Chapter 7
International Terms of Payment

International Terms of Payment

- Characteristics of International Payments
- Risks in International Trade
- Different Methods of Payment
- Methods of Payment as a Marketing Tool

Characteristics of International Payments (I)

- Credit information

  It is much harder to find credit information on a person in a foreign country.

- Lack of personal contact

  Due to the different physical locations, communication is typically not done face-to-face. This can make it hard to get to know a person, which is particularly important is certain cultures.

- Collections are difficult and expensive

  If a customer fails to pay it is difficult and expensive to collect on the past-due account.

Characteristics of International Payments (II)

- No easy legal recourse

  Due to the nature of international transactions, there is no single court that has direct jurisprudence over an international trade dispute between an exporter and an importer.

- Higher litigation costs

  If legal proceedings are required, there are much more expensive and complicated than for a domestic case.

Because of all of these issues, a climate of mistrust is often created.

Risks in International Trade

- Risk

  The risk of non-payment is the probability of not getting paid or of being paid late, and it dictates the terms of payment chosen by the exporter.

  There are commercial and country risks.

- Exposure

  The consequence of a loss to a particular firm is the exposure. A small firm has more exposure in a $50,000 transaction than a large firm.

Risks in International Trade

Country Risk

Different issues affect the risk that a country represents. It includes the possibility of not being paid because a customer's country does not have the foreign currency to pay the debt, or the customer is not allowed to pay. Political unrest, chances of a strike, and variations in interest and exchange rates should also be taken into account.

Commercial Risk

An individual firm may not be able (or willing) to pay for a number of reasons. It is difficult to find reliable credit information on international firms.

Methods of Payment

- Traditional Methods
  - Cash in Advance
  - Open Account
  - Letter of Credit
  - Documentary Collection
- Alternative Methods
  - Purchasing Cards
  - TradeCard
  - Bank Guarantees

Cash in Advance

The exporter requests that the customer provide payment in advance, before shipment of the goods can take place. This method is totally “risk free” to the exporter—no collections worries, no foreign exchange fluctuations exposure, no cash-flow problem, and only nominal fees to pay to banks.

- Only recommended for doing business in very few countries; those in which fraud is rampant, where there is political instability, where the currency is non-convertible or where there is the possibility of foreign exchange “freezes.”

- Not recommended for business conducted in developed countries and in countries in which there is some level of sophistication in international business.

Open Account

The exporter conducts international business in a manner similar to the way it conducts business domestically. The exporter sends an invoice to the customer and expects the customer to pay it promptly (or within a certain pre-arranged period).

This method presents many risks for the exporter.

- This method should be used with well-established customers or customers with which the exporter expects to have a long-term relationship. The customer's credit should be checked before this method is used.

Credit Insurance

It is possible to sell internationally on an open-account basis and still take little risk, by transferring the risk of non-payment to an insurance company.

Insurance companies sell **credit insurance**, a policy that will cover non-payment by the importer.

This method was subsidized by some European countries in the 1980s, and exporters from the EU frequently use credit insurance when selling on open account.

Letter of Credit

A letter of credit is a document in which the importer's bank essentially promises to pay the exporter if the importer does not pay. The credit worthiness of the bank is substituted for that of the importer, and the exporter is protected.

Letters of credit are not paid until the exporter supplies the importer with a specified set of documents, agreed in advance. The importer is therefore also protected.

Therefore, letters of credit are also called "documentary credit."

Letter of Credit

Letters of Credit are frequently used in international transactions, especially in those cases in which the exporter has no pre-existing business relationship with the importer, or when the importer is located in a country that is considered to be risky.

They are also used when the importer is risk averse.

It is important to realize that letters of credit are documentary; the bank is only obligated to pay upon presentation of certain documents by the importer.

Letter of Credit (Issuance)

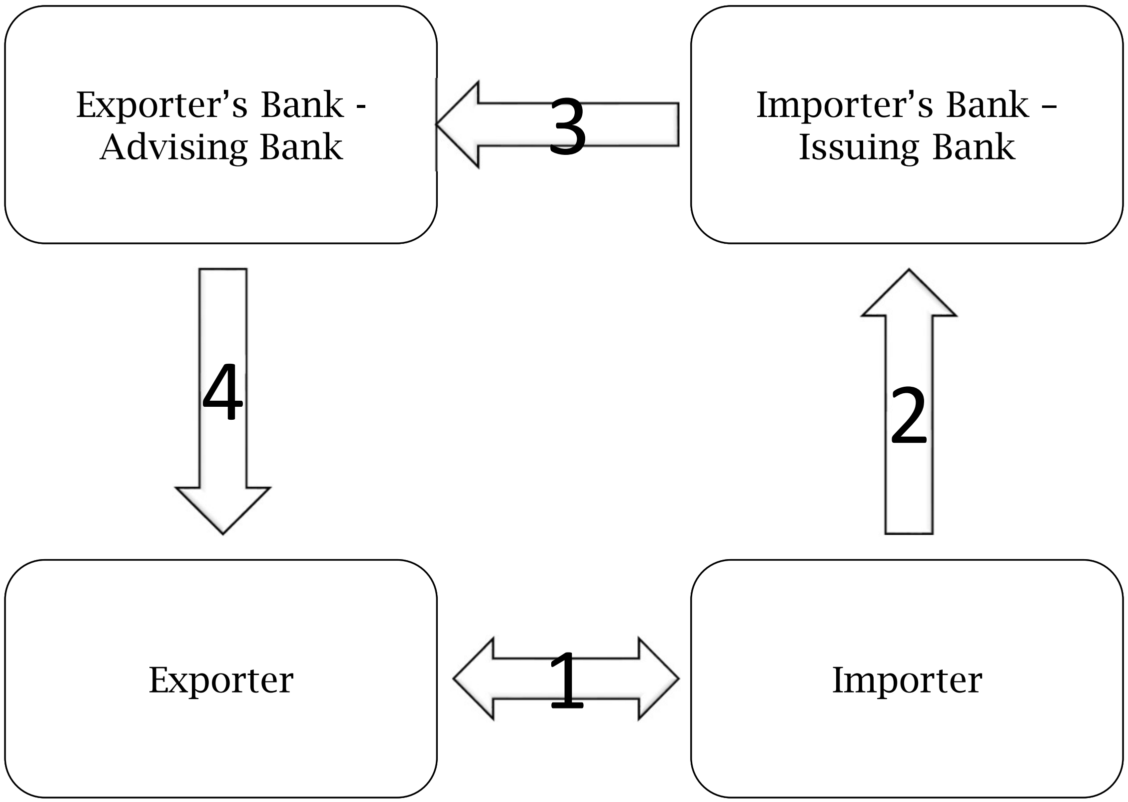
1. The exporter and the importer agree to conduct business on a letter of credit basis. The exporter sends a *pro forma* invoice to the importer.

2. The importer asks his bank, called the issuing bank, to provide him a letter of credit, naming the exporter as the beneficiary.

3. The importer's bank sends the letter of credit to the exporter's bank, called the advising bank.

4. The exporter's bank reviews ("advises") the letter of credit, making sure that it is conform to the terms to which the exporter agreed.

Letter of Credit (Issuance)



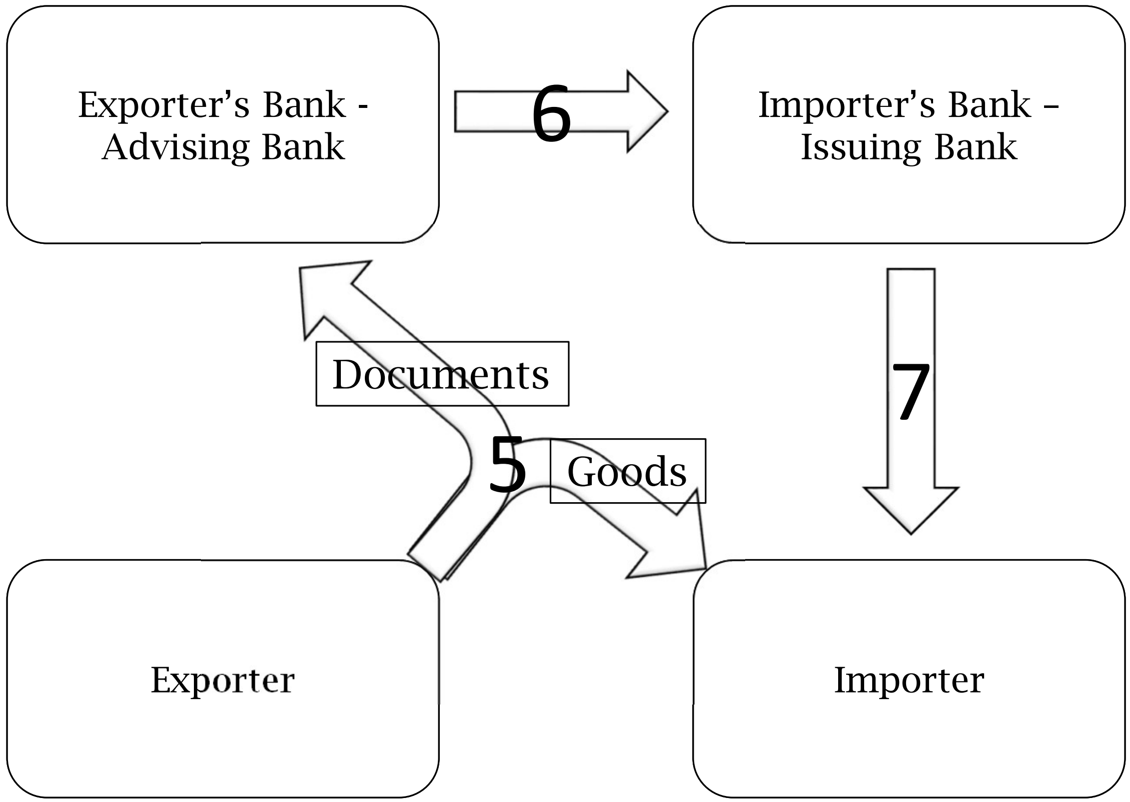
Letter of Credit (Shipment)

5. The exporter ships the goods to the importer. By doing so, it collects some documents from the carrier (which documents depend on the Incoterm chosen), and sends all these documents (including invoice and so on) to the advising bank.

6. The advising bank checks the documents against the letter of credit, and then notifies the importer's bank that all documents are in order. The exporter's bank then sends the documents to the issuing bank.

7. The issuing bank sends the documents to the importer.

Letter of Credit (Shipment)



Letter of Credit (Shipment)

- Discrepancies & Amendments

  When the advising bank checks the documents against the letter of credit, and notices that there are differences (called discrepancies) between the documents submitted by the exporter and the documents requested by the letter of credit, it asks the issuing bank to amend the letter of credit.

  It is only after the letter of credit has been amended (with the agreement of all parties) that the advising bank forwards the documents to the issuing bank.

- About 50 percent of all letters of credit transactions necessitate an amendment.

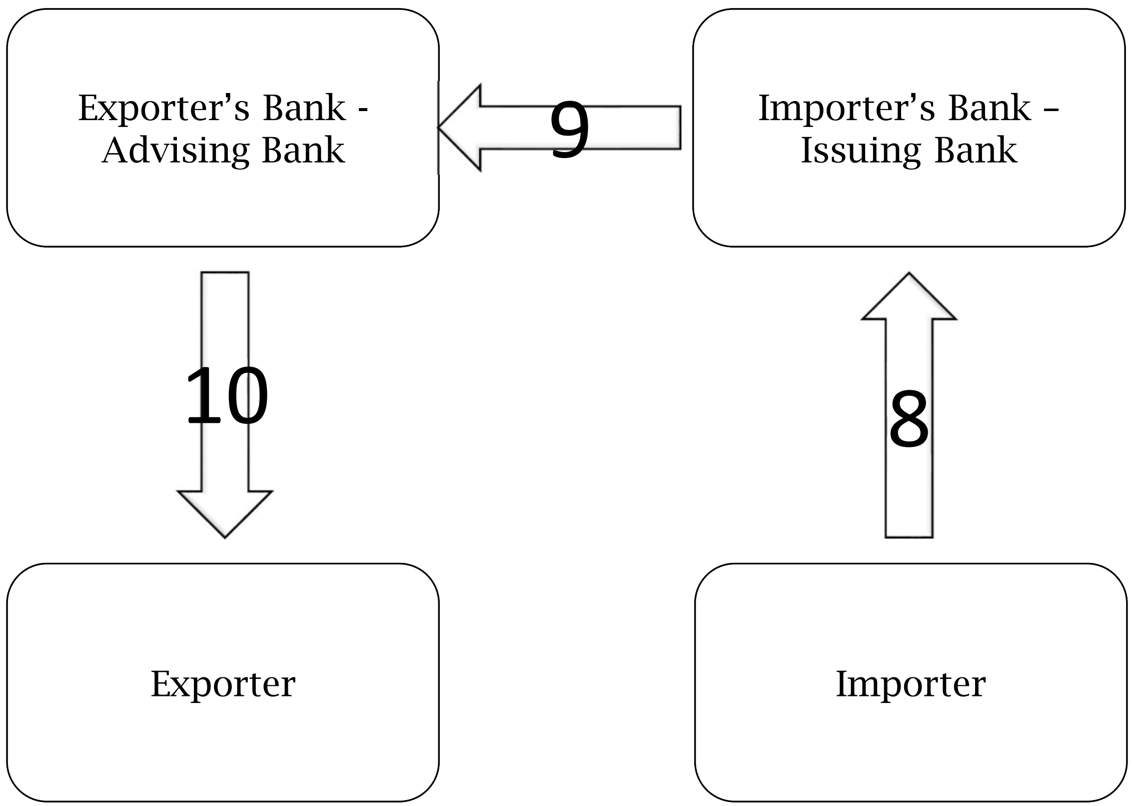
Letter of Credit (Payment)

8. After receiving the documents, the importer pays the importer’s bank.

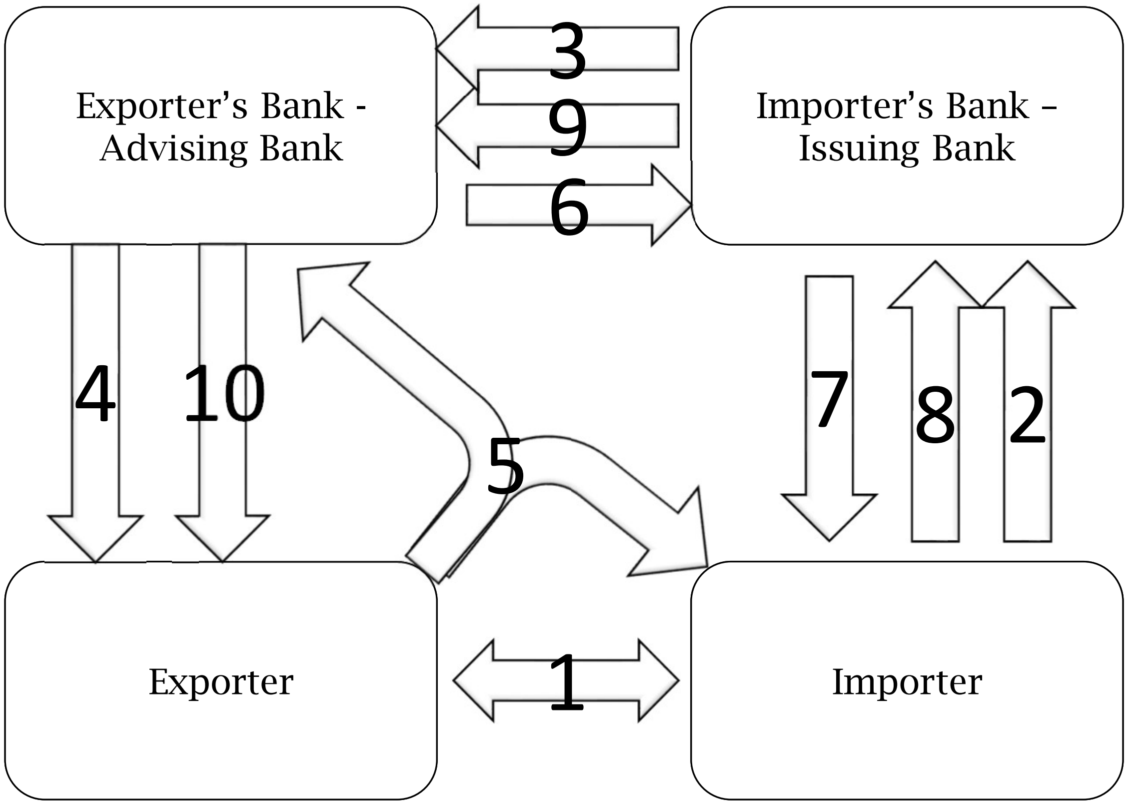
9. The importer’s bank transfers the funds to the exporter’s bank.

10. The exporter’s bank pays the exporter.

Letter of Credit (Payment)



Letter of Credit (Entire Process)



Letter of Credit (Other Issues)

- Advising Bank

  On occasion, the exporter's bank does not have the ability (or is not willing) to advise a letter of credit issued by a bank with which the exporter's bank is not familiar.

  In that case, the exporter's bank asks an additional bank to advise the letter of credit.

  In those cases, the exporter's bank and the advising bank are two separate entities.

Letter of Credit (Other Issues)

- Correspondent Bank

  On occasion, there is a bank in the importer's country with which the exporter's bank has an established relationship. Such a bank is called a correspondent bank.

  It is also possible that there is a bank in the exporter's country with which the importer's bank has a prior relationship. This is the correspondent bank for the importer's bank.

  It is therefore possible to have as many as two correspondent banks involved in a letter of credit transaction, one for the exporter's bank, and one for the importer's bank.

Letter of Credit (Other Issues)

- Confirming Bank

  On occasion, the exporter may be unsure about the credit worthiness of the bank that issued the letter of credit.

  It can then ask a bank (often the advising bank) to confirm the letter of credit; should the issuing bank renege on the payment, the confirming bank will pay the exporter.

  Although routinely used by some exporters, confirmed letters of credit are a reflection of an excessively cautious mindset. Almost no letter of credit ever goes unpaid.

Letter of Credit (Other Issues)

- Stand-By Letter of Credit

  A stand-by letter of credit is similar to an ordinary letter of credit, but it is valid for multiple shipments and allows for bills of lading issued on multiple dates. Under such a system, the exporter will make shipments on an open-account basis and will “call” on the letter of credit only if the importer is not meeting its obligations.

- Transferable Letter of Credit

  A letter of credit that the beneficiary uses to secure its own payment to others. A transferable letter of credit is used when the exporter needs to purchase raw materials before it can produce what it sold to the importer.

Letter of Credit (Other Issues)

- Back-to-Back Letter of Credit

  A letter of credit issued by the exporter, naming its supplier as beneficiary, and that uses the letter of credit issued by the importer's bank as evidence of credit worthiness.

- Red-clause Letter of Credit

  In some cases, the exporter may not have enough working capital to finance the manufacturing of the goods that it is selling to the importer. In that case, it is possible to ask the importer to issue a red-clause letter of credit, with which the importer provides the exporter with a cash down payment, prior to shipment, to finance the production of the goods.

Stand-By Letter of Credit

A stand-by letter of credit covers more than one shipment; it allows for multiple bills of lading, issued on different dates. The bank is obligated to pay if the exporter presents the documents required by the letter of credit and the importer has not paid.

In a similar fashion, stand-by letters of credit can also be used to secure the performance of the exporter. The bank that issues the letter of credit is obligated to pay the importer, if the importer provides documents showing that the exporter has not performed its obligations.

Documentary Collection

A process by which an exporter asks a bank located in the importing country to safeguard its interests by not releasing the documents until the importer satisfies certain requirements.

The exporter gives the foreign bank very specific directions on the way it wants the transaction handled, by supplying the foreign bank with a "letter of instruction."

Documentary collection is less cumbersome and cheaper than a letter of credit. The exporter keeps control of the documents (and therefore title) until the importer accepts the draft or makes payment.

Documentary Collection

1. The exporter and the importer agree to conduct business on a documentary collection basis. The exporter sends the goods to the importer, but sends the documents to the exporter's bank, which acts as the remitting bank.

2. The remitting bank sends the documents to a bank in the importing country, called the presenting bank.

3. Upon receipt of the documents, the presenting bank notifies the importer that the documents are available.

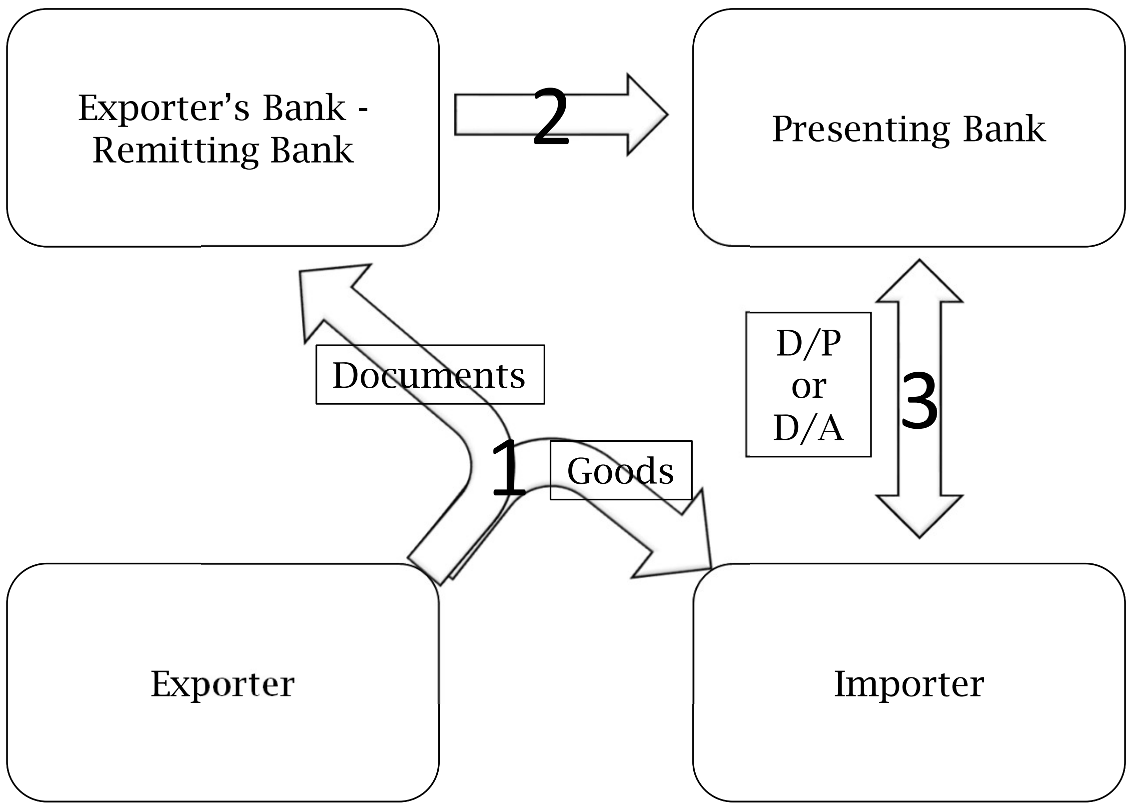
Documentary Collection

Once it has received the documents sent by the exporter, the presenting bank follows the letter of instruction given by the exporter.

- It can give the documents to the importer in exchange for payment. This type of transaction is called "documents against payment" or D/P.
- It can give the documents to the importer in exchange for a signature on a draft. This type of transaction is called "documents against acceptance" or D/A.

A draft is a promissory note (also called a bill of exchange) with which the importer promises to pay the exporter within a defined timeframe.

Documentary Collection



Types of Drafts

- Sight Draft

  Once the importer accepts the draft by signing it, the importer has to pay the exporter immediately. The draft is payable "at sight."

- Time Draft

  Once the importer accepts the draft by signing it, the importer has to pay the exporter a certain number of days (30, 60, 90, or 180) after the date of acceptance.

- Date Draft

  Once the importer accepts the draft by signing it, the importer has to pay the exporter a certain number of days (30, 60, 90, or 180) after the date of shipment for the goods.

Acceptance

The exporter can specify in the letter of instruction whether it wants trade acceptance or banker's acceptance:

- In requesting a trade acceptance (or trader's acceptance), the exporter expects the importer to accept (sign) the draft in a reasonable amount of time after being notified that the presenting bank has the documents in its possession.
- In a banker's acceptance, the exporter asks the presenting bank to accept the draft "on behalf" of the importer.

A presenting bank will only agree to a banker's acceptance if it can be sure that the importer will honor the bank's commitment. It will therefore only sign if it can aval the importer's commitment.

Forfaiting / Factoring

An exporter can sell the draft it collected from the importer to a forfaiting firm who buys them, without recourse.

An exporter can also sell international receivables to a factoring house (also called a factor) who can buy them with or without recourse.

- If a receivable is bought "without recourse," it means that the factor cannot turn to the exporter if the importer does not pay.
- If it is bought "with recourse," the factor can hold the exporter responsible for the debt.

Purchasing Cards

Purchasing cards (also called procurement cards or p-cards) are conceptually similar to consumers credit cards and are managed by the big credit card networks (Amex, Visa, ...) . Each department of a corporation with a purchasing card is given:

- A certain credit limit, imposed on each purchase, and on total monthly purchases
- A list of authorized suppliers from which it can purchase goods

At the end of the month, the corporation gets a single invoice, itemized for each department. Suppliers are paid right away, but collect only about 97 percent of the invoice. The difference is the banks’ fees.

P-Cards Advantages (I)

Purchasing cards present several advantages for international purchases:

- The exporter is essentially paid "in advance," because it is paid almost immediately after the goods have shipped.
- The importer does not have to pay until the monthly purchasing card bill is due, or about 30 days after the purchase is made.
- The non-payment issue is transferred to the bank that issued the card and granted the credit to the importer. The exporter bears no risk of non-payment.

P-Cards Advantages (II)

- The currency exchange rate on the transaction is the best one can get; it is the inter-bank exchange rate for very large transactions.

- The company purchasing the goods can de-centralize its small purchases so that the central purchasing department can concentrate on big items.

Purchasing cards make a lot of sense for small transactions, for which a letter of credit or a documentary collection would be too cumbersome.

TradeCard

TradeCard is a proprietary electronic system that combines payment and document handling:

- TradeCard makes no payment to the exporter until TradeCard has received all the documents, and they are in order.
- The importer does not have to pay TradeCard for about 30 days.
- The system is efficient: documents are transmitted electronically, and payments are made at the inter-bank exchange rates.

TradeCard

TradeCard has tried to gain wider acceptance in the trade community because it is extremely inexpensive, charging only $150 for a transaction up to $100,000, in contrast to 1 to 3 percent for letters of credit and 2 to 3 percent for purchasing cards.

However, it has not been as successful as its advantages would lead to anticipate.

In 2013, TradeCard was purchased by GT Nexus, which has incorporated it in its Global Trade Management software package. It does not report on the number of transactions conducted under TradeCard.

Bank Guarantees

A bank guarantee is another instrument used in international trade, but is used in different situations: A bank guarantee is usually requested to secure the performance of the seller (exporter), rather than to ensure that payment will be made by the buyer (importer).

Because United States law prohibits bank guarantees, American banks instead offer the same type of financial instrument through their stand-by letters of credit.

Bank Guarantees

- Guarantee payable at first demand

  A bank guarantee in which the beneficiary does not have to provide any evidence that the terms of the underlying contract between the contractor and the beneficiary have not been met; the issuing bank has to pay at the first request of the beneficiary.

- Guarantee based upon documents (caution)

  A bank guarantee made conditional upon presentation of certain documents rather than "on first demand." The beneficiary must present documents that demonstrate that the contractor is not meeting its obligations.

Terms of Payment as a Marketing Tool

An exporter has several alternatives from which to choose in negotiating terms of payment with the importer.

Although the choice of the term of sale is dependent on the level of experience of both the exporter and the importer and on the level of confidence that the exporter has in the ability of the importer to make the payment, there are some alternatives that are definitely preferable and will increase an exporter's probability to clinch the sale.

Terms of Payment as a Marketing Tool

Method of Payment	**Probability of Losing the Sale Because of the Choice of Method of Payment**
Cash in advance	High
Open account	Nil
Letter of credit	Fairly high
Purchasing card	Low
TradeCard	Low