

Trade finance

Finance alternatives

To be able to give or to arrange finance as part of an export transaction is increasingly important, both as a sales argument and to meet competition from other suppliers. This applies particularly in the case of heavier capital goods or whole projects, where finance is often an integrated part of the package, but it may also apply to raw materials, consumer goods and lighter capital goods for shorter periods.

The length of credit is often divided into short term, medium term and long term, even though such classifications are arbitrary and dependent on the purpose. Short-term credits are normally for periods up to one year, even though the typical manufacturing exporter would normally trade on short-term credits of 60 or 90 days, perhaps up to a maximum of 180 days. Periods between one and two years may be described as both short and medium term depending on the purpose, whereas periods from two up to five years are medium term and periods above that are long-term credits.

In general, the buyer often prefers to split the payment for capital goods (machinery and installations with a considerable lifespan) into separate instalments over longer periods, perhaps with the intention of matching the payments against the income generated from the purchased goods. In such cases, the seller may have to offer these longer credit terms in order to be competitive.

The credit period is usually calculated from the time of shipment of the goods, or some average date in case of several deliveries. However, in practice, payment is seldom made at that early stage and some form of credit is therefore included in most transactions. The seller may prefer to refinance such credits through ordinary bank credit facilities, especially for shorter periods and smaller amounts. However, in other cases the financing has to be arranged in some other way, which can also affect the structure of the transaction.

Trade finance

The expression ‘trade finance’ generally refers to the financing of the fluctuating working capital needs for either single or bulk trade transactions. This financing, should, in principle, be self-liquidated through the cash flow of the underlying transactions.

Trade finance is a major issue for both seller and buyer. In this book, however, the focus and presentation are mainly based on the exporter’s situation. This is not only because it is normally a more complex question seen from the exporter’s point of view, but also because it will make the text more understandable. However, the text will be as easily understandable for readers who want to view it from the buyer’s perspective.

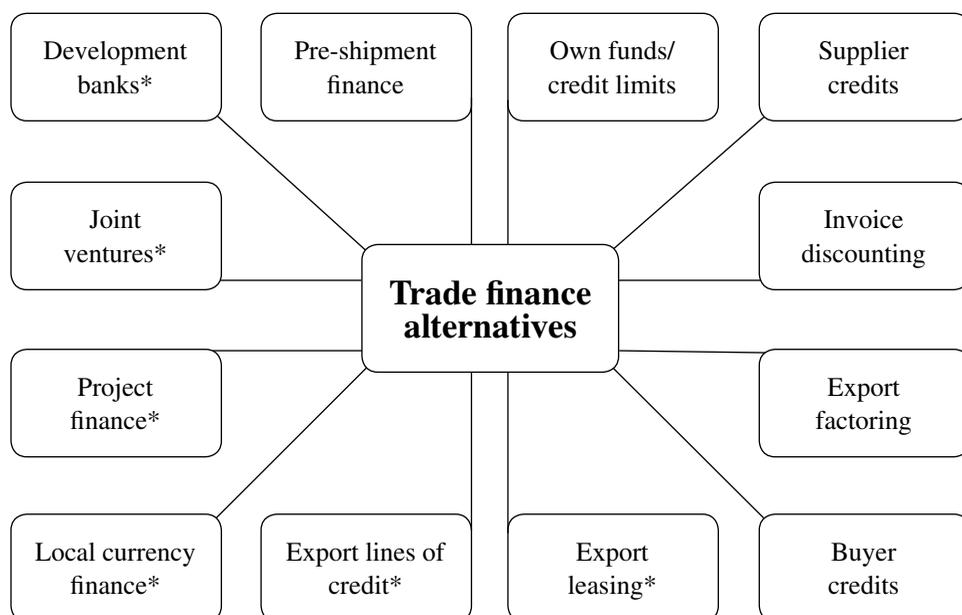
Typical trade finance lending is, whenever possible, secured by the export goods and/or future receivables or other trade debt instruments such as bills of exchange, thereby assuring the lender that the incoming cash flow will first be used for repayment of any outstanding debt before being released to the seller.

This self-liquidating aspect of trade finance is generally also more secure for the lender compared to other forms of working capital facilities and could therefore facilitate a higher lending ratio and often even better terms than would otherwise be applicable.

Another aspect of trade finance involves ways of obtaining security that will enable the seller to extend such credits, often directly through the terms of payment, or in combination with separate credit insurance. Such risk coverage and the terms under which such policies can be issued have a strong influence on how export credits can be structured, but they also affect the terms of payment and other conditions related to the transaction, particularly for longer periods. Figure 6.1 provides a summary of the most frequently used techniques for financing or refinancing of international trade and the following text will be structured accordingly.

Of the alternatives, only one or two may be of interest in each case, depending on the particular area of business or trade cycle of the transaction, that is, the period from the time when the first costs are incurred for ordering raw material or other goods, until shipment and final payment from the buyer. However, the trade cycle also covers the time from when the first risks have to be incurred, for example agreements with other suppliers or simply the need to change internal procedures or preparations for the new production.

This trade cycle can be relatively similar for most products within one and the same company, depending on the area of business, or it can be unique for every transaction. The character of the trade cycle will also differ between most suppliers and will determine the structure of the terms of payment, as well as the method of dealing with different trade finance alternatives.



*See Chapter 7, Structured trade finance

Figure 6.1 Summary of trade finance alternatives

Pre-shipment finance

The expressions ‘pre-export finance’ and ‘pre-shipment finance’ (sometimes also called ‘packing finance’) are defined as the temporary working capital requirement needed for the fulfilment of one or several specific export transactions. This covers the cash flow (and guarantees, if any) related to costs of raw material and other goods, labour, equipment and overheads, until final payment – or until the earlier stage where receivables or debt instruments are received from the buyer, which can be refinanced.

The period before delivery is often the most difficult part of the export transaction, particularly when trading on an open account basis. In that stage of the transaction the seller has only a sales contract, not a bill of exchange or other debt instruments related to the trade, nor any of the shipping documents that come with the actual delivery; for example, copies of the bill of lading and the invoice, showing that delivery has taken place and that a trade debt has been created.

For ordinary day-to-day transactions, the most frequent method of arranging pre-delivery finance requirements is through existing or additional bank credit limits, without involving the specific sales contract and/or the additional security, if any, created by the method of payment. However, when a business expands, or, in the case of individual larger or more complex transactions, when existing limits are fully used or needed elsewhere in the ordinary business, it is important to know how to

find the additional means to finance the new transaction until payment is made or until documents can be produced, which are necessary for the refinancing. In some cases the sales contract itself can be used for creating that additional finance during the pre-delivery period, for example when a third party covers the buyer's payment obligations.

The difficulty of arranging pre-shipment finance in connection with open account trading is a major reason for the present development by SWIFT of a new SWIFTnet Trade Services Utility (TSU), a central data information database, which will increase the transparency of the transaction and reduce the uncertainty for the participating bank, enabling them to expand their pre-shipment finance. The TSU is presently under development (January 2008), and is described in more detail in on pages 34–36.

The existence of an L/C or a payment guarantee in favour of the seller could strongly facilitate the pre-shipment finance requirements in many ways. The advantages of having the L/C made transferable are also obvious; it will automatically transfer not only the financial cash flow but also security from the seller to the suppliers, who might use the transferred L/C for their own pre-shipment arrangements.

Many banks also extend special *export loans* on the basis of the L/C to a certain percentage of its value, with or without the L/C and its future proceeds pledged to the bank. Both the percentage and the collateral will most certainly vary depending on the many aspects to be considered by the bank, for example the issuing bank, the size and maturity of the L/C, its terms and conditions, the nature of the goods and, perhaps equally important, the knowledge and experience of the seller.

The advantages of an L/C as a pre-shipment finance instrument also applies to a payment guarantee issued by the buyer's bank in favour of the seller, but perhaps not to the same degree. The payment guarantee (supposed to be a normal trade-related and conditional guarantee) is more like a credit risk umbrella covering the general payment obligations of the buyer according to the contract. But it does not contain a mechanism, such as an L/C, where the issuing bank automatically has to pay, irrespective of the buyer's consent, when certain specified terms and conditions are met. Even though it is thereby less precise than an L/C, most banks will nevertheless regard such a guarantee as an important instrument for increasing the seller's credit limits.

In a mutually advantageous business negotiation and when the commercial parties know each other well, the buyer may even be willing to make further concessions in the payment structure to accommodate the seller and their need for additional pre-delivery finance. In fact, the buyer has already done so indirectly by agreeing to an L/C as a method of payment in the first place, or by having it made transferable. However, if agreeing to support the seller's pre-delivery cash flow, this could also be done through insertion of a so-called 'red clause' in its terms, even if such clauses are now relatively rare in international commercial trade.

A red clause allows the seller to make use of an agreed part of the value of the L/C before delivering the documents, sometimes earmarked for payment only for some specific purpose. By inserting such clauses in the L/C, this pre-delivery part-payment will, in fact, become an advance payment. However, such advance payments are otherwise mainly used only as part of an overall part-payment structure, with the

larger part being payable at shipment and with one part up-front and often one part also as a deferred payment; this type of split is often used in contracts containing more than just delivery obligations, such as installation or maintenance and over a longer period.

Even if any form of advance payment has to be secured by a conditional bank guarantee in favour of the buyer, and thus issued under the seller's existing credit limits, it is still to their advantage both from a cash-flow and a collateral perspective. Such a guarantee cannot be drawn upon as long as the seller fulfils the contractual obligations and therefore involves no additional risk; for that reason it may be issued with other, less stringent security requirements from the issuing bank, compared with ordinary lending.

Working capital insurance/guarantees

When dealing with pre-shipment finance, one also has to look at the sales contract between the commercial parties and how that could be used as a financial tool. Both private market insurers and export credit agencies may offer pre-delivery cover (see 'Different forms of insurance/guarantees' on page 121), even if structured differently and with different requirements on the status of the buyer or on the terms of payment.

Such cover can be issued in the form of an insurance policy to the exporter or directly as a guarantee to an authorized lending institution, thereby enabling the seller to obtain a loan to finance their export of goods and services. This can then be used for the following purposes:

- purchase of finished products for export;
- cost of raw materials, equipment, supplies, labour and overheads to produce goods and/or provide services for export;
- work in progress and finished export goods;
- support standby L/Cs or other arrangements serving as contract or payment guarantees;
- finance of open account or term receivables.

With such a working capital or pre-shipment guarantee, the seller would be able to increase their borrowing capacity considerably in comparison with normal lending criteria. Such insurance/guarantee may cover up to 90 per cent of the loan amount and with a maturity to match the underlying cash-flow requirements, typically from six months up to a few years.

The existence of separate credit insurance will increase the security of the transaction and will have a strong influence on the bank's decision on additional finance. This interaction between the seller, the insurer and the bank (ongoing during the entire negotiation process with the buyer) may be the key for securing additional pre-finance needed for the transaction.

This procedure also gives the seller feedback on the terms on which the insurer and/or the bank may be willing to participate and what might be required from the seller and from the terms of the sales contract. Having achieved that, the seller will

have secured the support needed from these institutions, covering both the risks involved and the cash needed as pre-shipment finance.

Supplier credits

Supplier credits are the most commonly used method of trade finance, mainly for shorter periods but to a lesser degree also for medium-term periods. Its structure is determined by the time-span of the credit, its size, the buyer's country and the method of payment agreed in the sales contract – details that determine not only the seller's risk exposure but also the structure required by the financial institution, should the credit have to be refinanced at a later stage.

The possibility of the seller agreeing to a supplier credit is determined by how it can be refinanced, either through existing bank limits for smaller amounts and shorter periods, or by separate discounting or refinancing of the finance instrument that becomes available at shipment or shortly thereafter. The credit terms that can be offered by the seller are also important as a sales argument and as a competitive advantage – or at least as a means of being on an equal footing with competitors.

Sometimes the terms of such short credits can be made particularly advantageous for the buyer as part of the offer, even if the seller compensates themselves in another part of the contract. The problem for the buyer is that it is not easy to see if the price has been increased because of the favourable credit terms, and if so, by how much. There is also a risk that the seller may overcompensate for the risks in their credit offer if the buyer is unfamiliar or if the seller cannot evaluate the commercial risk correctly. The buyer, on the other hand, may ask for a quotation to include both cash against delivery and a supplier credit alternative in order to be able to make a fair comparison.

The buyer may even start the negotiations based on cash against delivery or short-term open account terms to allow for new and longer credit negotiations, when the price discussions are more or less concluded. It will then be more difficult for the seller to add the credit costs to the price and these will have to be part of a separate negotiation in which the buyer again tries to get the best solution – or arranges the finance elsewhere or, in the worst case, chooses another supplier altogether.

Irrespective of how the negotiations proceed, there are some general questions that the seller must evaluate before offering a supplier credit, such as:

- To what degree is the requested credit changing the commercial and/or the political risk involved in the transaction?
- Can the buyer be expected to take any open credit costs?
- Should the financial costs be included in the original price offer or should the seller be proactive by keeping the credit terms open as a separate question to be discussed with the buyer?
- How can such credit be refinanced?
- In the case of foreign currency invoicing, how should the currency risk be evaluated and covered?

In cases of shorter periods and smaller amounts, these questions are easily dealt with, but in other cases they might be one of the major aspects of the transaction.

Short-term supplier credits

The most common form of short-term supplier credits is in combination with open account payment terms; that is, the contract is based on a future payment transfer, and the invoice specifies the date when payment must be received at the seller's account. However, the seller has no other security for the buyer's payment obligations. Sometimes, particularly for periods over 3–6 months, even short-term credits are arranged through a bill of exchange to be accepted by the buyer at delivery, thereby replacing the open credit with a documented debt instrument, payable at a specified later date.

The seller may nevertheless also enclose a bill of exchange with the invoice even when trading on open account and on shorter payment terms (30–90 days), showing the delivery date together with a fixed maturity date. This could have value even if the bill is not accepted by the buyer because it connects the sales contract with the delivery and the buyer's corresponding payment obligations. This is the same procedure as used in connection with documentary collections, payable at presentation.

The seller should also evaluate whether it would be beneficial to offer both cash against delivery terms and short-term credit on favourable terms as alternatives; however, if choosing the latter, then it will be conditional upon the buyer's acceptance of a bill of exchange when presented together with the invoice. A short, well-documented supplier credit could have advantages for both parties, compared to open account payment terms, for the following reasons:

- it could be an additional advantage from a sales perspective;
- the buyer can use the credit for improved cash-flow management, perhaps at more favourable terms, but with the strict obligation to pay at maturity – with the risk for noting and protest of the accepted bill if not paid;
- the seller has the advantage of an accepted finance document that is easier to refinance at an earlier stage, if needed;
- the seller can plan liquidity more exactly at the outset, knowing that payment on maturity is highly likely; and
- the seller may wholly or partly include interest in the bill of exchange, compared with a later overdue interest (which in practice is very difficult to receive).

The difference between open account payment terms and the accepted bill of exchange is also greater than one might first expect (even with the same maturity date). With open account terms, the buyer has a stronger case for negotiating with the seller prior to payment, should it be considered that the delivery was not in accordance with the agreement. It could be anything from time of delivery to shortcomings in the quality or quantity of the goods – the main point is that the buyer may refuse to pay until the matter is resolved.

However, by accepting the bill of exchange at or about the time of shipment, the buyer has an unconditional obligation to pay, irrespective of any real or alleged shortcomings discovered later in the delivery. If the claim is correct, the buyer will probably get compensation; however, the bill must be paid at maturity, irrespective of the ongoing discussions with the seller.

When documentary collection is used as the method of payment together with supplier credits, the documents will be released against acceptance of a bill of exchange with a fixed maturity. The documents are exchanged against the bill, normally without any further security for the seller. But, if the supplier credit is given as part of an L/C (with documents against acceptance), the banks involved will determine the procedure and will also check the accuracy of the documents. Upon approval, the bill of exchange will be accepted (by one of the banks as a banker's acceptance and not by the buyer) and can then easily be discounted by the seller on favourable terms, mostly without recourse.

Medium- and long-term supplier credits

Supplier credits of two years or more are usually arranged in connection with the sale of machinery, vehicles, equipment or other capital goods, and with credit documentation that tends to be more complex than for shorter periods. In these cases separate financial documentation is often used, with or without supplementary bills of exchange – or promissory notes with the same but more summarized wording compared to a complete loan agreement.

When bills of exchange or promissory notes are refinanced externally, the seller often has a prearranged facility from a bank or financial institution, specifying the details, including the security required for such refinancing to take place. In any case, the seller is likely to have such refinancing agreed as part of the transaction, with all preconditions in place before delivery.

With longer supplier credits, two questions are important for both commercial parties to agree upon: 1) the choice of currency; and 2) the choice of fixed or floating interest rate. The choice of currency need not be the same as the invoicing currency, even if that is normally the case. However, if the parties agree to a separate financing currency, they also have to agree at what future date the change from invoicing to financing currency will take place.

The buyer's possible currency deliberations are described in Chapter 4. The outcome may be a 'neutral' third-party currency, often USD, which also has good liquidity over longer periods and, therefore, is possible to hedge at reasonable terms. However, if the currency of the credit is not the buyer's home currency, then the buyer takes the currency risk, or the hedging cost, until final maturity (often with a substantial risk or cost if it is either not hedged at all or hedged against a weaker currency).

The box on page 133 shows an example of a promissory note, the last in a medium-term supplier credit over five years with 10 equal, semi-annual instalments and fixed interest rate. And, as can be seen in the example, a bank guarantee as well as a currency transfer guarantee from the central bank may sometimes be required in order to make the notes acceptable for refinancing (in this example by a UK forfeiting institution under UK law).

Example of a promissory note* (issued under a medium-term supplier credit agreement)

Promissory note No. 10

For value received, Bayala Machinery Group Bhd, 2 Jalan Tong Shin, 50201 Kuala Lumpur, Malaysia (the buyer), hereby irrevocably and unconditionally promises to pay, on 21 June 2009, to Pierson & Henders Ltd, 4 West Regent Street, London EC2 4LP (the seller), or order, the principal sum of one hundred and thirty-five thousand US dollars (USD 135,000) and to pay interest on said amount from and including the date hereof at the rate of five per cent (5 per cent) per annum. Interest shall be payable annually in arrears on 21 June each year, commencing on 21 June 2005, calculated on the exact number of days and a year of 360 days, and any overdue payment should be calculated on a day-to-day basis at an interest rate of 8 per cent, until payment is made. Both principal and interest is payable in USD at First Commercial Bank, 3 Tower Hill Street, London EC2 3JK, in favour of the lawful holder of this note, without set-off or counterclaims and without any deduction for present or future withholdings or taxes.

This note is one of a series of ten (10) promissory notes in the aggregate amount of USD 1,350,000, of the like form and tenor except their number and date of maturity, issued pursuant to the Contract Number DN/8318/26, entered into between the buyer and the seller on 3 February 2004. The contract cover sixteen (16) 280-KW diesel generating machines, the delivery of which is fulfilled according to contract and unconditionally approved by the buyer by signing this note.

This series of notes is to be covered by a separate bank guarantee issued by Bank of Berhad, 304 Sultan Road, 50230 Kuala Lumpur, Malaysia, a currency transfer guarantee by the Central Bank of Malaysia and by a legal opinion issued by the law firm Derr & Whitney, Kuala Lumpur.

The laws of the United Kingdom shall govern this note, and the courts of England should settle any legal dispute.

Date and Signatures

*This example is an illustration only; any debt instrument should always be subject to legal scrutiny in each particular case.

The choice of fixed or floating interest in a medium- or long-term supplier credit is primarily a choice of the buyer, if a fixed rate alternative can be obtained through the refinancing bank. That is most likely in the larger trade currencies, either as direct refinancing or through interest swaps, which are separate contracts with the bank, exchanging floating for fixed interest rate under a fixed period of time. Such

contracts in the larger trade currencies can be obtained at reasonable rates for very long periods.

Refinancing of supplier credits

In one way or the other, the exporter has to finance or refinance the supplier credit extended to the buyer, and some of these methods have been mentioned. As a summary, some of the most used forms of refinancing supplier credits on short or medium term periods are:

- bank loans and trade finance limits;
- invoice finance facilities;
- export factoring;
- forfaiting;
- structured export finance.

The last point, structured export finance, is related to a number of specialized and individually formed financing techniques, shown in the box on page 133, used primarily in connection with larger or more complex deals, when both the collateral aspects and the documentation itself become more complicated. They are therefore more frequently used in connection with buyer credits, which are described in Chapter 7, but it is important to keep in mind that these forms of finance can also be used in connection with refinancing of supplier credits with longer maturities.

Bank loans and trade finance limits

The most common method of refinancing short-term supplier credits is simply by using the seller's existing bank credit limits, often the current account and its overdraft facility, based on general collateral pledged to the bank in the form of fixed or floating charges on the company's assets. This refinancing is then done at a floating interest rate determined by the lender as for any other domestic loans, but based on the prime or base rate of the country, set by the central bank.

This form of domestic bank finance is mainly used to finance ordinary trade transactions based on open account payment terms, and since they represent the major part of international trade, the banks are also the main refinancing source of this shorter end of trade finance.

If the transaction is made in foreign currency, the seller may choose to take a separate loan in the same currency in order to refinance the supplier credit, but also in order to cover the currency risk involved. Such a loan could also have beneficial interest advantages if the currency in question has a lower interest rate than the domestic currency. The currency loan will then immediately be changed into local currency at the spot rate and repaid by the incoming payment from the buyer. The cost for such a currency loan as compared to a domestic base or prime rate loan will be based on the following factors:

- the bank's refinancing costs, which are generally based on the interbank money market rates in that currency and for that period, as explained in more detail at the end of this chapter ('The international money market', pages 145–47);
- the bank's interest margin as determined by the amount, customer relationship and market competition;
- the cost for any currency hedge (which in this example is not needed since the loan is automatically hedged by the incoming currency from the buyer).

Apart from these basic forms of general bank finance, banks also offer different forms of trade-related loans based on the individual transaction, normally connected to documentary collection and letters of credit, where if necessary the documents and the corresponding flow of money can also be pledged to the bank as additional security.

In connection with documentary collection, the banks may give advance payment against documents under collection to a certain percentage of their value (up to 70–80 per cent), often under a separate and more favourable trade-finance limit, to be used for self-liquidating trade transactions. The accepted short-term trade bill of exchange, normally three to six months, may also be discounted under the same limit.

In case of a letter of credit payable by acceptance, some banks may offer export loans up to a percentage of its value, available from the time of its opening. At the time of presentation of documents, the advising bank (if that is the place where the L/C is payable) or the issuing bank will accept the bill of exchange, which can then almost automatically be discounted and the net proceeds paid to the seller.

There are additional finance alternatives offered by both banks and finance companies, which become available after delivery and even in connection with open account trading, covering the short-term credit of normally 30–90 days included in most trade transactions. At that time, the seller has fulfilled their delivery obligations and a payment obligation on behalf of the buyer has been created, evidenced by the seller's invoice. It is true that the buyer may have objections to how the delivery has been executed, but unless that is the case, it should be possible to refinance that invoice in one way or the other in order to generate immediate cash for the seller, less interest and fees involved in the refinancing.

The main alternatives available after delivery (invoice discounting facilities and export factoring) are described separately on pages 136 and 138 respectively; they are relatively similar and consequently often synonymous with each other, but in this book we make the main distinction between the following two main areas:

- Confidential factoring, where the finance is a transaction between the seller and the bank/finance company, of which the buyer is not aware. This service will be referred to as invoice discounting below, as described in 'Invoice discounting' on page 136.
- Notified factoring, where the buyer is fully informed about the finance transaction, normally through an assignment on each invoice and where the seller is offered not just finance but also a range of other services. This service/these services will be referred to as factoring below, as described in 'Export factoring' on page 138.

The parties offering these services are either banks or bank-owned finance companies, which receive most of their business through referrals within the group, larger and independent finance or factoring companies, or smaller niche players concentrating on certain segments only. Since pure invoice discounting or other invoice finance facilities are a quite straightforward service offered by both banks and their finance companies but also by a number of other financial institutions, the term ‘provider’ is generally used in that section, whereas ‘factoring company’, or *factor* as it is commonly known, is used in the area of export factoring.

However, there are probably few areas within international trade finance where both terminology and procedures differ so much as to how such refinance is carried out in practice in all its different forms. The segmentation into invoice discounting and factoring, and the detailed description below, may therefore not always be valid in all countries, but it nevertheless has a pedagogical advantage which will enable the reader to understand the concepts and make use of them to their advantage according to their individual circumstances.

Invoice discounting

Invoice discounting (also called invoice finance or invoice lending depending on the nature of the facility) can briefly be described as the provision of finance (against the security) of a bulk of receivables, mostly but not always secured by an earmarked floating charge or a specific debenture.

Invoice discounting is a confidential facility; it is also mostly a pure lending facility where the title to the invoice and the right to the proceeds remain with the seller. It gives cash payment of a certain percentage of a bulk of receivables, and invoice discounting is therefore mostly used when the seller already has an internal system in place for effective credit control.

Invoice discounting can accommodate most of the seller’s invoices based on open account payment terms on a rolling basis; however, as it is confidential, the buyer is unaware of the facility and the seller is responsible for sales ledger administration and later collecting procedures, should that be necessary.

Some providers integrate invoice discounting with other services, such as credit information, credit insurance and debt collection, in order to make this combination more competitive at a reasonable cost. Even if these ‘packages’ are constructed somewhat differently, this combined service has even more similarities with factoring, seen from the seller’s point of view.

It is important to remember that there is no typical invoice discounting or invoice finance facility since they differ not only between countries but also between providers in one and the same country. However, the main features of an ordinary invoice discounting facility used for trade finance purposes may include the following aspects:

- The buyer is unaware of the arrangements between the seller and the provider.
- The provider may arrange the opening of a separate bank account in the name of the seller, where all trade payments must be paid. This account, along with the invoices, could be, but is not necessarily, pledged to the provider as security.

- The seller is required to send copies of invoices to the provider to be included under the facility, in order for them to keep the pool of eligible invoices constantly updated. New invoices are included, and paid invoices, together with unpaid and long overdue invoices, are deleted.
- The provider will make the facility available to the seller at an agreed percentage of the underlying invoices in the 'pool'.
- The provider will send the seller regular statements in order for the seller to check against the export invoice ledger, and the seller will be obliged to send to the provider copies of that sales ledger at intervals for control purposes.

Invoice discounting is suitable for most companies and is particularly useful for smaller and rapidly growing companies whose balance sheets would not be sufficiently strong to allow for the volume of ordinary credit limits they may need for their expanding business. Such facilities mostly cover both domestic and export transactions in order to reach administrative advantages and critical mass, with foreign buyers mainly from developed and neighbouring countries where open account payment terms are normally practised.

Invoice discounting is a 'with recourse' form of lending up to a certain level of the face value of the invoices, often 70–80 per cent, based on a risk assessment and mostly secured by either a general pledge on all the company's assets or a specific and unsecured debenture covering invoices not already pledged. The finance percentage offered is not only based on the invoices themselves, but also on their average distribution regarding amounts, buyers and countries. As it is a confidential facility based on invoices only, the general credit standing of the seller is most important, as is their experience and track record, and the aggregate of all these criteria will determine the percentage lending value and the cost structure.

In most cases, invoice discounting could be used as an ordinary overdraft facility at the seller's discretion, set by the volume of the underlying eligible invoices, forming a pool of available borrowing under the facility at any time. As the value of the pool of invoices fluctuates, more or less money will be available. In case of maximum utilization in conjunction with reduced total invoice value, or in case of non-payment when the invoice will be deleted from the pool, the seller may even have to repay money in order to keep the agreed percentage.

Invoice discounting can instantly release liquidity at a high percentage of the underlying receivables and because of the nature of the facility it can also be made relatively cost-effective, especially when covering both domestic and export sales, hence its popularity in many countries. Many providers also offer these facilities via the internet, which facilitates the practical day-to-day handling for both parties and gives the seller an instant picture of usage and availability at any time. The cost depends on the services involved, but the facility is often charged for by means of a flat fee related to the agreed total limit and an interest rate for actual usage which is normally higher than a normal overdraft facility, together with additional handling charges, based on volume and work involved.

Export factoring

Factoring is a special form of short-term finance where a finance company (the factor) purchases the seller's receivables and assumes the credit risk, either with or without recourse to the seller. Factoring is still mainly used in the industrialized countries and within trading areas with a relatively similar structure of harmonized laws, rules and procedures. It is generally more complex, involving not only finance but also additional services, and in many countries it is therefore used more selectively and often for larger individual amounts compared to invoice discounting finance.

In its original form, the seller entering into a factoring agreement sells the receivables to the factor, mostly also relieving themselves of the credit control and debt collection functions, which are assumed by the factor against a fee. In such a case, the factor also gains the title to the invoice and the right to the proceeds, and takes future decisions, if any, regarding collection and other measures, including the legal work in the event of non-payment. The seller will display a notification on the factored invoices, informing the buyer that the invoice has been transferred to the named factor, together with instructions on how payment is to be made directly to them in order to discharge their payment obligation. The seller also sends copies of the invoices and the shipping documents to the factor, but often the factor issues the invoices themselves upon instruction from the seller.

The factor starts with a credit assessment of the seller and the general structure of their trade and previous export experience, followed by an assessment of the different buyers, including any insurance cover, in order to establish individual lending limits on the buyers and a total credit limit for the seller. Factoring could have the following advantages for the seller:

- a better risk performance than for other finance alternatives through the credit information services included;
- more punctual payments from the buyers, as the seller is pre-notified of the sale of the invoices to the factor;
- the borrowing value of the invoices could be higher than through bank lending, thereby increasing the seller's total liquidity;
- the seller can use additional administrative systems to reduce workload.

Export factoring is mostly in the form of 'with recourse factoring' with up to 90 per cent of invoice value, with the provision that if the buyer fails to pay the invoice after a set period of time, the factor will be repaid by the seller. In some cases export factoring can be provided as 'non-recourse factoring', where the factor stands the risk in the event of bankruptcy or liquidation of the buyer. In these cases the seller will never be requested to repay the discounted invoice to the factor and can then remove the invoice from the receivables in the balance sheet. However, they may have to pay interest for the agreed waiting period after the due date, normally 60–90 days, as specified in the factoring agreement. Most such non-recourse factoring is either based on very good corporate names with little risk or secured by separate credit insurance or similar security.

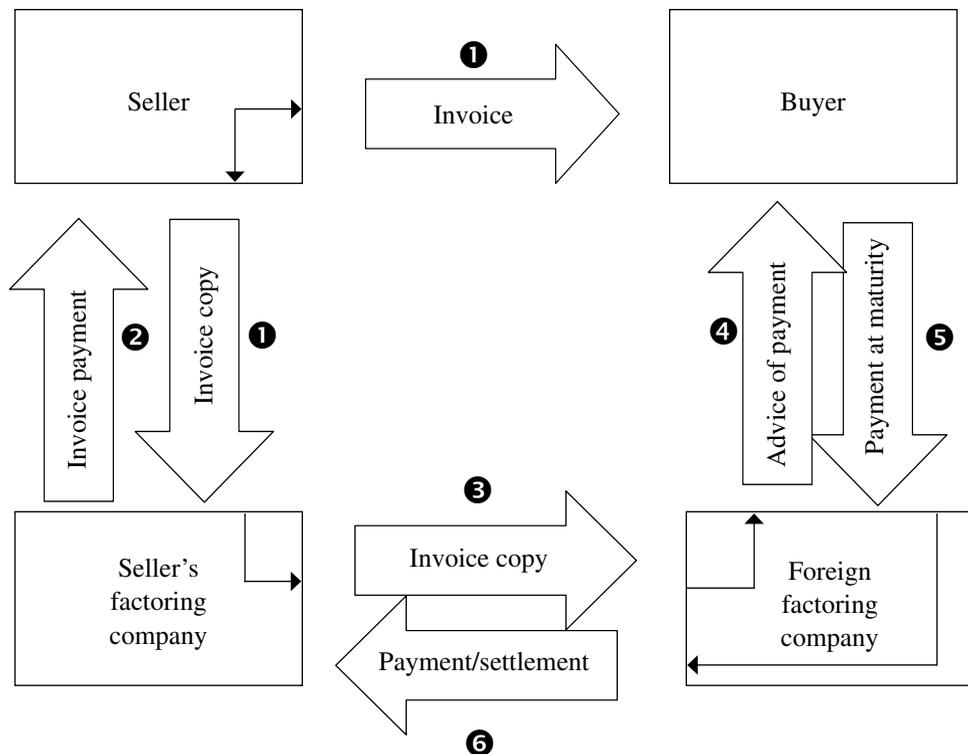


Figure 6.2 Export factoring*

*Explanations relating to the numbering are included in the text.

It is often said that export factoring is more expensive than similar bank services, but such a comparison could be somewhat misleading as the services are difficult to compare. In most cases factoring does lead to considerably more punctual payments, better control of outstanding receivables and less administrative workload for the company. The factoring services are generally more efficient with regard to slow payers and in these cases the use of a factor can have an effect – and the seller avoids straining the business relationship.

Apart from the interest charged, a flat service fee is also charged on every invoice factored, the size of which depends on workload and services included, numbers of factors involved and the total factoring turnover. The seller should therefore complete a cost/revenue valuation in relation to the services offered – and needed – compared with other alternatives, for example invoice discounting finance.

In practice, there are in principle two basic forms of export factoring, either the so-called ‘two-factor export factoring’, where the seller’s domestic factoring company uses local correspondents in the buyer’s country within a chain of cooperating factors, or ‘direct export factoring’, without a local factor being involved.

However, some major international companies, originally within the area of credit insurance, have now expanded their services into the credit risk management area, thereby offering services relatively similar to those of the factors within their own organization through a network of branches around the world. They can then offer in-house combinations of purchase of invoices, credit information, credit insurance and debt collection in competition with established factoring companies.

Figure 6.2 shows the two-factor alternative, in which the seller's factoring company cooperates with a domestic factor (either an independent company or a branch) in the buyer's country. The use of domestic factors or branches of an international organization will often increase the overall cost structure, but has the advantage of a local presence, together with knowledge of the buyers and the local procedures for collecting money according to local law and common practice, including debt recovery, and is therefore mostly used for larger amounts.

Forfaiting

In many countries the refinancing of medium- or long-term supplier credits is handled by the commercial banks, either together or in competition with separate export banks specializing in export finance.

The medium- and long-term finance market also includes the special forfaiting institutions, which have a long history in financing international trade. They are mainly located in the larger financial centres such as London and New York, but do not have the same importance today owing to increased competition from commercial and international banks. Forfaiting basically means the surrender of an unconditional future right to make a trade-related claim through accepted and freely negotiable bills or notes, in return for the receipt of prompt payment.

Forfaiting, whether through specialized departments within the banks or through a few traditional and still independent forfaiting houses, is a special type of discounting of trade-related and mostly fixed-term-interest bills of exchange with different maturity dates, without recourse to the seller. When it comes to risk evaluation of both individual buyers and countries, the forfaiters are well placed in trading these negotiable financial instruments, by spreading the risks through risk participation and distribution through domestic and international credit risk insurers, using reinsurance and syndication techniques.

Forfaiting risks are generally based on security in the form of first-class corporate risks, acceptable land risks, bank guarantees, standby L/Cs, undertakings from ministries of finance in the case of sovereign buyers, with or without currency transfer guarantees from a central bank. The diversity of the operations, often with specialization in different countries or areas together with existing exposure and limits, may therefore create different risk evaluations and credit decisions among these institutions.

If a deal is acceptable, the forfaiting house will issue a firm or a conditional facility letter to the seller, specifying the terms and conditions for discounting and the interest level to be applied. The example of a promissory note shown earlier in the box on page 133 illustrates the terms and conditions that could be used by a forfaiting

house to discount the notes without recourse, among others a separate bank guarantee covering the payment obligations of the buyer in combination with a currency transfer guarantee from the central bank.

Forfaiting may normally require larger transactions to be cost-effective, but today this form of finance is often done as non-recourse invoice discounting by the commercial banks. However, the procedure is quite simple in both cases; at receipt of the bills or notes according to the terms in the facility letter, the net amount is paid to the seller without recourse.

Buyer credits

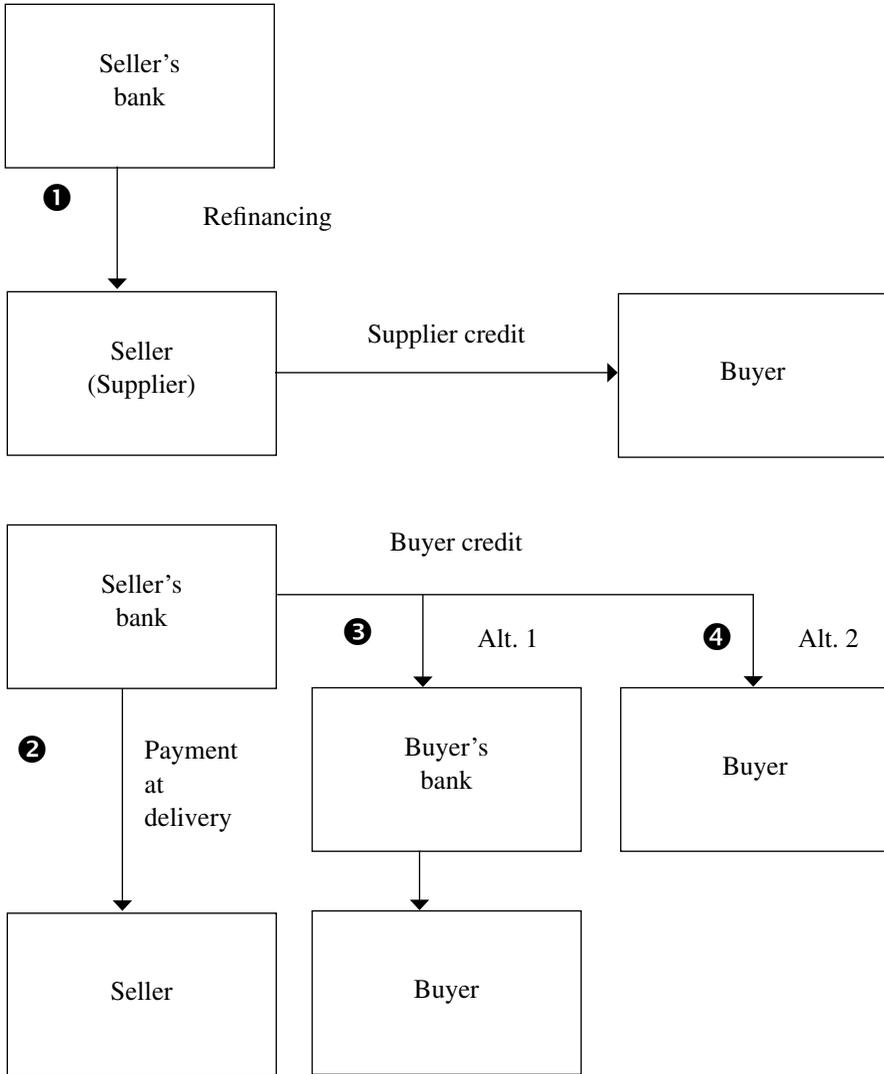
Buyer credits are given directly to the buyer or the buyer's bank in connection with the export transaction, but not directly by the seller. This enables the seller to receive cash payment at delivery and/or at different stages of construction or installation, while at the same time a longer-term credit is extended to the buyer. Buyer credits are normally used for larger individual transactions, particularly when the transaction involves more than just delivery of goods or covers a longer contract period, and often also when the delivery is tailor-made to the specifications of the buyer.

Buyer credits may be given in two different forms, either directly to the buyer's bank (bank-to-bank credits) for further on-lending to the buyer, or directly to the buyer (bank-to-buyer credits), then mostly covered by a guarantee from the buyer's bank. However, since this difference is relatively small from the perspective of the seller, we shall deal with both these forms as bank-to-buyer credits below.

When exporting to industrialized countries, but also to many emerging market countries, buyer credits are usually arranged on pure market terms. However, outside these countries it is seldom possible to finance transactions of this nature on longer terms on the open market; they need to be backed by additional security, mostly in the form of export credit insurance. The seller should then coordinate the commercial negotiations with the buyer and with both the chosen bank and the insurer so that the contract and the corresponding loan agreement can be developed in parallel during the negotiating process.

One of the important aspects of buyer credits is how they relate to the underlying contract. Financial credits are principally unrelated to the obligations between the commercial parties, and that also applies to buyer credits when the buyer normally has to approve the delivery in connection with entering into the loan. The outstanding contractual risk at that time, if any, for the due fulfilment of the seller's obligations is then normally covered outside the loan agreement by a separate performance guarantee in favour of the buyer, in order to keep the commercial contract and the financial credit separate while protecting the buyer at the same time. Should that procedure not be suitable, the loan may contain recourse clauses towards the seller until the obligations of the seller are approved by the buyer, but that involves a corresponding credit risk on the seller which the lending bank has to approve.

The loan agreement and its final wording have to be approved by all parties – the buyer, the seller, the banks and the credit insurer, if applicable. It is normally based



1. Refinancing is done through a bank or some other financial institution, with or without recourse to the seller.
2. Credit amount is normally 80–85 per cent of contract value; the buyer pays the remaining part-payment directly to the seller at or before delivery.
3. The seller's bank has the buyer's bank as counterpart in this case, which forwards the credit to the buyer, often with the same/similar documentation.
4. With bank-to-buyer credits, the seller's bank has the buyer as a direct counterpart in the same way as the seller in the commercial transaction and will, in these cases, request a third-party guarantee, normally from the buyer's bank, covering the obligations under the credit agreement.

Figure 6.3 Supplier and buyer credits – a comparison

on the same principles as an ordinary international loan agreement, but also including the relevant parties to the commercial contract, in order for the two agreements to harmonize during the disbursement period. Thereafter, they should be seen as two totally separate agreements.

Export credit banks/financial institutions

In most countries the actual lending of export credits is made through commercial banks, either on their own without additional support, or with such support, mostly in the form of guarantees from export credit agencies, when the credit risk (commercial and/or political) is otherwise deemed too high. The agencies, on the other hand, are basically insurance or guarantee institutions, but they very seldom give direct loans.

In many countries, however, the actual financing is done through special export credit banks or similar financial institutions, owned or partly owned by the government as official export institutions, even if the practical aspects of loan documentation and loan administration remain in the hands of the commercial banks during the lifetime of the loan. But the official lender is then the export credit bank, which also funds that lending on the international markets, capitalized in such a way that they achieve the very best terms for their funding.

As official institutions, the structure and their activities may include:

- administration of state-supported export credit schemes as well as extending loans on commercial terms based on market funding, both floating and fixed rates of interest;
- lines of credit (see page 154) established with banks in different countries, providing export finance for smaller transactions without separate loan negotiation;
- administration of grants in tied or untied mixed or concessionary credits to developing countries (see also 'Multilateral development banks', pages 158–61), on behalf of the government aid agency;
- financing of long-term investments and acquisitions made by domestic businesses in their internationalization process.

Most export credit banks also have the additional advantage that they, as official export institutions, may avoid having to pay withholding tax on interest which would otherwise be applicable in some buyer countries.

Normal terms and conditions in buyer credits

Buyer credits can be arranged in almost any way and on terms decided between the parties, as long as it is done on market terms without government support. However, when such support is needed, the credit terms must also comply with the Consensus rules, as described in the box on page 144.

The Consensus – a summary

The OECD has stipulated a number of guidelines for restricting state-supported export credit competition between countries, often referred to as the ‘Arrangement’ or the ‘Consensus’; it contains guidelines for minimum and maximum credit periods, amortization structure, minimum advance payment and, above all, minimum interest rates.

The minimum credit period for which these rules apply is two years, with repayment in equal quarterly/half-yearly instalments (plus interest); the first is due 3–6 months after the starting point of the credit, which is normally acceptance or the ‘mean acceptance date’ in the case of several deliveries. It could also be commissioning or physical possession relating to whole projects. A minimum payment of 15 per cent has to be paid before the starting point of the credit.

Buyer countries are divided into two groups. Group I consists of the industrialized countries and some of the countries that are members of OPEC (Organization of the Petroleum Exporting Countries). Group II includes most developing countries. This classification is made automatically, based on World Bank statistics of per capita gross national product (GNP).

The maximum credit period for countries in Group I is up to 5 years; however, in exceptional circumstances this may be extended to 8.5 years after international pre-notification, which means that other competitors should get the same advantage, so-called ‘matching’. For countries in Group II the maximum credit period is 10 years, but shorter periods may apply for certain commodities and lower contract values.

The minimum level for state-supported fixed interest rates is based on CIRR (commercial interest reference rates), which are revised monthly, based on the assumption of what they might have been if finance had been available. The two types of CIRR are contract CIRR and pre-contract CIRR, which is 20 basis points higher. The advantage for the seller with the pre-contract CIRR is that they can submit a cost-free offer to the buyer based on a fixed interest rate at the date of the application, which can then be held during the negotiations for up to 120 days. The contract CIRR must be applied for before signing the contract and will be the rate applicable at contract date, so in this case the parties will not know the exact rate in advance. After contract, the rates so determined will be held for another 180 days to allow time for credit documentation.

Further information can be obtained from commercial or export banks, or directly from the export credit agencies; see box on page 118.

The exported goods should then qualify for credit periods of at least two years, with 15 per cent of the contract value as advance payment and a maximum of 85 per cent credit, with disbursement, repayment and interest structure according to Consensus rules. However, for buyer credits, the minimum contract value is normally much higher compared to ordinary supplier credits, since this type of financing is mainly

applied to larger and often tailor-made transactions, which are more difficult and costly to arrange.

Buyer credits may be given in most trade currencies, at both floating and fixed-term rates. Officially supported rates may also be given, particularly on a fixed-term basis, even if the market rates often can be as competitive, particularly in a low-interest environment. Other finance techniques are also available to offer competitive fixed market rates for long-term credits and larger amounts through the international money or capital markets. If possible, offers can also be made to provide the loan, or part of it, in the buyer's local currency. (See 'Local currency finance' on page 154)

The loan agreement in a buyer credit contains the same standard clauses as in every other international loan, such as conditions precedent, default clauses and applicable law, along with legal opinions regarding both the loan and the sales contract, showing that they are compatible, legally enforceable and duly executed. It must contain confirmation of receipt of the stipulated advance payments, but other relevant details of the commercial contract must also be included. The disbursement clauses also have to be properly documented. Most buyer credits are disbursed directly to the seller in one payment or related to the seller's successive performance, and the loan amounts will be payable against certificates of completion countersigned by the buyer, according to a preliminary draw-down plan and timetable as an appendix to the agreement.

The international money market

Apart from purely domestic finance, based on prime or base interest rates fixed by the central banks, the market commonly used for the refinancing of trade finance is the international and unregulated money market or markets, operating within financial centres in different time zones. These markets trade in short-term currency loans and deposits, whereas the expression 'capital markets' refers to long-term periods, usually only for larger amounts and with fixed interest, for example through bonds and other long-term instruments.

Often the term 'Euro currency' is used for deposits traded on these markets, referring to funds that are held by a bank or other party outside the home country of the specific currency, but it now has nothing to do with Europe as such, even if that was where originally a major part of these funds were held. 'Eurodollar' is thus now a general reference regardless of location, for example to USD held outside the United States, and 'Euroyen' is a reference to JPY held anywhere outside Japan; the same goes for any other Euro currency.

The money markets are not physical marketplaces but a general description of the trade itself, carried out in different currencies between numerous lenders and borrowers. The major banks, both domestically and internationally, play a central role through their internal interbank deposit trading, which is crucial for both liquidity and stable market conditions – in the same way as banks operate in the currency market. For short-term loans and deposits in different currencies, this interbank money market is often referred to as the name of the financial centres where the main banks are operating; for example, the London Interbank Market, where the corresponding interest rates are referred to as London Interbank Offered Rates (LIBOR).

London is by far the largest money marketplace, not only in the European time zone, and is also the financial centre to which many commercial contracts or agreements worldwide are referred regarding interest rates for most trade currencies, even though other financial centres in different time zones are also often used to specify the interest rate for the main international currencies.

There are also a number of financial centres where interbank money market rates are quoted in the local currency, for example TIBOR which stands for Tokyo Interbank Offered Rates, the free and unregulated money market rates for the Euroyen, which are published daily by the Japanese Bankers Association. These constantly fluctuating money market rates are often different from the domestic base or prime rates in the same currency, which are regulated by the domestic central bank and mostly changed only at intervals in order to regulate economic activity within the country. This difference between domestic and free money market interest rates could be quite significant in times of credit crunches or turmoil on the money markets and these unregulated rates are therefore the best indicator of the real cost of short-term money in that currency.

When it comes to the euro currency itself, European banks have established an interbank reference rate called EURIBOR (Euro Interbank Offered Rate), which is the benchmark rate of the interbank euro money market that has emerged since 1999, sponsored by among others the European Banking Federation. EURIBOR is the rate at which euro interbank term deposits are offered between prime European and international banks, computed and published on the Reuter screen.

During the day, an interbank reference rate is fixed in most currencies, to be used as the reference rate in, for example, contracts and loan agreements. Most such rates are published daily by central banks or bank associations through different online information systems or separate web pages, usually at 11.00 am local time, for periods up to a year. They are also quoted in the newspapers as the established short-term international interest rates for the most common currencies. However, as the market interest rates change continuously during the day, more accurate information is also available, either through the banks' own internet-based information systems or through direct contact with their trading departments. For participants actively trading directly in the market, there are also specialized online systems available, with almost identical and instantly updated currency and money market information.

Therefore, when referring to floating interest rates in trade finance, these are often based on these interest rate fixings, even if more details have to be specified in each individual case (eg USD LIBOR 3 months interest rate, at 11.00 am on a given date as shown on ...). To be even more precise, many loan agreements also often refer to interest quotations from some specific major banks in that market as reference banks, in order to get the interest rate absolutely identified and fixed without referring to a general marketplace. The total interest rate for the customer also includes the margin as applied by the lending bank(s) in each individual case, or as specified in the loan agreement.

Trade finance transactions are generally based on bills or notes when it comes to supplier credits, but more frequently on separate loan agreements when it comes to buyer credits and structured trade finance transactions, as described earlier in this

chapter. Short-term bills of exchange are often combined with a fixed interest for the entire period until due date, with the capital amount and interest rate compounded into a fixed amount to be paid at maturity. Promissory notes are often made in the same way, but for longer periods they have to be more detailed and are usually designed as short loan agreements, based on either floating or fixed interest rate, as shown in the box on page 133.

When it comes to buyer credits (bank-to-bank or bank-to-buyer credits) and other forms of structured finance, a separate and detailed loan agreement is always used for these longer periods. If based on a floating interest rate they also contain a clear definition of how the interest should be calculated and fixed for each short interest period, with a successive number of roll-over periods of, for example, three or six months until final maturity. The borrower can often choose the length of these roll-over periods and at the end of each such period interest is due, together with amortization, if any.

Many loan agreements also give the borrower the option to change currency at the end of each interest period, but combined with a maximum amount expressed in one base currency in order to cap the total outstanding loan in case of adverse currency exchange movements. This structure, with different optional currencies, floating or fixed interest rates and variable loan periods, can be adapted to suit the changing circumstances of the borrower during the lifetime of the loan and makes the international money market a very flexible source for short-, medium- or even long-term trade finance, based on a variety of financing techniques.

One of the advantages with longer-term loans based on short-term roll-over periods is that they are simple to use and so flexible that, in principle, they can be adapted to any trade or financial transaction for almost any period. The disadvantage for the borrower on longer periods can be the floating rate, which makes the credit costs difficult to evaluate in advance, but this problem is also easily resolved in most cases.

In Chapter 4, the forward points system was described as the basis for establishing currency forward rates. The technique is similar for changing floating interest rates into fixed rates through interest swap agreements. A five-year loan based on, for example, three-month LIBOR may be changed into a fixed interest rate loan at any time during the loan period. This is done through a separate interest rate swap agreement with a bank, whereby the borrower agrees to receive the floating rate needed to service the loan and deliver interest rates to the bank under the swap agreement.

However, such a swap agreement also contains an additional risk for the bank should the borrower default during the period of the loan, thereby not being able to deliver the fixed interest. It is, therefore, subject to a separate credit decision within the bank but the technique and the market liquidity make it possible to hedge the interest rate for very long periods. In the most traded currencies this can be done up to 5 or 10 years, thereby eliminating the potential disadvantage of using the money market's short-term interest rates.

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