Money Business

Exporting – Part III

Letters of credit, documentary collection, forward options, and other "must know" banking terms for exporters.

Nancy Bartels

The object of any business transaction, be it foreign or domestic, is making a profit. That's why you go through all the effort of making and selling your product in the first place. Getting paid in a timely and convenient manner is crucial to making a profit, but when your customer is in another country, this "timely and convenient" payment can become complicated; hence, your need for a banker with expertise in international markets.

To help explore the basics of the banking part of your export equation, *Gear Technology* spoke with Terese S. Gravenhorst, second vice president, International Banking Division, American National Bank and Trust Company of Chicago.

Like other experts we have consulted for this series, Gravenhorst emphasizes that you should contact your banker early and ask lots of questions. "Call your banker at the same time you're contacting your freight forwarder, your lawyer, and your accountant. Even if you're still in the 'just thinking about it' stage, that's a good time to get your bank involved."

The questions you should be asking relate to your bank's capability to assist you with foreign transactions. Can it help you with wire transfers, foreign exchange, various international payment methods, documentary collections, letters of credit, etc.? How deep is the bank's expertise in these areas?

If your bank is a large one in a major metropolitan area, the chances are that it can handle your export banking needs. But even if you are accustomed to dealing with a smaller bank without this background, you can probably get the services you need without changing bankers.

Many smaller banks are "domestic correspondents" of larger banks; that is, they count on the larger bank to provide services like international banking, which the smaller bank cannot. Gravenhorst explains: "[The smaller bank] doesn't have the international expertise, so it will piggyback off us. On the export side we will deal directly with the customers, but it's understood that we are assisting the smaller bank as a service to their customer, not competing with them in any way."

Involving your banker in your export plans early has other advantages as well. He or she will be essential if you need to increase your line of credit to finance some of your export ventures, but, in addition, your banker may be

MANAGEMENT MATTERS

Managing a business today is hard work. Let "Management Matters" lend a hand. Tell us what management matters interest you. Write to us at P. O. Box 1426, Elk Grove, IL 60009, or call our staff at (708) 437-6604.

Terese S. Gravenhorst
is the second vice president in the International Banking Division of American National Bank and Trust Company of Chicago, IL.

able to provide you with other ideas or connect you with people or organizations who can advance your export plans. "They can sometimes point you in other directions or ask, 'Have you thought of this or that?'" says Gravenhorst.

The Documents in the Case

The financial documents required in export transactions have an exaggerated reputation for being complicated and difficult to understand. They can be highly detailed, but their basic function in every case is simple — to see that you get your money once your product has been delivered to the buyer.

The documents required will depend on the method of payment upon which you and your customer have agreed. These terms can be an important negotiating point and will be a factor in determining how competitive your product will be and what your costs will be. They will affect your collection risk, how long you will have to wait for payment, and your ability to obtain financing.

Your decision about terms should be based on a number of factors, such as the value of the shipment, whether you have had to make special modifications to the product, the relative risk of shipping to the particular country, the creditworthiness of the buyer, and the terms your competitors are offering.

The riskiest method of payment from the seller's point of view is the open account. This is the same kind of arrangement you might enter into with a domestic customer: You deliver the goods, and the customer sends you a check or arranges for a wire transfer to your account within the agreed-upon amount of time.

This is a simple approach, but it has some obvious risks. Recourse is difficult should the customer default. Gravenhorst explains, "It's more complicated if the customer is halfway around the world. You have to go to his country, deal with his country's laws, etc."

The open account arrangement is probably wise only if you know your customer very well and are absolutely sure of his or her creditworthiness. And even then, if an overseas customer is willing and ready to pay, political realities may make it impossible. "Remember the situation in Kuwait," says Gravenhorst. "Those people had the money, but our government blocked payment. You have to consider the political stability of your customer's country."

Documentary collection offers some reduced risk to the seller. Under this method of payment, you ship the goods, and the shipping and commercial documents which enable the buyer to get the goods are transmitted through banking channels. They are released to the buyer only when he or she releases funds for payment.

Gravenhorst explains: "You ship your goods and then present the documents like the invoice, packing list, and ocean bill of lading to your buyer's bank, who notifies him and says, 'We've received the documents you need to get your goods released. We will release them to you only when you make payment.' The buyer instructs the bank to debit his account, and the foreign bank sends the funds to your bank. The problem with this arrangement is that the buyer can also say, 'I've changed my mind. I don't want this shipment.' In that case you either have to ship the goods back home or find another buyer for it there."

The least risky and, therefore, most popular method of payment with sellers is the letter of credit. This document works much like a certified check. The bank guarantees the payment of the money as long as the requirements specified in the letter of credit are met. "The issuing bank is saying, 'Whether or not our customer, who is your buyer, goes bankrupt or falls off the edge of the earth, we, the bank, promise payment to you.'" says Gravenhorst.

Letters of Credit

Letters of credit come in several forms, the most com-

MANAGEMENT MATTERS

The 10 Most Common Discrepancies in a Letter of Credit

1. The letter of credit has expired.
2. Documents are presented late.
3. Shipment is late.
4. Documents are inconsistent with one another.
5. Applicant's/beneficiary's name and/or address differs on the documents and the letter of credit.
6. Goods are shipped via air instead of ocean or vice versa.
7. Partial shipments are made when the letter of credit prohibits them.
8. Documents are not signed when required.
9. Draft not presented.
10. Insurance policy or bill of lading is not endorsed.

mon being irrevocable, confirmed, and advised. If you and your customer agree to use a letter of credit, be sure that you get an irrevocable one. This means that none of the conditions in the letter can be changed without your consent. Confirmed and advised letters of credit provide even more guarantees of payment under particular circumstances.

The letter of credit is great insurance, but it places obligations on you as well as on the buyer. A letter of credit will contain stipulations with which you must comply, or the issuing bank will not pay out on it. These stipulations may include method of shipment, dates and times of delivery, documents that will be required, etc.

It's a good idea to get copy of the terms and conditions that are to be included before an actual irrevocable letter of credit is issued. Your banker, lawyer, and freight forwarder should review these terms to make sure you can comply with them before the letter is issued, because once it is, additional fees will be incurred and time will be lost for every change you make.

"You as exporter have to review that letter," says Gravenhorst. "Sometimes customers will get the letter of credit and just stick it in a drawer and go ahead and make the shipment. Then comes time to present the documents, and they say, 'Well, we missed this expiration date,' or 'We needed to have these documents notarized by the Saudi Arabian consulate.' Now the bills of lading and the invoices are gone, and getting all that done may be impossible. Letters of credit are not that complicated, but you do have to review them line by line."

Most letters of credit are also "advised". This means that your banker in the U.S. verifies the authenticity of the letter of credit issued by your customer's bank. Gravenhorst explains: "If letters of credit are issued in telex form, code numbers are included by the issuing bank. Our telex department can decode these numbers to make sure that the letter of credit has really been issued by, say, Deutsche Bank in Germany, and not by the customer pretending to be Deutsche Bank. We also have books of signatures from thousands of banks around the world, and we can verify all the signatures. We don't see it often, but sometimes fraudulent letters of credit do come through."

Even with an advising bank to verify the authenticity of the letter, the customer would still look to the issuing bank, not the advising one, for payment.

Additional Guarantees

Under some circumstances, a simple irrevocable letter of credit is not enough to insure payment. If additional guarantees are required, you will want to look into confirmed letters of credit.

The confirmed letter of credit would be appropriate in a case where you do not feel comfortable with the issuing bank's ability to meet

Methods of Payment for Overseas Transactions

Open Account

Payment made as agreed upon between buyer and seller.

Risks:
- The buyer may default.
- Government regulations may cause delay in obtaining foreign exchange or funds transfer.
- Payment may be blocked because of political events.

Appropriate When:
- Seller trusts the buyer and knows payment will be made.
- No government regulations inhibiting foreign exchange or funds transfer exist.
- Seller has sufficient liquidity or access to outside financing to extend deferred payment.

Documentary Collections

Documents Against Payment — Payment will be made when sight draft is presented to buyer's bank, and buyer agrees to pay draft. Goods are available to buyer after payment.

Risks
- Buyer may refuse shipment.
- Government regulations may cause delay in obtaining foreign exchange or funds transfer.
- Payment may be blocked because of political events.

Appropriate When:
- Seller knows buyer will accept shipment.
- No government regulations inhibiting foreign exchange or funds transfer exist.

Documents Against Acceptance — Shipping documents are presented to buyer's bank with instructions to release documents after buyer has "accepted" draft (a promise to pay at a future date). Payment will be made on maturity date of accepted draft.

Risks
- Buyer will default.
- Government regulations may cause delay in obtaining foreign exchange or funds transfer.
- Payment may be blocked because of political events.

Appropriate When:
- Seller confident buyer will pay accepted draft.
- No government regulations inhibiting foreign exchange or funds transfer exist.
- Seller has sufficient liquidity or access to outside financing to extend deferred payment.

Commercial Letters of Credit

Sight — Payment is made when the documents are presented to issuing bank, provided that the documents are in compliance with the letter of credit terms. Goods are available to buyer after the draft has been paid.

Time — Payment is made on the maturity date of the accepted draft. Goods are available to the buyer after the draft has been accepted by the issuing bank (a promise to pay has been established).

Risks:
- Issuing bank defaults on its payment obligation.
- Payment blocked due to political events.
- Discrepancies in documents prevent payment.

Appropriate When:
- Seller isn't sure of buyer's creditworthiness.
- Seller is confident that buyer's country won't take any action to block payment.
- Seller is confident issuing bank will fulfill obligation.

Confirmed Letter of Credit

Time of payment and goods are available on the same basis as with a confirmed letter of credit.

Risks:
- Confirming bank defaults on payment obligation.
- Discrepancies in documents prevent payment.

Appropriate When:
- Seller is unsure or unable to evaluate issuing bank's creditworthiness.
- Seller is unwilling to accept political risks in issuing bank's country.

Cash in Advance

Payment is made before shipment. Goods are available after payment.

Risks:
- None.

Appropriate When:
- Seller has negotiating strength to demand cash in advance.
- Buyer's country doesn't prevent advance payment.

its obligations. In that case, you would ask your bank to add its confirmation (for which it will charge a fee), to that of the issuing bank. Then if the issuing bank cannot make payment for some reason, as long as all the documents are in compliance with the letter of credit, the U.S. bank will pay.

According to Gravenhorst, you probably would not need to ask for a confirmed letter of credit from a major bank in a major exporting country, such as Japan or Germany. But if you are doing business in a country where political and economic stability are questionable, or where the issuing bank itself is not as well-known, the confirmed letter of credit is an option you may wish to consider.

The Price of Security

What does this additional payment guarantee cost the seller? This will depend on a number of factors. And who (you or the buyer) pays what share will be one of the subjects of negotiation. But basic costs for an irrevocable letter of credit are about one-half percent of the invoice amount. Charges for amending and advising on a letter of credit run between $40.00 and $60.00. Fees for a confirmed letter of credit are on a sliding scale; the greater the risk in a particular case, the higher the fees.

The Other Side of the Coin

While an irrevocable letter of credit guarantees the seller payment, it is a riskier proposition for the buyer. If he or she agrees to such a payment method, what happens if the customer is not satisfied with the product when it's delivered? What recourse does he have?

From the issuing bank's point of view, none. Says Gravenhorst, "It's important to remember that banks deal only in documents. Sometimes customers will ask us not to pay out on a letter of credit, and we have to tell them that if the documents are in order, we have to pay. Customer satisfaction has nothing to do with it."

This is why buyers of big-ticket or custom-made iterms (like specialty gears) will commonly negotiate an inspection of the product prior to shipment. The buyer will insist on a signed inspection certificate as part of the terms of the letter of credit. Another approach to the same problem is to agree to partial payment upon delivery and the rest after a specified period of time during which the customer can inspect and use the product.

Foreign Exchange

Another complication of the overseas market is the fact that currencies in different countries have different values. If you have sold a product for $25,000 U.S., how do you guarantee that by the time the goods are delivered and payment is made, you will have $25,000 in payment, in spite of fluctuating currency markets?

The simplest way, of course, is to insist on payment in U.S. funds. But that may not be a realistic approach. If your competitors are dealing in pounds, yen, or deutschemarks, you may have to as well.

"This is a place where you need to get your bank's foreign exchange division involved," says Gravenhorst. "You have to be aware that, yes, there are currency risks, and if you're selling in currencies other than your own, you can't be dumb. You have to be aware that they do fluctuate, and if you sell today at one rate, and you actually receive your money at a later date, the amount could be quite different.

"There are instruments called forward options which allow you to lock into a rate of exchange, so no matter what happens to the value of the currency in six months, you get your $25,000. But you do need to work with people who are well versed in foreign exchange to explore these options.

"This is another place to ask questions of your bank. Sit down and talk to the people in your bank's foreign exchange department. They can give you their feelings about what these other currencies are going to do in the future. They won't be right 100% of the time, but they do provide a another resource for you, another piece of input."

EXIMBANK & FCIA

Letters of credit are not the only way to strengthen your financial hand when exporting. Two organizations which can provide you with export credit insurance are EXIMBANK and FCIA.

EXIMBANK is the Export/Import Bank of the United States, which is part of the Treasury Department. Its main function is to promote exports. Its programs are split up into two sections — insurance and guarantee.

On the insurance side, EXIMBANK will insure your export receivables. Gravenhorst explains: "Say most of your foreign competitors are offering open account terms, but you don't want to have to take that risk because that means you have foreign receivables on your books. Maybe your bank is doing receivable financing, and they're not going to take foreign receivables. So in order to mitigate that foreign risk and to keep your bank happy, you get this export credit insurance."

MANAGEMENT MATTERS

Banks deal only in documents. If the documents are in order, a bank must pay out on a letter of credit, regardless of any dispute between the buyer and seller.

This credit insurance comes in two kinds — commercial and political. Under commercial coverage, if for any reason the buyer fails to pay, you can collect from the insurer. With political coverage, if the political situation in your buyer's country makes it impossible for him or her to get money out to you, the insurer pays.

FCIA is the Foreign Credit Insurance Association. At one time it was affiliated with EXIMBANK, but is now an independent organization. It provides the same kinds of insurance and guarantee programs as EXIMBANK, but because it is a private company, it can offer arrangements under conditions where it might not be politically expedient for a government organization to do so, say, in the area of defense-related exports.

This kind of insurance can cost anything from 10 cents to $1.50 per $100 of invoice, depending on the risks involved.

EXIMBANK also provides loan guarantees for companies involved in exporting. "For example," says Gravenhorst, "one of our customers wanted to use some of their work in process as collateral for a line of credit for the purpose of export transactions. Because the work in process was for a foreign job, we wouldn't allow that as collateral, but EXIMBANK was willing to. So with the EXIMBANK guarantee, we could offer a line of credit to our customer."

Exporters should note that while EXIMBANK is interested in encouraging exports, its loan guarantees are by no means "free money." The bank is always looking for reasonable assurance of repayment and requires at least two or three years of financial operating experience on the part of the borrower.

Summing Up

Getting your money from a buyer in a foreign country is never as simple as collecting from one down the street, but the complications should not be a deterrent to the seller sincerely interested in overseas markets. Exporting is as business strategy as old as commerce itself, and the rules for success are just as venerable.

As Gravenhorst says, "Be prepared. Do your homework. Ask questions. Any bank or freight forwarder would rather have you ask questions early or while the work is in process than to wait until you've shipped the goods. Then it's too late. Ask as many people as you can and get a good team behind you. That's the way to do well." ■