Letter of Credit: Securing International Payments in Industrial Procurement

A letter of credit (LoC), known in German as Akkreditiv, is an abstract payment undertaking by a bank that allows the exporter to ensure he is paid only against presentation of conforming documents. For technical buyers and suppliers, the instrument is a central building block for minimising risk in transactions with new or politically risky markets. The article explains how it works, the process, costs, typical sources of error and KPIs relating to the letter of credit.

As of October 2026 · amplifa-marketplace.ai/en/glossary/letter-of-credit

Key facts at a glance

01 A letter of credit is a bank payment undertaking that is independent of the purchase contract and of the buyer's ability to pay.

02 The legal basis in practice is frequently the ICC's Uniform Customs and Practice (UCP 600) and the eUCP for electronic documents.

03 Typical costs usually range between 0.25 and 1.5 percent of the order value, depending on country, creditworthiness and tenor.

04 Document compliance is decisive: discrepancies between documents and letter of credit terms are the most common cause of delays and fees.

05 Confirmed letters of credit through a second bank reduce country risk but increase costs.

06 In B2B procurement, the letter of credit complements supplier risk management and supplier evaluation instruments for international first transactions.

Definition: Letter of Credit

The letter of credit is a written undertaking by a bank to pay the beneficiary (seller) against presentation of specified, precisely defined documents within a deadline. The payment obligation is abstract, i.e. legally separated from the actual performance and from the purchase contract.

Principle of abstractness

Banks examine only the documents, not the goods. Conforming documents lead to payment, even if a dispute over goods quality arises later. Conversely, a trivial document error leads to refusal of payment despite a flawless delivery. This separation protects both parties, but requires the procurement team to have a strong sense of formality and clean requirements management, as the letter of credit terms must precisely predefine the acceptance criteria and documents well in advance.

Parties involved

Five roles are typically involved: applicant (buyer), issuing bank, advising bank in the seller's country, beneficiary and, in the case of confirmation, an additional bank. The same bank often acts as both issuing and confirming party. Relevant for process quality is that procurement, finance and logistics departments share joint responsibility, similar to the three-way match rate in the invoice verification process.

Legal framework

In practice, the UCP 600 of the International Chamber of Commerce dominate. For electronic documents, the eUCP supplements the provisions. As national interpretations may differ, contracts should expressly agree the applicability of the UCP and have special cases legally reviewed on an individual basis.

Types of letters of credit

Depending on the risk profile, order scenario and negotiating position, the parties choose different types of letter of credit. The choice significantly influences costs, flexibility and security.

Sight vs. deferred payment

With a sight letter of credit, the bank pays immediately after document examination. With deferred payment or acceptance credit, payment is made only at a specified later date, usually ten to ninety days after shipment. Sellers can pre-finance such receivables through forfaiting or factoring, which incurs additional costs that are included in a total cost tree as a financing component.

Confirmed and transferable letters of credit

A confirmed letter of credit additionally binds a second bank, which makes sense for countries with foreign exchange or transfer restrictions. Transferable letters of credit allow the beneficiary to pass the claims on to an intermediary or subcontractor, common in trading and with 3PL providers with trading functions. Revolving letters of credit cover recurring partial deliveries without each tranche having to be newly issued.

Standby letter of credit

The standby letter of credit is a fallback instrument: it only becomes effective if the buyer fails to settle a

claim, and economically functions similarly to a bank guarantee. It is suitable for framework agreements with recurring deliveries where open account remains the norm. For the supplier, it substitutes one element of supplier risk management.

Methods and procedure for processing

The process follows a fixed sequence from contract conclusion to payment. Discipline in each phase determines costs and cycle time.

Defining letter of credit terms

Procurement and finance formulate the terms precisely: document list, delivery dates, shipment and expiry deadlines, permitted partial shipments and transhipments, and inspection certificates. Vague wording such as "current test reports" is to be avoided. This is where requirements management is particularly valuable: the closer the terms are to the contract, the lower the risk of discrepancies. In practice, a document audit checklist that buyers, logistics and the freight forwarder run through before each issuance is helpful.

Issuance, advice and shipment

The buyer instructs his bank to issue the credit; the advising bank verifies its authenticity and notifies the seller of the terms. Only then does the seller manufacture and ship within the specified deadline. Tracking deadlines and monitoring bottlenecks in the shipment dates is critical here, as late loading already constitutes a ground for discrepancy, irrespective of goods quality.

Document presentation and discrepancy management

The seller submits the required documents to his bank, which carries out an examination under UCP 600. In the event of discrepancies, there is a period for correction, or the buyer consents to payment despite the discrepancy (waiver). A structured deviation workflow and deviation analysis help to systematically avoid fees and delays here. Established practice is a discrepancy log with root cause analysis using the 5-Why method.

Costs and KPIs in the letter of credit process

Letters of credit incur ongoing and one-off fees on both sides. Without key figures, these costs remain invisible and accumulate across many transactions.

Fee structures

Typically, issuance fees apply (usually 0.1–0.5 percent p.a. of the volume), confirmation fees (strongly country-dependent, often 0.3–2 percent), flat discrepancy fees per presentation, plus bank and courier charges. With deferred payment structures, interest and pre-financing costs are added. Those wishing to compare total landed costs should integrate these items into a total cost tree alongside sea freight cost components and insurance.

Relevant key figures

Possible KPIs are the discrepancy rate (proportion of presentations with objections), the cycle time from document presentation to payment, the share of letter of credit fees in procurement volume, and the proportion of first presentations without discrepancies. These figures are suitable for supply chain analytics and can largely be captured automatically via ERP integration in creditor and payment master data.

Economic classification

For evaluating individual procurement transactions, letter of credit volume belongs in category intelligence and in the category governance of a procurement team. Those making international sourcing decisions should weigh the security premium of the letter of credit against alternatives such as advance payment, documentary collection or export credit insurance.

Risks and controls in letters of credit

Despite high security, residual risks remain: document fraud, discrepancies, foreign exchange restrictions and contractual gaps. Controls must therefore cover several levels.

Document and fraud risks

The bank examines plausibility, not the truth of the documents. Forged bills of lading or certificates are real fraud vectors, particularly in intermediary chains. Controls include: independent inspection companies before shipment, examination of the shipping company and ownership structures, and supplier audits along the supplier audit programme. For sensitive goods such as dual-use goods, export controls and end-use certificates must also be stipulated.

Contractual clarity

Purchase contract and letter of credit must be congruent. If shipment deadlines, inspection clauses or the document list diverge, a conflict arises that the seller cannot resolve. In practice, contract annexes with detailed acceptance criteria, which are referenced word for word in the letter of credit, have proven effective, as has a deviation analysis after each transaction.

Payment and country risks

Residual risks arise from currency and transfer restrictions or disruptions in the buyer's country. For critical markets, a confirmed letter of credit is standard; alternatively, buyers combine letters of credit with export credit insurance. Such risks are systematically recorded in supplier risk management and in ongoing supplier evaluation.

Current developments: digitalisation of the letter of credit business

The letter of credit business has long been considered paper-heavy and slow. Digital documents, standardisation initiatives and automation are increasingly changing that picture.

Electronic documents and eUCP

The eUCP permits the presentation of electronic documents. Digital bills of lading and managed trading platforms for trade documents reduce courier routes and mix-ups. In practice, penetration remains heterogeneous, particularly with suppliers in emerging markets, hybrid paper-electronics workflows are still common.

Automation and system integration

Those who integrate letter of credit processes into ERP and treasury systems can automatically evaluate deadlines, discrepancy rates and fees. ERP integration also enables linking with shipment deadline tracking and the purchase order system. This turns the letter of credit process from a legal procedure into a manageable procurement process.

Sustainability and compliance aspects

Increasingly, buyers require sustainability evidence as letter of credit documents, such as raw material certificates, RoHS declarations of conformity or emission values. This expands the document list but also increases the risk of discrepancies. A carefully maintained audit checklist for such evidence is therefore standard in mature procurement organisations.

Typical metrics

Metric	Typical value
Discrepancy rate	< 10% *Proportion of document presentations with objections; a low value reduces fees and delays*
Cycle time from document presentation to payment	< 5 working days *typical value for a clean presentation under UCP 600*
Letter of credit cost share	0.25–1.5% *fees relative to order value, depending on country, confirmation and tenor*
First presentations without discrepancies	> 90% *indicator of process maturity and supplier document quality*

Practical example

A medium-sized machinery manufacturer procures a custom gearbox worth around EUR 480,000 from a new supplier in Asia. Due to the lack of payment history, the supplier demands security, while the buyer does not want to tie up liquidity through advance payment. The parties agree on a confirmed sight letter of credit under UCP 600 with a detailed document list.

- Purchase contract and letter of credit terms aligned word for word, including inspection certificate and tolerance specification as acceptance criteria.
- Independent goods inspection before shipment and checking of all documents against an internal audit checklist.
- Discrepancy log per transaction with 5-Why analysis; discrepancy rate reduced from an initial 60 to below 20 percent over four tranches.
- Letter of credit fees included in the total cost tree of the procurement comparison and evaluated against alternatives (documentary collection, ECA cover).

Conclusion

The letter of credit remains a proven instrument for international industrial transactions when liquidity and supplier risk must be protected simultaneously. Its value, however, depends almost entirely on process discipline: precise terms, document-compliant presentation and systematic discrepancy management. Those who systematically track key figures such as discrepancy rate and cycle time demonstrably reduce costs and delay. Supplemented by supplier evaluation, a total cost tree and modern ERP integration, the letter of credit process becomes a plannable part of supplier risk management. Buyers should therefore understand the letter of credit not as a legal necessity but as a manageable procurement instrument.

Frequently asked questions

? What is a letter of credit in simple terms?

A letter of credit is a bank's payment undertaking under which the seller is paid once he submits the documents specified in the credit on time and without discrepancies. The bank examines only the documents, not the goods. This balances buyer and seller risk in international trade.

? What does a letter of credit cost?

In practice, costs typically range between 0.25 and 1.5 percent of the order value, depending on country, bank, creditworthiness, confirmation and tenor. Confirmed letters of credit and deferred payment structures make the instrument significantly more expensive. In addition, flat fees for discrepancies apply.

? What types of letters of credit are there?

Key types are sight and deferred payment letters of credit, confirmed, transferable, revolving and

standby letters of credit. The choice depends on risk profile, delivery structure and negotiating position. For recurring frame supply agreements, revolving or standby letters of credit are often more economical.

? What happens in the event of discrepancies in a letter of credit?

If documents deviate from the letter of credit terms, the bank may refuse payment. In practice, there is then a period for correction, or the buyer issues a waiver, i.e. authorises payment despite the discrepancy, usually for a fee. Discrepancies are the most common cause of delays and additional costs.

? When is a letter of credit worthwhile in procurement?

Typically for first transactions with unknown suppliers, high order values, politically or foreign-exchange-critical countries and long delivery times. For established relationships with good historical data, more open payment terms or export credit insurance are often cheaper. The decision should be made within the framework of supplier risk management.

? What is the difference between a letter of credit and a bank guarantee?

A letter of credit serves to make regular payment to the seller against documents, whereas a bank guarantee secures the performance of an obligation and is only called upon in the event of a breach of contract. With a letter of credit, payment is the normal case; with a guarantee, it is the exception. The standby letter of credit combines both logics.

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