

*Original Research Article*

## Application of letter of credit in international trade

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**Abstract:** In today's world, with the rapid development of economy, many countries have kept up with the pace of economic globalization, and international trade is becoming increasingly important. As a settlement method with banks as guarantors of both parties, L/C (letter of credit) is much safer than commercial credit, and has become the choice of most buyers and sellers in international trade. The purpose of this paper is to introduce the L/C and discuss its advantages and disadvantages in various situations in the application of international trade, and put forward relevant improvement measures.

**Keywords:** International trade; letter of credit; advantages and disadvantages; improvement measures

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### 1. Introduction of letter of credit

The second article of UCP600 stipulates that a letter of credit refers to an irrevocable arrangement, regardless of its name or description, which constitutes a firm commitment of the issuing bank to commit to a complying presentation. In UCP500, the letter of credit can be revoked, and after UCP600 takes effect, all letters of credit are irrevocable. A letter of credit is a conditional promise of payment made by the issuing bank to the beneficiary, which is consistent presentation of documents.

The most commonly used letters of credit are documentary letters of credit, irrevocable letters of credit and sight letters of credit.

### 2. L/C process

Different types of letters of credit have different processes. The general L/C process is as follows: (1) The exporter signs a trade contract with the importer. (2) The importer applies for the L/C from the issuing bank. (3) The exporter obtains the L/C from the advising bank and submits the documents, and pays when there is no discrepancy after checking the documents.

As for transferable L/C, the whole process of L/C will be more complicated due to the existence of middleman. The middleman and the designated transfer bank should communicate and modify some information of L/C.

### 3. Application of letter of credit

#### 3.1 Applicable fields of L/C

In China, there is a great demand for the settlement methods of L/C in chemical enterprise marketing, customer procurement, commercial bank business, *etc.* Internationally, it is mainly in the field of goods trade.

### **3.2 Application of L/C**

Letter of credit is a kind of promise issued by the bank to guarantee the debtor to repay the principal and interest on time in the process of bond issuance. If the bond issuer fails to perform the repayment obligation, the issuing bank of the letter of credit shall perform the repayment obligation.

In international trade, L/C is a guarantee payment voucher issued by the importer's bank to the exporter's bank, which promises payment to the export bank when the goods arrive at the importer or the exporter issues the goods.

### **3.3 Advantages of L/C**

The advantages of L/C are obvious. In most transactions, the way of transaction is commercial credit. In the process of using L/C, the existence of banks changes commercial credit into bank credit. The first payer changes from the buyer to the issuing bank, transforming commercial credit into bank credit, which realizes risk transformation, improves the security of transaction, and makes the seller more secure when receiving payment guarantee. The processing of L/C business is converted into document processing, that is to say, if the seller does not submit the documents that the L/C conforms to, he has no right to require the negotiation bank to make payment, and he will not get the payment for goods, so as to ensure that the buyer can pick up the goods smoothly after payment<sup>[1]</sup>.

Since UCP600 stipulates that revocable L/C is no longer used, the benefits of L/C have increased much for the seller. The existence of the revocable letter of credit will cause the buyer to encounter some situations. For example, when the goods purchased are in the seller's stock period and the local goods of the same amount are greatly reduced, the buyer may want to abandon the transaction, which will cause certain losses to the seller. After removing the revocable letter of credit, the seller does not have to worry about such situation.

### **3.4 Disadvantages of L/C**

The letter of credit is opened according to the foreign trade contract, but once it is opened, it is independent of the foreign trade contract. This objectively embodies the principle of independence and abstraction of documentary credit. The principle of independence and abstraction brings a series of problems to the settlement of L/C.

First of all, the principle stipulates that documentary credit has no point to do with the contract after it is opened, and the beneficiary sometimes fails to perform the obligations in the trade contract, which will cause the disconnection between trade and settlement. Second, in the principle of independence and abstraction, documentary credit is separated from the basic trade contract, which increases the settlement risk of documentary credit. If the importer can receive the goods that meet the requirements smoothly and the exporter can receive the payment safely, it must be based on the premise that the documents submitted by the beneficiary can truly and fully reflect the actual situation of the goods, but this condition is not always met<sup>[2]</sup>. Sometimes, the first beneficiary will ask for changes to other terms (the transferring bank cannot and is unwilling to make changes according to its requirements), the documents submitted by the second beneficiary will finally meet the requirements of the original letter of credit. If the transferring bank changes the terms of the letter of credit at will when transferring the letter of credit, it may cause the documents submitted by the second beneficiary to be inconsistent with the original letter of credit. The concessionaire bank shall bear corresponding responsibilities for this, and even compensate the loss of the second beneficiary.

When the exporter achieves the consistency of documents, the behavior of the issuing bank prepaying funds in the L/C process becomes a loophole. Under the condition that the bank only reviews the surface consistency of documents, once the exporter escapes, dies or intentionally swindles, for example, if the delivery is false and the documents are true, the funds of the issuing bank cannot be recovered.

In international trade, because there is a bank acting as an intermediary, both parties of the buyer and the seller do not necessarily know the true reputation of the other party. Sometimes, there will be an example where one of them is the fraudulent party. The fraudulent party forges the documents to defraud the goods or funds, causing significant losses to the other party. However, the bank is not responsible for the goods, only for the characteristics of the documents, and

will not bear the documents any more. In addition, in international business, due to different cultures, laws, systems and practices between two countries, it is often difficult for the victims to investigate. Not only UCP600, but also international institutions and legislative provisions, do not aim at the content of documentary credits, which makes it difficult for other countries to find each other directly. Generally speaking, the issuing bank and the applicant are in the same country, while the confirming bank, the advising bank or the negotiating bank are often in the same country with the beneficiary. More complicated, the confirming bank and the negotiating bank are in the third country. This leads to the inconsistency of the legal provisions (including the substantive law and the procedural law) in various countries. Different legal traditions and legal ideas lead to the conflict and various blind spots in the practice of documentary credits.

## 4. Improvement measures

(1) For the bank, whether the issuing bank will pay the beneficiary depends on the content of the letter of credit rather than the content of the foreign trade contract. The foreign trade contract is only a contract between the beneficiary and the applicant, and cannot be used to restrict the issuing bank. Therefore, banks should strengthen the examination and verification of L/C, especially because the "soft clause" in some letters of credit is easy to lead to the inconsistency of documents. The foreign trade documenter must take the foreign trade contract as the basis of checking the letter of credit in the process of checking the letter of credit, judge whether the two provisions are consistent, and remind the seller to modify the differences, which plays a very important role in reducing disputes later. Although the bank is only responsible for reviewing the documents, it is still necessary to investigate the credit of the local bank of the other party in the interest of the local trading party, ask the other party's bank to investigate the credit of the opposite trading party, and help the local trading party to improve risk awareness and popularize relevant knowledge.

(2) It is suggested that an international organization should be established to deal with L/C business, and corresponding legislation and L/C code should be established. The establishment of an international organization for L/C can effectively prevent the differences in laws and practices of different countries from making it difficult to adjudicate L/C cases. The specific suggestions are as follows: the parties may file a lawsuit against the other party for the damage caused to the parties due to the serious inconsistency between the content of the letter of credit and the basic content of the contract; In the legal relationship of L/C, people should strengthen the balance of the interests of the parties involved in import and export, incline to the importers to a certain extent, give them a certain time to verify the goods, and change the stipulation that the exporter and the beneficiary will receive the payment upon presentation of the document into a certain time after presentation of the document, which can delay the collection period. Similar to Alipay's confirmation receipt, click on payment before the other party can receive the money. Although this kind of balance has some advantages, it still can not have a negative impact on the L/C system. At the same time, the beneficiary can also hold the applicant responsible for the loss of the applicant under the condition of complying with the law<sup>[3]</sup>.

## 5. Conclusion

Although L/C is widely used in international trade and is more secure than other settlement methods, it is not perfect in all aspects of the world, and the buyer and the seller still face many potential risks. People should make rational use of L/C and conduct trade with prudence.

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