

An example of a letter of credit financing using warehouse receipts

The example involves a grain trader in Minnesota, who buys a shipment of grain from a producer and who plans to then resell the same grain to a buyer in the Middle East. Using what is called the "warehouse receipts financing" method, the Minnesota trader acquires the grain and "deposits" it in a recognized public warehouse and, in return, receives a warehouse receipt, identifying - among other things - the type of grain, its quality, the quantity, and the date it was received into the warehouse. The trader takes this warehouse receipt to his/her bank as evidence of his ownership and assuming everything is in order, the bank will then extend a loan to the trader a loan based on the estimated market value of the grain, less some percentage amount (sometimes called a "haircut"). The trader then contacts the buyer in the Middle East, who agrees to buy the goods in the public warehouse from the seller in Minnesota.

The L/C mechanism in this case is as follows:-

1. The sales contract between the Minnesota seller and the Middle East buyer is agreed and both sides agree to do business on an L/C basis.
2. The buyer requests his/her bank to issue an L/C. This bank is the issuing bank. The L/C specifies that the seller must present certain documents to the bank before receiving payment and in this case the primary documentary requirement is the warehouse receipt.
3. The issuing bank notifies the seller through the correspondent bank (notifying bank) by SWIFT and then sends the original L/C to the seller.
4. The seller presents his bank with a bill of exchange (draft) based on the conditions of the L/C together with the warehouse receipt and he/she applies for negotiation.
5. The seller's bank checks the conditions of L/C and the warehouse receipt document. If the conditions of the L/C are found to be consistent with the documents, the seller's bank pays the seller. However, the seller has to be very careful as the bank is not able to honour the bill of exchange if there is any discrepancy between the conditions of the L/C and the documents provided by the seller. If a discrepancy occurs, the seller has to inform the buyer and have him request the issuing bank for an amendment to the L/C accordingly.

The rules for letter of credit transactions are comprehensively dealt with under the International Chamber of Commerce (ICC) rules called "UCP 600", which were updated this year.

For more information about the development of warehouse receipts, letters of credit or UCP 600, contact the author of this article, Daniel Day-Robinson, Day Robinson International (UK) +44 1392 271222 or ddr@dayrobinson.com.

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