Letters of Credit in Trade Finance

A letter of credit is a written promise from a bank to pay a seller, as long as the seller presents the documents that the credit asks for. It lets a buyer and a seller who do not know each other trade across borders with less risk. Banks widely follow the rules of UCP 600, published by the International Chamber of Commerce in 2007. We follow Youssef, who exports olive oil to a new buyer abroad.

1. The Parties and the Promise

A letter of credit involves several parties. The applicant is the buyer, who asks a bank to issue the credit, and the beneficiary is the seller, who receives the promise of payment. The issuing bank is the buyer's bank, and it promises to pay if the documents comply with the credit. An advising bank passes the credit to the seller, and a confirming bank may add its own promise. The promise is independent of the sales contract, because banks deal only with documents, not with goods.

Example: On an online marketplace, the platform holds a buyer's payment and releases it only when delivery is confirmed. It plays the role of the issuing bank: it promises payment if the agreed proof arrives.

At work: Youssef's buyer, the applicant, asks a bank to issue a credit in Youssef's favour. As the beneficiary, Youssef receives it through an advising bank in his own country, so he knows that payment is promised.

2. The Flow

The process follows clear steps. First, the buyer and the seller agree in the sales contract to use a letter of credit. Second, the buyer applies to the issuing bank, which sends the credit through the advising bank. Third, the seller checks the credit, ships the goods and collects the documents. Fourth, the seller presents the documents to a bank, which examines them against the credit. If they comply, the bank pays on the agreed date, and the documents go to the buyer to collect the goods.

Example: A courier delivers a parcel, presents the signed receipt and is paid after it is checked. This is the same flow as shipping, presenting documents and being paid.

At work: Youssef follows the steps. He checks the credit, ships the oil and presents the documents to the bank in his own country. After the bank checks them, he is paid, and his buyer receives the documents to collect the oil.

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3. The Documents

The credit lists the documents that the seller must present. Common ones are the commercial invoice, a transport document such as a bill of lading, an insurance document, a packing list and a certificate of origin. The bank checks them strictly against the credit. Under UCP 600, they must be presented no later than 21 calendar days after shipment, and always before the credit expires.

Example: A club issues a membership card only when the ID, the form and the receipt are all presented. The clerk checks each paper against the list and does not guess.

At work: The credit asks Youssef for an invoice, a bill of lading, an insurance certificate and a certificate of origin. The bank checks each one against the credit, line by line, before sending them to the issuing bank.

4. Avoiding Discrepancies

A discrepancy is any difference between the documents and the credit, and it gives the issuing bank a reason to refuse payment. Common examples are names spelled differently, wrong amounts, different descriptions of the goods, missing documents, late shipment and late presentation. To avoid them, the seller reads the credit carefully on arrival, asks for any change at once and checks every document before presenting it. If a discrepancy is found, the seller can correct it in time or ask the buyer to accept it.

Example: A visa office rejects an application because a name is spelled differently on the form and in the passport. One small difference is enough for a refusal.

At work: Youssef notices that the credit spells the buyer's company name differently from the contract. He asks the buyer to amend the credit before shipping and checks every document twice. His documents are accepted at the first presentation.

Conclusion

In summary, a letter of credit is a bank's promise to pay against documents that comply with the credit, under rules such as UCP 600. Four steps put it to work: know the parties, follow the flow, present the right documents and avoid discrepancies. Used carefully, it lets business partners trade across borders with less risk.

Sources

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- UCP 600 is a publication of the International Chamber of Commerce (ICC).

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