Chapter Objectives

- Describe methods of payment for international trade.
- Explain common trade finance methods.
- Describe the major agencies that facilitate international trade with export insurance and/or loan programs.

Payment Methods for International Trade (1 of 7)

Five basic methods of payment are used to settle international transactions, each with a different degree of risk to the exporter and importer: (Exhibit 19.1)

- Prepayment
- Letters of credit
- Drafts (sight/time)
- Consignment
- Open account

Exhibit 19.1 Comparison of Payment Methods

METHOD	USUAL TIME OF PAYMENT	PRODUCTS AVAILABLE TO IMPORTERS	RISK TO EXPORTER	RISK TO IMPORTER
Prepayment	Before shipment	After payment	None	Relies completely on exporter to ship products as ordered
Letter of credit	When shipment is made	After payment	Very little or none, depending on credit terms	Is assured that shipment has been made, but relies on exporter to ship products described in documents
Sight draft; documents against payment	On presentation of draft to importer	After payment	If draft is unpaid, must dispose of products	Same as above unless importer can inspect products before payment
Time draft; documents against acceptance	On maturity of drafts	Before payment	Relies on importer to pay drafts	Same as above
Consignment	At time of sale by importer	Before payment	Allows importer to sell inventory before paying exporter	None; improves cash flow of importer
Open account	As agreed	Before payment	Relies completely on importer to pay account as agreed	None

Payment Methods for International Trade (2 of 7)

Prepayment

- Same as cash in advance
- Payment usually by wire transfer
- Method offers exporter greatest degree of protection
- Usually requested when
  - First time buyer
  - Danger of pre-shipment cancellation
  - Importer country has high political risk

Payment Methods for International Trade (3 of 7)

Letters of Credit (L/C) (Exhibits 19.2 and 19.3)

- A written obligation to ensure that the importer makes payment to the exporter once it receives proof that the products have been shipped.
- The importer's bank (the "issuing bank") issues an L/C by making a written commitment on behalf of the importer to pay the exporter when the importer's bank receives shipping documents confirming that the exporter has shipped the products to the importer.

Trade Finance Methods (1 of 7)

Letters of Credit (L/C) (Continued)

- **Bill of Lading (B/L)** — Serves as a receipt for shipment and a summary of freight charges. It conveys title to the merchandise. A B/L includes the following provisions:
  - A description of the merchandise
  - Identification marks on the merchandise
  - Evidence of loading (receiving) ports
  - Name of the exporter (shipper)
  - Name of the importer
  - Status of freight charges (prepaid or collect)
  - Date of shipment

Trade Finance Methods (2 of 7)

Letters of Credit (L/C) (Continued)

- **Commercial Invoice** (currency) — Exporter’s (seller’s) description of the merchandise being sold to the buyer is the commercial invoice, which contains:
  - Name and address of seller
  - Name and address of buyer
  - Date
  - Terms of payment
  - Price, including freight, handling, and insurance if applicable
  - Quantity, weight, packaging, etc.
  - Shipping information

Exhibit 19.2 Example of an Irrevocable Letter of Credit

Name of importer's bank
Address of importer's bank

Name of exporter
Address of exporter

We establish our irrevocable letter of credit:
for the account of *(importer name),*
in the amount of (value of exports),
expiring *(date),*
available by your draft at *(time period)* days sight and accompanied by:
(any invoices, packing lists, bills of lading, etc., that need to be presented with the letter of credit)
Insurance provided by *(exporter or importer)*
covering shipment of (merchandise description)
From: (port of shipment)
To: (port of arrival)

(*Authorized Signature*)

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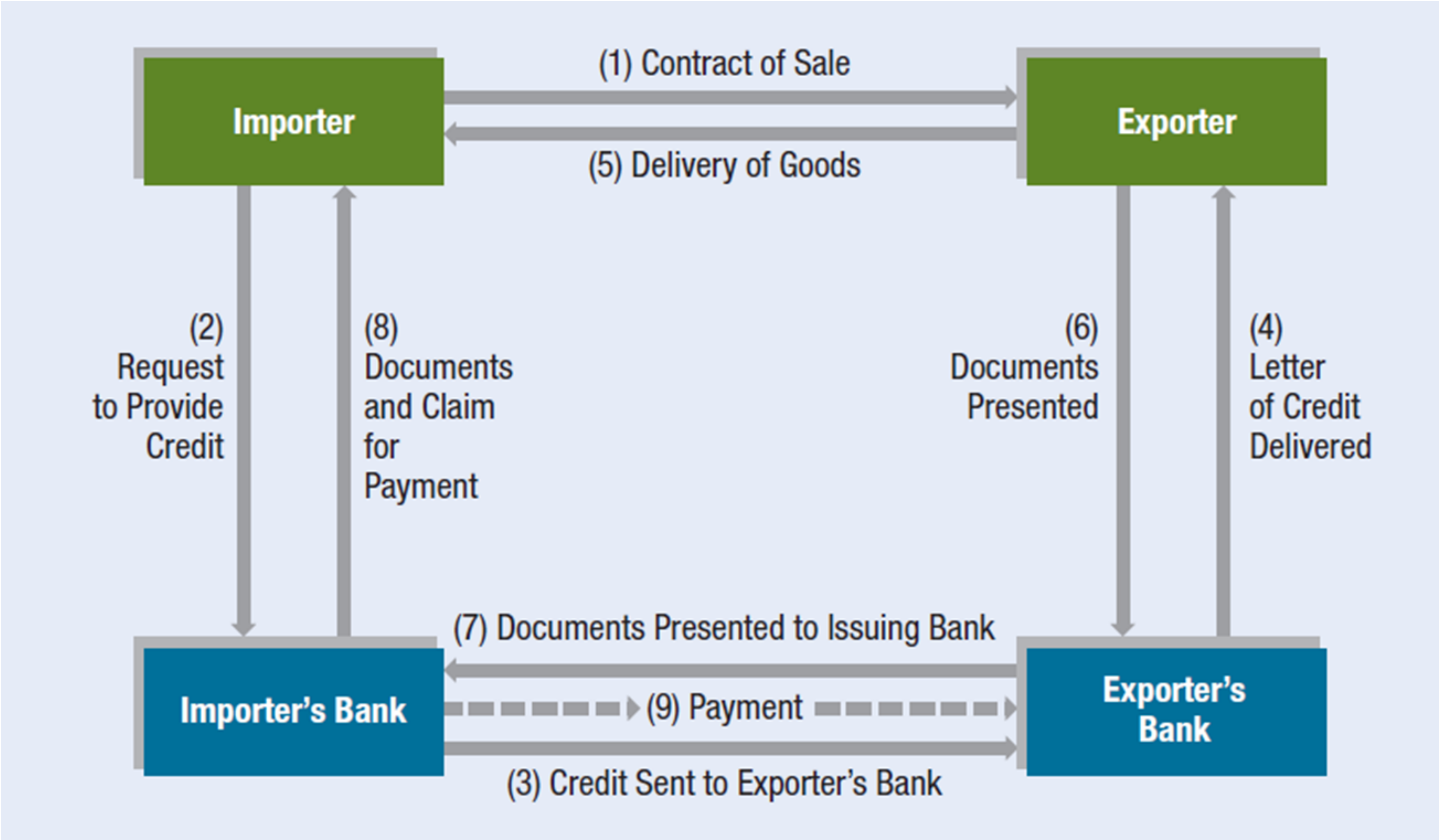
Exhibit 19.3 Documentary Credit Procedure



Payment Methods for International Trade (4 of 7)

Drafts (or bill of exchange)

- **Draft** — Also known as a bill of exchange, a draft is an unconditional promise drawn by one party, usually the exporter, requesting the importer to pay the face amount of the draft at sight or at a specified future date.
- Draft represents the exporter's formal demand for payment from the buyer.
- Draft affords the exporter less protection than an L/C because the banks are not obligated to honor payments on the buyer's behalf.

Payment Methods for International Trade (5 of 7)

Consignment

- Exporter ships the goods to the importer while still retaining actual title to the merchandise.
- The importer has access to the inventory but does not have to pay for the goods until they have been sold to a third party.
- The exporter is trusting the importer to remit payment for the goods sold at that time.
- If the importer fails to pay, the exporter has limited recourse because no draft is involved and the goods have already been sold.

Payment Methods for International Trade (6 of 7)

Open Account

- The opposite of prepayment — The exporter ships the merchandise and expects the buyer to remit payment according to the agreed-upon terms.
- The exporter is relying fully upon the financial creditworthiness, integrity, and reputation of the buyer.
- Method is used when the seller and buyer have mutual trust and a great deal of experience with each other.

Payment Methods for International Trade (7 of 7)

Impact of Credit Crisis on the Payment Methods

- When the credit crisis intensified in the fall of 2008, international trade transactions stalled.
- Many financial institutions experienced financial problems. Consequently, exporters lost trust in commercial banks.
- The crisis illustrated how international trade is so reliant on the soundness and integrity of commercial banks.

Trade Finance Methods (3 of 7)

Accounts receivable financing

Factoring

Letters of credit (L/Cs)

Banker’s acceptances

Medium-term capital goods financing (forfaiting)

Countertrade

Trade Finance Methods (4 of 7)

Accounts Receivable Financing

Could take the form of an open account shipment or a time draft; the bank will provide a loan to the exporter secured by an assignment of the account receivable.

Factoring

The exporter sells the accounts receivable without recourse.

Trade Finance Methods (5 of 7)

Letters of Credit (L/C)

- **Variations of the L/C**
  - **Standby letter of credit** — Can be used to guarantee invoice payments to a supplier. It promises to pay the beneficiary if the buyer fails to pay as agreed.

Trade Finance Methods (6 of 7)

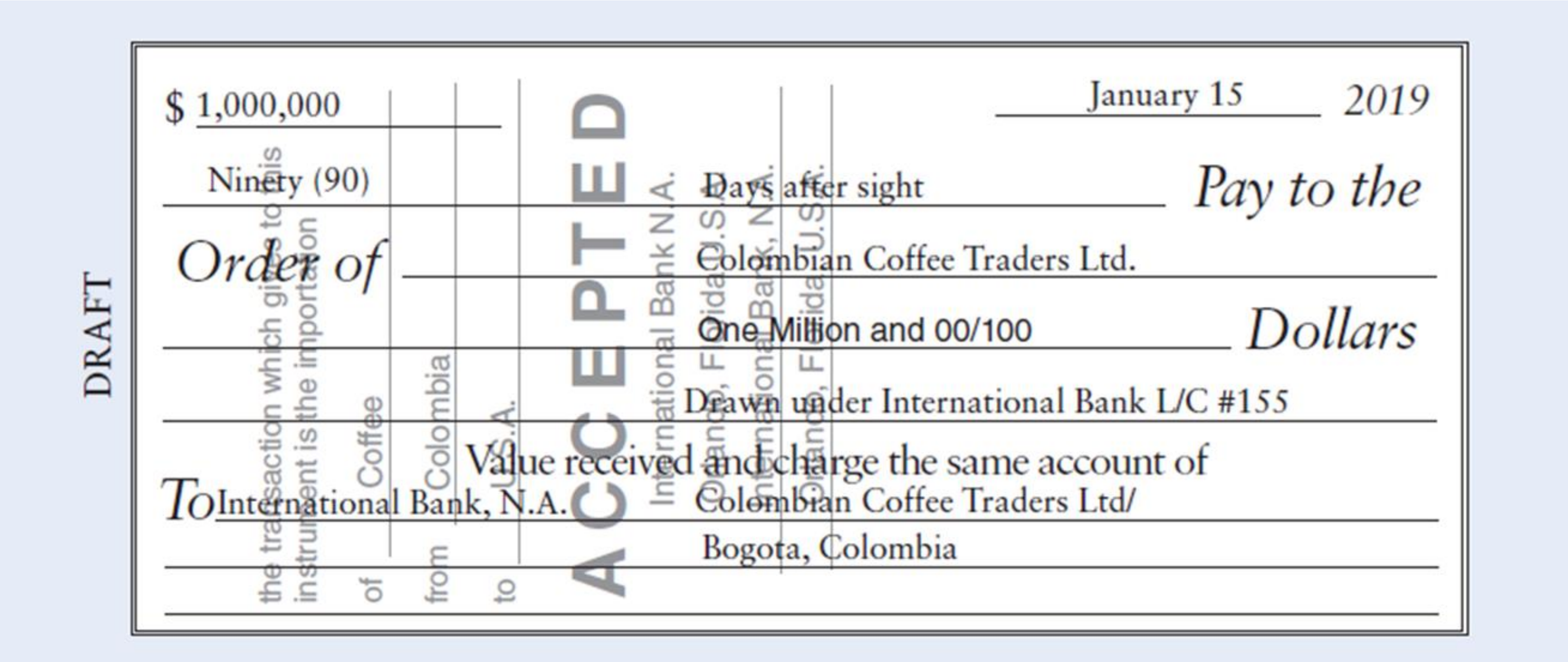
Banker's Acceptance (Exhibits 19.4 and 19.5)

- Bill of exchange, or time draft, drawn on and accepted by a bank. It is the accepting bank's obligation to pay the holder of the draft at maturity.

Medium-Term Capital Goods Financing (Forfaiting)

- Similar to factoring in that the forfaiter (or factor) assumes responsibility for the collection of payment from the buyer, the underlying credit risk, and the risk pertaining to the countries involved.

Exhibit 19.4 Banker’s Acceptance



DRAFT

$ 1,000,000 January 15 2019

Ninety (90) Days after sight *Pay to the*

Order of Colombian Coffee Traders Ltd.

One Million and 00/100 *Dollars*

Drawn under International Bank L/C #155

Value received and charge the same account of

To International Bank, N.A. Colombian Coffee Traders Ltd/

Bogota, Colombia

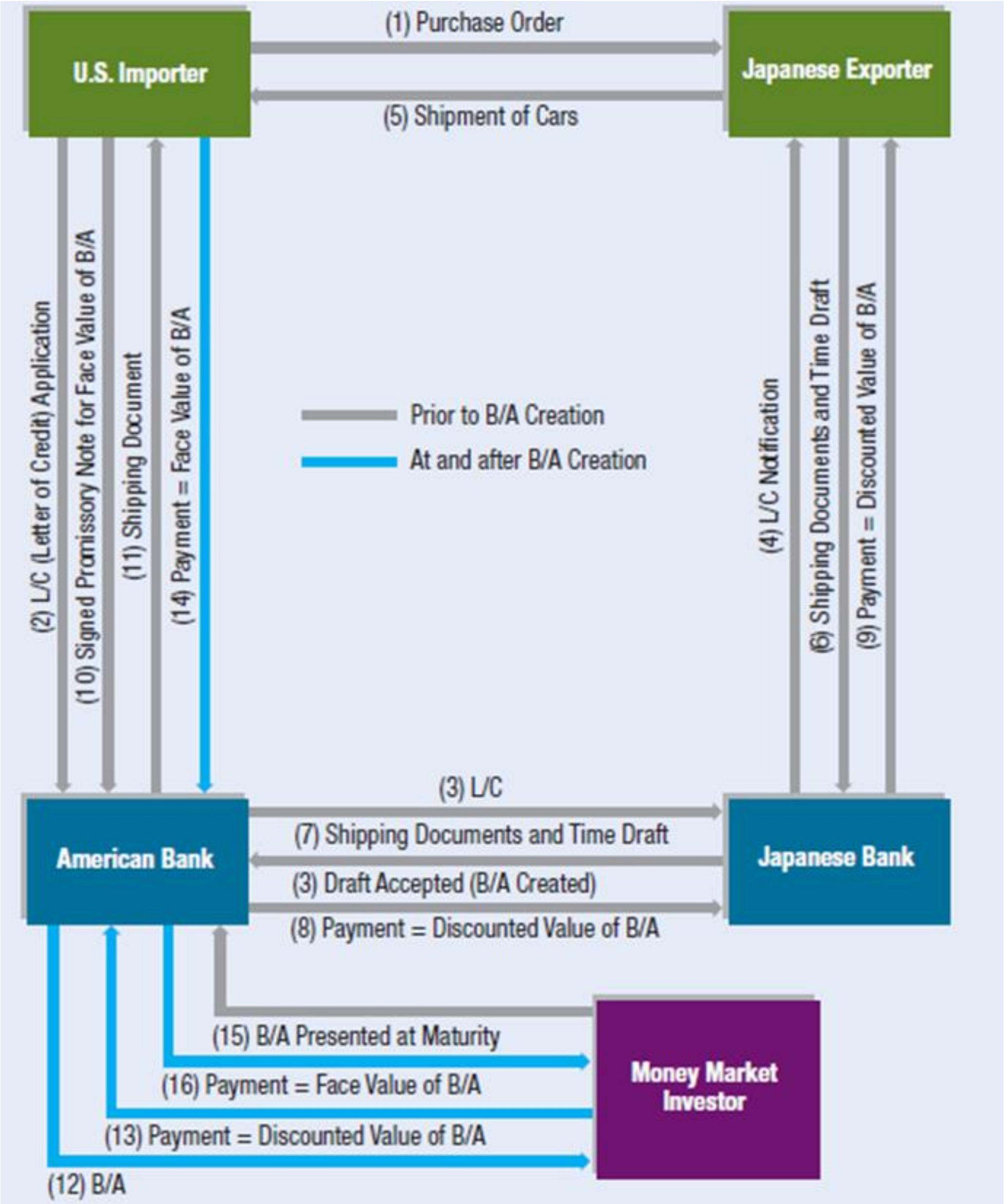
the transaction which gives rise to this instrument is the importation of Coffee from Colombia to U.S.A.

ACCEPTED

International Bank N.A. Orlando, Florida U.S.A.

International Bank, N.A. Orlando, Florida U.S.A.

Exhibit 19.5 Life Cycle of a Typical Banker's Acceptance (B/A)



Trade Finance Methods (7 of 7)

Countertrade

- Denotes all types of foreign trade transactions in which the sale of goods to one country is linked to the purchase or exchange of goods from that same country.
- Some types of countertrade, such as **barter**, have been in existence for thousands of years.
- Recently countertrade gained popularity and importance.

Agencies That Facilitate International Trade (1 of 2)

Export-Import Bank of the United States

- Established in 1934 with a goal of facilitating Soviet-American trade.
- Today, its mission is to finance and facilitate the export of American goods and services and maintain the competitiveness of American companies in overseas markets.
- Offers programs that are classified as:
  - Guarantee programs
  - Loan programs
  - Bank insurance programs
  - Export credit insurance

Agencies That Facilitate International Trade (2 of 2)

Private Export Funding Co. (PEFCO)

- Is owned by a consortium of commercial banks and industrial companies.
- Provides medium and long-term fixed rate financing to foreign buyers.

Overseas Private Investment Corporation (OPIC)

- A self-sustaining federal agency responsible for insuring direct U.S. investments in foreign countries against the risks of currency inconvertibility, expropriation, and other political risks.

Summary

- The common methods of payment for international trade are (1) prepayment (before products are sent), (2) letters of credit, (3) drafts, (4) consignment, and (5) open accounts.
- The most popular methods of financing international trade are (1) accounts receivable financing, (2) factoring, (3) letters of credit, (4) banker's acceptances, (5) medium-term capital goods financing (forfaiting), and (6) countertrade.
- The major agencies that facilitate international trade with export insurance and/or loan programs are (1) the Export-Import Bank of the United States, (2) the Private Export Funding Corporation, and (3) the Overseas Private Investment Corporation.