**SHORT TERM ASSET AND LIABILITY MANAGEMENT**

**PAYMENT METHODS FOR INTERNATIONAL TRADE**

In any international trade transaction, credit is provided by either the supplier (exporter), the buyer (importer), one or more financial institutions, or any combination of these. The supplier may have sufficient cash flow to finance the entire trade cycle, beginning with the production of the product until payment is eventually made by the buyer. This form of credit is known as **supplier credit.** In some cases, the exporter may require bank financing to augment its cash flow. On the other hand, the supplier may not desire to provide financing, in which case the buyer will have to finance the transaction itself, either internally or externally, through its bank. Banks on both sides of the transaction can thus play an integral role in trade financing.

In general, five basic methods of payment are used to settle international transactions, each with a different degree of risk to the exporter and importer

• Prepayment

• Letters of credit

• Drafts (sight/time)

• Consignment

• Open account

***Prepayment***

Under the prepayment method, the exporter will not ship the goods until the buyer has remitted payment to the exporter. Payment is usually made in the form of an international wire transfer to the exporter’s bank account or foreign bank draft. As technology progresses, electronic commerce will allow firms engaged in international trade to make electronic credits and debits through an intermediary bank. This method affords the supplier the greatest degree of protection, and it is normally requested of first-time buyers whose creditworthiness is unknown or whose countries are in financial difficulty. Most buyers, however, are not willing to bear all the risk by prepaying an order.

***Letters of Credit (L/Cs)***

A letter of credit (L/C) is an instrument issued by a bank on behalf of the importer (buyer) promising to pay the exporter (beneficiary) upon presentation of shipping documents in compliance with the terms stipulated therein. In effect, the bank is substituting its credit for that of the buyer. This method is a compromise between seller and buyer because it affords certain advantages to both parties. The exporter is assured of receiving payment from the issuing bank as long as it presents documents in accordance with the L/C. An important feature of an L/C is that the issuing bank is obligated to honour drawings under the L/C regardless of the buyer’s ability or willingness to pay. On the other hand, the importer does not have to pay for the goods until shipment has been made and the documents are presented in good order. However, the importer must still rely upon the exporter to ship the goods as described in the documents, since the L/C does not guarantee that the goods purchased will be those invoiced and shipped.

***Drafts***

A draft (or bill of exchange) is an unconditional promise drawn by one party, usually the exporter, instructing the buyer to pay the face amount of the draft upon presentation. The draft represents the exporter’s formal demand for payment from the buyer. A draft affords the exporter less protection than an L/C because the banks are not obligated to honour payments on the buyer’s behalf. Most trade transactions handled on a draft basis are processed through banking channels. In banking terminology, these transactions are known as documentary collections. In a documentary collection transaction, banks on both ends act as intermediaries in the processing of shipping documents and the collection of payment. If shipment is made under a sight draft, the exporter is paid once shipment has been made and the draft is presented to the buyer for payment. The buyer’s bank will not release the shipping documents to the buyer until the buyer has paid the draft. This is known as documents against payment. It provides the exporter with some protection since the banks will release the shipping documents only according to the exporter’s instructions.

The buyer needs the shipping documents to pick up the merchandise. The buyer does not have to pay for the merchandise until the draft has been presented. If a shipment is made under a time draft, the exporter instructs the buyer’s bank to release the shipping documents against acceptance (signing) of the draft. This method of payment is sometimes referred to as documents against acceptance. By accepting the draft, the buyer is promising to pay the exporter at the specified future date. This accepted draft is also known as a trade acceptance, which is different from a banker’s acceptance (discussed later in the chapter). In this type of transaction, the buyer is able to obtain the merchandise prior to paying for it. The exporter is providing the financing and is dependent upon the buyer’s financial integrity to pay the draft at maturity. Shipping on a time draft basis provides some added comfort in that banks at both ends are used as collection agents. In addition, a draft serves as a binding financial obligation in case the exporter wishes to pursue litigation on uncollected receivables. The added risk is that if the buyer fails to pay the draft at maturity, the bank is not obligated to honour payment. The exporter is assuming all the risk and must analyse the buyer accordingly.

***Consignment***

Under a consignment arrangement, the 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. As a result of the high risk, consignments are seldom used except by affiliated and subsidiary companies trading with the parent company. Some equipment suppliers allow importers to hold some equipment on the sales floor as demonstrator models. Once the models are sold or after a specified period, payment is sent to the supplier.

***Open Account***

The opposite of prepayment is the open account transaction in which 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. As might be expected, this method is used when the seller and buyer have mutual trust and a great deal of experience with each other.

**TRADE FINANCE METHODS**

As mentioned in the previous section, banks on both sides of the transaction play a critical role in financing international trade. The following are some of the more popular methods of financing international trade:

• Accounts receivable financing

• Factoring

• Letters of credit (L/Cs)

• Banker’s acceptances

• Working capital financing

• Medium-term capital goods financing (forfaiting)

• Countertrade

Each of these methods is described in turn.

Accounts Receivable Financing

In some cases, the exporter of goods may be willing to ship goods to the importer without an assurance of payment from a bank. This could take the form of an open account shipment or a time draft. Prior to shipment, the exporter should have conducted its own credit check on the importer to determine creditworthiness. If the exporter is willing to wait for payment, it will extend credit to the buyer.

If the exporter needs funds immediately, it may require financing from a bank. In what is referred to as accounts receivable financing, the bank will provide a loan to the exporter secured by an assignment of the account receivable. The bank’s loan is made to the exporter based on its creditworthiness. In the event the buyer fails to pay the exporter for whatever reason, the exporter is still responsible for repaying the bank. Accounts receivable financing involves additional risks, such as government restrictions and exchange controls, which may prevent the buyer from paying the exporter. As a result, the loan rate is often higher than domestic accounts receivable financing. The length of a financing term is usually 1 to 6 months. To mitigate the additional risk of a foreign receivable, exporters and banks often require export credit insurance before financing foreign receivables.

***Factoring***

When an exporter ships goods before receiving payment, the accounts receivable balance increases. Unless the exporter has received a loan from a bank, it is initially financing the transaction and must monitor the collections of receivables. Since there is a danger that the buyer will never pay at all, the exporting firm may consider selling the accounts receivable to a third party, known as a factor. In this type of financing, the exporter sells the accounts receivable without recourse. The factor then assumes all administrative responsibilities involved in collecting from the buyer and the associated credit exposure. The factor performs its own credit approval process on the foreign buyer before purchasing the receivable. For providing this service, the factor usually purchases the receivable at a discount and also receives a flat processing fee. Factoring provides several benefits to the exporter. First, by selling the accounts receivable, the exporter does not have to worry about the administrative duties involved in maintaining and monitoring an accounts receivable accounting ledger. Second, the factor assumes the credit exposure to the buyer, so the exporter does not have to maintain personnel to assess the creditworthiness of foreign buyers. Finally, by selling the receivable to the factor, the exporter receives immediate payment and improves its cash flow.

Since it is the importer who must be creditworthy from a factor’s point of view, cross-border factoring is often used. This involves a network of factors in various countries who assess credit risk. The exporter’s factor contacts a correspondent factor in the buyer’s country to assess the importer’s creditworthiness and handle the collection of the receivable. Factoring services are usually provided by the factoring subsidiaries of commercial banks, commercial finance companies, and other specialized finance houses. Factors often utilize export credit insurance to mitigate the additional risk of a foreign receivable.

***Letters of Credit (L/Cs)***

Introduced earlier, the letter of credit (L/C) is one of the oldest forms of trade finance still in existence. Because of the protection and benefits it accords to both exporter and importer, it is a critical component of many international trade transactions. The L/C is an undertaking by a bank to make payments on behalf of a specified party to a beneficiary under specified conditions. The beneficiary (exporter) is paid upon presentation of the required documents in compliance with the terms of the L/C. The L/C process normally involves two banks, the exporter’s bank and the importer’s bank. The issuing bank is substituting its credit for that of the importer. It has essentially guaranteed payment to the exporter, provided the exporter complies with the terms and conditions of the L/C. Sometimes the exporter is uncomfortable with the issuing bank’s promise to pay because the bank is located in a foreign country. Even if the issuing bank is well known worldwide, the exporter may be concerned that the foreign government will impose exchange controls or other restrictions that would prevent payment by the issuing bank. For this reason, the exporter may request that a local bank confirm the L/C and thus assure that all the responsibilities of the issuing bank will be met. The confirming bank is obligated to honour drawings made by the beneficiary in compliance with the L/C regardless of the issuing bank’s ability to make that payment. Consequently, the confirming bank is trusting that the foreign bank issuing the L/C is sound. The exporter, however, need worry only about the credibility of the confirming bank.

***Banker’s Acceptance***

Introduced earlier, a banker’s acceptance is a 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. In the first step in creating a banker’s acceptance, the importer orders goods from the exporter. The importer then requests its local bank to issue an L/C on its behalf. The L/C will allow the exporter to draw a time draft on the bank in payment for the exported goods. The exporter presents the time draft along with shipping documents to its local bank, and the exporter’s bank sends the time draft along with shipping documents to the importer’s bank. The importer’s bank accepts the draft, thereby creating the banker’s acceptance. If the exporter does not want to wait until the specified date to receive payment, it can request that the banker’s acceptance be sold in the money market. By doing so, the exporter will receive less funds from the sale of the banker’s acceptance than if it had waited to receive payment. This discount reflects the time value of money.

***Medium-Term Capital Goods Financing (Forfaiting)***

Because capital goods are often quite expensive, an importer may not be able to make payment on the goods within a short time period. Thus, longer-term financing may be required here. The exporter might be able to provide financing for the importer but may not desire to do so since the financing may extend over several years. In this case, a type of trade finance known as forfaiting could be used. Forfaiting refers to the purchase of financial obligations, such as bills of exchange or promissory notes, without recourse to the original holder, usually the exporter. In a forfait transaction, the importer issues a promissory note to pay the exporter for the imported goods over a period that generally ranges from 3 to 7 years. The exporter then sells the notes, without recourse, to the forfaiting bank.

In some respects, forfaiting is 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. Since the forfaiting bank assumes the risk of non-payment, it should assess the creditworthiness of the importer as if it were extending a medium-term loan. Forfait transactions normally are collateralized by a bank guarantee or letter of credit issued by the importer’s bank for the term of the transaction. Since obtaining financial information about the importer is usually difficult, the forfaiting bank places a great deal of reliance on the bank guarantee as the collateral in the event the buyer fails to pay as agreed. It is this guarantee backing the transaction that has fostered the growth of the forfait market, particularly in Europe, as a practical means of trade finance. Forfaiting transactions are usually in excess of $500,000 and can be denominated in most currencies. For some larger transactions, more than one bank may be involved. In this case, a syndicate is formed wherein each participant assumes a proportionate share of the underlying risk and profit. A forfaiting firm may decide to sell the promissory notes of the importer to other financial institutions willing to purchase them. However, the forfaiting firm is still responsible for payment on the notes in the event the importer is unable to pay.

***Countertrade***

The term 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. Only recently, however, has countertrade gained popularity and importance. The growth in various types of countertrade has been fueled by large balance-of-payment disequilibriums, foreign currency shortages, the debt problems of less developed countries, and stagnant worldwide demand. As a result, many MNCs have encountered countertrade opportunities, particularly in Asia, Latin America, and Eastern Europe. The most common types of countertrade include barter, compensation, and counterpurchase. Barter is the exchange of goods between two parties without the use of any currency as a medium of exchange. Most barter arrangements are one-time transactions governed by one contract. An example would be the exchange of 100 tons of wheat from Canada for 20 tons of shrimp from Ecuador. In a compensation or clearing-account arrangement, the delivery of goods to one party is compensated for by the seller’s buying back a certain amount of the product from that same party. The transaction is governed by one contract, and the value of the goods is expressed in monetary terms. The buy-back arrangement could be for a fraction of the original sale (partial compensation) or more than 100 percent of the original sale (full compensation). An example of compensation would be the sale of phosphate from Morocco to France in exchange for purchasing a certain percentage of fertilizer. In some countries, this is also referred to as an industrial cooperation arrangement. Such arrangements often involve the construction of large projects, such as power plants, in exchange for the purchase of the project’s output over an extended period of time. For example, Brazil sold a hydroelectric plant to Argentina and in exchange purchased a percentage of the plant’s output under a long-term contract. The term counterpurchase denotes the exchange of goods between two parties under two distinct contracts expressed in monetary terms. Delivery and payment of both goods are technically separate transactions. Despite the economic inefficiencies of countertrade, it has become much more important in recent years. The primary participants are governments and MNCs, with assistance provided by specialists in the field, such as attorneys, financial institutions, and trading companies. The transactions are usually large and very complex. Many variations of countertrade exist, and the terminology used by the various market participants is still forming as the countertrade market continues to develop.