located in

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another state. In the absence of any previous experience, the supplier is reluctant to extend the contractor $15.000 in open account credit on its normal 30-day terms.

Of course, the supplier could require prepayment or cash payment on delivery. But either alternative would strain the contractor's cash flow. So, the bank issues a letter of credit that solves both companies' problems.

More precisely, the bank issues a $15,000 letter of credit *in favor of* the supplier, and *for the benefit of* the contractor. The letter provides the bank's irrevocable guarantee for the contractor's $15,000 purchase from the supplier on the standard 30-day terms.

The contractor remains an unknown entity to the supplier, but the latter can easily verify the bank's standing as a sound financial institution. So, after receiving the letter of credit, the supplier can make the $15,000 sale to the contractor on its normal 30-day terms. Should the contractor fail to honor those terms, the supplier can obtain payment directly from the bank.

But the bank's payment comes from the proceeds of a new $15,000 loan to the contractor, which must then repay the bank's loan when scheduled. So, in every circumstance, the contractor remains responsible for the $15,000 payment. The contractor either pays for the purchase directly, or, repays the loan created from the bank's need to honor its letter of credit.

Many business people erroneously assume a bank assumes no risk from issuing a letter of credit. After all, assuming a customer pays his obligations, the seller never draws against the letter of credit.

But a bank cannot arbitrarily withdraw its commitment after issuing a letter of credit. A bank letter of credit remains irrevocable until its expiration date. Nor can any bank be sure no draw will even be made against a letter of credit.

So, banks view requests for letters of credit similarly to requests for a direct loan. The same criteria govern both the loan and credit decision processes. Businesses unable to qualify for loans will remain unable to qualify for credit.

But returning to the above example, when issued, the letter of credit helped avoid unnecessary strain on the contractor's cash flow. The letter enabled the firm to delay the $15,000 payment to the supplier for 30-days.

Of course, the contractor could have borrowed the necessary $15,000 from the bank and pay cash for the purchase. As noted above, a business that qualifies for a $15,000 letter of credit can also qualify for a direct bank loan in the same amount. But using a letter of credit instead of a loan offers some cost advantages.

Assume the bank charges a 10 percent annual interest rate for the $15,000 loan, or $1,500 for a full year. But the loan in this instance would extend only 30 days, so the charge becomes only $125.

Charges for issuing letters of credit naturally vary among banks. But as a typical example, many banks charge 1½ percent per year of the face value of a letter of credit. The banks then pro-rate that charge for letters that cover shorter than one year. In this instance, the contractor pays only $18.75 for a $15,000 letter of credit that expires in only 30 days.

In some instances, buyers can even negotiate price reductions from suppliers in exchange for the payment guarantees that come from letters of credit. The letter eliminates financial risk for the supplier, and some suppliers will adjust their prices accordingly.

Apart from any potential price concessions, using letters of credit can facilitate development of relations with new suppliers. The ability to provide a bank's letter of credit affirms a company's creditworthiness. Coupled with prompt payment for purchases, a business can then more readily develop open lines of credit with new suppliers.

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The experience of the contractor in the above example illustrates the most common uses of letters of credit. But standby letters of credit can also serve other useful business purposes.

Construction companies may use standby letters of credit to enhance bonding capacity. Builders may use standby letters of credit to secure pieces of property pending completion of financing. Businesses may also use letters of credit as partial collateral for longer-term debt obligations, enabling them to receive lower loan rates.

Indeed, standby letters of credit are useful in any business circumstance where one party wants additional evidence of another's financial capability. Letters of credit can provide that evidence at a modest cost and, when used properly, can be a profitable device.