

Payment methods and letters of credit

Cash in advance, letter of credit, documentary collection, open account: who carries the risk?

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SHORT ANSWER

A letter of credit (L/C) is an undertaking by the buyer's bank to pay the seller when compliant documents are presented, governed by the ICC's UCP 600 rules. Banks deal with documents, not goods. The five basic payment methods, ranked by exporter risk, are cash in advance, letter of credit, documents against payment (D/P), documents against acceptance (D/A) and open account.

Why the payment method matters

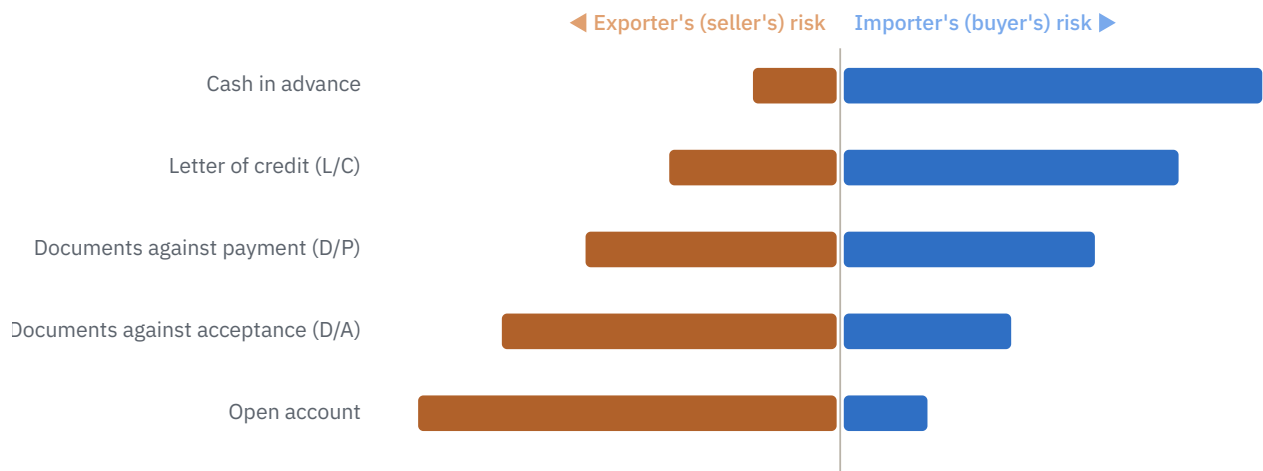
In international trade, the seller and the buyer work in different countries, under different legal systems and often without ever meeting. The seller does not want to ship before being paid; the buyer does not want to pay before seeing the goods. Payment methods are tools that solve this trust problem to different degrees.

The basic rule is simple: **a method that is safe for one party is risky for the other.** The right method is chosen according to the trust between the parties, country risk, the size of the transaction and competition in the market.

The risk ladder

The chart below ranks the five basic methods by the exporter's risk. Click a method to see how it works and what it means for each side.

Relative risk of payment methods



Method	Exporter risk	Importer risk	How it works
Cash in advance	Very low	Very high	The buyer pays before the goods are shipped.
Letter of credit (L/C)	Low	High	The buyer's bank undertakes to pay when the specified documents are presented in compliance with the terms.
Documents against payment (D/P) Documentary collection	Medium	Medium	The documents representing the goods are sent through the banks; the buyer receives them on payment.
Documents against acceptance (D/A) Documentary collection	High	Low	The buyer receives the documents by accepting a time draft; payment is made on the due date.
Open account	Very high	Very low	The goods and documents are sent directly to the buyer; payment is made at maturity (e.g. 30, 60 or 90 days).

Ranking: U.S. Department of Commerce, International Trade Administration — Trade Finance Guide. The source treats documentary collection as a single category; the split into D/P and D/A is the author's interpretation. Risk levels show a relative ranking, not a measured value.

Cash in advance

How it works	The buyer pays before the goods are shipped.
For the exporter	No collection risk.
For the importer	Payment is made, but whether the goods will arrive on time and as ordered is uncertain; cash flow suffers.
When?	New buyers with no established trust, small orders or made-to-order goods.

Letter of credit (L/C)

How it works	The buyer's bank undertakes to pay when the specified documents are presented in compliance with the terms.
For the exporter	Payment depends on the bank rather than the buyer; the documents must be flawless. Under a confirmed credit the exporter's bank also undertakes to pay.
For the importer	Payment is made only when compliant documents are presented; there are bank charges and collateral requirements.
When?	High-value transactions, risky countries, and cases where trust between the parties is not yet established.

Documents against payment (D/P)

How it works	The documents representing the goods are sent through the banks; the buyer receives them on payment.
For the exporter	If the buyer does not pay, the documents (and control over the goods) stay with the seller; but the goods wait at the port of destination and costs build up. The banks do not guarantee payment.
For the importer	Receives the documents against payment; cheaper than a letter of credit.
When?	Buyers in stable countries with whom some trust already exists.

Documents against acceptance (D/A)

How it works	The buyer receives the documents by accepting a time draft; payment is made on the due date.
For the exporter	The goods pass to the buyer and payment is left until maturity. There is a risk of non-payment on the due date.
For the importer	Can sell the goods and pay at maturity; a financing advantage.
When?	Reliable, long-standing trade relationships.

Open account

How it works	The goods and documents are sent directly to the buyer; payment is made at maturity (e.g. 30, 60 or 90 days).
For the exporter	The riskiest method; collection depends entirely on the buyer's good faith and financial strength. Export credit insurance or factoring can reduce the risk.
For the importer	The most favourable method; pays after seeing and checking the goods.
When?	Intra-group trade, long-standing reliable customers, highly competitive markets.

What is a letter of credit (L/C)?

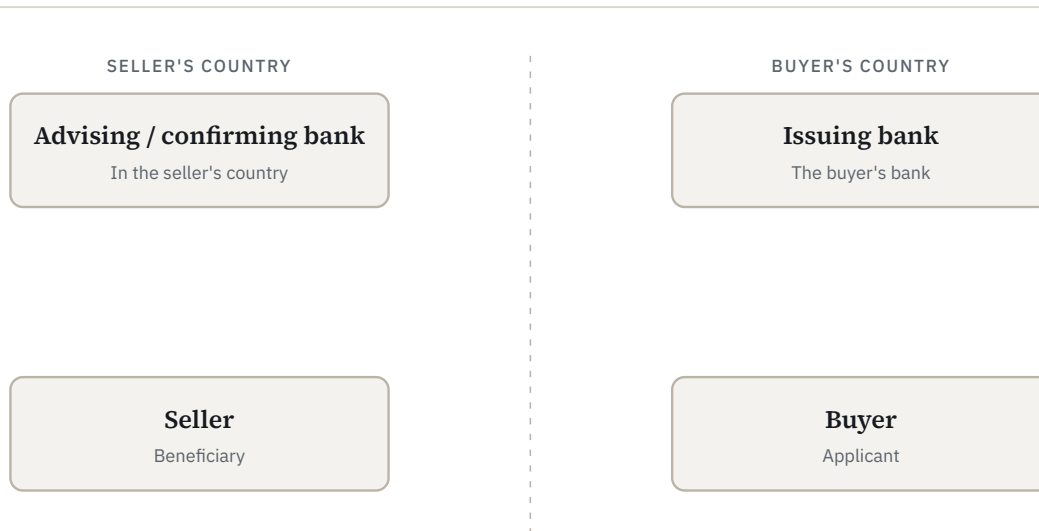
A letter of credit is an undertaking by the buyer's bank to pay the seller **when the specified documents are presented within the specified time and in line with the terms**. The payment guarantee moves from the buyer to the bank.

The most important feature of a letter of credit is this: **banks deal with documents, not goods**. Even if the goods are perfect, the bank can refuse payment if the documents contain a detail that conflicts with the credit (a wrong date, a missing signature, a different description of the goods). In L/C transactions, preparing the documents is therefore as important as the shipment itself.

Letters of credit are subject to the ICC's **UCP 600** rules. Under these rules a credit is **irrevocable**: it cannot be amended or cancelled without the agreement of the parties.

The letter of credit process, step by step

There are four parties: the buyer, the buyer's bank (issuing bank), the correspondent bank in the seller's country and the seller. Step back and forth to follow how the documents and the money move.



1. Sales contract (Seller → Buyer)

The parties agree in the contract that payment will be made by letter of credit, and agree the type of credit, its validity and the documents required.

2. Application to open the credit (Buyer → Issuing bank)

The buyer applies to its own bank and asks it to open a credit on the terms of the contract. The bank assesses the buyer's credit limit or collateral.

3. Credit issued (Issuing bank → Advising / confirming bank)

The issuing bank opens the credit and transmits it (usually via SWIFT) to the correspondent bank in the seller's country.

4. Advice to the seller (Advising / confirming bank → Seller)

The correspondent bank checks that the credit is authentic and advises the seller. If confirmation was requested, it adds its own undertaking to pay.

5. Shipment and documents (Seller)

The seller checks the terms of the credit, ships the goods on time and prepares the required documents: bill of lading, commercial invoice, packing list, certificate of origin and, if required, the insurance policy.

6. Presentation of documents (Seller → Advising / confirming bank)

The seller presents the documents to the bank within the period stated in the credit.

7. Examination of documents (Advising / confirming bank)

The bank examines the documents for compliance with the terms of the credit. Under UCP 600 banks have a maximum of 5 banking days for the examination. If the documents comply, payment is made, or accepted if the credit is deferred.

8. Documents forwarded (Advising / confirming bank → Issuing bank)

The documents are sent to the issuing bank, which carries out its own examination.

9. Interbank payment (Issuing bank → Advising / confirming bank)

The issuing bank pays the correspondent bank against compliant documents.

10. Buyer's payment (Buyer → Issuing bank)

The buyer pays the issuing bank (or the amount is debited to its credit line) and receives the documents.

11. Taking delivery of the goods (Buyer)

With the original bill of lading, the buyer takes delivery of the goods from the carrier and starts import clearance.

Types of letter of credit

- **Confirmed / unconfirmed:** Under a confirmed credit, a bank in the seller's country also undertakes to pay. Confirmation is requested when the buyer's bank or country is seen as risky.
- **At sight / deferred payment:** Payment is made either as soon as the documents are found compliant, or at a set maturity.
- **Transferable:** The seller can transfer all or part of the credit to its own supplier. Used in intermediary trade.
- **Revolving:** A credit whose amount is automatically reinstated, used for regular repeat shipments.
- **Standby:** Less a means of payment than a guarantee that comes into play if the other party fails to perform.

The most common document errors

- The shipment date on the bill of lading is later than the latest shipment date in the credit
- The description of the goods on the invoice does not match the description in the credit exactly
- The documents are presented after the presentation period stated in the credit
- The insured amount is below the required amount (usually 110% of the invoice value)
- A document required by the credit (for example a certificate of origin or an analysis report) is missing

Test yourself

1. Which method is safest for the exporter and riskiest for the importer? (*Answer: Cash in advance.*)
2. Under an L/C, the goods were delivered in full, but the description of the goods on the invoice differs from the credit. What does the bank do? (*Answer: It can refuse payment because the documents do not comply. Banks deal with documents, not goods.*)
3. How does a documentary collection differ from a letter of credit? (*Answer: The banks only pass the documents on as intermediaries; they give no undertaking to pay.*)

Frequently asked questions

What is the difference between a letter of credit and a documentary collection?

Under an L/C the buyer's bank undertakes to pay against compliant documents. In a documentary collection the banks only pass the documents on; they give no undertaking to pay. An L/C is therefore safer for the exporter but more expensive.

Why does a bank refuse to pay under a letter of credit?

Usually because of discrepancies in the documents: a late shipment date, an invoice description that differs from the credit, presentation after the deadline, an insufficient insured amount or a missing document. Even perfect goods will not be paid for if the documents do not comply.

How long do banks have to examine L/C documents?

Under UCP 600 banks have a maximum of 5 banking days to examine the documents.

SOURCES

U.S. Department of Commerce, International Trade Administration — Trade Finance Guide —

<https://www.trade.gov/print/pdf/node/80>

ICC — Uniform Customs and Practice for Documentary Credits (UCP 600)

This guide is for educational purposes and reflects the author's personal views, not those of KINAY. For contract, customs and finance decisions, consult current official sources and specialists. Incoterms® is a registered trademark of the International Chamber of Commerce (ICC).

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