
LC VIEWS

Newsletter No. 97, February 2007

Pitfalls in Red Clause LC

PITFALLS IN RED CLAUSE LC

By Jee Meng Chen



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See his bio at www.lcviews.com

1. Historical Background

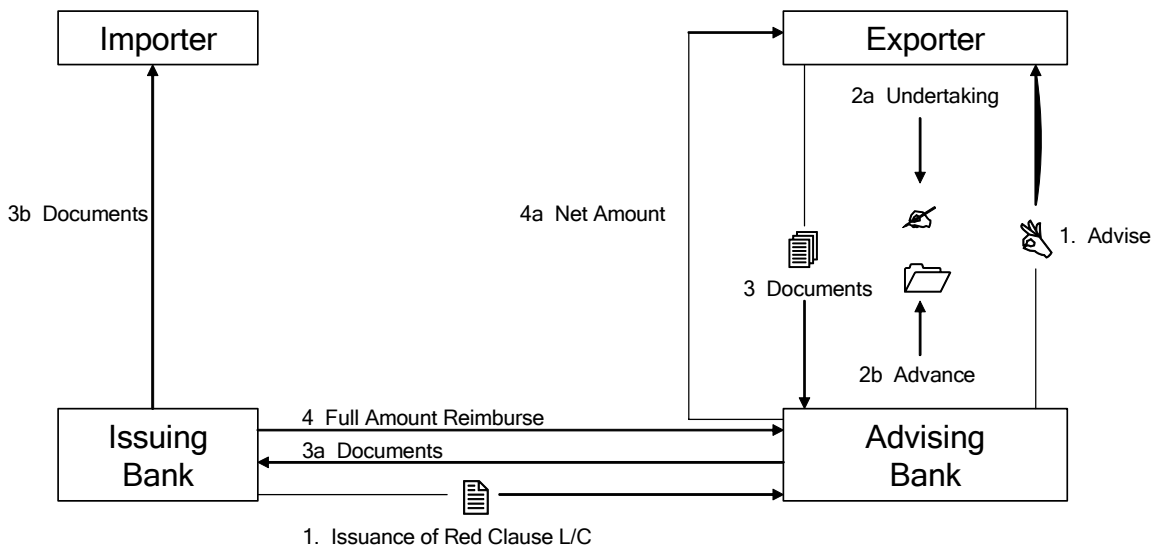
A red clause letter of credit ("L/C"), is so named, as trade practitioners had adopted the traditional practice of highlighting the pre-shipment financing, a special clause, in "red" ink. The red markings denote heightened risk exposure for the parties involved. Historically, red-clause L/Cs originated to allowing wool buyers in Australia to obtain financing to buy wool from the growers. With the advent of S.W.I.F.T., the red clause is expressed in Field 47B and worded (illustrative) as follows -

“Beneficiary may draw in advance up to ___ percent of the L/C value by clean sight draft against an undertaking that the advance is to be used to pay for the purchases of the merchandise... ..”

2. **Financing Modus Operandi**

As requested by the exporter and/or owing to the country’s export requirements, the importer may accede to making a certain portion of the purchase price available to the exporter, in the form of pre-shipment advance(s). The schematic flow of a red-circle L/C issuance is graphically depicted, as follows: -

Mechanics of Red Circle L/C



The advance is effected from within the L/C issued. The financing arrangement also provides for the amount of the advance to be deducted (subsequently) from the amount payable to the exporter upon presentation of documents. The L/C incorporates a clause authorizing the Advising or Confirming Bank to pay a stated percentage of the credit to the exporter (a.k.a beneficiary). The clause, depending on how it is being “structured”, may require the beneficiary to (non-exhaustive): -

- Giving an undertaking to utilize the funds to purchase the raw materials and/or pack the commodities [**Clean Red-Clause**]; OR
- Giving an undertaking to provide certain specified documents, for example, a receipt from an independent warehouse that the goods are / will be stored and insured; OR

- Presenting the full set of documents, as stipulated in the L/C, to the Negotiating Bank, within the L/C expiry period [[Documentary or Secured Red-Clause](#)]

Of course, to provide greater comfort to both the Issuing Bank and the Applicant, the beneficiary may be required to furnish documentary proof evidencing confirmation from the shipping agent that they have booked shipping space on a particular vessel, the sailing date of which is consistent with the L/C

There are two points relating to the [mechanics of financing](#), which deserve special mention:

- Depending on how the underlying financing modus operandi is being engineered, the L/C Applicant (instead of the Issuing Bank) may be the party financing the beneficiary; and
- While red-clause L/Cs are used in commodity financing, they are different from structured commodity financing (“SCF”) to the extent that the documents, if so stipulated, are a condition precedent to the disbursement of loan(s).

3. [Risk Points](#)

Apart from unforeseen circumstances, for instance, logistical issues over at the beneficiary’s country, delays in the port of loading, etc., the main risks associated with red-clause L/C are: -

- **Potential misuse of funds by the beneficiary**
- **non-delivery of goods part-paid**
- **possibility that the beneficiary may fraudulently divert shipment**

4. [Risk Mitigating Controls / Techniques](#)

I will not attempt to discuss the controls and structuring techniques in detail. The succeeding paragraphs will summarize the key points.

(A) The Issuing Bank’s Perspective

The Issuing Bank can risk-mitigate its risk exposure via (i) credit considerations and (ii) structuring techniques, as follows: -

(i) [Credit Considerations](#)

Generally, red clause L/C issuance facility is offered to borrowers who are financially robust. While the borrower’s credit standing is important, it is even more important to assess the economic purpose for the issuance. For example, one of the reasons for the availment of pre-shipment advance relates to the supplier’s inability to finance the production and/or procure the raw materials for

production. To mitigate against potential fraud losses, however, the preshipment advance is never disbursed at 100% of the contract. And the said beneficiary should possess acceptable market track record i.e. as an assurance of performance.

For the said commodities in-question, the goods should not be vulnerable to excessive price fluctuations and should be readily saleable.

(ii) Structuring Techniques

(1) Restricted L/C

More often than not, the Issuing Bank may issue red clause L/Cs on “**restricted**” basis and the subsequent negotiation is henceforth, restricted to the Issuer’s own banking branch(es), if not, the correspondent banking branch(es). From the Negotiating Bank’s perspective, a restricted L/C makes risk-sense. Indeed, with the potential complexity of red-clause credit operations, a bank will hardly find it comforting without being a party to the entire transaction.

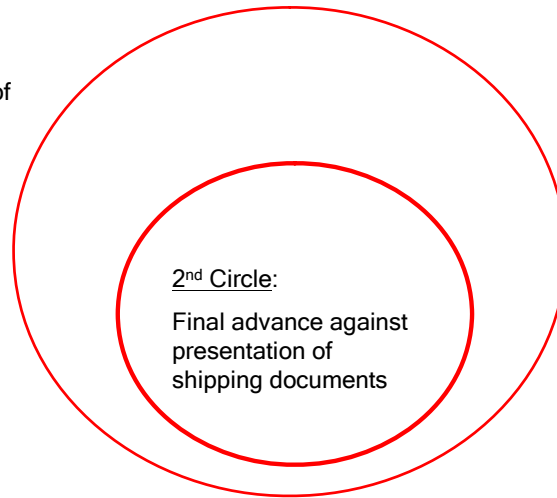
(2) Red Circle

The concept of “red circle” relies on the fundamental principle of the L/C, that is, advance(s) will only be drawn against documents that evidence the existence of the said goods. In other words, the Issuing Bank exercises control via disbursement of advance(s) against the receipt of stipulated documents, for instance, third-party certificates of quality and quantity. This has been referred to as ‘an L/C within an L/C’. And as illustrated in the accompanying diagram, payments are literally controlled in two cycles.

Red Circle L/C

1st Circle:

Advance(s) made
against presentation of
stipulated documents



2nd Circle:

Final advance against
presentation of
shipping documents

The red circle is, however, no safeguard against an unscrupulous beneficiary who may exploit the movements of the spot price and divert shipment to another buyer at a higher price.

(3) Red Ghost (i.e. transferable red clause)

Howard Palmer had cited an interesting alternative to "Red Circle". The transferable red clause, which can be applied in bulk commodity financing, is a good protection against potential misuse of pre-shipment funds by the said beneficiary.

Logic of the Red Ghost: Under a clean and/or documentary red-clause, the main risks are centred on the beneficiary. If beneficiary's risks are deemed as "non-desirable", then the beneficiary must be "removed" from the transaction. Instead, the Negotiating Bank will assume the role of the beneficiary and its main responsibility is to police the transaction in the exporter's country. The concept of "Ghost" is such that while the Negotiating Bank is clearly not the producer of the said commodities, the designated Bank "ghosts" as the beneficiary, with full responsibilities of a transferor.

(B) The Negotiating Bank's Perspective

Like any documentary credits, the Negotiating Bank will ensure that the terms of the L/C are not inoperable [Note: Unlike conventional L/Cs, red clause L/Cs do contain inoperative clauses for purpose of risk-mitigation, not of mala fide intent]. The release of pre-shipment advances are effected strictly in accordance to L/C terms. And the

Negotiating Bank will obtain the necessary documentation (per L/C terms) from the beneficiary to 'support' of its claim on the Issuing Bank.

In essence, the red clause L/C is a versatile instrument. In its plain vanilla form; it can be totally unsecured and thus, exposing the genuinely interested parties to potential fraud. And depending on the requirements of the transaction as well as the financier's structuring skills, the unsecured mode of financing can be transformed into a secured platform.

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