Financial

SITPRO

International Trade Guides

Methods of Payment in International Trade

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This guide explains the different methods of getting paid and the different levels of risks involved. You should note that none of the methods outlined below will completely eliminate the payment risks associated with international trade, so you should consider your preferred payment option with care and hedge the risks along with appropriate credit insurance and credit checks on your customers.

You should read it if you trade internationally and want to know what your options are in making and receiving international payments. You may wish to pass on the information in this Briefing to your colleagues in the Sales & Marketing team and your Finance Director so that they are aware of these issues.

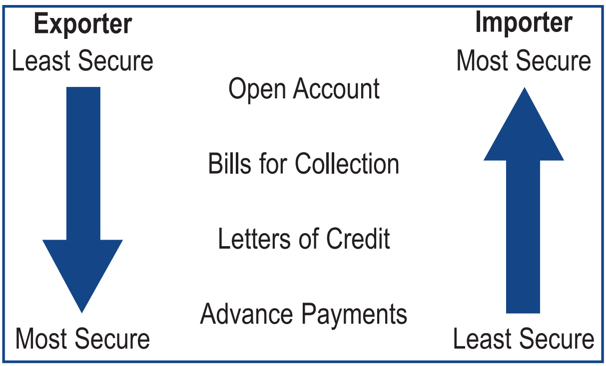
Introduction

Getting paid for providing goods or services is critical for any business. However, getting paid for an international transaction (also commonly known as "export receivables") can be a very different experience from securing payment on business with other UK entities, due to the number of extra factors that can influence the process.

The main factor in considering how an exporter expects to be paid for a transaction is the potential risk that they and their customer are willing to face between them - don't forget, there are always two sides to any situation. There are different types of risk that you will face as an exporter, this briefing will consider the payment risk.

Payment Risk Ladder

It is often a good idea, during, or even before contract negotiations, to consider where, on the diagram below, you and your customer will be comfortable in placing yourselves.



Open Account

This is the least secure method of trading for the exporter, but the most attractive to buyers. Goods are shipped and documents are remitted directly to the buyer, with a request for payment at the appropriate time (immediately, or at an agreed future date). An exporter has little or no control over the process, except for imposing future trading terms and conditions on the buyer. Clearly, this payment method is the most advantageous for the buyer, in cash flow and cost terms. As a consequence, Open Account trading should only be considered when an exporter is sufficiently confident that payment will be received.

In certain markets, such as Europe, buyers will expect Open Account terms. The financial risk can often be mitigated by obtaining a credit insurance policy to cover the potential insolvency of a customer, that provides reimbursement up to an agreed financial limit. A number of commercial insurers specialise in this market - contact your insurance representative for details.

Advance Payment

The most secure method of trading for exporters and, consequently the least attractive for buyers. Payment is expected by the exporter, in full, prior to goods being shipped.

As one might imagine, having covered the two extremes on the Payment Risk Ladder, commercial decisions have to be made and this usually results in selecting one of the middle rungs of the ladder. This is where banking products such as Bills for Collection and Letters of Credit come in to play.

Bills for Collection

More secure for an exporter than Open Account trading, as the exporter's documentation is sent from a UK bank to the buyer's bank. This invariably occurs after shipment and contains specific instructions that must be obeyed. Should the buyer fail to comply, the exporter does, in certain circumstances, retain title to the goods, which may be recoverable. The buyer's bank will act on instructions provided by the exporter, via their own bank, and often provides a useful communication route through which disputes are resolved.

The Bills for Collection process is governed by a set of rules, published by the International Chamber of Commerce (ICC) called "Uniform Rules for Collections" document number 522 (URC522). Over 90% of the world's banks adhere to this document - pick up a copy from the ICC (See contact details below) or your bank and familiarise yourself with the contents.

There are two types of Bill for Collection, which are usually determined by the payment terms agreed within a commercial contract. Different benefits are afforded to exporters by each and they are covered separately below.

Documents against Payment (D/P)

Usually used where payment is expected from the buyer immediately, otherwise known as "at sight". This process is often referred to as "Cash against Documents".

The buyer's bank is instructed to release the exporter's documents only when payment has been made. Where goods have been shipped by sea freight, covered by a full set of Bills of Lading, title is retained by the exporter until these documents are properly released to the buyer. Unfortunately, for airfreight items, unless the goods are consigned to the buyer's bank no such control is available under an Air Waybill or Air Consignment Note, as these documents are merely "movement certificates" rather than "documents of title" (N.B. Under URC522, goods should not be consigned to a bank without prior approval). Similarly there is no such control available for road or rail transport.

Documents against Acceptance (D/A)

Used where a credit period (e.g. 30/60/90 days - 'sight of document' or from 'date of shipment') has been agreed between the exporter and buyer. The buyer is able to collect the documents against their undertaking to pay on an agreed date in the future, rather than immediate payment. The exporter's documents are usually accompanied by a "Draft" or "Bill of Exchange" which looks something like a cheque, but is payable by (drawn on) the buyer. When a buyer (drawee) agrees to pay on a certain date, they sign (accept) the draft. It is against this acceptance that documents are released to the buyer. Up until the point of acceptance, the exporter may retain control of the goods, as in the D/P scenario above. However, after acceptance, the exporter is financially exposed until the buyer actually initiates payment through their bank.

Bills for Collection are used in certain markets (particularly Asian) to fulfil Exchange Control Regulations. They are a cost-effective method of evidencing a transaction for buyers, where documents are handled (and reported) via the banking system.

Letters of Credit (L/Cs)

A Letter of Credit (also known as a Documentary Credit) is a bank-to-bank commitment of payment in favour of an exporter (the Beneficiary), guaranteeing that payment will be made against certain documents that, on presentation, are found to be in compliance with terms set by the buyer (the Applicant).

Like Bills for Collections, Letters of Credit are governed by a set of rules from the ICC. In this case, the document is called; "Uniform Customs and Practice" and the latest version is document number 600. In short, it is known as UCP600 and, again, over 90% of the world's banks adhere to this document.

Irrevocable: The terms and conditions within a L/C cannot be changed without the express agreement of the Beneficiary. Under UCP600, revocable L/Cs are no longer acceptable under any circumstances.

Unconfirmed: The payment commitment within the L/C is provided by the Applicant's issuing bank.

Confirmed: If an exporter has any concerns about the circumstances which may prevent payment being made from either the Issuing Bank or buyer's Country, the adding of "Confirmation" moves the bank/country risk issues to the bank which adds its confirmation (the confirming or advising bank) and notifies the DC to the exporter. The price of such a confirmation will obviously depend upon the level of perceived risks to be covered. Banks can often provide indicative pricing for confirmations prior to the arrival of the DC, so that costs can be estimated.

What does all this mean?

The exporter and buyer can agree detailed terms, as part of the commercial contract. This can include exactly what documents need to be produced and precisely what detail such documents should quote. Letters of Credit, as well as offering a bank's commitment to pay, also offer benefits in terms of finance. Speak to your bank, or the Advising/Confirming Bank to see how they can help. Additionally, commercial insurers now offer an insurance-backed product that covers the same basic risks as confirmations. Please speak to your insurer for details.

Standby Letters of Credit (SBLCs) or Bank Guarantees

SBLCs are similar to Bank Guarantees, in that they sit behind a transaction and are only called upon if the buyer fails to pay in the normal course of business (which is often Open Account). They can be particularly useful to cover an underlying financial risk where multiple payments are to be made, possibly as part of an agreed schedule. However, they do not offer the documentary control of Letters of Credit to buyers and, as such they are an unconditional guarantee.

Other International Trade Risks

Customer Risks

Can they/will they pay? Exporters should find out everything they can about their buyers. Banks can help by contacting the buyer's bank for a reference. Many commercial organisations can provide credit information at relatively little cost. Does the exporter have any local contacts or agents who might be prepared to undertake some research?

On the basis of this information, the exporter can start to think about his stance in terms of the payment risk ladder.

Country Risks

Key issues include:

- Economic, financial and political stability - at a aational as well as financial institutional level;
- Foreign Exchange availability and volatility - an exporter's UK bank should be able to assist
- Import restrictions/tariffs - Are there any?
- If the country has a habit of changing rules regularly or quickly?

SITPRO produces a guide to **Managing the Risks of International Trade**, which can be downloaded from the SITPRO website.

Main Types of Money Transfers

SWIFT Inter-Bank Transfer: Now firmly established as standard practice in the major trading nations. The buyer will instruct their bank to make payment to any bank account specified by the exporter. Therefore, it is good practice for the exporter to include their account details on their invoice heads.

Buyer's Cheque: An unsatisfactory method of settlement for the exporter as it carries the risk of dishonour upon presentation as well as the added inconvenience of being slow to clear. There is also the very real danger of the cheque being lost in transit as well. A cheque is also unsatisfactory if it is in the currency of the buyer, as this will take longer to clear and will involve additional bank charges. Exporters should only use this method if they have an established trading history with their customer or in cases where the profit margin has been increased to offset cash flow problems anticipated by the delay in receiving payment.

Banker's Draft: This is arranged by the buyer who asks their bank to raise a draft on its corresponding bank in the exporter's country. Provides additional security to a buyer's cheque, but they can be costly to arrange and they do run the risk of getting lost in transit.

International Money Orders: These are similar in nature to postal orders. They are pre-printed therefore cheaper to obtain than a Banker's Draft, although again there is the risk of loss in transit.

Acknowledgement
SITPRO gratefully acknowledges the assistance of HSBC in the drafting of this guide.

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