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**Trade Tutorials**

IMPORT TRADE FINANCE

International trade continues to grow every year as nations expand their global sales and new nations join in. Today, over 225 nations are active in trade resulting in over $9 Trillion dollars in global business every year. Trade related financial services have developed and expanded in depth, complexity and effectiveness to support the expansion of world trade. Many trade finance options are now available. However, in North America the Small to Mid- sized Enterprises (SME) trading community is relatively unaware of many of the more sophisticated and/or the sources of the more effective trade finance services. Traders commonly believe that the major international banks are the primary providers of these services. For the SME community this is no longer the case. A fragmented market of trade finance organizations has grown over the last 20 years to fill the void left by the major international banks which retreated from trade finance service in the 1980's.

This tutorial is intended as an introduction to import trade transactions settlement terms and the key types of import trade finance. Understanding these options will help businesses select the most appropriate and effective import trade financing to fit a company's unique financial circumstances.

For additional information and assistance, TradePort makes available the services of Trade & Export Finance Online (TEFO), a trade finance service provider for international trade businesses. TEFO structures trade deals and provides access to a variety of trade finance resources and capital for small and mid-sized enterprise companies (SMEs), their buyers, suppliers and partners worldwide. Find out more [about TEFO](http://www.tefo.org/).

Introduction - Importing

As a result of major changes during the last two decades in the structure of the global economy, the US has largely recognized that liberal trade policies are on balance good for domestic consumers, workers, and businesses alike. The encouragement of imports has generally led to the vitalization of economies in other countries and, in return, greater de- mand for US products. In addition, imported products offer US consumers a wide range of choices of products to buy, while the competition between foreign and US products helps keep domestic prices down. Because US imports have outpaced exports during the last two decades, the current US focus is on increasing exports and opening new markets abroad for US products. Nevertheless, the US remains the world's top import market.

Settlement of Import Trade Transactions

Various trade terms are available to balance the trade transaction risks for both the importer and exporter. As an importer/distributor you will wish to negotiate the most favorable terms of purchase with your overseas supplier. You will negotiate terms of purchase to ensure that you receive your import purchase in the right quantity, right quality, at the right price and on time. At the same time you can expect your overseas supplier to negotiate terms that will minimize potential risks - particularly the risk of nonpayment. Import trade transactions can be structured in a number of ways. The structure used in a specific transaction reflects how well the participants know each other, the countries involved, and the competition in the market.

The most common terms of purchase are as follows:

1. Consignment Purchase
2. Cash-in-Advance (Pre-Payment)
3. Down Payment
4. Open Account
5. Documentary Collections
6. Letters of Credit

1. Consignment Purchase

In a consignment purchase arrangement, the importer/distributor makes payment to the overseas supplier only after sales to end user is made and payment received. Consignment purchase terms can be the most advantageous to an importer/distributor. It is also considered the most risky term for the overseas supplier.

2. Cash-in-Advance (Pre-Payment)

Under these terms of purchase, the importer must send payment to the supplier prior to shipment of goods. The importer must trust that the supplier will ship the product on time and that the goods will be as advertised. Basically, Cash-in- advance terms place all of the risk with the importer/buyer. An Importer may find his seller requiring prepayment in the following circumstances:

(1) The Importer has not been long established.

(2) The Importer's credit status is doubtful, unsatisfactory and/or the country political and economic risks are very high.

(3) The product is in heavy demand and the seller does not have to accommodate an Importer's financing request in order to sell the merchandise.

There are advantages and disadvantages with Cash in Advance terms. This method of payment involves direct Buyer/Seller contact without commercial bank involvement and is therefore inexpensive. However, the Buyer faces a very high degree of payment risk while retaining little recourse against the Seller for poor quality goods or incorrect or incomplete documentation. In addition there is a possibility that an unscrupulous Seller may never deliver the goods even though the Buyer has made full prepayment. Although pre-payment terms eliminates virtually all risks to the seller these terms can place the seller at a competitive disadvantage.

3. Down Payment

The Buyer pays the Seller a portion of the cost of the goods "in advance" when the contract is signed or shortly thereafter. There are advantages and disadvantages of down payment terms. The down payment method induces the Seller to begin performance without the Buyer paying the full agreed price in advance. The disadvantage is that there is a possibility the Seller may never deliver the goods even though it has the Buyer's down payment. This option must be combined with one of the other options to cover the full cost of goods.

4. Open Account

Unsecured Open Account terms allows the importer to make payments at some specific date in the future and without the buyer issuing any negotiable instrument evidencing his legal commitment to pay at the appointed time. These terms are most common when the importer/buyer has a strong credit history and is well-known to the seller. The buyer may also be able to demand open account sales when there are several sources from which to obtain the seller's product or when open account is the norm in the buyer's market. This mechanism offers the seller no protection in case of non-payment. However, an exporter can structure his open account sale transaction to minimize the risk of non-payment. For example, the exporter can reduce the repayment period and retain title to the goods until payment is made. Even then, it is difficult to enforce this especially if the goods have been either resold by the buyer or consumed in some other processing activity. Despite the dangers, open account terms with extended dating are becoming more common in international trade. Exporters that offer open account terms are increasingly obtaining credit insurance to mitigate the potential open account credit risks.

There are many advantages and disadvantages of open account terms. Under an open account payment method, title to the goods usually passes from the Seller to the Buyer prior to payment and subjects the Seller to risk of default by the Buyer. Furthermore, there may be a time delay in payment, depending on how quickly documents are exchanged between Seller and Buyer. While this payment term involves the fewest restrictions and the lowest cost for the Buyer, it also presents the Seller with the highest degree of payment risk and is employed only between a Buyer and a Seller who have a long-term relationship involving a great level of mutual trust.

5. Documentary Collections

Collections terms offer an important bank payment mechanism that can serve the needs of both the exporter and importer. Under this arrangement, the sale transaction is settled by the bank through an exchange of documents, thus enabling simultaneous payment and transfer of title. The importer is not obliged to pay for goods prior to shipment and the exporter retains title to the goods until the importer either pays for the value of the draft upon presentation (sight draft) or accept to pay at a later date and time (term draft). The principal obligations of parties to a documentary collection arrangement are set out in the guidelines of the "Uniform Rules for Collection" (URC) drafted by the Paris- based International Chamber of Commerce.

Role of Banks in Documentary Collections

Banks play essential roles in transactions utilizing documentary collections as follows:

**Remitting Bank:** This is the exporter's bank and acts as the exporter's agent in collecting payment from the importer. It basically transmits the exporter's instructions along with the terms of the draft to the importer's bank. The bank does not assume any risks and does not undertake to pay the exporter but can influence to obtain settlement of a bill.

**Collecting Bank:** This is the importer's bank and takes up the role of ensuring that the buyer pays (or accept to pay) for the goods before shipping documents are released to him.

Generally, the banks in the transaction control the flow and transfer of documents and regulate the timing of the transaction. They must ensure the safety of the documents in their possession but are not responsible for their validity and accuracy.

Variations of Documentary Collections

This form of trade settlement comes in two forms - Documents against Payment and Documents against Acceptance. Each of these forms of collections may be either "clean" (financial document alone) or "documentary" (commercial documents with or without a financial document). A financial document is a check or a draft; a commercial document is a bill of lading or other shipping document. A clean collection involves dollar-denominated drafts and checks presented for collection to U.S. banks by their foreign correspondents. In a documentary collection, the exporter draws a draft or bill of exchange directly on the importer and presents this draft, with shipping documents attached, to the bank for collection.

Cash against documents/Sight Drafts

In a transaction on documents against payment, the exporter releases the shipping documents to the importer only on payment for the goods. In this arrangement, the exporter retains title to goods on board and may decide to refuse their discharge if payments are not received. This arrangement which demands the buyer's immediate payment of the exporter relies on a sight draft drawn on the buyer.

Document against Acceptance/Term Drafts

An exporter may decide to release shipping documents to a buyer on acceptance of the exporter's drafts. In this case, the importer is under an obligation to pay at a future date. This method satisfies both parties since the importer is able to receive the goods before payment and the exporter has a firm assurance (but no guarantee) that payment will come at a specified future date.

Flow of Transaction in a Documentary Collections Deal

1. Exporter/drawer and Importer/drawee agree on a sales contract, including payment to be made under a Documentary Collection.
2. The Exporter ships the merchandise to the foreign buyer and receives in exchange the shipping documents.
3. Immediately thereafter, the Exporter presents the shipping documents with detailed instructions for obtaining payment to his bank (Remitting bank).
4. The Remitting bank sends the documents along with the Exporter's instructions to a designated bank in the importing country (Collecting Bank).
5. Depending on the terms of the sales contract, the Collecting Bank would release the documents to the importer only upon receipt of payment or acceptance of draft from the buyer. (The importer will then present the shipping documents to the carrier in exchange for the goods).
6. Having received payment, the collecting bank forwards proceeds to the Remitting Bank for the exporter's account.
7. Once payment is received, the Remitting bank credits the Exporter's account, less its charges.

Advantages and disadvantages of Documentary Collection

The major advantage of a "cash against documents" payment method for the Buyer is the low cost, versus opening a Letter of Credit. The advantage for the Seller is that he can receive full payment prior to releasing control of the documents, although this is offset by the risk that the Buyer will, for some reason, reject the documents (or they will not be in order). Since the cargo would already be loaded (to generate the documents), the Seller has little recourse against the Buyer in cases of non-payment. A payment against documents arrangement involves a high level of trust between the Seller and the Buyer and should be adopted only by parties well known to each other.

Risks in Documentary Collections

For the Exporter

If it is a sight draft, the exporter will reduce the risk of non-payment but will not eliminate it totally since the importer may not be in a position to pay for the goods or may not be able to procure sufficient foreign exchange to make the payment. In this case the exporter may be forced to either call back the goods or negotiate sale to some other interested party, which may be at a reduced rate.

In the case of term draft, the risk to the exporter is higher since the foreign buyer will take possession of the goods and may not pay at due date, forcing therefore the exporter to try and collect payment from the foreign buyer in the foreign buyer's home country.

For the Importer

The importer faces the risk of paying for goods of sub-standard quality or even with shortages. In such a circumstance, it would take some time to get refunds from the exporter. It could also happen that the exporter refuses to make refunds, leading the importer to lengthy legal proceedings.

When to use Documentary Collections?

Since Documentary Collections transactions entail some measure of trust, it advisable to use the mechanism when the following conditions apply:

1. When the exporter and importer have a well established relationship
2. When there is little or no threat of a total loss resulting from the buyer's inability or refusal to pay
3. When the foreign political and economic situation is stable
4. When a letter of credit is too expensive or not allowed

6. Letter of Credit

A letter of credit is the most widely used trade finance instrument in the world. It has been used for the last several hundred years and is considered a highly effective way for banks to transact and finance export and import trade. The letter of credit is a formal bank letter, issued for a bank's customer, which authorizes an individual or company to draw drafts on the bank under certain conditions. It is an instrument through which a bank furnishes its credit in place of its customer's credit. The bank plays an intermediary role to help complete the trade transaction. The bank deals only in documents and does not inspect the goods themselves.

Therefore a letter of credit can not prevent an importer from being taken in by an unscrupulous exporter.

The Uniform Commercial Code and the Uniform Customs and Practices for Documentary Credits published by the United States Council of the International Chamber of Commerce set forth the covenants governing the issuance and negotiation of letters of credit. All letters of credit must be issued:

* In favor of a specific beneficiary,
* for a specific amount of money,
* in a form clearly stating how payment to the beneficiary is to be made and under what conditions, and
* with a specific expiration date.

Role of Banks in Documentary Letters of Credit

Compared to other payment forms, the role of banks is substantial in documentary Letter of Credit transactions.

* The banks provide additional security for both parties in a trade transaction by playing the role of intermediaries. The issuing bank working for the importer and the advising bank working for the exporter.
* The banks assure the seller that he would be paid if he provides the necessary documents to the issuing bank through the advising bank.
* The banks also assure the buyer that his money would not be released unless the shipping documents evidencing proper and accurate shipment of goods are presented.

Types of Letters of Credit - 1

A letter of credit may be of two forms: Revocable or Irrevocable

Revocable L/C

This is one that permits amendments or cancellations any time by the issuing bank. This means that the exporter can not count on the terms indicated on the initial document until such a time as he is paid. This form is rarely in use in modern day trade transactions.

Irrevocable L/C

Such a letter of credit cannot be changed unless both buyer and seller agree to make changes. Usually an L/C is regarded as irrevocable unless otherwise specified. Therefore, in effect, all the parties to the letter of credit transaction, i.e. the issuing bank, the seller and the buyer, must agree to any amendment to or cancellation of the letter of credit. Irrevocable letters of credit are attractive to both the seller and the buyer because of the high degree of involvement and commitment by the bank(s). By the 1993 revision of the UCP, credits are deemed irrevocable, unless there is an indication to the contrary.

Types of Letters of Credit - 2

A letter of credit may be of two forms: Confirmed or Unconfirmed.

Confirmed L/C

If the exporter is uncomfortable with the credit risk of the issuing bank or if the country where the issuing bank is situated is less developed or politically unstable, then as an extra measure, the exporter can request that the L/C to be confirmed. This would add further comfort to the transaction; an exporter may request that the L/C be confirmed. This is generally by a first class international bank, typically the advising bank (now the Confirming Bank). This bank now takes the responsibility of making payments if no remittance is received from the issuing bank on due date.

Unconfirmed L/C

In contrast, an unconfirmed credit does not require the advising bank to add its own payment undertaking. It therefore leaves the liability seller with the issuing bank. The advising bank is merely as a channel of transmission of documents and payment.

Methods of Settlement

The documentary letters of credit can be opened in two ways:

1. **Sight Letter of Credit**: A Sight Letter of Credit is a credit in which the seller obtains payment upon presentation of documents in compliance with the terms and conditions.
2. **Time Draft or Usance Letter of Credit**: A Time Draft or Usance Letter of Credit is a credit in which the seller will be paid a fixed or determinable future time. A time Draft or usance letter of credit calls for time or usance drafts to be drawn on and accepted by the buyer, provided that documents are presented in good order. The buyer is obligated to pay the face amount at maturity. However, the issuing bank's obligation to the seller remains in force until and unless the draft is paid.

Financing Importers through Letters of Credit

While the L/C can be used as a payment mechanism, it can also be used to provide financing to the applicant (importer). Deferred and Acceptance credits (i.e. term credits) are considered to be financing instruments for the importer/buyer. Both payment structures provide the importer/buyer the time opportunity to sell the goods and pay the amount due with the proceeds.

Under the Deferred Payment structure payment is made to the seller at a specified future date, for example 60 days after presentation of the documents or after the date of shipment (i.e. the date of the bill of lading).

Under the Acceptance structure the exporter is required to draw a draft (bill of exchange) either on the issuing or confirming bank. The draft is accepted by the bank for payment at a negotiated future fixed date. This gives the importer the potential time needed to sell the product and pay off the Acceptance at due date. For example, payment date under an acceptance credit may be at sight or after 90 days from presentation of the documents or from the shipment of goods.

Special Note on Documentary Letters of Credit

Documentary Letters of Credit hinge much on the appropriateness of documents. Banks involved in the transaction do not need to know about the physical state of the goods in question but concern themselves only with documents. If proper documents are presented, banks will make payment whether or not the actual goods shipped comply with the sales contract.

Thus, special care needs to be taken in preparation of the documents since a slight omission or discrepancy between required and actual documents may cause additional costs, delays and seizures or even total abortion of the entire deal.

(1) Documents associated with an L/C

Documents are the key issue in a letter of credit transaction. Banks deal in documents, not in goods. They decide on the basis of documents alone whether payment, negotiation, or acceptance is to be effected. A single transaction can require many different kinds of documents. Most letter of credit transactions involve a draft, an invoice, an insurance certificate, and a bill of lading. Transactions can culminate in sight drafts or acceptances. Because letter of credit transactions can be so complicated and can involve so many parties, banks must ensure that their letters are accompanied by the proper documents, that those documents are accurate, and that all areas of the bank handle them properly.

The four primary types Documents associated with an L/C are as follows:

* Transfer documents
* Insurance documents
* Commercial documents
* Other documents

Transfer documents are issued by a transportation company when moving the merchandise from the seller to the buyer. The most common transfer document is the Bill of lading. The bill of lading is a receipt given by the freight company to the shipper. A bill of lading serves as a document of title and specifies who is to receive the merchandise at the designated port (as specified by the exporter). It can be in nonnegotiable form (straight bill of lading) or in negotiable form (order bill of lading). In a straight bill of lading, the seller (exporter) consigns the goods directly to the buyer (importer). This type of bill is usually not desirable in a letter of credit transaction, because it allows the buyer to obtain possession of the merchandise without regard to any bank agreement for repayment. A straight bill of lading may be more suitable for prepaid or open account transactions. With an order bill of lading the shipper can consign the goods to the bank, which retains title until the importer acknowledges liability to pay. This method is preferred in documentary or letter of credit transactions. The bank maintains control of the merchandise until the buyer completes all the required documentation. The bank then releases the bill of lading to the buyer, who presents it to the shipping company and gains possession of the merchandise.

Insurance documents, normally an insurance certificate, cover the merchandise being shipped against damage or loss. The terms of the merchandise contract may dictate that either the seller or the buyer obtain insurance. Open policies may cover all shipments and provide for certificates on specific shipments.

Commercial documents, principally the invoice, are the seller's description of the goods shipped and the means by which the buyer gains assurances that the goods shipped are the same as those ordered. Among the most important commercial documents are the invoice and the draft or bill of exchange. Through the invoice, the seller presents to the buyer a statement describing what has been sold, the price, and other pertinent details. The draft supplements the invoice as the means by which the seller charges the buyer for the merchandise and demands payment from the buyer, the buyer's bank, or some other bank. Although a draft and a check are very similar, the writer of a draft demands payment from another party's account.

In a letter of credit, the draft is drawn by the seller, usually on the issuing, confirming, or paying bank, for the amount of money due under the terms of the letter of credit. In a collection, this demand for payment is drawn on the buyer. The customary parties to a draft, which is a negotiable instrument, are the drawer (usually the exporter), the drawee (the importeror a bank), and the payee (usually the exporter), who is also the endorser. A draft can be "clean" (an order to pay) or "documentary" (with shipping documents attached).

A draft that is negotiable:

* Is signed by the maker or drawer
* Contains an unconditional promise to pay a certain sum of money
* Is payable on demand or at a definite time
* Is payable to order or to bearer
* Is two-name paper
* May be sold and ownership transferred by endorsement to the "holder in due course."

The holder in due course has recourse to all previous endorsers if the primary obligor (drawee) does not pay. The seller (drawer) is the secondary obligor if the endorser does not pay. The secondary obligor has an unconditional obligation to pay if the primary obligor and the endorser do not, therefore the term "two-name paper."

Other documents include certain official documents that may be required by governments in order to regulate and control the passage of goods through their borders. Governments may require inspection certificates, consular invoices, or certificates of origin. Transactions can entail notes and advances collateralized by trust receipts or warehouse receipts.

Import Trade Finance Services

**Pre-Import Working Capital Program for Importers** to fund the purchase of materials, services, and labor to fulfill import sales contracts. Find out more about the [Pre-Import Working Capital Program](http://www.tefo.org/)

**Accounts Receivable Factoring for Importers** provides for the purchase at discount of an Importer's accounts receivable representing sales to pre-approved North American Buyers. Find out more about [Accounts Receivable Factoring for Importers](http://www.tefo.org/).

**Asset Based Line of Credit for Importers** provides financing of imports by leveraging a company's equity in current and fixed assets advancing funds based on a percentage of the firm's qualified receivables, inventory and other assets. Find out more about [Asset-Based Financing](http://www.tefo.org/).

**Inventory Financing for Importers** provides for the financing of Importer's Inventory pre-sold to credit worthy North American Buyers. Find out more about [Inventory Financing](http://www.tefo.org/).

**Purchase Order Financing for Importers** provides a solution to finance the purchase or manufacture of goods that have been pre-sold to an overseas creditworthy customer. Find out more about [Purchase Order Financing for Importers](http://www.tefo.org/).

**Purchase Order Confirmation Facility** provides an overseas supplier the assurance that they will be paid for their shipment of product to an Importer prior to the importer receiving any funds from the proceeds of an Accounts Receivable finance credit facility. Find out more about the [Purchase Order Confirmation (POC) facility](http://www.tefo.org/).

**Equipment Leasing for Importers** provides the professional expertise to facilitate the direct importation and lease of equipment to be acquired by North American companies. Find out more about [Import Lease Financing](http://www.tefo.org/).

**Import Letters of Credit** provide importers the most widely used and accepted international trade payment mechanism and finance instrument. By structuring Letter of Credit terms to allow Deferred Payment or Trade Acceptance an L/C can be utilized to provide financing to the importer. Find out more about [Import Letter of Credit Financing](http://www.tefo.org/).

**Accounts Receivable Management Service** provides Importers with on-line access to account information, A/R analysis reports, critical credit analyses, monitoring of credit limits, collection, receiving, posting, and depositing payments. Find out more.

**Debt Collection Program for Overseas Suppliers and Importers** providing professional legal collections of past due debt obligations from Buyers in North America. Find out more.

**For more advice and services throughout the world on legal and tax matters, correspond with an** [**international tax specialist**](http://www.allenbarron.com/)**!**