**[Academic Script]**

# Payment System Part - 1

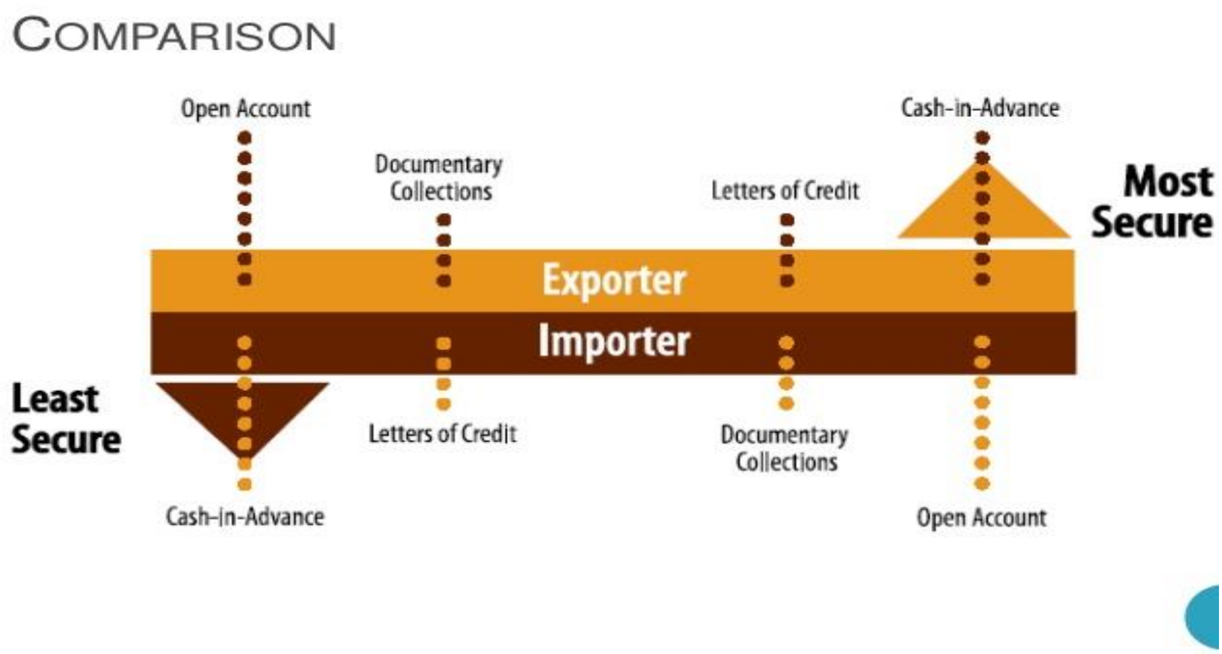
| | |
|---|---|
| **Subject:** | Business Economics |
| **Course:** | B. A. (Hons.), $6^{th}$ Semester, Undergraduate |
| **Paper No. & Title:** | Paper – 611<br>International Finance |
| **Unit No. & Title:** | Unit – 5<br>Payment Systems |
| **Lecture No. & Title:** | Lecture – 1<br>Payment System Part - 1 |

**Academic Script**

## 1. Introduction

To succeed in today’s global marketplace and win sales against foreign competitors, exporters must offer their customers attractive sales terms supported by appropriate payment methods. Because getting paid in full and on time is the ultimate goal for each export sale, an appropriate payment method must be chosen carefully to minimize the payment risk while also accommodating the needs of the buyer. There are several basic Export Payment Methods - Import Payment Methods for products sold abroad. As with domestic sales, a major factor that determines the method of payment is the amount of trust in the buyer's ability and willingness to pay. So in today’s session we will be learning about these payment terms for international trade.

## 2. Basic Methods of Payment



As shown in figure the figure on the screen there are four primary methods of payment for international transactions. During or before contract negotiations, you should consider which method in the figure is mutually desirable for both you and your customer.

For sales within our country, if the buyer has good credit, sales are usually made on open account; if not, cash in advance is required. For export sales, these same methods may be used; however, other methods are also often used in international trade. Ranked in order from most secure for the exporter to least secure, the basic methods of payment are:

1. cash in advance,
2. letter of credit,
3. documentary collection or draft,
4. open account, and
5. other payment mechanisms, such as consignment sales.

Since getting paid in full and on time is of utmost concern to exporters, risk is a major consideration. Many factors make exporting riskier than domestic sales. However, there are also several methods of reducing risks. One of the most important factors in reducing risks is to know what risks exist. For that reason, exporters are advised to consult an international banker to determine an acceptable method of payment for each specific transaction.

1. CASH IN ADVANCE

Cash in advance before shipment may seem to be the most desirable method of all, since the shipper is relieved of collection problems and has immediate use of the money if a wire transfer is used. Payment by check, even before shipment, may result in a collection delay of four to six weeks and therefore frustrate the original intention of payment before shipment. On the other hand, advance payment creates cash flow problems and increases risks for the buyer. Thus, cash in advance lacks competitiveness; the buyer may refuse to pay until the merchandise is received.

## 2. DOCUMENTARY LETTERS OF CREDIT AND DRAFTS

The buyer may be concerned that the goods may not be sent if the payment is made in advance. To protect the interests of both buyer and seller, documentary letters of credit or drafts are often used. Under these two methods, documents are required to be presented before payment is made. Both letters of credit and drafts may be paid immediately, at sight, or at a later date. Drafts that are to be paid when presented for payment are called sight drafts. Drafts that are to be paid at a later date, which is often after the buyer receives the goods, are called time drafts or date drafts.

Since payment under these two methods is made on the basis of documents, all terms of sale should be clearly specified. For example, "net 30 days" should be specified as "net 30 days from acceptance" or "net 30 days from date of bill of lading" to avoid confusion and delay of payment. Likewise, the currency of payment should be specified as "US$XXX" if payment is to be made in U.S. dollars. International bankers can offer other suggestions to help.

Banks charge fees - usually a small percentage of the amount of payment - for handling letters of credit and less for handling drafts. If fees charged by both the foreign and local banks for their collection services are to be charged to the account of the buyer, this point should be explicitly stated in all quotations and on all drafts.

The exporter usually expects the buyer to pay the charges for the letter of credit, but some buyers may not accept terms that require this added cost. In such cases the exporter must either absorb the letter of credit costs or lose that potential sale.

**Letters of credit**

A letter of credit adds a bank's promise of paying the exporter to that of the foreign buyer when the exporter has complied with all the terms and conditions of the letter of credit. The foreign buyer applies for issuance of a letter of credit to the exporter and therefore is called the applicant; the exporter is called the beneficiary.

Payment under a documentary letter of credit is based on documents, not on the terms of sale or the condition of the goods sold. Before payment, the bank responsible for making payment verifies that all documents are exactly as required by the letter of credit. When they are not as required, a discrepancy exists, which must be cured before payment can be made. Thus, the full compliance of documents with those specified in the letter of credit is mandatory.

Often a letter of credit issued by a foreign bank is confirmed by a local bank. This means that the local bank, which is the confirming bank, adds its promise to pay to that of the foreign, or issuing, bank. Letters of credit that are not confirmed are advised through a local bank and are called advised letters of credit. Exporters may wish to confirm letters of credit issued by foreign banks not only because they are unfamiliar with the credit risk of the foreign bank but also because there may be concern about the political or economic risk associated with the country in which the bank is located. An international banker can help exporters evaluate these risks to determine what might be appropriate for each specific export transaction.

A letter of credit may be either irrevocable (that is, it cannot be changed unless both the buyer and the seller agree to make the change) or revocable (that is, either party may unilaterally make changes). A revocable letter of credit is inadvisable. A letter of credit may be at sight, which means immediate payment upon presentation of documents, or it may be a time or date letter of credit with payment to be made in the future. See the "Drafts" section of this chapter.

Any change made to a letter of credit after it has been issued is called an amendment. The fees charged by the banks involved in amending the letter of credit may be paid by either the exporter or the foreign buyer, but who is to pay which charges should be specified in the letter of credit. Since changes can be time-consuming and expensive, every effort should be made to get the letter of credit right the first time.

An exporter is usually not paid until the advising or confirming bank receives the funds from the issuing bank. To expedite the receipt of funds, wire transfers may be used. Bank practices vary, however, and the exporter may be able to receive funds by discounting the letter of credit at the bank, which involves paying a fee to the bank for this service. Exporters should consult with their international bankers about bank policy.

**A Typical Letter of Credit Transaction**

Here is what typically happens when payment is made by an irrevocable letter of credit confirmed by a local bank:

After the exporter and customer agree on the terms of a sale, the customer arranges for its bank to open a letter of credit. (Delays may be encountered if, for example, the buyer has insufficient funds.)

The buyer's bank prepares an irrevocable letter of credit, including all instructions to the seller concerning the shipment.

The buyer's bank sends the irrevocable letter of credit to a local bank, requesting confirmation. The exporter may request that a particular bank be the confirming bank, or the foreign bank selects one of its local correspondent banks.

The local bank prepares a letter of confirmation to forward to the exporter along with the irrevocable letter of credit.

The exporter reviews carefully all conditions in the letter of credit. The exporter's freight forwarder should be contacted to make sure that the shipping date can be met. If the exporter cannot comply with one or more of the conditions, the customer should be alerted at once.

The exporter arranges with the freight forwarder to deliver the goods to the appropriate port or airport.

When the goods are loaded, the forwarder completes the necessary documents.

The exporter (or the forwarder) presents to the local bank documents indicating full compliance.

The bank reviews the documents. If they are in order, the documents are airmailed to the buyer's bank for review and transmitted to the buyer.

The buyer (or agent) gets the documents that may be needed to claim the goods.

A draft, which may accompany the letter of credit, is paid by the exporter's bank at the time specified or may be discounted at an earlier date.

**Tips on Using a Letter of Credit**

When preparing quotations for prospective customers, exporters should keep in mind that banks pay only the amount specified in the letter of credit - even if higher charges for shipping, insurance, or other factors are documented.

Upon receiving a letter of credit, the exporter should carefully compare the letter's terms with the terms of the exporter's pro forma quotation. This point is extremely important, since the terms must be precisely met or the letter of credit may be invalid and the exporter may not be paid. If meeting the terms of the letter of credit is impossible or any of the information is incorrect or misspelled, the exporter should get in touch with the customer immediately and ask for an amendment to the letter of credit to correct the problem.

The exporter must provide documentation showing that the goods were shipped by the date specified in the letter of credit or the exporter may not be paid. Exporters should check with their freight forwarders to make sure that no unusual conditions may arise that would delay shipment. Similarly, documents must be presented by the date specified for the letter of credit to be paid. Exporters should verify with their international bankers that sufficient time will be available for timely presentation.

Exporters should always request that the letter of credit specify that partial shipments and transshipment will be allowed. Doing so prevents unforeseen problems at the last minute.

**DRAFTS**

A draft, sometimes also called a bill of exchange, is analogous to a foreign buyer's check. Like checks used in domestic commerce, drafts sometimes carry the risk that they will be dishonored.

**Sight Drafts**

A sight draft is used when the seller wishes to retain title to the shipment until it reaches its destination and is paid for. Before the cargo can be released, the original ocean bill of lading must be properly endorsed by the buyer and surrendered to the carrier, since it is a document that evidences title.

Air way-bills of lading, on the other hand, do not need to be presented in order for the buyer to claim the goods. Hence, there is a greater risk when a sight draft is being used with an air shipment.

In actual practice, the bill of lading or air way-bill is endorsed by the shipper and sent via the shipper's bank to the buyer's bank or to another intermediary along with a sight draft, invoices, and other supporting documents specified by either the buyer or the buyer's country (e.g., packing lists, consular invoices, insurance certificates). The bank notifies the buyer when it has received these documents; as soon as the amount of the draft is paid, the bank releases the bill of lading, enabling the buyer to obtain the shipment.

When a sight draft is being used to control the transfer of title of a shipment, some risk remains because the buyer's ability or willingness to pay may change between the time the goods are shipped and the time the drafts are presented for payment. Also, the policies of the importing country may change. If the buyer cannot or will not pay for and claim the goods, then

returning or disposing of them becomes the problem of the exporter.
Exporters should also consider which foreign bank should negotiate the sight draft for payment. If the negotiating bank is also the buyer's bank, the bank may favor its customer's position, thereby putting the exporter at a disadvantage. Exporters should consult their international bankers to determine an appropriate strategy for negotiating drafts.

**Time Drafts and Date Drafts**

If the exporter wants to extend credit to the buyer, a time draft can be used to state that payment is due within a certain time after the buyer accepts the draft and receives the goods, for example, 30 days after acceptance. By signing and writing "accepted" on the draft, the buyer is formally obligated to pay within the stated time. When this is done the draft is called a trade acceptance and can be either kept by the exporter until maturity or sold to a bank at a discount for immediate payment.
A date draft differs slightly from a time draft in that it specifies a date on which payment is due, for example, December 1, XXXX, rather than a time period after the draft is accepted. When a sight draft or time draft is used, a buyer can delay payment by delaying acceptance of the draft. A date draft can prevent this delay in payment but still must be accepted.
When a bank accepts a draft, it becomes an obligation of the bank and a negotiable investment known as a banker's acceptance is created. A banker's acceptance can also be sold to a bank at a discount for immediate payment.

**CREDIT CARDS**

Many exporters of consumer and other products (generally of low value) that are sold directly to the end user accept Visa and MasterCard in payment for export sales.

International credit card transactions are typically placed by telephone or fax, methods that facilitate fraudulent transactions. Merchants should determine the validity of transactions and obtain proper authorizations.

## 3. OPEN ACCOUNT

In a foreign transaction, an open account is a convenient method of payment and may be satisfactory if the buyer is well established, has demonstrated a long and favorable payment record, or has been thoroughly checked for creditworthiness. Under open account, the exporter simply bills the customer, who is expected to pay under agreed terms at a future date. Some of the largest firms abroad make purchases only on open account.

Open account sales do pose risks, however. The absence of documents and banking channels may make legal enforcement of claims difficult to pursue. The exporter may have to pursue collection abroad, which can be difficult and costly. Also, receivables may be harder to finance, since drafts or other evidence of indebtedness are unavailable.

Before issuing a pro forma invoice to a buyer, exporters contemplating a sale on open account terms should thoroughly examine the political, economic, and commercial risks and consult with their bankers if financing will be needed for the transaction.

## 4. OTHER PAYMENT MECHANISMS

### 4.1 Consignment sales

In international consignment sales, the same basic procedure is followed as in the local market. The material is shipped to a foreign distributor to be sold on behalf of the exporter. The exporter retains title to the goods until they are sold by the distributor. Once the goods are sold, payment is sent to the exporter. With this method, the exporter has the greatest risk and least control over the goods and may have to wait quite a while to get paid.

When this type of sale is contemplated, it may be wise to consider some form of risk insurance. In addition, it may be necessary to conduct a credit check on the foreign distributor. Furthermore, the contract should establish who is responsible for property risk insurance covering merchandise until it is sold and payment received.

4.2 Foreign currency

A buyer and a seller in different countries rarely use the same currency. Payment is usually made in either the buyer's or the seller's currency or in a mutually agreed-on currency that is foreign to both parties.

One of the uncertainties of foreign trade is the uncertainty of the future exchange rates between currencies. The relative value between the local currency and the buyer's currency may change between the time the deal is made and the time payment is received. If the exporter is not properly protected, a devaluation in the foreign currency could cause the exporter to lose money in the transaction.

One of the simplest ways for an exporter to avoid this type of risk is to quote prices and require payment in local currency. Then the burden and risk are placed on the buyer to make the currency exchange. Exporters should also be aware of problems of currency convertibility; not all currencies are freely or quickly convertible into local currency.

If the buyer asks to make payment in a foreign currency, the exporter should consult an international banker before negotiating the sales contract. Banks can offer advice on the foreign exchange risks that exist; further, some international banks can help one hedge against such a risk if necessary, by agreeing to purchase the foreign currency at a fixed price regardless of the value of the currency when the customer pays. The bank charges a fee or discount on the transaction. If this mechanism is used, the fee should be included in the price quotation.

4.3 Counter-trade and barter

International counter-trade is a trade practice whereby a supplier commits contractually, as a condition of sale, to undertake specified initiatives that compensate and benefit the other party. The resulting linked trade fulfills financial (e.g., lack of foreign exchange), marketing, or public policy objectives of the trading parties. Not all suppliers consider counter-trade an objectionable imposition; many exporters consider counter-trade a necessary cost of doing business in markets where exports would otherwise not occur.

Simple barter is the direct exchange of goods or services between two parties; no money changes hands. Pure barter arrangements in international commerce are rare, because the parties' needs for the goods of the other seldom coincide and because valuation of the goods may pose problems. The most common form of compensatory trade practiced today involves contractually linked, parallel trade transactions each of which involves a separate financial settlement. For example, a counter-

trade contract may provide that the exporter will be paid in a convertible currency as long as the exporter (or another entity designated by the exporter) agrees to export a related quantity of goods from the importing country.
Exporters can take advantage of counter-trade opportunities by trading through an intermediary with counter-trade expertise, such as an international broker, an international bank, or an export management company. Some export management companies offer specialized counter-trade services. Exporters should bear in mind that counter-trade often involves higher transaction costs and greater risks than simple export transactions.

**3. DECREASING CREDIT RISKS THROUGH CREDIT CHECKS**

Generally, it is a good idea to check a buyer's credit even if credit risk insurance or relatively safe payment methods are employed. Banks are often able to provide credit reports on foreign companies, either through their own foreign branches or through a correspondent bank.
Private credit reporting services also are available. Several services compile financial information on foreign firms (particularly larger firms) and make it available to subscribers. Reliable evaluations can also be obtained from foreign credit reporting services, many of which are listed in The Exporter's Guide to Foreign Sources for Credit Information, published by Trade Data Reports, Inc., 6 West 37th Street, New York, NY 10018.

**4. COLLECTION PROBLEMS**

In international trade, problems involving bad debts are more easily avoided than rectified after they occur. Credit checks and the other methods that have been discussed can limit the risks involved. Nonetheless, just as in a company's domestic business, exporters occasionally encounter problems with buyers who default on payments. When these problems occur in international trade, obtaining payment can be both difficult and expensive. Even when the exporter has insurance to cover commercial credit risks, a default by a buyer still requires time, effort, and cost. The exporter must exhaust all reasonable means of obtaining payment before an insurance claim is honored, and there is often a significant delay before the insurance payment is made.

The simplest (and least costly) solution to a payment problem is to contact and negotiate with the customer. With patience, understanding, and flexibility, an exporter can often resolve conflicts to the satisfaction of both sides.

This point is especially true when a simple misunderstanding or technical problem is to blame and there is no question of bad faith. Even though the exporter may be required to compromise on certain points - perhaps even on the price of the committed goods - the company may save a valuable customer and profit in the long run.

If, however, negotiations fail and the sum involved is large enough to warrant the effort, a company should obtain the assistance and advice of its bank, legal counsel, and other qualified experts. If both parties can agree to take their dispute to arbitration agency, this step is preferable to legal action, since arbitration is often faster and less costly. The International Chamber of Commerce handles the majority of international arbitrations and is usually acceptable to foreign companies because it is not affiliated with any single country.

## 5. SUMMARY

Most of the beginners of exports may worry about the terms of payment. Because, unlike other domestic business, you are dealing with a buyer who is located thousands of miles away from one's place crossing borders of your country. One may or may not know the financial condition or credit worthiness of one's buyer. Also one may not be meeting the buyer personally at initial stage, may not be aware of the specific policy of trade of buyer's country, no idea about political status or natural calamity chances of the region etc. Payment term in any business is a major part of sales contract. Terms of payment in exports and imports plays an important role in international business. Ranked in order from most secure for the exporter to least secure, the basic methods of payment are: cash in advance, letter of credit, documentary collection or draft, open account, and other payment mechanisms, such as consignment sales, foreign currency, counter trade and barter. Also we talked about how to reduce credit risk by having credit checks and the collection problem arising in collection and how to solve it.