Trade finance

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Treasurers who are involved in the sale of goods to or, the purchase of materials from, overseas companies need to be aware of the increased risks involved when crossing international borders. In addition, they must be in a position to evaluate the level of risk protection offered by the range of trade finance products available to facilitate overseas transactions and to ascertain the optimum balance between transaction costs and risk exposures.

Risks of international trade

Exporting presents uncertainties not found in domestic trade. First, there is political risk associated with the government in the buyer's country. This covers possibilities such as the imposition of foreign exchange controls and expropriation. Second, there is transfer risk, i.e. the risk that, due to the fact his country has a negative balance of payments, no foreign exchange (US dollars or other "hard" currency) may be available to one's buyer when he is ready to pay for the goods he has purchased.

The final uncertainty involves counterparty credit risk. This is heightened in cross border sales because, with the buyer in another country, the seller generally not only has less reliable information regarding the buyer's financial condition and integrity but also typically has fewer avenues of redress should the buyer fail to pay or otherwise violate the agreed-upon terms of sale.

The existence of these political, transfer, and credit risks explains why almost half of all international sales are made using some form of risk mitigation.

Inability to impose restrictive payment terms

The competitiveness of the international market often precludes insistence upon cash in advance. Just as in domestic trade transactions, the buyer's preference is to take as long as possible before paying. He will ask the seller to allow him some time to resell the goods or use them to otherwise generate the cash needed to pay for them. And, whereas companies in developed, domestic markets are used to dealing with each other on open account terms of 30 days from invoice date, in international transactions it is not uncommon to see "supplier financing" of 60, 90, or even 180 days and more, depending on the goods.

Thus a company is likely to experience ballooning of its accounts receivable and its "days-sales-outstanding" ratio due to export activity even as it is incurring increased risks.

Trade finance solutions

Treasurers should be somewhat comforted to know that some middle ground exists between open account and cash in advance – middle ground in which intermediaries conduct the exchange of documents for payment, assume various degrees of risk, and may even provide pre-export financing for the seller and post-import financing for the buyer.

The choice of credit terms will depend on many factors including industry norms, country practices, anticipated frequency and value of shipments, profit margin, payment history, and whether any bank financing is involved. A number of options are listed in Table 1 and are arranged in order of risk, from the highest risk to the exporter (which is lowest risk to the importer) to lowest risk to the exporter (highest risk to the importer). A brief overview of some of the most common approaches is set out in Table 1, and this is followed by a glossary of common trade finance terms.

Key trade finance instruments

Documentary draft collections

In a documentary draft collection, documents are entrusted to a bank for delivery only after the seller's collection instructions are met. Normally, these documents include the commercial invoice, the bill of lading, and any paperwork needed by the buyer to clear customs in his country. The bank acts only as a collection agent and does not assume any liability for payment. Neither the counterparty risk associated with the buyer, nor the political and transfer risks associated with the buyer's country are eliminated. When asked by a bank for payment, the buyer could simply refuse or the situation in his country could make payment impossible. Using a sight draft accompanied by properly consigned ocean bills of lading or multimodal transport documents, however, ensures that title to the goods will not legally pass if the buyer refuses or is unable to pay, since documents will not be delivered until payment is tendered. Such control of title depends on having a title document, as in most ocean shipments, which is released to the buyer only after he has made payment; this control is not available when making air shipments or when using time drafts or clean drafts for any type of shipment.

Commercial letters of credit

A commercial letter of credit replaces the commercial risk associated with the buyer with that of the bank issuing the

Table 1: Trade finance options

Term	Description
Extended terms	Importer pays for goods over period of time during which they are used by importer, often three to 10 years. A set of promissory notes is normally issued upon shipment, payable at six month or one year intervals.
Open account, clean draft	Exporter makes shipment and awaits payment direct from importer. Any documents needed by importer sent directly by exporter when sale is invoiced though a draft may also be presented separately through banking channels.
Time or date draft documents against acceptance	Exporter makes shipment and presents draft and documents to bank with instructions that documents are to be released to importer upon importer's acceptance of the draft (importer's acknowledgement of his/her debt and promise to pay at a future date).
Consignment, retention of title	Exporter makes shipment first and subsequently receives payment, as goods are sold by importer. Sales contract and/or other legal documentation gives exporter right to repossess any unsold goods.
Sight draft documents against payment, cash against documents	Exporter makes shipment and entrusts documents to a bank with instructions that documents be released to importer only upon payment of draft.
Cash against goods, shipment into bonded warehouse	As opposed to traditional cash on delivery, usually involves shipping goods to a warehouse operated by exporter in importer's country. Goods are released in relatively small amounts from warehouse by exporter's local agent.
Irrevocable letter of credit	Instrument issued by importer's bank in favour of exporter, payable against presentation to the issuing bank of specified documents. May be payable at sight or may incorporate bank guaranteed financing.
Confirmed irrevocable letter of credit	Same as above, except importer's bank asks advising bank to add its engagement to pay. Payable upon presentation of compliant documents to the confirming bank. May be payable at sight or may incorporate bank-guaranteed financing.
Cash in advance	Importer sends good funds before exporter ships.

letter of credit. In a letter of credit transaction, the issuing bank commits up front to pay a specified amount of money to the seller when presented with a specified set of documents. Hence, the seller is no longer relying upon the buyer's promise to pay – with the confidence he can produce the required documents, he is relying upon the promise and ability to pay of the buyer's bank. If the seller wishes to reduce further the risks of non-payment, he can request that a bank in his own country be authorised to confirm the letter of credit. A bank that confirms a letter of credit undertakes to honour the credit as though they had issued it themselves.

It is crucial to understand that a letter of credit is neither an unconditional guarantee of payment to the seller nor a means of assuring the buyer that goods paid for will be satisfactory – rather, the issuing bank engages to pay if, and only if, the documents required by the letter of credit precisely comply with the terms and conditions of the credit. Anyone selling on a letter-of-credit basis should read very carefully each one received to be certain the terms and conditions can and will be complied with. Discrepancies can delay or even preclude payment. And anyone buying on a letter-of-credit basis needs to understand that payment will be effected despite any disputes with the seller over compliance with the underlying contract just as long as the documents meet the letter of credit requirements.

Commercial letters of credit are often referred to as import credits and export credits. This division reflects only a difference of perspective, not different instruments. One company's export credit is another's import credit.

Standby letters of credit/demand guarantees

Standby letters of credit do not cover the direct purchase of merchandise. Rather, they are based on the underlying principle of letters of credit that payment is made against presentation of documents – not necessarily shipping documents but whatever documents the applicant, beneficiary, and issuing bank may agree to. The party requesting a bank to issue a standby letter of credit (the applicant) need not be involved in a commercial transaction at all. In fact, most standby letters of credit are payable against the presentation of documents as simple as a certificate from the beneficiary stating that the applicant has not performed some act, has not complied with a specific contract or other agreement, or has defaulted either in payment for certain goods and services or in making repayment on a loan. These are highly versatile instruments whose range of uses seems to be limited only by the imagination.

Demand guarantees usually work the same way, but are somewhat less standard; many are subject to local guarantee laws rather than standard international rules.

Bankers' acceptances

Bankers' acceptances arise from the drafts covering certain international and domestic trade transactions. A banker's acceptance is a time draft "accepted" by the bank upon whom it is drawn. Once accepted, it constitutes an unconditional obligation on the part of the accepting bank to pay the draft at maturity (out of funds it expects to receive at that point in time – by creating the acceptance, the bank intermediates the risk of receiving these funds).

In some countries, such as the US, there is a market in which bankers' acceptances can be bought and sold in the months between their creation and maturity.

Bankers' acceptances can arise from transactions involving letters of credit, documentary draft collections, or contractual sales and purchases. They are used by importers mainly as a low-cost alternative to loans: the importer asks the bank to create an acceptance which the importer then immediately sells, at a discount, to generate funds to pay for goods purchased; at maturity the accepting bank pays the investor and the importer must repay the amount of the acceptance to the bank. The investor earns the amount of the discount.

Bankers' acceptances can be used by exporters in much the same way, to bridge the time between shipment of goods and receipt of payment, and they can even be used to sell receivables to a bank. In the latter case, the bank disburses funds to the exporter immediately after shipment of goods but obtains payment at maturity from the buyer of the goods.

Sale of receivables/credit insurance

Alternative risk-reducing structures might involve arranging a pre-committed sale of the anticipated receivable or taking out credit insurance covering non-payment. Although the exact protection differs (for example, credit insurance will not pay when there is a contractual dispute), from the seller's viewpoint, either of these alternatives would reduce or eliminate the foreign political and transfer risks and replace the counterparty risk of the buyer and his bank with that of the receivable purchaser or insurance company. In some cases, banks providing working capital or accounts receivable financing for goods being exported will require that the exporter obtain either letters of credit or credit insurance for all sales being financed. Sometimes insurance companies themselves will require letters of credit from specified buyers before granting coverage.

More extensive discussion on the topics of letters of credit, documentary draft collections, import and export financing, and other banking services for exporters and importers, can be found in the book Users' Handbook for Documentary Credits under UCP600, written by Walter (Buddy) Baker and John F Dolan, and available from ICC Publishing at http://www.iccbooks.com

GLOSSARY OF TERMS

Acceptance – time draft "accepted" by the party upon whom it is drawn by so endorsing the front of the draft. Acceptance constitutes an unconditional obligation on the part of the accepting party to pay the draft at maturity. A draft accepted by a bank is called a "banker's acceptance" whereas one accepted by a company is called a "trade acceptance".

Advising bank – bank that receives a letter of credit from the issuing bank for authentication and delivery to the beneficiary. The advising bank is usually a correspondent of the issuing bank located in the vicinity of the beneficiary.

Aval – guarantee added by a bank to an accepted time draft by endorsing the front of the draft "per aval". The avalising bank becomes obligated to pay the draft at maturity if the drawee/acceptor fails to do so.

Bill of exchange – synonym for draft.

Bill of lading – document signed by a transportation company ("carrier") to show receipt of goods for transportation from a port of loading to a port of discharge. A "clean" bill of lading bears no clause or notation which expressly declares a defective condition of the goods and/or the packaging.

Cash against documents/documents against payment – terms for documentary collection instructions requesting the presenting bank to deliver documents only upon receipt of payment from the drawee/importer.

Clean draft – draft (bill of exchange) that is not accompanied by documents.

Clean letter of credit – letter of credit that calls for presentation of nothing more than a draft to trigger payment. The term is sometimes used (incorrectly) to mean "standby letter of credit".

Collecting bank – any bank other than the remitting bank involved in the collection of a draft and/or documents.

Confirmed letter of credit – letter of credit to which the advising bank has added its own, independent undertaking to honour presentation of the required documents, i.e. to pay the beneficiary at sight or at maturity, as specified by the letter of credit.

Confirming bank – bank that has added its confirmation to a letter of credit. This term is also sometimes used loosely to refer to a bank that has issued a commitment to purchase letter of credit documents without recourse, a practice called "silent confirmation".

Direct collection – service for handling export draft collections in which the exporter's bank provides the exporter with a means to create forms that bear the bank's own letterhead for mailing documents to the buyer's bank for collection. To the buyer's bank, it will appear that the documents were sent from the exporter's bank, but time and expense are saved by bypassing unnecessary processing at the exporter's bank.

Documentary credit – synonym for "letter of credit".

Documentary draft collection – process for collecting payment in a sale of goods wherein a legal demand for payment from the buyer is made by a bank acting as collecting agent for the seller. Demand is made by presenting a draft (bill of exchange). The collecting bank is also entrusted with documents to deliver in accordance with accompanying instructions, usually once the draft is either paid or accepted. These documents are generally needed by the buyer to obtain title to the goods and/or to clear customs.

Documents against acceptance – term for documentary collection instructions requesting the presenting bank to deliver documents only upon acceptance of the draft (bill of exchange) by the drawee/buyer.

Draft – written demand for payment of a specified amount addressed to a named party, called the "drawee", and signed by the "drawer". A draft may demand payment immediately upon presentation ("at sight") or on a specified maturity date and must also specify a party to be paid (the "payee"). Most drafts are "negotiable", meaning the payee's right to payment can be transferred by the payee to another party by endorsement and delivery of the draft. Also called a bill of exchange.

eUCP – a 12-article supplement to the UCP containing rules for electronic presentation of documents under a letter of credit.

Evergreen letter of credit – standby letter of credit with an initial expiration date but containing a clause that states that it will be automatically extended for additional periods unless the issuing bank provides notice to the beneficiary stating that they elect not to allow further extensions.

Freely available letter of credit – letter of credit that indicates it is "available with any bank by negotiation". By including this wording, the issuing bank authorises the beneficiary to present documents to the bank of his choice for examination and collection of payment.

Guarantee – undertaking by a bank or other party not otherwise directly participating in a contract, added to the undertaking of the party being guaranteed. There are two very different categories of guarantees. A "demand guarantee" (or "independent guarantee") is payable for a stated amount immediately upon presentation of documents specified in the guarantee, without inquiry as to the veracity of the documents or into compliance with the underlying contract. In contrast, under an "accessory guarantee" the guarantor joins with the guaranteed party and agrees to fulfil that party's obligations if necessary, effectively co-signing the contract. Under an accessory guarantee the guarantor also acquires rights under the contract and may require actual evidence of default and resort to terms in the contract to dispute claims against the guarantee. A demand guarantee is completely independent of the underlying contract. In essence demand guarantees and standby letters of credit are the same thing.

Instalment letter of credit – letter of credit calling for multiple shipments within specified date ranges.

International Standard Banking Practice for the Examination of Documents under Documentary Credits (ISBP) – compendium of standards for the examination of documents under the UCP600, revised by the International Chamber of Commerce in 2007.

International Standby Practices (ISP) – international standards of practice for demand guarantees and standby letters of credit established for bankers by the International Chamber of Commerce. The term "standby" is used to include both letters of credit and guarantees, but it must be kept in mind that the ISP, like all ICC publications, only applies to letters of credit and guarantees that say they are subject to it.

Irrevocable letter of credit – letter of credit that cannot be amended or cancelled without agreement of both the beneficiary and the issuing bank. Any letter of credit subject to the UCP600, the ISP, or to US law is irrevocable unless it specifies otherwise.

Issuing bank – bank that has issued a letter of credit. The issuing bank is obligated to pay if documents are presented to them that comply with the letter's requirements.

Letter of credit – undertaking, usually on the part of a bank and at the request of one of the bank's customers, to pay a named beneficiary a specified amount of money (or to deliver an item of value) if the beneficiary presents documents in accordance with the terms and conditions specified in the letter of credit.

Multimodal transport document – transport document covering shipment of goods by more than one means of transportation but including an ocean leg. The two major forms of multimodal transport document are the combined transport document and the through bill of lading. Under the former, the carrier signing the transport document (the "contractual carrier") frequently subcontracts the various legs to other carriers (the "actual carriers"), but still takes responsibility for delivery of the goods to the "place of delivery" and for any damage that might occur during carriage. Under the latter, the carrier takes responsibility for the goods only up to a specified point (still called the "place of delivery") and then passes responsibility to a second carrier for "on-carriage" to the "final destination".

Negotiable – quality belonging to a document of being able to transfer ownership of money, goods, or other items of value specified in the document by endorsement and/or delivery of the document. Cheques, drafts, promissory notes, bonds, stock certificates, bills of lading, and warehouse receipts are examples of documents often issued in negotiable form.

Negotiating bank – bank, usually in the seller's country, nominated by the bank issuing a letter of credit to purchase (negotiate) documents presented by the seller. The term is also used, imprecisely, to refer to banks nominated to pay or to accept drafts, but payment and acceptance are without recourse while negotiation may be with or without recourse.

Presenting bank – in a draft collection transaction, the bank that contacts the drawee, generally the buyer of goods, for acceptance and/or payment.

Reimbursing bank – in a letter of credit transaction, the bank with which the issuing bank maintains an account and that is authorised by the issuing bank to charge that account to pay claims received from the negotiating bank for documents that have been presented.

Remitting bank – in a draft collection transaction, the first bank in the chain of collection, i.e. the principal's, or seller's, bank.

Retention of title – legal arrangement under which a seller of goods delivers these goods "on consignment" into someone's custody but ownership remains with the seller until he is paid. In many countries, retention of title allows the seller to repossess the goods whenever desired and to establish a claim against the custodian if the goods are sold or used without being paid for.

Revocable letter of credit – letter of credit that can be amended or cancelled at any time without notice to or consent of the beneficiary. A letter of credit that is subject to the UCP600, the ISP, or to US law is revocable only if it clearly specifies so.

Sight draft – draft that demands payment "at sight", or immediately, as opposed to a time draft, which may be payable, e.g. ,"90 days after sight" or "30 days after date of shipment".

Silent confirmation – term used for a bank's commitment to negotiate (i.e. purchase) documents under a letter of credit at a future date, without recourse. A silent confirmation is not a confirmation in the true sense, and will not use the word "confirm", but is rather an equivalent form of protection for the beneficiary. The bank will require that the letter of credit be negotiable by the bank in order to be able to establish holder-in-due-course rights equivalent to those of a confirming bank.

Standby letter of credit – as opposed to a commercial letter of credit, a letter of credit that does not cover the direct purchase of merchandise, so called because it is often intended to be drawn on only when the applicant for whom it is issued fails to perform an obligation. There is, nonetheless, a type of standby letter of credit that is intended to be drawn on, referred to as a "direct pay letter of credit". Standby letters of credit are based on the underlying principle of letters of credit that payment is made against presentation of documents – whatever documents the applicant, beneficiary, and issuing bank may agree to, not necessarily documents showing shipment of goods.

Time draft – draft that demands payment at a specified future date rather than immediately upon presentation.

Transferable letter of credit – type of letter of credit that names a "middleman" as beneficiary and allows him/her to give another party, the actual supplier, certain rights to present documents and receive payment under the letter of credit.

Uniform Customs and Practice for Documentary Credits (UCP) – international standards of letter of credit practice established for bankers by the International Chamber of Commerce. Historically, the UCP has been revised about every 10 years to keep up with changing practice, the current revision, UCP600, having been given an effective date of 1 July 2007. Although the UCP defines rights and obligations of the various parties in a letter of credit transaction, it is not law and any given letter of credit is subject to the UCP only to the extent indicated in the letter of credit itself.

Uniform Rules for Collections – international standards of draft collection practice established for bankers by the International Chamber of Commerce. The Uniform Rules are not law but are more properly viewed as a handbook for banks used to establish common understanding of terminology and expectations.