The Big Picture

Some Export Financing Basics–Or, Terms of Payment

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Before undertaking export transactions supported by the Supplier Credit Guarantee Program (SCGP) or other assistance, the U.S. supplier or seller must assess the potential financial risk inherent in the sale. Once the seller has determined the risks that his or her company can afford, a method of payment is agreed upon between buyer and seller.

When considering which terms of payment will suit your sale, remember that every transaction involves two commodities: the product and the money. Because of the intense competition for export markets, offering the buyer attractive payment terms (low transaction costs, deferred payment terms, lower interest rates) is often essential to export success. Here are definitions of the terms used in this issue, especially as they relate to export credit programs.

Promissory note issued by the importer to the exporter is the payment instrument used in the SCGP. The promissory note must be payable in U.S. dollars. Participants should carefully review the provisions of the note. No changes can be made to the note, nor can another form of note be used.

Documentary letter of credit is a commitment from the issuing bank to pay the seller (as beneficiary) a specified amount, provided terms and conditions of the letter of credit are met. The U.S.-dollar-denominated letter of credit is the payment instrument used in the GSM-102 and GSM-103 Export Credit Guarantee Programs.

Letters of credit are generally irrevocable. Once the letter of credit is established, it cannot be revoked or changed without the consent of all parties, unless the original letter of credit specifically states that it is revocable.

The letter of credit distributes risk between the seller and buyer. The seller is assured of payment when the conditions of the letter of credit are met; the buyer is assured that he or she won't have to pay for goods if the documented conditions are not met. It is a common method of payment, especially in new seller/buyer relationships.

The letter of credit is, however, not without drawbacks. If, after shipment, discrepancies exist in the required documents that cannot be corrected by the seller, the buyer has the option to approve the discrepancies and pay for the shipment—usually at a discount—or to reject it. If the shipment is rejected, the seller retains title to the goods. A rejected shipment means that the seller must quickly renegotiate with the buyer, locate a new buyer (usually at a lower price) or pay for the shipment to be returned. Also, costs of a letter of credit add to the price of the product and can tie up the buyer's working capital or credit.

You, your banker and your freight forwarder should scrutinize the letter of credit to determine whether it is legitimate and whether terms and conditions can be met. Bankers and forwarders can also help prepare documentation and reduce the chance of discrepancies.

It is sometimes preferable to get a letter of credit confirmed by a U.S. bank if you are concerned the foreign bank may not be willing or able to pay you after shipment. A confirmation guarantees to the seller that the U.S. bank will pay the seller if the documents conform to the requirements of the letter of credit regardless of whether the foreign bank pays.

Another issue to consider is transferability. If the seller is acting as a broker for, or shipper of, the goods, and the seller does not wish to take title to the goods, the letter of credit can be transferred to the supplier, so both exporter and supplier get paid at the same time after shipment.

Standby letter of credit, like the documentary letter of credit, is a commitment or promise from the buyer's bank to pay the seller only if another business transaction specified in the standby letter of credit is not performed. For example, if the buyer and seller have agreed to an open account sale and the buyer defaults, the seller could present documentation to the buyer's bank certifying that the buyer failed to pay for the shipment secured by the standby letter of credit, and collect payment from the buyer's bank.

A standby letter of credit is frequently used as performance security when a seller bids on an international tender by a state trading company. In this case, the buyer may require the seller to open a standby letter of credit; if the seller is unable to perform the contract, the buyer can draw on the value of the standby letter of credit as a penalty.

Open account is a transaction in which the seller agrees to provide the goods to the buyer, who agrees to make payment at a specified future date. Payment by the buyer is typically made by wire transfer or check.

Open account is a high-risk method of payment for the seller. The seller must be confident that the buyer is well-established, has a long and reputable payment record, has good credit and is able to convert currency into U.S. dollars. Collection on delinquent payments may be difficult–and costly–if the obligation of the buyer to pay the seller is not well documented. Even when well documented, collection on delinquent open account sales usually requires legal action in the buyer's country.

Documentary collection is a method of payment whereby the seller uses a bank as an agent in obtaining payment. A documentary collection usually consists of: a collection instruction; financial documents to obtain payment for money; and commercial documents (e.g., invoices, bills of lading and quality certificates).

The collection instruction provides complete and precise instructions to the banks, including contact points for seller, buyer, and their respective banks, amounts and currencies to be collected, a list of documents enclosed, the terms and conditions for payment and acceptance of goods, charges, interest, the method of payment and instructions in case of nonpayment.

To collect payment from a foreign buyer using a documentary collection, the seller prepares collection instructions, a draft or other demand for payment and the related commercial documents which are sent through bank channels to the buyer's bank. The buyer's bank releases the documents to the buyer upon receipt of payment or a formal promise of payment.

The banks facilitating the collection have no responsibility to pay the seller should the buyer default. Documentary collection carries the risk that the buyer will walk away from the sale. If this occurs, it is the burden of the seller to locate a new buyer or pay for return shipment of the goods.

Documentary collections can be beneficial when shipping by ocean freight, because the ocean bill of lading is a negotiable document and acts as title to the goods. The shipping company will not release the shipment unless the buyer has the original bill of lading, which the buyer cannot obtain unless he or she agrees to pay the bank.

When shipping by air, the bill of lading is not a negotiable document and does not act as title to the goods–possibly negating the benefit of documentary collection. ■

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It's All in the Details

Paperwork presents considerable challenges, as everyone knows. It's essential to safeguard your company's interests through documentation that sets all the details down, and to check and double-check them. For example, the paperwork must include provisions for late or partial payment and remedies for nonpayment.

To avoid major pitfalls, here are some things to look for:

General:

- Documents inconsistent with each other
- Description of goods on invoice different from that in letter of credit
- Marks and numbers that differ between documents
- Absence of documents called for in letter of credit
- Incorrect or incomplete names and addresses

Draft (Bill of Exchange):

- Amount that does not match invoice
- Amount drawn on wrong party
- Incorrect endorsement
- Indeterminable or unclear date of payment

Transport Documents:

- Shipment made between ports other than those in letter of credit
- Signature on bill of lading that fails to specify on whose behalf it was signed
- Required number of originals not presented
- Bill of lading that does not show whether freight is prepaid or collect
- No evidence of goods actually "shipped on board"
- Bill of lading incorrectly consigned
- "To order" bills of lading not endorsed

Insurance:

- Insurance document different from that required by letter of credit
- Shipment under-insured
- Insurance not effective for date(s) in transport documents
- Insurance policy incorrectly endorsed