The practicalities of trade finance

Martin Smith of AGCO explores the various payment methods in trade finance and highlights the pitfalls exporter's should look out for.

To the treasurer, cash is king. This is achieved by getting paid promptly or by arranging discounting to bring the cash in earlier.

Equally, the export finance department is there to assist the sales manager in getting the sale, and potential customers are likely to be attracted to your company by the offer of credit instead of a cash prepayment. By offering credit, of course, you must have done your homework. Much depends on what type of credit you are willing to offer as to how much work is done in-house.

In this article, we will explore some of the various payment methods that can be used, their pitfalls and their risk. Much also depends on the credit option available in the country you are selling to. Here, we will deal with short-term trade finance of up to 180 days payment terms.

The various types of payment mechanisms are best covered by a description of each:

- letter of credit (L/C);
- avalised bill of exchange;
- credit insurance;
- forfaiting; and
- bank guarantee.

Letter of credit

The letter of credit is a traditional method of payment for the exporter, but its use has changed as the perception of risk of the country improves. As credit insurance has expanded and certain countries have better credit risks, so the L/C has moved to cover the more difficult markets not covered by credit insurance.

Ideally, the exporter should look for a confirmed irrevocable letter of credit, whereby the advising bank agrees to add its confirmation. This means the banks will pay the exporter once documents have been accepted within the validity of the L/C. This eliminates the political risk. You may be happy to accept an unconfirmed L/C if you think there is no political risk in the country you are exporting to. That may be acceptable for a sight L/C, but for a deferred payment L/C, you should always seek confirmation. That way you can discount the proceeds, normally from the advising bank.

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You may receive an L/C from a Middle Eastern country where the advising bank is informed not to add its confirmation by the opening bank. In this case, you would need to find a bank or forfaiter which will silently confirm the L/C. The difficulty for the exporter of the L/C is that it calls for a list of documents to be provided as well as a whole host of conditions it has to comply with. Therefore, it is essential to examine closely the wording of the L/C when it arrives. Ideally, the sales manager, the shipping co-ordinator and the export finance representative should get together to review the L/C and ask the following questions:

- does the L/C agree to what the sales manager negotiated;
- can the company manufacture and ship the goods within the time frame set by latest date for shipment;
- is there an inspection required? This has to be arranged so as not to delay document presentation;
- does the L/C stipulate the number of days for documents to be presented to the bank? Ideally, 21 days from date of shipment; and
- are amendments required?

Martin Smith

It is best for the exporter to prepare a full list of amendments to be sent to the customer so all the changes can be done at the same time and not delay the order being shipped. It is important that the opener reacts quickly to get the amendments issued by its bank. When dealing with Middle Eastern countries, for example, the exporter may only get one chance to make amendments.

For the large value L/Cs, or where the exporter is uncertain, it is always best to discuss the wordings with the advising bank – assuming, of course, that it has been advised in the UK. At this point, any misinterpretations can be ironed out and the exporter obtains a better understanding of how the advising bank is going to interpret what wording has to be put on which documents and number of original documents as opposed to copies. All original documents must be clearly marked 'original'. At the end of the day, the exporter wants to present the correct documentation as soon as possible after shipment and well before the allocated number of days for presentation expire.

However, many banks find a large number of discrepant documents. Sometimes there is enough time to correct errors before the expiry date is reached, but dealing with discrepancies after this date has been exceeded can result in the confirmation being lost and payment being delayed. Much depends on the exporter knowing its customer because it will have to instruct its bank to accept discrepant documents for the bank to arrange payment. Be warned though, that some countries are slower than others in getting this organised and delayed payment causes the treasurer additional expense.

One important factor is to ensure that the costs of finance are included within the price quotation. Once the order has been won and an L/C received, there will not only be normal bank processing charges to take into account but also confirmation fees, which will vary according to the country risk as well as the length of period being covered. If this is overlooked, the cost will be a direct hit on the profit margin.

Standby letter of credit

Another form of L/C is the standby L/C, which is useful where the exporter has regular weekly and/or monthly shipments. The benefit of the standby L/C is that the amount of documentation required to be presented to the bank is limited to, perhaps, only a copy of the invoice and evidence of shipment, but this occurs only where the customer has not made the payment by the due date. In other words, credit is given to the customer for, say, 30 days, and only if payment is not received would the exporter present documents to the advising bank. The value of the standby L/C has to cover the projected shipments over the credit period in addition to another 30 days.

Banks are willing to use the standby L/C as a basis for discounting where the exporter is granting up to 180-day payment terms. But it is best the exporter always refers to the advising bank in advance of the document being issued so the wording is acceptable to both parties.

NCM

The role of NCM credit insurance is described elsewhere in this section of

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The Treasurer (see page 49), but the ability to offer your overseas customer credit terms of open account is a great advantage. NCM is not the only credit insurer the exporter can approach, other options include Coface and Euler Trade Indemnity. Ideally, the exporter will obtain credit limits from its credit insurer for as many markets as possible – for example, by taking out a whole turnover policy – which therefore leaves markets not willing to be covered by the credit insurer and those markets requiring letters of credit outside. Even then, NCM may provide cover on an unconfirmed L/C. The exporter should compare the cost of the insurance premium with the cost of confirmation from the bank.

Forming a close working relationship with your credit insurer is essential, as the credit insurer has taken a variety of countries and spread its risk on the markets you are selling to. There are two important area s for the exporter: the level of the credit limit and the length of the payment terms. The exporter wants the underwriter to grant the credit limit required and the payment terms requested. But to obtain these the underwriter will consider the political risk of the country, the financial strength of the buyer, its existing exposure (other exporters may be selling to the same overseas buyer), and any experience of claims and late payments. To assist the underwriter, it is best if the exporter obtains the latest financial accounts of the overseas distributor or third party customer in advance. Get your own finance people to analyse them so you already have an idea whether the underwriter will accept your credit limit application. If getting hold of annual accounts direct is difficult, then a credit agency report from credit agencies such as Dun & Bradstreet or Graydon can obtain the information on your intended customer. This will enable you to discover whether the buyer is in good or bad financial health and anticipate the likely outcome of the underwriter's decision will be. Sending any financial information you obtain to the underwriter, along with your application, will greatly speed up the response.

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Increasingly, treasurers are assigning their credit insurance policy to the banks to obtain discounting of the receivables at very competitive rates of interest. They are also using the policy in securitisation funding.

Doing your own in-house analysis of your overseas distributors and customers assists not only the credit insurer but also the sales manager where you can report on the financial health of their customers. This is particularly useful where you may have a national distributor in each export market, and continuity and profitability is important in selling your goods within that market. Deteriorating financial performance requires investigation and may indicate, as well as other factors such as falling market share, that it is time to change your distributor.

Forfaiting

Another form of financing is forfaiting. Although this article is focusing on short-term payment terms of up to 180 days, forfaiting can extend to payment terms of five years and more, depending on the risk of the country involved and the bank avalising the bill of exchange, normally in the country of the buyer.

Under forfaiting, the exporter sends out a bill of exchange to be accepted by the buyer (signed) and then counter-signed (avalised) by their bank. The exporter then sells the bill of exchange to the forfaiter and collects the cash without recourse minus the discounting costs. The forfaiter will either keep it on its books until maturity or sell the bill of exchange on. There are overseas companies the forfaiter will accept as company risk and not require a bank avalisation.

Most major banks have their own forfaiting department, with London Forfaiting Company (LFC) and WestLB amongst the specialist.

Bank guarantees

Bank guarantees are another useful tool for short-term financing – not only on their own but also to enhance your credit insurance credit limits where the underwriter is not able to provide the credit limit required. Therefore, the bank guarantee can be used not only for the one-off transaction but also as cover for a flow market where normally the bank guarantee will be renewable annually. Do not forget to keep a record of the expiry date so that it can be renewed in good time and shipments are not delayed.

If you wish to discount the bank guarantee ensure it is worded satisfactorily, for example, transferable. As you want to discount without recourse, it is important the wording is adequate for the discounting institution to receive payment on the due date.

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There are a number of banks in London representing a whole host of markets around the world. The international banks have all got their specialist niche markets where they are able to offer the exporter assistance with finance, whether it be Africa or Eastern Europe. Through their extensive relations with customers inside those markets, as well as exporters to that market, the bank may be able to offer the exporter finance where the exporter is finding difficulties.

Sometimes, the connection is not obvious and may entail the use of a trade finance consultant or broker, but in the long run when you collect the payment, a small commission fee for their services is worthwhile. After all, money in the treasurer's bank accounts saves on overdraft interest or increases deposit interest on overnight cash.

Make sure everything is in order

We have covered several methods of payment here. But also the exporter should not overlook the currency of invoicing and ensuring that the treasurer has taken out the necessary foreign exchange cover.

Care must be taken to ensure that necessary documentation is prepared and presented to the banks or forfaiters. Bear in mind that incorrect documentation results in delayed payment, additional bank charges, and therefore extra costs to the treasurer. ■

Martin Smith is Manager, Export Finance, AGCO Ltd (formerly Massey Ferguson).