A FirstBank Presentation

PAYMENTS SYSTEM IN NIGERIAN INTERNATIONAL TRADE

An Overview

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Payment Systems

To succeed in today's global marketplace, exporters must offer their customers attrac-tive sales terms supported by appropriate payment methods to win market share against foreign competitors.

Since getting paid in full and on time is the primary goal for each export sale, appropriate payment methods must be carefully chosen to minimise payment risks, while also accommodating the needs of the buyer.

As with all sovereigns, Nigeria is involved in export and import activities.

Consequently, the theme of this paper will be addressed from both importers' and exporters' perspectives.

International trade presents a spectrum of risks, causing uncertainty over the timing of payments between the exporter (seller) and importer (foreign buyer).

- To exporters, any sale is a gift until payment is received.
- Therefore, the exporter wants payment as soon as possible, preferably as soon as an order is placed or before the goods are sent to the importer.

- To importers, any payment is a donation until the goods are received.
- Therefore, the importer wants to receive the goods as soon as possible, but to delay payment as long as possible, preferably until after the goods are resold to generate enough income to make payment to the exporter

Methods of payment for International trade

There are four primary methods of payment for international transactions. During or before contract negotiations, it is advisable to consider which method is mutually beneficial to the seller and buyer.

1. Advance payment
2. Open account
3. Documentary collection
4. Documentary letters of credit
5. Escrow account arrangements

Advance Payments

- Here, the exporter can avoid credit risk, since payment is received prior to the transfer of ownership of the goods. Telegraphic transfers and credit cards are the usual methods of advance payments.
- Advance payment is the least attractive method to the buyer as this method creates cash flow problems and the risk that the goods may not be received after all. It is the fastest and cheapest form of payment.
- Advance payment method is not fully supported by the Central Bank of Nigeria (CBB). Strict regulations govern its use.

- This payment method can not be funded from the official foreign exchange market.
- Where funded through the buyer's domiciliary account amount transferrable is restricted to USD10,000 if funded by cash deposit.
- The advance payment option is quite attractive to companies that engage in export activities or have unfettered access to foreign inflow of Foreign exchange into their domiciliary accounts.
- It is also used between buyers and sellers who have already established mutual trust, as this negates the risks associated with it. It is the fastest and cheapest form of payment

Letters of Credit

- Letters of credit (LCs) are among the most secure instruments available to interna-tional traders.
- An LC is a commitment by a bank on behalf of the buyer that payment will be made to the beneficiary (exporter) provided that the terms and conditions have been met, as verified through the presentation of all required documents. The buyer pays its bank to render this service.
- An LC is useful when reliable credit information about a foreign buyer is difficult to obtain, but you are satisfied with the creditworthiness of your buyer's foreign bank.

- This method also protects the buyer, since no payment obligation arises until the documents proving that the goods have been shipped or delivered as promised are presented.
- The LC is a separate contract from the sales contract on which it is based and, therefore, the bank is not concerned whether each party fulfills the terms of the sales contract.
- The bank's obligation to pay is solely conditional upon the seller's compliance with the terms and conditions of the LC. In LC transactions, banks deal in documents only, not goods.

Types of Letters of Credit

- **Confirmed LCs:** This is a form of LC which bears the payment obligation guarantee of the offshore bank(confirming bank) in addition to that of the issuing bank. It offers the highest level of payment protection for the exporter since the confirming bank "backs up" the obligation of the issuing bank though at an additional cost

- **Unconfirmed LCs:** For this type of LC no offshore confirmation is required. Country risk of the issuing bank is not mitigated

- **Transferable LC:** When an LC is issued as transferable, the payment obligation under the original LC can be transferred to one or more "second beneficiaries."

- **Revolving LC:** With a revolving LC, the issuing bank restores the credit to its original amount once it has been drawn down.

- **Standby Letters of Credit (SBLC):** SBLC represent an undertaking by a bank to pay a third party(i.e. the beneficiary) upon the failure of the bank's customer to perform specified obligations.

Types of Letters of Credit

- **Red Clause LC:** This is where the beneficiary of a letter of credit requests that certain sum is paid to him before presentation of shipping documents evidencing performance from his side. Usually, advance payment is required for capital intensive importation e.g. machineries.
- However, Central Bank of Nigeria through her foreign exchange manual has indicated that maximum of 15% FOB value can be paid as advance payment and the seller is required to submit performance bonds or bank guarantees to enable beneficiaries access the advance payment fund.

Documentary Collections

- A documentary collection (D/C) is a transaction whereby the exporter entrusts the collection of payment to the remitting bank (exporter's bank), which sends docu-ments to a collecting bank (importer's bank), along with instructions for payment.
- Funds are received from the importer and remitted to the exporter through the banks involved in the collection in exchange for those documents. D/Cs involve the use of a draft that requires the importer to pay the face amount either on sight (document against payment—D/P) or on a specified date in the future (document against accep-tance—D/A).

- The draft lists instructions that specify the documents required for the transfer of title to the goods. Although banks do act as facilitators for their clients under collections, documentary collections offer no verification process and limited recourse in the event of nonpayment. Drafts are generally less expensive than letters of credit (LCs).
- Usually, it is adopted by buyers and sellers that have parent – subsidiary relationship and also traders that have built trust and integrity in their business relationship overtime.

Documentary Collections

Documents Against Acceptance (D/A) Collection

- Under a D/A collection, the exporter extends credit to the importer by using a time draft. In this case, the documents are released to the importer to receive the goods upon acceptance of the time draft.
- By accepting the draft, the importer becomes legally obligated to pay at a future date. At maturity, the collecting bank contacts the importer for payment. Upon receipt of payment, the collecting bank transmits the funds to the remitting bank for pay-ment to the exporter.

Documents Against Payment (D/P) Collection

- Under a D/P collection, the exporter ships the goods, and then gives the documents to his bank, which will forward them to the importer's collecting bank, along with instructions on how to collect the money from the importer.
- In this arrangement, the collecting bank releases the documents to the importer only on payment for the goods. Upon receipt of payment, the collecting bank transmits the funds to the remitting bank for payment to the exporter.

When to Use Documentary Collections

Under D/C transactions, the exporter has little recourse against the importer in case of nonpayment. Thus, the D/C mechanism should only be used under the following conditions:

- The exporter and importer have a well-established relationship.
- The exporter is confident that the importing country is stable politically and economically.
- An open account sale is considered too risky, but an LC is also too expensive for the importer.

Open Account

- An open account transaction means that the goods are shipped and delivered before payment is due, usually in 30 to 90 days. Obviously, this is the most advantageous option to the importer in cash flow and cost terms, but it is consequently the highest risk option for an exporter.
- Because of the intense competition for export markets, foreign buyers often press exporters for open account terms. In addition, the extension of credit by the seller to the buyer is more common abroad. Therefore, exporters who are reluctant to extend credit may face the possibility of the loss of sale to their competitors.

- However, while this method of payment will definitely enhance export competitiveness, exporters should thor-oughly examine the political, economic, and commercial risks, as well as cultural influences to ensure that pay-ment will be received in full and on time.
- It is possible to substantially mitigate the risk of nonpayment associated with open account trade by using such trade finance tech-niques as export credit insurance and factoring. Exporters may also wish to seek export working capital financing to ensure that they have access to financing for both the pro-duction for export and for any credit while waiting to be paid.

Open Accounts

- Open account terms may be offered in competitive markets with the use of one or more of the following trade finance techniques:

    i. Export Working Capital Financing,

    ii. Government-Guaranteed Export Working Capital Programmes,

    iii. Export Credit Insurance,

    iv. Export Factoring, and

    v. Forfaiting.

- These finance techniques are not readily available in the Nigeria Financial system for use by exporters. Even for importers, imports on open account basis is not guaranteed by the Federal Government of Nigeria.

Conclusion

- Despite the focus on Letters of Credit and Documentary collection over the years, trade financing is shifting away from this cumbersome methods of conducting business. It is now estimated that over 80% of global trade is conducted on an open account basis.

- Led by large corporates, this form of payment saves time and so has been adopted by smaller corporates as they become more comfortable with their buyer and supplier relationships. The Federal Government should consider the use of open account as this is fast gaining ground in the international trade finance world.

THANK YOU