Trade Finance

GENERAL PROBLEMS

One important aspect of global markets is, of course, international trade. If we consider the various problems which will arise in the export/import business, there are many ways in which banks can provide assistance:

1. *Payment services* The basic question of money transfers
2. *Collection of debts* The heart of the matter – how to ensure that we get paid
3. *Extension of credit* This involves ensuring that we get paid and the question of extending credit using, say, the bill of exchange
4. *Finance* This may be for the exporter to fund completion of the contract or for the importer to help pay for goods
5. *Foreign exchange* Sales/purchases of foreign currency spot, forward and by way of options, which are discussed in Chapter 8
6. *Trading guarantees* This covers many questions – quality of goods already paid for (importer), failure of chosen supplier to perform on award of a tender (importer), insurance against political risk, sudden withdrawal of export licences (exporter)
7. *Miscellaneous* This involves market intelligence, letters of introduction, correspondent banking facilities and similar services.

PAYMENT SERVICES

There are various ways in which the banks may arrange to remit funds:

- *Mail transfer* (MT) – instruction by letter
- *Telegraphic transfer* (TT)
- *SWIFT* – the Society for Worldwide Interbank Financial Telecommunication, is the bank-owned cooperative supplying secure messaging services and interface software to 7800 financial institutions in 202 countries. SWIFT helps its customers reduce costs, improve automation and manage risk. In addition to its 2292 member banks, SWIFT users include brokers, investment managers, securities deposit and clearing organisations and stock exchanges.
- *International money transfer* (IMT) or *Express* IMT – modern terms for the mail transfer and telegraphic transfer
- *International money order* (IMO) – A UK bank, for example, may issue a cheque drawn on their New York office

- *Bank draft* – This will be drawn on a bank's home account or on their nostro account at a correspondent bank.

The last two documents are usually sent by the customer and not their bank.

SWIFT reported its network traffic grew 11% in 2004 to 2.3 billion messages, compared with, say, 812 million in 1997. On an average basis SWIFT is handling more than 9 million messages per day.

Securities traffic grew 9% in 2004. The securities sector represents 32% of SWIFT's total message volume. Securities messages are the second largest category of messages used by SWIFT's customers.

There are four message categories for which the share of business at end of 2004 is shown in Table 1.

Table 1 *SWIFT message categories and share of business, 2004*

Market	*Traffic (millions)*	*Share %*
Payments	1355	58.9
Securities	737	32.1
Treasury	148	6.4
Trade services	47	2.0
System	12	0.6

Source: SWIFT.

COLLECTION OF DEBTS

There are methods which may not involve extension of credit:

- *Advance payment* This seems ideal but there are still problems. Suppose the advance payment is not received? What if the order is cancelled *prior* to sending the payment? Time must be allowed to clear the cheque/draft anyway. From the *importer's* point of view, the goods may not be shipped, or the wrong goods may be shipped, or the shipping documents may be wrong.
- *Payment on shipment* The exporter emails notice of shipment and awaits payment. The exporter could find themselves having shipped goods and yet the payment does not arrive. The bill of lading may give the importer title to the goods. From the *importer's* point of view, the goods may be found to be faulty or the wrong goods.

- *Open account trading* We despatch the goods and send an invoice marked 'payment within 7 days' (for example). Full of risk but quite suitable for circumstances where a valuable trading relationship has been set up and trust exists. This is very common in the US.

EXTENSION OF CREDIT

We now consider methods which involve extension of credit or cash on delivery but where we ask for a bank's help in collecting the money and guaranteeing arrangements to a certain extent.

Bill of Exchange

This is drawn by the exporter on the importer, with the latter agreeing to pay on demand or at a determinable future time the value of the goods to a specified person or bearer of the bill. This is explained fully in Chapter 5.

- *Sight bill or demand draft* Immediate payment upon presentation of the bill and documents, with no required acceptance of the bill by the importer, as part of a documentary credit.
- *Usance, tenor or term bill* Payable in a number of days or months, usually 'accepted' by a bank, the exporter then sells to a bill broker who holds to maturity or trades.
- *Documentary bill* With documents (bill of lading, invoice, insurance cover and similar documents) attached.
- *Clean bill* Without documents.

Documentary Letter of Credit

A bill of exchange is drawn by the exporter. A documentary letter of credit is opened by the *importer*.

There is an international code of practice for documentary credits set out in the International Chamber of Commerce's *Uniform Customs & Practices for Documentary Credits*.

(The International Chamber of Commerce was set up in 1919 to define the rules and norms by which trade is carried out. Sixty national commissions make up its federal structure.)

The importer opens a documentary credit with his bank (*issuing bank*). This arranges for the issuing bank, upon instructions from the importer, to:

(a) make payment to the exporter (the *beneficiary*); or
(b) pay on or accept a bill of exchange drawn by the exporter; or

(c) authorise another bank (probably its correspondent bank in the exporter's country) to be the *advising bank*, which makes payment to the exporter or accepts his bill of exchange (thus becoming a 'documentary acceptance credit'). The advising bank may also be asked to be the *confirming bank*, to add its guarantee that the exporter will get paid if the issuing bank does not. (However, some countries, for example Iran, prohibit banks from opening credits on terms that require an advising bank to add its confirmation.)

All the above have to be backed by *stipulated documents*. These documents include:

- *Transport documents* Usually by sea under a *bill of lading*, which gives evidence that the goods have been dispatched, purport to be of the type and quality ordered and be properly transported. A copy of the bill of lading is the buyer's claim to possession of the goods when they arrive.

  With container traffic these days there may be a *forwarder's bill of lading* – not necessarily a document of title.

  If by air there is an *air waybill*, not however a document of title, merely acknowledgement of acceptance for delivery.

  If by road or rail there is a *carrier's receipt* or *railway receipt* and this is also not a document of title.
- *Commercial invoice* Specifying quality, quantity and unit and total price.
- *Insurance documents*
- *SAD document* Simplified customs form for the EU.
- *Other documents* Certificate of origin; certificate of quality; health certificate; veterinary certificate; weight note.

There are potential problems with documents – documents missing, incorrectly completed or showing an invoice value different from that on the documentary letter of credit. The bank's staff check these and should see, for example, 'freight paid' on the bill of lading and insurance certificate if goods are sent CIF (including cost, insurance and freight). Incorrect documents can cause delays at the port on landing and incur costs such as local storage.

Types of Documentary Credit

- *Confirmed credit* – when the advising bank also guarantees payment.
- *Revocable/Irrevocable credit* – *revocable* may be amended/cancelled by the issuing bank if the importer is not satisfied. This is obviously not usually acceptable to the exporter but may be suitable for selling to overseas subsidiaries where letters of credit must be used by local regulation. *Irrevocable* can only be amended/cancelled with agreement of the confirming bank and the beneficiary.

- *Sight credit, term or acceptance credit*
  Sight – the exporter draws a demand draft (bill) and presents it to the correspondent bank for payment.
  Term/acceptance – the exporter draws a draft for a period of time (30, 60, 90 days) on the issuing or confirming bank.
- *Negotiation credit* – the confirming bank is instructed by the advising bank (if they are not one and the same) to negotiate the bill which is drawn on the advising bank. *Or* the bill may be drawn on the confirming bank who will accept it, making it a bank bill and therefore 'discountable'.
- *Standby credit* – to fall back upon if payment has not been made to the beneficiary by the other arranged methods.
- *Deferred payment credit* – payment made later.

Typically, in the Western world, all questions of import licences, exchange controls, insurance and documentation have been settled prior to issuing the letter of credit.

From the point of view of the *exporter* there are these advantages:

- Assurance of a payment or acceptance on shipping the goods.
- If an acceptance, then it will be a banker's acceptance and at best discount rates. Who pays the discount is a matter for negotiation!
- Generally, the reassurance of a bank (or banks) rather than just the importer's promises.

The *importer*, too, has advantages:

- No money will be paid until the goods are shipped and the required documents lodged.
- There may be time to pay, if a bill of exchange is involved. Again, acceptance will not be made until the goods are shipped.
- All formalities are complete before authorising the letter of credit.

There is, finally, the question of the relationship of the *bank* and the *bank's client* wanting to issue a letter of credit. The request to the bank for a letter of credit must be signed by someone in authority as it incurs obligations for the client (the 'accountee'). Links with the bank in this day and age may be *electronic*. The whole trade deal must conform with local import regulations and EU rules if the client is a member of that community.

From the *bank's* point of view, this is a contingent liability and affects existing credit agreements and limits. It is also an off-balance sheet transaction which needs capital under BIS capital ratio rules. The bank will probably charge the client a deposit and needs authority to debit expenses and charges. If a bill of lading is not used, the bank may require the goods to be at the disposal of the bank or consigned to the bank.

If the bank is the *advising* bank, it is responsible for seeing that the proposed credit is authentic.

Documentary Collection

The exporter ships the goods and presents the documents through a bank. The bank may be requested either to collect the payment in return for the documents or to see that a bill of exchange is accepted in return for handing over the documents.

The bank, however, is only using its 'best efforts' to collect the money or acceptance. The importer may still refuse the documents. If the goods have been shipped and the documents are *not* documents of title, the importer might even be able to collect the goods anyway. We may request the collecting bank to protect our interest in the event of default. If the importer doesn't pay or refuses the transaction, the goods (having been despatched) may have to be stored locally.

Effect of 1997 Asian Crisis

Prior to the Asian crisis in mid-1997 (see 'Insurance'), much international trade had moved to an open account basis or was transacted through payment on documentary collection. The demand for confirmed letters of credit naturally increased after the crisis. Although this is more expensive for the exporter, it provided more secure cover for sales to countries like South Korea, Thailand and Malaysia. The bank issuing the confirmation would look at it on a case-by-case basis.

FINANCE FOR THE EXPORTER

The exporter may need finance while waiting to be paid other than that provided by, say, discounting the bill of exchange. Two possibilities are forfaiting and factoring.

Forfaiting This is traditionally associated with longer-term high value capital goods and construction projects. In the UK, London Forfaiting has a high concentration of deals in excess of £50 million in value. However, others have also done a lot of 60 day business with £250 000 probably a minimum figure.

A bill of exchange or promissory note is bought 'à forfait', meaning *without recourse* to the exporter: that is, the purchaser forfaits all recourse to other parties. They look to the importer's bank to sign the bill or promissory note to guarantee payment and the bill/note will be unconditional. They can then sell the note/bill in an active secondary market. The major currencies are dollars, Swiss francs and deutschmarks.

For the exporter, forfaiting has the advantage that the finance is without recourse and has no effect on credit limits with their bank or any other. It is useful where export credit guarantees (or private insurance) are not available and, where it is

available, avoids cash flow problems while waiting for a claim to be met. However, the forfaiter needs to be satisfied about client, country and political risk and the discount may be expensive. Also, they may not finance 100% of the value.

Factoring Factoring companies purchase trade debts of clients and usually pay 80% of the full value of debts due to be paid in less than six months. Normally, this is used for continuous rather than *ad hoc* business. The remaining 20% is passed to the client after all the debt has been collected. The factor runs the sales ledger and collects the money. Factoring can be with or without recourse. The latter can be very convenient, especially for export business, but is, naturally, more expensive. Frequently 'open account' terms are used. As well as a charge for providing finance, there is also a service fee for running the sales ledger and collecting the debt. This service fee varies from ½% to 2%. A variation on the theme is *invoice discounting*, in which the factor provides finance against invoices as before but the client runs the sales ledger and collects the debt. In the UK, invoice discounting is 85% of the market and factoring 15%. This is because it is cheaper, companies like to keep control of the sales ledger and it is more confidential.

The overseas agent of a factor will investigate credit status so that a quick report can be made to the factor, and the agent will usually underwrite the debt and deal with any queries locally. Factors may have their own offices abroad or be part of a network of independent factoring organisations. The largest such network is Factors Chain International (FCI), founded in 1968. It has 150 members in 50 countries and factoring/invoice discount business of €760 billion in 2004. In the UK, the Factors and Discounters Association reported that 40 000 businesses used the services of 38 full members and 8 group members in 2004. At the end of the second quarter in 2005, turnover for the year to date was £70.9 billion of which domestic invoice discounting was £59.0 billion. Factoring companies are often subsidiaries of banks – for example, in the UK, Barclays Sales Financing, HSBC Invoice Finance and Lloyds TSB Commercial Finance. The exporter has the advantages of dealing with a bank subsidiary, funding working capital on normal finance terms, not having to run the sales ledger and collect the debt and (in the case of non-recourse) peace of mind.

As stated, factoring is only provided for short-term debts and continuous sales of consumer items. In principle, it is similar to an overdraft.

While most factoring is *domestic*, international factoring is on the increase. The biggest markets using international factoring are the Netherlands, Germany, Italy, the UK, France, Belgium and the US.

Other finance The exporter may require more general financial help than that merely required to bridge the gap while waiting to be paid – finance to produce capital goods, for example, that may take up to a year to deliver. Most large banks have departments which specialise in export finance and have 'packaged' schemes available. Sometimes some form of government aid or support may be available and the most important of these is insurance from a government export credit guarantee body (discussed later). If it is a large international project, then the term

used may be 'project finance' with a syndicate of banks involved, and recourse is available only to the stream of funds from the project. The exporter, in some cases, may be interested in the question of aid to the *importer* to help purchase the goods. In a small number of cases, where factors are involved, the factor's overseas agent may get involved with providing finance to the importer also. On many occasions, however, a key component will be official sources of finance.

There are programmes from donors such as the World Bank, the EU and the African Development Bank. It is estimated that more than one third of sub-Saharan African imports are aid-financed. Assistance is focused on countries implementing the economic reform programmes of the IMF and the World Bank. The paperwork and bureaucracy are formidable but payments are guaranteed and there is no currency risk.

In other cases, banks provide 'buyer credits' in conjunction with export credit guarantee insurance.

FOREIGN EXCHANGE

This subject was dealt with in Chapter 10.

TRADING GUARANTEES

The question of guarantees has been mentioned and the concerns of both exporters (political and currency risk) and importers (faulty goods or general non-performance of contracts). There is a series of schemes for trading guarantees other than export credit guarantees. These refer to guarantees backed by banks.

Bid or tender bond This is required to support an exporter's offer to supply goods or a contractor's offer to carry out a service.

The bond safeguards a buyer against loss if the tender is awarded but the seller fails to proceed by signing the contract or submitting a performance bond.

A bid bond is guaranteed by the seller's bank and is usually 2%–5% of the value of the contract.

Performance bond When the seller's bid is accepted, the bid bond is replaced by a performance bond, usually 10% of the value of the contract.

It is issued by the seller's bank, guaranteeing that he will supply goods (to the standard required by the buyer) or perform a service. If the buyer does not accept that goods are up to standard then they can claim under the performance bond.

Advance payment guarantee The buyer pays the seller an agreed percentage of the contract price as an advance payment, which can be claimed back if goods/services provided are not satisfactory.

Retention monies guarantees / progress payment bonds Part of the contract price (usually 5%) can be held back by the buyer for a certain period to give time

to assure themselves that the goods or services supplied are satisfactory, or stage payments may be made on a similar basis.

These may be conditional or unconditional – for example, conditional on the seller admitting the fault or having won an arbitration proceeding or legal case. The bank must have a counterindemnity with their client, authorising debit of the said sum if money is paid under the guarantee. 'Unconditional' means that the bank will pay up simply on the signed statement by the buyer that the seller has failed in their obligation.

The bank guarantee may have to be paid *even if the bank's client goes into liquidation*.

Export credit guarantees Government departments often provide exporters with facilities for insuring their shipments of goods against default by foreign importers and most other risks, except for normal marine insurance. Premiums are charged but the service is generally provided on a non-profit making basis. Such government departments do not themselves extend export finance but in providing insurance against risk encourage the banks to do so.

There are, however, also private insurers that will quote premiums for trade risk; for example, in the UK, Trade Indemnity. The UK's Export Credit Guarantee Department was founded in 1919. There is a distinction drawn between short-term projects, up to two years, and longer-term risks. The short-term end was located in Cardiff and called the Insurance Services Group (ISG). However, the government sold this in December 1991 to the Dutch insurer NCM. The new name is 'NCM Credit Insurance'. NCM also took control of the short-term export insurance in Sweden following the collapse of Svenska Credit.

The insurance protection is against non-payment, insolvency, withdrawal of import licences, problems due to foreign government decree and war and earthquake. Cover is typically up to 90%. The element of risk can be noted when we see from a report in 2003 that the UK's ECGD had run up debts of £9 billion, dating back three decades, much of it to poor countries. It was estimated that only £2 billion was recoverable.

Given export credit guarantees, the banks are obviously happier to provide export finance and may arrange and administer the policy as part of the deal.

Other export credit guarantee organisations are:

- Euler Hermes — Germany — (private sector)
- NCM — Holland — (private sector)
- COFACE — France — (state majority holding)
- SACE — Italy — (state majority holding).

An example of international cooperation here is seen in the case of the financing of the two A340 and three A320 Airbus passenger jets for China Eastern Airlines. Export credit finance of $363 million has been organised by BNP Paribas with the

assistance of the US Export-Import Bank, ECGD (UK), Coface (France) and Euler Hermes (Germany).

The biggest names in international trade finance are ABN Amro, Citigroup and Deutsche Bank.

MISCELLANEOUS SERVICES

Export houses These are market experts who know about shipping, insurance, quotas, licences, exchange terms and local conditions. They may:

- Handle all the paperwork and even promote sales abroad but the exporter is still the principal although the export house carries the risk
- Act for an overseas buyer – find a supplier, arrange shipment and insurance and confirm the contract on the buyer's behalf
- Act as an agent and buy goods and resell them but only against firm orders.

Confirming houses Similar to export houses but will place an order for a buyer as a *principal* and will pay the exporter when the goods are despatched. May arrange credit for the buyer.

International credit unions Finance houses and some banks have entered into reciprocal arrangements to arrange local finance to help an importer to import goods from a fellow member. An exporter, for example, may be asked by the importer of capital goods for instalment terms of payment. The bank may be able to arrange this through the partner in the credit union in the foreign company. The local bank/finance house will investigate and arrange finance – typically for machinery and capital goods generally. Examples are European Credit Union, Amstel Club, Export Finance International.

Barter/Countertrade These arrangements are common where currencies are not convertible or subject to any restrictions preventing normal issue of export licences. Barter is a simple exchange of goods; countertrade is a wider term including things like counterpurchase and buy-back. Under these arrangements, exporters may agree to buy back goods from the importing companies, for example, the exporter of textile machinery must agree to buy back textiles. Alternatively, the exporter agrees to buy back goods in a more general way to a given percentage value of the exports.

For many years, Russia dealt with Finland on the basis that Russian oil purchased by Finland accumulated credits that could only be used to buy Russian goods. Other examples: car imports into Tunisia (Peugeot, VW) were only permitted on the basis that spare parts were purchased from Tunisian companies to a value of 50% of the cost of the car; Balfour Beatty in the UK won a contract for £2 million in Malaysia on the basis that Balfour Beatty had to find buyers for tin, palm oil and rubber goods.

Barter and countertrade have now become a very big international business, with specialist companies like ICON International and Attwood Richards. For example, Keebler, a US biscuit company, was left with $1 million of unusable packaging. Attwood Richards asked Keebler UK to fill the packaging with biscuits worth $14 milion for sale in markets where Keebler had no presence – Russia, Ukraine and the Baltic States. Keebler was paid in trade credits, eventually exchanged for packaging and shipping services. Attwood Richards also arrange barter for surplus seasonal goods – swimwear, beach umbrellas and golf clubs. Trade credits have also been used to buy office furniture, computers, cleaning services, hotel rooms and airline seats.

General Banks also provide a host of other services in connection with export/import business – market intelligence, credit status enquiries, letters of introduction, correspondent banking, translation, legal and accountancy facilities.

SUMMARY

Banks facilitate international trade with cross-border payment systems. The *SWIFT* system is the most important.

Simply sending an invoice to the importer and awaiting payment is *open account trading*.

Credit may be extended by the use of a *bill of exchange* which may be a *sight*, *tenor*, *documentary* or *clean* bill.

A promise by the importer's bank either to pay for the goods or to sign a bill of exchange on despatch is a *documentary letter of credit*, which may be *revocable* or *irrevocable*. The importer's bank is the *issuing* bank in this connection and the exporter's bank is the *advising* bank.

The exporter is the *beneficiary*. If the exporter's bank agrees to pay for the goods, even if the importer or the importer's bank doesn't, it is a *confirmed* letter of credit.

With *documentary collection*, the exporter's bank attempts to obtain payment by offering the shipping documents to the importer's bank.

Finance for export might be based on *forfaiting* or *factoring*. There may also be official help from development banks. Export credit guarantees, offered by governments or the private sector, insure against non-payment. The banks offer other guarantees such as *bid* or *tender bonds*, *performance bonds*, *advance payment guarantees* and *progress payment bonds*.

Miscellaneous services offered by banks include acting as *export* and *confirming houses* and assisting with *barter* and *countertrade*.