Transferable Letters of Credit as catalysts for Working Capital Optimisation, Cost Efficiency and Enhanced Competitiveness for SME Businesses

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Abstract

In commercial transaction (International and domestic), letters of credit are widely accepted as instruments of payment. A key reason for its wide acceptance is that it assures the seller of "timely defined payment" and the buyer of "defined quality and quantity" of goods if discrepant free presentation is made at counters of issuing bank. This attribute makes Letters of Credit a widely accepted payment instrument in international trade as it meets the needs of both buyer and seller. Under letters of credit, however, the payment is due to the seller once the presentation made by seller is accepted by issuing bank. This implies that the seller receives funds post-presentation and must utilize these funds or working capital finance to meet obligations under the letter of credit. Hence, seller will require funds for procurement, production and dispatching. This necessitates the use of own fund by seller to fulfil his obligation under letter of credit. The requirement of such funds is often termed as working capital finance. The working capital finance is often fulfilled by various facilities like Supplier Financing, Suppliers Credit, Inventory Financing, Invoice Financing (Factoring and Discounting) or Working capital loans through overdraft or cash credits from bank and NBFCs. However, these working capital facilities often demands for Securities or Collateral from seller which assures lender that, in the event of default, they can recover their funds by liquidating these assets. Such Securities or Collateral often includes tangible assets such as residential, commercial or industrial real estate, inventory, or equipment of the borrower. The need for collateral and securities often constrains the accessibility of working capital, limiting their financial flexibility and potentially hindering their growth opportunities. Fortunately, this stated challenge of liquidity deployment through working capital by seller can be addressed through the use of "Transferable letters of credit". Under Transferable letters of credit, the first beneficiary(seller) transfers part or full amount of credit to subsequent beneficiaries (Seller's supplier). This transferability feature ensures that portion of obligation that is transferred does not require the utilization of the seller's liquidity or funds. Consequently, this process leads to the elimination or reduction of the seller's working capital requirements. As a result, sellers can minimize or entirely eradicate the use of their own funds or working capital finance to fulfil their obligations by leveraging the use of Transferable Letters of Credit. This utilization helps sellers in reducing interest costs and mitigating administrative and legal charges associated with collateral mortgages. This characteristic of transferable letter of credit to reduce or eliminate the use of working finance provides cost efficiency and enhance competitiveness to small, medium and

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large enterprises. This often positions it as a widely accepted method of payment in both domestic and international market.

Introduction

A Transferable Letter of Credit functions as a financial tool employed in international trade transactions, facilitating the transfer of its terms from the initial beneficiary (the first seller) to one or more secondary beneficiaries (subsequent sellers). Within this arrangement, the initial beneficiary, who might not be the ultimate supplier of the goods, possesses the ability to transfer the credit, either in whole or part, to others within the supply chain. Subsequently, secondary beneficiaries can present relevant documents and access funds based on the value of the goods or services they contribute. The transferability's terms and conditions are explicitly delineated in the original Letter of Credit, requiring approval from the issuing bank for any transfer. This instrument offers flexibility in complex trade scenarios, enabling various entities within the supply chain to participate in a regulated manner. In simple terms, it clarifies that a transferable letter of credit is a type of letter of credit in which the issuing bank authorises the beneficiary bank to transfer all or a portion of the letter of credit's value to a second beneficiary at the first beneficiary's request. However, it can only be transferable only if it is stated to be 'Transferable' in the original letter of credit. It should be noted that all Letters of Credit are not transferable. The letters of credit in which issuing bank has specified that this Letter of credit is transferable can only be transferred.

The use of Transferable Letters of Credit adheres to international guidelines such as the Uniform Customs and Practice for Documentary Credits (UCP600) set forth by the International Chamber of Commerce (ICC). This regulatory framework not only aids in risk mitigation but also facilitates smoother transactions across global markets. Article 38 of UCP 600 outlines the rules and procedures for the operation of transferable letters of credit, providing comprehensive details for each step in the process.

It is important to highlight that when transferring Letters of Credit, the transferring bank must follow specific guidelines governing this financial transaction. Adhering to these guidelines is crucial for a smooth and compliant transfer process. The key guidelines include:

1) **Limit on Aggregate Value:** The transferring bank is bound by the condition that the total value of all transferred letters of credit must not surpass the value specified in the parent Letter of Credit. This constraint ensures that the financial commitments do not exceed the originally established parameters, maintaining financial integrity.

2) **Partial Shipments and Multiple Beneficiaries:** Transfer to more than one beneficiaries is permissible only if the original Letter of Credit explicitly allows partial shipments. This condition offers flexibility in cases where multiple entities contribute to the fulfilment of a single letter of credit, aligning with the diverse nature of international trade scenarios.

3) **Single Transfer Allowance:** A critical limitation is imposed on the transferring bank, allowing the Letter of Credit to be transferred only once. Hence, in Transferable letters of Credit, second beneficiary has no right to transfer to the third beneficiary. This restriction ensures that the

transferability feature is employed judiciously and mitigates the potential complexities that could arise from multiple transfers.

However, in the process of transfer of credit, there will be some logical accepted changes in the terms and conditions of the original letter of credit which are permitted by transferring banks. These exceptional conditions in which change can be made are listed below where any one or all of which may be reduced or curtailed.

1) The amount of the credit.
2) Any unit price stated therein.
3) The expiry date.
4) The latest shipment date or given period for shipment.
5) The period for the presentation of documents.

In summary, a Transferable Letter of Credit plays a dynamic role in commercial trade by enabling the smooth transfer of credit terms from the original beneficiary to secondary beneficiaries. This setup fosters flexible involvement in the supply chain, allowing various entities to participate in a regulated manner. Following guidelines during the credit transfer, which include limits on total value, allowances for partial shipments and a single transfer restriction, highlights the importance of maintaining financial integrity and responsible use of the transferability feature. While allowing for reasonable changes, these outlined conditions create a balanced framework, ensuring a seamless and compliant transfer process in the complex landscape of commercial trade, benefiting both buyers and sellers.

Working Capital Optimisation through Transferable Letter of Credit

The utilization of transferable letters of credit act as a catalyst for businesses. It catalyses working capital through a binary mechanism. Under this, binary mechanism acts as a catalyst for working capital through two ways. Firstly, it serves as the financial guarantee to suppliers, ensuring a stable and reliable partnership. Secondly, they contribute additional working capital, bolstering the business's financial capacity beyond its regular working capital limits. In essence, the binary roles facilitated by transferable letters of credit are integral for enhanced financial stability and operational flexibility in commercial transactions. The binary roles facilitated by transferable letters of credit can be summarized as follows.

1) **Providing supplementary working capital:** The transferable Letter of Credit acts as a financial instrument that not only assures payment but also unlocks financing options based on the creditworthiness of the original buyer. Essentially, it acts as a valuable form of collateral, extending beyond its primary purpose of ensuring payment. This financial instrument gains significance in accessing additional funding opportunities. The issuing bank evaluates the creditworthiness of the original buyer, paving the way for the transferable Letter of Credit to serve as security. This enables the seller to access extra credit beyond their existing working capital limit. Financial institutions recognize the credibility of the transferable Letter of Credit and treat it as collateral, similar to traditional forms of collateral. Consequently,

businesses can access supplementary funding linked to the transferable Letter of Credit, often termed as transactional limits, which function as supplementary facilities beyond conventional working capital, which is in addition to the standard working capital facilities. These credit facilities are different from traditional setups so they eliminate the need for adhering to drawing power calculations. In short, this approach not only reduces dependence on internal working capital but also strategically provides supplementary funding to optimizes financial resources.

2) **Serving financial security to seller's supplier to avoid advances:** The transferable Letter of Credit assumes a crucial role as a security measure for the seller's supplier, offering a means to circumvent the necessity for the seller to provide advances directly from their working capital. This is especially significant in cross-border transactions, where significant financial resources are frequently needed for the procurement or production of goods before the actual payment is received from the buyer. By utilizing the transferable Letter of Credit as security, the seller can forge a financial arrangement with their supplier that mitigates the need for upfront payments or advances. The Transferable Letter of Credit, assurance of payment upon compliance with the specified terms, provides the supplier with confidence and financial security. In turn, this empowers the seller to establish more favourable terms with their suppliers, fostering smoother and more efficient trade relationships. As a result, the transferable Letter of Credit acts as a valuable financial tool, promoting liquidity and financial efficiency.

   In summary, the use of transferable letters of credit provides supplementary funding to optimize the financial resources and financial security for sellers and their suppliers. Such streamlined approach not only enhances efficiency in trade but also strengthens financial resilience in the dynamic landscape of commerce.

Cost Efficiency in Working Capital through Transferable Letter of credit

The use of transferable letters of credit brings about cost-effectiveness in working capital management through several crucial avenues. Let us delve into each of these four factors in detail to better understand how they collectively contribute to the effectiveness of working capital management.

1) **Enhancing working capital:** Transferable letters of credit play a pivotal role in enhancing cash flow management for businesses. In the standard calculation of working capital facilities, the lender determines the borrower's drawing power based on periodic assessments using provided stock statements. Borrowers, however, are typically restricted from utilizing funds beyond this calculated drawing power. Unlike traditional methods, getting funds through negotiated bills using

a transferable letter of credit does not involve the usual drawing power calculations. These funds go beyond the borrower's existing working capital, providing more flexibility in financial operations. It is important to note that drawing power calculations don't apply because the funds from negotiated bills under transferable letters of credit are considered separately as transaction limits. This independence from existing limits adds flexibility for businesses, helping them manage cash flow better and seize opportunities without conventional restrictions.

2) **Lower Interest cost for working capital:** Transferable Letter of credit or letter of credit have unique combination of traits, whereby, it serves as an unsecured method of funding at the borrower's end and a secured method of funding at the lender's end, making it a more cost-effective option compared to unsecured funding methods like overdrafts. It serves as an unsecured method of funding at the borrower's end because much like unsecured overdrafts they are not obligated to provide any collateral through mortgage or pledges to the lender. It serves as secured method of funding at the lender's end because Transferable letter of credit have inherent characteristics of definite undertaking from the issuing bank which offers full security to sender. Such unique combination of traits positions transferable letters of credit as both an unsecured method of funding at the borrower's end and a secured method of funding at the lender's end, which results into lower Interest cost option compared to traditional unsecured funding methods like overdrafts. Additionally, funding raised through negotiation of accepted bills under transferable letters of credit involves dealing with foreign currency. The prevailing interest rates for such foreign currency funding are consistently lower compared to domestic rates. This translates to a significant reduction in borrowing costs for the borrower. Hence, leverage on these characteristics provides lower interest rates for working capital and allows businesses to access the necessary funds more cost-effectively at lower interest cost.

3) **Lower expenses for working capital:** Raising funds under transferable letters of credit offers distinct advantages by eliminating the need for any mortgage or pledge, thus, eradicating associated costs linked to security creation. Moreover, the funds acquired through transferable letters of credit are transactional in nature, sparing borrowers from additional expenses such as processing fees or renewal charges. Moreover, these funds are raised in foreign currency through bill negotiation hence, can be used for import payments without need for currency conversion. This approach eliminates the requirement for currency conversion at the borrower's level, resulting in substantial savings, as expenses associated with currency conversion are often significant in absolute terms. Hence, leverage on these

characteristics reduces expenses and save costs to provide efficiencies in lowering the expenses associated with working capital.

4) **Enhancing Cash Flow Management:** The use of transferable letters of credit presents a valuable solution for businesses by eliminating the need to provide advances to suppliers, thereby, significantly improving cash flow management. This feature allows businesses to optimize their financial resources more effectively and ensures a smoother flow of funds within their operations. Additionally, the negotiation of bills under transferable letters of credit goes beyond the confines of existing working capital facilities. This means that businesses can access additional funding beyond their established limits, offering greater flexibility in addressing financial needs and capitalizing on strategic opportunities. In essence, the adoption of transferable letters of credit not only enhances cash flow by removing the requirement for supplier advances but also provides an avenue for supplement funding, reinforcing financial resilience for businesses.

In summary, transferable letters of credit save the cost by providing extra working capital, lowering interest costs, cutting overall working capital expenses and improving the flow of funds in business operations. Hence, they provide complete and cost-effective financial solution with benefits of managing working capital.

Enhanced Competitiveness through Transferable Letter of credit

Business can enhance their competitiveness through the strategic utilization of transferable letters of credit. In employing this financial instrument, sellers are alleviated from the need to provide advances for supplies, thereby, strengthening their ability to manage cash flows effectively. This advantage not only enhances financial stability but also positions the firm competitively against counterparts not leveraging similar financial tools. Moreover, the use of transferable Letter of Credit results in a significant reduction in the cost of working capital. This reduction, in turn, bestows financial competitiveness, giving the business a distinctive edge over competitors. Concurrently, the utilization of Transferable Letter of Credit enables businesses to curtail expenses associated with drawing working capital, amplifying their competitive advantage. The flexibility of this financial mechanism further supplements working capital, empowering Small and Medium Enterprises (SMEs) to meet operational demands seamlessly. In essence, the adoption of Transferable Letter of Credit becomes a pivotal strategy for SMEs, enhancing their financial robustness and competitive positioning in the market.

Conclusion

In conclusion, the exploration of “Transferable Letters of Credit as Catalysts for Working Capital Optimization, Cost Efficiency and Enhanced Competitiveness for SME Businesses” has shed light on the multifaceted benefits of leveraging this financial instrument. The introduction provided a comprehensive understanding of transferable letters of credit and their operational mechanisms. The subsequent sections delved into the pivotal roles they play in working capital optimization, offering supplementary funds and streamlining financial resources. The examination of cost efficiency underscored how transferable letters of credit not only reduce interest costs but also eliminate expenses associated with traditional security creation, presenting a more economical option for SMEs. Moreover, the enhanced competitiveness stemming from these financial tools positions SMEs favourably in the market, enabling them to navigate challenges with agility.

In essence, this article affirms that transferable letters of credit serve as catalysts, not only optimizing working capital and ensuring cost efficiency but also fostering enhanced competitiveness for SME businesses in today's dynamic business landscape.

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