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## Terms of Payment in International Trade

- ❑ Terms of payment in international trade:
  - (a) Cash in advance, documentary credit (D/C), salient features of a D/C to the beneficiary and applicant
  - (b) Collection, open account
- ❑ Different types of documentary credit:  
Red clause credit, revolving credit, transferable credit, back-to-back credit, standby credit, confirmed letter of credit
- ❑ Advantages and disadvantages of:
  - (a) Documentary credit to importers and exporters
  - (b) Collection to importers and exporters

## 1 Terms of Payment in International Trade

“Terms of payment” refers to the extent to which an exporter would like to be guaranteed payment before he ships the goods to the importer or to a designated place. In general, the lesser the risk to an exporter, the greater the risk to an importer. In other words, to minimize both parties’ worries, the importer and the exporter must agree to mutually acceptable payment terms before a contract is agreed. There are basically four terms of payment in international trade. The extent of the risk implied by each term is different for different parties.

These terms of payment are ranked here in ascending order of risk to the exporter. In other words, they are increasingly unfavorable to the exporter but increasingly favorable to the importer:

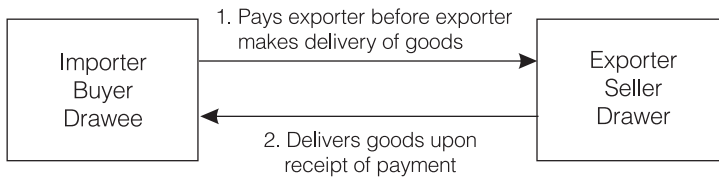
- (a) Cash in advance
- (b) Documentary credit
- (c) Documentary collection
- (d) Open account

### 1.1 Cash in Advance

Under this payment term, an importer is required to pay an exporter prior to delivery. Upon receipt of payment, the exporter delivers the goods to the importer. Cash in advance gives the exporter the greatest protection because payment is received by the exporter either before shipment or upon arrival of the goods. It enables the exporter to avoid tying up his own funds. It is most useful when the importer’s country is facing instability such as political uncertainty. Sometimes, exchange controls in the importer’s country may cause payment delays or even prohibit funds from moving out of the country. If an exporter is facing this kind of country risk, it is advisable for him to insist on trading on this term (see Figure 1.1).

In summary, an exporter may consider trading with this term under the following circumstances:

- (a) He is selling the goods that are exclusive to him in the global market;

**Figure 1.1 Cash in Advance**

- (b) When he is doubtful about the buyer's character and/or ability to pay for the goods; and
- (c) When he is exposed to the buyer's country risk, arising for example from political and/or economic instability.

## 1.2 Documentary Credit (D/C)

The meaning of a documentary embodies the following. It is:

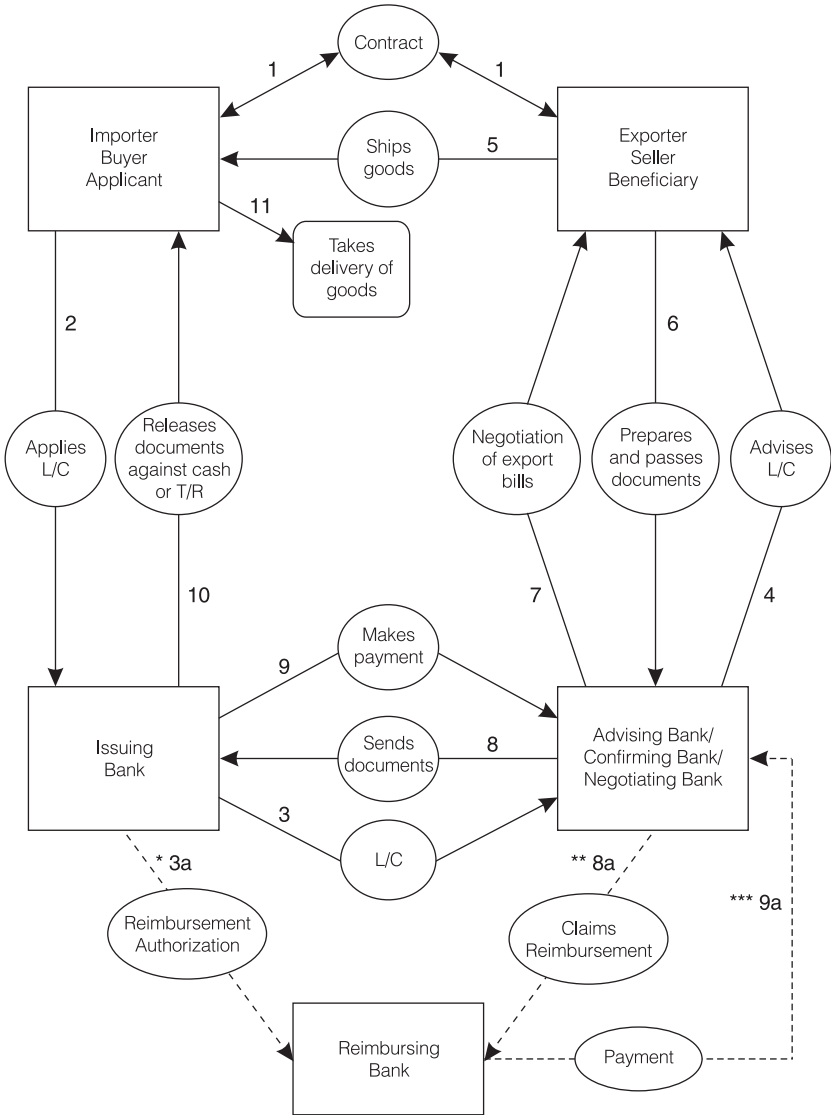
- (a) A written undertaking given by a bank, known as an issuing bank or opening bank;
- (b) To a seller, known as a beneficiary;
- (c) At the request and on the instructions of its customer (buyer), known as the D/C applicant;
- (d) To pay either at sight or at a specific future date;
- (e) A stated sum of money;
- (f) Against the delivery of shipment and submission of stipulated documents and fulfillment of all the terms and conditions in the D/C.

In other words, a D/C is a conditional payment instrument made by the issuing bank in favor of a designated beneficiary (or issuing bank and a transferee if transferable). It is especially appropriate in the following circumstances:

- (a) When the importer is not well known, the exporter selling on credit terms may wish to have the importer's promise of payment backed by his banker;
- (b) On the other hand, the importer may not wish to pay the exporter until it is reasonably certain that the merchandise has been shipped in good condition and/or in accordance with his instructions.

A D/C, in this case, can satisfy both the exporter and the importer.

Figure 1.2 Diagrammatic Explanation of Various Steps in the Operation of a Documentary Credit



Note: In the case of a reimbursement credit,  
 1. \* 3a } will be involved as well.  
 \*\* 8a }  
 2. \*\*\* 9a } will replace 9.

### 1.3 Diagrammatic Explanation of Various Steps in the Operation of a Documentary Credit

Figure 1.2 shows various steps in the operation of D/C.

- (1) The importer and exporter make a contract before the D/C is issued.
- (2) The importer applies for a letter of credit (L/C) from his banker, known as the issuing bank. He may have to use his credit lines. If he is a new customer, a margin deposit may be required: e.g., 20% deposit on credit amount.
- (3) Issuing bank opens the D/C which is channeled through its overseas corresponding bank, known as the advising bank.
- (4) Advising bank informs the exporter (the beneficiary) of the arrival of the D/C.
- (5) Exporter ships the goods to the importer or other designated place as stipulated in the D/C.
- (6) Meanwhile, he prepares his own documents and collects shipping documents or other documents (e.g., insurance policy) from relevant parties. All these documents will be sent to his banker, which is acting as the negotiating bank.
- (7) Negotiation of export bills happens when the banker agrees to provide him with finance. In this case, he obtains payment immediately upon presentation of the documents. If not, the documents will be sent to the issuing bank for payment or on an approval basis as in the next step.
- (8) Documents are sent to the issuing bank (or reimbursement bank which is the bank nominated by the issuing bank to honor reimbursement by the negotiating bank) for reimbursement or payment.
- (9) Issuing bank honors its undertaking to pay the negotiating bank on condition that the documents comply with the D/C terms and conditions.
- (10) Issuing bank releases documents to the importer when the latter makes payment to the former or against the latter's trust receipt facility.

(11) The importer takes delivery of goods upon presentation of the shipping documents.

For an example of a documentary credit, please refer to the Appendix.

#### **1.4 Salient Features of a D/C to the Beneficiary**

The main worry for the seller in an export deal is the buyer's default in payment after he has relinquished control over the goods. Assuming that the seller receives a documentary credit issued by a reputable bank, that bank stands in the shoes of the buyer to promise to pay him. The promise is in the form of a definite undertaking to pay provided that:

- (a) He ships the goods before the latest shipment date.
- (b) He prepares documentary support for his shipment. In other words, he is required to submit all the documentary evidence, either gathered from outsiders (e.g., bills of lading, insurance policy) or prepared by himself (e.g., draft, invoice, packing list).
- (c) He has fulfilled all terms and conditions as stipulated in the D/C.

As long as he has complied with the instructions in the D/C, the issuing bank (confirming bank, if any) cannot withdraw its undertaking and refuse to pay him. The promise to pay him is enshrined in the "Engagement Clause" which is found in every D/C.

Despite the above promise, an exporter, upon receipt of a D/C, must make sure that he can subsequently produce all the documents in compliance with credit terms and conditions. Failure to comply with any term, no matter how trivial the inconsistencies may be, constitutes valid grounds for withholding payment. At any time, the exporter must bear in mind that the undertaking given by the issuing bank is conditional. Such conditions are clearly laid down in the Engagement Clause to the effect that the issuing bank engages with drawers and/or bona fide holders that drafts drawn in conformity with the terms of the credit will be duly honored.

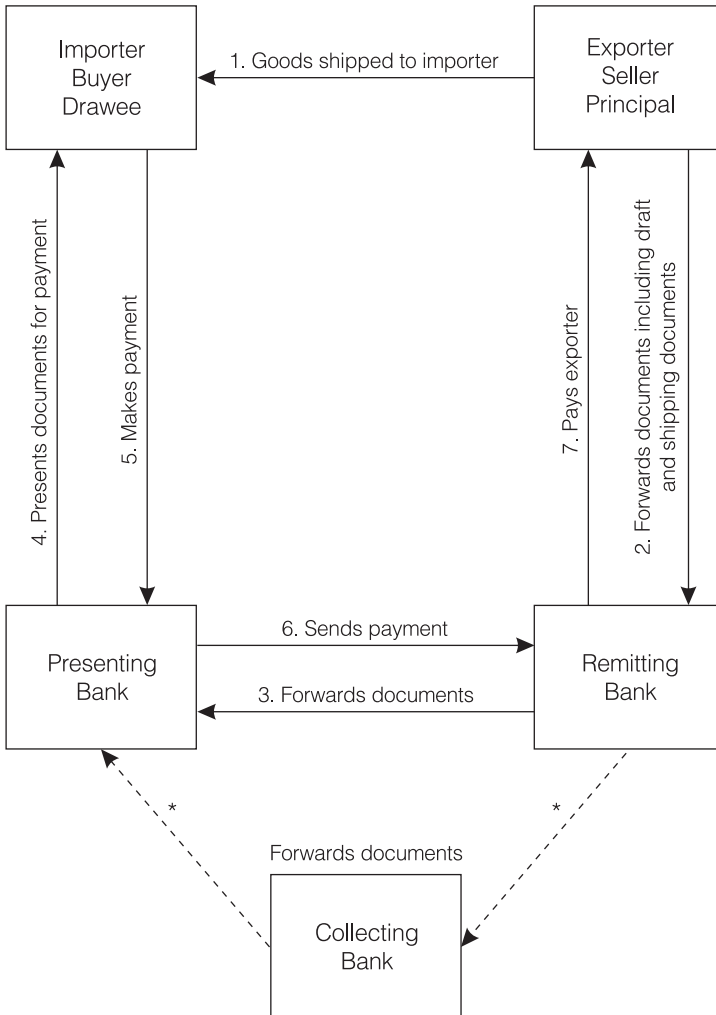
#### **1.5 Salient Features of a D/C to the Applicant**

For a beneficiary, it seems that a D/C is relatively more favorable to him compared to a collection. For an applicant, a D/C, meanwhile has much

value to him. To a buyer, his utmost concern is the goods, in terms of their quality and arrival time. To ensure that the quality of the goods ordered is up to his standard, he may insert in the D/C a clause calling for an inspection certificate (or even public surveyor's report with loading supervision). He may stipulate in the D/C the latest shipment date to ensure that the goods have been shipped before a stipulated date. Actually, a buyer can, via the issuing bank, add in the D/C any amendment to the terms and conditions which he would like the seller to fulfil before the latter gets paid (provided that the beneficiary accepts such terms).

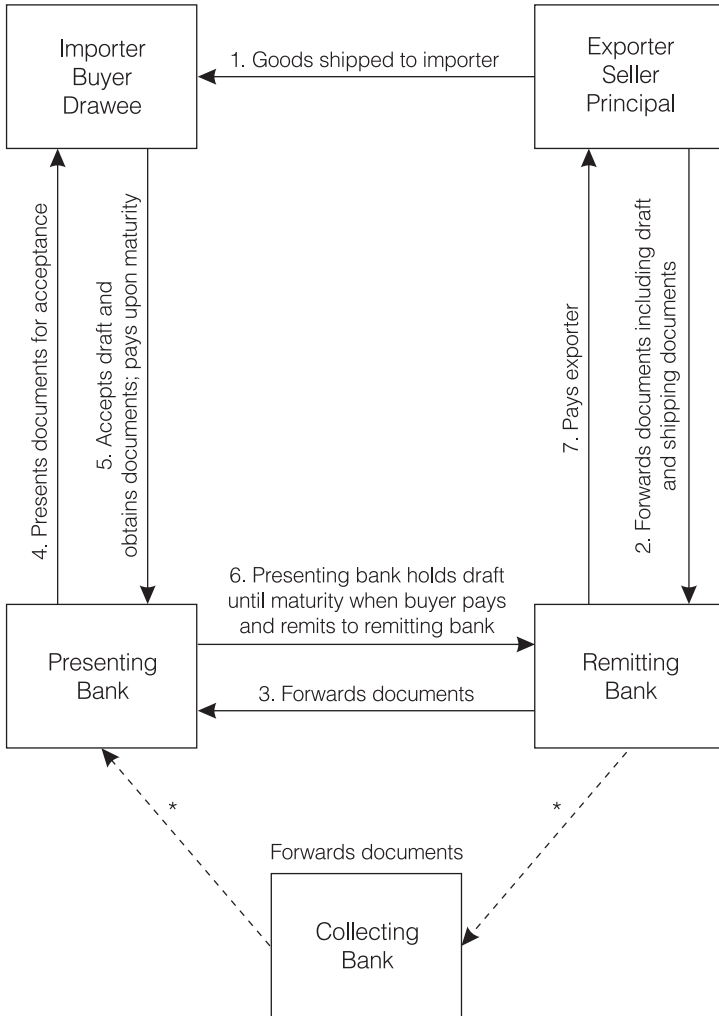
Despite the above protection, an applicant should remember that a D/C is a relationship (or contractual relationship as some lawyers said) made between the issuing bank and the beneficiary. According to Uniform Customs and Practice for Documentary Credit (UCP 600), a D/C is separated from the underlying sales and purchase contract made between the buyer and seller. This concept remains unchanged even if any reference whatsoever to such a contract is included in the D/C. Therefore, any disputes in the contract cannot invalidate the definite undertaking of the issuing bank to pay the beneficiary if documents presented comply with the terms and conditions of the D/C. In the worst scenario, even when an exporter has shipped inferior goods, the issuing bank is still obliged to pay the beneficiary if documents presented conform to the D/C. In this awkward situation, there is little the issuing bank can do to help the applicant as, according to UCP 600, Article 4, banks deal with documents, and not with goods and services.

Unless the applicant is granted an injunction to restrain the issuing bank from paying the beneficiary in the above case, the opening bank has to pay the seller. However, injunctions of this type are rarely granted by the court. In *Hamzeh Malas & Sons v British Imex Industries Limited*, an injunction was refused. In *Discount Records Limited v Barclays Bank Limited*, it was held that a judge tends to be slow to interfere with a banker's D/C. Both cases reveal that there is little inclination on the part of the courts to interfere in D/C transactions. This is quite understandable as D/C is an instrument to facilitate trade, not to police trade.

**Figure 1.3 Documentary Collections: Documents against Payment (D/P)**

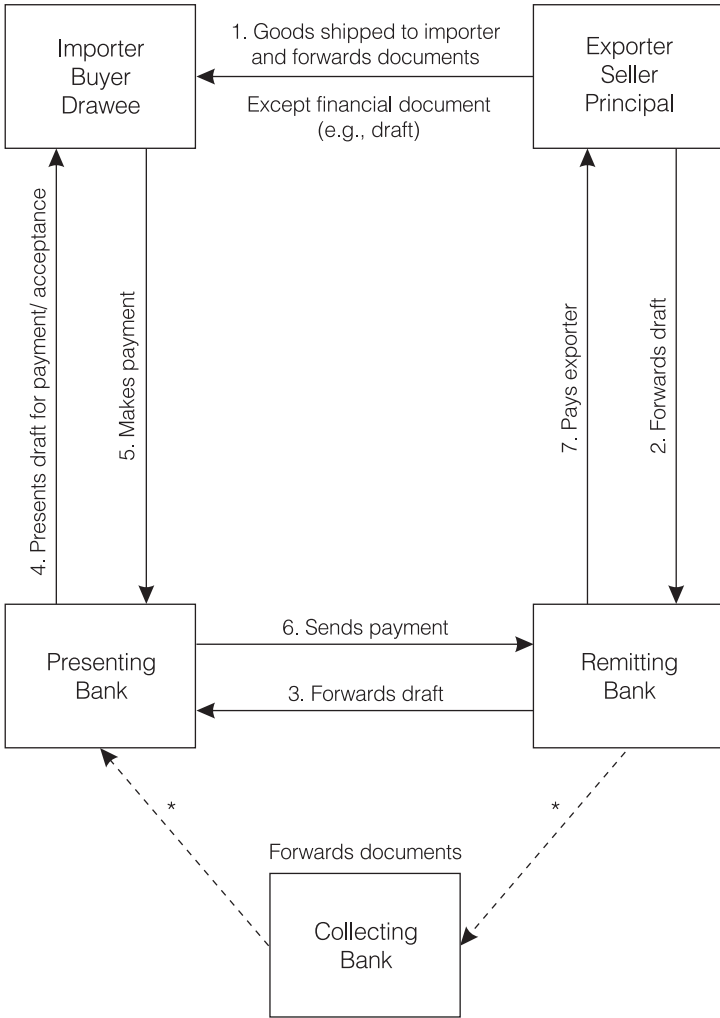
\* As an alternative to step 3

**Figure 1.4 Documentary Collections: Documents against Acceptance (D/A)**



\* As an alternative to step 3

Figure 1.5 Clean Collections



\* As an alternative to step 3