

## LESSON 8.

## METHODS OF PAYMENT



The buyer and the seller are at the heart of every business. Both parties have one thing in common: to profit from the transaction and to expose themselves to the least risk possible.

Payment methods in international trade are similar to those in domestic business. **In international trade, the means of payment are known as “terms of payment.”** There are four commonly used terms of payment, each of which offers different levels of risk and stability for buyers and sellers.

There are four basic terms of payment used in international trade. They are described from most beneficial to the seller to most beneficial to the buyer.

### **Cash in advance**

- ❖ Provides greatest security for the seller and greatest risk for the buyer. The buyer simply prepays the seller prior to shipment of the goods. This term of payment requires that the buyer to have a high level of confidence in the seller to deliver the goods as ordered.

### **Documentary (letter of) credit**

- ❖ Security and almost equal risk for both buyer and seller.
- ❖ Added costs (for handling of the documentary credit) to buyer.

A letter of credit is a bank's promise to pay the seller a specified sum on behalf of the buyer under precisely defined conditions. The buyer specifies certain documents (including a title document) from the seller before the bank is to make payment, and the seller is assured that payment will be received after the goods are shipped as long as the specified documents are provided.

### **Documentary collections**

- ❖ Security and almost equal risk for both buyer and seller.
- ❖ Less costly and easier to use than a documentary letter of credit.

A documentary collection is a form of settlement. The seller ships the goods to the buyer but sends the documents, including the bill of lading (title document), through the banks with instructions to release them to the buyer only upon payment.

### **Open account**

- ❖ Provides the least risk for the buyer and the greatest risk for the seller. The buyer agrees to pay for the goods within a designated time after the shipment, usually in 30, 60 or 90 days.

In documentary transactions sellers make a written demand upon either a bank or the buyer to pay for the shipment of goods. This demand accompanies the documentation package the seller presents to the bank. Such a formal written demand for payment is called Bill of Exchange or "draft."

## BILL OF EXCHANGE OR DRAFTS

A **Bill of Exchange (B/E) or draft** is an unconditional order in writing, addressed by the drawer (Seller) to the drawee (Buyer), and signed by the person giving it (the drawer), requiring the drawee **to pay on demand or at a fixed or determinable future time** a specified sum of money. **A bill of exchange is not only transferable but also negotiable.**

The most common versions of bills of exchange or drafts are: (1) **sight drafts** which are payable when presented, and (2) **time drafts** (also called **term drafts**) which are payable at a future fixed (specific) date or determinable (e.g. 30, 60, 90 days) date.

## ACCEPTANCES

An acceptance is a **time draft** that has been accepted and signed by the drawee (the buyer or the bank) for payment maturity. If a time draft is accepted by a buyer of merchandise is called a **Trade Acceptance** and if accepted by a bank is called a **Bankers Acceptance**.

① Place drawn and date  
 ② Currency and amount in numbers and words  
 ③ Validity period  
 ④ Number of originals (sole or first/second)  
 ⑤ If issued to own order: endorsement required  
 ⑥ Reference to credit  
 ⑦ Drawee  
 ⑧ Drawer (handwritten signature)  
 ⑨ Endorsement

## DOCUMENTARY COLLECTIONS

Documentary collection is a form of payment in international transactions. The Bank collects a specific amount, owed by the buyer, against the presentation of documents specified in advance and fulfills the agent's functions in cash payments between the exporter and importer. The Bank acts on behalf and in favour of the seller.

When payments are carried out on the collection basis, the legal responsibility of the bank is limited by the transfer and issuance of documents against payment or acceptance of bill of exchange.

### The Collection Order

The **collection order** is the key document prepared by the seller specifying the terms and conditions of a documentary collection. It must be prepared with great care and precision as the banks are only permitted to act upon the instructions given in the order and not on instructions from past transactions or verbal understandings. These are notes for key provisions of the document:

- ❖ The payment period as agreed with the buyer.
- ❖ The name and address of the buyer.
- ❖ The buyer's bank
- ❖ Instructions, if any, about what to do with the accepted bill of exchange.
- ❖ Notation concerning payment of charges for the documentary collection.
- ❖ Notation/instructions for the lodging of a protest in the event of non acceptance or non payment.
- ❖ Instructions for notification of agent or representative in the buyer's country.

# Sample Collection Order

Sender: <b>M ü l l e r Ltd.</b> Tellstrasse 26  4053 Basle	<b>Documentary collection</b>  Basle, 12th August 19..																			
Our Reference <b>AK/83</b>  We send you herewith the following documents for collection:	Registered <b>Swiss Bank Corporation</b> Schweizerischer Bankverein Documentary collections P.O. Box 4002 <b>B a s l e</b>																			
Amount <b>US\$ 14'300.--</b>	Maturity <b>90 days sight</b> ①	Drawee ② <b>Maxwell Hammerton Inc.</b> 12, Broadway New York, N.Y. 10014 Drawee's bank <b>Commercial Credit Bank ③</b> New York																		
<table border="1" style="width: 100%; border-collapse: collapse; font-size: small;"> <thead> <tr> <th>Draft/Receipt</th> <th>Invoice commercial</th> <th>cust. of comm.</th> <th>Insur. Cert.</th> <th>Copy of Orig.</th> <th>Weight/Packing List</th> <th>Bill of Lading</th> <th>Waybill</th> <th>Postal/Cons-Receipt</th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">1 3/3</td> <td></td> <td style="text-align: center;">4</td> <td style="text-align: center;">2</td> <td></td> <td style="text-align: center;">2</td> <td></td> <td></td> <td style="text-align: center;">2</td> </tr> </tbody> </table>	Draft/Receipt	Invoice commercial	cust. of comm.	Insur. Cert.	Copy of Orig.	Weight/Packing List	Bill of Lading	Waybill	Postal/Cons-Receipt	1 3/3		4	2		2			2	other documents 2 analysis certificates	
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1 3/3		4	2		2			2												
Goods: <b>100 barrels "Chemical products - harmless"</b> by: <b>S/B CAP SAN GIORGIO</b> from <b>Le Havre</b> to <b>New York</b> on <b>31.7.19..</b>																				
Please follow the instructions marked «X»																				
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Please credit the proceeds as follows: <input checked="" type="checkbox"/> to our <b>SFR</b> account No. <b>10-326'791.0</b> <input type="checkbox"/> remit to																				
⑦ Remarks: <b>In case of difficulties, the collecting bank is requested to inform our representatives: Messrs. Beach &amp; Co. Inc., Broad Street 485, New York 34, who will be of assistance but who are not allowed to alter the above instructions.</b>																				
<b>M ü l l e r Ltd</b>  Enclosures E 6851 N 1/2 4.80 5000																				
Signature: .....																				

The execution of this order is subject to the uniform rules for collections issued by the International Chamber of Commerce

## **Types of documentary collection**

### **Documents against payment**

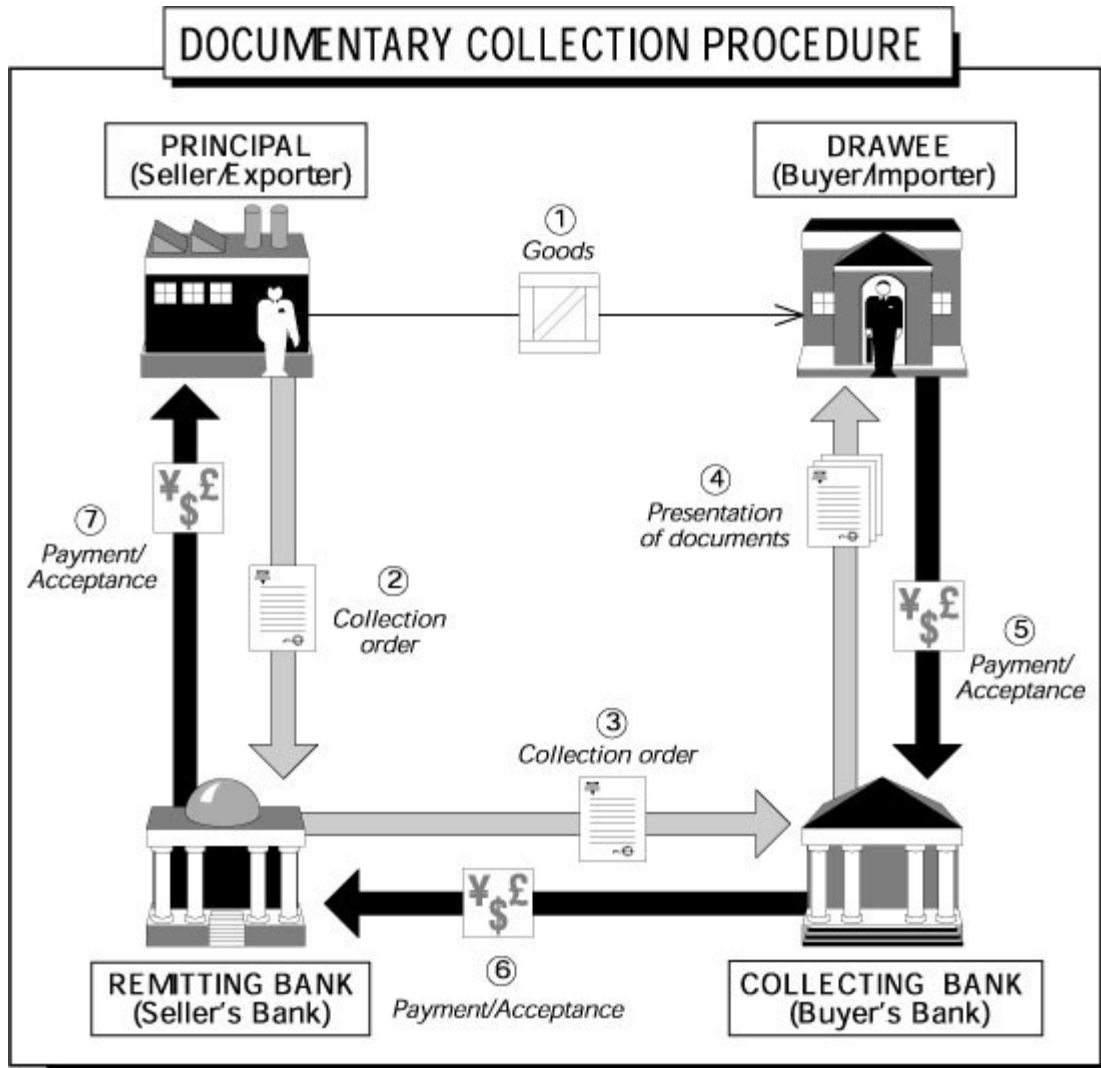
In D/P terms, the collecting bank releases the documents to the buyer only upon full and immediate cash payment. The buyer must pay the presenting /collecting bank the full payment in freely available funds in order to take possession of the documents. This type of collection offers the greatest security to the seller.

### **Documents against acceptance**

In D/A terms, the collecting bank is permitted to release the documents to the buyer against acceptance (signing) of a bill of exchange or signing of a time draft at the bank promising to pay at a later date (30, 60,90 days).

The completed draft is held by the collecting bank and presented to the buyer for payment at maturity, after which the collecting bank sends the funds to the remitting bank, which in turn sends them to the principal/seller.

The seller should be aware that he gives up title to the shipment in exchange for the signed bill of exchange that now represents his only security in the transaction.



## **Parties to a Documentary Collection**

There are four main parties to a documentary collection transaction. Note below that each party has several names. This is because businesspeople and banks each have their own way of thinking about and naming each party to the transaction.



### **THE PRINCIPAL (SELLER/EXPORTER/DRAWER)**

The principal is generally the seller/exporter as well as the party that prepares documentation (collection documents) and submits (remits) them to his bank (remitting bank) with a collection order for payment from the buyer (drawee). The principal is also sometimes called the remitter.



### **THE REMITTING (PRINCIPAL'S/SELLER'S/EXPORTER'S) BANK**

The remitting bank receives documentation (collection documents) from the seller (principal) for forwarding (remitting) to the buyer's bank (collecting/presenting bank) along with instructions for payment.



### **THE COLLECTING OR PRESENTING (BUYER'S) BANK**

This is the bank that presents the documents to the buyer and collects cash payment (payment of a bank draft) or a promise to pay in the future (a bill of exchange) from the buyer (drawee of the draft) in exchange for the documents.



### **THE DRAWEE (BUYER/IMPORTER)**

The drawee (buyer/importer) is the party that makes cash payment or signs a draft according to the terms of the collection order in exchange for the documents from the presenting/collecting bank and takes possession of the goods. The drawee is the one on whom a draft is drawn and who owes the indicated amount.

## DOCUMENTARY CREDITS

A **documentary credit** is the written promise of a bank, undertaken on behalf of a buyer, to pay a seller the amount specified in the credit provided the seller complies with the terms and conditions set in the credit.

The terms and conditions of a documentary credit revolve around two issues: (1) the presentation of documents that evidence title to goods shipped by the seller, and (2) payment.

Banks act as intermediaries to collect payment from the buyer in exchange for the transfer of documents that enable the holder to take possession of the goods.

**Documentary credits** provide a high level of protection and security to both buyers and sellers engaged in international trade. The seller is assured that payment will be made by a party independent of the buyer as long as the terms and conditions of the credit are met. The buyer is assured that payment will be released to the seller only after the bank has received the title documents called for in the credit.

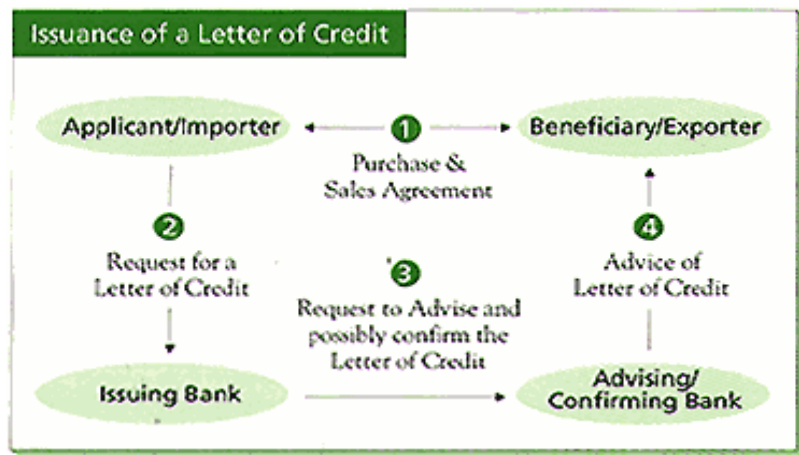
**Documentary credits** are so named because of the importance of documents in the transaction. **Letter of Credit (L/C)** is the historic and popular term used for a documentary credit because such credits were and are transmitted in the form of a letter from the buyer's bank.

## LETTERS OF CREDIT

**Letters of Credit** have been a cornerstone of international trade for many years. They continue to play a critical role in world trade today.

A letter of credit is a payment term generally used for international sales transactions. It is basically a mechanism, which allows importers/buyers to offer secure terms of payment to exporters/sellers in which a bank (or more than one bank) gets involved. **The technical term for Letter of credit is 'Documentary Credit'.**

**Letters of credit** contain the following process: (1) A payment undertaking given by the bank (issuing bank) on behalf of the buyer (applicant) (2) To pay a seller (beneficiary) a given amount of money (3) On presentation of specified documents conforming to terms and conditions set out in the letter of credit representing the supply of goods within specific time limits and presented at a specified bank.

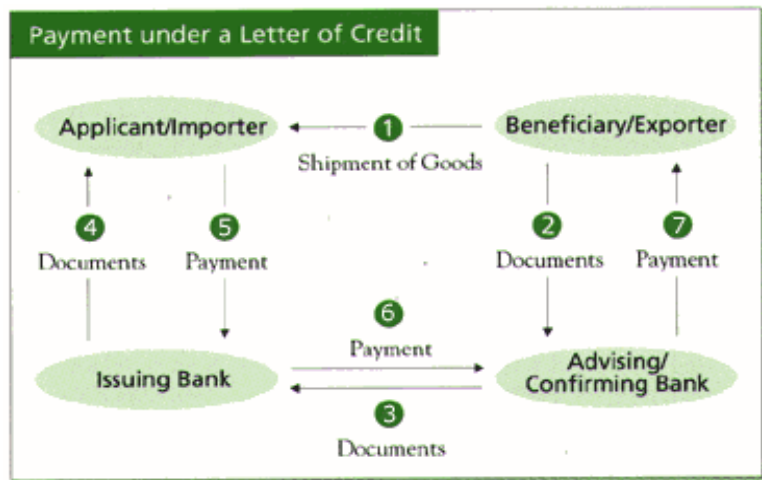


**Note:** In the diagram below, the Advising Bank is also acting as the Confirming Banks.

Letters of credit refer to and deal in documents representing the goods - not the goods. Banks do not examine the goods on behalf of the applicant of the Letter of credit, i.e. the buyer/importer.

Typically the documents requested in a Letter of Credit are the following: Commercial invoice, Transport document such as a bill of lading or airway bill, Insurance document, Inspection Certificate and Certificate of Origin. But there could be others too.

The safest and most reliable method of payment used in international trade is **documentary credit** or, in other words, letters of credit. The letter of credit takes into account the expectations of both the seller and the buyer related to performance and payment



Letters of credit (LC) could be '**irrevocable**' or '**revocable**'. The L/C usually indicates whether it is an irrevocable or revocable

### **Irrevocable Letter of Credit**

An **irrevocable LC** cannot be amended or cancelled without the consent of the issuing bank, the confirming bank, if any, and the beneficiary.

### **Revocable Letter of Credit**

A **revocable letter of credit** can be amended or cancelled by the issuing bank at any time without the consent of the beneficiary, often at the request and on the instructions of the applicant. There is no security of payment in a revocable letter of credit (L/C).

Letters of credit are governed by the provisions included in the 1993 issue and subsequent editions of publication N° 500 of the International Chamber of Commerce entitled "**Uniform Customs and Practice for Documentary Credits**".

### **Parties to a Letter of Credit**

**Accepting Bank:** The bank named in a **term** Letter of Credit on which drafts are drawn that has agreed to accept the draft.

**Advising Bank:** The bank to which the Issuing Bank sends the Letter of Credit, with instructions to notify the Exporter (Beneficiary).


**Confirming Bank:** The bank which, at the request of the Issuing Bank, adds its confirmation to the Letter of Credit.

**Exporter/ Beneficiary/ Seller:** The party that has contracted to sell goods.

**Importer/ Applicant/ Buyer:** The party that has contracted to buy goods.

**Issuing Bank:** The bank issuing the Letter of Credit at the request of its customer the Importer (Applicant) in favour of the Exporter (Beneficiary).

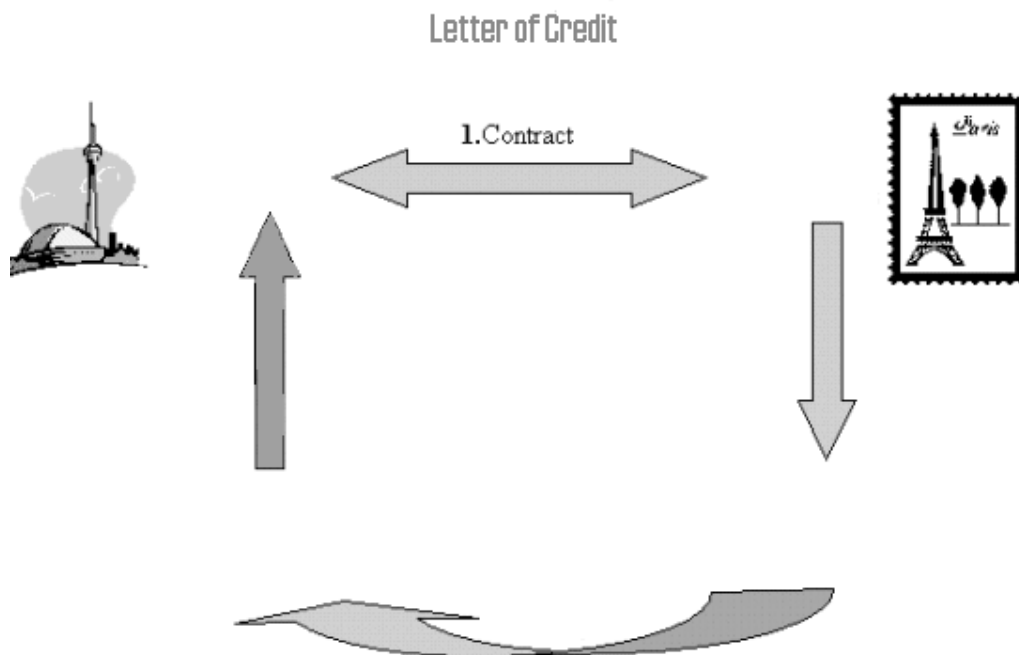
## Letter of Credit (Documentary Credit)

<b>CLARKS BANK</b> <b>INTERNATIONAL OPERATIONS</b> <b>5 MOONLIGHT BLVD.,</b> <b>EXPORT-CITY AND POSTAL CODE</b> <b>EXPORT-COUNTRY</b>	
<b>OUR ADVICE NO.</b> MB-5432	<b>ISSUING BANK REF. NO. &amp; DATE</b> SBRE-777 January 26, 2001
<b>TO</b>	UVW Exports 88 Prosperity Street East, Suite 707 Export-City and Postal Code
Dear Sirs:	
We have been requested by The Sun Bank, Sunlight City, Import-Country to advise that they have opened with us their irrevocable documentary credit number SB-87654 for account of DEF Imports, 7 Sunshine Street, Sunlight City, Import-Country in your favor for the amount of not exceeding Twenty Five Thousand U.S. Dollars (US\$25,000.00) available by your draft(s) drawn on us at sight for full invoice value accompanied by the following documents:	
<ol style="list-style-type: none"><li>1. Signed commercial invoice in five (5) copies indicating the buyer's Purchase Order No. DEF-101 dated January 10, 2001.</li><li>2. Packing list in five (5) copies.</li><li>3. Full set 3/3 clean on board ocean bill of lading, plus two (2) non-negotiable copies, issued to order of The Sun Bank, Sunlight City, Import-Country, notify the above accountee, marked "freight Prepaid", dated latest March 19, 2001, and showing documentary credit number.</li><li>4. Insurance policy in duplicate for 110% CIF value covering Institute Cargo Clauses (A), Institute War and Strike Clauses, evidencing that claims are payable in Import-Country.</li></ol>	
Covering: 100 Sets 'ABC' Brand Pneumatic Tools, 1/2" drive, complete with hose and quick couplings, CIF Sunny Port	
Shipment from	Moonbeam Port, Export-Country to Sunny Port, Import-Country
Partial shipment	prohibited
Transshipment	permitted
<ol style="list-style-type: none"><li>1. All documents indicating the Import License No. IP/123456 dated January 18, 2001.</li><li>2. All charges outside the Import-Country are on beneficiary's account.</li></ol>	
Documents must be presented for payment within 15 days after the date of shipment.	
Draft(s) drawn under this credit must be marked Drawn under documentary credit No. SB-87654 of The Sun Bank, Sunlight City, Import-Country, dated January 26, 2001	
We confirm this credit and hereby undertake that all drafts drawn under and in conformity with the terms of this credit will be duly honored upon delivery of documents as specified, if presented at this office on or before <b>March 26, 2001</b>	
Very truly yours,  Authorized Signature	
Unless otherwise expressly stated, this Credit is subject to the Uniform Customs and Practice for Documentary Credits, 1993 Revision, International Chamber of Commerce Publication No. 500.	

**\* Complete the following letter of credit using the information above.**

<b>NAME OF ISSUING BANK</b>	<b>REVOCABLE DOCUMENTARY CREDIT</b>
<b>PLACE AND DATE OF ISSUE</b>	<b>PLACE AND DATE OF EXPIRY</b> _____ at counters of advising bank
<b>APPLICANT</b>	<b>BENEFICIARY</b>
<b>Advising bank</b>	<b>Ref No.</b>
<b>Amount</b>	<b>Credit available with</b> <input type="checkbox"/> <input type="checkbox"/>
Shipment/dispatch from	By PAYMENT ACCEPTANCE
For transportation to	<b>Against presentation of documents detailed herein</b>
Draw on	
Commercial Invoice in _____ copies.	
_____ Note for goods dispatched to “_____” destination.	
Import Licence No.	
Covering _____	
Insurance Certificate covering all risks	
<b>Documents to be presented within _____ days after of issue of shipping documents.</b>	
We hereby issue this Documentary Credit in your favour. Small print. Small print. Small print. Small print. Small print. Small print. Small print.	
This document consists of 1 (one) signed page.	

**\*\* Complete this transaction using Letter of Credit with the corresponding participants and actions.**



**\*\*\* Explain the differences between a documentary collection and a documentary credit.**

## REFERENCES

Norman, S. 1983. We're in Business  
Documents and information from <http://www.export911.com>  
International Methods of Payments

**Content research and adaptation: Prof. Marina Meza**