# CUTTING DOWN ON THE RISKS

TRADING WITH OVERSEAS FIRMS CAN PRESENT A MAJOR HEADACHE FOR EXPORTERS WHEN IT COMES TO PAYMENT. BUT THERE ARE SEVERAL OPTIONS TO HELP EASE THE PAIN SAYS **JAMES WHITWELL** OF BFINANCE.

Trading in overseas markets presents a number of challenges for companies eager to expand their sales ledgers. Even once a potential partner has been located and a contract of sale agreed, exporters then need to worry about ensuring payment of goods. And that the goods to be paid for correspond to those described in the contract of sale is equally worrying for importers.

Fears that one side will fail to honour its obligations are exacerbated where no proven trading relationship between the counterparties exists. Consequently, both buyer and seller will seek to minimise the risk inherent in the trade, and there are a variety of payment methods available to them, depending on how that risk is perceived.

For example, where trust between two companies is high, trading on open account terms is the payment method of choice. Considered comparatively cheap and easy, trading on open account is the standard form of settlement between European and US firms. The seller of goods simply invoices its customers and expects to receive payment in due course, usually 30, 60 or 90 days after invoice date. Very often the only document required by the buyer is an invoice, which he will pay through his bank.

However, because trading on open account represents an extension of credit and not a guarantee of payment, the seller should be confident that the buyer will honour its obligations under the contract of sale: late or non-payment can scupper a firm's effective management of its cashflow or even lead to bankruptcy. Risk of non-payment can be offset with credit insurance.

Following a spate of massive mergers last year, the credit insurance industry is dominated by Euler & Hermes, NCM Gerling and Coface, each offering a varying degree of insurance and collection services tailored to exporters' individual needs. However, while trade finance consultants strongly recommend firms insure their trade receivables, credit insurance usage has been declining among UK exporters over the past three years on account of its perceived costliness.

Another, and increasingly popular, alternative for exporters is outsourcing their foreign sales ledger to a factoring firm. The exporter hands over responsibility for debt collection to a third party in return for immediate payment of up to about 90% of its value. The remainder is paid once the factoring firm has collected the exporters receivables, which it does via one of the international factoring chains. Although once equated with firms bordering on bankruptcy, factoring is losing its stigma as more and more firms sees its benefits in terms of effective cashflow management.

**BRIDGING THE GAP.** At the other extreme, if the exporter considers the risk of non-payment by its trading partner too great, it may insist on cash in advance – that is, payment before shipping or despatching the goods. Consequently, it is the most secure form of payment for the seller. However, while the seller's ability to insist on payment upfront typically reflects its dominance as a trading partner, without a guarantee of receiving the goods the buyer may be driven to look for an alternative supplier.

Banks provide a number of payment solutions that can bridge the gap between an exporter's fear of non-payment and the importer's concerns over non-receipt of goods. Where the requisite level of trust or willingness is lacking to trade on open account or pay cash in advance, bank-issued letters of credit (L/C) can protect buyers and sellers against non-shipment and non-payment respectively.

An irrevocable L/C is a written undertaking by an issuing bank given to the seller (beneficiary) at the request of the buyer (applicant) to effect payment for goods under stated conditions – that is, the issuing bank promises to pay the exporter's bank when it receives the right shipping documents for the goods in question. The documents required would be those agreed between buyer and seller as set out in the contract of sale. Typically, these are invoices, bills of lading, insurance certificates and certificates of origin.

The benefit to the buyer (or applicant) is that payments are made on his behalf in return for documents that represent the goods and give him ownership of them. The disadvantage is that he may have to provide a marginal deposit when the L/C is opened. The benefit to the seller is that he can look to the issuing bank for payment, instead of relying on the ability/willingness of the buyer. The disadvantage is that he cannot obtain payment unless he complies with all documentary credit terms.

L/Cs are either confirmed or unconfirmed. In an unconfirmed L/C,

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the bank issuing the credit on behalf of the buyer is the only party responsible for payment to the seller. The seller's bank is obliged to pay only after the payment from the buyer's bank is received. The seller's bank merely acts on behalf of the issuing bank.

If an exporter is concerned about the standing of the issuing bank and country, it can ask a bank of its choice – typically one of its relationship banks – to confirm the L/C. This is likely when trade is conducted in a high-risk area, where there are fears of war or social, political or financial instability. In accepting, the bank agrees to add its own binding guarantee of payment to that of the overseas bank. This guarantees that, provided the exporter complies with all the terms and conditions of the L/C, it is guaranteed payment, even if there are problems with the buyer's bank or country.

**CREDIT VARIETIES.** Unlike a confirmed or unconfirmed irrevocable L/C, a revocable credit may be amended or cancelled at any moment without prior notice to the beneficiary. However, the issuing bank is bound to reimburse a branch or other bank to which such a credit has been transmitted and made available for payment, acceptance or negotiation complying with the terms and conditions of the credit and any amendments received up to the time of payment.

The standby L/C, often known as a non-performing letter of credit, works in a similar way to a bank guarantee, but in a format that looks like a letter of credit. It acts as a backup payment and is only used if there is a non-performance of the underlying contract. It may provide for settlement to be made to the issuing bank upon receipt of a simple demand on the beneficiary, or alternatively a fuller statement and/or supporting documentation may also be required. Drawings are made by a simple declaration of non-performance.

In a revolving L/C, the issuing bank commits to restore the credit to the original amount once it has been used or drawn down. The credit also states the number of items it can be used and the period of validity. The credit can be cumulative, meaning sums can be added to the next instalment, or non-cumulative, meaning partial amounts expire if not used in the time stated.

With a deferred payment of an L/C, a bill of exchange is not called for. Instead, the bank will, at the time of presentation of the shipping documents in order, confirm to the exporter the due date for payment and undertakes to make a settlement at that time. It gives the buyer a period of credit, usually 30, 60 or 90 days, mirroring the payment terms of the underlying contract.

A bill of exchange is an order drawn and signed by the exporter (the drawer) addressed to the importer or the bank (the drawee) to pay the exporter (the payee) a certain sum on a specific day. When the drawee signs it, he becomes the 'acceptor' – he accepts that he will carry out the order. A promissory note only differs from a bill of exchange in that it is issued in the form of a promise of payment made by the debtor instead of a payment order or instruction by the creditor.

Documentary collections are used particularly where seller and buyer have been trading for some time and have built up a degree of trust with one another. The seller's bank sends documents related to the shipment of goods to the buyer's bank. The buyer's bank will only hand the shipping documents to the buyer when either the buyer pays for them or when it accepts bills of exchange payable at some date in the future, as agreed between buyer and seller. The buyer's bank does not make any promise of payment but simply agrees to hand the shipping documents to the buyer under the terms stipulated by the seller.

**COST CONSIDERATIONS.** The cost of different financing methods can vary, both in terms of interest rates charged and fees applied. These costs and the impact they will have on the viability of a transaction should be thoroughly understood before proceeding. For example, any one bank's appetite for taking on particular foreign bank or sovereign risk varies, depending on the limits outlined by its internal credit controllers. If its books are already heavy with Indonesian sovereign risk, for instance, it may either refuse to confirm an L/C or levy an inappropriately high confirmation fee in addition to its standard management fees. Exporters, therefore, are advised to always shop around the supply market for the best deal. While this can be time-consuming, the potential cost savings can be huge. Further, in recent years, a number of internet-based trade finance marketplaces have arisen to facilitate the process. These include UK-based LTP Trade and bfinance, and LCConnect in the US.

**ACCURACY.** The importance of ensuring the accuracy of documentation under an L/C cannot be overstated: the slightest error can be grounds for the issuing bank to refuse payment for goods. Not only does resolving mistakes protract the successful completion of the sale, but banks are only too happy to charge amendment fees.

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