Financing International Trade (LCs)

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by Bosco OLYENY

Discussion Areas

- International Trade?
- The role of Banks.
- Methods of Payment available through banks.
  - Open Account – Risks, Features
  - Cash in Advance – Risk, Features
  - Bills for Collection – Types, Risk, Risk Mitigation – Features
  - Letters of Credit, complexity, Risk, Risk Mitigation – Benefits and Features
- Trade Finance?
  - Major types – Access to Finance from Financial Institutions

International Trade!

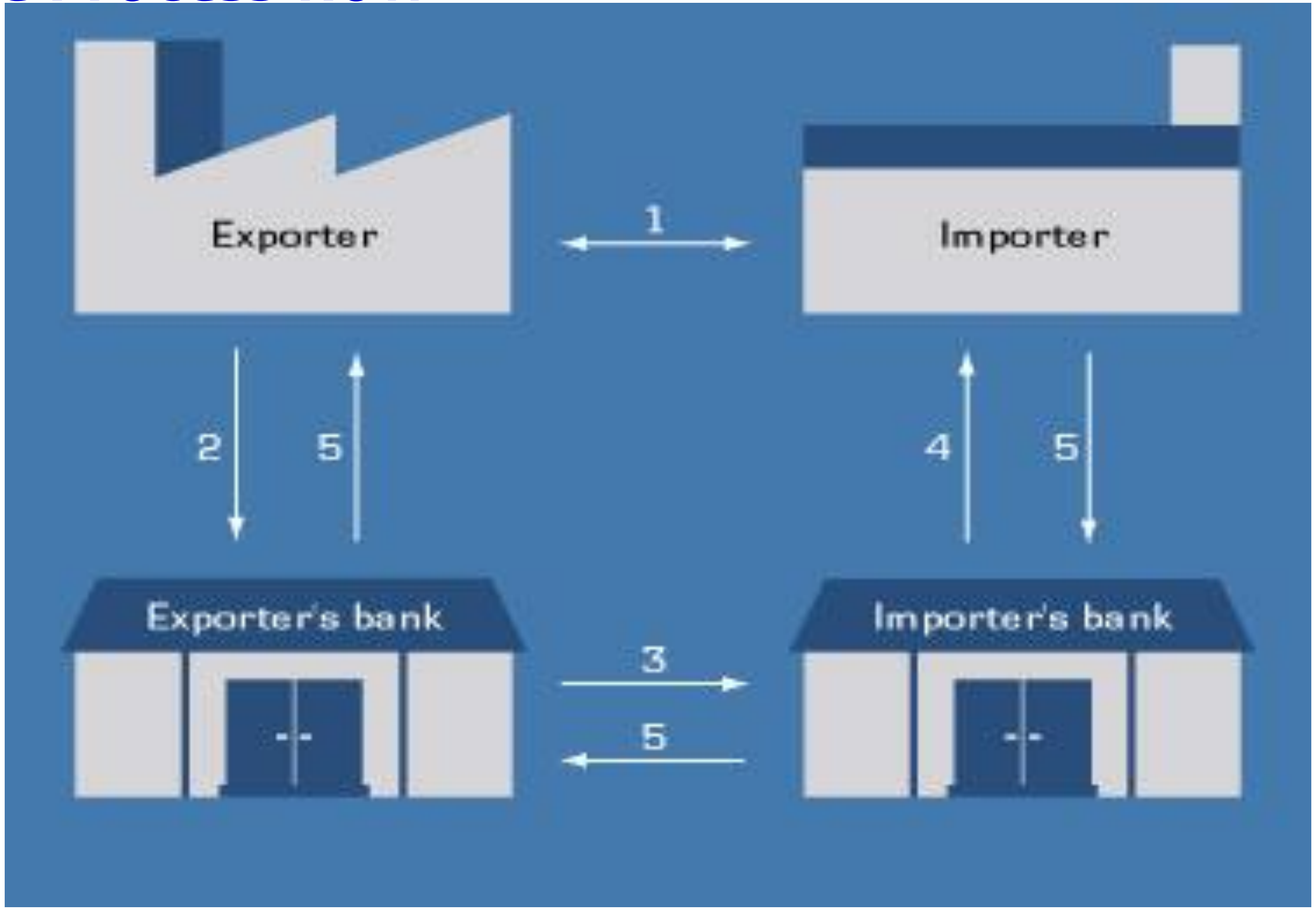
A Banker's Definition:

- International trade involves the flow of goods/services from seller to buyer in accordance with the contract of sale and the consequential flow of payment from buyer to seller. ***What then isn't international trade?***
- Parties.
  - Exporter/Seller/Beneficiary (Manufacturer)
  - Importer/Buyer/Applicant (Consumer)
  - Exporter's Bank/advising/presenting bank (Confirming Bank).
  - Importer's Bank/issuing bank
  - Correspondence bank
    (Confirming Bank)

International Trade!

- **International Trade Process flow**

- **1. Sales Contract**



International Trade

- **A product that is sold to the global market is an Export, and a product that is bought from the global market is an Import. Imports and exports are accounted for in a country's current account in the balance of payments**

- **In 2016, the value of international trade achieved23.5 trillion US dollars, i.e. More than 30% of the world GDP.**
- **Some 80 to 90 per cent of the world trade relies on trade finance (trade credit and insurance/guarantees), mostly of short term nature**
- **The WTO is seeking to encourage the revival of the complex links and networks involved in trade finance market in order to keep finance flowing for trade thereby mitigating at least one reason for the shrinkage of trade flows**

Banks and International trade

❖ Why Banks participates in International Trade

- International Trade presents a spectrum of risk, causing uncertainty over the timing of payment between the exporter (seller) and importer (foreign buyer)

- To the exporter, any sale is a gift until payment is received!
    - Therefore the exporter wants payment as soon as possible, preferably as soon as an order is placed or before goods are sent to the importer.

- To the importer, any payment is a donation until the goods are received!
    - Therefore, the importer wants to receive the goods as soon as possible, but to delay payment as long as possible, preferably until after the goods are sold to generate enough income to make payment to the exporter.

Banks and International Trade

- Other problems traders face
  - Distance between seller and buyer
  - Transportation of goods
  - Honesty
  - Different laws and regulations
    - Sorting out disputes

- Banks facilitate international trade by way of swift transfers of messages and payment system.
- They provide credit information about their customers
- They provide finances to the needy party or parties (Trade Finance)

Methods of Payment…

- … To succeed in today’s global marketplace and win sales against foreign competitors, exporters must offer their customers attractive sales terms supported by the appropriate payment methods.

  - Because getting paid in full and on time is the ultimate goal for each export sale, an appropriate payment method must be chosen carefully to minimize the payment risk while also accommodating the needs of the buyer.
  - There are four primary methods of payment for international transactions. During or before contract negotiation, a trader should consider which method of payment is mutually desirable for one and ones customer.

Payment Methods 1 & 2

Open Account

- Seller ships first, buyer pays latter. There is no trust, market controlled by buyer!
- Payment risk of buyer. Loss of control of goods
- Buyer enjoys supplier's credit.
- Not subject to any international rules and regulations

Cash in Advance

- Buyer pays for goods before seller ships. There is no trust, market controlled by seller!
- Performance risk of seller. Capital tied down by buyer
- Goods shipped at sellers convenience. Buyer finance i.e. seller enjoys float.

Payment Method 3 & 4

Bills for Collection

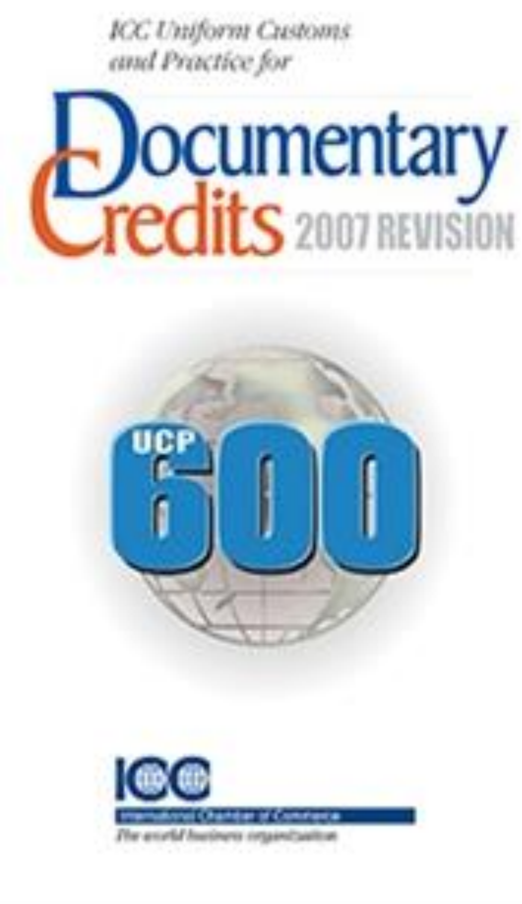
- Seller ships and sends all documents through its bank on collection.
- Documents to be release to buyer either after full payment or acceptance (to pay at maturity)
- There is payment risk, but acceptance constitute a legal evidence against buyer
- Seller retains constructive control over goods through the banks, buyer can still enjoy supplier's credit. Subject to URC 522.

Letters of Credit

- Seller ships goods to buyer and obtains payment based on presentation of documents that comply with agreed terms and conditions.
- Political risk/FX risk, Documentary risk and Performance risk of seller
- Protect both buyer and seller, Subject to UCP600, More than one bank serving various roles.

UCP 600 Reference

- The Uniform Customs and Practice for Documentary Credits (UCP) is a set of rules on the issuance and use of letter of credit. The UCP is utilized by bankers and commercial parties in more than 175 countries in trade finance. Some 11-15% of international trade utilizes letters of credit, totaling over a trillion dollars (US) each year.



- The latest revision was approved by the Banking Commission of the ICC at its meeting in Paris on 25 October 2006. This latest version, called the UCP600, formally commenced on 1 July 2007

Payment Method Risk Ladder

Open Account Trading

Documentary Bill for Collection

- D/A
- D/P

Letter of Credit

- Advised
- Confirmed

Payment in Advance

TRUST LADDER

Exporter's Trust

Importer's Trust

Trade Finance

- **Although international trade has been in existence for centuries, trade finance developed as a means of facilitating it further.**

- **The widespread use of trade finance is one of the factors that have contributed to the enormous growth of international trade in recent decades.**

- **In its simplest form, trade bank works by reconciling the divergent needs of an exporter and importer.**

Trade Finance

While an exporter would prefer to be paid upfront by the importer for export shipment, the risk to the importer is that the exporter may simply pocket the payment and refuse shipment.

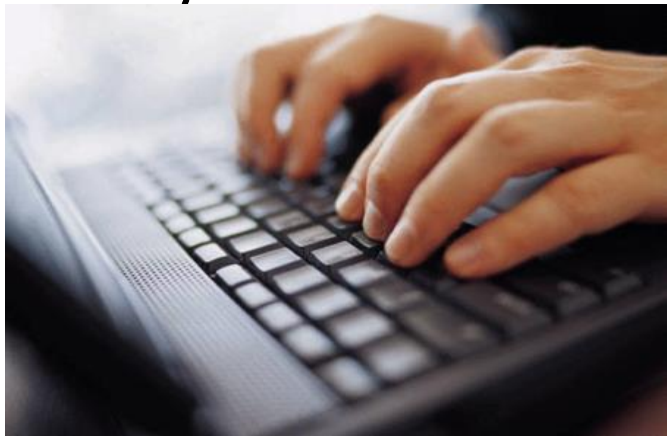
Conversely, if the exporter extends credit to the importer, the latter may refuse to make payment or delay it inordinately.

The most common solution to this problem is through a letter of credit… one of the most popular trade finance mechanisms

Trade Finance

- You are probability familiar with the general criteria used by banks for commercial lending propositions.

- There are some differences between trade finance and the general lending;
    - There is a short well defined business cycle
    - The loan is usually self liquidating over short period of time
    - The loan relates to specific assets which can serve as security



Some of the trade finance products

- Overdraft facility - Mostly utilised as TT (SWIFT) to support advance payment and open account transactions
- Import Loan facility – Used to pay off matured Bills for collection and imports under letters of credit
- Pre – export financing – enables an exporter deliver on the export contract preferable under export Letters of Credit
- Invoice Discounting or post shipment financing enables continuity in production as the exporter waits for payment from buyer
- Tax & Freight loan (duties and transport)

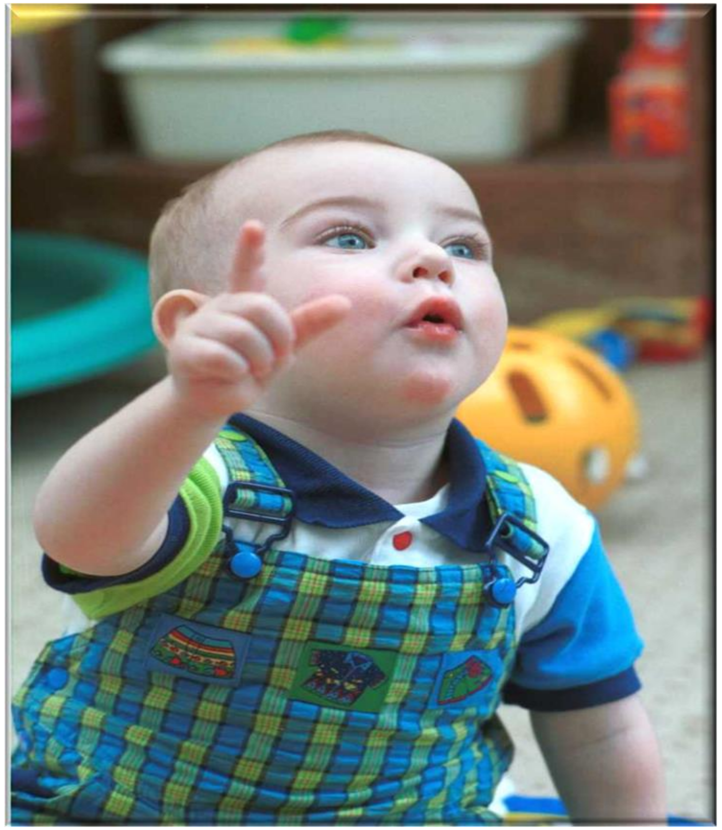
- STRUCTURED TRADE FINANCE helps transfer risk using complex legal and corporate entities. It has helped to open new sources of financing to consumers. It normally relates to <u>commodities</u> and <u>capital goods</u>

Summary

- Banks, Insurance and Inspection companies are necessary evils
- Always trade using sales contracts
- Be at your best at all times as far as payment methods are concerned
- Customers are kings, but not all the time

“Talk to your bank
•Explore Opportunities”

- **Bosco OLYENY: Business Consultant**
  T: +256 773 173355
  e: bolyeny@gmail.com



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