

Trade Finance

This chapter on trade finance provides a practical look at the problems that traders face (domestic and international) and how they can be overcome. Trade finance looks at how businesses trade with one another and we examine the risks involved in such trade and how they can be overcome. Also the methods of payment between the buyer and the seller are examined and what support facilities exist to enhance the ease of trade transactions are looked at.

International trade risk

The risks for an international trader are much the same as for a domestic trader, but generally greater due to the distance and the time involved being longer. Also international trade is subject to the rules of the overseas government, creating exposure to different laws and customs and necessitating one of the parties (importer or exporter) to engage in an exchange of currencies, thus creating the possibility of a **foreign exchange risk**. The risks open to the trader are as follows.

Physical risk

Due to the time lag and distance of international trade there is the risk that goods may be lost in transit or stolen or the documents needed for completion of transfer may go astray.

Credit risk

Assuming the goods reach the importer safely, if the buyer is unreliable they may refuse to pay for them, leaving the exporter to pursue costly legal proceedings in the courts of the foreign country.

Trade risk

This arises when the importer refuses to accept ownership and payment of the goods on arrival or cancels the order in transit. This may be because the item is not of the right quality/standard the importer expected or may be due to other factors stemming from the import side.

Liquidity risk

This is often the outcome of the above risks, as the suppliers (exporter) may not be able to finance their costs until they receive cash payment. Alternatively liquidity risk may be experienced by the importer unable to purchase due to insufficient funds.

Foreign exchange risk

This arises due to the fact that the invoicing for payment will either be in the exporters currency (so that the importer must buy the appropriate foreign currency) or in the importer's (so that the exporter must exchange it into their own domestic

currency), either way one of the two parties must engage in foreign exchange transfer. Alternatively, payment may be in a third currency, as in the case where a UK firm sells goods to Spain and is asking for payment in dollars.

Adverse movements in the foreign exchange rates will create risk in this transfer procedure. Such that if a UK importer buys goods from a US exporter (costing \$10,000) at an exchange rate of $\$1.50 = \pounds 1$, the UK importer will need £6666.66 to buy \$10,000. However, if the pound falls against the dollar to $\$1.40 = \pounds 1$, the cost to the UK importer becomes £7,142.8 (£476.2 more) to buy the necessary \$10,000 to acquire the good.

The USA exporter receives \$10,000 and is not affected. However, if the invoice was in sterling then the USA exporter would face the foreign exchange risk not the UK importer:

- ▶ at $\$1.5 = \pounds 1$, £6,666.66 received becomes \$10,000
- ▶ but at $\$1.40 = \pounds 1$, £6,666.66 received becomes \$9,333.3 (i.e. \$666.7 less).

Thus the exchange risk only arises for the party dealing in a foreign currency (not the party dealing in their domestic currency) and can deter some firms from engaging in international trade. Foreign exchange exposure is the term given to a firm's openness to such risk. Methods for dealing with exposure to currency risk are covered in Chapters 21 and 23.

Country risk

This arises when the importer attempts to pay the exporter in the exporter's currency and so tries to acquire foreign exchange, but is unable to get it due to their government regulations, such as exchange controls. Exchange controls mean that foreign exchange is rationed by the government and allocated at their discretion.

Government regulations which hinder international trade were examined in Chapter 14, under the heading 'Forms of protectionism'.

The UK government has abandoned exchange controls since October 1979.

Sovereign (Political) risk

This arises when the government of a country incurs a debt to a foreign exporter and then reneges on the promise to pay and cannot be made legally accountable by the process of law.

An example of this is the third world debt owed to many industrial country banks, which will be examined in more detail later. Country risk and political risk will be looked at again in Chapter 27.

Cultural risk

This arises for foreign customs, law and languages creating uncertainty and hindering the communication between trading partners.

To overcome such risks there is significant assistance from banks, government insurance agencies, such as the Export Credit Guarantee Department (ECGD) and the Chamber of Commerce.

First, physical risk can be overcome by undertaking commercial insurance schemes, which can be readily found in both the public and private sectors. Secondly, credit risk, which is a greater risk to exporters, can be evaluated by obtaining credibility reports on the potential importer from the banks dealing in the upcoming transfer. To reduce the risk, the exporter may ask for the buyers import order to be backed by a guarantee of payment from the bank dealing for the importer. Here should the importer not pay, the exporter will have recourse to a third party for payment, such as in the use of documentary letters of credit which are examined later.

Thirdly, trade risk arising from non-completion of the transfer can be insured against by the exporter by taking out official export credit insurance from the ECGD; this will be examined further later. To evaluate trade risks before shipment of goods the exporter may acquire status reports on the importer from the banks engaged in the transfer and request documentation stating that payment is forthcoming before releasing the goods to the buyer. This is how documentary collections work as a method of payment.

Liquidity risk can be eased by allowing a credit period before the importer has to pay for buying the goods. The working of instruments such as bills of exchange allow the importer a credit period before payment and should the exporter want immediate payment they can be discounted (sold) to a third party for payment. The extending of credit to the importer is common and depends on the method of settlement adopted between the two parties. Foreign exchange risk can be removed by **hedging** using a forward exchange market. Hedging, which is covered in detail in Chapters 21 and 23, means to remove risk by matching your assets and liabilities in the same currency, such that they both increase and decrease in value simultaneously. Foreign exchange tenders can do this on behalf of exporters. Alternatively if invoicing is in the exporter's currency, they do not face the exchange risk as it is passed on to the importer. Thirdly, if the exporter must accept the foreign currency in payment they can open a foreign currency bank account with their own domestic bank and carry out transactions in that currency only. For example, a UK company dealing in American dollars may open a dollar account with their UK bank so that it can make payments and accept receipts in dollars. The exporter can transfer the dollars into sterling at a favourable exchange rate in the future.

The extent of political risk can be determined by establishing the economic credibility of the country. Information can be obtained from the UK Department of Trade, domestic and overseas banks, UK Embassies/Consulates abroad.

By adhering to uniform international trading rules such as uniform rules for collections and uniform customs and practice, conformity can be achieved which will help to alleviate cultural differences creating risks. This considerably speeds up transactions in trade. However, not all countries have accepted the standardised format of the International Chamber of Commerce Rules.

As can be seen the ability to overcome such risks greatly involves the services of the banking sector. Banks act as **financial intermediaries** providing a place for surplus units to deposit their money and also an avenue for deficit units to borrow money, thereby linking the needs of depositors and borrowers. Their contribution to international trade are the following:

- ▶ They buy and sell foreign currency with the interested parties.
- ▶ They deal with the collection and transfer of funds so allowing importers to finance their payments and provide credit to exporters.
- ▶ Finance for exporters and importers is provided by the bank guaranteeing loans which have the backing of the Export Credit Guarantee Department.
- ▶ They provide an acceptance credit facility, accepting bills of exchange drawn on the bank by exporters.
- ▶ They provide overdrafts for home customers and loans for overseas customers, and are helpful in managing the accounts of customers.

Methods of payment and settlement in international trade

In trade we can distinguish between:

- 1 the method of payment agreed between the importer (buyer) and the exporter (seller); and

2 the method of settlement adopted to finalise the transfer between the parties.

The methods of payment are negotiated between the trading members and there can be differences in the procedures according to which countries are trading, for example trade between the UK, the EC and the USA is often on open account trading terms, while for trade with ex-colonial, distant areas documentary credits/collections are more usual. These are two of the five methods of payment which are examined next.

Methods of payment

Payment in advance

The exporter is paid in full (with the funds having cleared if settlement is via a cheque) before exporting the goods overseas to the buyer. As such it is the safest method for the exporter, but is riskier for the importer since on arrival the goods may not meet the required specifications (or be damaged in transit) and yet payment will have occurred. In a more extreme case the exporter may not actually dispatch the goods on receipt of payment!

As the exporter receives payment immediately they do not have to extend any credit to the importer in terms of a payment period, in fact the importer is financing the transfer before receiving possession. This is clearly advantageous to the exporter as opposed to the importer and thus it is necessary for the importer to have faith in the reputation of the exporter to deliver on time according to the terms of the contract. To allow such outright payments to occur the buyer must be liquid enough to finance the transactions, so this form of payment tends to occur where the cost of the import is small relative to the overall activity of the buyer (risk is insignificant overall). Also trade payments must be free from the buyer's side from government intervention (for example exchange controls), to allow full and prompt payment to the exporter.

Overall this is not an important method of payment in international trade and more usually a payment of a cash deposit typically of 10–20% is used with the remaining amount being paid through some other method, so reducing the importer's risk.

Payment upon shipment

The exporter informs the importer by cable of the fact that the goods have been dispatched and then payment from the importer will occur, whilst awaiting receipt of the goods. The advantage for the exporter is that possession of the goods is maintained by them, through holding the document of title (ownership certificate) even when the good is in transit. The title document is not relinquished until the exporter receives payment and hence it is a secure method of payment for the exporter.

Letters of credit; documentary credits

Documentary credits are both a method of payment and a way of obtaining working capital finance and for the exporter they are nearly free of risk, provided the exporter acts in accordance with the terms and conditions of the documentary credit. The term documentary credit comes from the fact that the letter of credit stipulates, as part of its conditions, that the exporter must make the presentations of certain documents, for the bank's guarantee on the transaction to hold.

Steps in the working of a documentary credit

- 1 Importer (buyer) and exporter (seller) adopt the documentary credit as the payment method in the transactions contract.
- 2 The importer (the applicant) opens the processes by instructing his bank (the issuing bank) to issue a letter of credit in favour of the exporter (the beneficiary).
- 3 Issuing bank contacts a bank in the exporter's country (the advising bank) to

inform the credit to the exporter, although the advising bank itself in no way backs the agreement (that is no recourse to the advising bank by the exporter).

- 4 However if the exporter requests additional assurance of payment (for example if there is a high country/political risk), the advising bank may be requested by the issuing bank to reconfirm the letter of credit (making it a confirmed irrevocable letter of credit), thus guaranteeing payment to the exporter by two banks, hence maximising security.
- 5 Once shipment of goods has occurred the exporter will present the said documents in the letter of credit (for example insurance policy certificate, transport documents, ownership details) to a third named bank (checking bank) in their own country, for payment. The third bank may be a separate one to either the confirming, advising or issuing bank, or, in fact one of the three.
- 6 If the documentary evidence is in order then payment will be made by the checking bank to the exporter. This payment is made by the bank against the documents not the possession of goods by the importer. If the method of payment is a sight bill the exporter gets paid immediately; if it is a time bill they will be paid later and thirdly the bill can be either negotiated or accepted (Accepted bills, for example bills of exchange, can be discounted – sold – immediately if the exporter wishes to acquire payment immediately).
- 7 If the documents are not in order then the exporter will not receive payment and will have to seek compensation by going back to the issuing bank or the advising reconfirming bank for payment (exporter has recourse to them both).

The cost of engaging in a documentary credit is usually borne by the importer, but can be shared with the exporter if negotiated and settled by the relative bargaining strength of the two trading parties.

To summarise, the documentary letter of credit is a guarantee of payment to the exporter, backed by at least one if not two banks. The benefit to the exporter is that the credibility of the importer is being replaced by the superior security of the advising bank, provided they comply to the terms and conditions dealing with documentary presentations correctly.

The letter of credit itself can be either:

- ▶ an irrevocable credit, which provides the beneficiary with the greatest security, as terms of the credit can only be amended by agreement of all parties and hence the importer can only change the transaction agreement with the consent of the exporter; or a
- ▶ revocable credit, which provides the beneficiary with no security, as the importer can cancel or amend the transaction agreement without the consent of the exporter. As such it is only used when the importer receives goods in discrete shipments, which they accept if the goods meet their specifications, paying for each order separately.

Letters of credit: documentary collections

The bank (a collecting bank) is responsible for collecting a set of financial documents (paper) on behalf of the exporter to allow for the speedy arrangement of payment and then depositing the receipts in their customers' accounts. The documents can be split into two groups:

- | | |
|---|---|
| 1 Financial documents | 2 Commercial documents |
| are mainly financial instruments such as, promissory notes, bills of exchange, bankers drafts, etc. | are mainly administrative details such as, document of title, shipping documents, bill of lading, certificate of origin, etc. |

Therefore this allows two types of collections.

1 Clean collections

is where only financial documents are collected by the bank.

The commercial documents are sent direct by the exporter to the importer.

2 Documentary collections

is where commercial as well as financial documents are requested to be collected

Or just commercial documents are requested to be collected depending on the terms stated in the document.

The command given by either the exporter or a bank acting on behalf of the exporter, for collection of documents is referred to as a collection order, which will detail whether the collection is to be clean or documentary. There is an advantage to the exporter in a documentary collection in that if it contains ownership details, such as documents of title the exporter will possess this giving them ownership of the good whilst it is in transit. Hence the exporter may instruct their bank to transfer these documents to the importer only once payment has occurred. However, with a clean collection such security does not exist and the exporter ships the goods before payment has reached them and must depend on the integrity of the importer to honour the terms of payment. These are often the terms used on open account trading.

Steps in the collection procedure

- 1 The exporter (the principal) engages in collections procedure with a bank (the remitting bank) to act on their behalf. This may be either an:
 - a) Outward collection: bank acts for domestic exporter to obtain payment from overseas; or
 - b) Inward collection: bank (in domestic country) acts for foreign exporter to obtain payment from domestic buyer.

The collection order is given.

- 2 A bank in the foreign country is contracted to work with the domestic remitting bank and is referred to as the collecting bank, to extract payment (if in an outward collection) or receive payment (if in an inward collection).
- 3 The payment to the principle (either domestic or foreign) is made by the presenting bank, which may or may not be the same as the collecting bank.
- 4 The collection procedure is closed with the settlement of the transaction by either accepting a term bill of exchange or payment of a sight bill.
- 5 The remitting bank may relinquish ownership of the commercial documents if the collection was a documentary collection (as opposed to a clean collection) when either:
 - a) the buyer receives payment: Documents against payment (D/P); or
 - b) when the buyer accepts the appropriate instrument of payment (bill of exchange): Documents against acceptance (D/A).

Summary

Since the exporter has recourse to supporting banks in the operation of documentary credits, there is greater security for them, than in the workings of documentary collection. However, documentary collections tend to be cheaper to organise, and assuming commercial documents contain ownership documents the exporter maintains ownership of the good until payment is received.

Open account trading

This is the riskiest form of payment for the exporter (conversely most advantageous for the importer), and normally only occurs when the exporter has trust in the buyer's integrity to honour payment for the goods sold. Open account trading involves the exporter dispatching the goods, together with all ownership and shipping details to the importer (hence relinquishing total control over the good) and awaiting payment at a future date. Thus the exporter is extending credit to the importer for the period of payment (60 days usually) and hence must be liquid enough to support this. As significant trust is needed in the buyer it is most popular as a means of payment for trade between geographically close areas (UK and EC) and where governments are not disposed towards market intervention but are more interested in liberalising (freeing) trade procedures (as in with the EC – which is a customs union).

Having examined the payment methods, we move next to examine the settlement methods used to engage in the transfer of payment between buyer and seller.

Methods of settlement

Cheque payments

Payment by cheque is slow for the exporter as the cheque has to clear with the importer's bank before they receive payment. Also on receipt of payment it is the exporter who pays his bank a collection fee. This fee will be greater if the exporter is accepting a cheque made payable in the importer's country, which their bank will have to collect on their behalf. Again the risk for the exporter is significant as the cheque may get lost in transit to them, may not be payable due to lack of funds in the importer's bank or be stopped by government regulations of the importer's country. However, as a method of settlement it is simple and advantageous to the importer, as they acquire a small grace period of payment while the clearing process etc is completed.

Payment by bankers draft

These suffer from many of the same problems as cheque payments, in that they can be slow and can go astray in transit between importers and exporters. The bankers draft is a cheque which a bank will draw on one of its own accounts (as opposed to a customer's account) and as such has greater credibility and face value to deal with overseas buying or selling. Formally bankers drafts work as follows:

- ▶ If a firm wished to do businesses in Spain with a counterpart firm and purchase exports from them, then the UK bank will purchase pesetas on its behalf (if the firm does not have a peseta account with them), and debit the sterling equivalent plus a commission charge.
- ▶ The draft is sent by the firm overseas to the exporter.
- ▶ The UK bank sends by air mail a letter of notification to the Spanish bank, an instruction to debit their account with the appropriate amount on receipt of their draft, from the Spanish exporter.
- ▶ Payment is made by the Spanish bank to their exporter customer.

Payment orders

These can be in two forms, either:

- ▶ mail transfers (MT) which is a written instruction sent by airmail, or
- ▶ telegraphic transfers (TT), which is a telex or cable instruction and hence quicker than MT.

Although MT are sent directly from the instructing bank to the overseas bank and hence are quicker than bankers drafts, there is still the chance the airmail may go astray (which is not the case with TT). The MT will instruct payment to the seller with the payment occurring in the seller's bank (credited) which will house an account of the buyer's foreign bank, that will be debited appropriately. However if the sums involved are large and need to be quickly transferred then TT will be used, but often this requires that the order be authenticated in the buyer's bank by an official of the bank, before being dispatched to speed up the checking procedure.

SWIFT – IMTs and EIMTs

SWIFT stands for Society for Worldwide Interbank Financial Telecommunications which is a non-profit making co-operative society created by a number of banks wishing to communicate through the speedy computerised communications network. SWIFT uses its own method of contact but this can only occur between banks which are SWIFT members, this is either:

- ▶ an international money transfer (IMT), which is equivalent to an MT message, or
- ▶ an express international money transfer (EIMT) which is equivalent to a TT message.

Increasingly IMT and EIMT are replacing MT and TT especially in the continents of Europe and North America as the added speed of settlement is seen as a great advantage, again especially for large sums of money being transferred.

International Money Orders

These are used when the exporter requires immediate payment for goods sold and they are dealt with via the agency of either the Post Office or International Banks. Mostly the sums involved are small and hence the importer is not granted a credit period.

Bills of Exchange

Bills of exchange are an instrument of payment often used in trade allowing, in some cases, a credit period for the importer as well as the advantage of immediate payment for the exporter if so desired. Bills of exchange are initiated by the exporter (the drawer) and dispatched with the goods to the importer (the drawee) for signing. Once signed it is an acceptance by the importer to pay the exporter either on demand or at some mutually agreed future date.

Bills of exchange are thus split into **sight bills** for immediate payment to the exporter, or **term bills** where the importer is allowed a credit period (for example 45, 60, 180 days).

Trade bills are accepted and drawn on commercial firms, whilst bank bills are drawn and accepted by quality high status banks and hence can be discounted (resold) at a finer rate, which is closer to their face value. If the bill of exchange is a term bill and the exporter does not wish to wait until it matures to receive payment from the importer, then it can be discounted in the secondary or parallel markets, that is they deal in buying and selling bills of exchange once they have been issued. The financial intermediaries which specialise in buying and selling bills of exchange are **discount houses**, that serve as half way houses between commercial banks and the Bank of England. The discount houses hold the Bills of Exchange which they mature and then receive payment from the importer who has had the benefit of the credit period given to them. The profit for the discount houses stems from the fact that they buy them at less than the face value (from the original exporter) and then receive payment at the full face value (from the importer) – the difference being their rate of discount or profit. Secondly, if the bill has been avalised (guaranteed by the importer's bank) then the exporter is sure of payment. The bills can be denominated

in either sterling or foreign currency. Similar in nature but less common are promissory notes (or IOUs), except they are drawn up and signed by the importer and sent to the exporter who accepts them, whereas in bills of exchange the exporter is the drawer (the opposite case).

International trade is significantly encouraged through the provision of trade finance; the various methods for this are examined next.

The main methods of international finance

Trade finance can be requested by the exporter (export finance) or the importer (import finance) and allows international trade to occur more readily. We can distinguish between the different methods of trade finance on a number of grounds, such as length of finance requested (short, medium or long terms), by whom it is requested, but here we will concentrate on the distinction between traditional and non-traditional sources of finance.

Traditional sources of trade finance (bank finance)

Bank overdrafts

These represent an extension of a customer's banking facility, be they importers or exporters, and can be denominated in either foreign currency or sterling. Banks are more willing to provide this facility to exporters if they are covered by an ECGD guarantee (this will be examined in more detail later). This type of finance is most likely used when the parties involved are trading in open account terms and as this is a relatively risky method of payment for exporters, this is reflected by the high cost of borrowing by means of bank overdrafts. The cost of borrowing is related to the London interbank offer rate (LIBOR), which can be given on wholesale borrowing.

Acceptance credit lines

This facility for borrowing is provided by accepting houses (that is merchant/foreign and other banks). Acceptance Credit Lines (ACL) provide short-term finance to exporters, as a bank will accept bills drawn upon it by the exporter against the security of a trade bill which the exporter will have drawn in turn on the importer. The trade bill will mature before the accepted bank bill (known as an accommodation bill) so that its sale and proceeds can be used to finance the accommodation bill guaranteed by the bank. The time period that ACL is granted is negotiable but there tends to be a maximum of 5 years and the minimum sum dealt with is £0.5M. This large amount is indicative of the fact that ACLs are only provided to large corporate customers of good repute. The terms of the bill range from 60, 90 to 180 days. Denomination of the bill is either in foreign currency or sterling.

Steps in setting up ACLs

- 1 Exporter requests a credit facility which will only be granted on the basis of a trade bill (drawn on the buyer) being present.
- 2 The exporter pledges the trade bill to the bank by instructing the bank to make a documentary collection (only finance documents not commercial, therefore it is a clean bill).
- 3 The exporter can draw a clean bill (accommodation bill) on the bank of about 85% of the trade bill value, which will mature after the trade bill.
- 4 The accommodation bill accepted by the bank can be sold on behalf of the exporter to give them immediate finance (that is the bank discounts the bill for the exporter).

- 5 The accommodation bill, now sold to a third party is a debt instrument of the bank to the third party. The bank however will be in possession of the trade bill upon collection, which will mature and so they will acquire payment from the original importer. These proceeds are then later used to pay the third party when the bank's accommodation bill matures at a later stage.
- 6 The gain for the bank stems from the cost of discounting the accommodation bill for the exporter and the bank's original acceptance commission. Also should the trade bill not be paid the bank has recourse to the exporter (who may in turn have ECGD insurance).

The advantages of ACLs for the exporter are:

- ▶ the cost of borrowing can be lowered for the exporter, as the discount rate of an accepted bank bill is finer (that is closer to its face value) than the rate of interest charged on bank overdrafts.
- ▶ the costs are fixed for the borrower and known in advance.
- ▶ ACLs are an alternative source of finance for exporters to bank overdrafts with the eventual liquidity being provided by the third party holding the discounted accommodation bill.

The cost to the borrower as mentioned earlier is the bank's acceptance commission, plus the cost of discounting the accommodation bill.

Produce loans

These are granted only to importers of goods whereby they offer as security the goods they are purchasing and hoping to then re-sell. The short-term loan granted to the importers allows the exporter to be paid immediately. Thus they are often given for goods which are easy to re-sell, such as raw materials or basic commodities (tea, coffee, etc.). Sale proceeds must cover the initial loan, interest charges and any handling/storage charge for the good. The importer must have a reputable standing with the bank, and these tend to be used only when their other borrowing facilities have been fully stretched, and additional credit is still needed. The credit period ranges from 7 days to 3 months.

The method of acquiring a produce loan is:

- ▶ The importer pledges the shipping documents and ownership rights to the bank when signing for the loan. (This is given in a letter of hypothecation/pledge.)
- ▶ On arrival of the goods in the importing country they are possessed by the bank which stores them engaging in warehousing costs and also insures them.
- ▶ The importer makes arrangements for their re-sale and will be granted a delivery order from the bank releasing the goods to him once a buyer is found.
- ▶ On signing the loan application the importer can receive up to 70% of the imports value to help payment to the exporter.

Bill finance

Bills of exchange have been examined earlier in methods of settlement and their advantages and disadvantages drawn out. They are a useful method of financing trade and are commonly used. They allow immediate payment to the exporter, if they are discounted, and provide a credit period of payment to the importer. Should final payment of the bill not occur however, the bank has recourse to the exporter or importer to extricate payment.

Non-traditional sources of trade finance

Factoring

This is trade finance provided by factoring companies that are often controlled by major banks who possess economic information on foreign countries. It is a form of non-bank finance, particularly useful for exporters dealing in risky open account terms, as the advantages of factoring help to alleviate the risks, such as the covering of foreign exchange risk, risk against bad debts is also covered. Factoring is a form of finance which has increased in popularity in recent years and is heavily used in the European continent or for trade between developed, relatively risk-free nations. Alan Hughes, Chairman of the Association of British Factors and Discounters, said his members, which provide companies with finance against invoices, raised their turnover by 16% in the last quarter of 1992.

Factoring involves an export factor buying trade debt (for example accounts) from an exporter who receives immediate cash, in return for a commission being charged. The factor also provides the exporter with services (at a cost) which they can avail themselves of should they wish:

- 1 Administrative services – Such as accounting services, debt collection services, etc. – at a commission rate of approximately 3%.
- 2 Credit insurance against bad debts is provided, but mostly for domestic trade as overseas trade is catered for by ECGD cover; or more specifically NCMC (Nederlandische Credietverzebering Maatschappij) that has taken over the privatised short-term credit insurance function from the previously UK government-owned short-term division of the ECGD.
- 3 Provision of immediate finance both in sterling or foreign currency (at a commission rate of 1–3% above the banks' basic rate). Thus this higher rate of interest reflects the fact that often this finance is obtained when bank loans have been fully stretched and are no longer available, that is when the exporter has cash flow problems. Factors can grant up to 70–80% of the debt amount value in cash for the exporter.

The advantage of this method of finance is that:

- ▶ it is an extra source of finance when bank borrowing has been fully utilised, albeit at an extra cost.
- ▶ risks are cut/covered for debts which are factored as collection of bad debts becomes the factor's responsibility and are brought without recourse to the exporter. (Note however that some export factors are with recourse.)
- ▶ there are cost savings on specialist management functions now provided by the factor, such as accounting.
- ▶ further access to finance allows exporters to extend their lucrative open account trading thus securing more business for them.

Overall, factoring is helpful in providing working capital as well as relieving the company's work from the administrative burden of debt collection. To pursue debt overseas cross-border factoring is needed which involves a foreign associate, known as the import factor, investigating, assessing and pursuing bad debts on behalf of the export factor. The advantage gain for exporters is the transformation of a debt owed into immediate cash, without any future come back, that the process of factoring allows.

This is a medium-term source of export finance (that is between 1–7 years) where the forfeiting bank discounts bank guaranteed overseas trade bills or promissory notes for the exporter at a fixed rate negotiated in advance. The advantage to the exporter is that they obtain immediate finance (up to 100%) and the forfeiter has no recourse back to them should non-payment occur by the overseas buyer – hence the term forfeiting, sometimes spelled forfaiting – as the bank is foregoing the right of recourse to the exporter. This type of finance is only available to domestic exporters (not importers) and is usually granted for the sale of capital goods (physical machinery) costing overseas buyers up to £1.5 M in value. Common currencies for forfeiting are US dollars, Deutschmarks, and Swiss Francs. This gives a clue to the origins of the procedure, which was set up in West Germany, Switzerland and is common in the European continent.

Steps in the forfeiting procedure

- 1 Exporter has contact with overseas intended buyer of capital goods that requires medium-term instalment credit finance.

The buyer must make a deposit payment of 15% of value and pay the remaining amount in regular intervals (by means of promissory note) over the length of the forfeiting period (up to 7 years). Promissory notes are more usual than bills of exchange as the former are without recourse to the exporter, a vital characteristic of forfeiting (whilst the latter can be with recourse).

- 2 Depending on the risk perceived by the exporter in dealing with the importer, they may request the instrument of payment (PNs) be avalised by the importer's bank, guaranteeing payment.
- 3 Exporters must arrange their forfeiting bank domestically.
- 4 On dispatched goods and delivery the importer sends the avalised PN to the exporter who can discount it for immediate cash (without recourse to them) with their forfeiting bank. The risk of non-payment is now undertaken by the forfeiter. These risks (for the factor) have been examined at the start of this chapter, but since payment is in instalments, perhaps the greatest is the risk of non-payment of future instalments.

Benefits of forfeiting for the exporter

- ▶ The exporter's debt is converted into cash thus improving liquidity and the opportunity to borrow more.
- ▶ Other bank credit facilities, for example overdraft, are not adversely affected for the exporter.
- ▶ The risk of bad debts or exchange risk is removed and hence does not need costly insurance cover.
- ▶ This considerably eases the administration burden of operations (as with factoring).
- ▶ The costs of the arrangement are fixed in advance by the forfeiter and hence known.
- ▶ Forfeiting is flexible and speedy to arrange and in some cases when dealing with very low risk countries can be cheaper than government ECGD cover. The forfeiter's charges are split between the exporter and the importer.

However, there are some disadvantages in that if the countries trading are higher risk then forfeiting can be more expensive. This would be reflected by the PN's/Bills of Exchange carrying higher discount rates (ECGD finance may be cheaper). The riskiness of the buyer may make it hard for the exporter to arrange a forfeiting bank domestically. The forfeiting bank will be concerned with the political risk and the problem of exchange controls or country risk and whether the country lacks foreign exchange reserves etc. However, fears about credit-worthiness of the buyer can be

allayed by ensuring that the availing bank is a first-class bank and also arranging payment in hard currencies of politically low risk countries.

Leasing

This is a form of medium to long-term finance provided by leasing companies that are subsidiaries of London banks. Leasing is where a firm has use of a fixed asset (such as technical office equipment, vehicles, use of buildings, etc.) without having to outlay the whole capital cost of actually buying it. Payment is made by the lessee as the asset is used at regular intervals.

Leases are arranged by the buyer of the asset (importer lessee) either in their own country through the use of domestic international contracts with the leasing company (the lessor) of the exporter's country overseas, by arranging the lease direct from the exporter's country with their own country. The latter is known as cross-border leasing and is more common for major items of value, whereas the former (local leasing) is used for lower value items where the term of the lease may be longer.

Once the lease is arranged, the lessor will immediately pay the exporter the full amount upon delivery and installation of the assets overseas. The leasing company has no recourse to the exporter should the lessee (importer) at some stage default on their payments. A secondary lease can also be taken out when the primary lease period expires.

First there are short-term operating leases taken out by companies wanting to use assets with a limited life (that is need updating technically) without wishing to pay for the maintenance costs of the asset. Secondly there are long-term finance leases taken out by larger companies, where the lessor would aim to recover their full capital outlay on the asset plus an adequate return overall. This type of lease cannot be cancelled. Finance leases are dealing in large assets, such as aircrafts, oil rigs, big industrial plants, where depreciation of the asset will occur over a long life time. There can be tax advantages for the lessee who is not the official owner of the good and hence is not accountable for tax reasons as such.

The advantages of leasing for the three parties are:

- ▶ the exporter is paid in full by the lessor and is free of any debt obligations in the future.
- ▶ the lessor obtains regular lease payments from the lessee and is still the legal owner of the asset who may sell it at the end of the lease for the remaining value.
- ▶ the lessee can acquire valuable assets for use, without having to pay the whole capital cost and often on more favourable cost terms than would be required in taking out a loan for purchase.
- ▶ with leases the lessee will be free of maintenance costs of the asset.

Hire Purchase

This is a form of finance used by firms to purchase equipment or other goods. It involves an initial down-payment, often large and regular payments of fixed amounts over an agreed period. It is a flexible form of finance provided by finance houses and UK hire purchase companies, and is popular for use by small firms.

It is similar in nature to leasing except that the arrangement is made by the exporter, who can receive immediate payment from the HP company whilst allowing the importer the convenience of paying in instalments. Again the exporter is free of recourse from the HP company should the importer default on payments. Another difference is that at the end of the payment period the ownership of the good passes to the importer. The arrangement can be made by the exporter either with a local hire purchase company that has an overseas counterpart in the importer's country or by arranging the finance in the importer's country through an international HP credit invoice. Either way the exporter can get immediate reimbursement from the HP company whilst they receive payments in instalments from the importer. The

disadvantage of this method of finance is that it can be higher in cost to arrange than more traditional bank finance.

We move next to examine how both the government and private agencies work to finance and undertake insurance to encourage international trade between businesses.

Export finance and insurance

Export Credits Guarantee Department (ECGD)

The Export Credit Guarantee Department (ECGD) of the government aims firstly to protect trade, via provision of credit insurance policies and secondly promote trade via export financing. Credit insurance covers the risk of non-payment by the purchaser of overseas exports. This is distinct from insurance in the conventional sense, which deals with damage and loss of goods during export abroad. Credit insurance policies on export goods become operative from their point of departure from the UK.

Due to past losses in the area of short term cover, (maximum 180 days) the function of credit insurance was privatised and transferred into the hands of NCM-UK (Nederlandsche Credietverzekering Maatschappij), a Dutch insurance giant in December 1991. This now provides most UK companies with short-term credit insurance so as to protect their export trade against non-payment by the overseas purchaser. A minority of the credit insurance is provided by private companies, for example Trade Indemnity.

The types of risks resulting in non-payment are looked at in more detail at the beginning of this chapter. Non-payment which is covered by credit insurance ranges from foreign government action preventing payment, that is political and economic risk (although currently political risk cover is under review) and to default by the buyer, due to lack of liquidity (trade risk due to non-completion of the contract). The emphasis in credit insurance is on trade risk by the buyer, resulting in non-completion of the contract. Foreign exchange risk is often not covered by the policy. Neither is non-completion of the transaction, as a result of the exporter not adhering to all the proper export procedures/credit insurance details.

NCM-UK provides an adjustable credit insurance service which allows exporters to choose insurance, either for the odd highly-priced item or to insure on a regular basis. NCM prefers to provide a full-ranging insurance service for all the export activity of a firm, as this allows it to be more cost effective and thus offer lower premiums for its service.

The extent of cover varies according to the circumstances of the non-payment, with purchaser default carrying a 90% guarantee, and the risk of exporting to a non-paying foreign country carrying a 95% guarantee.

The form of short-term cover is usually given by NCM-UK as a credit ceiling, below which all export activity of a firm is insured. Once full payment is received by the exporter, the credit insurance ceiling becomes available again for further new exports. For initial business, a firm can insure up to £250 of export activity in this way. Subsequent trade dealing with higher amounts can be insured only through further consultations with NCM-UK. In this way the short-term guarantees protect trade which is already occurring.

Secondly the ECGD itself provides the exporter's banks with long-term guarantees of payment. This backing allows banks to lend more confidently to exporters. Bank lending to both exporters (supplier credit finance) and importers (buyer credit finance) is therefore more forthcoming.

Supplier Credit Finance (SCF – exporters)

Exporters exporting capital goods of a minimum value of £25,000 can acquire credit to 85% of the value of the good from banks, without recourse to them, provided they have an ECGD guarantee backing them. The importer is expected to pay the remaining 15% on or before the delivery date.

Once the exporter and the bank come to an arrangement about the facility it will provide to the exporter outlined in the letter of declaration and acceptance, ECGD will issue a certificate of approval setting out its conditions of cover, which is passed to the bank for its ratification. Thus the bank, not the exporter, has the guarantee available to them. Thus participating banks are part of the Master Guarantee Agreement (MGA) establishing the conditions of ECGD cover. Once ratified, exporters can borrow against the terms stipulated in the letter of declaration on presentation of any necessary documentation (bills of exchange, evidence of shipment, etc.). In summary, therefore, a specific guarantee is offered by ECGD to the exporter's bank promising to pay 100% of any bill of exchange or promissory note issued, which is not paid within three months of the due date.

Buyer Credit Finance (BCF – importers)

This is provided to overseas importers buying high value (£1M–£5M) capital goods from UK exporters. This finance is often for large scale engineering projects. In this case the ECGD guarantee is used by the exporter's bank to provide a loan directly to the overseas importer, allowing them to pay the domestic exporter without delay. The importer must give a down payment or deposit of up to 20% of the value of the good to acquire credit from the bank for the remaining 80%. Again in this case there is no recourse to the exporter due to the ECGD guarantee. The bank is covered 100%, being in receipt of a full guarantee from ECGD. The administrative complexity of this policy means it is only viable on cost terms for large projects.

BCF can be illustrated by means of a flow chart (Figure 18.1). In this case when the UK exporter provides documentary evidence of export to the UK bank, they can obtain immediate payment from them in cash terms. This added advantage is granted to the exporter if they are prepared to pay an extra premium on the ECGD cover they undertake. This extra premium means that ECGD are in turn prepared to provide a direct guarantee to the UK bank backing the medium-term loan they provide to the foreign importer in their loan agreement. The initial cost of arranging the finance (that is ECGD premiums and bank charges) are paid by the UK exporter, however the overseas buyer is responsible for paying the interest charged on the loan from the UK bank.

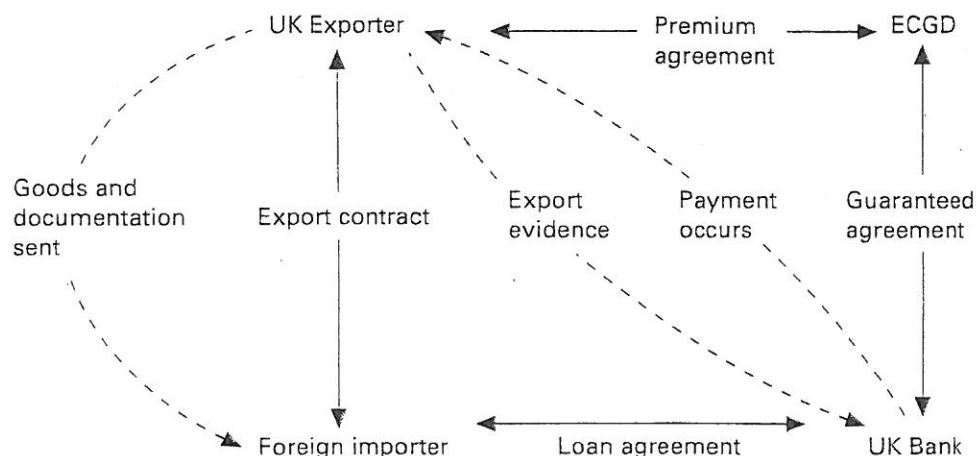


Figure 18.1 The principle of buyer credit finance (BCF)

Finally, lines of credit can also be offered by ECGD for mini buyer credit for contracts in value as low as £35,000. The amount of credit offered to the overseas buyer is limited to 85% with the remaining amount being covered by direct payment from the importer to the exporter. The loan from the UK bank is guaranteed by the ECGD. This type of finance tends to be for purchase of capital goods by overseas buyers from UK supplies. Cash payment is paid to the exporter at the time of shipment of the goods and there is no recourse to the exporter.

Having examined the area of export finance and insurance, we can now move to look at another form of international trade which is becoming important, that is counter trade. Counter trade has its own characteristics of how payment and settlement occur according to the various forms of counter trade which exist.

Counter trade

Counter trade is a type of barter or reciprocal trade whereby exports to one country occurs on the condition of the exporter in turn purchasing imports from the same country in return. Counter trade is a significant and increasingly important form of conducting trade and to reflect this banks operate counter trade departments to provide business advice to clients and in some cases finance. Also government assistance for this form of trade is provided by ECGD insurance policies and the services of the Department of Trade and Industry (DTI) under their project and export divisions.

One of the reasons for the growth of counter trade is the need to finance trade when countries lack the necessary foreign exchange for monetary payments. The debt crisis of less developed countries, which will be examined in Chapter 20, points to the lack of financial funds to back trade and hence the increased use of barter type arrangements. For many of these developing countries it is often used as a stimulus to domestic industrial development, which is implicit in the counter trade deal (ie. they are allowed to export in turn for imports). Their own domestic demand for industrial products may be small due to lack of consumer income and so trade opens up the avenue of world demand, which is both higher in value and securer. Clearly therefore, counter trade is used significantly by developing countries in Asia and Africa and many oil exporting nations whose method of payment for imports is often the sale of oil to the initial exporter. There are various forms of counter trade.

Barter

This is the simple direct exchange of commodities between exporters and importers, without any interaction of money as a means of payment. However, although the simplest type, it is difficult in practice to achieve as the exporter and the importer must both need/desire each other's commodities, that is there must be a double coincidence of wants which can be mutually satisfied!

Counter purchase

This occurs when an export order is accepted in return for an import order being accepted from the same country, which may be in value anything up to the exact initial exporter order value (100%). In this case, however, money is used as a means of payment for the initial exporter (or credit terms of equal value). The counter purchase import order is a promise to use this cash payment to purchase goods of equal value in return. Thus two separate agreements are made, one for the principal export and one for the counter purchase.

Buy back

This is used in capital equipment exports at large value and tends to be longer-term. The intention here is that the payment for the initial export is used to buy back the output of the export order when it starts producing in the foreign country, that is buying back oil from the initial export of oil rig equipment.

Offset

Exports are allowed on the basis of a local indigenous input being used, so that demand for one generates demand for the other. Again for countries trying to encourage industrial development it is a method of stepping on the ladder of development at the initial raw material input stage, and as such is common in exports of high technology products (for example defence).

Switch trading

This is complex and costly as it involves a third party who is the beneficiary of bilateral trade between two members, for example the USA may be owed payment by France, but rather than collecting directly it may purchase products from the UK (Figure 18.2).

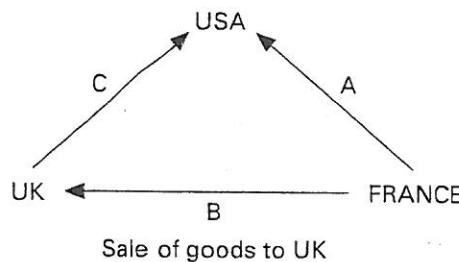


Figure 18.2 Switch trading

USA is owed payment by France – this is not collected directly via route A, but indirectly via routes B and C. Documents are switched in favour of the third party. Thus the third party, in this case the UK, has benefited from the accumulated trade supply that the USA had with France as it has conducted more trade.

Evidence accounts

These occur in large multi-national firm operations. Host countries that house MNE may request that MNE generate exports from the country on their behalf to balance the import into the host country that the MNE makes. As this cannot occur on a product-by-product basis, evidence accounts are kept to ensure the exports swapped are of equal 'value'.

For countries where foreign exchange is scarce, the advantage of barter/buy back etc. are obvious. However, the risks to the original exporter are greater as the responsibility does not end with the sale of the good. Substantial administrative costs (banks, brokers, agents) are involved in setting up the counter trade. The counter purchase may be superfluous to the needs to the exporter and so must be sold elsewhere, with maybe subsequent transportation costs.

Nevertheless for developing countries wanting to industrialise, with domestic debt overhangs restricting their ability to acquire foreign currency loans from banks, it is a helpful method of trading.

