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Finance for Foreign Trade

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There are a variety of different methods of settlement in international trade, the choice of which is a key factor in the selection of appropriate finance. Before sourcing from abroad or engaging in export markets, it is important at the outset to understand how the differences between international and domestic trade can affect the importer or exporter.

In international trading, the business environment may be very different from domestic market conditions in the following respects:

- lead times may be much longer;
- transit times in the carriage of goods and documents are almost certainly longer;
- different time zones, working week cycles, holiday periods and languages may impact communications;
- political risk, customs and excise routines and local laws and business practices may cause problems to the payment mechanism or delays in the settlement of insurance or other claims.

It will also be relevant whether the foreign trade takes the form of single infrequent transactions or a continuing flow of transactions. The key consideration is to minimise any funding gap generated by the company's foreign trading activity to a level that can be accommodated comfortably within the company's financing arrangements.

Methods of settlement

The following methods of settlement are all in current use and present differing degrees of risk for either buyer or seller.

Advance payment

The payment for goods in full before they are received, possibly when the order is placed, is the optimum method for the exporter, although some form of retention until the goods are received and checked is normal. The exporter's cash flow is positive and its position is secure.

However, the importer's cash flow and risk positions are the reverse and complete confidence in the exporter's ability to perform is a prerequisite. Where appropriate, independent inspection of goods before release of payment is an obvious precaution. Asking the seller for a performance guarantee and a provision for compensation in case of non-performance and insuring against political risks are actions that can be taken in mitigation of the risk.

Open account

Under open account conditions, the exporter despatches both the goods and documents directly to the importer. The importer receives the goods and in due course remits payment to the exporter according to the terms agreed between the parties. In terms of risk, this procedure is at the other extreme to advance payment and will only be acceptable to the exporter if the importer is of high standing and can be judged creditworthy after full enquiries.

Risk mitigation can include provisions for assured remedy or compensation in the event that proceeds are not remitted on time, credit risk and political risk insurance.

Documentary collections

The normal alternative to open account, where an exporter wishes to secure payment from lesser-known importers, is to make use of the banking system to obtain payment or acceptance of a bill of exchange. Documentary collection procedures, subscribed to by almost all banks in the commercial world and national Chambers of Commerce, are covered by the International Chamber of Commerce (ICC) Uniform Rules for Collection, which came into force in January 1996.

Under these procedures, an exporter normally hands the shipping and other appropriate documents to its bank, after shipping the goods, with instructions that they be transmitted to the buyer's bank and be released against payment by the importer or against acceptance of drafts drawn on the importer. All instructions must be full, clear and precise. Before shipment, the exporter should ensure that the importer possesses an import licence which is valid for a period sufficient for the goods to be cleared at their destination, allowing for any potential delay. The exporter should also confirm that current exchange control authorisation has been granted to the importer, where applicable, enabling payment to be made immediately or at maturity of the usance drafts, in the currency of collection and as instructed.

There are two main categories of documentary collections: documents against acceptance and documents against payment.

Documents against acceptance (D/A)

In this case, the exporter hands the drafts and accompanying documents to its bank with instructions for the documents' release to the importer in exchange for payment at maturity. The drafts would be drawn at an agreed date for the payment of the bill of exchange.

Unless the documents include documents of title (eg full sets of bills of lading), the position of the exporter is little better than an open account situation. If documents of title are included, control of the goods can be retained by the bank until such time as the drafts have been accepted by the importer, after which control is lost. The risk of non-payment after acceptance can be mitigated in one of two ways:

- with the prior approval of the buyer, by asking the collecting bank to add its 'per aval' endorsement to the acceptance. (This will give the seller the guarantee of payment at maturity and assist the seller's financing, as described below.)
- if the buyer is of sufficient financial standing, by obtaining credit insurance (typically at between 80 per cent and 85 per cent of the value of the collection).

Documents against payment (D/P)

The difference from the D/A situation is that the relevant documents are released to the importer against payment. Assuming that full sets

of documents of title are included in the collection, control of the goods is retained until payment is obtained and the seller is in a comparatively secure situation.

There is still the risk, as under D/A, that the goods are not taken up by the buyer, which can be mitigated by asking the collecting bank to store and insure them with a view to returning them to the seller (unless they are perishable) or to finding another buyer, perhaps at auction.

Documentary credits

There are five main types of documentary credit of which the usage is varied.

Revocable credits

Revocable credits where the buyer's commitment can be withdrawn are rarely used and best avoided.

Irrevocable credits – unconfirmed

The buyer is committed to pay and the seller has the undertaking of the issuing bank, but not the confirmation of a local bank. The risk to the seller lies in the standing of the issuing bank and in the country risk. The seller may mitigate the risk by demanding that the confirmation of an acceptable bank be added to the credit.

Irrevocable credits – confirmed

Under these arrangements the seller is assured of payment and the buyer, through the banking system which gives evidence that the goods have been shipped, is assured of receiving shipping documents. However, absolute clarity is essential in the terms of the credit and the specific documentation. The credit should be scrutinised as soon as it is received and any necessary clarification or amendments sought immediately.

Revolving credits

Documentary credits are reinstated automatically if they are stated as being 'revolving' according to written terms and conditions. They

usually take one of two forms: those that revolve automatically and those that revolve periodically.

A credit that revolves automatically is reinstated after each 'revolution' until the maximum amount or the number of revolutions stated are reached. A final expiry date will be stated and care must be taken to ensure that outstanding documents are presented within the limits specified. A credit revolving periodically would be reinstated after each stipulated period of time had elapsed, again with a fixed expiry date and for the same amount or number of revolutions. For each kind of revolving credit, the credit would state whether the amounts are cumulative or non-cumulative, stipulating whether any unutilised balance from any one revolution may be carried forward to the next.

Transferable credits

In addition, each of the above four forms of credit can be expressed as being 'transferable', and can be transferred only if expressly designated as transferable by the issuing bank. Under the ICC's Uniform Customs and Practice for Documentary Credits, which came into force in January 1994, a bank requested to effect a transfer will not be obliged to do so; therefore, the beneficiary to a transferable credit can request, but not demand, that the credit be transferred. A transferable credit can be transferred once only, and only on the same terms, ie CIF (Cost Insurance Freight), FOB (Free on Board) or other as the original credit. The only permissible changes are to the amount of the credit, the unit price of the goods, the expiry date, the last date for presentation of documents and the shipping period – any or all of which may be reduced or curtailed.

Finance alternatives

In relation to the four main methods of settlement, there are a series of different finance alternatives.

Bank overdraft

In its traditional form, the bank overdraft is a potentially useful and very flexible form of trade finance for both exporters and importers alike. It suffers only from the fact that it is payable on demand and is not necessarily related to the receivables of the operation.

In cases where a manufacturer or trader agrees with its buyer to accept a documentary credit but cannot finance the manufacture or purchase of the goods covered by the documentary credit, a bank may be persuaded to provide the necessary pre-shipment finance in the form of a short-term bridging loan or overdraft facility to cover the period in question. The arrangements may provide for the bank to have control over the goods as soon as they are manufactured or bought, until such time as they are shipped and the proceeds received from the incoming letter of credit.

Bill finance

Finance can be obtained in the form of an advance, with recourse to the drawer, in respect of bills of exchange sent through the banking system on either D/A or D/P documentary collection. Progress is traceable through the banking system and the advance is liquidated on receipt of proceeds from the collecting bank.

Red clause documentary credits

Originating in the Australian wool trade and sometimes used in commodity trades where the beneficiary needs to accumulate a given quantity of stock to make shipment, red clause documentary credits authorise the confirming or nominated bank to make advances to the beneficiary to enable it to buy the produce locally in order to make shipment. Typically, such advances are made against presentation of the beneficiary's simple receipt, possibly accompanied by an invoice. The extent of the permissible advance would be specified in the red clause, having been pre-negotiated between buyer and seller, and could vary commonly from 50 per cent to almost the full value of the credit.

Green clause documentary credits

A development of the red clause credit, the green clause credit authorises the confirming or nominated bank to make advances to the beneficiary but more tangible evidence of the existence of the goods is required. For example, an advance may be made to the beneficiary against presentation of a simple receipt accompanied by warehouse warrants or receipts for the stated produce, in a recognised independent warehouse in the name of the bank. Thus the existence of the

goods, their packing and quality is verifiable by inspection. As in the case of a red clause credit, the balance of the value of the goods due is claimed by the beneficiary on presentation of the documents stipulated in the credit.

Forfaiting

Forfaiting is defined as the purchase, without recourse to any previous holder, of debt instruments due to mature at a future date, which arise from the provision of goods and services. Most forfaiting transactions tend to relate to commodity trade and the sale of capital goods.

The debt instruments forfeited are usually bills of exchange or promissory notes which must be accepted by a multinational company of unquestionable status or guaranteed by the addition of a 'per aval' endorsement by a bank or government organisation acceptable to the forfaiter. The practice of forfaiting is applied most commonly to documentary collections (D/A) in respect of large-value transactions. However, small-value forfaiting transactions, eg tens of thousands of US dollars or pounds sterling, are not uncommon.

Export factoring

Available from specialist international factoring companies, many of which are owned by banks, export factoring allows the exporter to hand copies of all its invoices drawn on overseas buyers to the factoring company which purchases the debts, often without recourse. Responsibility for credit control, debt collection and foreign exchange risk may be taken on by the factoring company under a variety of schemes offered.

Equipment leasing

Generally confined to high-value capital goods such as ships, aircraft and sometimes machinery, equipment leasing enables the overseas buyer to acquire a capital asset without having to engage in foreign trade procedures. The leasing company would intervene, purchase the equipment from the manufacturer and lease it to the overseas buyer. As with any form of leasing, the buyer would have to satisfy the leasing company that it generates a sufficient cash flow to cover leasing payments.

Stock finance for importers

Finally, traders importing goods and stocking them for eventual resale on the domestic market may require finance. Banks or specialist trade financiers can provide finance against existing stock, through factoring or invoice financing as described above. Alternatively, they could open an import documentary credit on behalf of the trader, keep control over the stock and collect the receivables from the trader's customers.

Currency fluctuation

Any account of trade finance alternatives is incomplete without reference to currency fluctuations and the complex topic of currency management. Foreign trade in any currency other than the trader's own gives rise to the possibility that the rate of exchange of the 'foreign' currency may fluctuate against the trader's own currency, resulting in either an unexpected loss or realisable profit.

This concern persuades many exporters and importers to insist on trading in their own currency only, which very often results in less advantageous prices than trade in the counterpart's currency or a neutral currency, typically the US dollar, the Swiss franc or nowadays the euro. The currency exposure may be redressed by 'hedging' – the purchase or sale of a currency matching the trade contract in amount, currency and in value date.

For a more detailed account of foreign trade finance and documentation, consult: Curmi, G. (2001): International Trade Finance and Documentation, in Reuvid, J. (ed): A Handbook of World Trade, Kogan Page, London.