Payment methods in international trade

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Payment methods in international trade

- Similar to those in domestic trade
- Added risks involved in cross-border transactions
- Means of payment = terms of payment in international trade
- Four commonly used terms of payment – each of them defers in level of risk and stability for buyer and seller.
- Absolute v. relative security of parties (compromise of the parties interests)

Key factors determining the payment method

- Relationship between the seller and the buyer
- The length of business relationship between the parties (most important factor)
- Nature of merchandise
- Industry norms
- Distance between seller and buyer
- Currency fluctuations
- Political and economic stability

Export payment mechanisms

- Used as:
- 1. Means of payment
- 2. Security mechanisms
- 3. Finance devices

1. Payment means

- Ways to effect payment:
- Wire transfer
- Bank draft
- Bank cheques
- Drafts
- Bills of exchange (documentary bills, e.g. Bill of lading + commercial invoice)

2. Security mechanisms

- Documentary bills: involve neutral third party in the transaction (bank) = linkage of payment and security functions
- X
- Security instruments (standby credit, demand guarantee) are not primary payment devices

Security mechanisms – pros and cons

- Reduction or risk X greater documentary complexity, higher banking fees, service costs

- Factors:
- Confidence, bargaining position

3. Finance device

- Grant credit to exporter or importer
- Sources of finance

- Importers need to be granted a credit period so that they can earn revenues from re-selling the goods before they have to repay the exporter.

Credit Management

- System for dealing with credit risks and entire transaction
- Domestic X international
- Specialized service providers
- BUT basic familiarity with the issues is highly recommended

Credit Management

- Creation of export credit management system and credit policy
- Assessment of the risks associated with potential customers: credit rantings
- Companies
- Choice of appropriate payment mechanism or other security

Credit Management

- Management of exchange rate risks
- Installing document-processing systems (paper circulation, checklist, schedule)
- Obtaining export insurance (limited)
- Collection of overdue accounts (late payment penalties)

Export Credit Insurance

- **Range of risks:**
- Currency risks (ER fluctuations, exchange controls)
- Business risks (bankruptcy, force majeure event, failure to perform, refusal to pay)
- Political risks (force majeure – war, revolution, confiscaton or expropriation, enactment of new regulations)

Insurance Providers

- **Public X Private**
- Public – risk of indirect export subsidy (OECD on minimum interests rates, max. lengths of credits etc.)

- Private – often by specialized brokers
- Choice from available services

Types of policies

- Export Credit Insurance: Non-payment, default by importer
- Comprehensive policy: currency, business, political risks
- Excess of loss policy: total coverage for any losses in excess of a certain threshold
- Combinations of thereof
- Short- and long-term

Coverage

- Extends only to risks specifically named in the policy!
- Exporters own default normally not covered, currency risks either

- Commonly 90-95% range
- Costs of coverage 1-2% of the contract price + base fee + insurer´s min. processing charges

Four basic terms of payment

- Cash in advance
- Documentary credit (Letter of credit)
- Documentary collection
- Open Account

Cash in advance

- **not very common**
- Provides the greatest security for seller but not for buyer
- The buyer simply prepays the seller prior to shipment of the goods and risks that seller will not comply with all the terms of contract.
- Buyer has to have a high level of confidence in the ability and willingness of the seller to deliver the goods as ordered.

- HOW: Bank draft or check, wire payment to the bank account
- WHEN: Unique, high-demand products, orders from unknown buyers in unstable countires
- Small sample orders, large buyer-small seller-large order, new relationship, small transaction, avoid costs of documentary payments

- **Questions for the buyer**
- Are cash in advance terms the only option available?
- Will the seller comply with the terms and ship the goods as promised?
- What recourse is available if the goods are not shipped as ordered?
- Are there economic, political, or social instabilities in the seller´s country that may increase the likelihood that the seller cannot ship as promised?
- **Questions for the seller**
- Is the product unique enough or in high enough demand to get way with requiring cash in advance terms?
- Is the buyer willing to pay at least some proportion in advance?

Documentary credit (Letter of credit)

- **most common**
- Security and almost equal risk for both of the parties
- Added cost (for the handling of the documentary credit) to buyer
- A bank's commitment to pay the seller a specified amount of money on behalf of the buyer under precisely defined conditions
- The buyer specifies certain documents (including a document of title) which the seller has to give to the bank in order to receive the payment – must conform precisely!
- Payment after the goods is shipped and the bank is provided by the documents (bill of lading)
- Disagreements regarding the order are handled between B and S independently of the banks or of payment!

- **Questions for the buyer**
- Is my bank experienced in documentary credit transactions?
- Am I prepared to amend or renegotiate terms of the credit with the seller?
- Am I certain of all the documents required for customs clearance?
- **Questions for the seller**
- Will I take care to confirm the good standing of the buyer and the buyer´s bank?
- Will we carefully review the credit to make sure its conditions can be met?
- Am I committed to properly prepare documentation for the credit?
- Can we comply with every detail of the credit?
- Am I prepared to amend or renegotiate terms of the credit with the buyer?

Documentary collection

- Security and almost equal risk for both of the parties
- Less cost and easier to use than the Letter of credit
- An order by the seller to his bank to collect payment form the buyer in exchange for the transfer of documents that enable the holder to take position of the goods.
- The seller ships goods to the buyer (to the agent, bank) and sends the documents (including a document of title) through the bank with instructions to release them to the buyer only upon payment. The bank can not transfer the documents to the buyer until the payment is made. Once in possession of the documents the buyer may take the possession of the shipment.
  - Document against payment (D/P)
  - Document against acceptance (D/A)
- Bank involved in the transactions do not guarantee payment but act only as collectors of payment.

Documentary collection

- **Risks for seller:**
  - Payment is not made until after the goods are shipped
  - Good can be destroyed during the transit or storage
  - Bank not guarantee the payment
- **Risks for buyer:**
  - The shipped good wont have the ordered quality and quantity.

- **Questions for the buyer:**
  - Do I trust that the seller will ship the quality and quantity of goods as promised?
- **Questions for the seller:**
  - Do I know the buyer well enough to trust that he/she will pay for the documents?
  - If the buyer refuses to pay for the documents, are the goods we are shipping easily marketable to another client?
  - Is our company committed to prepare documents correctly?

Open Account

- Less risk for the buyer and the greatest risks for the seller that the buyer will not comply with the terms of the contract and pay as promised.
- The seller should always consider whether any other alternatives are available before agreeing to open account terms.
- The buyer has to pay for the goods within a designated time after the shipment, usually 30, 60, 90 days, no longer that 180 days.
- Time to: receive the goods, check it, market them in his domestic market, receive payment for it and make payment to the seller.
- Made by: bank draft, check, wire payment to the bank account specified by the seller
- If the buyer does not pay – the last chance is to take an legal action on the basis of sales contract.

Open Account

- **Used when:**
  - Not much common in international trade
  - goods are shipped to the foreign branch or subsidiary of a multinational company
  - High degree of trust between the persons
  - The seller has significant faith in the buyer's ability and willingness to pay.

- **Questions for the buyer:**
  - Can I convince the seller of my ability and willingness to pay on an open account terms?
  - Is my marketing or distribution strength and reputation in my domestic market attractive enough to the seller to justify open account terms?
- **Questions for the seller:**
  - Are open account terms the only option available?
  - Does the buyer have the ability and willingness to make payment?
  - Will economic, political, and social instability in the buyer's country hinder the buyer's ability to pay?