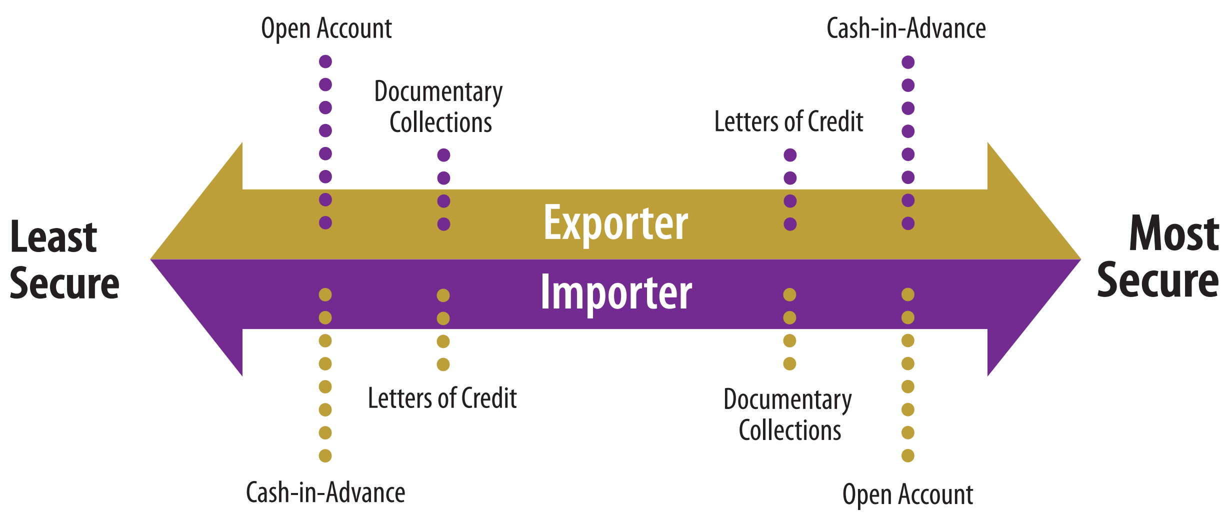
Chapter 1
Methods of Payment in International Trade

To succeed in today's global marketplace, exporters must offer their customers attractive sales terms supported by the appropriate payment method to win sales against foreign competitors. As getting paid in full and on time is the primary 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. As shown below, there are four primary methods of payment for international transactions. During or before contract negotiations, it is advisable to consider which method in the diagram below is mutually desirable for you and your customer.

PAYMENT RISK DIAGRAM



Key Points

- International trade presents a spectrum of risk, causing uncertainty over the timing of payments between the exporter (seller) and importer (foreign buyer).
- To exporters, any sale is a gift until payment is received.
- Therefore, the exporter wants payment as soon as possible, preferably as soon as an order is placed or before the goods are sent to the importer.
- To importers, any payment is a donation until the goods are received.
- Therefore, the importer wants to receive the goods as soon as possible, but to delay payment as long as possible, preferably until after the goods are resold to generate enough income to make payment to the exporter.

Cash-in-Advance

With this payment method, the exporter can avoid credit risk, since payment is received prior to the transfer of ownership of the goods. Wire transfers and credit cards are the most commonly used cash-in-advance options available to exporters. However, requiring payment in advance is the least attractive option for the buyer, as this method creates cash flow problems. Foreign buyers are also concerned that the goods may not be sent if payment is made in advance. Thus, exporters that insist on this method of payment as their sole method of doing business may find themselves losing out to competitors who may be willing to offer more attractive payment terms.

Letters of Credit

Letters of credit (LCs) are among the most secure instruments available to international traders. An LC is a commitment by a bank on behalf of the buyer that payment will be made to the exporter provided that the terms and conditions have been met, as verified through the presentation of all required documents. The buyer pays its bank to render this service. An LC is useful when reliable credit information about a foreign buyer is difficult to obtain, but you are satisfied with the creditworthiness of your buyer's foreign bank. An LC also protects the buyer since no payment obligation arises until the goods have been shipped or delivered as promised.

Documentary Collections

A documentary collection is a transaction whereby the exporter entrusts the collection of a payment to the remitting bank (exporter's bank), which sends documents to a collecting bank (importer's bank), along with instructions for payment. Funds are received from the importer and remitted to the exporter through the banks involved in the collection in exchange for those documents. Documentary collections involve the use of a draft that requires the importer to pay the face amount either on sight (document against payment—D/P) or on a specified date in the future (document against acceptance—D/A). The draft lists instructions that specify the documents required for the transfer of title to the goods. Although banks do act as facilitators for their clients under collections, documentary collections offer no verification process and limited recourse in the event of nonpayment. Drafts are generally less expensive than letters of credit.

Open Account

An open account transaction means that the goods are shipped and delivered before payment is due, usually in 30 to 90 days. Obviously, this is the most advantageous option to the importer in cash flow and cost terms, but it is consequently the highest risk option for an exporter. Due to the intense competition for export markets, foreign buyers often press exporters for open account terms since the extension of credit by the seller to the buyer is more common abroad. Therefore, exporters who are reluctant to extend credit may face the possibility of the loss of the sale to their competitors. However, with the use of one or more of the appropriate trade finance techniques, such as export credit insurance, the exporter can offer open competitive account terms in the global market while substantially mitigating the risk of nonpayment by the foreign buyer.