Payment Terms and UCP 600

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The Trade Relationship

- The nature of the relationship between the exporter and the importer is critical to understanding the methods for import-export financing utilized in industry.
- There are three categories of relationships (see next exhibit):
  - Unaffiliated unknown
  - Unaffiliated known
  - Affiliated (sometimes referred to as *intra-firm trade*)
- The composition of global trade has changed dramatically over the past few decades, moving from transactions between unaffiliated parties to affiliated transactions.

Alternative International Trade Relationships

Exporter

Importer is ….

Unaffiliated Unknown Party

A new customer which with exporter has no historical business relationship

Requires:
1. A contract
2. Protection against non-payment

Unaffiliated Known Party

A long-term customer with which there is an established relationship of trust and performance

Requires:
1. A contract
2. Possibly some protection against non-payment

Affiliated Party

A foreign subsidiary or affiliate of exporter

Requires:
1. No contract
2. No protection against non-payment

The Trade Dilemma

- International trade (i.e. between an importer and exporter) must work around a fundamental dilemma:
  - They live far apart
  - They speak different languages
  - They operate in different political environments
  - They have different religions
  - They have different standards for honoring obligations
- In essence, there could be distrust, and clearly the importer and exporter would prefer two different arrangements for payment/goods transfer

The Mechanics of Import and Export

1st: Exporter ships the goods

Importer — *Importer Preference* — **Exporter**

2nd: Importer pays after goods received

1st: Importer pays for goods

Importer — *Exporter Preference* — **Exporter**

2nd: Exporter ships the goods after being paid

The Trade Dilemma

- The fundamental dilemma of being unwilling to trust a stranger in a foreign land is solved by using a highly respected bank as an intermediary.
- The following exhibit is a simplified view involving a *letter of credit* (a bank’s promise to pay) on behalf of the importer.
- Two other significant documents are an *order bill of lading* and a *sight draft*.

The Bank as the Import/Export Intermediary

Importer

1st: Importer obtains bank's promise to pay on importer's behalf.

Bank

2nd: Bank promises exporter to pay on behalf of importer.

Exporter

3rd: Exporter ships 'to the bank' trusting bank's promise.

4th: Bank pays the exporter.

5th: Bank 'gives' merchandise to the importer.

6th: Importer pays the bank.

Benefits of the System

- The system (including the three documents discussed) has been developed and modified over centuries to protect both importer and exporter from:
  - The risk of non-completion
  - Foreign exchange risk
  - To provide a means of financing

Elements of an Import/Export Transaction

- Each individual trade transaction must cover three basic elements: description of goods, prices, and documents regarding shipping and delivery instructions.

Contracts:

- An import or export transaction is by definition a contractual exchange between parties in two countries that may have different legal systems, currencies, languages, religions or units of measure
- All contracts should include definitions and specifications for the quality, grade, quantity, and price of the goods in question

Elements of an Import/Export Transaction

Prices:

- Price quotations can be a major source of confusion
- Price terms in the contract should conform to published catalogs, specify whether quantity discounts or early payment discounts are in effect, and state whether finance charges are relevant in the case of deferred payment, and should address other relevant fees or charges

Elements of an Import/Export Transaction

- Documents:
  - ***Bill of lading*** – issued to the exporter by a common carrier transporting the merchandise. It serves three purposes: a receipt, a contract, and a document of title
  - ***Commercial invoice*** – issued by the exporter and contains a precise description of the merchandise (also indicates unit prices, financial terms of the sale etc.)
  - ***Insurance documents*** – specified in the contract of sale and issued by insurance companies (or their agents)
  - ***Consular invoices*** – issued in the exporting country by the consulate of the importing country
  - ***Packing lists***

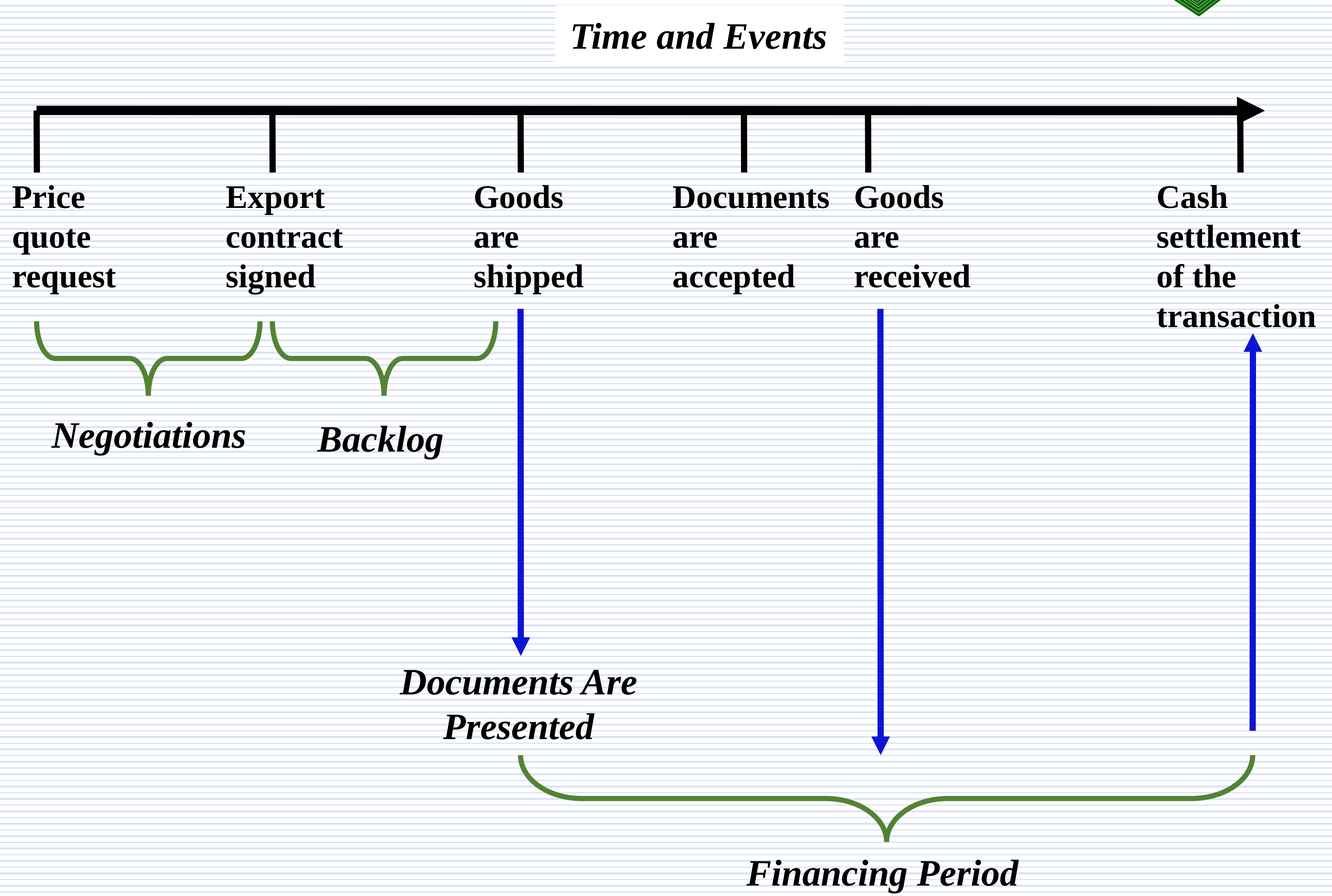
International Trade Risks

- The following exhibit illustrates the sequence of events in a single export transaction.

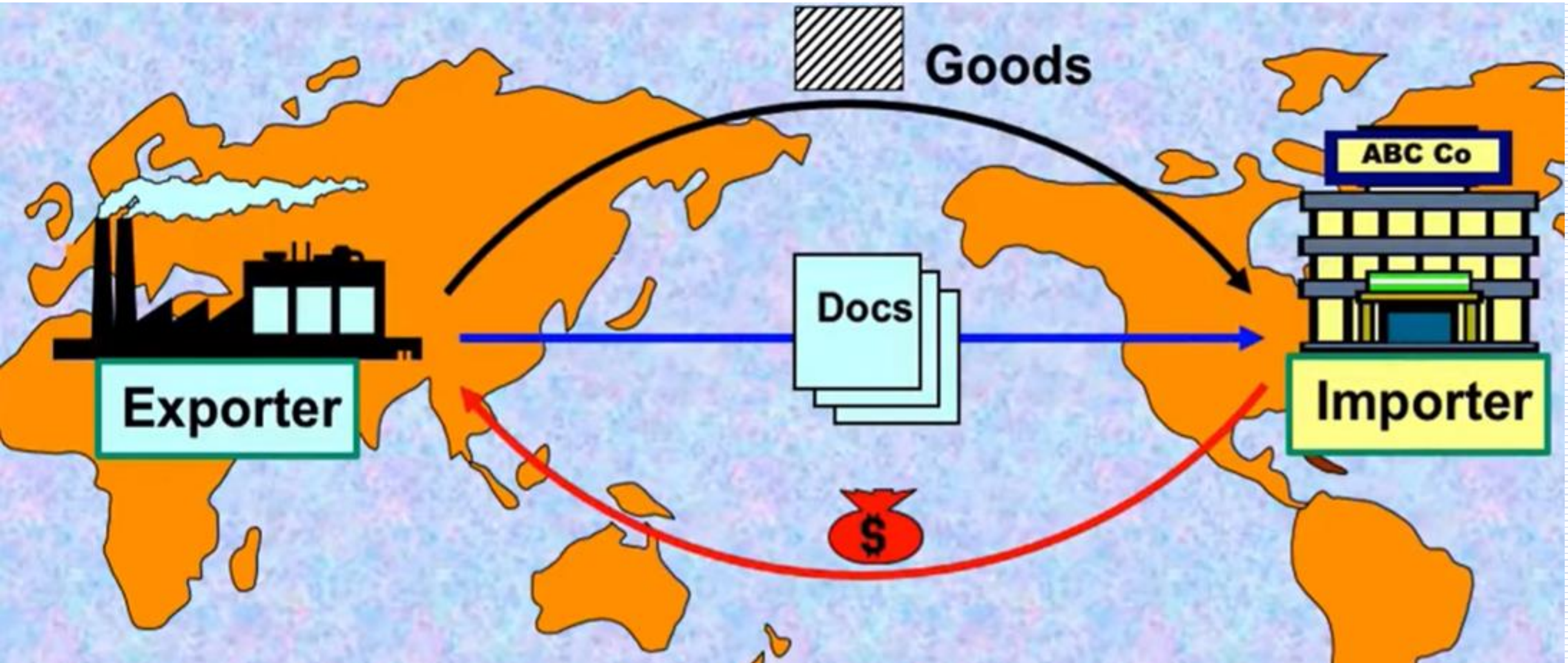
- From a financial management perspective, the two primary risks associated with an international trade transaction are *currency risk* (currency denomination of payment) and *risk of non-completion* (timely and complete payment).

- The risk of default on the part of the importer is present as soon as the financing period begins.

The Trade Transaction Time-Line and Structure



Methods of Payment



- Open Account
- Advance Payment
- Documentary Collection
- Documentary Credit

Bills

- Documents are necessary and integral to most trade transactions, serving wide ranging requirements
- They are generated for transfer of possession or ownership, statutory obligations, regulatory requirements and so on.
- A set of documents relating to a particular shipment are called as *shipping documents*
- A compelte set of documents (bills) relating to a particular shipment may be loosely termed as bills for collection, export bills, usance bills, import bill or LC bill etc.
- A set of these 'bills' may include bills of exchange, commercial invoice, transport documents, quality certificate, packing list, weight list, certificate of origin, phytosanitary certificates and so on

Documents Direct to Importer

- When the goods are consigned directly to the buyer to enable it to take delivery of consignment, commercial banking system need not be used
- Shipping documents can be directly dispatched by seller to buyer
- Commercial banking system may be used but only for remittance of the proceeds
- Transactions of this type are mainly used where settlement is:
  a. Against advance payment/Prepayment
  b. On open account
  c. Through escrow
  d. Against bank guarantee/payment guarantee

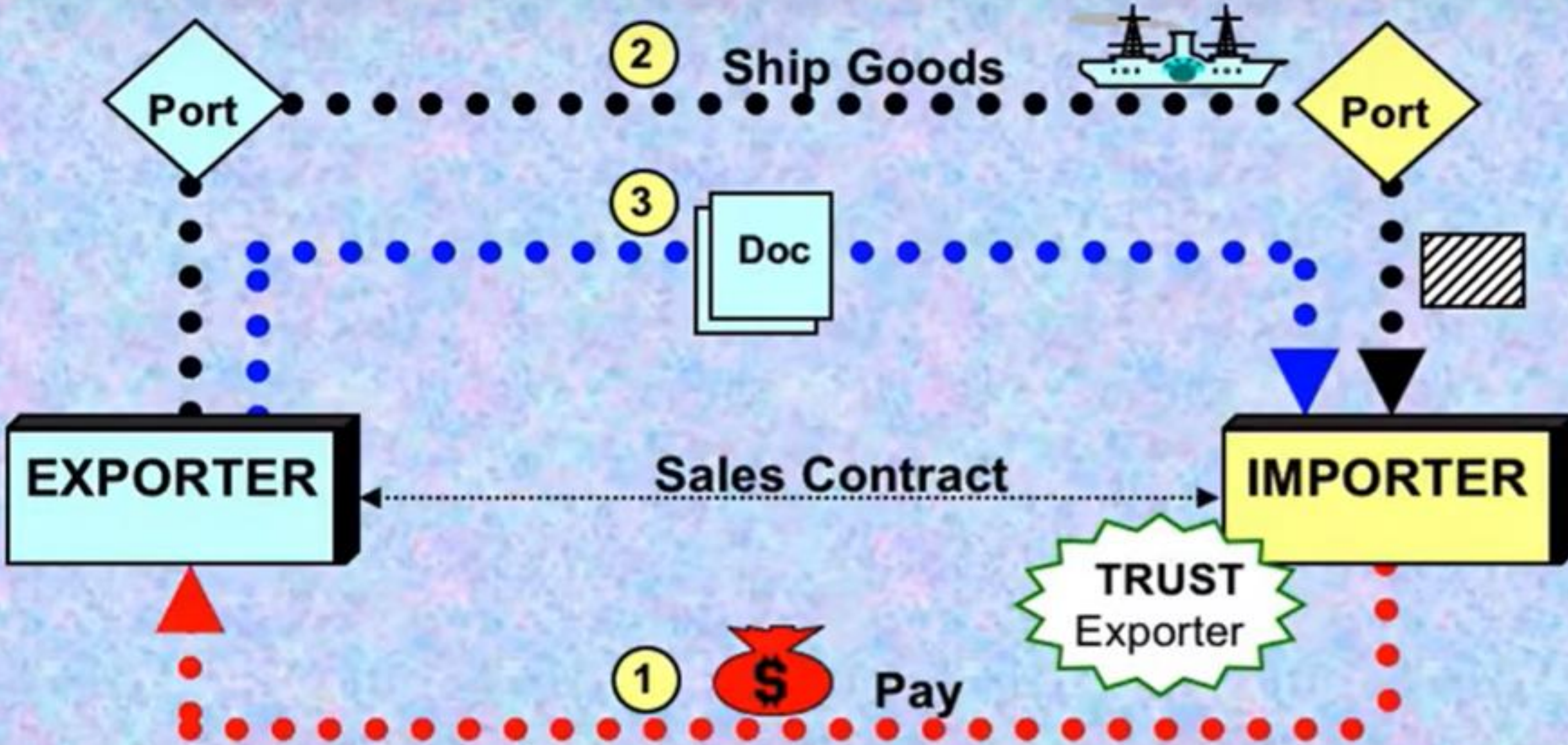
Payment Methods for International Trade

Method : Prepayments/ Advance payment

- The goods will not be shipped until the buyer has paid the seller.
- *Time of payment* : Before shipment
- *Goods available to buyers* : After payment
- *Risk to exporter* : None
- *Risk to importer* : Relies completely on exporter to ship goods as ordered

Sale on Advance Payment Basis

ADVANCE PAYMENT



- Time of Payment – Before shipment
- Risk to Exporter – None
- Good available to Importer – After Payment
- Risk to Importer – Relies completely on exporter to ship goods as ordered

Advance Payment or Pre-Payment Steps

1. Agreement of Sales Contract
2. Advance remittance
3. Shipment of Goods
4. Dispatch of documents
5. Payment of Balance if any

Payment Methods for International Trade

Method □ : Prepayments: Risk for seller

If full invoice value is received in advance, there is no risk Most buyers, however, are not willing to bear all the risk by prepaying an order. Many a times the advance is paid partly, then seller’s risk exposure may only be to the extent of amount not yet received

Payment Methods for International Trade

Method □ : Prepayments: Risk for Buyer

- Risk is for the amount unreceived
- Buyer is dependent on seller for performance as per agreement which depends solely on integrity and commitment of byer to pay seller
- Other risks like war or war like situation, damage or loss of goods in transit, inability of seller to fulfil his commitment inspite of being committed may wholly or partially frustrate main objective of buyer in receiving consignment
- Probable costs and delay in his efforts to recover funds paid in advance
- Seller may vary terms without consulting buyer
- The worst case is that buyer may never get goods and remain out of pocket of having parted away with funds

Payment Methods for International Trade

Method ❶ : Prepayments: Why Pay in Advance?

a. To avoid procedural formalities, costs and delays

b. Considerations of risk perceptions, relationship, track record

c. If the quantity of value is small or if buyer can't negotiate or search for best buy; or is in extreme need of item

d. Seller has necessary bargaining power "monopoly"

e. Intention of buyer is to demonstrate his commitment to the transaction or seller wants to bind buyer to deal.

f. Such arrangements are made for custom made goods, high value capital goods or speciality products that may not find alternate buyers if original purchaser defaults to pay

Payment Methods for International Trade

Method 2 : Open Accounts

- The exporter ships the merchandise and expects the buyer to remit payment according to the agreed-upon terms.
- Not supported by any traditional banking or documentary instrument
- *Time of payment* : As agreed upon
- *Goods available to buyers* : Before payment
- *Risk to exporter* : Relies completely on buyer to pay account as agreed upon
- *Risk to importer* : None

Payment Methods for International Trade

Method 2 : Open Accounts

- Sale on open account basis also called sale on ‘consignment’ or ‘account sale’ takes place when there is certain amount of mutual trust between two parties
- Seller sends goods and relevant documents directly to buyer
- If goods are dispatched unsecured, entire risk is on consignor-exporter
- Seller may reduce his risk if he can procure payment guarantee from buyer or a bank guarantee (BG)

Payment Methods for International Trade

Method 3 : ESCROW

- The importer deposits the purchase price with the Escrow, which is a third party before the shipment
- Third party: known as Escrow which collects, holds and disburses the purchase price according to a pre arranged procedure
- No universal rules to govern escrow
- Escrow acts only as an independent third party, as a custodian of buyer's funds till goods are accepted by buyer

Payment Methods for International Trade

Method 3 : ESCROW

- ***Time of payment*** : The buyer inspects the goods and once he is satisfied, the payment is made
- ***Goods available to buyers*** : After payment
- ***Risk to exporter*** : Allows importer to check the inventory before paying exporter
- ***Risk to importer*** : Money is blocked before the shipment
- **USP (Unique Selling Proposition)of Escrow**: Buyer pays only after inspection of goods, if rejected funds may get locked up till dispute is resolved

Payment Methods for International Trade

Documents Through Bank:

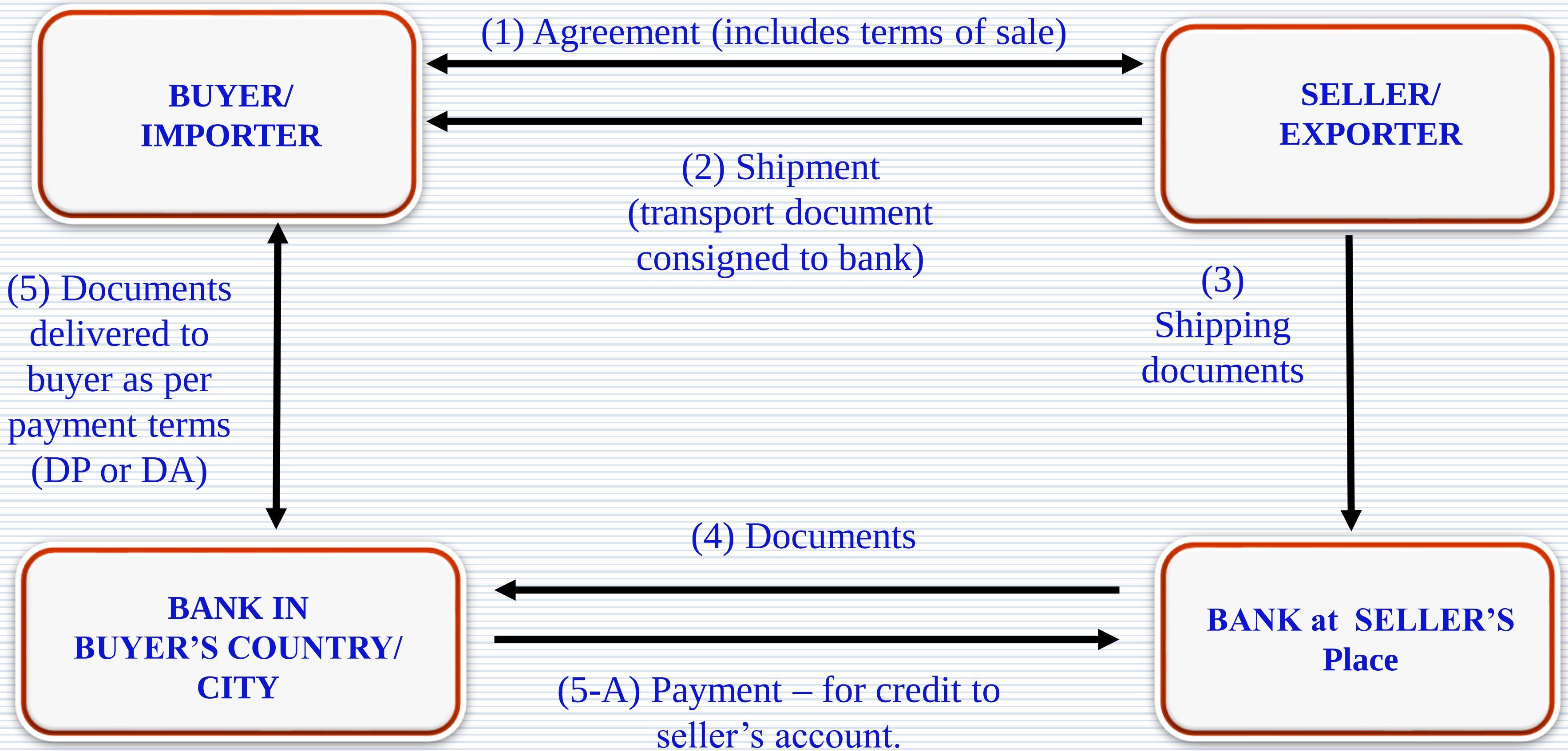
- Most frequently shipping documents and drafts are routed through banks acting as intermediary
- (Add Figure here)

Payment Methods for International Trade

Documents Through Bank:

- This route offers greater safety than when goods are directly sent to buyer
- Following are commonly used methods of settlement under this method:
    1. Bills for collection (payable at sight or demand)
    2. Bills for collection (acceptance or usance)
    3. Banker's Acceptance
    4. Deferred Payment
    5. Letter of Credit (LC)
    6. Bank guarantee (BG) or payment guarantee
    7. Standby letter of credit (SBLC)

Documents through bank



Payment Methods for International Trade via bank

Method 4: Bills for Collection (Non-LC Bills/Documentary Collection)

- Documentary collections constitute a significant volume of domestic and international trade
- As against LC they are cheaper, more flexible and easier to manage
- However, risks are much higher than in LC

Payment Methods for International Trade via bank

Classification and rules of Bills

- **All trade bills –** irrespective of their nature, purpose or content, whether covering domestic or export trade- are classified as:

  a. Non-LC bills : These shipping documents are processed without involvement of LC

  b. LC bills: They are processed under LC

Payment Methods for International Trade via bank

Classification and rules of Bills

- Because the applicable rules differ, every set of documents presented to a bank must be clearly identified under one of these two grouping:

Documents Through bank

If not under LC

Uniform Rules for Collection (URC)
ICC Publication No.522

If under LC

Uniform Customs and Practice for Documentary Credits (UCP),
ICC Publication No.600

Payment Methods for International Trade via bank

Rules applicable to two groups of Collection Bills

- **Non-LC bills:** Also referred to as ‘bills for collection’; are governed by Uniform Rules for Collection (URC) of International Chambers of Commerce (ICC), Paris. At present, ICC Publication No. 522 (1995 Revisions), also known as URC 522 or ICC 522 is in operations
- **LC Bills:** are governed by UCP. Presently 2007 Revision of UCP commonly referred to as UCP 600 is in operations

Note:

- *The UCP rules apply to all documents presented under LC*
- *Instead if the documents are presented to the bank for ‘collection’ the ICC URC522 rules are applied*

Payment Methods for International Trade via bank

Types of Collection Bills or non-LC Bills:

1. **Clean Bills for collection:** include only financial documents like bills of exchange, cheques etc. without commercial documents

2. ***Documentary bills for collection (Sight or Demand bills):*** *sets of shipping documents accompanied by sight bills of exchange (also known as drafts) or bills of exchange payable on demand/on presentation*

3. ***Documentary bills for collection (usance, accepted or DA bills):*** *set of shipping documents accompanied by usance or acceptance bills of exchange or usance/time drafts*

Payment Methods for International Trade via bank

Types of Collection Bills or non-LC Bills

- **Bill of Exchange (Draft or B/E):**is the principal financial document used in international trade

Note: Banks in countries like US and Europe avoid using B/E as it may attribute high stamp duties.

- In India B/E are governed by Negotiable Instrument Act (1881).
- Section 5 of N.I. Act defines B/E *as* ‘an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person to pay a certain sum of money only to, or to the order of, a certain person or the bearer of the instrument’

Payment Methods
for International Trade via bank

Types of Draft

- **Bill of Exchange (Draft or B/E):** defined in article 2 of URC 522 as a 'financial document' are of 2 types:

  a. *Sight draft/ DP : The drawee, the one on whom draft, is drawn, is supposed to pay immediately after demand is made for payment. Also known as drafts being payable 'on demand' or 'at sight'*

  b. Acceptance or usance draft/DA: Maturity date is determined from the face of the draft

(Drafts can be seen through following examples)

Date:____________________

Place: ___________________

Currency & Amount:___________________________

At Sight of this bill of exchange

2

PAY TO ____

the sum of ____

4

Against ____ **for value received.**

To: **for A B C Limited**

3

M/s XYZ Ltd.,___________________

____

1

(Buyer's name and address) ***(Seller signs here)***

Figure: Sight draft

Date: ____________________

Place: ___________________

Currency & Amount: ___________________________

____________________________________ **days after sight of this bill of exchange**

PAY TO 5 ____ **or order**

the sum of ____

against ____ **for value received.**

To: **for A B C Limited**

M/s XYZ Ltd., ___________________ 6

______________________________ ***(Seller signs here)***

Accepted for payment on

____

For XZ Ltd.
Authorized signatory

Dated:

(Buyer's name and address) ***(Authorised signature)***

Figure: Acceptance or usance draft

Date:__________________

Place: __________________

Currency & Amount:_________________________

____________________days from the date of (invoice, BL etc.) # PAY this bill of exchange

TO ____or order

the sum of ____

against ____ for value received.

To: **for A B C Limited**

M/s XYZ Ltd.,__________________

____

(Buyer's name and address)

Accepted for payment on __________________________ For XZ Ltd. Authorized signatory Dated:

(Seller signs here)

(Authorised signature)

Payment Methods
for International Trade via bank

Features of B/E (Draft)

1. Seal and Signature of Seller or drawer
2. Name of remitting or negotiating bank: first bank that handles documents on behalf of seller
3. A reference to underlying invoice, contract or principal document
4. Name and address of drawee, i.e. buyer, importer or applicant
5. The number of days after presentation to drawee-being the date of maturity of draft, which is due date of payment by drawee
6. On acceptance by drawee, maturity date of B/E is inserted in DA along with drawee’s authorized signature and date of acceptance

Note: In acceptance bills (like in bill 3) maturity date is calculated not from date of presentation but with reference to another date or event (like invoice date, date of shipment etc.) as agreed between parties

Payment Methods for International Trade via bank

Uses of B/E (Draft)

1. Documents accompanying a ‘collection’ are commercial documents and not financial documents, hence do not authorize or confer legal rights on banks to demand payment. However, if accompanied with B/E provides legal right to bank for demand by buyer
2. Acceptable in court of law to prove liability and establish claim
3. Otherwise courts will have o rely on circumstantial evidence in event of default
4. Drafts accepted or co-accepted (avalised) by commercial banks offer better security to their holder for value

Parties in Documentary Collection as per ICC guidelines URC-522

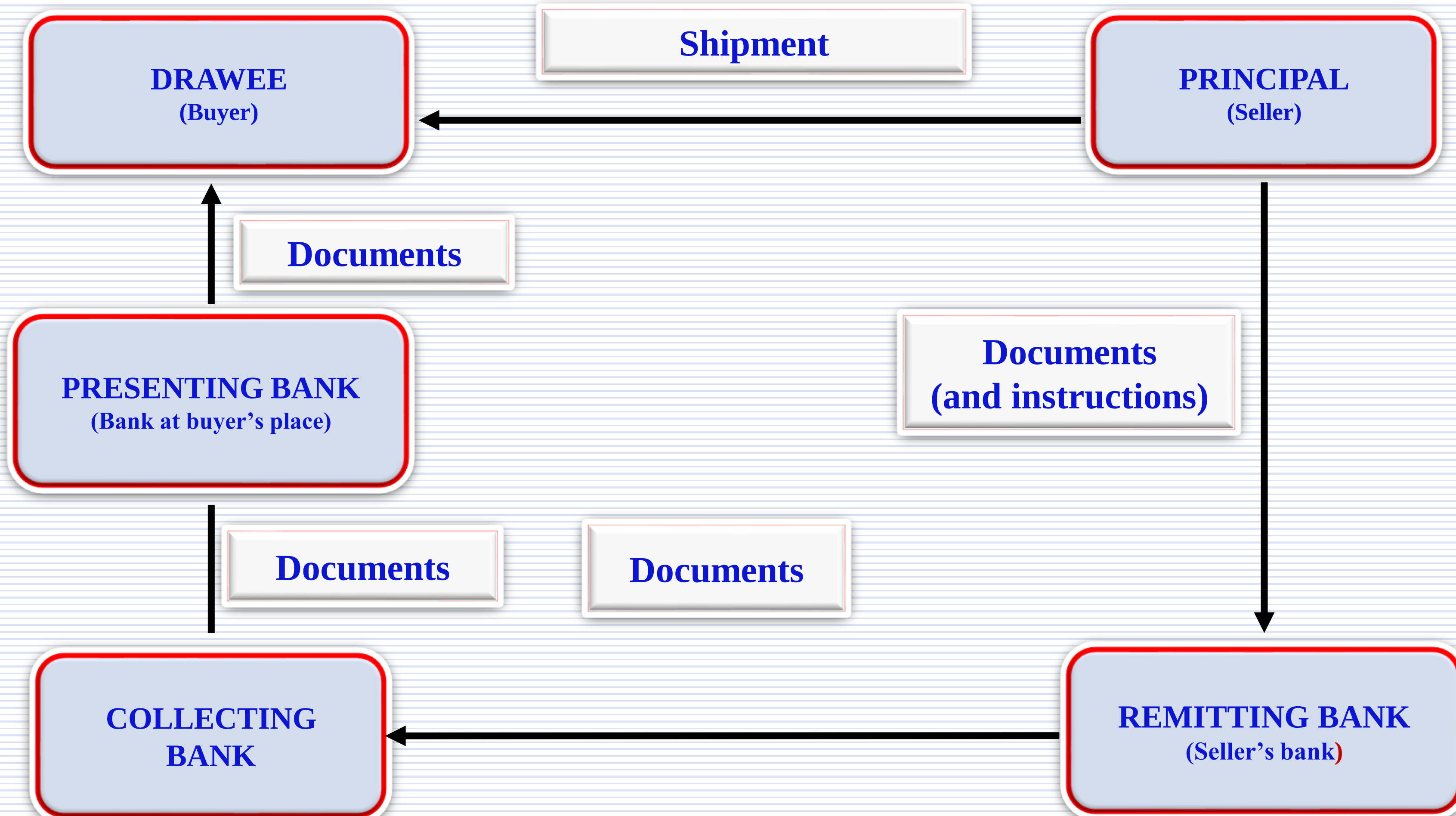
- **The Principal (the drawer):** the exporter who arranges the collection documents and delivers them to his bank with collection instruction.
- **The remitting bank:** the exporter’s bank which forwards the documents together with the exporter’s instructions to the collection bank.
- **The collecting bank:** any bank (other than the remitting bank) involved in the processing of the collection and would normally be the remitting bank's correspondent in the importer’s country

Parties in Documentary Collection as per ICC guidelines URC-522

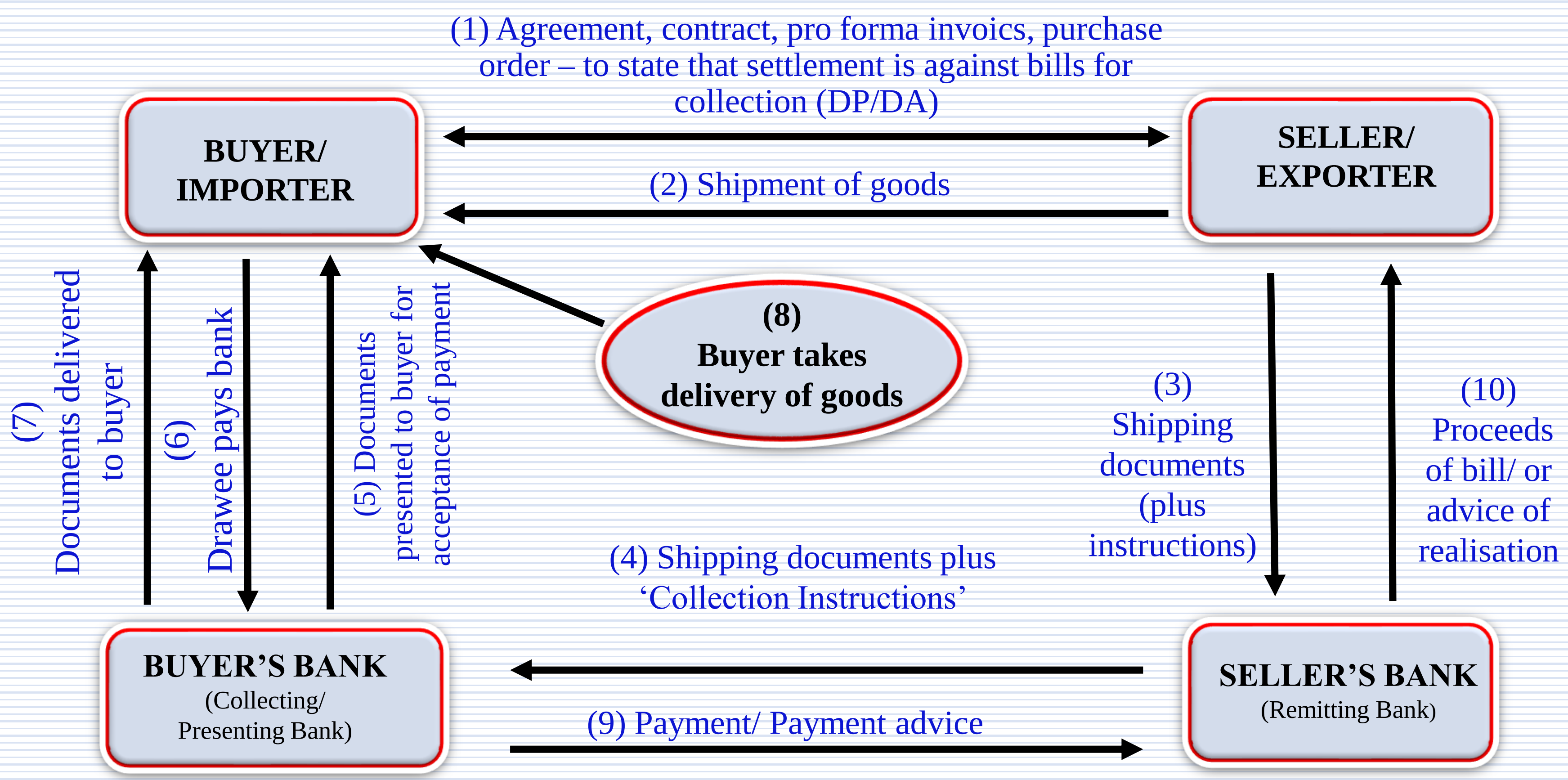
- **The presenting bank:** the importer's bank which presents the collection documents to the drawee (importer) and collects the payment or obtain the acceptance from the drawee. The collecting and presenting bank are often the same.

- **The drawee:** the importer to whom the documents are presented for payment or acceptance.

PARTIES TO A COLLECTION



Documentary collection - Flow chart



Case-I

- ABC, Malaysia, a retail trader has signed a purchase agreement on 1st November with a cloth company in Bangladesh. The order value of the Garments is USD 10,000.

- Shipment to be made on 25th November. As per the agreement Bangladesh Company has to deliver 1000 shirts to ABC Malaysia. Cloth Company ships the goods and submits the documents to its bank, say East Bank.

Collection under Documents against Payment or D/P (Sight Draft)

- If shipment is made under a sight draft, the collecting bank is instructed to deliver documents only against the payment

- It is a practice that provides the exporter with some protection, since the banks will release the shipping documents only according to the exporter's instructions

Collection under Documents against Payment or D/P (Sight Draft)

1. Ships the goods to Malaysia

Bangladesh

2. Submits the documents to its Banks

ABC Malaysia

East Bank in Bangladesh

1. Cloth Company Bangladesh ships the goods as a Consigner of the shipment
2. Cloth Company then submits the documents on 27th November to its bank East Bank (Remitting Bank).
3. Collecting bank or presenting bank collects the payment on sight or usance basis

Documents Involve for this transaction

1. Collection Order
2. Commercial Invoice
3. Packing List
4. Bill of Exchange drawn on ABC Malaysia payable at sight for USD 10,000
5. Marine Bill of Lading (Transport Document)

Collection under Documents against Payment or D/P (Sight Draft)

- The buyer needs the shipping documents to pick up merchandise. Sometimes goods reach the dock much earlier than document reaches the bank
- If the goods are not as per the ordered quality importer would lose as payment is already made
- If for any reason, the collecting bank overlooks the instructions on sight payment and delivers documents before getting paid it faces the risk of having to recompense the seller for loss

Collection under Documents against Acceptance or D/A (Time Draft)

- If a shipment is made under a time draft the exporter provides instructions to the buyer's bank to release shipping documents against acceptance
- This method of payment is referred to as documents against acceptance.
- By accepting the draft, the buyer promises to pay the exporter at the specified future date. Consequently, the buyer is able to obtain the merchandise and check the quality of the goods prior to the payment. It might create the risk of non-payment to the exporter

Collection under Documents against acceptance or D/A (Time Draft)

- It is the buyer’s responsibility to honour the draft at maturity. In this case, the exporter provides the financing in terms of time and is dependent upon the buyer’s financial integrity to pay the draft at maturity

- The added risk is that if the buyer fails to pay the draft at maturity; the bank is not obligated to honour payment. The exporter assumes all the risk and must analyse the buyer accordingly.

- Sometimes after checking goods importer refuses to pay, so seller may have to arrange some other customer in the same country or in different country

Risk in Documentary Collections

- Documentary collection shifts the risk from the exporter to the importer compared to the open account transaction

- Under documentary collection the importer takes control over the goods on presentation of an appropriate document of title (typically the same documents which would be presented under open account terms) together with some form of commitment to pay (typically a bill of exchange).

Risk in Documentary Collections

- Under the terms of a documentary collection, the banks are only concerned with the exchange of documents
- They offer no guarantee of payment, unless the buyer's bank AVALS an accepted bill of exchange
- AVALIZING a collection document means bank undertakes unconditional payment obligation on behalf of the importer, which may be extremely dangerous from a bank's point of view

Sight Bill: Risk Analysis

Advantages to Seller

- Goods in seller's possession till byer pays
- Seller comes to know quickly about byer's intent to pay
- Clear set on internationally accepted rules under URC522 to guide collection process

Risk to Seller

- No immediate recourse if buyer delays/cancel delivery/order
- No guarantee that buyer will take delivery
- If buyer delays delivery demurrages and other incidental costs to seller
- Legal remedy could be costly and time consuming
- Cost of storage, insurance etc. while legal process is on
- If buyer defaults, finding another buyer may be at heavy discount

Risk to Buyer

If seller does not ship on time may adversely impact buyer's production schedule or business plan

No control over quality, quantity or any aspect covering shipped goods

Buyer has to first pay to verify quality, packaging etc. of goods

Once paid, buyer can not recall funds if quality is not upto mark

Usance/Acceptance Bill (DA Bill): Risk Analysis

Advantages to Buyer

- Buyer pays after taking possession of goods
- Buyer can examine goods received, store, process and sell them before making payment
- No pressure on buyer’s cash flows and gets time to pay

Risk to Seller

- After receiving goods buyer may not pay
- Period of usance offered is a cost to the seller
- Payment terms are more advantageous to buyer

Banker’s Acceptance (Rescue to Seller)

- Accepted DA bill can be co-accepted by buyer’s bank which provides better security for eventual payment
- After buyer’s acceptance the document is said to carry a Banker’s Acceptance (avalization) which provides additional security to seller

Payment Methods for International Trade

Method 5. : Deferred Payment Arrangement

A. Deferred Payment Undertaking

- *B/E is not necessarily needed*
- *Payment spread over longer period 5-7 years*
- *Suitable for transactions involving project exports, capital goods, infrastructure financing etc.*
- *Payment made in installment with interest*
- *Banker's co-acceptance may be added apart from buyer's acceptance*

Payment Methods for International Trade

Method 5 : Deferred Payment Arrangement

B. Deferred Payment Guarantee (DPG)

- *At buyer's request bank may issue DPG to seller guaranteeing payment over a pre arranged contract period*
- *Mostly used for purchase of capital goods, large plant and machinery etc. where large money is involved*
- *Guarantee is invoked only if buyer fails to pay*

Payment Methods for International Trade

Method 5 : Deferred Payment Arrangement

C. Deferred Payment Credit (DPC)

- *It's LC issued by a bank covering payment due to be made not on presentation but later or in installments over a deferred period say 5-7 years or more*
- *The issuing bank's undertaking to meet payment obligation on respective due dates is main distinguishing feature*

Payment Methods for International Trade

Method 5 : Deferred Payment Arrangement

Comparison of 3 methods:

- *In DPU risk of seller is huge owing to longer time period and also as payment depends on the integrity and ability of buyer to honor his commitment*
- *DPG is relatively safer for seller as it is backed by bank’s undertaking*
- *DPC is best among 3 as it is documentary credit*

Payment Methods for International Trade

Method 6 : Guarantees

- A guarantee may be defined as an independent, documentary undertaking issued by a bank (or other legally qualified entity) at request of its customer (instructing party) by which guarantor irrevocably promises to pay a sum of money to third party (beneficiary), provided a complying demand is presented
- While there are standard Guarantee formats, Guarantees can be tailored to meet your specific contractual needs.
- The Uniform Rules for Demand Guarantee, ICC publication No.758 (URDG758) defines a demand guarantee or simply a guarantee as 'any signed undertaking, however named or described providing for payment on presentation of a complying demand'.
- *It's a passive instrument unlike LC and is expected to remain dormant until its expiry serving as security under commercial transactions*

Payment Methods for International Trade

Method 6 : Categories of Guarantee

1. Accessory guarantee

- *Guarantor binds itself for fixed amount to cover a debt or default for its applicant who is already bound to beneficiary via underlying contract*
- *There is linkage between guarantee and underlying contract*
- *It implies demand must prove the contractual default supported by an judicial or mediation 'award' consisting of amount resulting in default*
- *Dependent on local legislation, it may differ from country to country*
- *It cannot be issued subject to URDG758, UCP 600 or ISBP (International Standard Banking Practice)*

Payment Methods for International Trade

Method 6 : Categories of Guarantee

2. Independent guarantee

- *Depends solely on guarantee and complying relationship*
- *A reference in guarantee to underlying contract may be made*
- *Guarantor is not liable for effectiveness of documents i.e. he will not go beyond documents to check if information contained therein is correct or commercially justifiable*
- *Often referred to as 'Demand Guarantee'*
- *It may be issued subject to UCP 600 or ISBP but more preferably under ICC URDG 758*

Payment Methods for International Trade

Method 6 : Categories of Guarantee

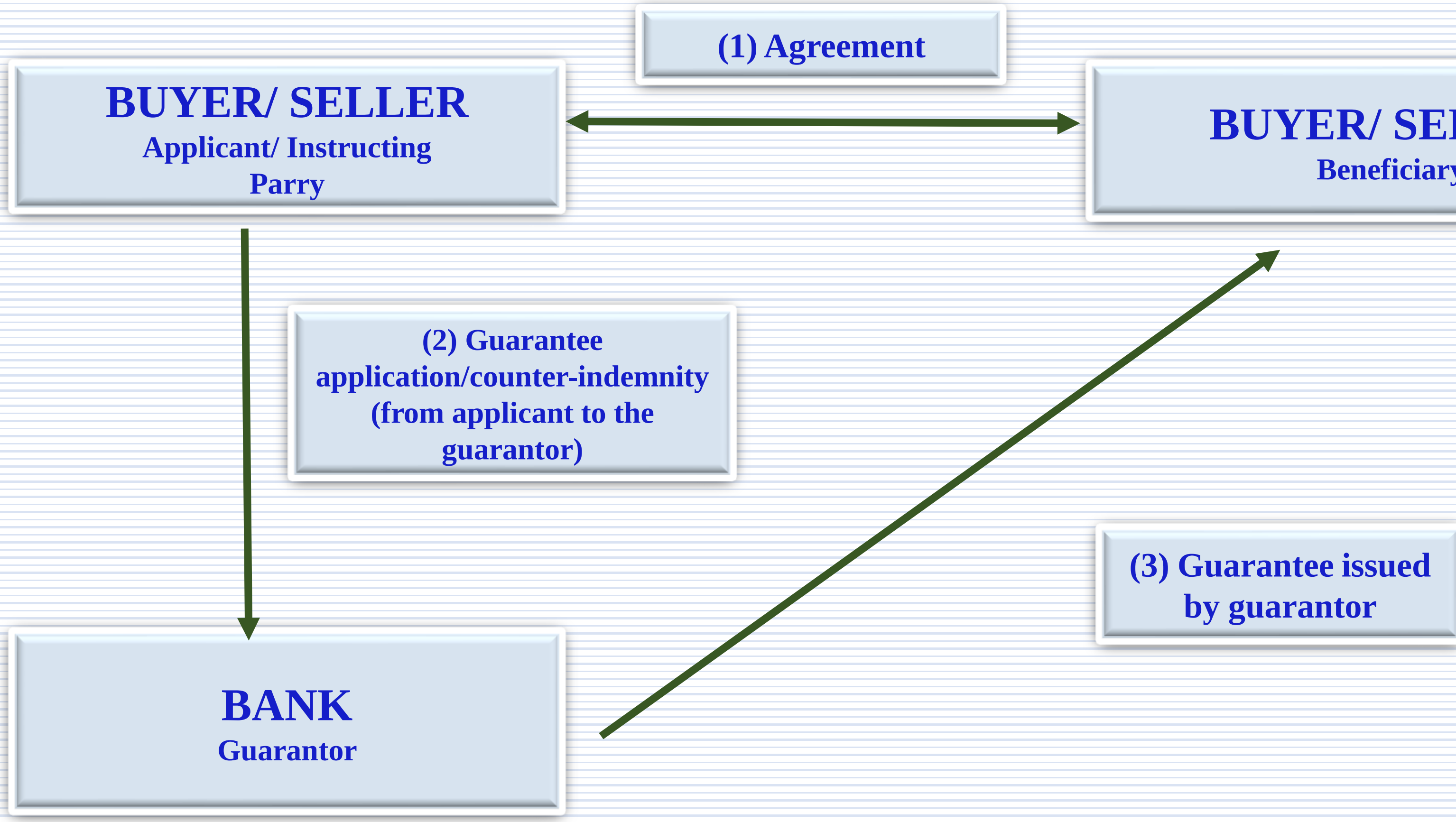
3. Direct and Indirect guarantee

- *Direct Guarantee: can be issued directly in favor of beneficiary by the principal bank or through an advising bank or through a bank in beneficiary's country*

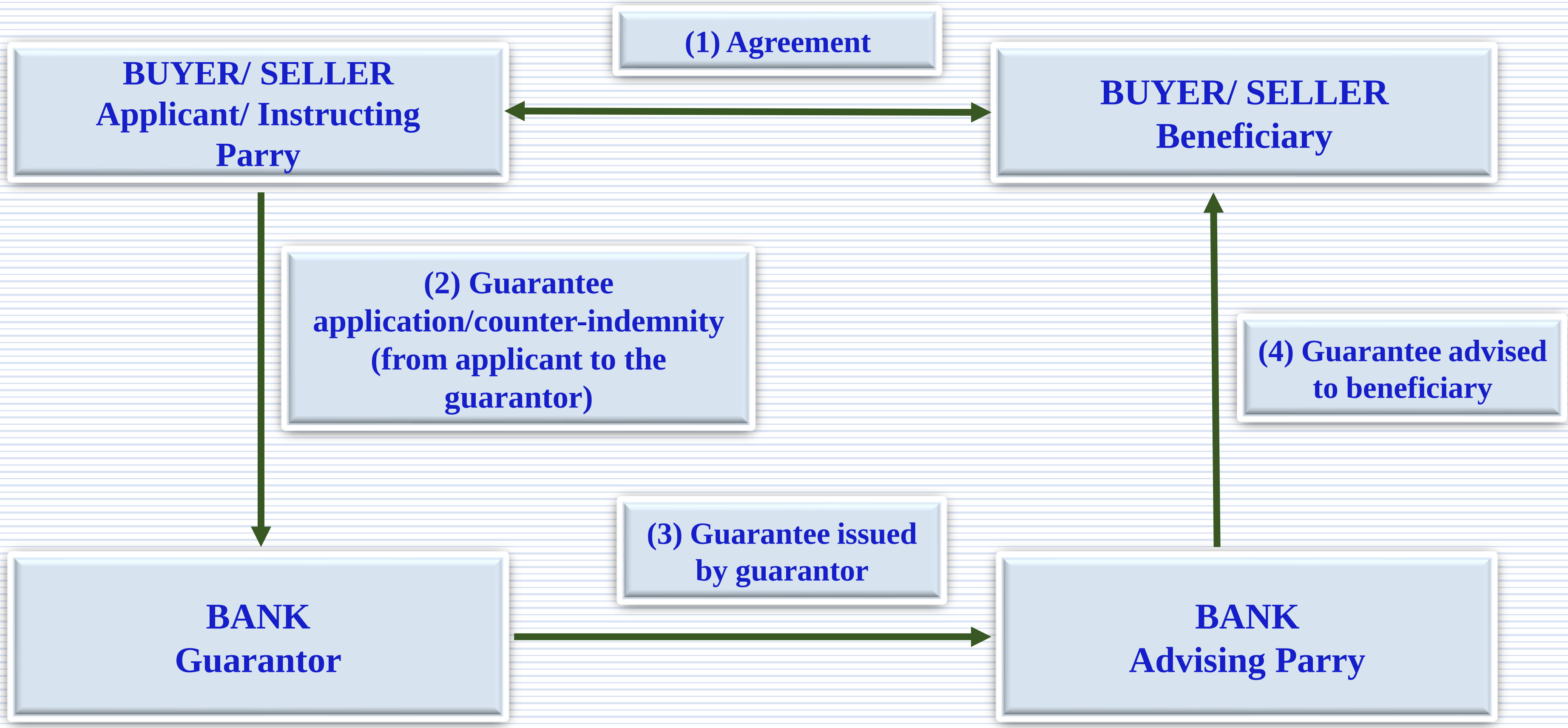
- *Indirect guarantee: the principal bank instructs a local bank (issuing bank) at beneficiary’s place of business to issue the guarantee in favor of the beneficiary*

- *As security the instructing bank issues a counter guarantee in favor of local bank entitling it to the right to submit a claim to instructing bank in event of payment of a claim*

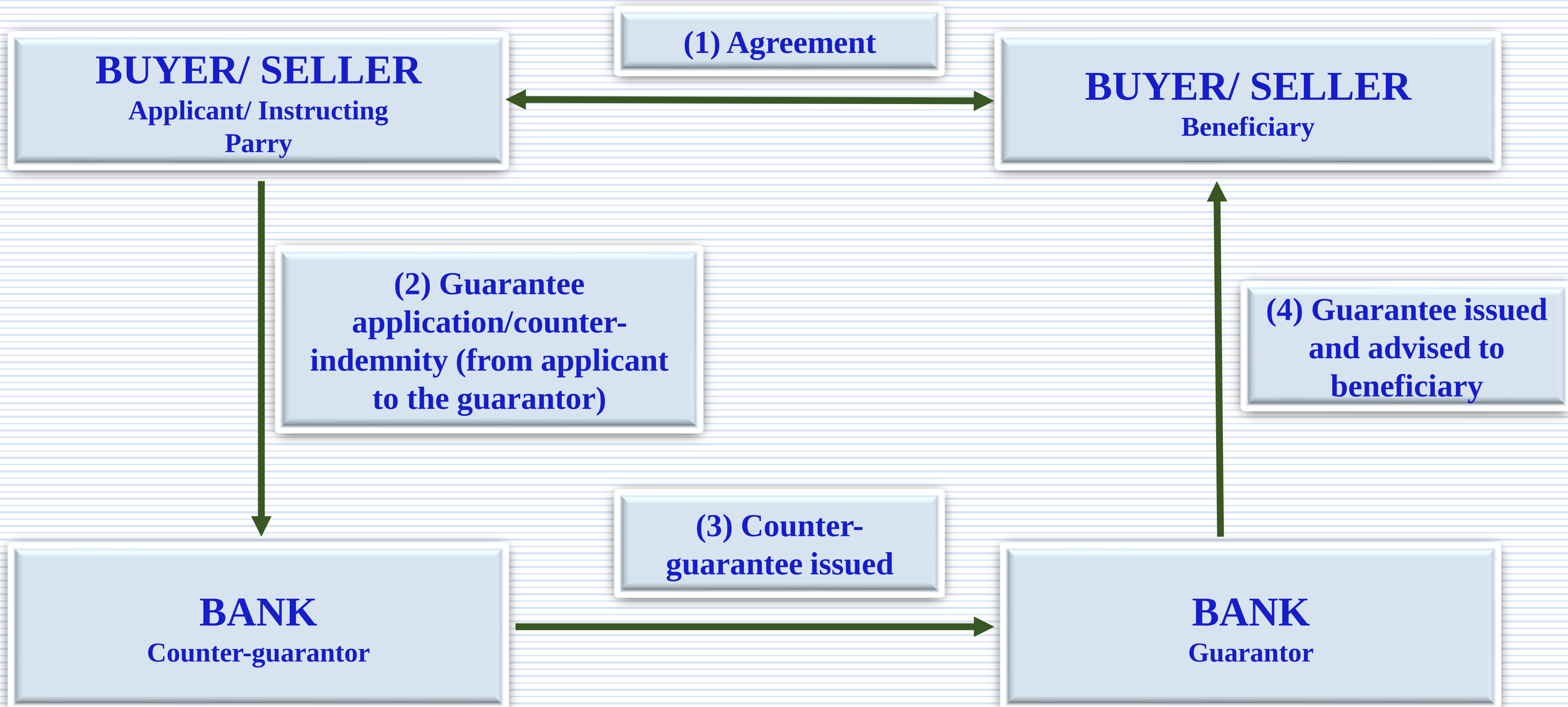
Direct Guarantee (no advising bank)



Direct Guarantee
(issued through advising bank)



Indirect Guarantee



Payment Methods for International Trade

Method 6 : Categories of Guarantee

4. Performance guarantee

- *It offers security of 'performance'*
- *Issuer of guarantee, the guarantor (say manufacturer or service provider) undertakes to repair or replace the offending item, thus ensuring uninterrupted service*
- *Performance guarantee is different from financial guarantee in that purpose of former is not to compensate breach in performance with money*
- *It is meant to ensure continuity in performance*

Payment Methods
for International Trade

Method 6 : Categories of Guarantee

4. Financial Guarantee

- *Designed to compensate with money against incidence of defect, default, failure of performance or breach in promise*
- *Commercial banks always issue financial guarantee and never performance guarantee*
- *If performance guarantee is issued, compensation is always stated in financial terms as bankers are neither equipped nor qualified to repair or replace a breach in performance*
- *They are also referred to as* ***Bank Guarantees (BG)***

Payment Methods for International Trade

Method 6 : Categories of Guarantee

4. Financial guarantee (BG)- Uses

- BG is useful and cost effective when multiple deliveries or pre-shipments are scheduled over an extended period
- In such cases, seller is not required to procure an LC to secure every shipment which requires rigor in its operations, preparing documents and compliance
- In certain cases it is also cheaper or convenient for parties concerned to operate under BG rather than use LC
- BG may lie dormant after procurement for all practical purposes but it gives greater comfort to parties at less cost and lower level of compliance
- However, BG does not help buyer to control certain aspects of transaction which LC can like control over shipment in case of LC is much higher than BG

Payment Methods for International Trade

Method 6 : Categories of Guarantee

4. Financial guarantee (BG) Rules - URDG

- Formats and contents of BG differ across issuers, transactions and countries depending upon its purpose
- Applicable laws also differ depending upon jurisdiction
- ICC, after a gap of 18 years, came out with revised set of guidelines for BG named as Uniform Rules for Demand Guarantees (URDG) in 2010 in its publication 758 and hence called as URDG758
- It comprises of 35 articles in all which apply to both domestic and international guarantees

Payment Methods for International Trade

Method 7 : Letters of credit (LC)

- LC is a written, irrevocable undertaking issued by a bank on behalf of the importer promising to pay the exporter upon ‘complying presentation’ (Article2, UCP600)
- *Time of payment* : When shipment is made
- *Goods available to buyers* : After payment
- *Risk to exporter* : Presenting complying documents
- *Risk to importer* : Relies on exporter to ship goods as described in documents
- Also called Documentary Credit or simply ‘Credit’

Payment Methods for International Trade

Method 7 : Letters of credit (LC)

- LC relies on two fundamental principles for their success:
  - Doctrine of strict compliance: (somewhat diluted now)
  - The independence principle

Features of Documentary Credit or Letter of Credit

- The exporter is assured of receiving payment from the issuing bank as long as it presents documents in accordance with the LC.

- It is important to point out that the issuing bank is obligated to honour drawings under the LC regardless of the buyer's ability or willingness to pay

- On the other hand, the importer does not have to pay for the goods until shipment is made and documents are presented in good order. However, the importer must still rely upon the exporter to ship the goods as described in the documents, since the LC does not guarantee that the goods purchased will be those invoiced and shipped.

Features of Documentary Credit or Letter of Credit

- All the LCs are subject to The Uniform Customs and Practices of Documentary Credit, 2007 Revision, ICC Publication No. 600 (UCP), are considered to be irrevocable LC

- Under UCP 600, all the LCs are treated to be irrevocable, even if there is no indication to that effect

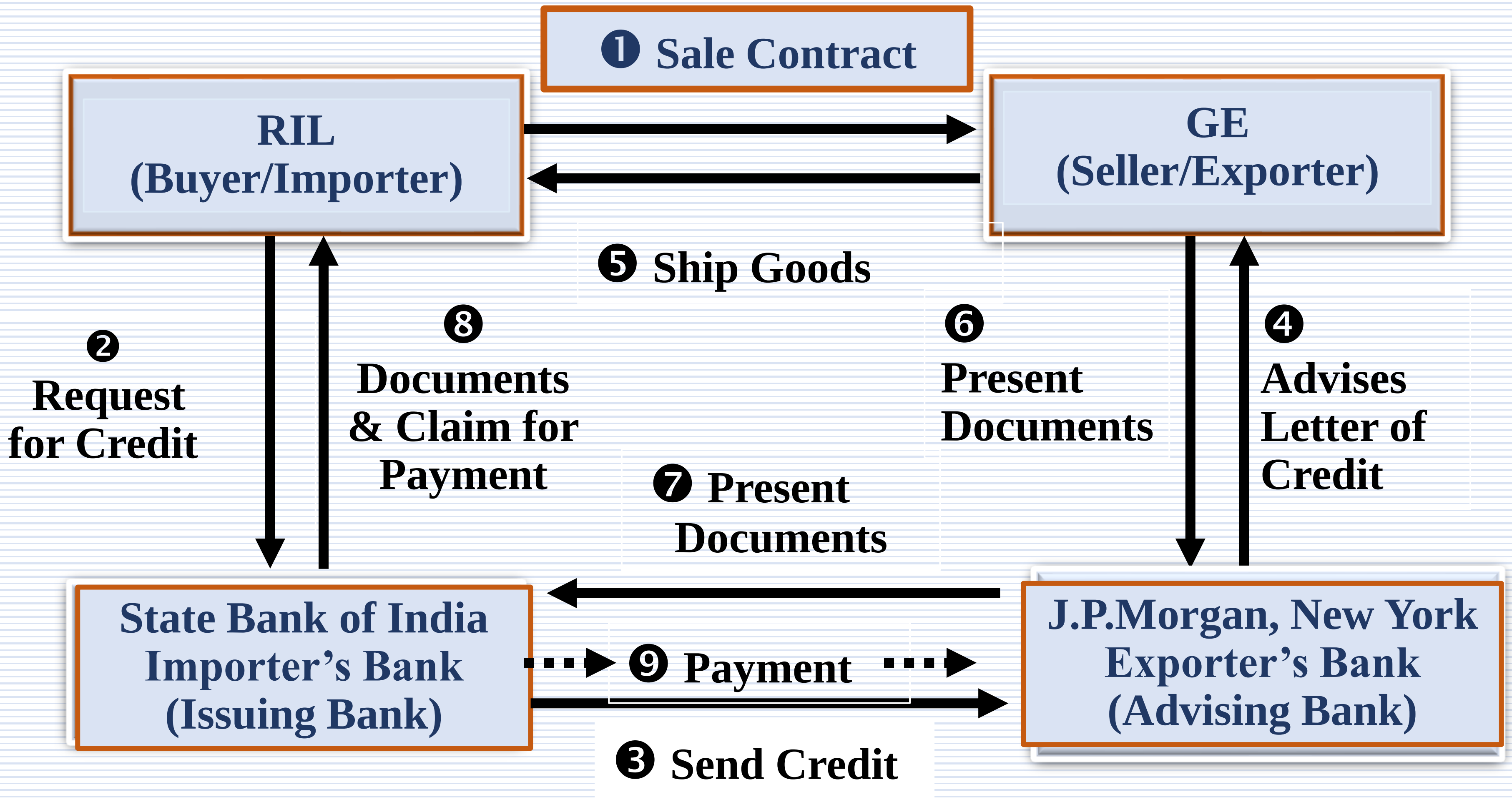
- An irrevocable letter of credit cannot be amended or cancelled without the consent of the issuing bank, confirming bank (if any) and the exporter

Features of Documentary Credit or Letter of Credit

- This allows the exporter to procure the goods or prepare them for shipment with the assurance that payment will be received if the stipulated documents are presented and complied with the terms and condition of the credit

- At present there is no existence of revocable letter of credit which allows importer to amend or even cancel the LC and it provides no security to the exporter

Documentary Credit (L/C) Procedure



Documentary Credit (L/C) Procedure

1. General Electric (exporter), USA and Reliance Industries Limited (importer), India establish a sales contract between them

2. The importer then initiates the LC mechanism by giving an application to its bank, State Bank of India (known as issuing bank) for issuing a letter of credit

3. The issuing bank (SBI) issues LC through Society for Worldwide Interbank Financial Telecommunication (SWIFT) in favour of the beneficiary or exporter. By opening an LC, SBI undertakes the payment obligation irrespective of the ability of the importer to pay. Then issuing bank sends the LC to advising bank or the exporter bank, J.P.Morgan New York, USA.

Documentary Credit (L/C) Procedure

4. J. P. Morgan advises or notifies GE about the LC without undertaking the payment obligation unless and until it plays a role of a confirming bank

5. Exporter ships the goods as per the terms and conditions of the credit.

6. Exporter submits all the documents asked by the credit along with bill of lading - a shipping document and a bill of exchange or draft representing issuing bank's payment obligation to his bank within 21 days from the date of shipment and within the validity of the credit

Documentary Credit (L/C) Procedure

7. All the documents are sent to the issuing bank.

8. The issuing bank checks the document. If the documents comply the payment terms then the importer either initiates the payment under a sight draft or accepts the future payment obligation under Time draft

9. The issuing Bank (SBI) makes payment to the Advising Bank (J. P. Morgan)

Documentary Credit (L/C) Procedure

10. If the documents do not comply then State Bank of India cites a documentary discrepancy, notifies GE through the advising bank within 5 banking days from the date of sighting the documents

11. If exporter is able to correct the documents as per the LC terms and resubmits within a stipulated time period then he gets the payment or else payment gets rejected

UCP and its Evolution

- LC's operations are guided by well defined, internationally recognized, widely accepted set of rules, practices and procedures

- The first attempt to codify LC goes back to 1929 when International Chamber of Commerce (ICC) introduced its 'Uniform Regulations for Commercial Documentary Credits', which initially were only limited to French and Belgian banking practices

- In 1933, ICC issued 'Uniform Customs and Practice for Commercial Documentary Credits' and these set of rules received formal acceptance in 40 countries

- In 1951 Revision, the acceptance of these rules doubled but after the issuance of UCP in 1962 the global acceptance of these rules took place

- Since then rules have been regularly updated at approximately after every 10 years, to arrive at the current 6th revision in 2007, commonly referred to as UCP 600

Interpreting Rules of UCP

- The essence of UCP has been embodied in article 1 of UCP 600 as:
- *“The Uniform Customs and Practice for Documentary Credits, 2007 Revision, ICC Publication No.600 (UCP) are rules that apply to any documentary credit (credit) (including, to the extent to which they may be applicable, any standby letter of credit) when the text of the credit expressly indicates it is subject to these rules. They are binding on all parties thereto unless expressly modified or excluded by the credit.”*
- As the very name suggests this ICC publication represents uniform customs and practice for (documentary credits).
- In order to minimise adverse effect of confusion and ambiguity in International Trade, ICC introduced degree of uniformity in terms and expressions often used in trade.
- UCP may be termed as standardized set of best practices to promote smooth operation of international trade through LC

Interpreting Rules of UCP

- UCP articles are rules and not laws or statues propounded by a statutory body anywhere in world
- However, over the years (as a result of judicial pronouncements, case studies and doctoral researches) rules of UCP have gained acceptance worldwide for documentary credit
- Since UCP articles are not laws by statute, so if the parties agree to subject themselves to rules of UCP, they do so purely on their will and declare it in the credit.
- Upon declaration only coverage of UCP extend to operations under credit
- The last sentence of article is important which means that once parties through declaration in credit document subject themselves to UCP, the rules are binding on them
- However, last sentence of UCP (1), also says that any provision of UCP could be **modified or excluded** by the credit with the consent of concerned parties. But it should be done with utmost care

Related, Useful ICC Publication (ISBP)

- Documentary rules under LC governed by UCP 600 are more complicated than for ‘collections’ governed by URC 522.
- Hence, trading communities even if they start with LC, tend to migrate to ‘collection’ as they gain confidence
- ISBP (International Standard Banking Practices) for the Examination of Documents under documentary credit, an ICC Publication, complements UCP
- The current version of ISBP i.e. ISBP 745 came in effect from July 2010
- It is an essential guide to everyone involved with preparation, presentation and examination of documents under LC.

Parties in Documentary Credit or Letter of Credit

As per sub-article 10(a) of UCP, a credit can not be amended nor cancelled without the agreement of issuing bank, confirming bank, if any, and beneficiary and hence main parties to credit are:

1. Issuing Bank (Article 7)
2. Beneficiary
3. The conforming Bank (Article 8)

Note:

- *In spite of being initiator of the credit applicant (importer) is not considered to be the party to credit*
- *Advising bank or second advising bank, reimbursing bank are also not party unless they are also confirming bank*

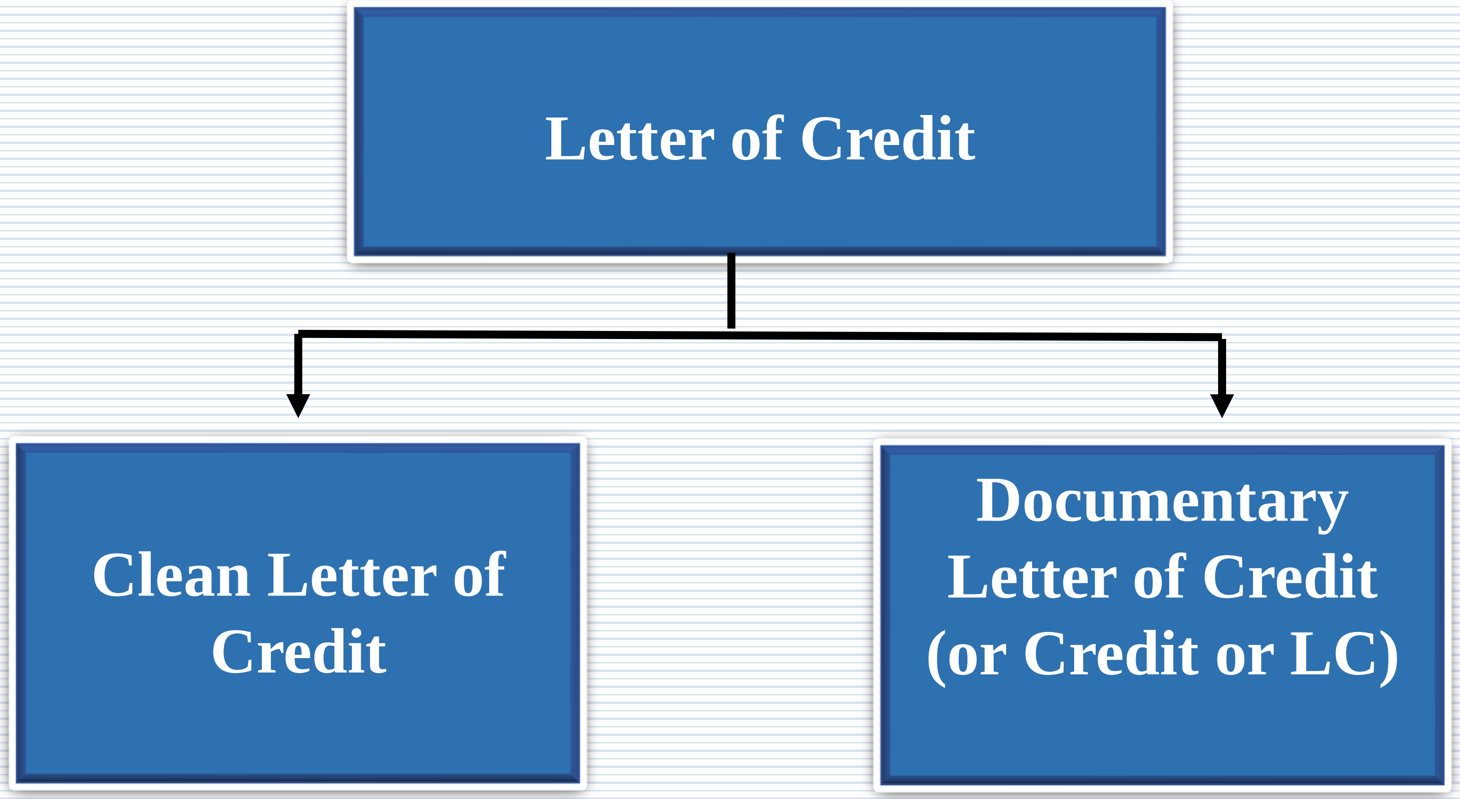
Parties in Documentary Credit or Letter of Credit

The definition, ‘parties to a credit’ therefore includes only those who have express obligation under the credit, none other.

Applicant is not a party to the credit because:

- LC is direct undertaking of issuing bank to beneficiary
- Conforming bank enters scene only if it confirms
- As LC is direct commitment of issuing bank, UCP and ISBP ruled that LC should not be made ‘available by draft on applicant’ because in such case very *availability* of it would become subject to applicant’s acceptance or refusal of draft. However, LC may call draft as part of ‘documents required’.
- Issuing bank must decide based on documents available to approve to reject credit. It’s sole discretion of issuing bank to give waiver to beneficiary in certain cases. And that’s why it is based on **doctrine of independence and called as an independent instrument**

LC Terms and Expressions



LC Terms and Expressions

Clean LC: does not call for financial or commercial documents

- Governed by URC 522 which defines a ‘clean’ document as a one that is ‘ a financial document that is not accompanied by a commercial document’
- In ancient times business men used this instrument as a convenient and safe mode for making cash available when away from home
- Overtime with development of technology clean LCs have virtually disappeared

Documentary Letter of Credit: LC in conjunction with financial or commercial or both it is termed as ‘documentary LC’.

Expressions Relating to LC

- **Applicant**: Party at whose request credit is issued
- **Issuing Bank:** Bank that advises the issue of credit at request of applicant
- **Advising Bank:** Bank that advises the issue of credit at request of issuing bank
- **Second Advising Bank:** Bank through which the first advising bank advises the issue of credit to beneficiary
- **Conforming Bank:** Bank that at request of credit issuing bank, adds its confirmation to a credit. The conforming bank is almost always (but not necessarily) the first advising bank

Advising bank

- **Beneficiary:** party in whose favour credit is issued
- **Nominated Bank**: The bank with which the credit is available for negotiation, acceptance, honour or deferred payment. If no bank is specifically nominated by credit, any bank is nominated bank
- **Negotiating Bank:** The bank which examines the documents presented by the exporter, then negotiates the credit (i.e., in the case time draft, either advances or agrees to advance funds to the beneficiary on or before the maturity date of the draft). This negotiation is usually done 'with recourse', which means that if the issuing bank fails to reimburse the negotiating bank, the negotiating bank will recover the funds advanced to the exporter

Doctrine of Strict Compliance

- It states that if seller wishes to be paid under LC, it must submit documents that strictly comply with terms of credit.
- If they don’t; nominated bank (including confirming bank) or issuing bank may refuse to honour or negotiate
- However, ISBP 745, has made a significant impact in lessening exactitude of doctrine of strict compliance as banks are not robots and also don’t know details of each contract signed between parties.
- It has been acknowledged that purpose of LC is to facilitate international trade, not to find excuses for refusing payment

Thank You