

Prepayment can be advantageous to both buyer and seller if financing costs, i.e. interest rates, are lower in the importer's than in the exporter's country. In such a case, prepayment terms allow the transaction to be financed at a lower cost and permit the prices to come down, because the exporter does not incur the higher rates in his or her own country. Prepayment terms also allow the importer to avoid foreign exchange losses if the domestic currency depreciates against the exporter's currency after the contract is signed — but before receipt of the goods.

## LETTERS OF CREDIT

A letter of credit (L/C) is issued by a bank on behalf of the importer for a fee, and is generally payable to the exporter's bank, also for a fee, when the terms and conditions of the contract have been met.

In terms of collections, the buyer instructs its bank to send a document to the exporter's bank, instructing the exporter's bank to pay the exporter upon presentation of specified documents. Because payment is made only on presentation of these documents, usually shipping documents, the buyer is assured that the exporter will not be paid until the contract terms are met. Because the exporter knows that payment will be made when the documents are presented, the goods can be shipped without worrying about payment. Both the importer and the exporter rely on their banks to protect their interests.

The exporter's bank will inform the exporter that an L/C from the importer has been received. Confirmation of the L/C adds the guarantee of the exporter's bank, meaning that the exporter will be paid upon presentation of the documents specified.

Letters of credit can take different forms, some of which are:

- **Documentary L/C.** This requires presentation of specified documentation before payment is made. This L/C requires only a simple demand for payment.
- **Revocable or irrevocable.** An irrevocable L/C cannot be amended or cancelled without the consent of all parties.
- **Confirmed or unconfirmed.** In the case of a confirmed L/C, the Canadian bank agrees to pay the exporter even if the Mexican institution defaults.
- **Sight or term.** This type of L/C is payable on sight, i.e. immediately upon fulfillment of the contract terms, or payable after a term specified in the L/C.
- **There can also be combinations of L/Cs.** An "irrevocable and confirmed" L/C, which is payable on sight, offers the exporter the optimal level of security. It also involves the highest fees.