Incoterms: The complications when using them with letters of credit

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Imagine you're a buyer and you want to purchase a high-value shipment from a seller overseas. You don't know each other well, so you bring in a letter of credit (LC)—your trusty financial bodyguard from a bank. The bodyguard promises the seller: "If you deliver everything properly and show me the right documents, I'll make sure you get paid, no matter what." Then, the seller ships the goods and submits the documents as agreed. But halfway across the ocean…disaster strikes. The cargo is lost at sea. Now what?

In international trade, one of the key tools credit professionals rely on is International Commercial Terms, or Incoterms. These rules help define who bears the cost, risk and responsibility during the shipping of goods.

Why it matters: Knowing what Incoterms do, and what they don't, is essential for preventing disputes and ensuring smooth transactions, especially when working with LCs.

Incoterms are standardized rules developed by the International Chamber of Commerce (ICC) to streamline the sale and shipment of goods globally. They clarify where risk passes between buyer and seller, what costs are included, and what obligations each party has. Updated every decade, Incoterms were most recently revised in 2020. The current structure consists of seven rules for any transport mode (EXW, FCA, CPT, CIP, DAP, DPU and DDP) and four rules for sea and inland waterways (FAS, FOB, CFR and CIF).

Despite their importance, Incoterms don't cover every part of a sales agreement. They do not address payment terms, transfer of ownership or contract breaches. One Incoterm, FOB (Free on Board), transfers risk to the buyer once goods pass the ship's rail. If a vessel sinks moments after loading, the buyer, not the seller, bears the loss. "If FOB is used under an LC that demands shipping documents, the seller faces problems when goods aren't loaded for months," said Fred Dons, global head of structured trade finance at Aria Commodities (Zug, Switzerland). "Without a bill of lading, and with the LC potentially expired, the seller can't claim payment. FCA would have been better since risk transfers once goods are handed to the shipping company, not when loaded onto the vessel."

Matching the right Incoterm to the shipping method and LC requirements is critical. Since LCs operate independently from the sales contract, they only verify that documents match the LC terms, not that the goods were properly shipped. If terms aren't aligned, payment can be denied. A common mistake credit professionals can make is agreeing to an FOB Incoterm when the buyer controls shipment. "If the buyer is a bad actor, they can withhold or manipulate the shipping documents," Dons warned. "So, if you do use FOB, make sure you control the documents or that the LC doesn't require them."

When a buyer fails to collect goods on time under Incoterms like EXW, FCA, FAS or FOB, the seller risks missing LC deadlines. "Never release goods until the LC has been extended if a delay occurs," Dons advised. Incoterms "D" terms, also known as "arrival" terms, dictate that the seller is responsible for delivering goods to a specified location, where the risk and cost of delivery are transferred to the buyer.

The "D" terms include DAP, DPU and DDP, which pose risks for the sellers, especially when tariffs change. "If overnight tariffs increase, the buyer may refuse to pay. You're then stuck with the goods and the additional cost."

For credit managers, understanding Incoterms is non-negotiable. "The ICC offers training, but even a visual chart showing when risk transfers and who covers freight costs is invaluable," said Dons. "Before agreeing to an Incoterm, understand what it truly means. For example, EXW might seem simple, but it puts all responsibility on the buyer and gives the seller no access to shipping documents—potentially a major issue if documents are required under an LC."

Economic instability and geopolitical risks have led to stricter banking requirements under LCs. That's why it's crucial to specify the Incoterm version being used, whether that's 2020, 2010 or older. "Use the correct term," Dons concluded. "Use FCA instead of FOB, CFR instead of CIF, especially when insurance responsibility shifts. The details matter."

Due to such risks, credit professionals are adapting their practices. "Yes, tariffs have changed how we use Incoterms," said Dons. "In trading, we buy FOB and sell CIF. That way, we control the goods as long as possible and ensure proper insurance. But small sellers on platforms like Amazon often use DDP. If tariffs spike, they're on the hook. That's why professionals are switching to DPU, leaving import taxes to the buyer."

The bottom line: Incoterms are essential in international trade. Misusing or misunderstanding them, especially under LCs, can lead to costly delays, disputes or non-payment. Always match the Incoterm to the actual shipping setup, control the shipping documents when needed, and understand where risk transfers.

Learn more about working with letters of credit and Incoterms by completing NACM's Letters of Credit Course, available in the Credit Learning Center (CLC). FCIB's International Credit and Risk Management (ICRM) course also features extensive coverage on these topics.