The London Institute of Banking & Finance

ICC

Guide to International Trade and Finance

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The International Chamber of Commerce (ICC) is the largest, most representative business organization in the world.

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Copyright acknowledgements

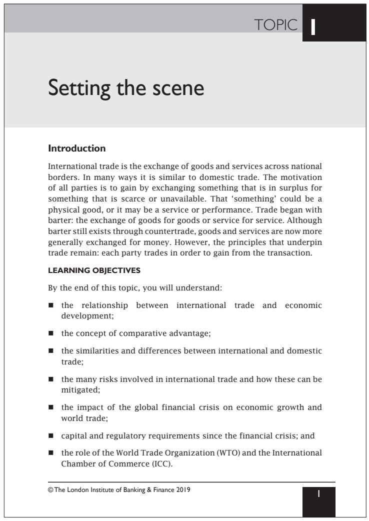
Contents

About this book

This book has been developed specifically to support you in your studies for the Certificate in International Trade and Finance. In each topic, there are features to help you to break down your studies, absorb information and prepare you for your exam.

Learning objectives

These set out what you will be learning in each topic and how the topic content links to the syllabus requirements.



TOPIC 1

Setting the scene

Introduction

International trade is the exchange of goods and services across national borders. In many ways it is similar to domestic trade. The motivation of all parties is to gain by exchanging something that is in surplus for something that is scarce or unavailable. That 'something' could be a physical good, or it may be a service or performance. Trade began with barter: the exchange of goods for goods or service for service. Although barter still exists through countertrade, goods and services are now more generally exchanged for money. However, the principles that underpin trade remain: each party trades in order to gain from the transaction.

LEARNING OBJECTIVES

By the end of this topic, you will understand:

- the relationship between international trade and economic development;
- the concept of comparative advantage;
- the similarities and differences between international and domestic trade;
- the many risks involved in international trade and how these can be mitigated;
- the impact of the global financial crisis on economic growth and world trade;
- capital and regulatory requirements since the financial crisis; and
- the role of the World Trade Organization (WTO) and the International Chamber of Commerce (ICC).

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THINK …

This feature, which appears at the start of each topic, is especially helpful if you are new to the financial services sector. It helps to provide a context for your studies by suggesting how the topic content might relate to your own experiences, to products and services that might already be familiar to you, or to previous studies.

INFORMATION PANELS

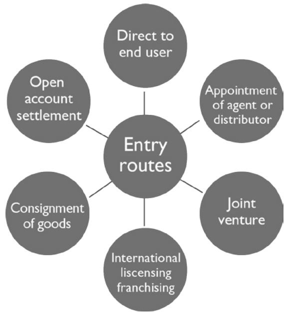
These provide background or additional information. Content that appears in these panels may be covered in your exam, so you must read them.

KEY TERMS

Key terms are explained alongside the content in which they are used.

Figures

Most of the figures in this book provide visual summaries to help you to absorb information quickly. Try creating your own diagrams to help you with your revision. The source for all figures is The London Institute of Banking & Finance unless otherwise stated.



FACTFINDS

These provide useful links to authoritative sources of information where you can check current details or learn more about a topic, such as relating to the progress of legislation that had not been implemented at the time this book was written. They also provide pointers to further information if you would like to find out more about a particular topic.

✓ Check your understanding

These help you to make sure you understand what you have just read or help you to check whether you can recall information from an earlier topic that is relevant to the current topic. Referring back to your earlier work and applying your learning in a different context helps you to assimilate the information. Answers are provided at the back of the book.

Think again . . .

This feature encourages you to reflect on how much you have learned in each topic and to make sure you have really understood what you have been reading. It does not cover all the content of the topic but it prompts you to check your understanding.

? Test your knowledge

Confident you have understood and can recall the topic content? Test yourself before you move on to the next topic. Answers are provided at the back of the book. A good score will be a great confidence boost. If you don't do as well as you'd hoped, revisit the content areas where you got the answers wrong.

Setting the scene

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THINK . . .

Where do the components of your computer or laptop come from? Are iPhones or other Apple products made out of parts that originate in the United States of America (USA)?

Is the engine that powers the bus or train that you take to work made in the country you live and work in?

1.1 Why do businesses trade internationally?

We live in an interlinked world consisting of heavily interdependent countries and communities. The components of your computer are likely to have interesting origins:

- Oil from the Middle East may have been used to manufacture the plastic.
- The printed circuit board could have been produced in China or Taiwan.
- The software installed on it could have been written in India.
- The gold that coats some of the components could have been mined in Africa.
- The patent may have been drawn up in the USA.

So why do businesses trade internationally despite the additional challenges and risks that arise in the process?

There are several reasons. Consumers have far-reaching demands in the globalised economy that we now live in. Companies need to produce goods and services as quickly and efficiently as possible to meet that demand. In addition, they must do so as competitively as possible. Not doing so would result in a loss of competitive advantage and business failure.

Import

For instance, if a company requires raw materials or components that cannot be sourced from the local market, it will look to international markets to purchase these from foreign suppliers. This is known as 'importing'. Alternatively, a company may choose to manufacture a product in another country as it may cost too much to do so locally. Agents and distributors may choose to import goods for resale for various reasons such as lower costs or consumer demand for particular products. You will learn more about this in Topic 3.

Export

On the opposite side of an international trade transaction is the seller. Businesses enter the export market for different reasons than the import market. There may not be a domestic market for their product or service. Alternatively, they may find that an export market offers them an additional customer base from which they can generate additional income.

Reverse globalisation

Although our world remains highly globalised, companies are increasingly moving away from globalisation to nearshoring for various political and economic reasons. You will learn more about this in section 1.1.3.

1.1.1 Comparative advantage

It is difficult for most countries to achieve self-sufficiency. However, even if this were possible, it would not appeal to most people. This is because they would find their consumption confined to a narrow range of goods.

SELF-SUFFICIENCY

"The quality or state of being able to provide everything you need, especially food, without the help of other people or countries." (Cambridge Dictionary, 2018)

Few individuals in modern economies try to produce exactly what they consume. Instead, individuals work for money, which is, in turn, used for consumption purposes. This specialisation and division of labour provides a higher standard of living than would be possible through self-sufficiency.

What applies at an individual level also applies at a national level. International trade is simply a logical development from specialisation and division of labour, as is the concept of comparative advantage.

The theory of comparative advantage is one of the most widely accepted theories among economists. It is attributed to David Ricardo, who wrote about it in his 1817 book *On the Principles of Political Economy and Taxation*.

FACTFIND

Exploring comparative advantage

Take a closer look at the impact of comparative advantage on trade flows and access to credit.

https://study.libf.ac.uk/refer.php?resource=EBSCO&id=AN=121570949

https://study.libf.ac.uk/refer.php?resource=EBSCO&id=AN=122960894

Browse through the following article on comparative advantage in UK and global wine markets:

http://www.wine-economics.org/aawe/wp-content/uploads/2017/12/Vol12-Issue03-U.K.-and-Global-Wine-Markets-by-2025-and-Implications-of-Brexit.pdf.

[All accessed: 26 November 2018].

1.1.2 Simplified example: comparative advantage

In a highly simplified illustration, let us assume that:

- Portugal can produce 100kg of tomatoes from one unit of production and one roll of cloth from one unit of production;
- England can produce one roll of cloth from one unit of production, but requires three units of production to produce 100kg of tomatoes.

This position is summarised in Table 1.1.

TABLE 1.1 UNITS OF PRODUCTION REQUIRED TO PRODUCE 100KG OF TOMATOES OR ONE ROLL OF CLOTH

Country	Tomatoes	Cloth	Total
Portugal	1	1	2
England	3	1	4

If England devoted four units of production to cloth and Portugal devoted its two units of production to tomatoes, England would produce four rolls of cloth and Portugal would produce 200kg of tomatoes. Thus the total output of the two countries is now greater than before for the same total number of units of production. England could then exchange two rolls of cloth for 100kg of tomatoes from Portugal. The net outcome is shown in Table 1.2.

TABLE 1.2 A SIMPLIFIED ILLUSTRATION OF RICARDO'S THEORY OF COMPARATIVE ADVANTAGE

	Portugal	England
Total number of units of production used	2	4
Total output produced	200kg of tomatoes	4 rolls of cloth
Net output after exchange of 2 rolls of cloth by England for 100kg of tomatoes from Portugal	100kg of tomatoes and 2 rolls of cloth	2 rolls of cloth and 100kg of tomatoes
Net gain from comparative advantage	1 roll of cloth	1 roll of cloth

Assumptions

This simplified example relies on assumptions that may not hold good in the real world.

- Greater effort and higher costs will be required in the United Kingdom (UK) to produce the same quantity of tomatoes when compared with

Portugal. For example, greenhouses, as well as additional fuel and irrigation, may be required.

- A unit of production is identical in both countries for the production of both goods.
- There are no transaction costs in connection with the trade.
- The gains from comparative advantage are split evenly, as each country gains the same, ie one roll of cloth.
- There are no foreign exchange rate complications.
- The tomato growers in England and the cloth producers in Portugal will not object to being 'closed down'.

Regardless of the assumptions, the example demonstrates how comparative advantage is a logical extension of specialisation and division of labour, generating higher overall output and wealth.

1.1.3 Comparative advantage revisited: reverse globalisation

Although we still live in a globalised world, there are indications that this trend is in reverse due to political, economic and social reasons. Many of the factors that led to increased globalisation are no longer quite as dominant as they used to be. At the same time, other factors have become more relevant.

Increasing cost of labour

As you learned in section 1.1 and section 1.1.1, comparative advantage introduced specialisation and the division of labour, generating higher overall output and wealth. One of the great attractions of globalisation was the ability to gain access to economies with lower labour costs to produce manufactured goods. The logic was that the resulting saving in production costs more than outweighed the costs associated with moving goods around the world. This cost advantage is decreasing, reducing the advantage of producing goods some distance from the markets for such goods.

KEY TERMS

Offshoring

This occurs "when a company moves all or some of its activities to another country" to save costs (Dictionary of International Trade, 2018).

Nearshoring

"The transfer of business processes to companies in a nearby country, where both parties expect to benefit from one or more of the following dimensions of proximity: geographic, temporal (time zone), cultural, linguistic, economic, political, or historical linkages." (Dictionary of International Trade, 2018)

Digital disruption

Advances in technology have also had the effect of reducing the labour component in the costs of goods. Automated production requires much less manual labour so the cost advantage of an economy with relatively low labour costs has been eroded still further. An extreme example of such automation would be 3D printing.

Sustainability

We have also seen much greater awareness of the need for sustainability. In order to reduce the 'carbon footprint' of manufactured goods, it makes sense to reduce the distance covered as the physical supply chain progresses and the finished goods are available to the end consumer. You will learn more about this in section 1.1.4.

Protectionism

Finally, political developments have led to an increase in protectionism through the imposition of various barriers to free trade. You will learn more about this in section 1.8.

Source for this section: Bugeja and Taylor (2018)

FACTFIND

A new nearshoring game

The following articles provide an insight into the reasons why companies are looking closer to home for labour, components and services.

Find out more:

https://www.computerweekly.com/opinion/A-new-nearshoring-game-is-emerging

https://www.business-news.eu/2018-nearshoring-the-advantages-of-looking-closer-to-home

[All accessed: 26 November 2018].

1.1.4 Sustainability and sustainable trade

Sustainability can be described as "a process by which companies manage their financial, social and environmental risks, obligations and opportunities" (FT.com, no date). "This is commonly referred to as a triple bottom line approach where business connects to healthy and balanced economic, societal and environmental systems" (ICC, 2015). Sustainable businesses consider the three Ps – people, planet and profit.

Several forces are steering the entire trade finance industry in a more sustainable direction, as follows.

Regulation

More local, national and international authorities recognise the need to combat and adapt to the impact of climate change, support the Paris Agreement, and realise the UN's Sustainable Development Goals.

EXAMPLES

The Financial Stability Board's Task Force on Climate-Related Financial Disclosures highlights the need for businesses to be transparent about material risks from climate change.

As of 2018, the European Commission's high-level expert group on sustainable finance is outlining a blueprint for a financial system that makes sustainability considerations part of decision-making.

Credit and reputational risk

No corporate or bank wants its image tarnished, or to risk greater losses, due to the unsustainable practices of a customer or a company in its supply chain.

Market demand

Consumers are more conscious than ever of the environmental and social footprint of the products they buy. They have the power to vote with their wallets. Corporates are reacting by committing to sourcing sustainably produced goods, and requiring verification from certification schemes that screen for environmental and social effects.

Sustainable trade

The sustainable trade working group of the ICC Banking Commission defines sustainable trade as "the business and activities of buying and selling commodities, goods and services that meet some environmental, social and economic standards [and that are] capable of benefitting all actors involved and minimising adverse impacts – while fostering sustainable global development" (Buruiana, 2017).

The demand for sustainable trade and its finance will only grow in the years to come. Banks and corporates have to be ready.

1.2 Business entities

Business entities provide a product or service for their customers with the aim of generating a profit for their owners or investors. There are exceptions to this rule. Not-for-profit organisations such as charities and non-governmental organisations (NGOs) do not share this aim.

KEY TERMS

Profit

"The residual amount that remains after expenses have been deducted from income." (Ramin and Reiman, 2013)

Profit or loss

"The total of income less expenses, excluding the components of other comprehensive income." (Ramin and Reiman, 2013)

For those entities that aim to generate profit, they do so through trading. It is basically the net result of all of the income achieved by the business minus the expenditure incurred.

You will explore the profit and revenue implications for those organisations that trade internationally in later topics. You will also examine the risks associated with importing and exporting various products and services and how those risks might be mitigated.

Goods and services

Goods or products are generally visible and tangible. Examples of products include shoes, cars, phones or computers.

Services are usually intangible. They could be experiences, advice, or acts such as a barber cutting a customer's hair.

Buyers and sellers

Buyers purchase goods or services from sellers in exchange for a payment. Buyers can be people or organisations and are often referred to as customers.

Traditionally, buyers have typically been importers and sellers have been exporters. As trade has evolved to incorporate complex supply chains, it is increasingly common for the same entity to be both an importer and exporter. Trade is also undertaken by businesses that act as intermediaries, bringing buyers and sellers together in exchange for a fee. We will elaborate more on intermediaries that are active in international trade in Topic 3.

NGOs AS COUNTERPARTIES

NGOs like the Red Cross, Greenpeace and Médicins Sans Frontières can also be important counterparties in business. For example, organisations like the Red Cross need to buy significant quantities of food, medicine and tents. As their funding sources are limited, they will have to bargain for the best prices available.

NGOs IN TRADE DEVELOPMENT

Several NGOs are directly involved in trade policy, negotiations, economic development, financing and training.

Find out more:

http://www.tradeforum.org/NGOs-in-Trade-Development-International-Players/ [Accessed: 26 November 2018].

1.2.1 Understanding your counterparty

Understanding the corporate structure of your counterparty is important whether you are a buyer or a seller. You could be dealing with a sole proprietor or a large publicly listed multinational corporation.

Whether it is an SME or a listed company, it is important to understand its structure.

Bargaining position

The business type of your counterparty will determine your bargaining position and comparative strength. It will also have an impact on the price your counterparty will be prepared to pay as a buyer or will charge if it is a seller. It may additionally have an impact on payment terms. A large corporate in a favourable competitive position may be able to put pressure on its buyer to pay in advance. It could also be in a position to force its sellers to allow deferred payment terms that are favourable or advantageous to itself.

Disputes settlement

Large corporates with legal departments and dedicated legal advisers often opt to settle disputes through litigation. They also have the time and resources to stretch lawsuits as long as possible in order to 'draw the longest straw'. On the other hand, smaller businesses generally endeavour to reach agreement by negotiating compensation or the like. Some smaller businesses make use of outsourced legal counsel. It is, therefore, important to understand your counterparty and the nature of potential disputes that may arise from doing business with them.

1.3 Similarities and differences between international and domestic trade

Similarities

There are, of course, certain similarities between international and domestic trade. For example, both involve:

- a seller and a buyer;
- the sale of goods or services in exchange for payment;
- a contractual agreement regarding the description of the goods or services, the price and the terms of payment; and
- the delivery of goods or services.

In addition, some risk considerations are the same:

- The seller is still exposed to the risk of non-payment if they sell on deferred payment terms.
- The buyer is exposed to the risk of loss if they pay for goods in advance of delivery.

Differences

However, the differences are more extensive if they arise as a consequence of the cross-border nature of a transaction. For example:

- The end-to-end trade cycle is usually much longer due to longer transit times and pre-shipment lead times.
- Consignment sizes and values tend to be higher due to the economies of scale associated with containerisation and sea freight.
- Control over the secure storage and release of goods may be more difficult due to the distances involved coupled with the mode of transport.
- Resolution of problems may take longer and be more difficult due to time zone, language and local practice differences.

Source for this section: Bugeja and Taylor (2018)

A brief summary of the risks involved in international trade follows in the next section. You will learn about these risks in more detail in Topic 2.

1.4 Risks involved in international trade

There are many risks and challenges involved in international trade. Some of these risks are also present in domestic trade. You will learn more about these as well as various mitigation measures in Topic 2.

EXCEPTIONS TO THE RULE

When a company in Antwerp does business with a company in Rotterdam, this is considered to be international trade. Antwerp is in Belgium and Rotterdam is in the Netherlands. However, the distance between the two parties is just over 100km by road. It will take less than two hours for the goods to be shipped by truck.

Contrast this with domestic trade between a company in Moscow and another in Vladivostok. Although both cities are in Russia, the distance between them is more than 9,000km. The risks and challenges for both parties are far greater than those in the first example involving international trade.

The following is a summary of the key challenges and risks that can occur in international trade.

Challenges

- **Cultural and language differences** – difficulties in communication may cause delays or misunderstanding resulting in additional costs. You will learn more about these differences in section 2.1.1.
- **Documentation and other formalities** – certain jurisdictions may have complex documentation requirements that are different to the importer or exporter's home country. These may affect both goods and services. You will learn more about various types of documents required in international trade in Topic 6.
- **Transport and insurance** – it generally takes more time to ship goods over long distances. Additional costs relating to transport and insurance could be incurred.

- **Political considerations** – protectionism, through the imposition of tariffs or quotas on imports, can have a significant impact on international trade. Barriers to trade are mentioned with reference to political risk in section 2.1.1.
- **Economic considerations** – legislation or taxation policies can have an adverse impact on the expected profit from trade.

Risks

- **Counterparty risk** – any commercial contract carries a certain degree of counterparty risk. However, enforcing contractual rights against a business located in another country can be more difficult than in the case of a domestic counterparty.
- **Foreign exchange risk** – foreign currencies may be used for settlement. This can lead to unexpected financial gains or losses, unless managed very closely. You will learn more about FX risk management in Topic 14.
- **Compliance risks** – smaller businesses may not have the resources to employ legal expertise to deal with different laws and regulations from various jurisdictions.
- **Financial crime risks** – international trade can sometimes act as a front for money laundering or the avoidance of sanctions. You will learn more about measures to prevent this in Topic 5.
- **Fraud** – it is easier to commit fraudulent acts where security is poor. Cybersecurity is, therefore, of increasing importance. If IT systems are weak, forged documents or money may be sent to bank accounts under the control of fraudsters instead of to the seller's bank. In countries where security is poor, domestic trade carries a similar level of risk to international trade.
- **Other operational risks** – employee error, fraud and communication issues are more likely to occur in less developed countries. You will learn more about country risk in section 2.1.1.

1.5 Risk mitigants

Various measures are available to international traders wishing to mitigate risks. These are analysed in further detail in later topics. Here is a brief list of some of the main ones.

Connect with the local chamber of commerce

Most chambers of commerce provide services that facilitate trade. They also act as conduits to other service providers that can help with communication, translation, documentation and legal advice. Sometimes a chamber of commerce may help disseminate information about standards, protocols and interpretations of legal issues. This information could cover areas such as payment for transportation or other services. You will learn more about chambers of commerce in Topics 2 and 3.

Banks and other finance providers

All finance providers aim to reduce the effect of unexpected changes in foreign exchange rates through methods such as forward exchange contracts. You will learn more about these in Topic 14. Banks also provide specific undertakings or guarantees to cover counterparty risk. These include documentary credits, and indemnities for release of goods without bills of lading. You will learn more about these in later topics.

Specialist freight forwarders

These exist to facilitate the safe transport of goods.

Insurance

There are various versions of marine and cargo insurance available to reduce exposures incurred while goods are in transit. You will learn more about specialised insurers that offer credit insurance in Topic 13.

Government or quasi-government agencies

These can provide insurance against buyer default and can provide guarantees to help sellers to obtain finance that may not be commercially available.

Risk mitigants will be covered extensively in Topic 2.

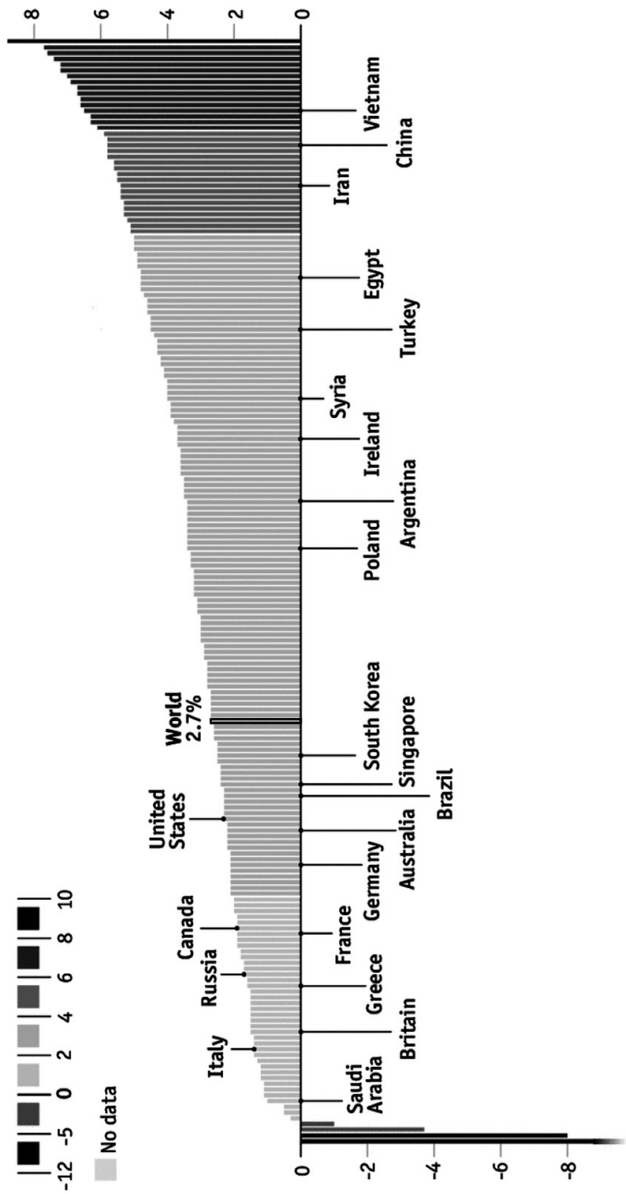
1.6 Impact of the global financial crisis on world trade

The global financial crisis of 2007–08 led governments in many countries to address shrinking domestic demand by encouraging businesses to boost exports. Conversely, the crisis also led to an increase in compliance and capital requirements. This has, in certain instances, acted as a disincentive to export due to the additional regulatory requirements.

Export-led growth

Export sales were used as a solution to counter reduced domestic turnover and diminishing gross domestic product figures. The UK is a prime example of how an emphasis on exports to fast-growing markets has resulted in positive economic growth figures. In the year to March 2018, the value of UK exports "grew faster to Canada (up 12.7%), India (31.8%) and China (15.3%) than to the EU (10%)" (GOV.UK, 2018). This corresponds with the comparatively faster economic growth in China and India, when compared with the EU.

FIGURE 1.1 THE FASTEST GROWING AND SHRINKING ECONOMIES IN 2018



Source: The Economist (2018)

The ICC Global Survey 2018 indicates that while trade is showing signs of regaining its position as an engine of growth, there is still work to be done to reach historical levels.

FACTFIND

Trade: an engine for global economic growth

The ICC Global Survey 2018 is a useful guide to the expected transformation that banks, importers and exporters can look forward to in international trade.

https://iccwbo.org/publication/global-survey-2018-securing-future-growth/

The following article from *The Economist* provides an insight into the fastest growing and shrinking economies in the world. It provides useful background on the role that trade continues to play in economic growth.

https://www.economist.com/graphic-detail/2018/01/05/the-fastest-growing-and-shrinking-economies-in-2018

[All accessed: 26 November 2018].

1.6.1 Compliance and capital requirements

Banks play an important role in international trade by facilitating payments and exchanging documents for money. In doing so, they address certain risks and provide trade financing.

Basel Committee on Banking Supervision

All banks are under the supervision of the Basel Committee on Banking Supervision (BCBS). The BCBS is responsible for setting out a resilient and credible regulatory framework that specifies capital requirements.

RISK-WEIGHTED ASSETS

"[A]n estimate of risk that determines the minimum level of regulatory capital a bank must maintain to deal with unexpected losses." (BCBS, 2017)

Basel II and III

Since the publication of Basel II in 2004, banks have faced stricter rules for payments and all activities that involve risk. The financing of international trade is no exception. These rules were strengthened following the financial crisis with the publication of Basel III. As a result, banks have had to set aside a greater amount of risk-weighted assets. In 2017, the BCBS set out further reforms to Basel III. See the factfind panel at the end of this section.

Other regulations and sanctions

Regulations against money laundering are also increasing. In addition, banks are required to comply with financial sanctions that have been imposed on various countries. Some banks have faced severe penalties for breaching sanctions. Regulations governing the trade in dual-use goods have also increasingly affected the smooth processing of transactions.

All these regulations have led to a reduction in risk appetite. Many banks have reviewed their international trade finance activities resulting in the cessation of many relationships with customers of correspondent banks. This has, in turn, impeded access to trade finance for companies of all sizes worldwide and threatened to have a negative impact on the evolution of world trade.

FACTFIND

Impact of increasing regulation

Find out more about the impact of increasing regulation and compliance requirements on trade finance:

https://www.bis.org/bcbs/publ/d424_inbrief.pdf

https://iccwbo.org/publication/global-survey-2018-securing-future-growth/

The following document from the FATF provides useful guidance on combatting money laundering and the financing of terrorism:

http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF%20Recommendations%202012.pdf

UK strategic export control lists can be found here:

https://www.gov.uk/guidance/uk-strategic-export-control-lists-the-consolidated-list-of-strategic-military-and-dual-use-items

Find out more about the trade finance principles put forward by the Wolfsberg Group, ICC and BAFT:

https://www.wolfsberg-principles.com/sites/default/files/wb/pdfs/comment-letters/6.%20Trade-Finance-Principles-Wolfsberg-Group-ICC-and-the-BAFT-2017.pdf

[All accessed: 26 November 2018].

1.7 Trade agreements

Trade agreements are formed when countries get together and agree the rules and terms on how they are to trade with each other. These agreements provide the parties involved with preferential trade status. These agreements can be bilateral (agreed by two countries) or multilateral (agreed by many countries).

KEY TERMS

Bilateral agreements

"An agreement between two countries setting out the conditions under which trade between them will be conducted." (Dictionary of Trade Policy Terms, 2007)

Multilateral agreements

"Intergovernmental agreements aimed at expanding and liberalising international trade under non-discriminatory, predictable and transparent conditions set out in an array of rights and obligations." (Dictionary of Trade Policy Terms, 2007)

Examples from Europe

The European Single Market Programme (SMP) and customs union are examples of multilateral agreements.

The SMP

This was signed by European Union (EU) member states in February 1986. It contains around 270 measures to create a borderless single market for goods, capital, services and people.

Customs union

"The EU is also a customs union. Its members impose common tariffs on imports from non-EU countries and can trade freely with each other without border checks. EU countries automatically benefit from trade deals that the EU strikes with other states but cannot set their own tariffs." (Strauss, 2018)

FACTFIND

Bilateral and multilateral agreements

Explore detailed definitions from the Dictionary of Trade Policy Terms:

https://search.credoreference.com/content/entry/cuptpt/bilateral_trade_agreement/0

https://search.credoreference.com/content/entry/cuptpt/multilateral_trade_agreements/0

[All accessed: 26 November 2018].

Search the web to find out more about the following free trade areas, multilateral and bilateral agreements and economic partnerships:

- African Continental Free Trade Area;
- ASEAN Free Trade Area;
- Eurasian Economic Union;
- European Commission: bilateral trade and investment agreements;
- Greater Arab Free Trade Area;
- North American Free Trade Agreement;
- Regional Comprehensive Economic Partnership; and
- Southern African Development Community.

1.8 The World Trade Organization (WTO)

The World Trade Organization (WTO) was formed in 1995 and arose from the General Agreement on Tariffs and Trade. At the time of writing (September 2018), the WTO had 164 members and had successfully concluded "16 different multilateral agreements (to which all WTO members are parties)" (WTO, no date a).

IT'S ALL ABOUT NEGOTIATION

Trading nations often find that they have conflicting interests. The WTO steps in to help disputing parties reach agreement.

It provides:

- "a forum for negotiating agreements aimed at reducing obstacles to international trade and ensuring a level playing field for all, thus contributing to economic growth and development [and] [. . .]
- a legal and institutional framework for the implementation and monitoring of these agreements, as well as for settling disputes arising from their interpretation and application."

(WTO, no date a)

Trade facilitation agreement

A multilateral trade facilitation agreement ratified by two-thirds of the WTO's membership came into force in 2017. It "contains provisions for expediting the movement, release and clearance of goods, including goods in transit" as well as "measures for effective co-operation between customs and other appropriate authorities on trade facilitation and customs compliance issues" (WTO, no date b).

Rise in barriers to free trade

In 2017, the US government led by Donald Trump's administration began reviewing many of its multilateral trade agreements. Import quotas and duties as well as bilateral trade agreements have been subject to substantial change. This has had a serious impact on international trade. Other countries have responded by introducing new regulations vis-à-vis the US and themselves. At the time of writing (September 2018) these moves had begun to ignite trade wars.

FACTFIND

Explore the WTO website:

https://www.wto.org/english/thewto_e/thewto_e.htm

Find out how the WTO settles disputes:

https://www.wto.org/english/thewto_e/whatis_e/tif_e/disp1_e.htm

Read more about recent trade restrictions and the US position:

https://www.wto.org/english/news_e/news18_e/trdev_25jul18_e.htm

https://www.wto.org/english/thewto_e/countries_e/usa_e.htm

https://www.wto.org/english/news_e/news18_e/ddgra_09feb18_e.htm

[All accessed: 26 November 2018].

The WTO site is regularly updated with current news and analysis. Check it regularly to keep up to date.

1.9 International Chamber of Commerce (ICC)

The International Chamber of Commerce (ICC) was founded in 1919. Today its global network comprises over 6m companies, chambers of commerce and business associations in more than 130 countries. National committees work with ICC members in their countries to address their concerns and convey to their governments the business views formulated by ICC.

ICC AT A GLANCE

"ICC is the world business organisation, a representative body that speaks with authority on behalf of enterprises from all sectors in every part of the world. The fundamental mission of ICC is to promote open international trade and investment and help business meet the challenges and opportunities of globalisation. Its conviction that trade is a powerful force for peace and prosperity dates from the organization's origins early in the 20th century. The small group of far-sighted business leaders who founded ICC called themselves 'the merchants of peace'.

ICC has three main activities:

1) rule setting;

2) dispute resolution; and

3) policy advocacy.

Because its member companies and associations are themselves engaged in international business, ICC has unrivalled authority in making rules that govern the conduct of business across borders. Although some of these rules are voluntary, they are observed in countless thousands of transactions every day and have become part of the fabric of international trade.

ICC also provides essential services, foremost among them the ICC International Court of Arbitration, the world's leading arbitral institution. Another service is the World Chambers Federation, ICC's worldwide network of chambers of commerce, fostering interaction and exchange of chamber best practice. ICC also offers specialised training and seminars and is an industry-leading publisher of practical and educational reference tools for international business, banking and arbitration.

Business leaders and experts drawn from the ICC membership establish the business stance on broad issues of trade and investment policy as well as on relevant technical subjects. These include anti-corruption, banking, the digital economy, marketing ethics, environment and energy, competition policy and intellectual property, among others.

ICC works closely with the United Nations, the WTO and intergovernmental forums including the G20."

(ICC, 2012)

FACTFIND

Rules applicable to banking and finance

Find out more here:

https://iccwbo.org/global-issues-trends/banking-finance/

The ICC Banking Commission has published specific rules for methods used by banks to facilitate international trade, such as:

- *Uniform Customs and Practices for Documentary Credits* (UCP 600);
- *Uniform Rules for Collections* (URC 522); and
- *Uniform Rules for Demand Guarantees* (URDG 758).

You will learn more about these in later topics.

Resources for business

Find out more about Certificates of Origin, ATA Carnets and Incoterms® rules:

https://iccwbo.org/resources-for-business/

https://iccwbo.org/resources-for-business/incoterms-rules/

[All accessed: 26 November 2018].

You will learn more about Incoterms® rules in Topic 6.

Conclusion

International trade has been severely challenged in 2018 for political and nationalistic reasons. Sensible concerns over sustainability and the rising cost of labour have resulted in an increase in nearshoring.

Nevertheless, export-led growth continues to transform economies around the world as cross-border business relationships develop and even increase in certain sectors. In the topics that follow, you will learn about the risks and mitigation methods available to financiers in this ever-changing area.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain what is meant by international trade?
- illustrate the reasons why businesses trade internationally?
- define what a business entity is and what it does?
- discuss the effects of the global financial crisis on world trade?
- highlight the differences between bilateral and multilateral trade agreements?
- compare and contrast the role of the WTO and ICC?

Test your knowledge

?

Use these questions to assess your learning for Topic 1. Review the text if necessary.

Answers can be found at the end of this book.

1) What are the three core activities of the International Chamber of Commerce (ICC)?

   a) Rule setting, policy advocacy and dispute resolution.

   b) Dispute resolution, policy advocacy and market research.

   c) Market research, policy advocacy and rule setting.

   d) Dispute resolution, rule setting and customs advice.

2) Which three of the following are roles played by the World Trade Organization (WTO)?

   a) Negotiation of agreements.

   b) Advising on pricing.

   c) Constructing the legal framework of agreements.

   d) Dispute resolution.

   e) Trade missions.

   f) Market research.

3) Which of the following is **not** a key principle of comparative advantage?

   a) Higher overall output of products/services.

   b) Specialisation.

   c) Higher overall wealth.

   d) Obtaining domestically unavailable products/services.

4) To cope with an increasing cost of labour, a company might opt to move all or some of its activities to another country. This is called:

   a) nearshoring.

   b) offshoring.

   c) globalisation.

   d) comparative advantage.

5) Since the publication of Basel II in 2004 and later Basel III by the Basel Committee on Banking Supervision, banks have faced stricter rules.

   These rules are related to:

   a) anti-money laundering.

   b) the trade in dual-use goods.

   c) payments and all activities involving risk.

   d) penalties for breaching sanctions regulations.

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TOPIC 2

The international trade environment

Introduction

International trade is a constantly evolving scene involving many players with varied and often far from predictable behaviour. In this topic, you will explore various risks faced by actors in the theatre of international trade. You will also be introduced to risk mitigation measures. You will then learn how to research new markets, choose counterparties and select appropriate methods to enter those markets.

LEARNING OBJECTIVES

By the end of this topic, you will understand:

- the risks inherent in international trade;
- the nature of buyers and sellers in various markets;
- the methods used to evaluate potential trading partners; and
- export and import strategies for entering new markets and sourcing supplies.

THINK . . .

Have you ever wondered where your children's toys were designed and manufactured? As you watch videos on YouTube, have you considered who owns the intellectual property of the content featured in the clips? Could there be more than one owner? Which country did the content actually originate from?

2.1 Risks involved in international trade

As with the iPhone components in Topic 1, most of the toys your children, brothers, sisters, nieces or nephews play with were manufactured in a country on the other side of the globe. Retailers in your country would have searched for popular, educational or innovative toys. They would then have negotiated reasonable prices with manufacturers or wholesalers and considered the risks involved before placing an order. Wholesalers or distributors would have rented containers and a shipping company would have transported the toys to your local toy shop. Insurance companies would also have come on the scene to cover transport risks. Banks would have made an appearance at some point, facilitating the payment to finance production, distribution and transportation.

We live in a world where products and services originate from many countries. In this topic, you will learn about the main risks that buyers and sellers face in both domestic and international trade. These risks include:

- country risk;
- commercial risk;
- transportation risk;
- foreign exchange and interest rate fluctuation risk;
- legal risk;
- trade-based financial crime risk;
- administrative risk;
- price fluctuation risk; and
- manufacturing risk.

You will explore these in more detail in the sections that follow, along with accompanying risk mitigation methods for each.

2.1.1 Country risk

This term encompasses all risks arising from cross-border trade.

Political risks

Changes in government could happen in any country. The status of trading agreements or political systems is subject to change as well. Companies should be aware of these risks and prepared to cancel or renegotiate contracts. The following are some key political issues that exporters and importers should consider:

- **Bilateral and multilateral agreements** – are there signs that a country may be removing itself from a multilateral trading agreement?
- **Historical relationships** – will these hinder or benefit the deal being negotiated?
- **Political system** – how stable is the system? Are there any signs of excessive control over business and/or trade?
- **Political sanctions** – you will learn about these in Topic 5.
- **Barriers to trade** – are there any import duties or quotas that encourage nationalism and the nationalisation of businesses?

Language and cultural risks

Risks involving language, culture and religion do not only affect international trade. These risks can also be present in domestic trade. Many countries, such as Switzerland, Canada, Belgium, India and Singapore, are multilingual. Others, such as China, are so vast that there may be cultural differences within the country itself.

- **Customs, practices and etiquette** – are there any religious or cultural differences manifest in social or business practices that need to be respected? For example, the name of a product could cause offence or convey the wrong image.
- **Negotiation styles** – these can differ between countries. For example, bargaining may be customary in one country but offensive in another. You learned in section 1.2.1 about the stronger bargaining position that a large corporate will have over an SME or micro-entity.

- **Labour laws** – policies regarding labour and trade unions may vary. Are there policies in place to prevent child labour?
- **Language** – while English is the language of international trade, its use is not universal. English literacy rates will vary. Many other languages are also used in more than one country. This facilitates trade between these countries. Chinese, Arabic, Hindi, Urdu, French, German, Spanish and Portuguese are a few examples.

Technology-related risks

The following are just a few of the risks related to technology that you should be aware of:

- **Legal and IT requirements** – does the imported hardware or software that the company uses comply with local legislation? Is it compatible with system requirements? Modifications may be necessary.
- **Safety and security** – standards in the counterparty's country could be either higher or lower than in your country. Familiarise yourself with these requirements and ensure they are met.
- **Communication tools** – is internet access necessary for your product or service to function? Are adequate communication tools and systems in place?

Environmental risks

You learned about sustainability in section 1.1.4. The following are broad areas that should be considered for a start:

- **Manufacturing methods** – are there laws in place requiring that goods consumed have to be produced in an environmentally friendly manner?
- **Sustainable policies** – are there regulations in place to combat climate change and global warming and/or to protect another aspect of the environment?

Economic risk

A country suffering from an economic downturn can pose an economic risk. Conversely, high growth can also present challenges. Key economic indicators to watch include:

- GDP growth rates;
- interest rates; and
- employment levels.

Transfer risk

This occurs when buyers are unable to exchange their local currency for the currency contractually agreed for payment. Countries that are highly dependent on income earned in a foreign currency are subject to transfer risk. These economies are often highly dependent on the export of hard or soft commodities or specific services such as tourism. A natural disaster could affect crops. Fluctuations in markets could have an impact on price. Transfer risk is often underestimated. Many African and Latin American countries are subject to this risk, as are some emerging Asian economies. For example, transfer risk can occur in Nigeria and Mexico where there is a dependence on oil. It can also occur in Egypt where there is a dependence on tourism. Countries dependent on the export of sugar, cocoa, palm oil and iron ore also potentially face transfer risk.

Many, but not all, country risks can be mitigated.

POSSIBLE MITIGATION METHODS

The following methods are possible:

- **payment in advance** – provides full mitigation for a seller, but is not always possible;
- **insurance** – credit insurance or insurance provided by export credit agencies (ECAs);

- **payment guarantees (or standby letters of credit)** – both issued or confirmed by the seller's bank;
- **documentary credits** – confirmed by the seller's bank.

Note: banks are only allowed to issue documentary credits if the import licence is approved and the foreign currency needed has been reserved by the local exchange authorities.

2.1.2 Commercial risk

This involves the possibility that one of the parties to a contract may be unable or unwilling to fulfil its obligations.

The buyer is unable or unwilling to pay

A buyer could be **unable** to pay due to a cash flow problem, a deteriorating financial position or even bankruptcy. There are many reasons why a buyer could be **unwilling** to accept a delivery of goods. The quality or quantity of the merchandise delivered could be in question; alternatively, the buyer could have made an estimation error when ordering the goods and then have found that part or all of the shipment is no longer needed. In these situations, the seller will need to be aware of the commercial risks involved.

POSSIBLE MITIGATION METHODS

The following methods are possible:

- payment in advance;
- payment guarantee (or standby letters of credit);
- documentary credits;

- documentary collections; and
- credit insurance.

The seller is unable to deliver goods or services

Buyers should be aware that a seller can be in default and commercial risk can occur if:

- the seller is unable to deliver the goods;
- the goods delivered are of a poorer quality or lower quantity than ordered; or
- the goods are delivered late.

Faced with any of the scenarios above, buyers may be unable to profit from resale of the goods or to fulfil contractual obligations towards customers due to lack of stock or raw materials.

POSSIBLE MITIGATION METHODS

The following methods are possible:

- payment after delivery of the goods;
- performance-related guarantees or standby letters of credit;
- documentary credits;
- documentary collections; and
- inspection of the goods by an independent surveyor.

2.1.3 Transportation risk

With international trade, it generally takes longer to move goods to their final destination when compared with domestic trade. This is because the distances involved are usually much greater. You have learned in section 1.4 how this rule is can be reversed. This poses the additional risk that goods may be damaged or tampered with while in transit. Appropriate insurance is available to cover such risks. Guidance from ICC, available to all parties in the form of Incoterms® rules, helps reduce these risks.

Incoterms® rules are internationally accepted terms that set out the responsibilities of the two parties with regard to transport and insurance. The agreed Incoterm® that is incorporated into the sales contract will determine who bears the risks involved in transportation. The party that bears the transportation risk will have to purchase insurance. You will learn about Incoterms® in full detail in Topic 6.

INCOTERMS® RULES

International Commercial Terms (Incoterms®) rules are a set of standardised terms that mean exactly the same to both parties. They are interpreted the same way by courts in every country. They were drafted by ICC.

POSSIBLE MITIGATION METHOD

Transport insurance is the only form of mitigation used.

CHECK YOUR UNDERSTANDING 1

1) Are cultural and political issues classified as country risks? Why should businesses be aware of these risks?
2) If two companies in Russia are trading with each other, would transportation risk be an issue?
3) Can language risk be an issue in domestic trade?

2.1.4 Foreign exchange and interest rate fluctuation risk

If a company agrees to buy or sell a product priced in a foreign currency from a seller or to a buyer based in another country, it must agree on the price at the outset. The other party will not tolerate the business wanting to change the price after the contract has been signed if the exchange rate moves in a less favourable direction. Currencies fluctuate all the time, strengthening and weakening against each other. If an exchange rate moves up or down, an unexpected profit or loss can result.

Bargaining power

The choice of currency used is largely determined by the relative bargaining power or by customs and practice. If the seller is in a strong bargaining position, payment is likely to be made in the seller's currency. The opposite will apply if the buyer is in a strong bargaining position.

Commodities denominated in US dollars

Some commodities, such as oil, are always denominated in US dollars regardless of where the buyer or seller is based. Both parties will, therefore, inevitably face foreign exchange risk.

Interest rate fluctuation

As with fluctuations in exchange rates, interest rate movements can affect the cost of financing, resulting in an unexpected loss or profit. It is beyond the scope of this qualification to explain interest rate fluctuation in more detail.

You will learn more about foreign exchange risk management in Topic 14.

POSSIBLE MITIGATION METHODS

If the buyer or the seller is in a strong bargaining position, they will be able to include **price fluctuation clauses** in their contracts. The price of the goods will then fluctuate according to the movement of exchange rates or interest rates.

Banks can offer products to mitigate currency exchange and interest rate fluctuation risk.

- **Forward exchange contracts** – these are used to fix future currency exchange rates.
- **Currency exchange options** – buyers of options are protected against exchange rate fluctuations that are to their disadvantage.
- **Forward rate agreements** – buyers or sellers can mitigate interest rate fluctuation risk through forward rate agreements or various other interest rate options.

HEDGING

"[T]he reduction of an existent risk by the elimination of exposure to price movements in an asset." (The Princeton Encyclopedia of the World Economy, 2010)

CHECK YOUR UNDERSTANDING 2

Risks involving currency

What is the difference between transfer risk and foreign exchange risk? Why is transfer risk classified as a country risk?

2.1.5 Legal risk

In section 2.1.1 you were introduced to legal risks, such as how labour laws may differ between countries. The following are some important questions to ask in order to understand the legal risks that can affect international trade.

- **Intellectual property** – will patents that protect technology in some countries be respected in other countries?
- **Legal systems** – will different laws between countries affect the way an underlying contract is interpreted?
- **Independence of courts** – what is the situation of jurisprudence and independence of courts? This can have a serious effect on a seller's or a buyer's position should a lawsuit arise.
- **International agreements and local law** – do local trade laws take international agreements into consideration?
- **Payment injunctions** – how easy is it for buyers to get payment injunctions or court attachments in their country?
- **Local acceptance of ICC rules** – to what extent do local practices and regulations accept frameworks such as ICC's UCP 600, URC 522, URDG 745 or ISP98? You will learn more about UCP 600 in Topic 9 and URC 522 in Topic 8.

POSSIBLE MITIGATION METHOD

Both parties should conduct their own research and seek legal advice from competent law firms.

The legal risk connected to some settlement methods can be mitigated by using ICC's rules.

2.1.6 Risks relating to trade-based financial crime

In international trade, there is an ever-present risk that a transaction is fraudulent, in breach of sanctions or has contravened anti-money-laundering regulations.

All parties involved in any transaction should ask the following questions. If the answer to any is negative, further investigation is necessary.

- Is the transaction consistent with other regular business activities?
- Are the goods of a type commonly traded between the two countries?
- Are any of the countries involved in the transaction considered to be high risk or subject to sanctions?
- Is the invoice price consistent with the retail price of the goods/services?
- Are the goods 'dual use', ie could they be used either for military or non-military purposes?
- Are there any signs of, or connections with, possible terrorist financing?
- Have background checks on the counterparty been carried out? Has any negative information been revealed?
- Has the transaction been structured in an unusually complex way?

POSSIBLE MITIGATION METHOD

In-depth research is required to counter each of these risks. This is particularly necessary when doing business for the first time with the party in question.

You will learn about trade-based financial crime in detail in Topic 5.

2.1.7 Administrative risk

Incomplete or incorrect documents

Administrative risk relates to incomplete or incorrect customs or import documents. This could result in goods being blocked at the border or at ports or airports. In extreme circumstances, goods can also be confiscated or returned to the sender.

Difficulties related to documentary credits

In addition, completing the required documentation under ICC rules is far from easy. Mistakes or missing documents can lead to delays in the delivery of goods, increases in cost and payment delays.

Difficulties related to documentary collections

Mistakes are less frequent in the documentation required for documentary collections as these are less challenging when compared with documentary credits. However, if a buyer does not receive the documents necessary for customs clearance, or any other administrative purpose, they might not be able to make payment.

POSSIBLE MITIGATION METHOD

Utmost care should be taken while preparing the required export documentation. As much information as possible should be collected beforehand.

2.1.8 Price fluctuation risk

This risk exists for both domestic and international trade.

Traders dealing in commodities with volatile market prices are sometimes required to take risky positions. Prices of oil, chemicals, soft commodities (such as sugar, cocoa, cotton and coffee) as well as certain metals (such as steel) are known for their volatility.

When concluding a contract, sellers may be confronted with higher than expected prices for commodities that they are required to sell. As a result, the purchase prices of these commodities may be higher than the prices they will receive from their buyers. If prices move in the opposite direction, this will have a similar negative effect on buyers.

The increase in prices of raw materials required to manufacture goods may also have a negative impact. This could cause the seller's profit margin to decrease or even disappear altogether.

POSSIBLE MITIGATION METHODS

The following methods are possible:

- **Bargaining position** – sellers or buyers in a strong bargaining position might be able to negotiate price fluctuation clauses in their contracts. However, this is not always possible.
- **Fixed price** – if payment is negotiated through a documentary credit, a seller can be certain of a fixed price for goods, irrespective of the movement of the market price. Since a documentary credit is irrevocable, the buyer will have to accept the goods at the price specified on the contract.
- **Hedging** – commodity houses or financial institutions offer the possibility of hedging price fluctuation risk by means of futures or other derivatives.

IRREVOCABLE

A contract that cannot be amended, changed or reversed without the agreement of both parties in the transaction.

CHECK YOUR UNDERSTANDING 3

1) What other risks are related to movements in financial markets?
2) Are the recommended mitigation methods different or similar to those suggested for price fluctuations?

2.1.9 Manufacturing risk

As long as a seller is dealing in manufactured goods, there will be a production process and various associated risks involved. Much investment is required before these goods are ready for sale and delivery. All manufactured goods require investment. For example, a machine may need to be conditioned for a particular customer or goods may need specific packing or labelling.

If, for any reason, the buyer cancels the contract during that process, the investment made will be lost. The size of the loss will depend on that of the investment made or on the likelihood that the goods can be sold to another party.

POSSIBLE MITIGATION METHODS

The following methods are possible:

- **Penalty clauses** – some sellers are able to incorporate penalty clauses in their contracts. But are they enforceable? This will depend on the legal and regulatory environment.

- **Irrevocability** – a documentary credit is irrevocable. Therefore, it cannot be amended or cancelled without the seller's agreement. If the buyer wants to cancel the contract, he may want to cancel the documentary credit as well. The seller may not agree to a cancellation or amendment request from the buyer. If this happens, it will ship the goods and present the documents as specified in the original version of the credit. The buyer will then be obliged to pay and take up the goods. You will learn more about this in Topic 9.

2.2 Research and networking

Businesses should research new markets in order to trade successfully. Most research is now done online. Networking is also carried out via web-based digital services such as social media. However, there is no substitute for visiting a country in person and meeting representatives of the business you wish to trade with face to face.

Networking

Other people who have recent experience in international trade are often an excellent source of advice and information. Local chambers of commerce or trade associations will often arrange seminars or networking events where businesses can meet and share experiences. For example, representatives from companies that have penetrated new markets may participate in a panel discussion sharing their experience and providing insights into pitfalls and successes.

Government departments

Most governments have departments dedicated to helping exporting companies explore new markets. Some also provide advice on importing goods. The factfind panel at the end of this section provides examples of these departments. Embassies are also an excellent source of information for prospective buyers and sellers.

Chambers of commerce

In section 1.5, you learned about some of the services offered by local chambers of commerce and how these can act as risk mitigants. Through education and networking opportunities they help promote understanding between businesses in different countries, thus reducing risks.

Some chambers of commerce also have regional offices. In addition, some also work with their counterparts in other countries to promote trade. An example is the Franco-British Chamber in France. Chambers of commerce should be the first point of contact for sellers entering a new market. They usually specialise in local products and are often able to advise on technical requirements.

Services offered may include:

- training courses in transport and logistics, trade finance and international documentation;
- translation services and country reports;
- bespoke market research matching buyers and sellers;
- overseas trade missions; and
- information on international exhibitions and trade shows (see section 2.2.1).

While chambers of commerce often have a far reaching role in promoting international trade, only governments are able to ratify official trade agreements between countries.

FACTFIND

Explore the websites of various government trade bodies. The list that follows is not exhaustive.

https://www.austrade.gov.au/international https://www.icc-austria.org/en/Home.htm

http://www.gtai.de/GTAI/Navigation/EN/Meta/about-us.html

https://www.koreaexim.go.kr/site/main/index002

https://www.enterprisesg.gov.sg/resources

http://www.thedti.gov.za/about_dti.jsp

https://www.gov.uk/government/organisations/department-for-international-trade

[All accessed: 26 November 2018].

2.2.1 Trade missions, exhibitions and shows

Trade missions are co-ordinated overseas visits by a group of individuals representing their company. The aim is for them to meet potential overseas buyers or sellers. A company will usually attend a trade mission after it has completed its initial market research and identified its potential new market. Trade missions are often organised by chambers of commerce, industry bodies or local trade associations. Many government departments that are responsible for international trade also organise trade missions. The delegation that goes out will involve a mixture of businesses and some representation from the organisers. Sometimes companies that provide services in international trade, such as banks, freight forwarders or lawyers specialising in international law, will attend. In some cases, grants are available for companies wishing to attend trade missions. These are co-ordinated to coincide with trade exhibitions or trade shows.

An exhibition or trade show, sometimes referred to as an ‘expo’, is an event where companies exhibit their latest products and services to potential buyers. They can be industry specific or general, where products from several sectors are displayed. Trade shows are usually held annually. However, some such as the Canton Fair (also known as the China Import and Export Fair) are held twice a year and attract visitors from all over the world. This is China's largest trade show and it is held every April and October. It incorporates a complete range of the latest Chinese goods.

FACTFIND

Trade shows

The following are links to examples of popular trade shows. Explore others that your bank or financial institution may be interested in.

https://www.ces.tech/

http://www.cantonfair.org.cn/en/index.aspx

https://www.africabig7.com/

http://arabiantravelmarket.wtm.com/

https://10times.com/international-poultry-expo

[All accessed: 26 November 2018].

CHECK YOUR UNDERSTANDING 4

✓

1) Can a chamber of commerce ratify a trade agreement? What is the role of a chamber of commerce?

2) Can a government department organise a mission to a trade show? Which government or quasi-government agencies would you approach for assistance when exploring a new market?

2.2.2 Banks

Most banks have trade finance operations and some have managers who specifically help customers with international trade ventures. In the factfind panel at the end of this section, we have included a few examples of international trade portals from major banks.

Trade finance products

Banks offer a range of products, from simple payment systems to more complex methods such as documentary credits or commodity hedging. These include:

- **Currency risk** – most banks will advise their customers on currency risk and how to address this.
- **Payments** – all banks advise buyers or sellers on making and receiving payments overseas, the risks involved, and the mechanisms offered to minimise risk.
- **Economic reports** – you learned about country-specific risks in section 2.1.1. Many of these will be addressed in economic reports about individual countries. Some banks produce these internally while others recommend reports produced by other parties. Areas covered include the standard of living, consumer expenditure, foreign exchange reserves, as well as regulations and controls that apply to imports into the country.

Introductions to third party providers

Most banks also help their customers to develop their international trade operations by introducing them to specialists in related areas. These services include the following.

- **Third-party inspection and quality control** – these act as mitigants against the risks related to a supplier not meeting contracted standards.
- **Documentation** – some banks provide advice on trade, transport, commercial and insurance documents. You will learn about documentation in Topic 6.

FACTFIND

Trade finance solutions offered by banks

As it is impossible to include all the banks in the world, we've included the trade finance portals of major UK banks. If you don't live in the UK, explore those in your country as well.

Lloyds: https://www.lloydsbanktrade.com/en/international-banking/bank-with-us?vider_sticky=oui

Santander: https://en.portal.santandertrade.com/

HSBC: https://www.gbm.hsbc.com/solutions/global-trade-receivables-finance/international-trade-growth

RBS: https://www.business.rbs.co.uk/business/trade-hub.html

Barclays International Banking: https://www.barclays.co.uk/InternationalBanking/Tradesolutionselector/P1242680721085

[All accessed: 26 November 2018].

2.2.3 Status enquiries and credit control

All businesses are concerned with the risk that they may not get paid, and this risk is higher when trading internationally. A buyer will also face the risk that their supplier may not fulfil their part of the contract. They might pay for goods that do not arrive or might be let down by late delivery or poor quality, resulting in a loss of business and income.

A status enquiry or credit reference is a report that is collated from all of the information and history available on a company and made available to the enquirer, often for a fee. It is a historic look at how a company has traded. Although these reports do not forecast how the company will trade in the future, they are a good indicator of how it has traded so far. Status enquiries and credit references are easily available from a number of sources.

Credit reference agencies

Some credit reference agencies operate in specific countries or regions. Others have an international presence. Examples of credit reference agencies include Graydon, Experian and Dun & Bradstreet. Research services are also offered by many of these agencies.

Credit rating agencies

Fitch, Moody's and Standard & Poor's are the three largest in this market. They provide ratings on the credit standing of any large business that has raised capital on international markets.

Credit insurers

Providers of credit insurance also provide credit reports. Some are produced internally and others by associated companies. Appropriate credit limits for the company under consideration are provided. These are good indicators for sellers when assessing the size of a contract. For example, if a seller receives a USD500,000 order from a customer who has been given a credit limit of USD20,000, they should proceed with caution. Obvious questions arise as to whether the customer will be able to pay for the goods. Providers of credit insurance include Aon, Euler Hermes and Atradius. You will learn more about credit insurance in Topic 13.

Export credit agencies (ECAs)

Some ECAs also provide country reports. Examples include Coface, Ex-Im Bank, Credendo, EKN and Atradius. ECAs finance international trade projects. The majority of these are medium or long-term projects. You will learn more about ECAs in Topic 13.

Financial statements

In some countries, businesses have a legal obligation to publish their financial statements (balance sheets and income statements) with a governmental body such as their central bank or a chamber of commerce. These data then become freely available to the public. If a company has not published their financial statements, this may reflect carelessness, poor management or that they have something to hide.

FACTFIND

Credit reference and ratings agencies

Explore the differences between the two types of agencies.

https://www.fitchratings.com/site/home

https://www.moodys.com/

https://www.graydon.co.uk/

https://www.experian.co.uk/

https://www.dnb.co.uk/

[All accessed: 26 November 2018].

2.2.4 Digital networking and information gathering

As mentioned in section 2.2, both networking and research can now be carried out online.

Company websites

Most businesses have websites that provide information as to the size of the company, its history, its product range and even testimonials. Caution is advised – you cannot believe all that you read. However, you can often get a feel for a company by examining its website.

Reports on countries and specific industries

You learned in section 2.2.2 that banks often produce country-specific economic reports. These are also produced by government export agencies, chambers of commerce, think tanks and research institutes. All these organisations also produce reports on specific industries.

Trade publications

Print or digital trade journals and magazines provide sector-specific information. Potential buyers or sellers may be featured, as well as interesting articles on specific countries or policies. It is also worth reading the business, economic and financial press information and navigating to sections relevant to your chosen markets.

Digital marketing strategy

All large corporates will have a well-crafted web and digital strategy. Most will employ professional digital marketing agencies. Increasingly, SMEs and micro-businesses are building their online presence and generating leads through digital marketing techniques such as search engine optimisation and social media. LinkedIn is a particularly useful social media channel for businesses offering entry level options at no cost.

Online networking tools

Most chambers of commerce and government trade departments mentioned in section 2.2 offer networking opportunities, either through webinars, discussion forums or social media feeds. Following the social media feeds of both trade and financial journals can also provide a source of leads and networking opportunities.

FACTFIND

Online networking opportunities

Explore the social media feeds of the following trade journals.

https://twitter.com/gtreview

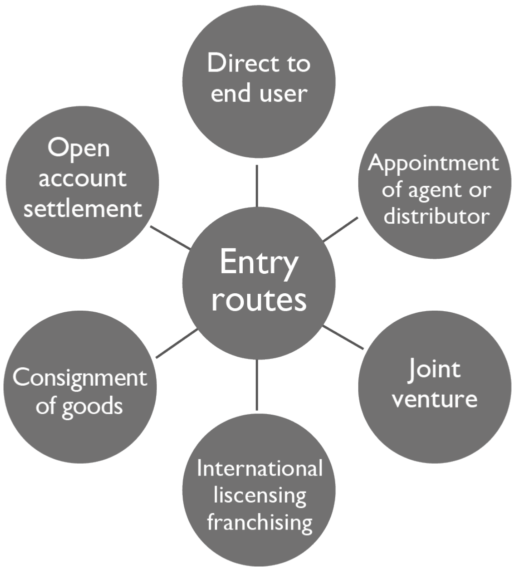
https://twitter.com/TXFMedia

[All accessed: 26 November 2018].

2.3 Methods of entering an international market

Once a potential new market has been identified and researched, a seller must decide on an appropriate entry strategy or route to market. The research that may have been done so far may have identified demand for the seller's product, barriers to entry and potential buyers; it may not have highlighted how best to enter the market with the product or service. The first step in this process is to decide whether to export direct to the end user or indirectly via an intermediary.

FIGURE 2.1 ENTRY ROUTES AVAILABLE TO A SELLER



You will learn about agents, distributors and other intermediaries in Topic 3.

2.3.1 Direct exporting *v* indirect exporting

Direct exporting

Direct exporting is when a company sells direct to the end user. If you have ever personally purchased something on eBay from an overseas seller, then the seller has engaged in direct exporting to you.

Advantages include:

- more control over the whole export process;
- potentially higher profits;
- closer relationships with its overseas customers; and possibly
- collaborative marketing efforts.

Disadvantages include:

- greater time investment; and
- the need to employ more staff with specialist experience.

Indirect exporting

Indirect exporting is where the company engages the services of an intermediary that specialises in finding foreign markets and buyers for its products. The main advantage for the seller in adopting this approach is that it provides a route to entering an overseas market without the risks and complexities of direct exporting. The intermediary will provide all of the export services. The main disadvantage is that control is lost over how the goods are sold and marketed as well as the potential cost incurred. However, this must be weighed against the number of potential new sales that the intermediary has generated. An intermediary will also charge a fee or commission. This will have an impact on the profitability of the transaction. You will learn more about intermediaries in Topic 3.

Key factors to consider

The factors that will influence a company's decision to export directly or indirectly include:

- the size of the firm;
- the level of resources available within the company to devote to its international marketing effort;
- the nature of the product being sold;
- any previous experience or expertise in exporting;
- general conditions in the selected overseas market.

2.3.2 Joint ventures

A joint venture is a legal entity formed between two or more parties, sometimes referred to as a 'co-operative agreement'.

How it works

The company wishing to export finds a local company that it would like to work with in the target country. Each party involved in the joint venture would bring different skills and expertise to the newly formed entity. Once the joint venture is formed, responsibilities and goals for each organisation will be clearly defined. Agreement will be reached on the share of the revenues, expenses, assets and the control of the newly formed enterprise. Equity in the new company would be split between the parties, and any profits and losses would be shared on the same basis. Taxes would be paid in the country where the joint venture is set up to trade from. The share of profits due to the exporting company must be expatriated back to its country.

EQUITY

"The value of a company, divided into many equal parts owned by the shareholders, or one of the equal parts into which the value of a company is divided." (Cambridge Dictionary, 2018)

Advantages

This approach is attractive when countries impose high tariffs or quota restrictions in order to protect their domestic manufacturers. In some territories, the country's laws may not permit foreign nationals to operate alone. For example, in some Arab countries it is not legal to carry out business without forming a joint venture with a local partner. A joint venture can also be an easier first step before moving on to franchising, as McDonald's and other fast food companies found out when they first entered the Chinese market.

Other reasons for forming a joint venture are as follows:

- Entry risks to the overseas market are greatly reduced by using the local partner.
- The local partner will have greater understanding of the legal framework and business culture of that country.
- Once the venture is established, labour and overhead costs may be lower than manufacturing in the domestic country and exporting to the overseas country.

Disadvantages

These include the following:

- There may be an imbalance in the levels of investment and expertise provided by one party.
- The parties may have potentially conflicting management styles, business cultures and operational styles.
- There may be different strategic objectives for the involved parties.
- They are complex to set up, and a great deal of time and money may be needed to invest in finding the right partner.
- Research has to be made into the reliability of the partner in the joint venture.

Contractual joint venture

A joint venture can also be established via an agreement between two existing legal entities without the creation of another legal entity. This is known as a ‘contractual joint venture’.

2.3.2.1 Joint ventures: how banks can help

Banks may be able to help with joint ventures.

Advice

Some provide advice on the following questions:

- Is an equity stake or a loan capital injection better? How is interest taxed when compared with dividends, and vice versa?

- Are there any overseas exchange controls that could affect remittance of dividends or capital back to the home country?
- Is there a likelihood of expropriation or country default (based on political and economic reports)?

Credit replacement guarantees

Banks can help to provide local financing by issuing a guarantee in favour of another bank in the country where the joint venture is based. That local bank will then provide financing to the joint venture in the form of loans, overdraft facilities, investment credits, etc. If the joint venture is not able to fulfil its obligations under the credit facilities, the local bank will be compensated by the bank that issued the guarantee. This enables the local bank to provide financing to the joint venture. You will learn more about this in Topic 10.

Letters of introduction

In addition, banks may be able to provide letters of introduction to a reputable local lawyer or accountant.

EXPROPRIATION

"The action by the state or an authority of taking property from its owner for public use or benefit." (Oxford Dictionaries, 2018)

2.3.3 International licensing and franchising

If a company decides not to export directly or to manufacture in a particular country, licensing and franchising are two possible options.

Licensing

Licensing is the granting of intellectual property rights – trademarks, patents, etc – to another manufacturer in exchange for a fee. The company that is granted the licence is known as 'the licensee' and the granting company is known as 'the licensor'. The license agreement will set out the terms and conditions that the licensee must adhere to. The licensee will agree to pay a fee or commission on its sales.

ADVANTAGES TO THE LICENSOR

Licensors are able to establish a presence in a particular market that the licensee is committed to developing. The main disadvantage to the licensor is that they lose control over the manufacture of their product and, as such, run the risk that an inferior product that bears their name/brand will be sold in the overseas market.

Franchising

International franchising is similar to international licensing. However, the overseas party is subject to greater control in the use of the products. In an international franchise, a company permits an overseas party to use its business model or brand in a specified territory for a given period.

The exporting company becomes the franchisor and the overseas company the franchisee. Licence fees or royalties are paid by the franchisee for the privilege of using the franchisor's name and business model. International franchising has been very successful for many fast food outlets, such as McDonald's, Subway and Starbucks, to name but a few. It is often said that the franchisee has a greater incentive than an actual employee in the company as it has invested a direct stake in the business.

The franchisee will usually pay a lump sum up front and then a royalty on subsequent sales. The franchisee effectively becomes a controlled outlet of the franchisor. The franchisor will often provide training and business advice for its franchisees, as well as assistance in marketing and promotion. A further advantage of franchising is that it allows a company to expand rapidly through its network of franchisees. Some countries have specific laws governing franchising. Brazil, for example, regulates franchises more closely than many other countries.

Franchising is attractive for businesses with a good track record of profitability and for business models that are easily duplicated.

ADVANTAGES OF BOTH FRANCHISING AND LICENSING

The following are advantages from the point of view of a franchisor:

- There is greater commitment on the part of licensees than is found among traditional agents or distributors.
- There is greater control over presentation and pricing of products.
- There are lower start-up costs compared with joint ventures or traditional selling techniques.
- There is closer involvement with the overseas marketplace.

2.3.4 Consignment of goods

Another method of entering an overseas market is through the consignment of goods. This refers to a transaction where the seller sends goods to an overseas distributor who is responsible for managing and selling the goods for the seller for a commission. The seller retains title to the goods until they are sold. Payment to the seller is required only for those items sold. This enhances export competitiveness, as goods are held with the distributor and thus readily available for delivery to the end user.

You will learn more about this in Topic 3.

2.3.5 Open account with limits

In an open account transaction, a seller will despatch its goods to a buyer, asking for payment, or an agreement to pay, on a specified date. A considerable amount of trust is, therefore, placed on the buyer by the seller in an open account arrangement. Once goods have been despatched or services delivered, sellers will lose all control over payment. This leaves them completely reliant on the trustworthiness and creditworthiness of the buyer.

In many cases, sellers have put up internal limits on the outstanding debt held by the buyer. As long as the outstanding debt does not exceed the limit, the delivery of goods will continue.

Risk mitigation

There are many ways to mitigate the risks involved in open account trading. These include payment guarantees, as well as supply chain finance techniques. These techniques are increasingly being used to finance international trade. You will learn more about payment guarantees in Topic 10 and about supply chain finance in Topic 11.

You will also learn more about open account settlement in Topic 7.

Conclusion

Before entering a new market, businesses should assess the risks involved, as well as all possible mitigation methods. It is therefore essential to conduct adequate research in order to formulate a successful export strategy. Governmental bodies and chambers of commerce provide opportunities for research and networking, both online and in person at trade shows and through trade missions. Exporters should also approach banks for assistance and credit reference agencies for reports on companies they hope to do business with. Finally, companies should evaluate the many ways of entering the markets they have identified.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- outline the risks associated with international trade?
- describe the research you would conduct before embarking on a business venture overseas, eg utilising government bodies, the bank, chambers of commerce and the media?
- explain how you would check the credit standing of an overseas business?
- formulate an entry strategy to foreign markets?

Test your knowledge

?

Use these questions to assess your learning for Topic 2. Review the text if necessary.

Answers can be found at the end of this book.

1) Match the following seven risks involved in international trade with the correct explanation.

	Risks		Explanations
1	Foreign exchange risk	A	The risk that the buyer does not pay for the goods.
2	Commercial risk	B	Money laundering or the breach of sanctions.
3	Transfer risk	C	English is not a universal language and the level of understanding will vary greatly from country to country.
4	Trade-based financial crime risk	D	If a company agrees to buy a product overseas that is priced in a foreign currency, it must agree a price at the outset. The price cannot be changed because an exchange rate is less favourable.
5	Language and cultural risk	E	Risk that the goods are damaged or tampered with while in transit.
6	Legal risk	F	Risk that the buyer is unable to transfer his local currency into the currency of the contract.
7	Transport	G	Legal system and laws of countries vary greatly.

   a) 1B, 2F, 3C, 4D, 5A, 6G, 7E.

   b) 1D, 2A, 3F, 4B, 5C, 6G, 7E.

   c) 1C, 2G, 3F, 4E, 5B, 6D, 7A.

   d) 1G, 2F, 3E, 4C, 5D, 6A, 7B.

2) Credit reference agencies and credit rating agencies are the same thing. True or false?

3) A status enquiry on a potential overseas trading partner will usually provide an exporter with:

   a) a forecast of earnings growth.

   b) competitive edge.

   c) confidential information.

   d) information about and history of the company.

4) Which of the following statements is correct with reference to trading under open account with limits?

   a) The buyer will pay and the seller will despatch the goods up to the amount of the payment.

   b) Trading under open account with limits is used when there is no trust at all between the parties.

   c) The bank of the buyer will grant a credit limit to the buyer to enable him to pay for the goods.

   d) The seller will despatch the goods, asking the buyer for payment. As long as the outstanding debt does not exceed a certain limit, the delivery of goods will continue.

5) Which of the following statements is correct with regard to foreign exchange risk?

   a) Foreign exchange risk is the risk that the buyer is unable to change his currency into another currency.

b) A bank can mitigate foreign exchange risk by fixing the exchange rate that will be used at a later date (forward exchange contract).

c) In case the exchange rate of the currency changes and creates a disadvantage for the seller, the seller always has the right to adapt the invoice value to cover his potential loss.

d) A local authority can mitigate foreign exchange risk by fixing the exchange rate that will be used at a later date (forward exchange contract).

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TOPIC **3**

Parties and their roles

Introduction

In this topic, we will look at the various players in the theatre of international trade. Each party should know exactly how they should act and understand the roles of the other players. In achieving this, an international sale of goods or services should run smoothly. This topic will detail each party and intermediary involved in international trade and the role that they play.

LEARNING OBJECTIVES

By the end of this topic, you will understand:

- the basic considerations that sellers and buyers need to bear in mind before entering into a binding export/import transaction;
- the role of various intermediaries who may be involved in an export/import transaction;
- the principles that apply to the relationship between a bank and its customers; and
- how banks work with banks in other countries to effect payment or provide other services useful in international trade.

THINK . . .

If a Chinese company wants to buy a piece of machinery from a Canadian supplier, how many intermediaries are needed to make the transaction work?

3.1 Parties in international trade

Trading internationally is a complex process that involves many parties. Even if you export directly, as discussed in Topic 2, there will still be many potential parties involved in an international trade transaction – the seller, the buyer, the freight forwarder, the insurer and the bank.

When you export indirectly, even more intermediaries can be involved in the process, including:

- export management companies;
- trading houses;
- confirming houses;
- agents;
- distributors;
- banks.

We will discuss these parties and intermediaries throughout this topic.

INTERMEDIARIES

An intermediary is "one that acts as a means or a go-between in a matter involving other parties" (Merriam-Webster, 2018).

> Intermediaries exist to bridge the gap between the buyer and seller and act as a conduit for the goods or services being offered; according to Bernard et al. (2011, p2) they "overcome barriers to international trade at a lower cost". Intermediaries are usually engaged because they have a greater knowledge of the export market than the buyer. As outlined in section 2.1, there are many possible risks involved in international trade, some of which can be caused by the physical and socioeconomic differences between the buyer and seller; using intermediaries may help to mitigate these risks.

3.2 Before entering into a transaction with a new counterparty

In purely domestic transactions, it is usually possible for a prudent business to obtain information on potential new business partners. It may be possible to visit the other party, obtain a bank reference, or seek formal advice from trade associations or informal advice from others in the same trade. Communication, including face-to-face meetings, is relatively straightforward compared to dealing with businesses located overseas.

International business transactions need the same degree of due diligence as domestic transactions, and there are additional potential complications, such as fraud or sanctions, which are less likely to be an issue in purely domestic business. Before proceeding in a transaction with a new counterparty located overseas, a business should undertake a preliminary analysis based on the well-known PESTLE system. A business should also consider the risks laid out in section 2.1. In addition, many banks provide 'country guides'. The golden rule is to make full use of the services provided by organisations such as banks, trade bodies and chambers of commerce, as well as government departments. This will allow the business to obtain advice on the local business practices and information about the potential counterparty.

PESTLE

The PESTLE model is often used to assess the impact of external factors that affect a business and the market in which it operates.

It stands for:

Political

Economic

Social

Technological

Legal

Environmental

These are the factors that a business must contemplate before entering into an overseas market.

The following article provides an example of how you would apply PESTLE to trading in a foreign market:

https://www.nibusinessinfo.co.uk/content/pestle-analysis-example [Accessed: 7 September 2018].

Before entering into a contract with a counterparty, the business might proceed as follows:

- Check creditworthiness via an international credit reference agency.
- Ask for references.
- Check reputation with an overseas trade body, if such a body exists for the type of transaction under consideration.
- See whether the seller's own bank can obtain a status report via the banking system. However, many banks have ceased offering such a

service or have become reluctant to do so due to compliance rules, privacy considerations and an enhanced sensitivity to liability in case such a report is abused.

- Examine the published accounts.
- Obtain bank account details, such as the IBAN if in a country that uses these (see section 3.8.3). After obtaining the information, seek confirmation from a separate source within the counterparty business that the details are correct. However, due to privacy rules, banks are not allowed to provide information about their customers – they are not even supposed to indicate whether a business is a customer or not.

3.2.1 Potential dangers to avoid

The following examples are warning signs that should put a business on its guard:

- Bribery – if a 'facilitation fee' is required, take legal advice to ensure that the incentive is lawful. Most countries in the Organisation for Economic Co-operation and Development (OECD) have bribery and corruption laws that apply to domestic and international transactions.
- Failure of the counterparty to give clear answers to basic questions regarding financial or technical issues.
- Lack of a business logo, or use of an email address from Gmail, Yahoo or similar, which suggests a personal email as opposed to a website with a registered domain name (although this in itself is no guarantee of business integrity).
- An inappropriate address – if the businesses dealing with such transactions are located in a particular district, take care if your potential counterparty's address is somewhere else. Whenever possible, visit the business in person, though cost does have to be considered. While conversations over a medium like Skype can take place, it is easy for a fraudster to rent a palatial office for the day and conduct the conversation from these apparently impressive surroundings.

- Be aware of which factors can give rise to a suspicious transaction and what constitutes 'suspicion'. If something seems too good to be true, it usually is not true.

SUSPICIOUS TRANSACTIONS

Business proposals involving sugar, fertilisers, urea and scrap metal should be treated with caution. These commodities are sensitive to fraud, and only a few worldwide known traders deal with such commodities.

These warning signs will be covered in detail in Topic 5.

FACTFIND

Fighting global corruption

Visit the website of Transparency International, the global coalition against corruption:

https://www.transparency.org/news/feature/corruption_perceptions_index_2017 [Accessed: 7 September 2018].

Take a look at its latest survey – the Corruption Perceptions Index 2017 – which considers transparency on a country-wide basis.

3.2.2 Sanctions

SANCTIONS

"[. . .] Political trade restrictions put in place against target countries with the aim of maintaining or restoring international peace and security." (GOV.UK, 2016)

Any breach of sanctions, even if inadvertent, could result in a prison sentence, a heavy fine and major damage to reputation.

Check the route of the carrying vessel, as shipping via countries that are subject to sanctions will invariably result in a breach of those sanctions, even if the goods concerned never leave the ship until they reach the ultimate destination. For example, in August 2018 the US implemented sanctions on ships from China, Russia and Singapore for violating UN trade restrictions with North Korea (Haynes, 2018).

Other means of transport, such as air or land transport, can also be subject to sanctions. If the goods are despatched by a transport company that is on a sanctions list or owned by a government or resident of a country subject to sanctions, this will also result in a breach of the rules.

Intermediaries such as insurance companies, forwarders and surveyors can be subject to sanctions as well.

Sanctions are covered in more detail in Topic 5.

3.2.3 Pre-requisites

Once the seller and buyer are satisfied as to each other's integrity and the legality of the transaction, negotiations can begin. In the negotiation stages of a contract, a purchase order or a pro forma invoice may be issued. The two parties will need to enter into a binding contract (see Topic 4), which will cover, among other things:

- the terms of payment (open account, documentary collection, documentary credit or payment in advance);

- the denomination of the currency in which payment is to be made (see Topic 14 for consideration of foreign exchange risks);
- details of how the goods are to be despatched and who is responsible for the various stages of the journey.

It is vital that the commercial contract stipulates which Incoterm® will apply. Full details of Incoterms® 2010 (produced by ICC and applicable worldwide) are provided in Topic 6, together with details of the various documents required.

Sellers must take care to ensure that the goods shipped and any relevant documents are in accordance with the pro forma invoice, or the buyer may be able to refuse to accept/pay for the goods or may try to negotiate a lower price.

Once the commercial contract and Incoterm® have been agreed, each party can make appropriate arrangements for transportation (as described in section 3.3). In practice, trade bodies or chambers of commerce, or a freight forwarder, will normally be able to help with documentation for duty (such as value added tax), customs declarations, import licences and any other export formalities that may apply to the specific country or transaction.

3.3 Freight forwarders

FREIGHT FORWARDERS

The organisations that manage the movement of goods internationally using the appropriate mode of transport.

Freight forwarders are typically appointed by either the buyer or seller to organise the transport of goods. Many countries have freight forwarder trade bodies, which insist that their members adopt good practice and hold appropriate freight forwarder liability insurance. New sellers or new buyers should consult the appropriate trade body or a local chamber of commerce when selecting a freight forwarder.

A freight forwarder will book space on the appropriate transport mode, which could be by aircraft, ship, rail or road. The freight forwarder will arrange for the goods to be collected from the seller's premises and delivered to the carrier at the appropriate time and can liaise with its overseas offices to co-ordinate delivery to the buyer.

Freight forwarders may also offer additional services such as:

- warehousing;
- final assembly and packaging of goods (particularly useful if the importing country has its own specific regulations);
- managing customs requirements, including customs clearance of import freight and delivery to final destination;
- documentation services for documentary credits and documentary collections. They will draw up the documents and can guide the exporter through the whole process from start to finish.

CUSTOMS FORMALITIES

Governments or governing bodies of the individual countries concerned usually pass laws with which sellers and buyers must comply when they import goods into – or export goods out of – the country. Non-compliance can result in penalties, which may involve fines or even imprisonment.

These rules can be complex, and inexperienced sellers and buyers should leave the formalities to a suitably qualified freight forwarder or take advice from a chamber of commerce. Typical issues covered by the regulations are:

- details of goods that cannot be imported or are subject to licensing;

- the responsibility of buyers and sellers to submit documentation and pay any duties;
- the powers of customs officers to conduct physical inspections of the goods;
- import restrictions related to the total quantity of specific goods that can be imported. If these import quotas are exceeded, goods may be refused or may be subject to higher import duties.

3.3.1 Instructions to freight forwarders

Because transport is so complex, instructions should always be given to a freight forwarder in writing. The details to be communicated will vary, depending on the individual transaction. However, the following should normally be covered:

- name, address and other contact details of the seller and buyer;
- details of the collection and delivery address if they are different from that of the seller and buyer;
- whether the goods are classed as 'hazardous';
- details of the Incoterm® that applies;
- whether the freight forwarder is asked to arrange insurance;
- special instructions, for example whether the terms of payment are by documentary credit or documentary collection. It is of paramount importance that the forwarder is involved in such processes from the beginning; otherwise, documents may not be drawn up as stipulated in the documentary credit, or may be unusable for documentary collections.

3.4 Marine cargo insurance

Whenever goods are in transit, there is an obvious risk of loss or damage, which could have serious consequences for either the buyer or the seller, or both.

> **MARINE CARGO INSURANCE**
>
> Covers the risk of loss or damage to goods while being transported by any method, including road, rail, air and sea.

The Incoterm®, which should be specified in the commercial contract of sale, will clarify the point or place of 'delivery': the point when risk and liability pass from seller to buyer (see section 6.9.2 for a diagram which illustrates this). However, there are only two out of the 11 Incoterms® 2010 (CIF and CIP) that actually state who is specifically liable for providing insurance and which effectively require documentary evidence that insurance has been effected. If one of the other Incoterms® is used, the contract of sale should specify from which point the liability for the goods passes from one entity to the other.

For example, if the Incoterm® 2010 EXW applies, the seller's responsibility ends once the seller has sent a notice to the buyer enabling them to take delivery of the goods. From that moment on, the goods are at the buyer's risk. Incoterm® 2010 EXW does not stipulate that the buyer has to insure the goods; it is at the buyer's own discretion whether they do so or not.

If the seller fears that the buyer may not insure the goods for the part of the journey that is their responsibility, then the seller could arrange, and pay for, sellers' interest insurance. Sellers' interest insurance would compensate the seller if the goods were damaged in transit and as a result the buyer could not pay for them. The buyer should not be advised of the existence of any sellers' interest insurance.

Marine freight insurance is a specialist area, so it may be wise to consult an expert marine broker registered with Lloyd's. Alternatively, the freight forwarder could be instructed to arrange the insurance. In such cases, the seller or buyer may benefit from the 'bulk buying power' of the freight forwarder, who will be handling insurance for many clients.

3.4.1 Types of insurance contracts

There are two types of insurance contracts.

- **One-off**: an insurance contract is concluded for one voyage or one specific shipment only. The contract ends when the goods have arrived at the point indicated in the contract. In this case, the insured party will receive an insurance policy from the insurance company.
- **Open policy**: most corporates active in international business will conclude an open policy with an insurance company covering all their shipments with well-defined conditions (eg warehouse-to-warehouse). An annual fee is calculated based on the turnover of the corporate. If needed, an insurance certificate can be obtained, evidencing that the goods are insured under an open policy.

WAREHOUSE-TO-WAREHOUSE

"A warehouse-to-warehouse clause in an insurance policy provides for coverage of cargo in transit. A warehouse-to-warehouse clause usually covers cargo from the moment it leaves the origin-warehouse until the moment it arrives at the destination-warehouse. Separate coverage is necessary to insure the cargo while it is being stored in either warehouse." (Investopedia, no date)

Some transport documents also include an insurance contract, such as a truck consignment note (also known as a CMR), as explained in Topic 6.

3.5 Intermediaries used in indirect exporting

CHECK YOUR UNDERSTANDING

What is the difference between direct and indirect exporting?

Intermediaries that can assist a seller in indirect exporting are outlined here.

Export management companies

Export management companies will act as the export department for the seller and are set up to provide a whole range of services. They will act on behalf of the seller, either in the name of the seller or in their own name for a commission, salary, or retainer fee plus commission. Some of the larger export management companies can provide immediate payment for the seller by either arranging financing or by directly purchasing the product. Typically, the export management company will have expertise either in products or in the market, which is one of the main advantages to the seller. The main disadvantage of using such a firm is that the seller can potentially lose all control over the marketing and sale of its products.

Trading houses

Export trading houses will purchase the goods directly from the manufacturer and sell them on in an overseas market. They are often product-specific or market-specific. Once they have purchased the goods from the manufacturer, they are then able to sell them to whoever they wish and at whatever price they choose. Again, the manufacturing company will lose all control; however, the upside is that additional sales are generated.

Confirming houses

Confirming houses are not, strictly speaking, a route to entry for an exporting company. They are firms commissioned by a foreign buyer to find products from the country of the seller. They will seek to obtain the product at the lowest price and will be paid a commission by their foreign client. In some instances, confirming houses may be foreign government agencies or quasi-government firms that are tasked with promoting export trade for their country. They offer a guarantee of payment to the seller from the buyer, which is useful if the buyer has a poor credit rating. Some export credit agencies can fulfil the role of the confirming house (for more about export credit agencies, see Topic 13).

Buying agent (based in the seller's country)

Many large overseas companies or buying agencies will employ agents whose responsibility is to look for products and buy for their respective companies or clients. Their position is usually to source the product and negotiate the sales contract; however, because they are based in the home country, the sales contract would be subject to the home country's law.

Co-marketing

Co-marketing is an arrangement in which one manufacturer agrees to distribute a second firm's product or service. A typical example would be when a company has a contract with an overseas buyer to provide a wide range of products or services. The supplying company may not have the capability to fulfil the whole of the contract, so it will turn to other domestic companies to provide the remaining products. This second company is then able to export its products to the international market, which has the advantage to the second company that it is often able to export its product, sharing the marketing and distribution costs associated with exporting.

3.6 Agents or distributors

AGENT

A third party appointed by the exporting company to act on its behalf to market and sell its product or service in a particular geographical territory or industry sector.

Agents are often employed on a commission basis and usually work for a number of non-competing companies. Generally, they will negotiate a retainer fee and any subsequent sales will generate a commission. Because they are self-employed, the more sales they can generate, the more they can earn. Agency agreements are drawn up between the exporting company (the principal) and the agent, so the exporting company can be assured of having some control over who its goods are sold to and at what price. The agreement also defines the territory where the agent is allowed to market its product, so in any one country it is not unusual for a company to employ the services of several agents.

DISTRIBUTOR

Fulfils a similar role to an agent, with the main difference that the distributor usually makes an outright purchase of the goods and then sells them on, again in a specified territory, at a profit.

Using a distributor provides an advantage to the seller, as they are not usually responsible for any losses or claims incurred by the distributor. However, the main disadvantage is that as the goods have been sold to the distributor, the seller has less control over where and how they are sold. The distribution agreement can provide some protection.

Distribution agreements can either be sole distributorships, where the sole rights to sell the product or service in a particular market are granted, or a selective distributorship, where restrictions are applied as to whom (and under what conditions) the product or service can be sold.

TABLE 3.1 DIFFERENCES BETWEEN AGENTS AND DISTRIBUTORS

Agent	Distributor
Does not take ownership and control of the goods, therefore is not assuming risks	Purchases the goods outright, taking ownership and control, assuming all risks
Negotiates the sale of the goods on behalf of the exporting company for a commission	Sells the goods on to customers, making a profit
Has no authority to agree the sale price	Usually has the authority to set the selling price of the goods
Does not usually provide after-sales support for the buyer	Quite often provides after-sales support
	Can be selective or sole distributorships

3.7 The banker/customer relationship

Banks are important parties in a trade transaction. They offer a variety of services to buyers, sellers, transporters and others. Their role could involve financing, facilitating or advising other parties. These services are explained in section 3.7.1.

The general principles that govern any bank/customer relationship apply as much in trade finance as in any other service provided by a bank to its customer.

The bank, among other duties, has a duty to:

- make payment through a secure and reliable system;
- collect amounts payable to its customer in respect of cheques and other instruments, such as bills of exchange;
- provide regular statements;

- keep its customer's affairs confidential, subject only to certain laws that require information to be disclosed;
- have a clear complaints procedure;
- co-operate with the customer to protect against fraud and to prevent criminal activity in accordance with money-laundering regulations;
- handle transactions such as documentary collections, documentary credits and bank guarantees in a suitable manner, according to associated rule frameworks or legal requirements applicable to such transactions.

The customer has a duty to:

- provide its bank with any reasonable information requested about its activities and those of its customers;
- repay advances as agreed;
- pay reasonable charges;
- co-operate with the bank to protect against fraud and prevent criminal activity in accordance with money-laundering regulations.

3.7.1 Services provided by banks

Section 2.2.2 covered those services that banks may provide for customers planning to become involved in international trade. The remaining topics cover the services that make it possible for buyers and sellers to reach an agreement about where the balance of risk lies between the transfer of ownership of the goods shipped and being paid.

The services provided by banks can be categorised under the following general headings:

- providing advice and contact details for other supporting organisations, such as ICC offices;
- collecting and making payments;
- handling documents;

- providing guarantees that customers will fulfil obligations to trading partners;
- exchanging currencies and protecting customers against currency fluctuations;
- providing finance.

3.8 Correspondent banking

To provide many of the services listed in section 3.7.1, banks are often required to work with banks in other countries, collectively referred to as 'correspondent banks'. They may be separate banks or members of the same group.

For any domestic bank, their correspondents will include:

- wholly independent banks with which formal correspondent banking agreements have been reached;
- subsidiary or associate companies operating in another country also subject to a correspondent banking agreement;
- state-owned/government-owned banks;
- overseas branches of the domestic bank.

Alternatively, a company may use the services of a foreign bank's branch in the company's country for a transaction.

Banks can open representative offices in foreign markets. These operate without a banking licence, and will in many cases not be able to enter into correspondent banking agreements or conduct any transactions, but allow the bank to establish a presence in the other country.

Nowadays there are many regulatory obstacles with regard to compliance and risk policies (see section 1.6.1). As such, the cost and risk of maintaining relationships has significantly increased and many banks are reducing their correspondent networks.

The mechanisms used in correspondent banking are generally the same whatever the ownership relationship between the domestic bank and the overseas correspondent. Correspondent banking services include:

- ‘nostro’ and ‘vostro’ accounts;
- SWIFT payments (requiring IBAN and BIC numbers within the EU and a few other countries – see section 3.8.3);
- real-time gross settlement (RTGS);
- overseas bank accounts;
- bank drafts and customer cheques;
- continuous linked settlement (CLS);
- the handling of documentary collections;
- the issuance and/or confirmation of documentary and standby letters of credit;
- the issuance of direct or indirect bank guarantees.

3.8.1 Payments

There is strong pressure on financial organisations to deliver ever speedier and more efficient means of payment for international trade between countries.

Within the EU, the disappearance of exchange control regulations restricting transfers of funds in and out of countries has removed official barriers and delays to international money transmission, although it is important that full and accurate records of all transactions are maintained for statistical purposes, and also to aid detection of money laundering and other economic crimes.

Most banks now offer a full range of choices for international financial transactions, with prices reflecting the speed with which the transaction is completed. The rule is generally that the quicker the beneficiary (seller) receives cleared funds in its account, the higher the charge for the transaction. In today’s IT-enabled environment, funds can be transferred instantaneously around the world by interlinked computers at only a moderate cost to banks.

The main requirement to enable banks to make transfers between themselves is the transmission and receipt of an authenticated instruction from one bank to another, authorising the recipient bank to credit the account of the beneficiary (seller). Such instructions used to be transmitted by sea or air mail in signed documents to correspondent banks overseas and took an inordinate time to be acted upon. Each correspondent bank was sent books containing specimen signatures of those authorised to sign such instructions, so that messages could be confirmed as authentic by the recipient, and such signature books were regularly updated when staff changed. Later, instructions were sent between banks by telex or cable and, lacking signatures that could be authenticated, the messages were encoded and carried test keys, for which banks at either end held books of code tables, enabling authentication to be achieved.

Transfers made under such systems were once called 'mail transfers' (MTs), 'cable/telegraphic transfers' (TTs) or 'wire transfers' and, for a long time, these systems ran side by side, with all being used depending on the urgency of the transfers in question. Nowadays, funds transfer instructions are sent between banks almost instantaneously through the interlinking of computers, using systems such as 'SWIFT', and such transfers tend to be called 'international payments', 'priority payments', 'express payments', or 'ordinary' or 'urgent' payments, depending on the bank and type of payment required. Authentication is by encryption built into the system.

FACTFIND

World's largest secure financial messaging system

SWIFT (Society for Worldwide Interbank Financial Telecommunication) is a co-operative owned by its members. It operates the world's largest secure financial messaging platform for communicating payment and information relating to payments. SWIFT currently processes on average over 28.1m individual financial messages per day (SWIFT, 2018).

Find out more at www.swift.com [Accessed: 7 September 2018].

3.8.2 'Nostro' and 'vostro' accounts

As well as transmitting instructions to one another authorising transfers, banks need to have systems for settling up with each other financially in respect of such payments and, when different currencies are involved, nostro and vostro accounts are used. The word 'nostro' means 'our' and 'vostro' means 'your'.

EXAMPLE

From the point of view of a German bank, a nostro account is its account in the books of a foreign correspondent bank, denominated in foreign currency. An example would be an account in the name of Deutsche Bank, Frankfurt, in the books of Citibank, New York, denominated in US dollars. Deutsche Bank is a customer of Citibank.

From the point of view of a German bank, a vostro account is a foreign bank's account with that bank, denominated in euro. An example of a vostro account would be an account in the name of Citibank, New York, maintained in the books of Deutsche Bank, Frankfurt. The account would be denominated in euro and Citibank would be a customer of Deutsche Bank.

When funds are remitted from Germany, nostro accounts are used if the payment is denominated in foreign currency and vostro accounts are used if payment is denominated in euro.

(Adapted from: Wang, 2004)

Banks treat their nostro accounts in the same way as any other customer would treat their bank account. The bank will maintain its own record of the nostro account, known as a 'mirror account', and will reconcile the bank statements against these mirror accounts (Wang, 2004).

To maintain accurate records, the bank tries to value-date all transactions: the bank estimates the date on which authorised transactions will actually be debited or credited to the nostro account and it uses these dates in its mirror account (Wang, 2004). Value-dating of transactions is not possible everywhere – in these cases, credit or debit interests will be calculated.

3.8.2.1 Bookkeeping for transfers of funds

The following examples outline the bookkeeping for a French bank customer transferring funds to the bank account of a beneficiary abroad. It assumes that an account relationship exists between the respective banks.

EXAMPLE 1

In this example the funds being transferred are denominated in euro.

- The French customer is debited with the euro amount, plus charges, and this amount is credited to the euro account of the overseas bank (this is a vostro account from the French bank's point of view).
- On receipt of the advice, the overseas bank withdraws the euro from the vostro account, converts it to local currency, and then credits the beneficiary with the currency equivalent, less its charges.

EXAMPLE 2

In this example the transfer is denominated in foreign currency.

- The customer is debited with the euro equivalent, plus charges, of the required currency amount and the nostro account is credited with the currency (if the French customer maintains a foreign currency account, then the appropriate currency amount can be debited to that account, and there will be no need to arrange for conversion into euro).
- The overseas bank is advised that it can debit the nostro account with the requisite amount of currency and credit the funds to the account of the beneficiary.

The various methods of settlement all involve the same bookkeeping. The only difference is the method by which the overseas bank is advised about the transfer.

3.8.3 Use of BIC and IBAN

Banks require all transfers within the EU to include full and clear beneficiary bank and account details. These are known as Bank Identifier Code (BIC) and International Bank Account Number (IBAN) details, and are usually quoted at the top of bank statements of current account holders in the EU.

EXAMPLE OF A BIC

A typical BIC identifies the bank and branch. It would appear as follows: MIDLGB22123.

The BIC consists of a bank code (MIDL), a country ISO code (GB), and a branch identifier number (22123).

EXAMPLE OF AN IBAN

An IBAN identifies a specific bank account and makes it easier to process payments across borders. A typical IBAN can be up to 32 characters long and would appear as follows: GB15MIDL40051512345678.

The IBAN consists of the country code (GB), a check digit (15), the bank code (MIDL), followed by a sort code (400515) and an account number (12345678).

Inclusion of both of these codes in funds transfer instructions enables banks using SWIFT to send messages to each other using straight-through processing (STP), eliminating delays and queries.

STRAIGHT-THROUGH PROCESSING (STP)

A system where a transaction is processed by automated systems with minimal human intervention.

FACTFIND

IBAN

An IBAN-checking tool and more information on some of the systems mentioned are available online at the European Commerce Banking Services' website:

https://www.ecbs.org/iban.htm [Accessed: 7 September 2018].

In the example, a UK IBAN is used. Check to see whether the length and structure of the IBAN in the example is indeed correct.

Then look at how the IBAN would differ for other countries.

3.8.4 Real-time gross settlement (RTGS)

Banks, on their own behalf and on behalf of their customers and other large institutions, can also access electronic clearing and settlement systems. An example is the UK-based CHAPS payment system used by, among others, solicitors to make payments when a property purchase is completed. CHAPS provides a same-day, secure electronic transfer of funds in either pounds sterling or euro between member banks, a service known as RTGS.

REAL-TIME GROSS SETTLEMENT (RTGS)

A payment system that transfers and settles payments between banks electronically, in real time (instantaneously) and on a one-to-one basis.

Payments made either via SWIFT messages or by RTGS systems are irrecoverable. They cannot be withdrawn or cancelled once sent, even if they have been sent in error, unless the recipient agrees to return the money.

CHAPS payments in euro involve a linkage between the RTGS systems of each European country, a system called TARGET 2. TARGET 2 provides a direct payment platform in Europe without the involvement of the member country's own RTGS systems.

3.8.5 Overseas bank accounts

A company that expects to make or receive regular payments in another country may be able to open its own overseas account(s). Such companies open an account with their domestic bank's correspondent bank or, if their bank is represented in the overseas country by another member of the same banking group or by a branch, then an account can be opened with that group member or branch. Opening an account overseas will be subject to any local rules governing bank accounts and to any exchange controls applicable to accounts belonging to foreign nationals.

If the domestic bank of the company is a member of a group of banks with representation in the country with which it is trading, opening an overseas bank account can be a most efficient means of managing and transferring money. For example, a bank with an overseas subsidiary may offer a service that gives its customers with overseas accounts held with that subsidiary the ability to transfer money instantly between the two countries, giving payment instructions online.

The foreign bank may also offer specialised services such as zero-balancing, netting, sweeping, etc – all of which enable a company to optimise its cash position.

3.8.6 Bank drafts and customer cheques

Payments can also be made with bank drafts, a form of cheque drawn by a buyer's bank, payable to the seller and drawn on the buyer's bank's correspondent in the seller's country. If the draft is in the seller's own currency, the funds can be credited directly to the seller's account. If the draft is not in the seller's currency, its bank may negotiate the draft and credit the local currency equivalent at the prevailing exchange rate, subject to any charges. Otherwise, the bank will send the draft to the drawee bank for collection of the proceeds. Settlement between the banks will be via the nostro and vostro accounts.

A buyer can pay by issuing its own cheque, subject to local exchange control regulations. The seller's bank may either agree to negotiate the cheque – credit the seller's account immediately – or send the cheque to its correspondent to obtain payment, ie via a documentary collection (see Topic 8).

Negotiation will involve a charge to the seller to cover the interest cost to the bank for the period between making and receiving payment. This charge can be built into the exchange rate if the cheque is in a foreign currency. Negotiation will be 'with recourse', ie if the cheque is unpaid, the bank will debit the seller's account to recover the amount originally negotiated. Negotiation facilities are therefore at the bank's discretion.

A collection means that the seller will only get funds when its bank receives payment from the buyer's bank.

3.8.6.1 Disadvantages of using cheques

In some countries, sending a cheque abroad may contravene the exchange control regulations of the buyer's government. The buyer's bank and the beneficiary's bank usually impose heavy charges for handling such cheques.

There is an inevitable delay between the time when the cheque is collected and the time when funds are actually remitted by the buyer's bank. One method of speeding up the process of clearing cheques is to use a 'lockbox' facility, which is particularly useful for sellers who sell to the USA and who are paid by the buyer's cheque. The buyer is instructed to post the cheque to a post office (PO) box address in the

USA. A local bank opens the 'lockbox' at least once a day and initiates the clearing of the cheques. This process dramatically reduces the clearing time because the cheque itself does not have to go from the USA to the originating country and back again. Banks may be able to organise 'lockbox' facilities by making arrangements with correspondent banks abroad.

CHEQUE CLEARING

The process of presenting cheques for payment.

Over 20m cheques are used in the USA every day, but this is just a third of the total presented 20 years ago (Federal Reserve, 2018). In many regions, particularly Europe, the use of cheques is declining rapidly, and some places have eliminated them altogether, such as Finland and Poland.

3.8.7 Continuous linked settlement (CLS)

CLS is the name of an institution owned and operated by banks engaged in large multi-currency inter-bank settlements of money owed to other CLS participants, particularly for intra-day (same-day) foreign exchange transactions.

The benefits to bank participants are:

- elimination of settlement risk – the risk that one bank owing money to another does not pay;
- cost-efficiency;
- ease of management for the department of the bank that reconciles payments made and due.

At the height of the global financial crisis, some financial markets (such as the short-term inter-bank deposit and borrowing markets) 'froze'. However, the foreign exchange markets continued to function. Many commentators believe that it was the guarantee afforded by the CLS process that ensured confidence, and hence liquidity continued to be available.

The use of CLS has reduced the number of bank nostro/vostro account relationships.

EXAMPLE

CLS impact on nostro/vostro accounts

UK Bank plc may regularly send customer-initiated transfers of funds to several beneficiaries who bank at several different US banks. Prior to CLS, UK Bank plc would have needed nostro/vostro relationships with each US bank, the alternative being to face delays in the internal transfer of the funds within the USA. Now, UK Bank plc needs only one nostro account. UK Bank plc will use this nostro account to meet its obligations to CLS as regards the transfers of funds to US beneficiaries. It is CLS that will transfer the funds to the US banks, provided that UK Bank plc has sufficient balances in US dollars with CLS to meet these obligations.

Conclusion

In this topic we have seen that there are numerous parties and intermediaries within international trade, all of which have their own role to play in a transaction. It is the task of buyers and sellers to understand these roles. Intermediaries will enable the smooth settlement of a transaction by mitigating many of the risks we discussed in Topic 2. It is also important to understand how international banks work with each other to facilitate these transactions through systems such as RTGS and CLS.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- list the precautions that must be taken to ensure that a potential overseas business partner is reputable and creditworthy and that the underlying transaction is legal?
- explain what advice is available from ICC, trade bodies, banks and government departments?
- explain the role of freight forwarders in the movement of goods?
- explain how correspondent banks operate accounts for each other and make payments?
- describe the international conventions where banks and accounts are identified by IBAN and BIC numbers?
- discuss how RTGS technology is used to effect electronic payment exchanges?
- explain why international electronic payments are irrecoverable once sent?
- highlight the benefits of using CLS in the process of international funds transfer?

?

Test your knowledge

Use these questions to assess your learning for Topic 3. Review the text if necessary.

Answers can be found at the end of this book.

1) Which of the following is **not** a deterrent to initiating trade transactions with a new counterparty?

    a) An inappropriate address.

    b) Bribery.

    c) Financial status of the agent of the counterparty.

    d) Lack of business logo.

2) Freight forwarders are mainly:

    a) importers that provide the documentation and organisation related to the transportation of goods.

    b) exporters that provide the documentation and organisation related to the transportation of goods.

    c) trade bodies that provide the documentation and organisation related to the transportation of goods.

    d) agents appointed by the buyer/seller to organise the transportation of goods.

3) Authentication by encryption is an inherent feature of which of the following payment methods?

    a) Cable transfers.

    b) Electronic mail.

    c) Foreign cheque.

    d) SWIFT transfer.

4) Use of continuous linked settlement (CLS) systems has led to a reduction in the use of which of the following?

   a) Bank nostro accounts.

   b) BIC codes.

   c) Customer accounts.

   d) Overseas bank branches.

5) Which of the following services is provided as part of correspondent banking services?

   a) Freight forwarding facilities.

   b) Local current and OD accounts.

   c) Money exchange facilities.

   d) RTGS.

6) Which of the following is not an inherent part of an IBAN?

   a) Bank address.

   b) Bank code.

   c) Check digit.

   d) Sort code.

7) CHAPS payment in euro involves linkage between the RTGS systems of each European country and which of the following systems?

   a) CCS.

   b) CHIPS.

   c) SWIFT.

   d) TARGET 2.

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TOPIC 4

Contracts

Introduction

In a sale of goods and services, it is important to determine the liabilities, rights and duties of the parties involved. The most appropriate way to do this is to draw up a contract, which should be clear and unequivocal to all parties. In this topic, we will explain what makes a contract valid, what the various forms are, and which international conventions govern contracts. We will also look at the various methods of dispute handling and arbitration should the contract be breached.

LEARNING OBJECTIVES

By the end of this topic, you will understand:

- what makes a valid contract;
- offer, counter-offer and acceptance;
- the order process;
- contract management;
- the 1980 United Nations Convention on Contracts for the International Sale of Goods (CISG); and
- dispute handling and arbitration.

THINK ...

A Dutch importer of toys has met a Chinese manufacturer during a trade fair in Germany.

How will both parties proceed in coming to an agreement? Does saying ‘okay’ or shaking hands constitute a legally binding agreement? Which country's contract law will apply to them? What happens if one of them doesn't deliver as promised?

4.1 The contract

The definition of a contract varies from country to country and is dependent on the law that applies. However, in general terms a contract can be described as an agreement between two or more persons or entities, which may or may not contain specific terms, in which there is a promise to do something in return for a consideration.

Once the negotiation process is completed between the parties, the next stage is to draw up a contract. The first and most important question that arises in any international trade transaction is which law will govern the contract. The contract should always specify the applicable law as legal jurisdictions from around the world may have different laws and interpretations, with their own advantages and disadvantages. For example, French law recognises as a contract any agreement between parties who have negotiated in good faith, whereas English law does not recognise a duty of good faith. It is important for practitioners to understand local circumstances.

In general terms, for a valid contract to come into effect, the following conditions must have been met:

- There must be a **firm offer** and an **acceptance** of that offer.
- There must be an **intention** to create a contract.
- There must be **consideration** – each party provides something to the other.
- There must be **capacity** to contract – for a limited company that means that the nature of the business is within the objectives set out in the company's memorandum and articles.
- **Consent must be freely given** without duress and without basis in false information.
- The purpose must be **legal**.

The requirement for formal validity of a contract will differ in jurisdictions around the world. Local legal advice should always be taken as sometimes local laws will apply irrespective of the governing law chosen in the contract. In some jurisdictions even a verbal agreement is binding.

When the parties involved are frequent and experienced traders, they will usually each have a standard set of contract terms that they would like to impose on any orders. On many occasions, the parties involved will be satisfied with a pro forma invoice or an email with the specifications of the goods or services to be delivered, which will then be returned by the buyer with their approval.

PRO FORMA INVOICE

"An abridged or estimated invoice sent by a seller to a buyer in advance of a shipment or delivery of goods. [. . .] Pro forma invoices are commonly used as preliminary invoices with a quotation, or for customs purposes in importation. They differ from a normal invoice in not being a demand or request for payment." (BusinessDictionary, no date)

FACTFIND

ICC model contracts

The ICC Commission on Commercial Law and Practice develops model contracts and guides to international contracting:

https://iccwbo.org/media-wall/news-speeches/icc-model-contracts-assisting-professionals-to-effectively-draft-international-contracts/ [Accessed: 10 September 2018].

ICC's series of model contracts comprehensively sets out each party's rights and obligations. However, there will often be some need to vary any standard terms to meet local legal requirements or to suit specific circumstances and to reflect the relative commercial strengths of each side's position.

4.1.1 Negotiating the contract

Once a seller has produced the contract, it will constitute their offer to the buyer, who may respond in one of the following ways.

- **Give acceptance as presented**. Even a verbal agreement to the contract can constitute an acceptance in some jurisdictions. Additionally, acceptance may also occur by the parties beginning to perform the contract.
- **Give acceptance, but with reservations or conditions**. This represents a counter-offer, which will have to be considered by the seller, who may then accept the amendments proposed or go back with a further offer for the buyer to consider.
- **Reject the offer entirely**.

It is worth noting that buyers can also produce contracts and send them to sellers, who may respond in a similar way.

Offers and counter-offers may flow backwards and forwards between the parties until, eventually, either mutual agreement is reached or there is a final rejection and abandonment of the negotiation process, perhaps to be resumed at a later date.

Once final agreement is reached and signed by (or validly on behalf of) both parties, the contract will be binding to both the seller and buyer, and any further amendments will require consent of both parties, preferably evidenced in writing.

Once a contract is in place, all terms must be complied with. If they are not then this constitutes a breach of contract, unless there is some event that under the law of the contract brings it to an end, such as force majeure. Typical breaches would include delivery of substandard goods, late shipment or failure to carry out what was promised. A breach of contract by one party usually entitles the other party to make a legal claim for any losses suffered and, in some cases, to void the contract (ie walk away from their obligations).

FORCE MAJEURE

French for 'superior force', meaning an act of God. This is an event beyond the control of either party, such as riot, war or natural disaster.

However, in most commercial arrangements the parties will attempt to resolve their differences themselves and will only take the dispute to arbitration or some alternative dispute resolution or mediation if they cannot do so. Only as a last resort will the party facing an actual and significant loss go to the courts for redress, which is potentially expensive and time-consuming, and the outcome uncertain.

4.1.2 Information included in an international sales contract

For each sale it is usual for the contract to state the:

- currency to be used for payment;
- exact nature and quantity of the goods or services;
- price;
- packing requirements;
- inspection and quality control requirements;
- insurance requirements;

- shipping terms to be applied – who arranges and pays for carriage, freight and all other costs, duties and taxes at each stage of the goods' journey (see Topic 6 on Incoterms® for more information);
- date by which goods must be despatched/delivered;
- method and timing of payment, and at what point risk to, and ownership of, the goods shipped passes from the seller to the buyer.

4.2 The ordering process

The following list outlines in general terms how an order may be processed between a seller and a buyer. Note that this is only a guide and does not include financial instruments such as documentary credits or bills of exchange.

- An enquiry is received from a buyer.
- The seller determines whether they are able to fulfil the order and whether any modifications are required, etc.
- An export-costing exercise is carried out to verify whether the transaction is commercially viable.
- Due diligence may be carried out by the seller at this point to establish the creditworthiness of the buyer.
- A written quotation is submitted to the buyer.
- If the buyer accepts the quotation, they place an order.
- The seller accepts the order.
- The order is processed by the seller and arrangements are made for shipment of the goods or delivery of services.
- Goods are shipped.
- Any relevant documents are forwarded to the buyer or through the banking system for presentation to the buyer.
- Goods are received or services are delivered.

- Payment is made at the time and according to the method set out in the contract.

Where there is an established relationship, email/fax or electronic documentation may be used.

For some countries, the seller has to provide the buyer with a pro forma invoice, giving all the details of the proposed shipment. This may be required by the buyer to comply with local import controls, or for an application to the central bank for a release of foreign exchange, or to obtain approval for the issue of a documentary credit.

An example of a pro forma invoice is shown in Figure 4.1.

FIGURE 4.1 A PRO FORMA INVOICE

To JJF

[*full address*]

March 10, 20xx.

PROFORMA INVOICE

Your order reference, T098x/03.09/3/Marie 346754 dated March 4th, 20xx.

Supply and shipment of 50 computer games, model T098x, for delivery to Rouen on DDP terms by April 15th, 20xx.

A complete and clear description of the goods should be given

Origin: UK.

Packaging details: [*to be inserted*]

Total cost DDP Rouen Incoterms 2010: £37,500

Settlement terms: Bill for collection through Banque de Grand Crédit.

We look forward to receiving your final order.

Carl McBrain

For ALG

[*full address*]

Where there is no existing agreement, a seller may receive a pro forma invoice following a trade enquiry or even quite unexpectedly. In such cases, it represents a contractual offer from a potential buyer. The seller would need to make all necessary enquiries regarding the buyer and then decide whether to accept the pro forma invoice as submitted, to negotiate changes or to refuse it.

4.3 Contract management

The process – from potential order to a firm contract and finally to delivery – will often be time-consuming and may involve several departments on the seller's side. At pre-contract stage, the seller will have to liaise with its sales department and the production or supply department to be able to quote potential delivery dates and prices. The accounts or export department will have to become familiar with, and prepare, export documentation.

The credit control manager must understand how to manage the risks and consider the most appropriate method of settlement. That could be payment by open account, documentary credit, payment in advance or by bill for collection, depending on the new customer's credit standing and status report. We explore these methods of settlement, and the buyer and seller risks associated with each one, in more detail in Topic 7.

To fulfil the contract, a team effort is required and everyone involved must handle their part of the transaction with care to ensure that the export of goods is made in accordance with the relevant contract.

- Supplies need to be ordered or labour arranged.
- Goods must be manufactured.
- Packaging must be arranged.
- Transport and shipping space must be booked.
- Goods will have to be despatched to the port, airport or place of destination in time, or services delivered in a timely manner.
- All necessary documentation should be obtained and supplied by the export documentation department.
- The buyer should be advised of shipping details.

- All necessary documents must be submitted for payment directly to the buyer or via the banking system, depending on the method of payment set out in the contract, as quickly as possible.
- Effective export order management will be required to oversee all these functions and to periodically check progress.

Changes in costs between the dates of order and final completion are not unusual and such risks must be allowed for, whether in raw materials, labour costs, insurance and freight costs, or the ever-present factor of fluctuating exchange rates. The seller will need to monitor all of these issues if the contract is to be profitable and viable.

4.4 UN Convention on Contracts for the International Sale of Goods (CISG)

The 1980 CISG is an agreement under international law that provides a code of legal rules governing the formation of contracts for the international sale of goods. The CISG was developed by the United Nations Commission on International Trade Law (UNCITRAL) and although it was signed in Vienna in 1980 it did not come into force until 1 January 1998, when it was ratified by 11 countries. It is sometimes referred to as 'the Vienna Convention'.

As of September 2018, it had been ratified by 89 countries, which accounts for a significant proportion of world trade.

FACTFIND

CISG signatories

A full list of signatories for the CISG and their current status can be found at:

http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG_status.html [Accessed: 10 September 2018].

Countries that have ratified the treaty are referred to within the treaty as 'contracting states'. The CISG is deemed to be incorporated into the domestic law of any trade between these contracting states, unless excluded by the express terms of the individual contract.

The major absentees from this list include India, South Africa and the UK, which for domestic legal and governmental reasons have all decided not to ratify the CISG.

When dealing with counterparties in countries that have not ratified the treaty, traders need to be aware that local laws and customs will normally apply, unless otherwise specified in the contract, and they should not rely on the terms of the treaty to cover these transactions.

The CISG establishes universal rules for drafting international contracts and allows the exporter to avoid choice of law, which is a stage in the litigation of a case involving conflicts of laws.

The CISG is written in six languages – each described as "equally authentic" by UNCITRAL (2010, p32) – in a style that uses plain language. Each text avoids domestic legal terminologies and is translated so that it can be easily interpreted by the contracting states.

Small and medium-sized enterprises and traders located in developing countries can often have a relatively weak bargaining position when dealing with larger counterparties from the developed world. In addition, they generally lack access to legal advice when negotiating a contract. By providing fair and uniform regulations for contracts falling under its scope, the CISG can be particularly beneficial to such businesses.

FACTFIND

CISG

Visit the UNCITRAL webpages about CISG:

http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG.html [Accessed: 10 September 2018].

1) Find out which six languages the CISG has been written in.
2) Use the status or map page to find out whether your country has ratified the CISG.

4.4.1 Content of the CISG

The CISG is divided into four parts.

Part I – Sphere of application and general provisions (Articles 1–13)

The CISG is applied to sale of goods contracts between contracting states. It applies whether the parties reside in the same country or different countries. A contract between a trader from a contracting state and a trader from a country that has not ratified the CISG, such as India, may contain a clause that, in the event of arbitration, the CISG would apply. The CISG governs contracts for the international sales of goods between private businesses; it does not apply to sales to consumers and sales of services, and sales of certain specified types of goods are also outside its scope (for example, sales of stocks and shares, ships, planes and electricity are not governed by CISG).

One of the controversial features of the treaty is whether or not a contract needs to be signed to be binding. The CISG allows for a sales contract to be oral or unsigned; however, in some countries, a contract is not valid unless written. Parties to a contract will need to be aware of the rules that apply.

Part II – Formation of the contract (Articles 14–24)

Any offer to contract must be addressed to a person, must give full details of the goods, including price and quantity, and must indicate an intention for the person making the offer to be bound on acceptance.

Generally, once the offer has been made, it may only be subsequently revoked if the withdrawal reaches the offeree (ie the party to whom the offer has been made) before or at the same time as the offer has been received or before the offeree has accepted the offer. There are some offers that cannot be revoked, for example when the offeree has reasonably relied upon the offer as being irrevocable.

The CISG demands a positive act to indicate acceptance. Inactivity or silence is not recognised as acceptance.

Part III – Sale of goods (Articles 25–88)

Articles 25–88 outline the obligations of the seller and of the buyer, including those common to the buyer and seller, and the passing of risk.

Under the CISG, the seller "must deliver the goods, hand over any documents relating to them and transfer the property of the goods, as required by the contract" (UNCITRAL, 2010, p9). The duty of the buyer is to take all steps "which could reasonably be expected" (p18) in order to both take delivery of the goods and pay for them. In addition, the buyer is to examine the goods and advise the seller within a "reasonable time" (p12) of any lack of conformity.

Although the CISG outlines when the risk passes from the seller to the buyer, in practice it is the underlying Incoterm® (such as FOB or CIF) that will be followed (see Topic 6 for further discussion of Incoterms®).

Part IV – Final provisions (Articles 89–101)

The final provisions outline how and when the CISG comes into force, permitted reservations and declarations, and the application of the CISG to international sales where both trading countries have the same or similar law.

FACTFIND

Case law

A body of case law has been developed over the years and is available via internet sources, which you can access at this link:

> www.uncitral.org/uncitral/en/case_law.html [Accessed: 10 September 2018].
>
> Visit this website and examine a small sample of recent case law entries to familiarise yourself with the types of cases concerned.

4.4.2 Criticism of the CISG

In the event of breaches in contract, decisions made by the courts can be inconsistent between different contracting countries. This is because the CISG is naturally interpreted by judges using the underlying principles and methods that are common in their domestic law.

There is also criticism that the multiple-language versions of the treaty are not totally consistent with each other – although this could be said about all treaties that are translated into multiple languages.

There are also criticisms that the CISG is incomplete. For example, the CISG considers neither electronic contracts nor the sale of services, and it does not govern the validity of the contract.

4.5 Dispute handling and arbitration

However carefully contracts are drawn up, it is impossible to foresee every eventuality and, when buyers and sellers are unfamiliar with each other's commercial practices, laws and customs, misunderstandings will occur.

When this happens, there are three basic means of resolving a dispute:

1) Both sides first attempt to reach a mutually satisfactory **compromise**. This is cheap, with no third-party fees (arbitrators or lawyers) and, if successful, will not get in the way of future opportunities for doing business together.

2) **Arbitration** involves both sides agreeing to an independent means of resolving a dispute and deciding what each party should do to resolve matters. There are costs involved.

3) A **legal remedy** involving lawyers and courts, maybe in unfamiliar jurisdictions. After both sides have taken legal advice, they may agree to compromise or take matters before a court for a decision. An application to a court for a decision to resolve a dispute is usually a last resort because of the uncertainty of outcome, the cost and the bad feeling that is often engendered between the parties. However, when a general principle of law is at issue, this may be the only option.

Overseas agents can prove to be useful when a dispute arises. In fact, a reputable agent should prevent a dispute from arising in the first place. However, that is not always the case. Agents, frequently of the same nationality and culture as the overseas customer, can stray from full support of their principal's interests, particularly if regular communication is not maintained.

Because there is always a possibility that a dispute may end up in court, it is vital that contracts specify the jurisdiction that will apply and that the jurisdiction specified is one that is respected and whose laws are clear. If arbitration clauses are included in a contract, the jurisdiction specified should be one that is tolerant of arbitration.

Arbitration can come about either because the parties to a contract have written an arbitration clause into the contract or because, when a dispute has arisen, they have agreed to resolve the issues by arbitration.

MODEL LAW ON INTERNATIONAL COMMERCIAL ARBITRATION

Some countries have adopted UNCITRAL's 'Model Law on International Commercial Arbitration' (originally published in 1985). This law defines an arbitration agreement as:

- "an agreement by the parties to submit to arbitration all or certain disputes which have arisen or which may arise between them in respect of a defined legal relationship, whether contractual or not";
- "an arbitration agreement may be in the form of an arbitration clause in a contract or in the form of a separate agreement". (UNCITRAL, 2008, p4)

Arbitration can therefore cover all aspects of a commercial contract, not just transport issues. The use of Incoterms® will make it easier to resolve matters covered by Incoterms®.

4.5.1 Arbitration courts

There are a number of organisations that provide arbitration services; ICC is one of them. Since its inception in 1923, the ICC International Court of Arbitration (known as 'the Court') has handled more than 23,300 cases, and in 2017 the cases involved parties and arbitration from 142 countries (ICC, 2018).

FACTFIND

ICC Arbitration

Visit the ICC Arbitration webpage to familiarise yourself with the countries and types of cases it deals with:

https://iccwbo.org/dispute-resolution-services/arbitration/ [Accessed: 10 September 2018].

Other arbitration courts include:

- the London Court of International Arbitration (LCIA);

- the American Arbitration Association International Centre for Dispute Resolution;
- the Hong Kong International Arbitration Centre.

The Court and other institutions have established rules of arbitration and model contract terms. The LCIA (no date) recommends that the following arbitration clause be inserted into contracts:

- "Any dispute arising out of or in connection with this contract, including any question regarding its existence, validity or termination, shall be referred to and finally resolved by arbitration under the Rules of the LCIA, which Rules are deemed to be incorporated by reference to this clause.
- The number of arbitrators shall be [one/three].
- The seat, or legal place, of arbitration shall be [City and/or Country].
- The language used in the arbitration proceedings shall be [. . .].
- The governing law of the contract shall be the substantive law of [. . .]".

The English courts have reinforced the value of arbitration clauses by deciding that businesses that freely enter into such clauses should expect to resolve disputes accordingly.

Typically, the party raising the dispute will refer the matter, with reasons, to the arbitration court agreed upon. If the dispute is submitted to the ICC Court, the other party must respond within 30 days.

The arbitrators will then study these submissions and related documents and hear the arguments put by the parties. The arbitrators will hear witnesses, including experts, called by the parties and may appoint their own experts to examine the issues.

The decision made by the arbitrators, including deciding who should pay the costs of arbitration, is binding upon the parties. However, there will be an appeal process, for example if one party feels that the arbitrators have been biased.

FACTFIND

LCIA rules

You can find the rules of the LCIA in detail on the LCIA's website:

http://www.lcia.org/dispute_resolution_services/lcia-arbitration-rules-2014.aspx [Accessed: 10 September 2018].

Conclusion

All parties involved in a sale of goods or services should be well aware of their rights, duties and liabilities. A contract, in whatever form it takes, is the best way to formalise the obligations of both parties and helps to avoid disputes. However, breaches in contract can occur and, should there be a misunderstanding or dispute, there are guidelines and institutions to facilitate resolutions.

THINK AGAIN ...

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- list the key factors that must be evident in a contract?
- explain when contracts are put in place and what they cover?
- describe the order process?
- describe what contract management is?
- elaborate on the CISG, its content and the general criticisms of it?
- discuss dispute handling and arbitration?

Test your knowledge

?

Use these questions to assess your learning for Topic 4. Review the text if necessary.

Answers can be found at the end of this book.

1) The ICC International Court of Arbitration requires an initial response to its approach to the party from which resolution has been sought within:

   a) 30 days.

   b) 45 days.

   c) 60 days.

   d) 90 days.

2) The UN Convention on Contracts for the International Sale of Goods (CISG) is divided into four parts. True or false?

3) In general terms, for a contract to come into effect, which of the following conditions must be met?

   a) There must be a firm offer, with or without acceptance.

   b) The intention to create a contract.

   c) Consent must be freely given without duress or basis in false information.

   d) The purpose must be legal.

4) Where there is no existing agreement, a seller may receive a pro forma invoice following a trade enquiry. In this case it represents a contractual offer from a potential buyer. True or false?

References

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Further reading

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ICC (2016) *ICC Model Contracts: assisting professionals to effectively draft international contracts* [online]. Available at: https://iccwbo.org/media-wall/news-speeches/icc-model-contracts-assisting-professionals-to-effectively-draft-international-contracts/ [Accessed: 10 September 2018].

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Trade-based financial crime compliance

Introduction

Effective, trade-based compliance regimes are critical in combatting financial crime and ensuring that international laws and regulations are respected. In this topic, you will learn about forms of trade-based financial crime such as money laundering, terrorist financing and sanctions evasion. You will also learn about the underlying activities that motivate these crimes. Examples include human trafficking, migrant smuggling, the illegal drugs trade and the proliferation of weapons of mass destruction. All such activities involve the illegal movement of funds, some of which will be through international trade. It is, therefore, critical for financial institutions to play their part in deterring and preventing such activity.

LEARNING OBJECTIVES

By the end of this topic, you will understand:

- types of trade-based financial crime;
- risks that financial crime and non-compliance present to banks;
- international bodies that have a remit to tackle financial crime;
- operational procedures that banks must follow in financial crime prevention;
- key warning signs of potential criminal activity relating to trade finance transactions; and
- regulatory frameworks governing the prevention of financial crime.

THINK . . .

What are the consequences of financial crime in your country? How would you deal with suspicious activity related to financial crime? Does your bank or financial institution provide guidance on dealing with suspicious activity?

5.1 Open account trade and financial crime

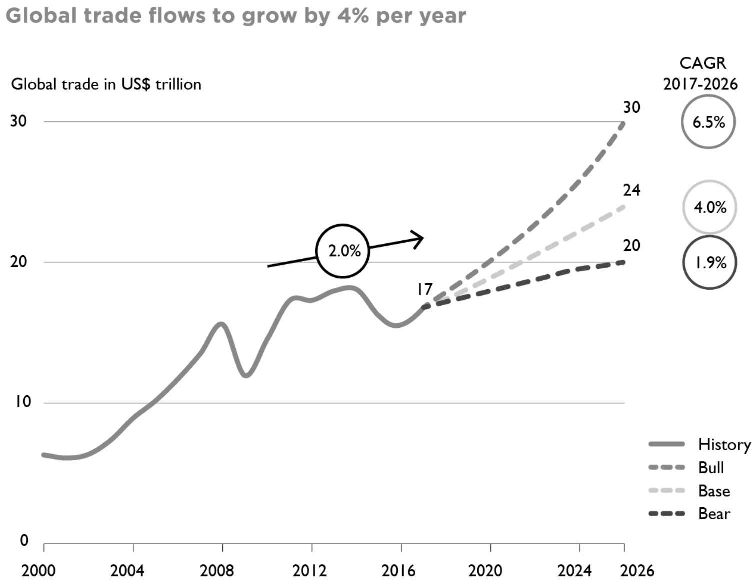
In section 1.6, you learned about the continued increase in international trade and its positive impact on economic growth. In Topic 11, you will learn about the corresponding rise in trade finance carried out on an open account basis.

Since 2000 there has been a dramatic rise in the volume of international trade. This is projected to increase still further with expected growth at 4 per cent per year, as shown in Figure 5.1. Banks have played a crucial role in international trade's meteoric rise through offering services and products that allow buyers and sellers to increase their trading activity.

In any trade transaction, it is likely that more than one bank will be involved at some point. However, as you learned in earlier topics, banks rarely come into physical contact with the goods being traded; they deal only with documentation. The amount and form of documentation provided varies according to the type of transaction.

With documentary credits, for example, banks will probably have access to shipping, commercial and financial documents such as bills of lading, commercial invoices and bills of exchange. In contrast, with open account trade, there may be little or no documentation available. As a consequence, financial crime is much harder to detect, particularly in relation to money laundering.

FIGURE 5.1 PROJECTED GLOBAL TRADE FLOWS TO 2026 (USD TRILLION)



CAGR = Compound Annual Growth Rate

Bull = a higher than projected growth rate

Base = projected growth rate

Bear = lower than projected growth rate

Source: Boston Consulting Group (2017)

5.2 Forms of financial crime

In the sections that follow we will cover money laundering, terrorist financing, sanctions evasion and the underlying activities that drive financial crime.

Money laundering

This refers to the act of concealing the origins of money that has been obtained through criminal offences such as drug trafficking. You will learn more about this in section 5.2.1.

Terrorist financing

Defining terrorist financing is a fairly straightforward matter, but it is difficult to find a universal definition of a terrorist. You will learn more about the definition of terrorist acts used by the Financial Action Task Force (FATF) and the United Nations (UN) in section 5.2.2.

Sanctions evasion

International sanctions are put in place to deter and punish activity that destabilises the peaceful world order. You will learn more about sanctions and how they are evaded in section 5.2.3.

Underlying activities

The following are some of the underlying activities that drive financial crime.

- **Human trafficking** – "Every year, thousands of men, women and children fall into the hands of traffickers, in their own countries and abroad. Almost every country in the world is affected by trafficking, whether as a country of origin, transit or destination for victims" (UNODC, 2018a).
- **Migrant smuggling** – "Migrant smuggling affects almost every country in the world. It undermines the integrity of countries and communities, and costs thousands of people their lives every year" (UNODC, 2018b).
- **Illegal drugs** – UNODC stated that there were 167,750 deaths in 2015 directly related to drug use disorders (UNODC, 2018c).

FACTFIND

Activities that drive financial crime

Read the latest news about efforts to fight some of the underlying activities that drive trade-based financial crime on the UNODC website:

https://www.unodc.org/unodc/index.html?ref=menutop [Accessed: 2 November 2018].

5.2.1 Money laundering

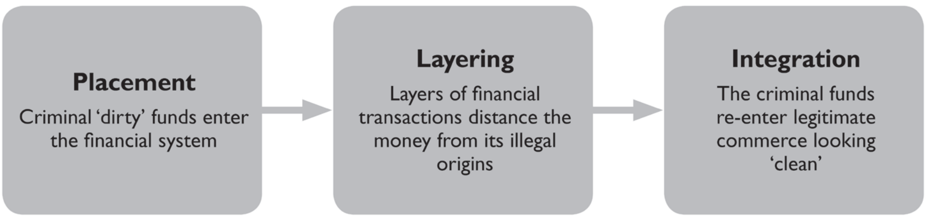
Money laundering refers to the offence of concealing and transferring illegally obtained money, then reintroducing it back into the financial system. Put simply, the purpose of money laundering is to make ‘dirty’ money obtained through illegal activity look ‘clean’.

The ‘laundering’ process involves changing the ownership of illegally procured assets such as cash, bank accounts, cars, machinery and houses to hide underlying illicit transactions. The origin of these assets is further disguised so that the sources seem legitimate. These assets are then channelled back into the financial system.

Historically, the term ‘money laundering’ was only applied to financial transactions carried out by organised crime such as in the illegal drug trade. However, the term now also covers white collar crime such as tax evasion and false accounting as well.

There are three recognised stages to money laundering, as shown in Figure 5.2.

FIGURE 5.2 STAGES IN MONEY LAUNDERING



Source: Adapted from FATF (2018a)

Money launderers are becoming increasingly sophisticated and it is, therefore, even more difficult to spot suspect transactions. For example, if a documentary credit is used as a means to ‘clean’ money, all of the three stages could take place at the same time.

All banks are required by law to have procedures in place, including appropriate staff training, to forestall money laundering.

5.2.1.1 Main methods used in trade-based money laundering

A report by the Wolfsberg Group, ICC and BAFT highlights the main methods used in trade-based money laundering "to obscure the illegal movement of funds". Examples include "misrepresent[ing] the price, quality or quantity of goods" (Wolfsberg Group, ICC and BAFT, 2017).

The main methods identified in the paper are outlined in Table 5.1.

TABLE 5.1 TRADE-BASED METHODS OF MONEY LAUNDERING

Method	**Description**
Over-invoicing	By misrepresenting the price of the goods in the invoice and other documentation (stating it at above the true value) the seller gains excess value as a result of the payment.
Under-invoicing	By misrepresenting the price of the goods in the invoice and other documentation (stating it as below the true value) the buyer gains excess value when the payment is made.
Multiple invoicing	By issuing more than one invoice for the same goods a seller can justify the receipt of multiple payments. This will be harder to detect if the colluding parties use more than one [financial institution] to facilitate the payments and/or transactions.
Short-shipping	The seller ships less than the invoiced quantity or quality of goods, thereby misrepresenting the true value of goods in the documents. The effect is similar to over-invoicing.
Over-shipping	The seller ships more than the invoiced quantity or quality of goods, thereby misrepresenting the true value of goods in the documents. The effect is similar to under-invoicing.

Deliberate obfuscation of the type of goods	Parties may structure a transaction in a way to avoid alerting any suspicion to FIs or to other third parties which become involved. This may simply involve omitting information from the relevant documentation or deliberately disguising or falsifying it. This activity may or may not involve a degree of collusion between the parties involved and may be for a variety of reasons or purposes.
Phantom shipping	No goods are shipped and all documentation is completely falsified.

Source: The Wolfsberg Group, ICC and BAFT (2017)

Note: In all of these scenarios, in order for the illegal activity to have the most chance of success, there will be collusion between buyer and seller. For example, with over-invoicing, the buyer will be well aware that it is being asked to pay an inflated price. The purpose of over-invoicing is, of course, for an illegitimate payment to be made from the buyer to the seller *separate and in addition to* the purported trade transaction.

5.2.2 Terrorist financing

There is no single definition of terrorism, however, as a catch-all the FATF definition includes "unspecified acts carried out with the relevant intention to cause death or serious bodily injury to a civilian, or to any other person not taking an active part in the hostilities in a situation of armed conflict with the purpose of intimidating a population, or compelling action by a government or an international organisation" (FATF, 2016).

Implications of terrorist financing

The reputational risk to any bank that becomes involved in terrorist financing is potentially huge. The implications are not just financial but may be devastating in human terms.

Similarities between money laundering and terrorist financing

There are common features between money laundering and terrorist financing.

- The destination of money used to support terrorism has to be disguised in the same way as the source of laundered funds.
- Both activities involve the financial sector.

Even if the source of funding for terrorist activity is legitimate, terrorists will often attempt to disguise it in order to preserve future funding. Many of the techniques used will be the same as techniques used to disguise the sources of the proceeds of crime.

Banks also face difficulties in identifying assets that are derived from legitimate sources but are destined to fund future acts of terrorism.

Prevention

The key to preventing both money laundering and terrorist financing is the adoption of robust customer due diligence (CDD) procedures, both at the commencement of a relationship and on a continuing basis (see section 5.4.5).

In section 5.2.3 you will learn about sanctions related to terrorist financing

5.2.3 Sanctions evasion

"Sanctions are a tool that can be used to persuade an individual, organisation or country to conform to specific rules or laws. Most sanctions are economically and/or politically motivated and may encompass the freezing of assets, including payments; restrictions on trade; cessation of diplomatic, cultural, and sport exchanges; and even military intervention. Sanctions may be issued by national and supranational bodies and can take on different forms. They can be preventative or reactive in nature, as well as domestic or international in focus.

While a range of different sanctions may be applied, those most often impacting on financial institutions are financial sanctions. These generally restrict or prohibit the passing of funds or economic resources to certain individuals, entities, or even countries."

"Sanctions are most often used internationally:

- to change the behaviour of a specific country or regime;
- to pressure a specific country or regime to achieve an outcome;
- to prevent the financing of terrorism;
- when international peace and security is threatened;
- when all diplomatic efforts have failed."

(Aragona and Wandhöfer, 2017)

Sanctions relating to terrorist financing

The UN regularly issues a list of known terrorist organisations and individuals to the regulatory agencies of governments and banks around the globe.

In addition, some countries apply financial sanctions against targeted individuals and countries. Banks will be subject to these sanctions to the extent that their laws specify.

Financial institutions will migrate these lists into their payment and trade transaction centres and systems. As SWIFT messages go through these centres, they will be screened against the lists to check for individuals and organisations subject to sanctions.

Staff at banks and financial institutions need to be aware of how sanctions can override other internationally accepted rules such as the ICC rules you learned about in earlier topics. For example, sanctions overrule ICC rules for documentary credits, eg UCP 600. Additionally, the use of sanctions clauses can cause confusion, especially where confirmation is required.

FACTFIND

UN Security Council consolidated list of sanctions

Find out more about current sanctions on the UN website:

> https://www.un.org/sc/suborg/en/sanctions/un-sc-consolidated-list [Accessed: 2 November 2018].
>
> Find out more about ICC guidance on the use of sanctions clauses in trade finance-related instruments that are subject to ICC rules:
>
> https://iccwbo.org/publication/guidance-paper-on-the-use-of-sanctions-clauses-2014/ [Accessed: 2 November 2018].

Sanctions screening

Many online systems provide a robust screening process that has proved to be far more effective than checks carried out manually by operational bank staff. Staff with the skills to deal with potential issues can then focus on alerts generated by online systems.

Such systems provide a wide range of services and have the ability to track:

- marine vessels;
- high-risk organisations; and
- politically exposed persons (PEPs).

Banks and financial institutions must focus on training and providing their staff with up-to-date knowledge in order for them to deal with the information generated. Detailed records of potential breaches and consequential actions must be maintained and retained.

5.2.4 Proliferation and proliferation financing

UN Security Council Resolution 1540 affirms that "the proliferation of nuclear, chemical and biological weapons, as well as their means of delivery, constitutes a threat to international peace and security" (UNODA, 2004).

Certain countries have been accused of bombing their own citizens using chemical weapons or using chemical nerve agents against individuals living in other countries who are seen to be a threat. There is near unanimous international agreement that the spread of weapons of mass destruction should be curtailed. Regions such as the EU control the “export, transit and brokering of dual-use items” as part of efforts to ensure international peace and security, and to prevent the proliferation of weapons of mass destruction (European Commission, 2018).

KEY TERMS

Proliferation

A sudden increase in number or amount.

Proliferation financing

“[T]he act of providing funds or financial services which are used, in whole or in part, for the manufacture, acquisition, possession, development, export, trans-shipment, brokering, transport, transfer, stockpiling or use of nuclear, chemical or biological weapons and their means of delivery and related materials (including both technologies and dual use goods for non-legitimate purposes), in contravention of national laws, or where applicable, international obligations.” (FATF, 2008)

Dual-use items

Goods, software and technology that can be used for both civilian and military applications.

Taking a risk-based approach

The most obvious way that financial institutions can contribute is to adopt a risk-based approach and have an effective policy in place for transactions involving dual-use goods. This should begin when customer due diligence (CDD) and know your customer (KYC) checks are carried out on new customers. Enhanced CDD should also incorporate checks on dual-use goods and high-risk jurisdictions. You will learn more about KYC and CDD in section 5.4.5. Identification of dual-use goods in trade transactions can be challenging given their complex and technical nature.

EXAMPLE

If a pharmaceutical company purchases bacterial strains for medical research, such a transaction will probably be considered legitimate. If, however, the buyer is found to be engaged in another industry then clearly all parties involved in the transaction must be investigated further. These investigations must be documented and the suspicions reported as appropriate.

Most of the regulatory provisions regarding weapons of mass destruction fall within sanctions regimes. However, bank personnel must be aware of these concerns and remain alert.

5.2.5 Other forms of financial crime

The banking system is vulnerable to fraudulent acts. The following are some issues of which practitioners need to be particularly aware.

FRAUD

Stealing money, property or services by deception, false pretences or misrepresentation.

Forged signatures

A bank has virtually no chance of recovering on a draft, cheque or promissory note from any party whose signature has been forged.

Fake, faulty or non-existent goods

Banks often rely on the goods for security in a trade transaction and if the goods themselves have no value, the bank has no security. An independent inspection of the goods prior to lending may mitigate this risk.

Fraudulent claims

Fraudulent claims occur most often in the insurance industry. A common example is inflated claims, where either the value of what is lost is exaggerated or the claim is 'added to' by including other goods that were not damaged. Whilst relatively rare, fraudulent claims may also be made against demand guarantees and standby letters of credit (see Topic 10).

Cybercrime

Some of the main dangers to the world banking system come from criminals intent on stealing money from banks or their clients by illegally hacking into IT systems, often diverting funds and information for their own benefit. Another common form of cybercrime is 'phishing', where emails purporting to come from banks persuade clients to reveal passwords and other private information to criminals.

Fraud related to trade

Fraud can take place at various points in international supply chains. Useful sources of information include Lloyd's of London Sea-Searcher checks and publicly available information from shipping companies that identify vessel journeys.

FACTFIND

Checks and processes

Guidance on key process flows and points at which checks should be made can be found in the appendices that accompany the report on trade finance principles by the Wolfsberg Group, ICC and BAFT. Appendix I covers documentary credits, appendix II bills for collection, appendix III guarantees and standby letters of credit, and appendix IV open account trade:

> https://www.wolfsberg-principles.com/sites/default/files/wb/pdfs/comment-letters/6.%20Trade-Finance-Principles-Wolfsberg-Group-ICC-and-the-BAFT-2017.pdf [Accessed: 2 November 2018].

5.3 Effects of financial crime

As highlighted at the start of this topic, financial crime can have devastating effects, expanding beyond financial implications to include people, communities and countries. For banks themselves, the following are two key risks that arise from becoming party – however unwittingly – to financial crime.

Reputational risk

Banks that become involved in a major money-laundering or terrorist-financing incident will suffer damage to their reputation that may prove more costly than any fines imposed. Additionally, the more that a bank is perceived to be weak in its control of financial crime, the more attractive it becomes to criminals and the less attractive it becomes as a correspondent bank. Many banks have undergone a process of rationalising their correspondent banking network to avoid potential exposure to banks without sufficiently high standards of compliance. This process is widely known as 'de-risking'.

CORRESPONDENT BANK

"Banks or financial institutions that act as an agent on behalf of other financial institutions, usually foreign banks" (Bankrate, 2018). Services offered include cross-border payments, treasury management, foreign exchange and international investments.

Legal risk

The penalties for breaching regulations relating to financial crime can range from fines on financial institutions to, in extreme cases, loss of banking licences. Individuals may be prevented from working in the finance industry and potentially face imprisonment. A bank must, therefore, ensure that all employees are informed of their obligations under the law and receive regular training.

Every bank must have written policies and procedures for escalating suspicions related to financial crime. Practitioners must be aware of these procedures and know to whom they must report suspicions.

FACTFIND

Reputational damage

"Danske Bank [has] admitted [. . .] that as much as $235 billion of transactions flowing through its Estonian branch between 2007 and 2015 may have been suspicious and connected to potential money laundering." (Martin, 2018)

Find out more about the impact on the bank and its senior executives:

http://uk.businessinsider.com/analysts-danske-bank-fines-could-hit-8-billion-in-money-laundering-scandal-2018-9?IR=T&r=US [Accessed: 2 November 2018].

5.4 Financial crime prevention

Financial crime is a global problem, and a number of international bodies have been created to pool resources in the fight against it. The FATF (covered in section 5.4.2) and the Wolfsberg Group (covered in section 5.4.3) promote a risk-based approach to managing financial crime. CDD and KYC are inherent components of the risk-based approach. You will learn about this specifically with reference to account opening and maintenance in section 5.4.5. Finally, you will learn about some key indicators of trade-based financial crime in section 5.4.6.

5.4.1 Risk-based approach

The risk-based approach, introduced by the FATF in 2014, requires member jurisdictions to first identify, assess and understand the money-laundering and terrorist-financing risks that they are exposed to. The second recommended step is to implement effective mitigation measures that are commensurate to those risks (FATF, 2014).

The key factors to consider when applying a risk-based approach include:

- product type;
- jurisdiction;
- customer type;
- volume and value of transactions.

By taking a risk-based approach, banks can ensure they focus their systems and controls on areas of highest risk. The same key factors have also been identified by the FATF in their international standards on combating money laundering, financing of terrorism and proliferation: the FATF Recommendations (see section 5.4.2.1).

FACTFIND

Industry guidance

Review the Wolfsberg Group Statement on the risk-based approach to managing money-laundering risks to understand how to be most vigilant where the threats are greatest:

https://www.wolfsberg-principles.com/sites/default/files/wb/pdfs/wolfsberg-standards/15.%20Wolfsberg_RBA_Guidance_%282006%29.pdf [Accessed: 2 November 2018].

Find out more about the risk-based approach recommended for the banking sector by the FATF:

http://www.fatf-gafi.org/media/fatf/documents/reports/Risk-Based-Approach-Banking-Sector.pdf [Accessed: 2 November 2018].

5.4.2 Financial Action Task Force

"The Financial Action Task Force (FATF) is an inter-governmental body [. . .] that set[s] standards and promote[s] effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system. FATF is therefore a 'policy-making body' which works to generate the necessary political will to bring about national legislative and regulatory reforms in these areas" (FATF, 2018b).

The FATF developed a series of recommendations that "form the basis for a co-ordinated response to [. . .] threats to the integrity of the financial system and help ensure a level playing field. First issued in 1990, the FATF Recommendations were revised in 1996, 2001, 2003 and [. . .] in 2012 to ensure that they remain [current] and relevant, and they are intended to be of universal application" (The Wolfsberg Group, ICC and BAFT, 2017). Updates are issued frequently, most recently in October 2018.

"The FATF monitors the progress of its members in implementing necessary measures, reviews money laundering and terrorist financing techniques and counter-measures, and promotes the adoption and implementation of appropriate measures globally. In collaboration with other international stakeholders, the FATF works to identify national-level vulnerabilities with the aim of protecting the international financial system from misuse" (John et al., 2014).

Originally a G7 initiative, the FATF now has 37 members (see Table 5.2) of which 35 are jurisdictions and two, the European Commission and Gulf Co-operation Council, are regional organisations. In addition, there are international and regional organisations that are associate members, observer countries and observer organisations of the FATF that participate in its work. In addition, the FATF has a network of FATF-style regional bodies (FSRBs), creating a global network of 204 jurisdictions. The FATF headquarters is housed at the Organisation for Economic Co-operation and Development in Paris.

TABLE 5.2 MEMBERS OF FATF (2018)

Argentina	France	Republic of Korea	Singapore
Australia	Germany	Luxembourg	South Africa
Austria	Greece	Malaysia	Spain
Belgium	Hong Kong, China	Mexico	Sweden
Brazil	Iceland	Netherlands	Switzerland
Canada	India	New Zealand	Turkey
China	Ireland	Norway	UK
Denmark	Italy	Portugal	USA
Finland	Japan	Russian Federation	

Source: FATF (2018c)

FACTFIND

Is your country a FATF member, associate member or does it have observer status?

Visit the FATF website and view the other international and regional organisations that are associate members, observer countries and observer organisations of the FATF that participate in its work:

http://www.fatf-gafi.org/countries/ [Accessed: 2 November 2018].

5.4.2.1 FATF Recommendations

Following an examination of the techniques used by launderers and trends in money-laundering activity, the FATF published international standards containing 40 recommendations. These recommendations were most recently updated in October 2018.

"The FATF Recommendations set out a comprehensive and consistent framework of measures which countries should implement in order to combat money laundering and terrorist financing, as well as the financing of proliferation of weapons of mass destruction. Countries have diverse legal, administrative and operational frameworks and different financial systems, and so cannot all take identical measures to counter these threats."

(FATF, 2018d)

"The FATF Recommendations set out the essential measures that countries should have in place to:

- identify the risks, and develop policies and domestic co-ordination;
- [investigate] money laundering, terrorist financing and the financing of proliferation;
- apply preventive measures for the financial sector and other designated sectors;
- establish powers and responsibilities for the competent authorities (eg investigative, law enforcement and supervisory authorities) and other institutional measures;
- enhance the transparency and availability of beneficial ownership information of legal persons and arrangements; and
- facilitate international co-operation."

(FATF, 2018d)

The 40 FATF Recommendations are grouped in the following categories:

- anti-money-laundering/countering the financing of terrorism (CFT) policies and co-ordination;
- money laundering and confiscation;

- terrorist financing and financing of proliferation;
- preventative measures;
- transparency and beneficial ownership of legal persons and arrangements;
- powers and responsibilities of competent authorities, and other institutional measures; and
- international co-operation.

FACTFIND

Read the FATF Recommendations in full at:

http://www.fatf-gafi.org/publications/fatf recommendations/documents/fatf-recommendations.html [Accessed: 2 November 2018].

How closely are FATF Recommendations followed?

Does your organisation adhere to the FATF Recommendations? Focus on the Recommendations listed here.

- CDD – Recommendation 10.
- Record keeping – Recommendation 11.
- PEPs – Recommendation 12.
- Reporting of suspicious transactions – Recommendation 20.
- Tipping-off and confidentiality – Recommendation 21.

If you don't work for a bank or financial institution, research other banks and financial institutions in your country.

5.4.3 The Wolfsberg Group

The Wolfsberg Group is an association of global banks that has developed frameworks and guidance for the management of financial crime risks. The 13 constituent banks are Banco Santander, Bank of America, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JPMorgan Chase, MUFG Bank, Societe Generale, Standard Chartered Bank and UBS.

One of the major contributions of the Wolfsberg Group to trade finance is the 2017 report, *Trade finance principles*, published in conjunction with ICC and BAFT (see sections 5.2.1.1 and 5.4.1). The report "outlines the standards for the control of financial crime risks associated with trade finance activities. In this paper, the term 'financial crime' refers to money laundering (all crimes including, but not limited to, fraud, tax evasion, human trafficking), bribery and corruption, terrorist financing, the financing of proliferation of weapons of mass destruction and other related threats to the integrity of the international financial system" (The Wolfsberg Group, ICC and BAFT, 2017).

FACTFIND

Trade-based money laundering

Watch the following video as an introduction to trade-based money laundering and how to prevent it:

https://www.kaltura.com/index.php/extwidget/preview/partner_id/1362782/uiconf_id/12749201/entry_id/0_v4hj3ryl/embed/auto?&flashvars%5bstreamerType%5d=auto [Accessed: 2 November 2018].

Other publications by the Wolfsberg Group relevant to trade

Besides the report on trade finance principles, other reports and recommendations that have been considered by many banks worldwide include:

Wolfsberg anti-money laundering principles for correspondent banking (2014): https://www.wolfsberg-principles.com/sites/default/files/wb/pdfs/wolfsberg-standards/8.%20Wolfsberg-Correspondent-Banking-Principles-2014.pdf [Accessed: 2 November 2018].

Wolfsberg Group payment transparency standards (2017): https://www.wolfsberg-principles.com/sites/default/files/wb/pdfs/wolfsberg-standards/1.%20Wolfsberg-Payment-Transparency-Standards-October-2017.pdf [Accessed: 2 November 2018].

Wolfsberg guidance on politically exposed persons (PEPs) (2017): https://www.wolfsberg-principles.com/sites/default/files/wb/pdfs/wolfsberg-standards/4.%20Wolfsberg-Guidance-on-PEPs-May-2017.pdf [Accessed: 2 November 2018].

5.4.4 Financial intelligence units

A financial intelligence unit (FIU) "serves as a national centre for the receipt and analysis of [. . .] suspicious transaction reports; and [. . .] other information relevant to money laundering, associated predicate offences and financing of terrorism, and for the dissemination of the results of that analysis. The FIU should be able to obtain additional information from reporting entities, and should have access on a timely basis to the financial, administrative and law enforcement information that it requires to undertake its functions properly" (Egmont Group, 2018a).

Many countries have an FIU that will provide information on current money laundering and terrorist financing trends. The Egmont Group is a united body of 159 FIUs. It "provides a platform for the secure exchange of expertise and financial intelligence to combat money laundering and terrorist financing that aims to facilitate international co-operation. [It meets] regularly to find ways to co-operate, especially in the areas of information exchange, to train, and to share expertise" (Egmont Group, 2018b).

FACTFIND

International co-operation

Explore FIUs in various countries.

- UK: www.nationalcrimeagency.gov.uk.
- USA: https://www.fincen.gov.
- Hong Kong: https://www.jfiu.gov.hk/en/.
- Singapore: https://www.police.gov.sg/about-us/organisational-structure/specialist-staff-departments/commercial-affairs-department/aml-cft.
- Australia: www.austrac.gov.au.
- Canada: www.fintrac.gc.ca.

[All accessed: 2 November 2018].

Research the most appropriate FIU for your jurisdiction on the Egmont Group website:

https://egmontgroup.org/en/content/financial-intelligence-units-fius [Accessed: 2 November 2018].

5.4.5 Due diligence

Account opening and maintenance

Banks handle their legal responsibilities on a 'risk assessment' basis. That is, they examine the nature of the businesses they deal with and the processes involved and apply a risk assessment to each business and process. Opening an account for a new customer, for instance, is an activity where there is a real risk of taking on a customer involved in criminality. To minimise this risk, customer due diligence (CDD) and know your customer (KYC) procedures are required.

KYC *V* CDD

Practitioners should be aware that KYC refers to the initial gathering of information, whereas CDD broadly refers to the assessment of the information gathered and continuous monitoring.

The better a bank knows its customers and understands the basics of its commercial relationship with them, the less likely it is to be associated with a firm that will attempt to carry out money-laundering or terrorist-financing activity.

CDD for trade account customers

"CDD for trade account customers, both borrowing and non-borrowing, requires the [financial institution] to have an understanding of the business model, the principal counterparties, the countries where the counterparties are located and the goods or services that are exchanged, as well as the expected annual transaction volumes and flows" (The Wolfsberg Group, ICC and BAFT, 2017).

CDD requirements are based broadly on the following procedures:

- Account information must include all of the customer's address information, contact details and taxation information.
- Account information must be retained and be made accessible in trade finance processing systems.
- Changes to customer information must be made immediately to computer databases.
- Material changes in ownership must be noted in customer information files.

Regulatory requirements

Regulators expect the bank to carry out CDD on the customer that is classified as the 'instructing party' for the purpose of the transaction.

They also expect relevant information to be available to trade finance operations staff so that they can ensure the transaction meets the parameters of the account. Parties included as 'applicant or beneficiary' or 'drawer or drawee' will be designated as 'instructing parties' by most regulators.

Additional due diligence on other parties to the transaction should be performed, as dictated by the bank's own financial crime risk-management policies and procedures.

Account maintenance

Once an account is open and transactions are passing through it, bank staff should be aware of money-laundering techniques. Transactions that might put staff 'on notice' include:

- requests that do not seem to make commercial sense, such as selling goods at well below market price;
- unusual sums in cash being paid in or transferred;
- the involvement of third parties – if the customer is acting for someone else, then the bank needs to know who they are and be satisfied that they are bona fide;
- transactions that involve 'inappropriate assets' – for example, why would a company selling computer parts from China to France suddenly want to ship an expensive car to Colombia?

Banks and financial institutions also need clear policies and procedures in place should a transaction appear to be suspicious. Staff should report their suspicions to the designated money laundering reporting officer (MLRO).

Regular reviews of business practices

Trade practitioners need to be aware of their customers' business and business patterns to ensure that no 'irregular' transactions are processed without appropriate review. Where a review has taken place, this must be recorded and retained for future reference.

5.4.6 Monitoring key indicators

When international trade transactions appear to be 'outside the norm', or if certain elements are missing from a transaction, additional scrutiny is warranted. Some regulators have published lists of key indicators, often referred to as ‘red flags’. Many banks and financial institutions customise these lists for their staff. The list that follows is not exhaustive.

- Missing transport documents evidencing movement of goods.
- Description of goods on the transport document not matching the documentary credit terms and/or actual invoice.
- Customers resubmitting documents that have already been rejected due to financial crime or suspicion of financial crime.
- Military goods.
- Goods such as sugar, cement, urea, precious gemstones, luxury cars, mobile phones, tobacco/cigarettes, liquor and scrap metals.
- Dual-use goods (as defined in section 5.2.4).
- Bill of lading consigned to a ‘to be advised party’ chosen between applicant and beneficiary.
- Request for proceeds of the transactions to be paid to an unrelated or unexplained third party.
- Change of a beneficiary name and address.
- Trade-related standby letter of credit claim made within a short time or immediately on/after issuance.
- Direct claim to issuer, where the trade-related standby letter of credit is advised through another bank with the claim to be routed via a nominated bank.
- Invoice showing other/undefined charges as being greater than a percentage variance (to be determined by the individual bank) of the total transaction value.
- Documentary credit overdrawn/overshipped by more than a percentage variance (to be determined by the individual bank) of the original value/quantity.
- Bill of lading describing containerised cargo but without container numbers or with sequential container numbers.

- Intermediary trade where price difference/arbitrage is greater than a percentage variance (to be determined by the individual bank) of the transaction value.
- Transaction requires referral.
- Suspicious client contact.
- Pre-accepted discrepancy(ies) by the applicant.
- Applicant is overly keen to waive discrepancy(ies).
- Shipment locations of the goods or shipping terms are inconsistent with the documentary credit.

FACTFIND

Signs and warnings

The following Financial Conduct Authority (FCA) report provides examples of trade-based money-laundering red flags to watch out for. Navigate to Appendix 1 on p46:

https://www.fca.org.uk/publication/thematic-reviews/tr-13-03.pdf [Accessed: 2 November 2018].

Red flags to watch out for in trade finance have also been identified in the following paper published by the Singapore-based AML/CFT Industry Partnership (ACIP). Navigate to section 4.1 on p15:

https://abs.org.sg/docs/library/best-practices-for-countering-trade-based-money-laundering.pdf [Accessed: 2 November 2018].

5.5 Regulation

Breaches in compliance with regulations and laws have cost many banks heavily. As you learned in section 5.3, many banks have paid out multibillion dollar settlements for alleged cases of money laundering, sanctions evasion or misleading clients. Increasingly, legislation is aimed at the criminal prosecution of individuals involved in processing or facilitating each transaction.

5.5.1 International regulation

In this topic you have learned about various international bodies, such as the FATF and the Wolfsberg Group, that have produced guidance, standards and principles to help prevent financial crime. Although these international bodies cannot impose fines or enforce legislative action, the FATF Recommendations *are* used internationally to guide government regulators who can then impose fines or enforce legislative actions as appropriate. You will learn more about domestic regulation in section 5.5.3.

Review of correspondent relationships

Besides the FATF Recommendations and the trade finance principles published by the Wolfsberg Group in conjunction with ICC and BAFT, various other guidelines are available to help prevent financial crime. The Basel Committee on Banking Supervision in Switzerland, for example, published a report on the sound management of risks related to money laundering and financing of terrorism in 2014. This was revised in 2016 and further revisions were made in 2017 to the annex on correspondent banking. These are in line with FATF guidance on correspondent banking published in 2016. The report by the BIS is "part of a broader initiative to assess and address the decline in correspondent banking coordinated by the Financial Stability Board" (BCBS, 2017).

FACTFIND

Delegating CDD?

Find out more about how banks use other banks, financial institutions or third parties to perform CDD in Annex 1 of the following report by the Basel Committee on Banking Supervision:

https://www.bis.org/bcbs/publ/d405.htm [Accessed: 14 November 2018].

More about the level of money-laundering and terrorist-financing risks posed by correspondent banking relationships can be found in Annex 2 of the same report.

5.5.2 Regional regulation

Banks in countries that are members of regional trade groups are often required to obey laws and regulations made outside their own countries.

In the European Union, for example:

- the European Securities and Markets Authority controls banks and others involved in the securities industry and trading infrastructure;
- the European Banking Authority regulates and enforces EU rules on capital requirements, credit and market risk, liquidity, leverage and resolution of institutions in case of collapse;
- the European Insurance and Occupational Pensions Authority will have an interest in banks operating in those areas; and
- the European Central Bank in Frankfurt controls banks in areas of the EU that use the euro.

New European preventative measures

In May 2018, the European Council strengthened existing EU rules to prevent money laundering and terrorist financing. Key improvements include:

- "broadening access to information on beneficial ownership, improving transparency in the ownership of companies and trusts;
- addressing risks linked to prepaid cards and virtual currencies;

- cooperation between financial intelligence units; and
- improved checks on transactions involving high-risk third countries."

(European Council, 2018)

FACTFIND

New rules for Europe

Read about the European Council's updated rules for money laundering and terrorist financing:

https://www.consilium.europa.eu/en/press/press-releases/2018/05/14/money-laundering-and-terrorist-financing-new-rules-adopted/ [Accessed: 2 November 2018].

5.5.3 Domestic regulation

Mutual evaluations

The FATF monitors the effectiveness of its Recommendations and how its network of 204 jurisdictions have implemented technical requirements through FATF-style regional bodies (FSRBs) (see section 5.4.2). Peer reviews of each jurisdiction are conducted regularly through FSRBs to assess levels of implementation, providing "in-depth description and analysis of each country's system for preventing criminal abuse of the financial system" (FATF, 2018e).

FACTFIND

Consolidated assessment ratings

Download the consolidated table of assessment ratings from the FATF website to compare how different countries have performed:

http://www.fatf-gafi.org/publications/mutualevaluations/documents/assessment-ratings.html [Accessed: 14 November 2018].

(This is available in both Excel and PDF format.)

As it is beyond the scope of this qualification to cover regulation in every country, you will now learn about the extent to which international standards and guidelines are enforced alongside local legislation in the UK, USA, Hong Kong, Singapore and China.

UK

The Bank of England has wide responsibilities for monitoring the soundness and suitability of banks operating in the UK. Through the Prudential Regulation Authority, the Bank assesses risks taken, not only by UK banks but also foreign banks based in the UK. The FCA polices all financial markets in the UK, watching out for mis-selling and other forms of financial crime. Legislation, such as the Bribery Act 2010, has had a positive effect on tracking criminal funds that are inevitably transmitted through the banking system.

FACTFIND

Assessing good and bad practice

In 2013 the FCA conducted an in-depth thematic review assessing banks' control of financial crime risks in trade finance.

Areas reviewed included governance and management information, risk assessment, policies and procedures, due diligence, training and awareness, anti-money-laundering procedures, sanctions and counter-terrorism financing controls.

Review the consolidated examples of good and poor practice highlighted in the report on p42–45.

https://www.fca.org.uk/publications/thematic-reviews/tr13-3-banks%E2%80%99-control-financial-crime-risks-trade-finance [Accessed: 2 November 2018].

USA

In the USA many organisations exist to regulate banks including:

- the Office of the Comptroller of the Currency;
- the Federal Reserve System;
- the Department of the Treasury, which includes the Office of Foreign Assets Control (OFAC); and
- the Department of Justice.

FACTFIND

Sanctions enforcement in the USA

As with most jurisdictions, economic and trade sanctions imposed by the USA are based on foreign policy and national security goals. These sanctions are "against targeted foreign countries and regimes, terrorists, international narcotics traffickers, those engaged in activities related to the proliferation of weapons of mass destruction, and other threats to the national security, foreign policy or economy" (US Department of the Treasury, 2018).

Research some of its recent activities:

https://www.treasury.gov/about/organizational-structure/offices/Pages/Office-of-Foreign-Assets-Control.aspx [Accessed: 2 November 2018].

The Federal Reserve is the central bank of the USA. It is responsible for regulating the US monetary system, as well as monitoring the operations of holding companies, including traditional banks and banking groups. The US Department of the Treasury was originally created to manage government revenues but has evolved to encompass several different duties (Council on Foreign Relations, 2018). These include recommending and influencing fiscal policy, regulating US imports and exports (managing OFAC), and collecting US revenues such as taxes; it also designs and mints all US currency.

Hong Kong

The principal regulators are the Hong Kong Monetary Authority, the Securities and Futures Commission, the Office of the Commissioner of Insurance, and the Mandatory Provident Fund Schemes Authority. They are responsible respectively for regulation of the banking, securities and futures, insurance, and retirement scheme industries.

Singapore

Banks are regulated by the Monetary Authority of Singapore (MAS), the central bank of Singapore. MAS is also the financial regulatory authority and its main role is to administer statues pertaining to money, banking, insurance, securities and the financial sector in general, as well as currency issuance.

FACTFIND

Fighting crime together

Money-laundering and terrorist-financing risks facing Singapore are addressed through the ACIP, a private–public collaborative effort. Established in 2017, it "brings together the financial sector, regulators, law enforcement agencies and other government entities to collaboratively identify, assess and mitigate key and emerging money laundering and terrorist financing risks facing Singapore" (ABS, 2016).

Find out more:

https://abs.org.sg/industry-guidelines/aml-cft-industry-partnership [Accessed: 2 November 2018].

You should have already read about red flags in the ACIP report mentioned in section 5.4.6. If not, this would be a good time to go through the report. Also highlighted are "recent typologies" and "industry best practices for the identification and mitigation of [trade-based money laundering] risks" (ABS, 2016).

https://abs.org.sg/docs/library/best-practices-for-countering-trade-based-money-laundering.pdf [Accessed: 2 November 2018].

China

The China Banking Regulatory Commission (CBRC) has responsibility for combatting financial crime. It is also responsible for prudential regulation, with a mandate to protect the interests of depositors and consumers as well as to maintain market confidence. The People's Bank of China (PBoC), the central bank, controls monetary policy and other regulatory powers. The State Administration of Foreign Exchange (SAFE) is responsible for drafting rules and regulations governing foreign exchange market activities and managing the state foreign exchange reserves.

FACTFIND

Regulation of banking in China

Find out more:

CBRC: http://www.cbrc.gov.cn/english/index.html

PBoC: https://www.centralbanking.com/organisations/peoples-bank-of-china-pboc

SAFE: https://www.safe.gov.cn/en/MajorFunctions/index.html

[All accessed: 2 November 2018].

5.5.4 Domestic regulation with international implications

Domestic regulation can have implications for businesses operating internationally. For example, the US Sarbanes–Oxley Act (SOX) 2002 was passed after the Enron collapse to oblige companies to work to higher standards of honesty and accuracy. However, as most banks around the world need US dollar accounts to trade internationally, compliance with SOX provisions is essential, as well as with the Dodd–Frank Act 2010. Failure to comply would put banks at risk of being unable to trade in US dollars. Senior executives at banks operating outside the country could even potentially face criminal charges in the USA should they contravene either of these laws.

PATRIOT Act

Another important piece of legislation in the fight against money laundering is the USA PATRIOT Act 2001. The acronym stands for Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism.

The Act reduced restrictions on law enforcement agencies' ability to search telephone, email, medical, financial and other records. It also gave these agencies the authority to regulate financial transactions, particularly those involving foreign individuals and entities.

5.5.5 Environmental and sustainability compliance

Many banks have environmental and sustainability targets as part of their corporate social responsibility policies. As this area becomes increasingly scrutinised, it adds another layer of potential regulation.

As you learned in section 1.1.4, more national, regional and international regulators have recognised the need to combat and adapt to the impact of climate change. Many support the Paris Agreement and are committed to the UN's Sustainable Development Goals.

Responsible organisations have begun to source raw materials and process goods responsibly due to increased awareness of the potential damaging impacts of uncontrolled development on the environment and its inhabitants. As consumers become more aware of their power as buyers, the pressures for responsible, sustainable farming and manufacturing will mount even further.

Sustainable trade and its finance is therefore set to grow in the short and long term. Banks and finance providers should be prepared to comply with increasing requirements in this area.

Conclusion

In this topic we have provided an overview of financial crime, focusing on money laundering, financing of terrorist activity and the proliferation of weapons of mass destruction.

We have considered the international bodies that have a remit to prevent financial crime, in particular the FATF and the Wolfsberg Group.

We have outlined the measures that banks must put in place in order to prevent financial crime and some of the warning signs relating to international trade finance transactions of which practitioners should be aware. We have also looked briefly at other common types of financial crime that sometimes take place through the banking system.

Finally, we have given an overview of the regulatory environment in which banks must operate.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- discuss the way in which laundered funds are 'layered'?
- outline the role of the Egmont Group?
- name the two keys risks facing banks in relation to financial crime?
- explain the purpose of 'customer due diligence'?
- discuss the purpose of monitoring warning signs?

Test your knowledge

?

Use these questions to assess your learning for Topic 5. Review the text if necessary.

Answers can be found at the end of this book.

1) Which of the following is not a stage in the money-laundering process?

   a) Placement.

   b) Layering.

   c) Integration.

   d) Structuring.

2) What is the full name of the intergovernmental body charged with developing and promoting policies to combat money laundering and terrorist financing?

   a) Financially Appropriate Task Force.

   b) Focus Action Territory Force.

   c) Financial Action Task Force.

   d) Final Active Territory Force.

3) How many Recommendations did the organisation from the previous question make?

   a) 30.

   b) 40.

   c) 50.

   d) 60.

4) When does the UCP overrule sanctions regulations?

   a) In the applicant's country of origin.

   b) In the beneficiary's country of origin.

   c) On every occasion.

   d) Never.

5) What is the name given to a financial transaction where no goods are shipped and all documentation is completely falsified?

   a) Spectre shipping.

   b) Phantom shipping.

   c) Ghost shipping.

   d) Zombie shipping.

6) Which organisation acts as a central bank for the USA?

   a) Federal Reserve System.

   b) OFAC.

   c) Bank of America.

   d) Office of the Comptroller of the Currency.

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Documents used in international trade and the Incoterms® 2010 rules

Introduction

Building on the knowledge you gained about contracts in Topic 4, you will now learn more about documents used by buyers and sellers and the significance of common shipping terms.

The number of documents required in a transaction and the content of the documentation will vary greatly according to the underlying contract, the nature of the goods, the complexity of the export sale, the type of shipment/transport required, and the rules, restrictions and trade agreements applicable to the transaction and the countries concerned.

Besides financial and commercial documents, we will also cover transport and insurance documents used in international trade.

LEARNING OBJECTIVES

By the end of this topic, you will understand:

- the sale and purchase of goods within the EU customs union and elsewhere;
- financial documents, including bills of exchange and promissory notes;
- other documents used in international trade, including transport, commercial and insurance documents; and
- the ICC Incoterms® 2010 rules.

THINK . . .

Think back to the Dutch buyer of toys produced in China mentioned in Topic 4.

Who will take care of transportation? What about customs clearance and insurance? How can the Dutch buyer take possession of the container of toys when it arrives in the port of Rotterdam?

6.1 Sale and purchase of goods within the EU customs union

In the EU, most goods circulate freely once inside EU borders, whether they are made within the EU or imported from outside. All customs posts at frontiers between EU countries have been abolished, but they remain at the external borders of the EU.

EXAMPLE

EU customs requirements

There are no entry or exit customs requirements for the documentation for a sale of computer games from Denmark to France. Furthermore, if the games have been imported into Denmark and duty paid at the Danish border, they may be sold on to France without formality, except for reporting for statistical purposes. Value added tax (VAT), a tax on goods and services levied on sales in Denmark, or its equivalent in other countries, is paid by buyers on trade within the EU.

Some goods do remain controlled and may not be exchanged, even between EU members, without formality:

- Excise goods – alcoholic drinks, tobacco and hydrocarbons.

- Animals and food products controlled under the EU Common Agricultural Policy.
- Military equipment.
- Explosives (including fireworks) and firearms.
- Prohibited (banned) and controlled (permission required) drugs.

Three of the four European Free Trade Area (EFTA) countries (Norway, Iceland and Liechtenstein) have joined with the EU to form the European Economic Area (EEA), whereby they have free trade agreements but customs formalities remain in force. The other EFTA country, Switzerland, has a separate agreement with the EU.

Many countries and territories have some preferential tariff agreements with the EU. Importing from those countries involves the buyer demonstrating that the imports adhere to the EU's rules.

At the time of writing in October 2018, the impact of Brexit (ie the UK leaving the EU) on the formalities applicable to the trade between the UK and other EU countries, or between the UK and countries outside of the EU, is not yet known.

6.2 Sale and purchase of goods in the rest of the world

Each country will need to be considered individually and/or as part of another trading bloc such as the North American Free Trade Agreement (NAFTA), the trading bloc of the USA, Canada and Mexico. Some countries impose strict regimes as part of an economic policy to restrict imports; others are more liberal.

A few countries are on a list where trade is restricted by the USA. The US authorities will seek to impose their laws, even on other countries exporting to these restricted countries, if those exports contain any US components.

FACTFIND

US trade restrictions

You can find this information on the Department of the Treasury Resource Center's website:

https://www.treasury.gov/resource-center/sanctions/Pages/default.aspx [Accessed: 20 August 2018].

New trading blocs are appearing regularly. The Comprehensive Economic and Trade Agreement (CETA) between Canada and the EU entered into force provisionally on 21 September 2017, and negotiations began in 2013 for the proposed Transatlantic Trade and Investment Partnership (TTIP) between the USA and the EU. The Trans-Pacific Partnership (TPP) was a proposed trade agreement between the USA and several Pacific Rim countries. It was signed on 4 February 2016 but was never ratified and did not take effect.

The World Trade Organization (WTO) aims to secure a worldwide trade agreement. The Doha Round, a round of trade negotiations among WTO membership, succeeded in passing a trade agreement with the purpose of lowering global trade barriers. The agreement was passed in a meeting in Bali, Indonesia in December 2013, with subsequent related decisions adopted on 27 November 2014. However, in some cases, local trading treaties are yielding results earlier than the long-running WTO negotiations.

FACTFIND

Trade agreements

Find out which trade agreements (if any) your own country is a member of, and which other countries are also members.

Note that your country may be a member of more than one group.

For example, if you come from Singapore, you will be a part of both of the following:

- Association of Southeast Asian Nations (ASEAN): www.asean.org [Accessed: 20 August 2018].
- Regional Comprehensive Economic Partnership (RCEP): http://asean.org/?static_post=rcep-regional-comprehensive-economic-partnership [Accessed: 20 August 2018].

6.3 Financial documents

It used to be common practice to use cheques or bank drafts to make payment for goods purchased abroad. However, these payment methods are becoming obsolete in many regions. Although it is still possible to make use of them, this topic will examine two other financial documents with a long history of use in international trade: the bill of exchange and the promissory note. These are widely used today and their specific use will be discussed in later topics.

6.3.1 Bill of exchange

A bill of exchange (or 'draft') is a convenient method of collecting debts internationally, with a special status recognised in many jurisdictions.

Many commercial laws of countries worldwide contain regulations about drafts.

BILL OF EXCHANGE

The UK Bills of Exchange Act 1882, applicable to the UK and widely referred to by many legal jurisdictions, defines a bill of exchange as follows:

"A bill of exchange is an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money to or to the order of a specified person, or to bearer." (Bills of Exchange Act 1882)

Each of these elements in this definition needs explanation:

- "Unconditional" means that no conditions are allowed. A clause such as "if you ship this machine by 1 February, I will pay you" is not a valid draft.
- "In writing" includes print.
- "Addressed by one person" refers to the drawer, ie the originator of the draft. In trade finance, the drawer is the seller seeking to collect money and the drawee is the buyer (or sometimes a bank). If the drawer makes the draft payable to it, the drawer/seller is also the payee, as in the example in Figure 6.1.
- "To another" refers to the person or business that is to make the payment to the drawer, ie the drawee; this might be the buyer's bank. The drawee will pay the amount of the draft, or if the drawee 'accepts' an obligation to pay on a future date by signing the draft on its face and adding the word 'accepted', they become the 'acceptor' and they are legally committed to pay on the due date.
- "On demand or at a fixed or determinable future time" means either for payment on immediate presentation to the drawee or for payment at a determinable due date. For example, 90 days after the date of the draft is a determinable date but 90 days after the arrival of a ship is not, as the exact date of arrival can never be certain.

- "A sum certain in money" effectively means that the draft is to be issued for a sum of legal tender including foreign currencies.
- "A specified person or to bearer" is either the named payee or the person holding it if payable to bearer.

6.3.2 Term and usance drafts

Drafts may be payable on demand (known in a trade transaction as 'at sight') or at some future date (known as a 'term draft' or a 'usance draft'). A sight draft is payable on presentation to the drawee and therefore the issue of acceptance does not arise.

Here is an example of a term draft.

FIGURE 6.1 EXAMPLE OF A TERM DRAFT

£xxx,xxx	Sydney, April 4th 20XX

At 90 days after sight of this sole bill of exchange please pay to our order the sum of GBP [*amount in words*].

To: Adam and Smith Bank plc Lothbury London	For and on behalf of: Digger Pty Pitt St Sydney, NSW

A term draft gives the drawee time for payment. A bank handling a draft on behalf of the seller will first obtain the drawee's acceptance and may then:

- hold it until maturity, present it for payment and then remit the funds to the seller;
- 'discount' it by immediately paying the seller the face value less a discount to represent interest for the period between the date of payment and the maturity date – see section 9.8.

At maturity, the draft will be presented for payment to the drawee or acceptor, or the bank nominated to pay on the acceptor's behalf. A draft accepted by a bank, and returned to a presenter, will normally be presented to them direct or via a correspondent bank. In documentary credits it is common for a draft to be held by the bank (drawee) on whom it is drawn.

6.3.3 Legal status of bills of drafts

Drafts have a special legal status. They are 'negotiable instruments' unless specifically stated not to be. Negotiable means much more than merely transferable from one person to another.

A draft stands alone from any contract that might have caused it to be written. Therefore, a holder of a draft who takes it in good faith and for value takes it free from any defect in the title to it of the previous holder. The commercial effect of this is, for example, that a bank that holds a draft, and expects to collect money from the acceptor when due, can sue the acceptor, or anyone else whose signature is on the draft, for non-payment irrespective of any contractual disputes there may be relating to the underlying goods or services.

The status of negotiable instruments is recognised by most international jurisdictions.

NEGOTIABLE INSTRUMENT

According to the US Uniform Commercial Code (Legal Information Institute, 2012), a negotiable instrument is:

"[. . .] an unconditional promise or order to pay a fixed amount of money, with or without interest or other charges described in the promise or order, if it:

1) is payable to bearer or to order at the time it is issued or first comes into possession of a holder;

2) is payable on demand or at a definite time; and

3) does not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money [. . .]".

6.3.4 Promissory notes

A promissory note is also a negotiable instrument. It is similar to a draft except that there are only two parties.

PROMISSORY NOTE

"[A]n unconditional promise in writing made by one person to another signed by the maker, engaging to pay, on demand at a fixed or determinable future date a sum certain in money to, or to the order of, a specified person or bearer." (UK Bills of Exchange Act 1882)

Promissory notes are widely used as debt instruments, for example in long-term projects containing numerous stage payments, where a buyer or borrower issues one or more promissory notes promising to pay a specified amount on a stated due date.

6.3.5 Further considerations about drafts and promissory notes

Here are some further things to consider about drafts and promissory notes.

- The difference between drafts and promissory notes can be illustrated as follows:
  - **Draft**: the drawer (the one who writes the draft) says: "you owe me".
  - **Promissory note**: the drawer says: "I owe you".
- Drafts and promissory notes payable at sight must be presented promptly for payment. Term or usance drafts must be presented promptly for acceptance and, when returned to the drawer or the presenter, presented on or just prior to the due date for payment.
- In some countries, electronic drafts can be used. They are sometimes referred to as 'truncated bills of exchange'. Examples of these are the *Lettre de Change Relevé* (LCR) in France and the *Ricevuta Bancaria*

(RIBA) in Italy. These are issued electronically and are presented by a bank to the drawee for payment. In case of non-payment within a fixed number of days, special procedures may be applicable and could result in a registration of the non-payment with the local central bank.

6.3.6 Unpaid drafts and promissory notes

If a draft or promissory note is not accepted or paid when due then special procedures in some countries require that the draft or promissory note be 'noted' or 'protested' for non-payment to preserve the holder's legal rights. It is common that within 24 hours of an indication of non-payment or non-acceptance, a notary public or similar person must be asked to demand acceptance or payment and then write the reason for non-payment or non-acceptance on the draft or promissory note. Protest for foreign bills may be done later and is a more formal record of non-payment or non-acceptance. Failure to comply with local requirements can result in the drawer (and any endorsers) being absolved from liability to pay.

Protesting a draft or promissory note may indicate an act of bankruptcy in some countries, and the implications of this should be considered before such instructions are given.

Rules for noting and protesting dishonoured drafts vary in different jurisdictions, depending on their sources of law.

Bank staff must understand what is expected of each party to a draft. Banks may be the drawee and/or acceptor on behalf of a customer, or the bank may be acting as the agent of a customer who expects payment on a draft drawn on, and accepted by, another party. In considering its duties as agent, a bank should act as though it were a party to the draft.

The UK Bills of Exchange Act 1882 has many sections dealing with the responsibilities of each party to negotiable instruments. The general rule is that anyone who signs as drawer, acceptor or endorser is legally liable to pay on it. But the drawer or endorser may refuse liability (except for the validity of the document) if they add the words 'without recourse' or '*sans recours*' next to their signature.

FACTFIND

Legal requirements: unpaid drafts

Research the legal requirements for dealing with unpaid drafts or promissory notes in your own country.

Note that in some countries the rules may differ from area to area within the country, sometimes depending on local practice or different laws in different states.

6.4 Transport documents

These are the documents issued by carriers, owners, masters, charterers, or their respective agents that evidence a contract of carriage, the receipt of goods and the details of the transport, what was carried, and from where to where. They fall into two main groups: those that give title to the goods (quasi-negotiable) and those that do not (non-negotiable).

Quasi-negotiable documents confer upon the holder of an original transport document a right to possession of the goods. The negotiable quality of a bill of lading (see section 6.4.1) is similar to a draft in that a transfer of the document represents a transfer of title to the goods. But a transfer of a bill of lading is subject to any defect of title, which is not the case for a holder of a draft.

DEFECT OF TITLE

This is where the title to a bill of lading is not a full legal title (for example, because of fraud or theft) and cannot be legally transferred to any other party. Therefore, the recipient (often a bank financing the shipment) cannot exercise full legal rights over the bill of lading or the goods covered by that bill.

This subjection to a defect of title is because the bill of lading (unlike a draft) is not a fully negotiable document, but only 'quasi-negotiable' (Bills of Lading Act 1855).

6.4.1 Bills of lading

Bills of lading are documents issued by a carrier, a master or their respective agent and usually have quasi-negotiable status. As well as evidencing the terms of the contract of carriage and acting as a receipt for the goods, a bill of lading can also provide entitlement to receive the goods.

The consignee (ie the entity to whom the goods are being sent or consigned) whose name can be preceded by the words 'to order of', or an entity to which the bill of lading has been endorsed, can take possession of the goods upon the surrender of an original negotiable bill of lading to the carrier or its agent at the port of discharge.

ORIGINAL BILL OF LADING

Bills of lading are usually issued in a set of three originals, with the number issued specified on the bill of lading. Once the goods are released to the bank, to the buyer or to another entity against surrender of one original, the others in the set become void.

Banks usually require a bill of lading to be made out to the bank's order ("to order of [name of bank]") or to the shipper's order ("to order" or "to order of shipper") and endorsed by the shipper to order of the bank or in blank. This enables the bank, the buyer or any other named entity to take possession of the goods.

IN BLANK

Endorsing a bill of lading in blank means that there is no specified recipient of the bill.

For a bank involved in trade finance transactions, having control of the rights to the goods under a bill of lading can be of paramount importance because:

- it can be the bank's security in case the obligor defaults;
- some bank regulators allow application of lower risk-weighted assets when the bank has control over the flow of the goods.

Bills of lading are issued and released to the shipper (who is usually the seller). Most bills of lading show that the goods have been "received for shipment". Once the goods are loaded on board the vessel, the bills of lading will be marked as "shipped on board". For presentation under documentary credits, only bills of lading marked "shipped on board" are acceptable. See Topic 9 for more details.

Sellers will either courier the bills of lading to the buyer or their agent (for an open account transaction – see Topic 7) or present them through the banking system for collection (see Topic 8) or for payment by documentary credit (see Topic 9). In the event that a buyer does not receive the bills of lading before the ship arrives, it may face storage costs known as 'demurrage charges', which the buyer may seek to recover from whoever caused the delay. See section 6.4.1.2 for more information.

Such problems will become less common with the introduction of electronic bills of lading, as discussed in section 6.4.1.3.

6.4.1.1 Other forms of bills of lading

Combined transport or multimodal transport documents

These are used when goods are transported, usually by container, and when there is more than one means of conveyance, for example from an inland terminal to a port, on to a destination port and finally to another inland terminal. The entity that issues a combined transport or multimodal transport document must either sign as carrier or, more often, as the agent for a named carrier.

Liner bills of lading

These are used for regular shipping services between two ports where the carrying vessel has a designated berth.

Charter party bills of lading

These are issued to the exporter by the owner of a ship, the master, the charterer or their respective agent. The terms of a charter party bill of lading are subject to the contract of hire between the ship's owner and the charterer. Such bills are usually marked "subject to charter party", and are usually issued for bulk cargoes such as oil, wheat and sugar. Because of the legal complexity involved, while charter party bills of lading are often to the order of a named party, they are not always considered to be documents of title, so care needs to be exercised.

6.4.1.2 Missing bills of lading

It regularly happens that a cargo arrives before the bills of lading are in the buyer's hands. The buyer will have received notification that the goods are ready for collection and that failure to collect will incur demurrage charges.

The buyer may ask its bank to issue a guarantee to the carrier, requesting the release of the goods and undertaking to reimburse the carrier if the carrier faces a loss as a result of releasing such cargo. If the bank accepts the risk of doing so, the bank's customer/buyer will have to sign a counter-indemnity agreeing to reimburse the bank if any claim is made against the bank. As security for issuing the guarantee, the buyer may be required to deposit cash collateral with the bank for the full period the indemnity is outstanding. The buyer will also undertake to deliver the bills of lading to the bank as and when they come to hand.

If the bills of lading have been issued in respect of a collection or documentary credit transaction, and in exchange for the issuance of the guarantee, then the buyer will usually be required to additionally undertake to:

- pay the collection on receipt or accept any bill drawn on them; or
- accept any discrepancies that may be found in a presentation under the documentary credit and for the bank to pay or agree to pay on a due date.

Such guarantees are also used in case the bills of lading are lost in transit or destroyed by accident.

6.4.1.3 Other considerations about bills of lading

The bill of lading will give a general description of the cargo with the clause "xx boxes/crates etc shipped on board in apparently good condition". In the context of documentary credits, importers and their banks will expect to receive a 'clean' bill of lading with this (or a very similar) clause. It is important to note that the bill of lading will mention "said to contain" or "shipper's load, stow and count" or wording of similar effect. This means that the shipping company is not liable for the content of a container or packing.

The shipping company may add adverse comments, such as "case number 40 split and broken". This is not a 'clean' bill of lading.

As will be seen in Topic 9, bills of lading so 'claused' will not be acceptable, and banks may be called upon to issue an indemnity against any potential loss to the importer or the importer's bank.

There is an ongoing move in industry towards 'paperless trading' – using electronic versions of various trade documents to remove paper from the system. Among the different types of electronic documentation in use are electronic bills of lading.

Forms of electronic bills of lading have become more successful in the last few years. Such systems not only replace paper bills of lading, but can also be used for a transfer of title in an electronic manner. Within a split second, with the click of a button, the title of the goods could be transferred from, for example, Hong Kong to Antwerp. Moreover, many of the systems on the market today – such as the two in the factfind that follows – comply with the latest IT and legal standards.

FACTFIND

Electronic bills of lading

Find out more about how some of these systems work:

essDocs: https://www.essdocs.com/

Bolero: http://www.bolero.net/home/electronic-bills-lading/

[All accessed: 3 September 2018]

6.4.2 Air waybills and non-negotiable sea waybills

KEY TERMS

Non-negotiable instrument

A transport document (such as an air waybill) or a financial instrument that cannot be signed over to anyone else.

Air waybill

A document issued by a carrier or their agent for goods shipped by air freight, which describes the goods and contains a contract of carriage, but does not evidence title to the goods and is not negotiable.

Sea waybill

"A transport document for maritime shipment which serves as evidence of the contract of carriage and as a receipt for the goods, but is not a document of title." (Dictionary of International Trade, no date)

Air waybills are frequently used today. Non-negotiable sea waybills are used less frequently than air waybills, and only on specific routes where the sailing time is quite short.

An air waybill is one of the ten transport documents that are recognised by the UCP in articles 19–25. Together with the bill of lading, an air waybill represents one of the most widely used transport documents.

It is a non-negotiable document and, as such, should not be issued 'to order' or 'to order of' a named entity. An air waybill document should evidence that the goods are consigned to a named entity.

Rules governing the examination of a non-negotiable sea waybill first appeared in UCP 500. At the time, a non-negotiable sea waybill was seen as a potential bridge between paper documents (with the inherent delays in delivery that can occur in the delivery of an original bill of lading) and electronic initiatives of the time.

Today, a non-negotiable sea waybill serves primarily as a transport document for use when there is a short sea journey and the delivery of the goods is not conditional upon the surrender of an original negotiable transport document, such as a bill of lading. Use of a non-negotiable sea waybill is not widespread as some banks still express concern over the ability of a consignor to divert the cargo despite the creation of a 'lien clause' by some carriers that is intended to 'fix' the name of the consignee.

LIEN

"[T]he right of the carrier to refuse to release goods or documents belonging to the shipper while its charges remain unpaid." (Freight Transport Association, 2018)

6.4.3 Other transport documents

Other transport documents include the following.

Road transport documents

These can be a simple document issued on the letterhead of the carrier, or, as is the case for consignments within Europe, a more formal document known as a CMR (*Convention Relative au Contrat de Transport International de Marchandises par Route*). These are not negotiable documents.

A CMR also includes an insurance contract, though it is very limited (see section 6.4.5).

Rail consignment notes

These are non-negotiable evidence of carriage and are usually issued by the railway company or the railway station of departure.

Parcel or courier receipts

These are issued by post offices or courier companies.

6.4.4 Risks

There are risks commonly associated with transport documents.

Security

One of the main risks with transport documents is that they may fall into the wrong hands. If a bill of lading is endorsed in blank by the shipper, it is possible for the goods to be collected by the wrong person rather than the rightful owner. As bills of lading are usually issued in sets with more than one original, it is particularly important to keep track of the whereabouts of the full set.

With a non-negotiable bill of lading, the goods will be released to the named consignee and the bank will have no security over the goods unless the bank or its agent is named as consignee. The risk of fraud was covered in Topic 5.

Timing of arrival

There is also the risk that, with today's faster transport systems, goods can arrive before the transport documents.

When carriage is by air, for example, evidenced by the presentation of an air waybill, the goods will be released to the named consignee upon proof of identification. If the goods are consigned to a bank, the bank may issue a delivery order (or similar) that will authorise the carrier or its agent to release the cargo to the buyer or its designate. A seller needs to consider the risks involved in despatching goods directly to a buyer, and possibly needs to arrange that the consignee be a bank.

Failure to make proper arrangements for prompt clearance of goods on arrival can incur demurrage or other such charges.

6.4.5 Transport documents and insurance

Sellers also need to be aware that each mode of transport has its own set of internationally agreed rules on the transport of hazardous cargoes and internationally agreed limitations to the liability of carriers. These limitations mean that compensation levels may be low.

Some transport documents not only show transportation of the goods, but can include insurance as well. One example is the insurance included in a CMR document, though it is very limited.

EXAMPLE

Insurance contract under a CMR

Transport insurance is included in a CMR, but compensation in case of damage is only applicable if the carrier's liability is engaged. The compensation is based on the weight of the cargo, not on the value.

Therefore, the loss of ten tonnes of computer material is indemnified the same way as ten tonnes of potatoes – and there is no compensation at all should the truck be involved in an accident and the truck driver's liability is not engaged.

6.5 The commercial invoice

In the negotiation stages, a contract, purchase order or pro forma invoice (see Topic 3) may be issued. Once such documents have been agreed and shipment of the goods is being organised, other documents will be required, depending upon the terms agreed between the buyer and seller and the rules and regulations of the countries concerned.

A commercial invoice must be produced in accordance with the contract, purchase order or pro forma invoice, incorporating any agreed changes.

INCLUSIONS ON THE INVOICE

The invoice will, for example:

- include a unique number and quote the contract, purchase order or pro forma invoice number;
- mention the seller and the buyer;
- describe the merchandise, often itemised by price and quantity;
- include all charges and costs for the buyer's account and specify the sales term or, by preference, the Incoterm® (see section 6.9) that was agreed for shipment;
- mention the terms of payment;
- include buyer and seller VAT numbers or similar (if applicable).

Where the seller is to be paid under a documentary credit (see Topic 8), the invoice is to be issued by the beneficiary of the credit, to be denominated in the same currency as specified by the documentary credit and to contain a description of the goods that corresponds to that in the letter of credit.

Where trade between countries attracts taxes or tariffs, then customs and tax authorities in the countries concerned often insist on the provision of special invoices, known as 'customs invoices' or 'tax invoices', containing sufficient information for the authorities to calculate the tariffs or taxes applicable to each transaction.

For exports to some countries, a seller may be required to issue a 'consular invoice', which some importing countries require for customs purposes. The forms can be obtained from the embassy, the consulate or the high commission (for British Commonwealth countries) of the importer's country. The exporter completes the details on the form and the document is then authenticated by the consulate of the country of the importer. This consulate is usually located in the exporter's country.

The purpose of consular invoices is to certify that the exporter is not dumping goods at artificially low prices. Their other function is to provide information that forms the basis of the import duty to be paid on the goods.

Importing countries that require production of consular invoices almost always charge a fee for certification. When a consular invoice is not available, the consulate will authenticate the exporter's own invoice. This is known as a 'legalised invoice'.

Many countries require legalisation of documents such as invoices and certificates of origin. The purpose of such legalisation is not always clear. For example, some embassies will only put a stamp on the documents and charge a fee for it. Others will look at the fulfilment of import regulations, the existence of import licences, etc. If a document has to be corrected, the correction will have to be approved by the legalising entity as well, once again incurring legalisation fees. Such legalisations can only be made on paper documents; electronic legalisations are not yet common practice.

6.6 Other documents

The packing/weight list

A packing list will usually accompany the cargo, but a copy may be required to be attached to the other documents. It will give information relating to the packing of the goods in brief or detailed terms. If requested, it will also list the weights of individual items, together with a total weight (in some cases separate weight lists are required, rather than the weights being included on the packing list). For some countries or types of goods there will be specific requirements for the packaging. On certain occasions, buyers request the presentation of a packing list where this document is redundant, such as for cars or for goods that are despatched in bulk.

The certificate of origin

The certificate of origin certifies that the goods were produced in the country or countries named therein. These are often issued by a chamber of commerce in the exporter's country, but some countries, typically those located in the Middle East, will often require an embassy of the importing country to countersign/legalise it.

EU imports from countries with preferential access (developing countries selling into developed countries) must be supported by the EU Generalised System of Preferences (GSP) form A. EU sellers to countries with preferential access will need to complete an EUR1 movement certificate or an invoice with a customs declaration. For other countries, such as Turkey, other arrangements can be applicable and an ATR1 certificate is used.

Pre-shipment inspection certificates

Pre-shipment inspection certificates may be required by the rules of the importing country to ensure that goods conform to local regulations and/or to minimise fraud. Buyers may also require such certificates to ensure that the quality of what is being shipped is in accordance with contractual agreements. For example, an importer of coal might specify a calorific value and a maximum level of moisture.

These certificates can be issued by specialist inspection organisations, such as SGS, Intertek International, Cotecna and Bureau Veritas, with staff able to assess goods against chemical, electrical or similar specifications. The certificates can also be described as weight, health, quantity, or quality analysis certificates, depending on what is required by the contract agreed between the buyer and the seller.

Phytosanitary inspection certificates

Phytosanitary inspection certificates are issued to satisfy the import or export regulations of some countries. They indicate that a shipment has been inspected and is free from harmful pests and plant diseases.

6.7 Import and export licences

Export licences

Export licences may be required because a country wishes to control:

- all exports in general; or

- export of certain goods (firearms, explosives, military equipment, commercial goods with a possible military use, drugs and goods deemed to be of strategic importance); or
- all exports to some countries.

Often the buyer has to give an undertaking (sometimes called a 'beneficiary certificate') covering its use and further onward sale of sensitive goods or technology. This is common with sales by US or US-controlled businesses.

Import licences

Countries may also wish to control what comes in. In most cases, the buyer will be responsible for complying with local regulations regarding import licences and payment of tariffs.

When applying for export or import licences, it is often necessary to provide a provisional invoice describing in detail what goods are involved in the proposed transaction.

When granting an import licence to an importer, the local exchange authorities will, in some cases, also reserve the amount in foreign currency needed for payment.

If a seller is aware of the fact that the goods are subject to an import licence in the country of the buyer, they should wait for the licence to be granted before the goods are shipped. Otherwise, delay of transit of the goods through customs or delay of payment may occur.

6.8 Insurance documents

Marine cargo insurance is vital to protect buyers, sellers and banks who finance trade transactions against risk of loss due to, for example, weather, theft, strikes, civil commotion, war and piracy. This last aspect is particularly worthy of attention as the number of ships hijacked globally by pirates increased for the first six months of 2018 compared with the same period the previous year (ICC International Maritime Bureau, 2018).

The decision as to who pays for insurance cover for all of (or each stage of) a journey is a commercial decision that is subject to negotiation between the parties and will form an important part of the contract. As outlined later in this topic, the Incoterm® 2010 that is selected clarifies which party or parties are responsible for arranging and paying for insurance. Banks that advance money against shipments will, however, wish to be aware that an appropriate insurance policy is in place.

A significant volume of insurance is arranged by freight forwarders on behalf of their customers and on a warehouse-to-warehouse basis, regardless of whether the transport is by one means of conveyance or multimodal transports.

When presenting insurance documents under a documentary credit, sellers must be careful to produce an insurance document that evidences coverage of all the cargo clauses specified in the credit.

Banks may receive insurance documents as a policy or, more frequently, an insurance certificate. Policies of insurance set out the full terms of the insurance contract between the insurance company and the insured. They are usually only seen when a seller is handling a one-off shipment or when a specific policy to cover unusual risks is involved.

Insurance certificates are used when there is an 'open policy' of insurance in place for a regular seller or buyer. The policy will be renewed annually and each shipment will be declared to the insurer with details against which an insurance certificate is issued.

CONTENTS OF THE INSURANCE CERTIFICATE

The insurance certificate will state the:

- details of the goods;
- amount of insurance (usually at least 110 per cent of the value of the goods);
- routing of the goods and possibly the mode of transport;
- date when cover commences;

- cargo clauses covered;
- name of the assured or insured.

If the certificate is issued under a seller's policy, where the seller is shown as the assured or insured, the seller will endorse the certificate in blank so that it may be passed on to any holder, or to the buyer's order. Under a documentary credit, such endorsement will be completed according to the terms of that credit.

Many insurance companies offer their customers the option to print out insurance certificates from a website in case of an open policy. The customer fills in the data needed on a form on the website and the certificate is printed and can then be used for presentation under documentary credits or for other purposes.

6.8.1 Types of insurance

The level and nature of insurance cover provided has been codified and will be applicable to most cargoes. The two main codes are contained in the clauses of the International Underwriting Association of London and the American Institute Clauses.

The General Cargo Clauses are available at three levels of cover.

LEVELS OF COVER

Level A

This level covers loss due to:

1) problems with the carrying vessel or train, such as collision, explosion, fire, sinking, capsizing, running aground, washing overboard, loss on loading or unloading and derailment;

2) events such as lightning, volcanic activity and earthquakes;

3) theft and non-delivery.

Level B

This level includes all of the risks in 1) and 2).

Level C

This level includes risks listed under 1) only.

Level A insurance also protects against 'general average'. For example, if it were necessary to jettison some cargo to save a ship, the normal rule is that all those with goods on board share the loss, even if their own cargo is not thrown overboard. But the general average clause protects the insured against this loss. The insured would also be covered in the event of a dispute as to which ship was to blame for a collision.

'Particular average', which is the failure of the insured to insure the goods for their proper value, may not be covered. Where the goods are underinsured, the insured will have to bear a partial loss in proportion to the underinsurance.

Additional cover can be obtained by purchasing insurance with one of the standard cargo clauses for war or strikes. Piracy is no longer covered by ordinary marine risk insurance, but cover is available under war risk policies where premiums are set according to the regions into which a ship is due to sail.

The insured is not covered for:

- misconduct of the insured;
- poor packing;
- any inherent vice of the cargo, such as a tendency to deteriorate over time;

- insolvency of the carrier;
- an unseaworthy vessel.

6.9 Sales terms

Background

In international trade it is possible to have one contract that covers the entire journey or up to three separate contracts to cover the transport of the goods. These contracts would cover the transport:

- from the seller's premises to a carrier or its agent within the seller's country;
- from the carrier or its agent's premises in the seller's country to a named point in the buyer's country (eg a port, airport or container depot);
- from the port, etc, in the buyer's country to the buyer's own premises.

It is vital to establish a clearly defined point of delivery of the goods to indicate where the seller's responsibility ends and where the buyer's responsibility begins. This delivery point refers, in the main, to the scope of the payment of freight and insurance of the goods while in transit. Unless the demarcation of responsibility is clearly understood, it will be difficult for a seller to price its goods accurately and for a buyer to accurately calculate the full cost of the import.

One of the potential risks with international trade is that countries could interpret contractual terms differently. ICC has approached this problem by creating a set of internationally agreed terms.

Purpose

The purpose of ICC's International Commercial Terms (Incoterms®) is to provide such a set of standardised terms that mean exactly the same to both parties and which will be interpreted in exactly the same way by courts in every country. Full details of the Incoterms® rules can be found in its publication no. 715, Incoterms® 2010.

Incoterms® rules are not incorporated into national or international law, but they can be made binding to both buyer and seller, provided that the sales contract, purchase order or pro forma invoice specifies that a particular Incoterm® rule will apply.

Note that the Incoterms® rules apply to both domestic and international trade.

!

EXAM TIP

In the context of the examination, the words 'sales terms' or 'terms of delivery' might be substituted for the word 'Incoterms®'. All of these words and phrases are synonymous.

"Incoterms" is a trademark of the International Chamber of Commerce (ICC). www.iccwbo.org.

6.9.1 The 11 Incoterms®

There are 11 Incoterms® and each term sets out the obligations of the seller and buyer.

!

EXAM TIP

It is not necessary to memorise the 11 terms for the exam, but it is necessary to be able to work out their implications, should a term appear in an examination question.

Generally speaking, where an Incoterm® sets out the obligations of the seller, by a process of elimination, any obligation that does not appear must be the responsibility of the buyer.

Incoterms® EXW, FCA, CPT, CIP, DAT, DAP and DDP are applicable to all modes of transport, including multimodal transport. Incoterms® FAS, FOB, CFR and CIF cover transport by sea or inland waterway.

If responsibility for insuring the goods is not clearly specified in the Incoterm® used (such as CIF and CIP), then it should be made clear in the contract of sale who is liable for the goods during transportation. That party has the option to insure the goods at their own discretion. It's possible that they use an open policy and a one-off insurance is not needed, or that they choose to bear the risk themselves.

It should be noted that contracts commencing before 1 January 2011, when the Incoterms® rules 2010 took effect, may still refer to Incoterms® set out in the previous version of the rules, Incoterms® 2000. Terms such as DAF (Delivered at Frontier), DES (Delivered Ex Ship), DEQ (Delivered Ex Quay) and DDU (Delivered Duty Unpaid) may have been applied to such contracts, but no longer appear in the Incoterms® rules 2010.

FACTFIND

New Incoterms® rules are due to come into effect on 1 January 2020.

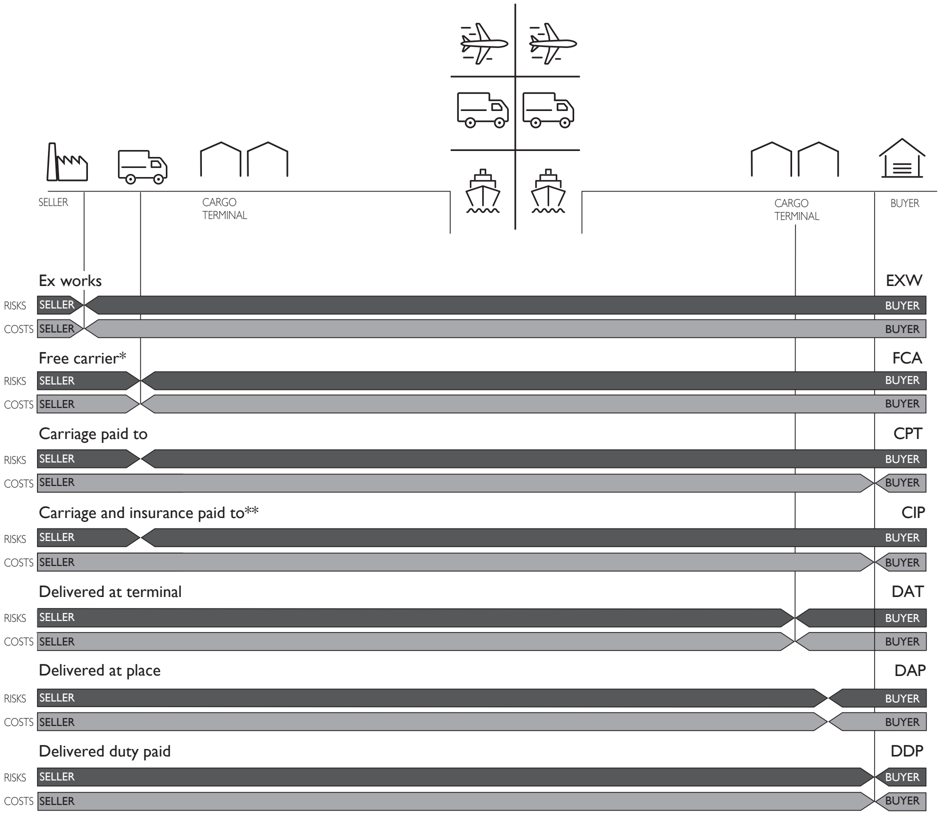
You can keep up to date on the Incoterms® on the ICC website:

https://iccwbo.org/resources-for-business/incoterms-rules/ [Accessed: 17 September 2018].

6.9.2 Examples of the 11 Incoterms®

Figures 6.2 and 6.3 illustrate the transfer of risks and costs for buyers and sellers for each of the 11 Incoterms®.

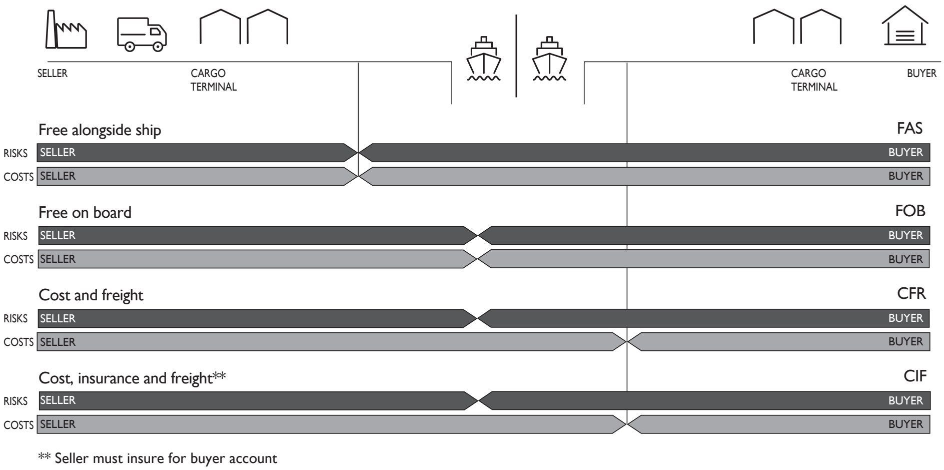
FIGURE 6.2 RISK AND COST FOR INCOTERMS® APPLICABLE TO ALL MODES OF TRANSPORT



* Depending on selected mode of transport the critical points of risks and costs will vary.
** Seller must insure for buyer account.

Source: adapted from ING Bank NV (no date)

FIGURE 6.3 RISK AND COST FOR INCOTERMS® APPLICABLE TO TRANSPORT BY SEA ONLY



Source: adapted from ING Bank NV (no date)

To illustrate how the rules work, we will examine various documents relating to a sale by Speirs and Wadley Ltd of Adderley Road, Hackney, London, to Woldal Ltd of New Road, Kowloon, Hong Kong. The tables in sections 6.9.3–6.9.13 explain the implications, where appropriate, for both parties for the different Incoterms® that could be applied to such a sale. The various Incoterms® are set out in a logical order, starting with that which imposes least obligation on Speirs and Wadley and ending with that which imposes the most.

6.9.3 Ex works (EXW)

Incoterm®	Standard ICC abbreviations
Ex works [named place of delivery, eg Adderley Road, Hackney]	EXW
Obligations of Speirs and Wadley Ltd (exporter)	**Responsibilities of Woldal Ltd (importer)**
Make the goods available for collection from Adderley Road, Hackney, by Woldal Ltd. Once collected by Woldal, all responsibility of Speirs and Wadley is ended. A commercial invoice or equivalent electronic message will be provided for Woldal. Goods will be suitably packed, unless it is the norm for the goods involved to be delivered unpacked.	Take delivery from Adderley Road. Make all arrangements at own cost to take goods to own premises. It is in Woldal's interests to arrange appropriate insurance to cover this journey. The obtaining of relevant export and/or import licences and also the completion of any customs formalities and payments for the export of the goods is the responsibility of Woldal. The goods are at buyer's risk from the moment that the seller sends a notice of readiness to the buyer. Should the goods be damaged or destroyed in the warehouse at Adderley Road, Hackney, this would be at Woldal's risk.

6.9.4 Free carrier (FCA)

Incoterm®	**Standard ICC abbreviations**
Free carrier [named place of delivery, eg Hackney container depot]	FCA
Obligations of Speirs and Wadley Ltd (exporter)	**Responsibilities of Woldal Ltd (importer)**
Make the goods available to Hackney container depot at the inland container depot on the exporter's means of transport, not unloaded. (Note: if the goods were to have been made available at the premises of Speirs and Wadley, delivery would be incomplete until the goods had been loaded onto the carrier's own transport.) Advise delivery of the goods at Hackney container depot to Woldal. Complete export and customs requirements, including obtaining any export licence and paying any costs, duties and taxes. Supply Woldal with commercial invoice or its equivalent electronic message, together with proof of delivery to Hackney container depot, eg a multimodal transport document. Goods will be suitably packed unless it is the norm for the goods involved to be delivered unpacked.	Make all arrangements at own cost and risk to cover transport of goods to own premises from Hackney container depot. It is in Woldal's interests to arrange appropriate insurance to cover this journey. Woldal should obtain any import licence and perform any customs requirements necessary for the import of the goods, including paying all costs, duties and taxes.

6.9.5 Free alongside ship (FAS)

Incoterm®	**Standard ICC abbreviations**
Free alongside ship [named port of shipment, eg Tilbury]	FAS
Obligations of Speirs and Wadley Ltd (exporter)	**Responsibilities of Woldal Ltd (importer)**
Complete export and customs requirements, including obtaining any export licence and paying any costs, duties and taxes. Supply Woldal with commercial invoice or its equivalent electronic message, together with proof of delivery, eg a transport document. Deliver goods to the quayside alongside the nominated vessel at the port of Tilbury, after which the liability of Speirs and Wadley ends. Goods will be suitably packed, unless it is the norm for the goods involved to be delivered unpacked. FAS terms are mainly used in the bulk and break-bulk trade (ie where goods such as coal are shipped loose in bulk).	Make arrangements with a shipping company for transport of goods by sea to Hong Kong. Notify Speirs and Wadley of the day and time that delivery is required at the port of Tilbury and the name of the nominated vessel. Woldal is responsible for all risks from the quayside in Tilbury to the delivery of the goods to their final destination. It is in Woldal's interests to arrange appropriate insurance to cover this journey. Woldal should obtain any import licence and perform any customs requirements necessary for the import of the goods, including meeting all costs involved, duties and taxes.

6.9.6 Free on board (FOB)

Incoterm®	**Standard ICC abbreviations**
Free on board [named port of shipment, eg Tilbury]	FOB
Obligations of Speirs and Wadley Ltd (exporter)	**Responsibilities of Woldal Ltd (importer)**
As for FAS, but Speirs and Wadley's delivery liability does not end until the goods have been loaded on board a named vessel at Tilbury.	As for FAS, but with the exception that Woldal does not assume responsibility for the goods until they are on board the vessel in the port of Tilbury. The moment the goods are on board, they are considered as being delivered.

6.9.7 Cost and freight (CFR)

Incoterm®	**Standard ICC abbreviations**
Cost and freight [named port of destination, eg Hong Kong]	CFR
Obligations of Speirs and Wadley Ltd (exporter)	**Responsibilities of Woldal Ltd (importer)**
Arrange and pay for transport of goods to Hong Kong port. Loading and unloading costs should be met if they form part of the charge for carriage. Complete export and customs requirements, including obtaining any export licence and paying any costs, duties and taxes. Advise Woldal of delivery of the goods on board the carrying vessel and also details of the voyage. Supply Woldal with a commercial invoice or its electronic equivalent, together with the relevant transport document, eg a bill of lading. Goods will be suitably packed unless it is the norm for the goods involved to be delivered unpacked. Speirs and Wadley are free of liability (for insurance purposes) once the goods are on board the vessel in Tilbury port.	Woldal should obtain any import licence and perform any customs requirements necessary for the import of the goods, including meeting all costs involved, duties and taxes. It is in Woldal's interests to arrange and pay for insurance of the goods from when they are on board the vessel in Tilbury, as that is the moment of delivery. If unloading costs are not covered by the charge for carriage, Woldal must also pay these.

6.9.8 Cost, insurance and freight (CIF)

Incoterm®	**Standard ICC abbreviations**
Cost, insurance and freight [named port of destination, eg Hong Kong]	CIF
Obligations of Speirs and Wadley Ltd (exporter)	**Responsibilities of Woldal Ltd (importer)**
As for CFR but, in addition, Speirs and Wadley must insure the goods as far as the port of Hong Kong and supply Woldal with evidence of this, eg an insurance policy or certificate. Delivery takes place when the goods are on board at Tilbury.	As for CFR, but insurance risk falls on Woldal only when the goods have been offloaded from the vessel at Hong Kong.

6.9.9 Carriage paid to (CPT)

Incoterm®	Standard ICC abbreviations
Carriage paid to [named place of destination, eg Kowloon]	CPT
Obligations of Speirs and Wadley Ltd (exporter)	**Responsibilities of Woldal Ltd (importer)**
Similar to CFR, except that Speirs and Wadley must arrange and pay for transport to the named place of destination, which could be an inland container depot in Hong Kong, as opposed to Hong Kong port. Speirs and Wadley must advise Woldal of details of the shipment and the name and address of the shipping company into whose custody the goods have been given so that Woldal can arrange insurance. Complete export and customs requirements, including obtaining any export licence and paying any costs, duties and taxes. Supply Woldal with commercial invoice or its equivalent electronic message, together with the relevant transport document. Goods will be suitably packed unless it is the norm for the goods involved to be delivered unpacked.	Woldal should obtain any import licence and perform any customs requirements necessary for the import of the goods, including meeting all costs involved, duties and taxes. It is in Woldal's interests to arrange and pay insurance for the goods from when they are delivered into the custody of the carrier at Tilbury. If unloading costs at place of destination are not covered by the charge for carriage, Woldal must pay them. Also, it must pay all costs of transport from Kowloon freight yard to its own premises.

6.9.10 Carriage and insurance paid (CIP)

Incoterm®	**Standard ICC abbreviations**
Carriage and insurance paid [to named place of destination, eg Kowloon]	CIP
Obligations of Speirs and Wadley Ltd (exporter)	**Responsibilities of Woldal Ltd (importer)**
Similar to CPT, except that Speirs and Wadley must pay insurance charges during the carriage. The relevant insurance policy or certificate must be supplied to Woldal.	Similar to CPT, except that Woldal does not have to arrange and pay insurance charges, which are met by Speirs and Wadley.

6.9.11 Delivered at terminal (DAT)

Incoterm®	Standard ICC abbreviations
Delivered at terminal [named terminal at port or place of destination, eg Terminal 2A Hong Kong Port]	DAT
Obligations of Speirs and Wadley Ltd (exporter)	**Responsibilities of Woldal Ltd (importer)**
Similar to CIF, except that the liability of Speirs and Wadley does not cease until the goods have been placed at the disposal of Woldal by unloading the goods from the arriving means of transport and placing them at the disposal of the buyer at a specific terminal at the named port or place of destination (if one is not specified, the seller may select the terminal that best suits its purpose). Theoretically, Speirs and Wadley need not insure the goods, but in practice it would be wise to do so.	Similar to CIF. The liability of Woldal exists from the time when goods are placed at its disposal in the destination terminal, and they must take delivery of the goods from that time. The insurance risk falls on Woldal once the goods are unloaded at the terminal.

6.9.12 Delivered at place (DAP)

Incoterm®	**Standard ICC abbreviations**
Delivered at place [named place of destination, eg Kowloon]	DAP
Obligations of Speirs and Wadley Ltd (exporter)	**Responsibilities of Woldal Ltd (importer)**
Deliver the goods to the agreed place of destination ready for unloading. Supply Woldal with a commercial invoice or its electronic equivalent together with the relevant transport document or delivery order. Arrange any export licence and complete export customs requirements, including payment of costs, duties and taxes. Arrange and pay for contract of carriage to the named point of destination. Advise Woldal of the expected time of arrival of the goods so that arrangements can be made to take delivery. Theoretically, Speirs and Wadley need not insure the goods on their voyage. However, in view of their liability for the goods, such action would be unwise. Goods will be suitably packed unless it is the norm for the goods involved to be delivered unpacked.	Woldal should obtain any import licence and perform any customs requirements necessary for the import of the goods, including meeting all costs involved, duties and taxes. Accept delivery of goods at the named place of destination. Woldal is liable for goods and costs from the time the goods are placed at its disposal at the place of delivery. The insurance risk is Woldal's once the goods have been delivered to the agreed place.

6.9.13 Delivered duty paid (DDP)

Incoterm®	Standard ICC abbreviations
Delivered duty paid [named place of destination, eg Kowloon]	DDP
Obligations of Speirs and Wadley Ltd (exporter)	**Responsibilities of Woldal Ltd (importer)**
Deliver the goods not unloaded to the named place of destination, and bear costs and risks involved in carrying the goods to that place. Advise Woldal of despatch in sufficient time for the company to make arrangements to take delivery of the goods. Arrange any export licences and complete export customs requirements, including payment of costs, duties and taxes. Supply a commercial invoice or its electronic equivalent, together with the relevant transport document or delivery order to Woldal. Speirs and Wadley theoretically need not insure the goods, but in view of its liability for them, such action would be unwise. Goods will be suitably packed unless it is the norm for them to be delivered unpacked. Speirs and Wadley are responsible for all import requirements and payments in addition.	Woldal must take delivery of the goods at the named place of destination and is liable for all risks from then on. Woldal is not responsible for all import requirements and payments of costs, duties and taxes.

✓

CHECK YOUR UNDERSTANDING

Now that you've read through examples of the Incoterms®, consolidate your understanding by noting down:

1) each Incoterm® and what it stands for;
2) what mode of transport each Incoterm® is applicable to;
3) the moment of delivery.

6.10 Storage

Where a bank is requested or required to store goods, either as security or as agents for a correspondent, the bank will wish to ensure that the storage is with a reputable warehouse or yard, and that the goods are appropriately insured and protected against the weather, insect attack or other risk relevant to the cargo.

The bank will either obtain a warehouse receipt (a non-negotiable document confirming receipt and the conditions of storage) or a warehouse warrant. The latter may be a document of title, similar to a quasi-negotiable bill of lading. Where a bank holds such a warrant, it should be in the bank's name or deliverable to the bank's agent.

6.11 Trust receipts

Trust receipts are written agreements between a bank holding specific goods pledged to the bank as security and a borrower or buyer. It allows the buyer to handle the goods before payment. The agreement permits the borrower/importer to take physical possession, while the bank retains title. The issuer of the trust receipt agrees to hold the merchandise in trust for the bank and to keep the merchandise, as well as any proceeds of sale, separate and distinct from their own property.

Conclusion

In this topic we have looked at various common documents that are used in international trade. Each of these documents performs a specific function; this can vary from a financial or commercial document to a transport document giving access to the goods. The ICC Incoterms® rules 2010 are important rules that help determine the obligations and liabilities of each party in a transaction.

THINK AGAIN ...

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- give an example of rules for trade within the EU?
- describe the difference between bills of exchange and promissory notes?
- explain the functions of a bill of lading?
- indicate to what extent banks can be involved in bills of lading?
- list the other documents regularly called for in a trade transaction and explain their purpose?
- explain the insurance of transport risks and the standard risk levels provided by insurers?
- explain the use of the ICC Incoterms® 2010 rules?

Test your knowledge

?

Use these questions to assess your learning for Topic 6. Review the text if necessary.

Answers can be found at the end of this book.

1) Match the following international trade documents to the category of document into which they fall.

Financial	Transport	Commercial	Insurance

   a) Bill of exchange.

   b) Bill of lading.

   c) Commercial invoice.

   d) Cargo insurance.

   e) Air waybill.

   f) Export/import licence.

   g) Promissory note.

2) Only goods made within the EU are freely traded inside the EU border. True or false?

3) Which of the following Incoterms® places the highest obligation on the seller?

   a) DDP.

   b) EXW.

   c) CIF.

   d) FOB.

4) Which of the following Incoterms® apply to any mode of transport?

   a) CFR.

   b) CIF.

   c) CIP.

   d) CPT.

   e) DAT.

   f) DAP.

   g) DDP.

   h) EXW.

   i) FAS.

   j) FCA.

   k) FOB.

5) Storage costs that a buyer may face in the event that a cargo arrives before the bill of lading are known as demurrage charges. True or false?

6) General cargo clause B of the International Underwriting Association of London covers which of the following risks? Choose all that apply.

   a) Costs incurred due to theft and non-delivery.

   b) Events such as lightning, volcanic activity and earthquakes.

   c) Problems with carrying vessel or train (ie collision, explosion, sinking).

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TOPIC 7

Methods of settlement

Introduction

In this topic we will introduce the four basic methods of settlement and discuss the risks involved for both the seller and the buyer.

LEARNING OBJECTIVES

By the end of this topic, you will understand the:

- four main settlement methods used in international trade;
- concept of the risk ladder;
- balance of risks for each settlement method, and which methods of settlement are suitable for the seller and which are suitable for the buyer.

THINK . . .

Think back to the Dutch buyer of Chinese toys mentioned in previous topics.

Which settlement method will they use? How can they minimise their risks? The Chinese importer will also want to mitigate any risks; how will they balance this?

7.1 Settlement terms

This topic introduces the main payment methods available to buyers and sellers in international trade finance.

The four basic methods of settlement are:

- open account;
- documentary collection;
- documentary credit;
- payment in advance.

The payment term selected by the parties will largely depend on a number of factors, including the:

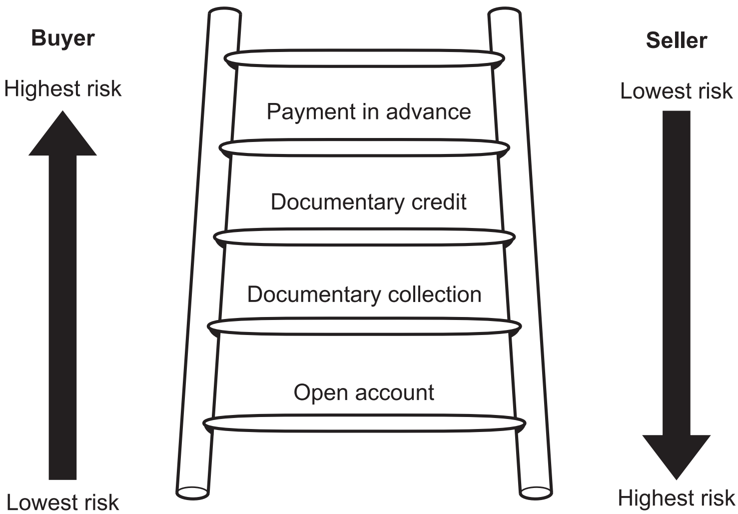
- relationship between the buyer and seller;
- availability of facilities and working capital to the buyers and sellers;
- countries involved in the transactions.

These methods of payment will be explained in detail in later topics. The purpose of this topic is to provide you with a brief overview of the terms.

7.2 The risk ladder

At the outset of negotiations, the buyer and seller must agree on the terms of how they are to trade. The risk ladder (Figure 7.1) is a popular concept that outlines the fact that the most secure method of settlement for a seller is the least secure for a buyer.

FIGURE 7.1 THE RISK LADDER



As the relationship between the buyer and the seller develops, more relaxed terms of settlement may be agreed. Later in this study text, we will explore the various settlement methods – from the riskiest from the seller's point of view (open account payment, ie when the seller ships the goods without any certainty of payment) to the most cautious from the seller's point of view (payment in advance).

There are a variety of guaranteed – or partially guaranteed – mechanisms that operate between these extremes.

7.3 The balance of risk between the seller and buyer

Once each party has carried out appropriate checks to ensure that the other party is a suitable counterparty and that the transaction is lawful, they can discuss the details of the commercial contract.

The buyer and seller should have reached an agreement about where the balance of risk will lie between them, and the service that will be required of one or more banks. When a bank is asked to provide a service appropriate to the contractual agreement between the buyer and seller, the bank must also decide whether or not that service poses a risk to it and whether or not it wishes to accept that risk.

Table 7.1 provides a summary of the settlement options that the buyer and seller have and the relative risk to each party of the options listed.

TABLE 7.1 THE BALANCE OF RISK BETWEEN THE SELLER AND BUYER

Payment method contracted	Goods in hands of buyer before (B) or after (A) payment	When paid for	Seller's risk	Buyer's risk
Open account – goods shipped and documents forwarded direct to the buyer on the expectation that it will pay against the invoice and other documents	B	As per contract	Highest	Lowest
Consignment – similar to open account. The seller sends goods to an overseas distributor who is responsible for managing and selling the goods for the seller. The seller retains title to the goods until they are sold. Payment to the seller is required only for those items sold. This enhances export competitiveness, as goods are with the distributor and thus readily available for delivery to the end user	B	When the distributor has sold the goods to the end customer	High	Low but will have storage costs

Collection through a bank with payment on D/A terms – documents to be released against acceptance	B	As per contract. The buyer will accept a bill of exchange payable after a fixed number of days	Medium to high	Low*
Collection through a bank on D/P terms – documents to be released against payment	A	On presentation of documents	Low but if buyer refuses payment, goods will need to be stored, resold or returned	Low*
Documentary credit	Depends on whether documentary credit is available by payment or usance terms	After complying to the terms of the credit, presentation made to the bank or bank accepts waiver of the applicant if discrepancies found (see Topic 9)	Low (provided documents are compliant)	Low*
Payment in advance	A	Before shipment	None	High

* Only if the quality of goods shipped has been independently verified.

7.4 Open account

In an open account transaction, a seller will despatch its goods to a buyer and send an invoice (and any other customary or required documents) asking for payment or agreement to pay on a specified date. If goods are shipped by sea, the goods are consigned to the buyer and the documents of title will be sent direct to the buyer; if goods are despatched by air, then the goods are consigned directly to the buyer. A set date for payment is given and the buyer remits the necessary funds to the seller as agreed. Open account arrangements therefore require the seller to place a considerable amount of trust in the buyer. Once the goods have been despatched or services delivered, a seller will lose all control over payment, and is reliant on the trustworthiness and creditworthiness of the buyer.

Open account trade is common in international trade; over 80 per cent of world trade is conducted on open account terms (ICC, 2018, p13). It is particularly useful in transactions involving regular shipments, where the importer often makes payments at set intervals for goods received during a preceding period. Where necessary, sellers can seek to obtain credit insurance on their overseas debtors and can use an export invoice discounting or factoring facility (see Topic 11) to accelerate cash flow.

In many cases, sellers will assign limits to their buyers that determine how much the buyer's unpaid balance can be. The size of the limit depends on the creditworthiness of the buyer. As long as the buyer pays for the deliveries of the goods as stipulated in the payment terms of the contract and the outstanding balance remains within the limit, the delivery of goods will continue. However, should the buyer delay payment or default on it, the limit will become overdrawn, and the seller may stop delivering goods.

In some cases, such limits can be secured by payment guarantees issued by the buyer's bank or by a credit insurance policy. The seller's credit department has an important to role to play – they must follow up on the buyer's position, and may have to intervene and stop the delivery of goods if the buyer stops paying or looks to be less creditworthy than previously thought.

It should also be noted that open account transactions are well suited to supply chain finance solutions (ICC, 2018, p13), which will be discussed in Topic 11.

7.5 Documentary collection

In a documentary collection, a seller will ship or despatch its goods; however, instead of sending the documents direct to the buyer, it will send them via the banking system to hold pending payment or acceptance by the buyer. This is covered in more detail in Topic 8.

Documentary collections are a compromise for the buyer and seller – they are neither the safest nor the riskiest method of settlement for either party. However, they do provide some protection for the buyer and seller (see Topic 8), as well as being a simple and cheap form of payment.

Documentary collections are governed by the ICC publication *Uniform Rules for Collections 522* (known as 'URC 522') when reference is made to their application in the collection instruction.

7.6 Documentary credit

A documentary credit is an undertaking provided by the buyer's bank, stating that if the seller complies with its various terms and conditions, the bank will arrange settlement in the manner described therein.

If the seller is in a strong bargaining position, but not strong enough to obtain payment in advance, then the next-best settlement method is a documentary credit. If the buyer agrees to settlement by documentary credit, it will request the issuance of the credit by its bank. Details of the credit are then advised through the banking system to the seller.

Once the seller receives the documentary credit, it can ship the goods, collate all of the documents required by the credit and present them through the banking system.

Once an issuing bank has fully compliant documentation in its possession, then it must make payment (either when the documentation arrives or on the date agreed with the seller).

As it is the buyer that requests its bank to issue a credit, the amount of the credit will be treated by its bank as a contingent liability in its credit facility. The buyer's bank must be satisfied that the buyer can reimburse it, in the event that the bank is required to pay out under the undertaking. Finance can be provided against the credit for both the buyer and seller, and the credit can be available in other forms – for example to allow for an advance payment, or to be transferable.

When reference is made to a documentary credit being subject to UCP 600, this refers to the rules set out in the ICC 2007 publication *Uniform Customs and Practice for Documentary Credits 600*.

Documentary credits are covered in more detail in Topic 9.

7.7 Payment in advance

With this method of payment, the buyer pays for the goods or services in advance. Once the seller is in receipt of the funds, it arranges for the goods to be shipped or despatched.

From the seller's point of view, receiving payment in advance of the shipment is an ideal situation, as it appears to eliminate all risks associated with non-payment. However, to be certain of payment, attention must be given to how the money is paid to the seller. For example, if payment is made by a cheque issued by a bank abroad, then time must be taken for the cheque to clear and to be honoured. Some sellers may accept payment by credit card. In the event that a fraudulent credit card is used, then the seller's merchant processor may reclaim the money from the seller's account.

From the buyer's point of view, payment in advance carries the greatest risk, as it is wholly dependent on the seller shipping the correct goods in accordance with the contract. In addition, payment in advance can create cash-flow problems for the buyer, as it has to wait to receive the goods.

Occasionally, a transaction can be arranged where part payment is made in advance (for example, a deposit of 30 per cent) and the balance is paid at a later date using one of the other three methods of payment.

FACTFIND

Check your local bank's transfer rules, so that you are aware of the requirements for making or receiving advance payments.

Also check the transaction amounts that banks in your country are obliged to report under local anti-money-laundering regulations.

Conclusion

The choice of settlement method is important. Depending on the method used, the buyer or seller will need to examine their position with regard to the risks they are willing to take and the bargaining position they are in.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- describe the four main methods of settlement?
- highlight the risks that each method presents for the buyer and for the seller?

Test your knowledge

?

Use these questions to assess your learning for Topic 7. Review the text if necessary.

Answers can be found at the end of this book.

1) Which of the following methods of settlement poses the least risk for the seller?

   a) Documentary collection.

   b) Documentary credit.

   c) Open account.

   d) Payment in advance.

2) In an open account transaction, the seller will despatch the goods to a buyer and send the documents of title for which of the following?

   a) Payment at a determinable future date.

   b) Payment on a specified date.

   c) Payment in advance.

3) In a documentary collection, the seller will despatch the goods and send the title documents for:

   a) acceptance of the debt by the buyer.

   b) holding, pending payment or acceptance by the buyer.

   c) the exchange of a cheque from the buyer.

4) A documentary credit is an undertaking provided by the buyer's bank to pay:

   a) as soon as is requested by the seller.

   b) to the seller without condition.

   c) if the seller complies with various previously agreed terms and conditions.

5) In a documentary credit transaction, once the goods have been shipped, the title documents of the goods will be sent:

   a) directly to the buyer.

   b) through the banking system.

   c) with the goods.

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TOPIC 8

Documentary collections

Introduction

We introduced documentary collections as a method of settlement in Topic 7. Throughout this topic, we will take a more detailed look at the documentary collection process and the advantages and disadvantages to the buyer and seller. Topic 6 discussed the documents that are used in international trade finance, and this topic will look at how these documents are used to facilitate payment for an underlying transaction.

LEARNING OBJECTIVES

By the end of this topic, you will understand:

- what is meant by a 'documentary collection';
- the nature of the instructions given by one bank to another;
- the responsibilities of the parties to a collection;
- the processing and monitoring of collections;
- how documents are delivered to a buyer and how payment or acceptance is obtained from them;
- what happens when payment is not forthcoming.

THINK . . .

The Chinese manufacturer mentioned in previous topics will want to minimise their risks, but payment in advance is too risky for the Dutch buyer.

A suitable solution for all parties may be payment by documentary collection, though both the seller and the buyer are still subject to some risks.

8.1 Basic principles

A documentary collection transaction is initiated by the seller, which despatches goods to the buyer. At the same time, the seller entrusts the related documents (which may include negotiable bills of lading or other transport documents) to its bank for collection of the sale proceeds, as well as the delivery of the documents to the buyer, according to the terms of the sales contract.

The seller's bank (the remitting bank) will ask the buyer's bank (the presenting bank) or a correspondent bank in the buyer's country to deliver to the buyer the documents of title to the goods against payment of the amount due (documents released against payment – 'D/P') or against acceptance of a term draft (documents released against acceptance – 'D/A').

The ICC publication that governs documentary collections is the *Uniform Rules for Collections* (URC), publication no. 522 ('URC 522'). In order for the URC 522 rules to be applicable to a transaction, it must be mentioned in the instructions relating to the handling of the documentary collection. If a collection instruction does not refer to the URC 522, caution is advised and the sender of those instructions should be contacted to ascertain the applicable rules or framework under which the collection is to be processed.

A summary of the URC 522 articles can be found in sections 8.9–8.11.

Definition

URC 522 (ICC, 1995) sub-article 2 (a) defines a collection as "the handling by banks of documents [. . .] in accordance with instructions received, in order to:

1) obtain payment and/or acceptance; or

2) deliver documents against payment and/or against acceptance; or

3) deliver documents on other terms and conditions."

Types

Collections can therefore be classified into three types, as outlined in the following key terms box.

KEY TERMS

Clean collection

The payment of a draft by the buyer on a sight basis or acceptance of a draft and payment on the due date. This type of collection is also used for cheques. No other financial or transport document accompanies the collection.

Documentary collection for payment on D/P terms

The payment at sight by the buyer against release of documents.

Documentary collection for acceptance on D/A terms

The acceptance of a term draft by the buyer against release of documents.

8.1.1 Parties

The following are the main parties to a collection, as defined in article 3 of URC 522 (ICC, 1995).

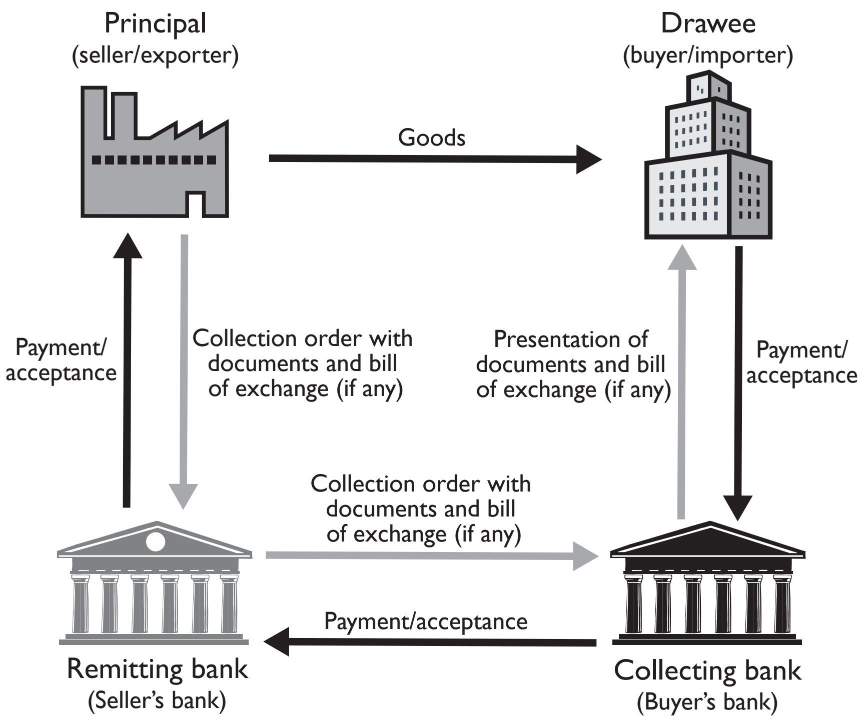
- The **principal**, which is normally the seller – the principal entrusts the handling of a collection to a remitting bank.
- The **remitting bank**, which acts for the seller – it is usually based in the seller's own country and is invariably the seller's own bank.
- The **collecting bank**, normally a correspondent of the remitting bank based in the buyer's country. The collecting bank, as agent of the remitting bank, will present the documents to the drawee (usually the buyer of the goods) for payment or acceptance.
- The **presenting bank** – a bank used by the collecting bank, where it has been identified by the collecting bank that the presenting bank is the banker of the drawee and is therefore better placed to approach the drawee with a request for payment or acceptance. It is not common to have a collecting bank and a presenting bank.

- The **drawee** – the party requested to pay or accept in accordance with the collection instructions. The drawee is usually the buyer.

8.2 Documentary collection process – the documents

Figure 8.1 illustrates the documentary collection process, and shows the transfer of the documents and payments between the parties involved (the buyer, seller, remitting bank and collecting bank).

FIGURE 8.1 DOCUMENTARY COLLECTION PROCESS



Source: Author (2018)

In the following example, the documentary collection process is outlined and the application of URC 522 is shown where applicable.

A seller would first agree with a buyer to utilise the banking system to arrange the transfer of documents and payment or acceptance. The seller then ships the goods and obtains the documents relating to the shipment, such as the commercial invoice, transport document, certificate of origin, etc. The seller will complete and sign a collection instruction form and present the documents together with the collection instruction to the remitting bank. Such a collection form can be the seller's own form or it can be a form provided by the bank.

DOCUMENTARY COLLECTION INSTRUCTION FORM

Although every bank's documentary collection instruction form will differ slightly, you would expect to see the following information included on the form:

- the seller's name, address and contact details;
- the buyer's name, address and contact details;
- the amount to be collected;
- a (general) description of the goods;
- a list and number of the documents that accompany the collection instruction;
- detailed instructions concerning settlement:
  - payment against release of documents (D/P terms);
  - acceptance against release of documents (D/A terms);
  - how any interest charges are to be calculated and collected;
- what the collecting or presenting bank must do if payment or acceptance is refused: whether goods are to be warehoused and insured; whether there is a need for 'protest' for non-payment/non-acceptance, if that procedure is available in the local jurisdiction;

- whether charges are for the buyer's account and whether or not they may be waived if refused, or whether they would be paid by the seller.

8.3 Documentary collection process – the payment

The seller will sign the collection form. The following points should be noted.

- The consignee on a transport document should not be the buyer's bank or any other bank unless prior arrangements have been agreed.
- Drafts drawn to the seller's order should be blank endorsed.
- Bills of lading made out 'to order' or 'to order of the shipper' should be endorsed in blank by, or on behalf of, the named shipper.
- The collecting or presenting bank will require a title document such as a negotiable bill of lading to arrange clearance of the goods and storage unless the collecting or presenting bank is the named consignee (provided the bank is willing to take such action). Any local regulations will have to be complied with, such as those covering import licences and rules regarding the storage of certain types of cargo.
- Where D/A terms have been agreed, a draft drawn on the buyer will usually be enclosed with the documents, with details of acceptance terms given on the collection instruction. Where D/P terms are agreed, technically a draft is not required, as the documents will be released upon payment by the buyer. Indeed, in some countries where drafts still attract stamp duty, it is best not to enclose them with a collection instruction, thus avoiding payment of expensive pro-rata stamp duty.

If in agreement with the seller's instructions, the remitting bank will then send its own collection instruction (based on the instructions received from the seller) to the collecting bank, with confirmation that the collection is subject to the URC 522 rules and accompanied by the documents provided by the principal. They will normally be sent by courier service.

If the collection form is provided by the remitting bank, it usually contains a declaration to the effect that the bank is not liable for loss or delay due to factors beyond its control, such as postal delays, or loss of documents in transit to the collecting or presenting bank. The bank will refer to URC 522, as article 14 stipulates that banks are not responsible for delay or loss of the documents.

Nowadays, banks need to follow strict compliance regulations. Article 13 of URC 522 states that banks are not obliged to check documents under collections. However, according to compliance regulations, banks should screen all documents for compliance-related issues (anti-money-laundering, sanctions, etc).

As an alternative to a paper-based system, sellers may have access to their banks' e-banking systems. The seller could prepare a collection instruction online in the name of the remitting bank, print the collection instruction and attach the documents, and send them to the buyer's bank.

The remitting bank will then perform the follow-up messaging with the collecting or presenting bank until the documents are paid or accepted. This procedure is commonly known as a 'direct collection'. However, some banks are reluctant to offer such a service. For compliance reasons, usually only corporates with detailed experience in handling documentary collections are eligible for using direct collections.

FACTFIND

Obtain and study a copy of your own bank's (or any local bank's) documentary collection instruction, to see what is included.

> Check whether this bank also offers web-based services for documentary collections and try to find some information. Sometimes, informational videos are available.

8.4 Obligations of the collecting/presenting bank

For the collecting bank, the collection will often be referred to as an 'inward bill for collection'.

As mentioned in section 8.3, a bank is not obliged to handle a collection it receives. If the bank decides not to handle a collection, it must inform the sender, by telecommunication or other expeditious means, of its decision without any delay (ICC, 1995). URC sub-articles 1 (b) and 1 (c) apply in this respect.

On receipt of the remitting bank's collection instruction and the documents, the collecting/presenting bank will examine what has been received, check the schedule of instructions it has been given, and make sure that the documents attached are as described and in the correct number of originals and copies. According to URC 522 article 4, collecting/presenting banks are not required to look to the documents for any instructions (ICC, 1995). The collecting/presenting bank should then inform the buyer of the instructions it has received.

The collecting/presenting bank may well have a banking relationship with the buyer but, when handling a collection, it is acting as agent for the remitting bank and therefore owes the remitting bank the normal duty of care an agent owes to its principal. Therefore, the collecting/presenting bank's duty and responsibility to the remitting bank overrides any duty to its customer.

What happens next depends on the type of collection.

8.4.1 Clean collection

A clean collection will involve the collecting/presenting bank presenting a draft to the buyer for payment or acceptance or presenting a cheque for payment, without invoices, transport or other documents.

- If paid, the collecting/presenting bank will transfer the funds to the remitting bank, normally via SWIFT (see section 3.8.1 for more information about SWIFT).
- If accepted, the collecting/presenting bank will advise the remitting bank, and the accepted draft will be handled according to the collection instruction, ie hold it until maturity and present it to the buyer for payment, or return it to the remitting bank for re-presentation shortly before the maturity date.
- If unpaid or unaccepted, the instructions to protest, if applicable, should be carried out pending further instructions. The procedure to protest unpaid drafts is explained in section 6.3.6.

8.4.2 Documentary collection

A documentary collection will involve the collecting/presenting bank as follows.

- If accompanied by a draft payable at sight, the documents will be released against payment. Where no draft is attached, the covering schedule will merely call for payment in exchange for release of the documents.
- If accompanied by a term bill, the collecting/presenting bank must obtain the buyer's acceptance prior to release of the documents.

The collecting/presenting bank will usually make available to the importer copies of the documents received or invite the importer into its offices to facilitate payment or acceptance.

It's also possible the buyer will have received copy documents, by separate post, direct from the seller. Some buyers and sellers have also established electronic means of exchanging PDF format documents for review prior to the arrival of a collection. Nowadays many banks offer web-based applications whereby the buyer can see images of the documents on-screen and click a button for approval or refusal.

As explained in URC 522 article 13 (ICC, 1995), banks are not responsible for the genuineness or validity of any documents.

Once a bill is accepted, the collecting/presenting bank must inform the remitting bank and, once payment thereof is received on the due date, funds, less any charges, will be sent via SWIFT.

The fact that the draft has been accepted by the buyer does not constitute a guarantee by any bank involved that the bill will be paid at maturity. This is only the case when the buyer's bank has added its 'aval' to the draft as explained in section 8.6.

8.5 Payment, partial payment, currency, interest and charges

There are a number of things to consider when it is time to make payment.

Payment to the remitting bank

URC 522 article 16 states that collecting banks will make payment only to the remitting bank, unless there is some agreement to the contrary.

Currency

When the sum payable and collected is denominated in the local currency of the buyer, and this is the currency that will be paid to the remitting bank, the collecting bank should not release the documents without seeking further instructions if payment of such local currency is subject to completion of any exchange control regulations.

When a collection is denominated in a foreign currency, the same applies. The SWIFT remittance/payment will be made in that currency unless there is a regulatory reason not to do so. In such an event, the collecting bank must retain the documents. The non-availability of foreign currency can occur in countries where buyers must, in addition to an import licence (from one department of government), obtain an approval to purchase foreign currency from the central bank (another department). If they have failed to obtain the necessary approval, the collecting or presenting bank will be unable to make a payment.

Partial payment

Buyers may offer to make a partial payment. On a clean collection, partial payments can be made, but the financial document will only be released when payment is made in full.

For documentary collections, it may be that partial or instalment payments have been provided for in the instructions given to the collecting bank, in which case the collecting or presenting bank must follow those instructions. However, an offer to make partial payment without prior arrangement must be referred to the remitting bank for instructions, with the documents being retained by the collecting or presenting bank.

Interest

When interest is due to the seller, the collecting or presenting bank should collect the interest due at the rate stated and for the period involved. Unless it is specifically stated that interest may not be waived, the collecting or presenting bank may release documents against payment of the principal sum only (URC 522 article 20).

Charges

The same rule that applies to interest also applies to bank charges. Documents may be released without charges having been collected unless waiver of charges is specifically not permitted. Collecting or presenting banks are entitled to be reimbursed for their costs and charges and, if not paid by the buyer, these will be collected from the remitting bank (usually by a deduction from the amount due) and the remitting bank will, in turn, collect the costs from the seller (URC 522 article 21).

8.5.1 Receipt of documents after arrival of goods

Where goods arrive before the relevant documents, the collecting bank may be willing to assist a creditworthy buyer to take delivery of the goods without delay. In doing so, it is no longer acting as agent for the remitting bank but on its own account and at its own risk. The buyer will be asked to provide a ‘trust receipt’ (see section 6.11) undertaking to pay or accept, as the case may be, the draft on presentation, so that the collecting or presenting bank can then honour the collection instruction.

Topic 6 also explains the various types of negotiable and non-negotiable transport documents. Where a negotiable bill of lading is involved, clearing the goods before the arrival of the bill of lading will require the buyer's bank to provide a guarantee to the carrier on the buyer's behalf and against the buyer's counter-indemnity. In this case, a guarantee from the bank undertakes that the carrier will not suffer loss as a result of their actions, ie releasing the cargo.

For non-negotiable documents, goods are released to the named consignee without the need for the surrender of a transport document.

When the collecting bank is the consignee and releases goods to the buyer against payment, acceptance or other terms and conditions, the remitting bank is deemed to have authorised such action. In practice, the collecting bank will then issue its own delivery order to the carrier, authorising release of the goods to a specific party, usually the buyer.

8.5.2 Non-payment/non-acceptance by the drawee

Despite the considerations discussed in this section, in a normal correspondent relationship, a collecting or presenting bank may seek to protect the remitting bank's interests (and therefore that of the seller) when payment or acceptance is not forthcoming, by arranging for storage and insurance at the remitting bank's expense. This is where a 'case of need', who may be the seller's local agent, can help, particularly if a new buyer must be found. If the buyer fails to pay, even at a renegotiated price, and no other buyer can be found, the goods will either have to be shipped back to the seller, sold by auction (almost certainly at a huge loss to the seller) or destroyed. If a previously accepted draft is subsequently dishonoured, then there is little to be done as far as the goods are concerned – they will already have been released to the buyer at the time the bill was accepted.

8.6 Finance against documentary collections

A seller may seek an advance from its bank, in anticipation of the proceeds of a collection. Alternatively, a collection may be handled as a 'negotiation', when the seller will sign an undertaking in addition to the collection instruction.

In a negotiation, the seller's bank will agree to pay the seller immediately the value of the draft. This type of arrangement would be with recourse to the seller, meaning that if the bank were unable to obtain payment from the importer, it would come back to the seller to retrieve its payment.

The seller would also agree to pay interest for the period between the negotiation date and the date when the remitting bank receives payment.

Finance can also be provided to the buyer, by the buyer's bank, by way of an advance to the buyer, to help pay the sight or term bill.

Avalisation

The buyer's bank may also provide a form of additional acceptance to the draft accepted by the buyer. This is common in a number of countries and is known as 'avalisation', because the bank signs the bill with the words 'Bon pour aval'. Clearly, with the collecting bank's name on the draft, the collecting bank effectively guarantees payment. Thus, it is possible for financing to be raised on the draft prior to the due date on the strength of the bank avalisation.

AVAL

"A payment such as a bill of exchange, promissory note, or cheque which a bank promises to pay if [its] customer is not able to pay it back themselves. An aval is sometimes referred to as a 'bank guarantee', since a bank is guaranteeing payment of the financial instrument." (Cambridge Dictionary, 2018)

The prior permission of the buyer and its bank should be obtained before submitting a collection instruction with a request for avalisation. The bank's acceptance 'pour aval' will incur further bank charges, and, prior to the collection being despatched, the buyer and seller must agree who will be responsible for these charges. Collecting banks must not release the documents unless they are prepared to avalise the draft, and to do so, they should ensure that the buyer is financially capable of paying the draft on the due date.

Negotiation, financing and avalisation are not part of the documentary or clean collection transaction. They also fall outside the scope of the URC 522 and are offered by banks as a competitive product connected with the result of a collection (an accepted draft, for example). The fact that a seller uses the method of collection does not automatically give them the right to obtain any form of financing. This is different from documentary credits, where discounting or pre-payment is part of the method itself, as laid out in UCP 600. This is explained in detail in Topic 9.

8.7 Advantages and disadvantages

The safest method of settlement for a seller would be to receive payment in full and in advance (see section 7.7), before the goods are shipped. However, as discussed in Topic 7, this is the riskiest method for the buyer, which would ideally prefer to have the goods sent on an 'open account' basis (see section 7.4), where payment is usually made after the goods arrive.

However, commercial reality frequently means that a compromise must be reached, to provide some built-in protection for both sides. Of the two main banking arrangements that enable buyers and sellers to protect their interests, the 'collection' is the simplest and cheapest. The other, the 'documentary credit', is the subject of Topic 9.

TABLE 8.1 DOCUMENTARY COLLECTIONS: ADVANTAGES AND DISADVANTAGES

Advantages	Disadvantages
The likelihood of payment for the seller is high, as the buyer may not be able to obtain the goods without payment or acceptance of the collection.	The security of payment for the seller is less than with payment in advance or with a documentary credit.
Some assurance is provided to the buyer that the shipment will arrive, although the buyer will often not be able to examine the goods before payment or acceptance of the collection.	The seller does not have the benefit of a bank's engagement to pay provided by a documentary credit, and relies only on the credit standing of the drawee/buyer.
It provides an opportunity to sell goods on, before payment has to be made (under a D/A transaction).	Should the collection remain unpaid, the costs of protecting the goods can be high. Finding an alternative buyer, willing to pay a fair price, in a far country may be difficult, particularly for perishable goods.

8.8 Risks

The risks of documentary collections to sellers and buyers are as follows:

- The seller is at less risk than when using open account payment but remains reliant on the credit standing of the buyer to a considerable extent.
- If the buyer does not pay or accept, the seller and the remitting bank are dependent upon the collecting bank acting efficiently, if so instructed, to store and insure the goods and, in the worst case, arrange for a sale.
- Sellers have a risk, more in some countries than others, that foreign exchange will not be available to the buyer. See 'transfer risk' in Topic 2.

- Buyers will have had no chance to examine goods before accepting or paying a draft.

Many of these risks can be covered by the following means:

- issuance of inspection certificates (see Topic 6);
- insurance against non-payment or country risk such as non-availability of foreign exchange (see section 2.1.1);
- documentary credits confirmed by a bank in the country of the seller can cover country risk, since that risk is taken over by the confirming bank (see Topic 9).

8.9 Summary of URC 522 articles 1–4

The following is a summary of URC 522 (ICC, 1995). Some content has been quoted directly. The full text is available from http://store.iccwbo.org/.

Article 1

Article 1 defines the application of URC 522. It states that banks are not obliged to handle any collection. Should a bank decide not to handle a collection, it must advise the party from which it received the collection or instruction without delay.

Article 2

Article 2 defines the different types of collection instructions and differentiates between the various terms.

Sub-article 2 (b) gives a definition of documents as being financial documents and/or commercial documents:

- "'Financial documents' means bills of exchange, promissory notes, cheques, or other similar instruments used for obtaining the payment of money;
- 'Commercial documents' means invoices, transport documents, documents of title or other similar documents, or any other documents whatsoever, not being financial documents."

(ICC, 1995)

Sub-articles 2 (c) and 2 (d) define, respectively:

- clean collection as a "collection of financial documents not accompanied by commercial documents" (ICC, 1995);
- documentary collection as either the collection of "financial documents accompanied by commercial documents" or "commercial documents not accompanied by financial documents" (ICC, 1995).

Article 3

Article 3 identifies the main parties to a collection as the principal, the remitting bank, the collecting bank, the presenting bank and the drawee. See section 8.1.1 for definitions of these parties.

Article 4

Article 4 covers the form and structure of a collection. It also states that banks will not examine documents in order to ascertain instructions and are only obliged to act on the instructions received from the party that presented the collection to them unless the collection instruction states otherwise.

Sub-article 4 (b) gives a detailed explanation as to what information, as appropriate, should be included in a collection instruction:

- details of the bank from which the collection was received;
- details of the principal, eg name, address and contact details;
- details of the drawee, eg name, address and contact details;
- details of the presenting bank;
- the amount and currency that is to be collected;
- a list of the documents enclosed and a numerical count;
- terms and conditions on how payment or acceptance is to be obtained;
- terms of delivery of the documents, eg against payment, acceptance or other terms and conditions;

- details of charges and interest to be collected and whether or not they may be waived;
- the method by which payment is to be remitted and form of payment advice that is required;
- instructions in the event of non-payment/non-acceptance or non-compliance with other instructions.

8.10 Summary of URC 522 articles 5–19

Articles 5–8

Articles 5–8 give details on the procedures relating to the form of presentation, making presentation for payment or acceptance, release of commercial documents and creation of documents.

Article 9

Article 9 states that "banks will act in good faith and will exercise reasonable care" (ICC, 1995) when handling a collection instruction.

Article 10

Article 10 states that goods should not be despatched directly to a bank, nor transport documents show that goods are consigned to or to the order of that bank, without the bank's prior agreement. Where no prior agreement has been given, there is no obligation on the part of the bank to take delivery of the goods. A collecting or presenting bank is under no obligation to take action to store and insure goods, even if there are instructions to that effect in the collection instruction.

Article 11

Article 11 provides a disclaimer for a remitting or collecting bank when it utilises another bank to fulfil the instructions of a principal, and such acts are not carried out by that other bank.

Article 12

Article 12 states that although the banks are not obliged to examine the documents presented in detail, a bank must check that it has received all of the documents listed on the collection instruction and in the number stated. In the event that some documents are missing or additional documents are received that are not listed, the bank must advise the party who sent the collection by telecommunication or, if that's not possible, by another means without delay.

Articles 13 and 14

Articles 13 and 14 provide a disclaimer on the effectiveness of data appearing within the presented documents, eg sufficiency, accuracy, genuineness, falsification, etc, and against any delays or loss of documentation in transit.

Article 15

Article 15 covers 'force majeure', which comes from the French term meaning 'superior force'. It indemnifies banks against any responsibility or consequences arising from interruption of their day-to-day business due to "acts of God, riots, civil commotions, insurrections, wars" (ICC, 1995) or any event that is beyond their control.

Articles 16–19

Articles 16–19 give definitions and explanations concerning payments procedures. Article 19, in particular, covers partial payment and differentiates between clean collections (where such payments may be accepted, provided that such an action is "authorised by the law in force in the place of payment" [ICC, 1995]) and documentary collections (where "partial payments will only be accepted if specifically authorised in the collection instruction" [ICC, 1995]).

8.11 Summary of URC 522 articles 20–26

Articles 20 and 21

Articles 20 and 21 relate to interest, charges and expenses and, in particular, the action that should be taken by a bank where these have been refused by the drawee.

Article 22

Article 22 states that the bank that releases documents against acceptance is responsible for seeing that the form of acceptance "appears to be complete and correct", but there is no responsibility to ascertain the "genuineness" or "authority" of any signatory to the acceptance (ICC, 1995).

Article 23

Article 23 states that a "presenting bank is not responsible for the genuineness of any signature or the authority of any signatory" (ICC, 1995) appearing on a promissory note, receipt or other instrument.

Article 24

Article 24 states that a bank is not obliged to protest in the event of non-payment or non-acceptance unless it is expressly required in the collection instruction.

Article 25

Article 25 relates to the use of a case of need. A case of need will usually be an agent of the exporter resident in the country where the goods have been shipped. Where indicated, the collection instruction should specify the scope of the powers that have been granted.

Article 26

Article 26 states that it is the collecting bank or presenting bank's responsibility and duty to advise the fate of the collection to the bank from whom the collection was received – whether paid, accepted or any advice of non-payment or non-acceptance.

Conclusion

Documentary collection is a method of settlement that reduces risks for both the buyer and the seller. A seller's collections are handled by its bank (the remitting bank), which sends the relevant documents to the buyer's bank (the collecting bank). The collecting bank's duty is to the remitting bank in an agency role.

Both sellers and buyers can obtain finance to overcome a cash-flow deficiency. Sellers can, subject to their credit standing, obtain loans against collections or they may negotiate a draft sent for collection to obtain early payment, albeit outside of the collection process.

A buyer's bank may also make funds available to its customer, so that it can meet its payment obligations before the imported goods have been processed and/or sold.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- describe all the parties in a collection?
- describe how the seller presents its documents to its bank?
- indicate what the responsibilities of the banks are in case of non-payment?
- elaborate on the risks the buyer and seller incur by using a documentary collection?

Test your knowledge

?

Use these questions to assess your learning for Topic 8. Review the text if necessary.

Answers can be found at the end of this book.

1) Which of the following is **not** a main party to a collection?

   a) The confirming bank.

   b) The drawee.

   c) The presenting bank.

   a) The remitting bank.

2) In relation to the parties to a collection, which of the following is **not** true?

   a) It is very common to have a collecting bank and a presenting bank.

   b) The collecting bank will present the documents to the drawee.

   c) The drawee is usually the buyer.

   d) The remitting bank is the bank that acts for the seller.

3) URC 522 states that:

   a) a bank that receives a collection must advise the principal without delay.

   b) a bank that decides not to handle a collection must advise the party from which it received the collection without delay.

   c) banks are obliged to handle collections.

   d) goods should be despatched directly to a bank without the bank's prior agreement.

4) Which of the following statements are **true** for a documentary collection?

   a) The collecting bank, a correspondent bank of the remitting bank, will present the documents to the seller for payment or acceptance.

   b) The presenting bank is normally the bank of the drawee.

   c) The principal is normally the seller.

   d) The remitting bank usually acts for the seller.

References

Cambridge Dictionary (2018) *Aval* [online]. Available from: https://dictionary.cambridge.org/dictionary/english/aval [Accessed: 2 October 2018].

ICC (1995) *Uniform Rules for Collections*. ICC Publication No. 522. ISBN 978-92-842-1184-0. Available at: store.iccwbo.org/ [Accessed: 16 October 2018].

Documentary credits

Introduction

Documentary credits, often referred to as letters of credit, are one of the oldest and most secure methods of settlement in international trade. They are an undertaking by a bank that offers certainty of payment to the seller and delivery of goods to the buyer, provided a number of conditions are met. These conditions involve the presentation of documents that you learned about in Topic 6. All parties, therefore, need to have a clear understanding of how the system operates. In this topic, you will gain a detailed insight into the entire process.

LEARNING OBJECTIVES

By the end of this topic, you will understand:

- what a documentary credit is and its main features;
- the principles that determine the processing and interpretation of documentary credits;
- the responsibilities of and risks to the parties involved;
- the various types of documentary credit;
- *ICC Uniform Customs and Practices for Documentary Credits* (UCP 600); and
- dispute resolution methods provided by ICC.

THINK . . .

- How do importers of toys, cars or electronic items minimise risks for both parties?
- Can banks take on those risks?
- How is financing provided?
- Is there a secure way for importers of toys, cars or electronic items to ensure receipt of these items?
- Equally, how can manufacturers or distributors be confident that they will receive payment?

9.1 ICC rules that govern documentary credits

UCP 600

As with documentary collections, ICC has produced a set of rules for documentary credits that are almost universally accepted. These are known as *Uniform Customs and Practice for Documentary Credits*, or 'UCP' for short. The latest version of these rules came into force on 1 July 2007 and was published as ICC Publication No. 600 (ISBN 978-92-842-1257-6). It is referred to as UCP 600. A summary of the articles is available at the end of this topic. The full publication is available from the ICC store. You will not be required to read this in full in order to pass this examination.

ISBP 745

In addition, ICC has produced a publication that provides guidance on how the articles of UCP 600 should be interpreted and applied in the examination of documents. This is called *International Standard Banking Practice for the Examination of Documents under Documentary Credits* subject to UCP 600, or 'ISBP' for short. The latest version is ISBP 745. It is a necessary companion to UCP 600 for all practitioners. You will not be required to read this publication in detail in order to pass this examination.

ICC PUBLICATIONS RELEVANT TO DOCUMENTARY CREDITS

Besides UCP 600 and ISBP 745, the following publications are useful.

- *ICC Uniform Rules for Bank-to-Bank Reimbursements under Documentary Credits* (URR 725).
- *ICC Supplement to the Uniform Customs and Practice for Documentary Credits for Electronic Presentation* (eUCP version 1.1).
- *ICC Banking Commission Opinions*.

Find out more at: http://store.iccwbo.org/ [Accessed: 22 October 2018].

You will **not** be required to read these publications in order to pass this examination.

9.1.1 Definition and key features

Documentary credits are very often used to settle the payment obligation of a buyer and, in the context of an issuing bank, may be defined as an irrevocable undertaking given by a bank whereby it undertakes to honour a presentation of documents submitted in accordance with the terms and conditions of the documentary credit and in compliance with UCP 600.

Explanations of the key features of this definition are as follows.

Irrevocability

The undertaking given by the issuing bank on behalf of a buyer of goods or services is irrevocable. This means that the bank agrees not to amend or cancel the credit without the consent of the beneficiary and a confirming bank, if any. You will learn about the role of a confirming bank in section 9.1.2. Once a documentary credit is issued, the buyer will become known as the 'applicant'.

Revocable credits

Although documentary credits used in international trade are always irrevocable, even if there is no indication to that effect, revocable credits still exist in some countries. They are seldom used in an international context and UCP 600 no longer makes reference to them. As a revocable credit can be cancelled at any time without the consent of a beneficiary, it does not provide a high degree of security. Banks will never confirm a revocable credit.

Honouring a presentation

The issuing bank can honour a presentation of documents in the following three ways:

- "pay at sight if the credit is available by sight payment";
- "incur a deferred payment undertaking and pay at maturity if the credit is available by deferred payment"; there is no requirement for a bill of exchange or 'draft' with this type of documentary credit;
- "accept a draft for payment on a maturity date if the credit is available by acceptance".

(ICC, 2007)

KEY TERMS

Sight payment

Immediate payment on presentation of a bill of exchange.

Deferred payment

A commitment to pay at a future date.

KEY TERMS

Draft

Another term used to refer to a bill of exchange.

Maturity date

A date in the future when a debt instrument or loan is due to be repaid.

An issuing bank can designate or 'nominate' another bank to honour a presentation or to negotiate drafts and/or documents. Honour is defined in article 2 of UCP 600.

On the basis of documents alone

Banks only deal with documents and not the goods, services or performances to which the documents may relate. UCP 600 sub-article 14 (a) states that banks examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation. Documents presented by the beneficiary must be those specified in the credit. For most transactions, these will include the documents you learned about in Topic 6 such as invoices, transport documents and insurance documents.

Terms and conditions of the documentary credit

Banks are only required to examine documents according to the terms and conditions of the credit and not terms that may appear in an underlying contract, pro forma invoice or purchase order.

9.1.2 Parties

The applicant for a documentary credit is the buyer that asks its bank to issue the credit. An applicant is not a party to a documentary credit transaction.

The main parties are as follows (ICC, 2007):

- **Advising bank** – a bank that advises the credit at the request of an issuing bank.

ADVISE A CREDIT

A bank sending a credit to the beneficiary once it is satisfied with the apparent authenticity of the credit. Advising is synonymous with transmitting, notifying or sending.

- **Beneficiary** – a company or individual to whom the credit is issued, in most cases the provider of the goods, services or performances.
- **Issuing bank** – a bank that issues a credit at the request of an applicant or on its own behalf. An issuing bank gives an undertaking to reimburse a nominated bank that has honoured or negotiated compliant documents under the terms of the credit, even if the applicant is unwilling or unable to pay. It also provides an undertaking to honour a complying presentation that is made to it directly by the beneficiary.
- **Confirming bank** – a bank that adds its confirmation to a credit upon the issuing bank's authorisation or request.

CONFIRMATION

A bank adding an additional undertaking to that of the issuing bank and thereby undertaking to honour or negotiate a complying presentation made to it by the beneficiary. If a bank 'confirms' a credit, the documentary credit is commonly known as a 'confirmed documentary credit'.

- **Nominated bank** – a bank with which the credit is available, or any bank in the case of a credit available with any bank. This refers to a bank at which a beneficiary may present documents for honour or negotiation. Each credit must indicate whether it is available with the issuing bank or with a nominated bank or with any bank (in which case, any bank is a nominated bank).

- **Reimbursing bank** – the bank nominated by the issuing bank to provide settlement. ICC has published a set of rules for bank-to-bank reimbursements known as *ICC Uniform Rules for Bank-to-Bank Reimbursements under Documentary Credits* (URR 725).

The advising, confirming and nominated bank may be the same institution.

'OPEN' OR 'SILENT' CONFIRMATION?

A bank can only add its confirmation if requested by the issuing bank (ICC, 2007).

Should the beneficiary nevertheless require confirmation, it can ask the advising bank to add a 'silent confirmation'. This concept is not defined in UCP 600, but the practice is widespread. Banks that choose to add a 'silent confirmation' will do so on their own terms and at their own risk.

9.2 Standards for the examination of documents

The standards for the examination of documents are listed in article 14 of UCP 600. More detail is provided in ISBP 745. The following are some key points:

- **Presentation period** – documents should be presented within 21 calendar days after the date of shipment by default. Ideally, each credit should indicate the applicable presentation period.
- **Examination period** – an issuing bank, a confirming bank or a nominated bank acting on its nomination has a maximum of five banking days following the day of presentation to determine whether the presentation complies.

- **Dates** – a document must not be dated later than the date of its presentation.
- **Description of goods** – in documents other than the invoice, the description of the goods, services or performances, if stated, may be given in general terms that do not conflict with the description in the credit.
- **Issuer of a document** – if the credit does not indicate a specific issuer for a document, such as for an inspection certificate, then the issuer named on the document will be accepted as submitted. Where the data content for a document is not given in a credit, banks will accept the document as presented, provided it fulfils the function of that document.
- **Data in a document** – "when read in context with the credit, the document itself and international standard banking practice, this need not be identical to, but must not conflict with data in that document, any other stipulated document or the credit" (ICC, 2007).

STRICT COMPLIANCE

The following are some key questions to ask when determining whether documents are compliant or not:

- Is the use of abbreviations in the document(s) acceptable?
- Are typographical errors acceptable?
- If the credit states that the currency is 'USD', is the use of the '$' symbol in the documents acceptable?
- Is it acceptable for the credit number to be missing from one document if it is stated in the credit that the credit number is required on all documents?

The ICC publication ISBP 745 provides detailed guidance on these questions and many more.

> *Notes on the Principle of Strict Compliance* is another useful publication to refer to in order to understand that strict compliance is a matter of looking at documents in a rational way. It is available in full at this link:
>
> https://cdn.iccwbo.org/content/uploads/sites/3/2016/05/ICC-Banking-Commission-Executive-Committee-Issues-Paper_Notes-On-The-Principle-Of-Strict-Compliance.pdf [Accessed: 22 October 2018].

9.3 Discrepancies

A high percentage of documents are found to be discrepant on first presentation, ie they do not comply with the terms and conditions of the credit. This is why the theoretical benefit to a beneficiary of a bank undertaking can be less than perfect in practice. Some estimates have put the percentage of discrepant presentations at 60–70 per cent on first presentation (Tradefinance.training, 2017).

Analysing discrepancies

When the officer of the bank examining documents notices discrepancies, they will advise the presenter of the discrepancies through a refusal notice. Such a refusal can also be communicated on a phone call with the beneficiary. The added value is that the bank officer can discuss the nature of the discrepancies with the beneficiary, thus addressing the issues and avoiding similar discrepancies in the future. The bank will give the beneficiary an opportunity to correct the documents. The issuing bank should not be contacted about the discrepancies until the beneficiary has had a chance to correct them or it gives permission to do so.

Discrepancies that cannot be addressed

It is not always possible to address discrepancies. For example, the credit may have expired or the date for latest presentation (eg 21 days after shipment as per article 14 of UCP 600) could have passed.

Amendments or waivers

If the discrepancy cannot be addressed, the beneficiary could contact the applicant to arrange for an amendment, or to seek the applicant's agreement to accept the documents. This is known as a 'waiver'. However, if the documents are not correct, the beneficiary is always in a weaker position.

WHY IS THE APPLICANT NOT A PARTY TO A DOCUMENTARY CREDIT TRANSACTION?

A documentary credit is an engagement made by the issuing bank. In this way, the risk of the buyer (applicant) not paying shifts from a company or entity to a bank.

A settlement agreement between the buyer and the issuing bank should also have been negotiated, but such arrangements are outside the scope of the documentary credit and UCP 600.

9.3.1 Addressing discrepancies

Once the beneficiary has been given the opportunity to correct any discrepancies, the nominated bank has the following options open to it.

- **Honour or negotiate** against corrected documents.
- **Send a message to the issuing bank** asking for permission to honour or negotiate despite identified discrepancies. The nominated bank will approach the issuing bank and, if it is in agreement, it will in turn approach the applicant for a decision (known as a 'waiver') as to whether the presentation may or may not be accepted as presented.
- **Make settlement to the beneficiary against a specific indemnity from the beneficiary** – subject to the credit standing of the beneficiary, or it may accept an indemnity from the beneficiary's own bank. This will indemnify the nominated bank against any claims from the issuing bank and incorporate an authority to debit

the beneficiary's account with any amount claimed or to claim from the beneficiary's bank. (This course of action may be prohibited by the terms of some documentary credits and is not a common feature today due to the amount being reflected against a credit facility).

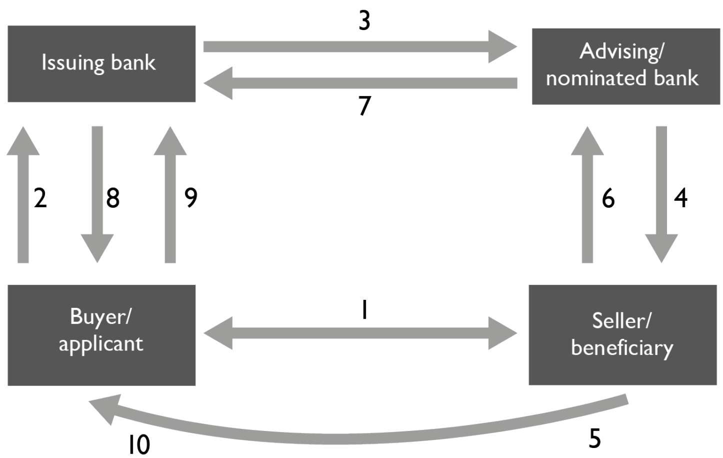
- **Forward the documents to the issuing bank** for settlement, if requested to do so by the beneficiary.
- **Return the documents** to the beneficiary.

INDEMNITY

"Protection against possible damage or loss, especially a promise of payment, or the money paid if there is such damage or loss." (Cambridge Dictionary, no date)

9.4 How a documentary credit works

FIGURE 9.1 HOW A DOCUMENTARY CREDIT WORKS



Source: Author (2018)

Steps in the process

1) Contract agreed between buyer and seller.

2) Buyer ('applicant') asks its bank to issue a documentary credit in favour of the seller ('beneficiary').

3) After a risk assessment, the issuing bank issues the credit and transmits it to the bank abroad ('advising bank').

4) The advising bank sends the credit to the seller.

5) After checking and agreeing the contents, the seller ships the goods to the buyer, having collated the documents required by the credit.

6) The seller presents the documents.

7) The nominated bank checks the documents, pays* the seller and sends the documents to the issuing bank.

8) The issuing bank checks the documents, pays* the nominated bank and sends the documents to the buyer.

9) The buyer pays* the issuing bank.

10) The buyer receives the documents with which it can collect the goods.

* Payment will be made in accordance with the terms of the documentary credit, such as sight, acceptance, deferred payment or negotiation.

9.5 Operation example

The following example outlines a typical transaction utilising a documentary credit as a mechanism for settlement.

Buyer and seller discuss and confirm contract details

A buyer and seller agree on the terms of a purchase/sale of goods or services. They decide to use a documentary credit as a method of settlement. Both parties discuss the following details before the buyer asks its bank to issue a credit:

- **Nature of the credit** – irrevocable, confirmed, transferable (see section 9.9.1 for a description of a transferable credit).
- **Payment terms** – at sight, acceptance, deferred payment or negotiation.

- **Other details** – currency and amount.
- **Sales term** that will apply and the associated responsibilities of each party.
- **Validity of the credit** – the expiry date for presentation of documents and the period for presentation.
- **Latest shipment date and routing of the goods**.
- **Other shipment issues** – whether part shipments and transhipment (a change of means of transport during the shipment) is allowed or not, the type of transport document to be presented and any other documentary requirements.
- **Description of the goods**.
- **Insurance requirements**.
- **Confirmation** – whether the credit is to be confirmed by a bank in the exporter's country.
- **Responsibility for bank charges**.
- **Inspection of goods** – is this required prior to shipment?

All points must be agreed by both parties. The documentary credit only gives certainty of payment to the seller/beneficiary if it can comply with all the terms and conditions. From the buyer's perspective, it provides certainty that the requested goods will be delivered once the required documents have been presented and the payment made.

Buyer approaches the issuing bank

Once agreement is reached on these issues, the buyer asks its bank to issue a documentary credit on its behalf. The bank may already have a documentary credit facility in place for the buyer. If it doesn't, it will need to establish one following the necessary checks on the buyer's financial standing and its ability to honour its obligations. The bank will account for the credit as a contingent liability as it is an undertaking to guarantee payment either at sight or at a future date, provided all terms and conditions are met.

Note: The lending process and decisions made by banks with respect to lending are outside the scope of the syllabus.

CONTINGENT LIABILITIES

"[P]ossible obligations whose existence will be confirmed by uncertain future events that are not wholly within the control of the entity [company] [. . .] A contingent liability is not recognised in the statement of financial position [balance sheet]" (IFRS, 2017). However, it should be disclosed in the notes that accompany an entity's financial statements.

Issuing bank conducts risk assessment: security against possible loss

The bank may also wish to take security to protect it against possible loss. This may take the form of:

- security independent of the transaction, such as a charge/pledge over the buyer's assets and guarantees of the directors; and/or
- security provided through the documents (see Topic 6), such as:
  - original bills of lading issued to order of the bank or endorsed by the shipper to their order or in blank, giving the bank the ability to take possession of the goods and, if necessary, the sale of them; or
  - the bank may be satisfied with non-negotiable transport documents that consign the goods to the bank, giving the bank control over them.

PLEDGE

"The transfer of objects or documents to someone as security for a loan." (Dictionary of Law, 2007)

Buyer completes application form

Once the issuing bank agrees to issue the credit, the buyer completes the bank's application form, providing exact details as discussed during contract negotiations. Further details required include:

- full details of the buyer as applicant;
- full details of the seller as beneficiary; and
- details of the seller's bank through which the credit will be advised and confirmed, if required. If the buyer doesn't have these details, the issuing bank will advise the credit through one of its group offices or correspondent banks.

Issuing bank issues documentary credit using SWIFT MT 700

When the bank issues the documentary credit, it is likely to use the SWIFT MT 700 message type that is used by most banks today. You will learn more about changes to SWIFT MT 700 in Topic 15. The issued documentary credit will include the details outlined in the application form, as well as:

- the issuing bank details;
- the documentary credit reference number;
- the date of issue; and
- reimbursement instructions that conform to the type of availability of the documentary credit.

The issuing bank sends the documentary credit to the advising bank

This could be the beneficiary's bank or a bank that is a correspondent of the issuing bank.

Advising bank confirms

The advising bank may, if requested to do so, add its confirmation after assessing the risk on the issuing bank. This will depend on the confirmation instructions in the credit.

Advising bank sends the credit

The advising bank sends the credit to the seller (beneficiary) via an online platform or by post. Many banks have web-based systems through which beneficiaries can receive the text of the credit directly.

Seller (beneficiary) checks contents

The seller (beneficiary) checks the contents of the documentary credit. If necessary, it will contact the buyer (applicant) to have the credit amended.

Seller despatches goods to the buyer

When the goods are ready, the seller despatches the goods to the buyer.

Seller presents documents to the nominated bank

The seller produces or collates the documents needed and presents these to the nominated bank as indicated in the credit. In most cases, the nominated bank will also be the advising bank.

Nominated bank pays the seller

The nominated bank checks the documents, sends them to the issuing bank and, provided the documents are compliant, pays the beneficiary in accordance with the terms of the documentary credit. This could be immediately after the bank has checked and approved the documents (ie at sight) or at a later date (ie usance). The terms of payment will depend on whether the credit is available by honour or by negotiation and whether it is has been confirmed.

USANCE

The time between the date when documents are presented and the date when they are paid.

Issuing bank pays nominated bank

The issuing bank checks the documents and pays the nominated bank, taking into consideration the terms of the credit. Alternatively, the nominated bank may be in a position to obtain reimbursement before sending the documents to the issuing bank. You learned about this in section 9.1.2.

Issuing bank sends documents to buyer

Finally, once it is satisfied that the buyer has fulfilled its obligations, the issuing bank sends the documents to the buyer.

Buyer collects goods

The buyer now uses these documents to collect the goods if required.

9.6 Responsibilities of the advising bank

Authenticity checks

The advising bank must satisfy itself as to the authenticity of the credit or amendment. With a SWIFT MT 700 message, no further checks are necessary as it is an automatically authenticated message.

Workability assessments

In accordance with UCP 600 sub-article 9 (b), there is no obligation for an advising bank to examine any credit for workability. However, most banks will check the documentary credit and warn the beneficiary and/or contact the issuing bank should there be obvious mistakes. The final responsibility for workability lies with the beneficiary.

Confirmation (optional)

If the advising bank has been asked to add its confirmation and it is willing to do so, it will advise the beneficiary of the details of the credit and add its confirmation. If it is not willing to do so, or if it is not willing to advise the credit, it must inform the issuing bank without delay. There is no requirement to give any reason for this. Reasons for refusal may include a lack of available credit or a low country risk appetite.

Conformity to the sales contract

Once the seller is in receipt of the credit, it should check that the credit conforms to the agreed sales contract and that it is able to meet its requirements. If the seller is not satisfied, it should immediately contact the applicant to arrange a suitable amendment.

Compliance and regulation

Banks need to adhere to an ever-increasing number of regulations. Each bank involved in a transaction should screen the texts of the documentary credit, amendments and all associated documents to ensure compliance with the relevant regulations. They should also check to ensure that they are not in breach of sanctions (you learned more about this in Topic 5). This is in addition to basic checks to ensure that the documents conform to the terms of the credit.

> **KEY TERMS**
>
> **Risk appetite**
>
> The amount of risk a bank and its stakeholders are willing to take.
>
> **Country risk appetite**
>
> The appetite of a bank or other institution to take on the risks associated with doing business with a country, after considering political, financial and economic factors. You learned about country risks in Topic 2.

9.7 Presentation of documents

Presentation of documents against payment

If the documentary credit is available by sight payment, the beneficiary will assemble the required documents as soon as shipment has taken place. It will then present them to the nominated bank or issuing bank, along with a draft (if required), for examination and payment.

If there is a nominated bank, it will have been given a reimbursement instruction that will allow it to pay the beneficiary immediately and to be reimbursed. If the nominated bank has confirmed the credit, it has no option but to pay (as long as the documents comply). If it has not confirmed the credit, it is under no obligation to pay. If it chooses not to confirm the credit, even though the documents comply, the onus will be on the issuing bank to examine the documents and pay the beneficiary once the nominated bank has forwarded the documents.

When the issuing bank is satisfied that the documents are compliant, it will inform the applicant and debit its account. The documents will then be released to the applicant. The limit on the credit facility will be reduced by the amount of the presentation.

Presentation of documents for acceptance

If the documentary credit is available by acceptance, the beneficiary will assemble the required documents as soon as shipment has taken place and present them to the nominated bank or issuing bank, along with the usance draft, for examination and acceptance.

If the documents are compliant and the draft is drawn on the nominated bank, and the credit has been confirmed by the nominated bank, the draft will be accepted to mature on the determinable due date. At the request of the beneficiary, the nominated bank can purchase the draft and advance funds without recourse to the beneficiary. Otherwise, the accepted draft may be returned to the beneficiary or held by the nominated bank until the due date and paid on that date.

RECOURSE

"[The] legal ability [that] the purchaser of a financial asset may have to fall back on the original creditor if the current debtor defaults. For example, an account receivable sold with recourse enables the buyer of the receivable to make claim on the seller if the account doesn't pay." (Dictionary of Finance and Investment Terms, 2014)

The pre-payment option is an integral part of this method of settlement and can be seen as an advantage in comparison with documentary collections. This feature is outlined in articles 7 and 12 of UCP 600.

If the nominated bank has not added its confirmation, and the draft is drawn on it, it is under no obligation to accept the draft. If it chooses not to accept the draft, the nominated bank will forward the documents to the issuing bank for their examination and acceptance.

An issuing bank or confirming bank is required to accept a draft and/or to pay at maturity when a nominated bank or another nominated bank does not accept a draft or, having accepted a draft, does not pay at maturity.

The documents will then be released to the applicant and they will be informed of the due date.

On the due date, the applicant's account will be debited and reimbursement made available to the nominated bank. The import facility will be reduced by the amount of the presentation.

The beneficiary will be paid on the due date.

Presentation of documents payable by deferred payment

This is similar to the procedure used for a credit available by acceptance, except that no draft is required. Payment is made at a future date, or the nominated bank can agree to prepay its deferred payment undertaking and advance funds to the beneficiary.

Presentation of documents where the documentary credit is available by negotiation

If a credit is available with a nominated bank by negotiation, and it agrees to act on that nomination, it will either advance funds to the beneficiary on the basis of a complying presentation being made, or agree to do so. Any negotiation made by the nominated bank will incur an interest charge to the beneficiary for the period between the date of the advance and the date when it receives reimbursement from the issuing bank.

Such advances are made 'with recourse'. This means that if reimbursement is not received when due from the issuing bank, repayment of the advance can be demanded from the beneficiary. If the credit was confirmed based on full compliance with all the terms and conditions, the advance or agreement to advance is made on a 'non-recourse' basis.

9.8 Advantages and disadvantages

A documentary credit is one of the more complex methods of settlement; however, it is also a sophisticated mitigant against many risks. It presents advantages and disadvantages to both the applicant (buyer) and the beneficiary (seller).

Advantages and disadvantages to the applicant (buyer)

The following are some advantages to the buyer:

- **Specific documentation** – it is able to specify documentation that meets its requirements.
- **Favourable terms** – it may be able to obtain a better price or more favourable credit terms.
- **Control** – timing of shipments and presentation of documents can be more tightly controlled by the terms specified in the documentary credit.
- **Certainty of delivery** – based on the documents presented there is more certainty that the goods will be delivered when payment or acceptance is made.

The following are some possible perceived disadvantages:

- **Impact on credit facility** – as the issuing bank has to account for the credit as a contingent liability, this results in the applicant utilising part of a credit facility.
- **Irrevocability** – if issued according to UCP 600, a credit is irrevocable and cannot be cancelled or amended without the beneficiary's consent.
- **Higher cost** – the costs of issuing the documentary credit and handling documentation in the issuing country are likely to be significantly higher than other forms of settlement, such as open account or documentary collection. However, if the applicant is in a good bargaining position, it might arrange for the beneficiary to pay certain charges.

- **No quality assurance** – as banks deal with documents (not in goods), a presentation of complying documents will result in payment regardless of whether the goods are of the required quality. It is important, therefore, that the applicant is either fully satisfied with the reliability of the beneficiary or addresses any potential concerns in the terms and conditions of the credit.

Advantages and disadvantages to the beneficiary (seller)

The following are some advantages to the seller:

- **Payment is guaranteed** – if the terms and conditions of the credit are fully met, payment is guaranteed by the issuing bank (or a confirming bank) and cash flow is certain.
- **Risks are transferred** – firstly from the applicant to the issuing bank and then to the confirming bank, if the credit is confirmed. Country risk is significantly mitigated.
- **Pre-shipment finance** – this may be available on the strength of the documentary credit from the issuing bank.
- **Discounts** – there is an opportunity to have accepted drafts or deferred payment undertakings discounted/prepaid.

The following are some possible perceived disadvantages:

- **Administrative risk** – to be certain of settlement, the beneficiary must produce compliant documents within the validity of the documentary credit. Presentation of non-compliant documents will almost certainly delay payment, may result in the beneficiary being forced to accept a lower price for the goods, services or performances, or may ultimately result in non-payment if the issuing bank or applicant refuses to accept discrepant documents. This is a typical example of administrative risk, which you learned about in Topic 2.
- **Staff training costs** – the beneficiary may need to train specialist staff to prepare documentation.
- **Finance-related costs** – any costs of advising/confirming the documentary credit are usually borne by the beneficiary. But if the

beneficiary is in a strong bargaining position, it could arrange for the applicant to pay certain charges. You learned about bargaining positions in Topic 2.

9.9 Other forms of documentary credits

We will now examine the following types of documentary credit:

- transferable credits;
- back-to-back credits;
- 'red clause' and 'green clause' credits;
- revolving documentary credits; and
- standby letters of credit – these are similar to guarantees in that they are used as a security to ensure that the contractual undertakings of the applicant are fulfilled. You will learn about these in Topic 10.

CHECK YOUR UNDERSTANDING 1

Advantages and disadvantages of documentary credits

1) List two advantages to the beneficiary.
2) List two disadvantages to the applicant.
3) Is the lack of quality assurance a disadvantage to a buyer or a seller?
4) Is certainty of delivery an advantage to a seller or a buyer?

9.9.1 Transferable credits

The operation example given in section 9.5 involved a direct sale between seller and buyer. However, it is common for buyers or sellers to make use of intermediaries to purchase or sell goods on their behalf. You learned about intermediaries in Topic 3. They often operate on narrow margins and do not carry stocks of goods. They also prefer not to place a financial burden on their working capital or to draw on their credit facilities. Transferable documentary credits address both these needs. Under UCP 600, all documentary credits are transferable.

Article 38 of UCP 600 defines a transferable credit as:

"[A] credit that specifically states it is 'transferable'. A transferable credit may be made available in whole or in part to another beneficiary ('second beneficiary') at the request of the beneficiary ('first beneficiary')."

(ICC, 2007)

The following points are important in this context:

- **Partial value** – transfers are usually for less than the full value of the original documentary credit.
- **More than one second beneficiary** – there can be more than one second beneficiary, provided the documentary credit allows for partial shipments.
- **Further transfers** – onward transfers from second to third beneficiaries are not permitted under UCP 600.
- **Benefits for suppliers** – the final supplier(s) benefit(s) from the security of a documentary credit and can present compliant documents direct to the transferring bank or a local nominated bank for settlement.
- **Risks for the applicant** – the applicant may not know the credit standing or reliability of the supplier, or even their name.

9.9.1.1 The procedure for handling a transferable credit

The procedure is as follows:

1) The contract between the buyer and the intermediary is completed in the usual way but must allow for a transferable credit. Intermediaries need not be in the buyer's or the seller's country.
2) The issuing bank issues the documentary credit and indicates that it is transferable.

3) When advising the credit, the advising bank will attach a request for transfer for completion by the intermediary (who will become known as the 'first beneficiary' when the credit is transferred).

4) The first beneficiary will request the transferring bank to transfer part of the credit to the ultimate supplier(s). The transferring bank has discretion over this. The supplier(s) will be known as the 'second beneficiary'.

5) The credit, as transferred, must carry the same terms and conditions as the transferable credit, with the following exceptions:

   - the amount of the credit, the unit prices, the expiry date, the latest shipment date and the last date for presentation may be reduced or curtailed;
   - the required insurance cover may be increased; and
   - the applicant's name may be substituted by the name of the first beneficiary.

6) The instructions from the first beneficiary to transfer must make clear the basis upon which amendments to the transferable credit are to be advised to the second beneficiary/beneficiaries, ie immediately or only after instructions are provided.

7) If the second beneficiary is in agreement with the transferred credit, it ships the goods and presents documents for settlement to a nominated bank or the transferring bank.

8) These documents are examined in the usual way. The transferring bank will then invite the first beneficiary to substitute its invoice and draft (if any) for those of the second beneficiary. In some instances, the first beneficiary may not want the applicant to become aware of the identity of the actual supplier. The first beneficiary's invoice will usually be for a larger sum. The difference in values will represent its profit margin.

Confidentiality

When dealing with transferable credits, it is particularly important to respect the need for confidentiality, as outlined in point 8. The first beneficiary's business is likely to depend on contacts and expertise. As mentioned before, in some cases it may not wish the applicant to become aware of the actual supplier's identity because it risks being cut out of future transactions. This point is also pertinent at the time of issuance of the transferred credit, ie by not divulging the name of the actual buyer in the transferred credit. However, should the first beneficiary fail to present its substitute invoice and draft (if any), the transferring bank may present the documents as received from the second beneficiary to the issuing bank.

Note: The fact that a credit is not transferable does not mean that the beneficiary cannot assign it, or the proceeds (all or part) due to it, to a third party in accordance with the assignment laws of the beneficiary's country. This is explained in article 39 of UCP 600.

9.9.2 Back-to-back credits

Separate credits

Back-to-back credits are used by intermediaries in similar circumstances to transferable credits. The difference is that they consist of two entirely separate credits. One credit acts as part or full security for the issuance of the other. If an intermediary's supplier insists on a documentary credit, the intermediary's bank may insist that it obtains a documentary credit in its favour from the ultimate buyer as security for the documentary credit in favour of its supplier.

How it works

The applicant of the second credit is the beneficiary of the original credit and will have to structure its credit in such a way that, when compliant documents are presented by the beneficiary of their documentary credit, it can use those documents (such as bills of lading), together with any documents added or substituted by it, such as invoices, in time to make a compliant presentation under the original credit in its favour.

Amendments

Any amendments to the original credit may have to be reflected in the back-to-back credit, and the beneficiary will not wish to agree to any amendment until it has obtained the agreement of the ultimate supplier to an equivalent amendment to the back-to-back credit.

Challenges

There are considerable challenges with back-to-back credits. Banks will usually only allow experienced and creditworthy traders to have facilities for back-to-back credits.

9.9.3 'Red clause' and 'green clause' credits

Red clause credits

These were sometimes known as 'packing' credits and include a clause that permits the advising bank to make an advance payment to the beneficiary. They were used when documentary credits were sent in paper form and quoted the advance payment condition in red ink. With the almost exclusive use of the SWIFT MT 700 message format, this is no longer possible. However, the term is still widely used.

Such credits originated in trades such as the Australian wool trade, where European buyers agreed to finance their suppliers who, in turn, used the funds advanced to collect and purchase wool from farmers over a wide area. Once a sufficient quantity had been gathered, the wool would be shipped, documents would be presented in the normal way and the advance would be repaid out of the proceeds. However, red clause credits are not restricted to the wool trade.

The issuing bank and the applicant are liable to reimburse a nominated bank for any advance made and not repaid through the presentation of compliant documents. Therefore, such arrangements are only made available to applicants who have the appropriate financial standing, expertise and knowledge of the trade to select reliable beneficiaries. Today, most advances are covered by an advance payment guarantee issued by the bank of the beneficiary. This provides assurance that the advance will be repaid even if the beneficiary does not ship the required goods.

ADVANCE PAYMENT GUARANTEE

"A guarantee that enables a buyer to recover an advance payment made under a contract or order if the supplier fails to fulfil its contractual obligations." (Dictionary of Accounting, 2007)

Normally such credits are issued without any instructions to the advising bank to take security or control of the goods.

Green clause credits

These allow pre-shipment advances to be made, as with a red clause credit, but stipulate that advances may only be made against goods stored in the advising bank's name pending shipment. The funds are advanced against warehouse receipts in the lending bank's name. Green clause credits are rare nowadays.

9.9.4 Revolving documentary credits

Revolving documentary credits are used for regular shipments. They avoid the need for repetitive opening formalities for repeat shipments over a period of time.

A revolving credit will state:

- that it is revolving;
- the number of times it will revolve;
- whether it will revolve automatically or not; and
- whether the revolving will occur on a cumulative or non-cumulative basis.

Revolving in time

A credit revolving in time is available every month until the expiry date, subject to the number of times stated in the credit.

Accounting issues

With an automatically revolving credit, the main disadvantage to the applicant and their bank is that it creates a liability equal to the face value multiplied by the maximum number of drawings.

CHECK YOUR UNDERSTANDING 2

1) Does an intermediary need to reside in the same country as a seller?
2) Which type of documentary credit was first used in the wool trade?
3) Do transferable credits operate separately?

9.10 Dispute resolution methods provided by ICC

Many presentations under documentary credits are found to have discrepancies on their first presentation. You learned about discrepancies in section 9.3. Several of these are admitted and can be easily corrected. There are, however, disputes between parties that are difficult to resolve.

Example of a dispute

An issuing bank determines that the documents are discrepant and the confirming bank disagrees.

Disputes can happen between all parties

Similar disputes may arise between the applicant and issuing bank, between the confirming bank or nominated bank and the beneficiary, or between the issuing bank and the beneficiary.

Legal resolution

If these disputes cannot be resolved amicably, the only course of action available is to take them to the applicable court of law. This can be costly and it may take some time for cases to be heard and resolved.

Alternatives

ICC provides two alternatives to litigation:

- Documentary Instrument Dispute Resolution Expertise (DOCDEX); and
- ICC Banking Commission Opinions.

Educational value

The summaries of DOCDEX resolutions and the conclusions of ICC Opinions are essential to all participants involved in documentary trade. In addition, they have an important educational value for those interpreting the texts of documentary credits. It is of paramount importance for staff at banks and corporations worldwide to have access to these resolutions and 'opinions' in addition to the relevant ICC rules.

9.10.1 Rules for Documentary Instrument Dispute Resolution Expertise (DOCDEX)

The ICC DOCDEX have been effective since 15 March 2002. They are designed to expedite the resolution of disputes by providing impartial solutions recommended by experts. ICC's International Centre for Expertise oversees the operation of DOCDEX. Use of the DOCDEX process is usually considered only when both parties have exhausted all other avenues of communication in an attempt to resolve differing viewpoints on the status of the documents. One or both parties must agree to bear the costs involved.

DOCDEX is not an immediate service. Decisions are generally given within 30 days of submission of all the paperwork for review by the nominated experts.

FACTFIND

DOCDEX

DOCDEX rules are available in many languages from the ICC website. A version covering a wider range of trade finance instruments came into effect in May 2015.

Find out more on the ICC website: https://iccwbo.org/dispute-resolution-services/docdex [Accessed: 22 October 2018].

9.10.2 ICC Banking Commission Opinions

ICC often receives requests for the interpretation or clarification of rules when problems are encountered in the execution of trade finance instruments. In response to these requests, ICC Banking Commission established a process that provides expert analysis of the rules in given situations. This process is referred to as official 'ICC Banking Commission Opinions'.

These are provided for:

- *Uniform Customs and Practice for Documentary Credits* (UCP 600);
- *Uniform Rules for Collections* (URC 522);
- *Uniform Rules for Demand Guarantees* (URDG 758);
- *Uniform Rules for Bank-to-Bank Reimbursements* (URR 725);
- *Uniform Rules for Forfaiting* (URF); and
- *Uniform Rules for Bank Payment Obligation* (URBPO).

ISBP 745 is often used as guidance in 'opinions' related to UCP.

The ICC Banking Commission administers these opinions and responds to occasional technical and educational queries.

Any organisation or company can make a formal request for an opinion through their ICC national committee or local banking association. ICC membership is not necessarily required. These requests are then sent to the ICC Banking Commission secretariat.

Responses or draft opinions are prepared by the technical advisory team and distributed to the initiating ICC national committee or banking association within four to six weeks following the receipt of the request. The initiator of the request will then receive this from their national committee or banking association. Draft opinions are not recognised as official until they have been presented to ICC Banking Commission and discussed and approved at a biannual meeting.

FACTFIND

National committees

Find out whether there is a national committee in your country or one of the countries in your region. More information on ICC national committees is available at: https://iccwbo.org/about-us/global-network/regional-offices/ [Accessed: 22 October 2018].

Further queries?

ICC Opinions are meant to address queries. Find out how more questions can often arise following an opinion on the Institute of International Banking Law & Practice website: http://iiblp.org/recent-icc-opinions/ [Accessed: 22 October 2018].

9.11 Undertakings and risks

The undertakings of, and risks to, those involved in documentary credits are summarised in Table 9.1.

TABLE 9.1 DOCUMENTARY CREDITS: UNDERTAKINGS OF PARTICIPANTS AND THE RISKS INVOLVED

Participants	The participant undertakes to [. . .]	Risks to the participant
Applicant (buyer)	Reimburse the issuing bank, when demanded or on the due date, when compliant documents are submitted.	Banks are not responsible for the genuineness or validity of documents. Even genuine documents do not necessarily guarantee that the contractual obligations of the beneficiary have been fully met.
Issuing bank	Reimburse a nominated bank that has honoured or negotiated a complying presentation.	The applicant may be unable or unwilling to reimburse. It may have to provide a credit that incorporates terms that do not give it the required control over the goods.
Advising bank	Satisfy itself as to the authenticity of the credit or any amendment. Forward to the beneficiary the credit or amendment received from the issuing bank.	It advises a credit that may subsequently be found to not be authentic.
Confirming bank	Satisfy itself as to the authenticity of the credit (if it is not the advising bank and has not already undertaken this role). Provide an undertaking to the beneficiary that conforms to the form of availability stated in the credit. Honour or negotiate a complying presentation.	The issuing bank may fail to honour its obligations to reimburse.

Nominated bank	Honour or negotiate according to the terms and conditions of the credit.	It may fail to correctly examine documents presented. The issuing bank or confirming bank may fail to reimburse for payments, negotiations or acceptances. Negotiation may be effected with recourse to the beneficiary but the beneficiary may fail to reimburse the bank when recourse is exercised.
Beneficiary/ first beneficiary of a transferable credit	Present compliant documents. In the event of non-presentation, this is outside of the scope of a documentary credit and UCP 600.	It may be unable to provide compliant documents. A request for a necessary amendment may be refused. The nominated bank may refuse to honour or negotiate. A confirming bank may refuse to reinstate its confirmation once discrepant documents have been accepted by the issuing bank. The issuing bank may be unwilling or unable to pay if the credit is not confirmed.
Second beneficiary of a transferable credit	Present compliant documents. In the event of non-presentation, this is outside of the scope of a documentary credit and UCP 600.	The first beneficiary may not arrange for the transfer of the credit or any required amendment. All other risks are the same as those for the first beneficiary.

9.12 Summary of UCP 600

The following is a summary of UCP 600 (ICC, 2007). Some content has been quoted directly. The full text is available from http://store.iccwbo.org/ [Accessed: 22 October 2018].

Article 1: application

Article 1 outlines the application of UCP 600, stating that the rules are binding on all parties unless expressly modified or excluded by the credit.

Article 2: definitions of key terms

Article 2 provides definitions of terms used in UCP 600. You have already learned the definitions of the parties involved in documentary credits in section 9.1.2. The remaining terms defined in article 2 are listed here:

- **Banking day** – the day on which a bank is regularly open at the place at which an act subject to UCP 600 is to be performed.
- **Complying presentation** – a presentation of documents that is in accordance with the terms and conditions of the credit, the applicable provisions of UCP 600 and international standard banking practice.
- **Confirmation** – a definite undertaking of the confirming bank to honour or negotiate a complying presentation. Note that this undertaking is in addition to the undertaking given by the issuing bank.
- **Credit** – any irrevocable arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation.
- **Honour**:
  - "to pay at sight – where the credit is available by sight payment";
  - "to incur a deferred payment undertaking and pay at maturity, if the credit is available by deferred payment";
  - "to accept a bill of exchange ('draft') drawn by the beneficiary and to pay at maturity if the credit is available by acceptance."

(ICC, 2007)

- **Negotiation** – the purchase by the nominated bank of drafts (drawn on a bank other than the nominated bank) and/or documents under a complying presentation by advancing or agreeing to advance funds to the beneficiary on or before the banking day on which reimbursement is due to the nominated bank.
- **Presentation** – either the delivery of documents under a credit to the issuing bank or nominated bank or the documents so delivered.
- **Presenter** – a beneficiary, bank or other party that makes a presentation.

Article 3: interpretation of terms

Article 3 gives a list of interpretations, including that all documentary credits are irrevocable, the manner in which documents may be signed, how the act of legalisation or certification may be evidenced on documents, the use of terms in a credit to describe the issuers of documents, what is understood by terms such as ‘promptly’, ‘immediately’, etc, the meaning of terms such as ‘from’, ‘to’, ‘until’, ‘after’, etc, and terminology used to describe certain parts of a month.

Article 4: distinction between a credit and a contract

Article 4 makes the distinction between a credit and the contract. Sub-article 4 (a) states:

“A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate, or to fulfil any other obligation under the credit is not subject to claims or defences by the applicant resulting from its relationship with the issuing bank or the beneficiary.”

(ICC, 2007)

In addition, this article gives a recommendation discouraging issuing banks from including the underlying contract as an integral part of the documentary credit.

Article 5: documents *v* goods, services and performances

Article 5 makes the distinction between documents versus goods, services or performances. This is an extremely important feature of a documentary credit, and an applicant must be aware that the banks only deal in documents and not the underlying goods, services or performances. In the event that a beneficiary ships the wrong or substandard goods, the applicant must still reimburse the issuing bank if a complying presentation has been made.

Article 6: availability

Article 6 details the requirements concerning availability, the need for an expiry date and the place for presentation.

Article 7: issuing bank's undertaking

Article 7 covers the issuing bank's undertaking. This can be summarised as follows: the issuing bank undertakes to honour a presentation made to it by the beneficiary, provided the documents comply with the credit. A credit may allow a beneficiary to submit a presentation to a named nominated bank or any bank, as specified in the credit. If a complying presentation is received from a nominated bank, the issuing bank must reimburse that bank, provided that the issuing bank is itself satisfied that the terms of its credit have been met.

Article 8: confirming bank's undertaking

Article 8 looks at the undertaking of the confirming bank. The confirming bank gives a similar undertaking to the beneficiary as that of the issuing bank. It will undertake to honour or negotiate a complying presentation that is made to it or to another nominated bank. The issuing bank is obligated to reimburse the confirming bank for any honour or negotiation that it effects, provided that the documents conform to the terms of the credit.

Article 9: advising of credits

Article 9 gives details on the advising of credits and any subsequent amendments. An advising bank is under no obligation to advise a credit or amendment to the beneficiary. If it agrees to do so, it is required to satisfy itself with the apparent authenticity of the credit or an amendment, or to advise the beneficiary that it has been unable to complete this task.

Article 10: amendment

Article 10 covers amendment in more detail. As a documentary credit is irrevocable, any amendment is subject to the consent of the issuing bank, the beneficiary and a confirming bank (if a confirming bank is involved in the transaction). However, once the parties to the credit have agreed to an amendment, the amendment will become an integral part of the credit and the beneficiary must comply with the original credit and the accepted amendment.

Article 11: authenticated teletransmission

Article 11 states that an authenticated teletransmission of a documentary credit or amendment will be deemed to be the operative credit or amendment. Historically, a pre-advice in the form of a telex message would precede the documentary credit sent in paper form. This would have been sent if the issuing bank was fully prepared to issue the operative credit or amendment. Telex messages no longer exist.

Article 12: obligations of the nominated bank

Article 12 declares that a nominated bank is not obliged to honour or negotiate, unless it is also the confirming bank or it has expressly communicated to the beneficiary its agreement to honour or negotiate. When an issuing bank issues a credit that is available by acceptance or deferred payment, it is an implied authorisation for the nominated bank to prepay or purchase the draft accepted by it or the deferred payment undertaking incurred by it.

Article 13: bank-to-bank reimbursements

Article 13 examines fairly basic bank-to-bank reimbursement arrangements. Banks can utilise the more extensive rules that exist in ICC's *Uniform Rules for Bank-to-Bank Reimbursements under Documentary Credits* (publication no. 725) (ICC, 2008). If not, sub-article 13 (b) is applicable.

Article 14: standards of examination of documents

Article 14 gives a number of standards relating to the examination of documents (see also section 9.2). Banks have a duty to examine documents, on the basis of the documents alone, to determine whether they appear on their face to constitute a complying presentation. This article gives banks a maximum of five banking days following the day of presentation to determine whether the presentation does comply.

Article 15: honouring compliant presentations

Article 15 reminds banks that once a presentation is determined to be complying, they must honour or negotiate. In the case of the confirming bank or nominated bank, it must also forward the documents as required by the documentary credit.

Article 16: discrepant documents

Article 16 looks at the scenario when discrepant documents are presented. In this instance, the nominated, confirming or issuing bank may refuse to honour or negotiate; however, it must notify the presenter by the close of the fifth banking day following the day of presentation, giving details of the discrepancies and indicating one of four statuses for the documents:

a) that the bank is holding the documents pending further instructions from the presenter; or

b) that the issuing bank is holding the documents until it receives a waiver from the applicant and agrees to accept it, or receives further instructions from the presenter prior to agreeing to accept a waiver; or

c) that the bank is returning the documents; or

d) that the bank is acting in accordance with instructions previously received from the presenter.

If a bank fails to comply with the provisions in article 13, it will be precluded from claiming that the documents are not correct.

Article 17: originals and copies

Article 17 states that at least one original of each stipulated document must be presented. A bank may treat a document as an original if it bears an apparently original signature, mark, stamp or label of the issuer unless the document states that it is not an original.

Article 18: commercial invoices

Article 18 requires that the commercial invoice must appear to have been issued by the beneficiary (except as required in article 38), must be made out to the applicant and must be in the same currency as the credit. It need not be signed. The invoice must contain a description of the goods, services or performances that corresponds with that in the credit.

Article 19: multimodal transport documents

Article 19 establishes that when a transport document covers at least two modes of transport, the document must, among other conditions:

- appear to indicate the name of the carrier and be signed by the carrier or its named agent, or the master or its named agent;
- indicate that goods have been despatched, taken in charge or shipped on board at the place stated in the credit;
- indicate the place of despatch, taking in charge or shipment and the place of final destination stated in the credit;
- be the sole original or, if issued in more than one original, be the full set of originals as indicated on the transport document;
- contain all conditions of carriage or make reference to another source containing the full terms and conditions of carriage;
- contain no indication that it is subject to a charter party.

Article 20: bill of lading

Article 20 states that a bill of lading must, among other conditions:

- appear to indicate the name of the carrier and be signed by the carrier or its named agent, or the master or its named agent;

- indicate that goods have been shipped on board a named vessel at the port of loading;
- indicate the port of loading and discharge as stated in the credit;
- be the sole original or, if issued in more than one original, be the full set of originals as indicated on the bill of lading;
- contain all conditions of carriage or make reference to another source containing the full terms and conditions of carriage;
- contain no indication that it is subject to a charter party.

Article 21: non-negotiable sea waybill

Article 21 covers non-negotiable sea waybills, the requirements of which are similar to those detailed for bills of lading.

Article 22: charter party bill of lading

Article 22 states that a charter party bill of lading must, among other conditions:

- contain an indication that it is subject to a charter party;
- appear to be signed by the master or its named agent, the owner or its named agent, or the charterer or its named agent;
- indicate that goods have been shipped on board a named vessel at the port of loading;
- indicate the port of loading and discharge as stated in the credit;
- be the sole original or, if issued in more than one original, be the full set of originals as indicated on the charter party bill of lading.

Banks will not examine charter party contracts.

Article 23: air transport document

Article 23 states, among other conditions, that air transport documents must appear to indicate the name of the carrier and be signed by the carrier or its named agent. In addition, they must state a date of issuance and indicate the airport of departure and destination as stated in the credit.

Article 24: road, rail or inland water transport documents

Article 24 states, among other conditions, that road, rail or inland waterway transport documents must appear to indicate the name of the carrier and be signed by the carrier or its named agent, or indicate receipt of the goods by either a signature, stamp or notation. In addition, they must indicate the place of shipment and place of destination as stated in the credit.

Article 25: courier and postal receipts

Article 25 establishes, among other conditions, that courier and postal receipts must both be stamped or signed at the place from which the credit states the goods are to be shipped. This article only relates to courier and postal receipts that are used for shipment of goods. Receipts that are occasionally requested when the beneficiary is asked in the credit to send copies of documents to the applicant are not the subject of this article.

Article 26: transport documents – loaded on deck

Article 26 requires that transport documents must not indicate that the goods are or will be loaded on deck. However, a clause on a transport document stating that the goods may be loaded on deck is acceptable.

Article 27: clean transport documents

Article 27 states that a bank will only accept a clean transport document, ie one that bears no clause or notation that expressly declares a defective condition of the goods or their packaging.

Article 28: insurance document

Article 28 examines insurance documents and coverage. Important features include that the date of the insurance document must be no later than the date of shipment or the document must indicate that cover was effective no later than the date of shipment. It must indicate the amount of insurance coverage in the same currency as the credit. Cover notes will not be acceptable unless required by the credit. The minimum insurance coverage is 110 per cent of the CIF or CIP value of the goods (see Topic 6 for explanation of these Incoterms®).

Article 29: extension of expiry date

Article 29 permits the expiry date or last date for presentation to be extended when that date falls on a non-banking day, except due to a 'force majeure' event. If the latest shipment date falls on a non-banking day, it is not extended.

Article 30: tolerance

Article 30 states that the words 'about' or 'approximately' when used in the credit in connection with the amount, quantity of goods or unit price can be construed as allowing a tolerance of not more than 10 per cent more or less. In the event that the goods are described by weight or volume, then a plus or minus 5 per cent tolerance in the quantity shipped is permissible, providing the amount of the credit is not exceeded.

Article 31: partial drawings or shipments

Article 31 covers partial drawings and shipments, which are allowed unless the credit states otherwise.

Article 32: instalment drawings or shipments

Article 32 states that when a credit includes a schedule for instalment drawings or shipments within given periods (ie a start date and an end date), a failure to ship or present under one of the dates or instalments will render the credit unavailable for that and any subsequent instalment.

Article 33: banking hours

Article 33 states that a bank has no obligation to accept a presentation outside its banking hours.

Articles 34 and 35: disclaimers

Articles 34 and 35 cover disclaimers on effectiveness of documents and on transmission and translation, limiting the bank's liability or responsibility. Loss of documents in transit is also covered and offers some protection to a beneficiary where a nominated bank has previously examined the documents and determined that they comply, whether or not the nominated bank has honoured or negotiated.

Article 36: force majeure

Article 36 covers the event of 'force majeure', which comes from the French term meaning 'superior force'. It simply means that the banks involved with the credit assume no liability or responsibility for any consequences arising out of any interruption in business caused by acts of God, riots, civil commotions, insurrections, wars and acts of terrorism, or by any labour strikes.

Article 37: liability

Article 37 makes it clear that the issuing bank is not liable should the advising bank not carry out its instructions, even if the issuing bank selected the bank. The applicant remains ultimately liable for any charges that cannot be collected from a beneficiary.

Article 38: transferable credits

Article 38 outlines the rules relating to a transferable credit (which are detailed fully in section 9.9.1). Important features of this article are that the first beneficiary can amend only certain parts of the transferable credit, namely:

- amount of the credit;
- unit price;
- expiry date;
- period for presentation;
- latest date for shipment;
- percentage of insurance cover;
- the name of the first beneficiary, which may be substituted for that of the applicant in the transferred credit.

Note that, of these, the first five listed here may be reduced or curtailed. A bank that is nominated to transfer a credit is under no obligation to do so.

Article 39: assignment of proceeds

Article 39 looks at assignment of proceeds of a documentary credit. Even if a credit is not designated as transferable, it does not affect the right of a beneficiary to assign the proceeds under the credit. This article relates only to the assignment of the proceeds under the credit and not the assignment of the right to perform under the credit.

Conclusion

A documentary credit is a method to mitigate many of the risks of international trade for all parties in a trade transaction. In this topic you have learned about the many rules, definitions, parties and methods of settlement that are part of a documentary credit transaction. You have also learned about dispute resolution and the non-litigious options available.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- define a documentary credit and explain the risk implications for banks when issuing a documentary credit?
- discuss discrepancies that may occur in the process?
- illustrate security implications?
- explain how risks are mitigated by a documentary credit?
- describe the role documentary credits play in the settlement process and in meeting compliance requirements?
- discuss the role of ICC in setting rules that govern documentary credits, as well as in dispute resolution?

Test your knowledge

?

Use these questions to assess your learning for Topic 9. Review the text if necessary.

Answers can be found at the end of this book.

1) Negotiation of documents presented under a documentary credit can result in the nominated bank:

   a) accepting drafts drawn on it by the beneficiary.

   b) honouring documents if the credit is payable at sight.

   c) incurring a deferred payment undertaking.

   d) purchasing drafts drawn on the issuing bank by the beneficiary.

2) The beneficiary has been given the opportunity to correct any discrepancies found on first presentation and the nominated bank can now forward the documents to the issuing bank for settlement, if requested to do so by the beneficiary. True or false?

3) Which of the following are advantages to the applicant of using a documentary credit? Choose all that apply.

   a) The applicant will be able to specify documentation that meets the company's requirements.

   b) The credit creates a contingent liability with its bankers and, therefore, utilises part of a credit facility.

   c) There is an opportunity to have accepted drafts or deferred payment undertakings discounted.

   d) The applicant may be able to obtain a better price or more favourable credit terms.

   e) Pre-shipment finance may be available from its bankers on the strength of the documentary credit from the issuing bank.

f) Timing of shipments and presentation of documents may be more tightly controlled by the wording of the documentary credit.

g) There is no obligation to examine the credit for workability.

4) In accordance with UCP 600, a transferable letter of credit may not be transferred:

a) by a second beneficiary to its supplier.

b) for less than the full value of the credit.

c) to more than one second beneficiary.

d) without prior agreement of the applicant and the issuing bank.

5) Under UCP 600, force majeure means that the banks involved in a documentary credit assume no liability or responsibility for any consequences arising from which of the following? Select all that apply.

a) Acts of God.

b) Acts of terrorism.

c) Buyer insolvency.

d) Civil commotions.

e) Confiscation of machinery or goods.

f) Inability to convert local currency into hard currency.

g) An embargo placed on imports.

h) Insurrections.

i) Labour strikes.

j) Riots.

k) Statutes introduced in a buyer's country.

l) Wars.

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Further reading

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ICC (no date) *National committees* [online]. Available at: https://iccwbo.org/about-us/global-network/regional-offices/ [Accessed: 14 October 2018].

ICC Banking Commission (2016) *Notes on the principle of strict compliance* [pdf]. Available at: https://cdn.iccwbo.org/content/uploads/sites/3/2016/05/ICC-Banking-Commission-Executive-Committee-Issues-Paper_Notes-On-The-Principle-Of-Strict-Compliance.pdf [Accessed: 24 October 2018].

TOPIC **10**

Guarantees and standby letters of credit

Introduction

You have explored various methods of settlement between buyers and sellers. But what if one of the parties (either the buyer or the seller) does not fulfil its obligations? Bank guarantees and standby letters of credit mitigate such risks in specific ways. They can also serve other purposes. In this topic, you will also learn about rules that govern guarantees and standby letters of credit.

LEARNING OBJECTIVES

By the end of this topic, you will understand:

- the role of guarantees in international trade;
- the various types of guarantee (often called 'bonds');
- the differences between conditional and unconditional guarantees;
- the content of URDG 758 and ISP98;
- standby letters of credit;
- unfair calling and options to insure this risk; and
- credit considerations for issuing a guarantee or standby letter of credit.

THINK . . .

Imagine you are a manufacturer of printed circuit boards and have sold 100 units to a buyer who hasn't paid. What can you do? Is there any form of recourse?

Or perhaps you have purchased 100 solar panels and the distributor/wholesaler has failed to deliver the goods. Do you have any options?

10.1 Introduction to guarantees

In some countries and banks, the term ‘bond’ may be used instead of the term ‘guarantee’. These terms can be used interchangeably. In this topic, we will use the term ‘guarantee’.

Definition: guarantee

A guarantee is usually issued by a guarantor (mainly a bank or a government organisation) in favour of the buyer (the importer) on behalf of the seller (the exporter). However, a guarantee can also be issued by the bank of the seller in favour of the buyer, as in the case of an advance payment guarantee. It is a guarantee that, in the event that the exporter fails to complete their contractual duties, the guarantor will reimburse the buyer with a sum of money that can be anything between 1 per cent and 100 per cent of the guarantee value.

Guarantees can be used to indemnify or compensate the beneficiary if its counterparty does not fulfil a contractual obligation.

Who is the beneficiary?

The beneficiary of a guarantee can be a seller or a buyer, depending on the purpose of the guarantee. However, a guarantee is usually issued by a guarantor (mainly a bank or an insurance company) in favour of a buyer on behalf of a seller. A guarantee can also be issued by the bank of a seller in favour of a buyer. We will look at the various types of guarantees in section 10.2.

KEY TERMS

Contractual obligation

"Something that a person is legally forced to do through having signed a contract to do." (Dictionary of Accounting, 2007)

Indemnify

"To protect someone or something against possible damage or loss by paying an indemnity to cover the costs." (Cambridge Dictionary, 2018)

Bond

"A written promise to repay a debt at an agreed time, which often includes an agreement to pay an agreed rate of interest on that debt." (ABI, 2018)

10.1.1 Rules for guarantees: URDG 758

You have learned about various other ICC rules in earlier topics – *Uniform Rules for Collections* (URC 522) in Topic 8 and *Uniform Customs and Practices for Documentary Credits* (UCP 600) in Topic 9.

ICC has also produced a set of rules for guarantees, the *Uniform Rules for Demand Guarantees*, ICC Publication 758 (URDG 758), that came into effect on 1 July 2010. As with UCP 600 for documentary credits, these rules are voluntary. However, the use of URDG 758 is not as widespread as the use of UCP 600. Sources working in the banking industry estimate that 60 per cent of all bank guarantees in Europe are issued subject to URDG 758.

URDG 758 is a set of contractual rules that apply to a demand guarantee and counter-guarantee when a transaction expressly indicates that it is subject to those rules. It covers obligations and interpretations relating to the parties involved, the drafting and wording of the guarantee, its irrevocability and general non-assignability (except in certain circumstances) and the guarantor's duties, among other points.

A summary of the most important articles from a bank's perspective is provided in section 10.8.

COUNTER-GUARANTEE

"[A] signed undertaking, however named or described, that is given by the counter-guarantor to another party to procure the issue by that other party of a guarantee or another counter-guarantee, and that provides for payment upon the presentation of a complying demand under the counter-guarantee issued in favour of that party." (ICC, 2010)

10.2 Conditional and unconditional guarantees

There are two broad types of guarantee: conditional and unconditional guarantees. There are significant legal differences between the two. Before you delve into these details, watch the videos in the factfind panel to understand how guarantees work and what their benefits are.

FACTFIND

Introduction to demand guarantees

The following video by ANZ Australia provides a useful and entertaining introduction to demand guarantees:

https://www.youtube.com/watch?v=gl_y2nBw280 [Accessed: 22 October 2018].

Benefits of demand guarantees

The second video demonstrates the benefits of demand guarantees through a simple example:

https://www.youtube.com/watch?v=FSsV6IPIb7Y [Accessed: 22 October 2018].

10.2.1 Conditional guarantees

Guarantees excluded from URDG rules

A contract guarantee is often known as a 'suretyship guarantee' or 'conditional guarantee' or 'conditional bond'. These guarantees are specifically excluded from the URDG rules, as stated in section 2.2 of the *Guide to ICC Uniform Rules for Demand Guarantees URDG 758* (ICC, 2010).

Performance guarantees as conditional guarantees

A number of specialist businesses and insurance companies provide performance guarantees as 'conditional guarantees' under the normal rules of English contract law. The Association of British Insurers provides a model form for such guarantees (see the factfind panel at the end of this section).

EXAMPLE

1) Company A signs a contract with Company B to build a bridge for Company B.
2) Company B requires a guarantee that Company A will build the bridge specified in the underlying contract.
3) Company A's bank issues a guarantee that Company A will build the bridge. Company A's bank is known as the guarantor. This will be specified in the underlying contract, which will specify the issuer of the guarantee, the purpose of the guarantee and in whose favour it has been issued.

The normal position in English law is that Company A's bank has a secondary obligation. This means that Company B must seek payment/ claim first from Company A and demonstrate that the terms of the contract have been broken or 'breached' before it can make a claim on

Company A's bank. Only if Company B's claim is unpaid by Company A can Company A's bank be called upon.

Furthermore, any amendments to the contract made without the guarantor's prior agreement could invalidate the guarantee.

FACTFIND

Guarantee bond: a model form by ABI

The ABI developed the following bond for use in the UK construction industry. It was later adopted by the UK National Joint Consultative Committee for Building. Find out more at the following link:

http://www.performancebonds.co.uk/wp-content/uploads/2016/09/ABI-Guidance-about-their-standard-form.pdf [Accessed: 22 October 2018].

10.2.2 Unconditional (demand) guarantees

Banks generally only issue unconditional guarantees where the obligation of the bank issuing the guarantee is independent of the underlying contract or reason for default. These are also known as demand guarantees.

URDG 758 states that the guarantor, like the issuer of a documentary credit, deals with documents and not with goods, services or performances to which the documents may relate.

A bank guarantee is a primary obligation. A claim may be made under it without a prior claim having been made upon the contracting party for whom the guarantee was provided.

As a minimum, a guarantee issued subject to URDG 758 must include the following information:

- names of the applicant and the beneficiary;
- name of the guarantor;

- reference number or other information identifying the underlying relationship;
- reference number identifying the issued guarantee or counter-guarantee;
- amount or maximum amount payable and the currency in which it is payable;
- expiry of the guarantee (date or an 'expiry event');
- terms for demanding payment;
- how demand is to be made – paper and/or electronic format;
- the language of any documents specified; and
- the party liable for payment of charges.

LIABILITY

"A present obligation of the entity to transfer an economic resource as a result of past events. An obligation is a duty or responsibility that the entity has no practical ability to avoid." (IFRS, 2018)

10.2.3 Advantages and risks associated with unconditional guarantees

Advantages

- **Governing rules** – they can be issued under a set of universally accepted rules such as URDG 758, UCP 600 or ISP98.
- **Simplicity** – the beneficiary has the satisfaction of knowing that a simple claim may be all that is required to obtain payment from a bank.
- **No impact on working capital** – the applicant's working capital is unaffected by the issue of a guarantee, unless the applicant's bank

requires a cash deposit to support their involvement and/or it reduces the applicant's overdraft facilities.

Risks

- **Independence of commercial contracts** – unconditional guarantees can be quite straightforward, being independent of potentially complex commercial contracts and contract disputes.
- **Legal issues** – the majority of guarantees are issued subject to local law and may therefore involve unfamiliar legal jurisdictions and/or may be subject to the onerous legal requirements of the issuer's country.
- **Potential disputes** – for the applicant there is a risk of an unjustified or disputed claim being made.
- **Similarities with cash deposits** – the applicant's position with respect to a demand guarantee is, in many cases, only marginally less risky than leaving a deposit of cash, unless the guarantee stipulates payment dependent upon documentary requirements that include those provided by independent assessors or entities.
- **Creation of a contingent liability** – while working capital may be unaffected, there will be a contingent liability created that could impact on the availability of additional or existing banking facilities.
- **Language issues** – guarantees (supported by counter-guarantees) are often required to be issued in the local language, subject to either a standard format adopted by the bank that is being requested to issue it or in a standard format that is applicable to the concerned industry. There is often little room for the banks to change the wording, or even to insert standard wording required by that bank.

WORKING CAPITAL

"The funds that are readily available to operate a business. Working capital comprises the total net current assets of a business, which are its inventory, debtors, and cash – minus its creditors." (QFinance, 2014)

10.3 Contract guarantees

There are various stages before and during the performance of a contract at which a guarantee may be required. A business tendering or bidding for a contract may be requested to provide a guarantee, which ensures that, if successful, a contract will be established and that the business will provide any further guarantees covering its performance and/or warranties.

The following sections outline the various types of guarantee, directly related to a sales contract between a buyer and a seller.

Tender or bid guarantees

When a company or government invites bidders to submit offers to deliver goods or to complete a contract, it will want to receive bids only from those genuinely capable of fulfilling – and willing to sign – a contract, if its bid is selected. To protect themselves, potential buyers may ask bidders to put up a guarantee that can be called in the event that the bidder does not contract and/or fails to meet the other bonding requirements of the purchaser. The value of such guarantees is typically a small percentage of the contract value, such as 3 per cent.

Advance payment guarantees

A seller may request an advance payment from the buyer to enable them to purchase materials and undertake design or other preparatory work. The seller may be asked by the buyer to provide a guarantee, payable on demand, against its failure to perform and for recovery of any money advanced. An advance can be up to 100 per cent of the contractual value, but it is more commonly 10–25 per cent.

Performance guarantees

Once a contract to supply equipment or to undertake a construction has been agreed, the purchaser may require some assurance that the equipment will do what is claimed or that a construction will be finished on time and in accordance with the agreed specification. A performance guarantee may therefore be required. Performance guarantees can be for any value: often this is 10 per cent of the contract amount, but anything up to 100 per cent is possible.

Warranty and retention guarantees

Warranty guarantees may be required by a purchaser once a performance guarantee has expired.

Alternatively, if the purchaser has held back a percentage of the contract price, the supplier might require a retention guarantee to guarantee that the money retained will be paid. Retention guarantees are often issued to release funds that are held by the buyer. The issuance of the guarantee provides an alternative security to a cash deposit.

Payment guarantees

A payment guarantee offers the right to the seller to claim should the buyer be in breach of its payment obligations. This way, the credit risk the seller has on the buyer is transferred to the bank that issued the payment guarantee.

FACTFIND

Payment guarantees and performance guarantees

In the following example, a representative from Allen & Overy discusses the difference between a payment guarantee and a performance bond:

http://www.allenovery.com/publications/en-gb/Pages/When-is-a-payment-guarantee-in-fact-a-performance-bond.aspx [Accessed: 22 October 2018].

10.4 Other guarantees

There are many types of guarantee that are not directly related to a sales contract.

Credit replacement guarantees

Banks can help to provide local financing by issuing a guarantee in favour of another bank in the country where the joint venture is based.

That local bank will then provide financing to the joint venture in the form of loans, overdraft facilities, investment credits, etc. If the joint venture is not able to fulfil its obligations under the credit facilities, the local bank will be compensated by the bank that issued the guarantee. This enables the local bank to provide financing to the joint venture.

Guarantees for missing bills of lading

These are issued by a bank to indemnify shipping companies if a bill of lading is missing or lost in transit. You learned about this in section 6.4.1.2.

Guarantees for other purposes

Guarantees may be required to act as security against legal costs in the event that a dispute is taken to litigation and the case is lost. They can also be used to secure the obligations of businesses to official bodies or to guarantee payment of customs duties or VAT.

FACTFIND

Guarantees offered by banks

As it is impossible to cover all the banks in the world, a selection of UK banks that offer guarantees is listed here. If you are not based in the UK, explore bonds and guarantees offered by banks in your country.

- Barclays: https://www.barclayscorporate.com/products-and-solutions/trade-solutions/bonds-guarantees-and-indemnities.html [Accessed: 22 October 2018].
- HSBC: https://www.business.hsbc.uk/en-gb/imports-and-exports/guarantees [Accessed: 22 October 2018].
- Lloyds Bank: https://www.lloydsbank.com/business/retail-business/international/foreign-guarantees.asp [Accessed: 22 October 2018].

10.5 Documents required under a guarantee

As you learned in sections 10.1.1 and 10.2.2, the party issuing a guarantee under URDG 758, regardless of the type of guarantee, is only concerned with payment obligations against a demand that complies with the requirements specified in the guarantee. URDG 758 discourages terms that attempt to bind a guarantee against the terms of an underlying contract.

Minimum documentation

The minimum documentation required under a URDG guarantee is the documentation specified in the guarantee together with a statement by the beneficiary indicating in what respect the applicant is in breach of its obligations. This may be incorporated in the formal demand documentation or in a separate accompanying document.

Maximum documentation required

At the other end of the scale, the documentary requirements could include one or more of the following:

- a notary's confirmation of the dishonour of a bill of exchange;
- a certificate from an independent expert (eg an engineer or architect);
- an award statement from an arbitrator or court of arbitration;
- a copy of a judgment from a court.

As with the other ICC rules for collections and documentary credits, URDG 758 establishes that a party issuing a guarantee is not liable for the accuracy, genuineness or validity of documents. It is also not liable for delays beyond its control.

URDG 758 sub-article 20 (a) specifies that, unless the presentation indicates that it is to be completed later, guarantors are required to examine a demand within five business days following the day of presentation to determine whether it is a complying demand. If they decide to refuse the demand due to it being non-compliant, they must immediately inform the presenter.

CHECK YOUR UNDERSTANDING

Unconditional guarantees

1) What are the advantages of unconditional guarantees?

2) What are some of the risks?

10.6 Issuance, assignment, demands

Issuance

A guarantee may be issued direct to the beneficiary by the applicant's bank or it may be issued by a bank in the beneficiary's country, supported by a counter-guarantee from the applicant's bank. In the latter case, the guarantee will usually be subject to local laws and customs in the beneficiary's country, and may not be subject to URDG 758. Banks will often work closely with correspondent banks in those countries to agree on acceptable wording for such guarantees.

Templates

Most banks have standardised wording for use in the more commonly issued types of guarantee. If a client requests to use a certain choice of words in the guarantee that does not comply with a standard template, the text may need to be vetted by the bank's legal experts or senior personnel within the guarantees department.

Due to local regulations, commercial practice or beneficiary preference, a beneficiary may insist that a bank local to it (or a preferred bank) issue the guarantee, which will result in the issuance of an indirect guarantee.

The applicant or instructing party will instruct its own bank (the counter-guarantor) to arrange for a bank identified by the beneficiary (the guarantor) to issue a guarantee in favour of the beneficiary. The counter-guarantor provides a counter-guarantee to facilitate the issuance.

Assignment

URDG 758 allows for guarantees to be assigned if specifically stated in the terms. Beneficiaries may assign proceeds that they may be, or may become, entitled to receive under the guarantee, but a guarantor shall not be obliged to pay an assignee unless it has agreed to do so (URDG 758 sub-article 33 (g)).

Demands

When a demand is made under a guarantee, the instructing party (or, where applicable, the counter-guarantor) must be informed without delay. Once the guarantor has examined the demand and found it to be compliant, the sum demanded and paid will be deducted from the total sum available under the guarantee.

10.7 Expiry

A guarantee should include an expiry date or an expiry event. The guarantee can only be cancelled with the consent of all parties. If the guarantee has expired, been cancelled or paid, its retention does not provide the beneficiary with any further rights.

Open-ended guarantees

However, many guarantees do not include an expiry date or event. These are known as 'open-ended' guarantees. Some countries do not accept guarantees with an expiry date – in the Middle East, for example.

When an expiry date does not apply

An expiry date does not apply if a guarantee is subject to a local law that dictates that it can be ignored. If such a law is in place, the guarantee would expire after a certain period of time (eg 30 days) after the original expiry date. Alternatively, the local law may allow the guarantee to expire after a designated grace period.

Accounting issues

The lack of a clear expiry date causes real difficulties to both the applicant (or instructing party) and the guarantor. Not only does a potential risk remain, but under international accounting standards a contingent liability must also remain on the statement of financial position (balance sheet) of either the applicant (or instructing party) and guarantor, until the beneficiary returns the guarantee or provides written consent to cancellation. You learned about contingent liabilities in section 9.5. In addition, as long as the guarantee remains outstanding, the client must pay the bank regular (usually quarterly) commission charges, so the sooner it can be cancelled, the better.

SOLUTION FOR AN OPEN-ENDED GUARANTEE

If a guarantee is ‘open ended’ and is subject to URDG 758, sub-article 25 (c) of the rules offers a solution, since it will limit the duration to three years after the date of issue:

“If the guarantee or counter-guarantee states neither an expiry date nor an expiry event, the guarantee shall terminate after the lapse of three years from the date of issue and the counter-guarantee shall terminate 30 calendar days after the guarantee terminates.” (ICC, 2010)

10.8 Summary of URDG 758

The most important articles from a bank’s perspective are summarised here. Some content has been quoted directly. The full text of URDG 758 is available from http://store.iccwbo.org/ [Accessed: 24 October 2018].

Article 8: content of instructions and guarantees

Article 8 can act as a checklist for both the guarantor when issuing a guarantee and the applicant when negotiating its terms and conditions.

Article 10: advising of guarantee or amendment

Article 10 contains information and instructions for the advising party when it receives instructions to advise a guarantee without any obligation or engagement on its part.

Article 11: amendments

Article 11 provides instructions on how to handle an amendment to a guarantee.

Article 14 (presentation) and Article 19 (examination)

Articles 14 and 19 both explain how a guarantor should treat a presentation and how it should examine the presented demand.

Article 20: time for examination of demand; payment

Article 20 stipulates that a guarantor has five business days following the day of presentation to examine the demand and to determine if it is a compliant demand.

Article 23: extend or pay

In the event of a complying demand being presented, the guarantor is now faced with two choices:

1) pay immediately;
2) suspend payment for a specified period (not more than 30 calendar days following the receipt of the demand) and the automatic paying of the demand at the end of that period, if an extension has not been granted.

Article 24: non-complying demand, waiver and notice

Article 24 explains the requirements when a demand has been refused by the guarantor.

As with documentary credits, a guarantor deals with documents and not with goods, services or performance to which the documents may relate. The effect is that, in the event of a claim, even if the applicant states that it has performed and considers that the claim is unjust, the guarantor is obliged to pay if the presented demand is compliant. The only circumstance in which the guarantor would not pay is if the applicant had strong proof that it is an unfair calling of the guarantee (see section 10.10), and then it would probably need to seek an order from a court to support its action. Guarantees not subject to URDG 758

(2010) (or URDG 458 [1992] for legacy transactions prior to 1 July 2010) will invariably be subject to the local law of the issuer.

In section 10.2.1 you were provided with an example of a guarantee. It is repeated here to facilitate the explanation of the parties that follows.

EXAMPLE OF A GUARANTEE

1) Company A signs a contract with Company B to build a bridge for Company B.
2) Company B requires a guarantee that Company A will build the bridge specified in the underlying contract.
3) Company A's bank issues a guarantee that Company A will build the bridge. Company A's bank is known as the guarantor. This will be specified in the underlying contract, which will specify the issuer of the guarantee, the purpose of the guarantee, and in whose favour it has been issued.

Parties to a guarantee

Under URDG 758, in our example:

- Company A is known as the 'applicant' or 'instructing party' and will be the provider of a 'counter-indemnity' to its bank to secure the issuance of the guarantee;
- Company B is known as the 'beneficiary' of the guarantee;
- Company A's bank is known as the 'guarantor'.

Article 25: reduction and termination

Article 25 explains the way an amount of a guarantee can be reduced or terminated. In the case of an 'open-ended' guarantee, sub-article 25 (c) is applicable. Sub-article 25 (d) covers extension if the expiry date falls on a non-business day.

10.9 Standby letters of credit

In Topic 9, you learned about UCP 600 and the concept of documentary credits that enable buyers and sellers to exchange documents relating to goods, services or performances. You learned how the documents represent evidence that the seller (beneficiary) has fulfilled its contractual obligations for either 'sight' payment or a future payment commitment.

The remaining sections of this topic cover a variation on this theme: the standby letter of credit. All the types of guarantee discussed earlier in this topic can also be issued in the form of a standby letter of credit. The most common uses are tender or bid standby guarantees, advance payment guarantees, performance guarantees and the guarantees mentioned in section 10.4.

Confirmation may be added to a standby letter of credit, as in the case of a documentary credit.

Documentation

Documentation under a standby letter of credit is usually much less complex than that for a documentary credit. Given that standby letters of credit are similar to guarantees, all that is normally required is a statement issued by the beneficiary that the applicant has, for example:

- not met the terms of a contract;
- not paid a loan on the due date;
- not paid for goods shipped;
- not built a bridge successfully or on time.

Other documents, such as a certificate of non-performance from an independent assessor or a ruling from an arbitration court, may also be appropriate, depending on the underlying transaction. This is similar to guarantees, as discussed in section 10.5.

Purpose

Standby letters of credit may be issued subject to UCP 600 (as stated in article 1), but are used differently to documentary credits. A standby letter of credit is used to protect against non-performance or non-payment. Standby letters of credit are not a primary means of making a payment.

Powerful tool for beneficiaries

A standby letter of credit is a powerful tool in the hands of a beneficiary. Being covered by the terms of UCP 600 (or ISP98 – see section 10.9.1), there is no possibility for the applicant or its bank to refuse to make a payment, even if the applicant has a strong case for resisting payment, should a complying presentation be made.

For example, in a building contract, the applicant might argue that the labour supplied by the beneficiary was inadequate and give this as a reason for non-performance. But this will give the applicant or the issuing bank no grounds to refuse payment under the standby letter of credit as the issuing bank will pay against presentation of the specified documentation. The applicant may, however, be able to prevent payment if fraud is involved.

Introduction to ISP98

Although standby letters of credit may be issued subject to UCP 600, many of the articles of UCP 600 are not relevant to a standby letter of credit or can even cause problems. As a result, the Institute of International Banking Law & Practice (IIBLP) drafted a set of internationally accepted rules: International Standby Practices specific to standby letters of credit, known as ISP98. These rules have been endorsed by ICC as well as the UN Commission on International Trade Law (UNCITRAL). ISP98 came into effect in January 1999. The rules are increasingly used by banks globally.

A standby letter of credit must, therefore, state clearly whether it is subject to UCP 600 or ISP98.

Expiry

Standby letters of credit usually have an expiry date or event as outlined in sub-article 6 (d) (i) of UCP 600 or Rule 9.01 of ISP98.

10.9.1 ISP98 rules

ISP98 rules (1998) include reference to standby letters of credit in the following terms:

- **Irrevocable** – Rule 1.06b says: "Because a standby is irrevocable, an issuer's obligation under a standby cannot be amended or cancelled.
- [. . .] except as provided in the standby or as consented to by the person against whom the amendment or cancellation is asserted".
- **Enforceable** – Rule 1.06c goes on to make it clear that the enforceability of a standby is not affected by:
  - "the issuer's right or ability to obtain reimbursement from the applicant";
  - "the beneficiary's right to obtain payment from the applicant";
  - "any knowledge the issuer may have of a breach of contract".

For payment against documents

Rule 1.06d sets out the principle that the issuer's obligation to pay is to be decided on only by the examination of required documents. Rule 4.08 states: "If a standby does not specify any required document, it will still be deemed to require a documentary demand for payment". Rule 4.11 goes on to make it clear that any terms of a standby that do not refer to documents may be disregarded.

Limited as to the issuer's responsibilities

Rule 1.08 makes it clear that the issuer is not responsible for breaches in the performance of the underlying contract or for "the accuracy, genuineness or effect of any document".

Undertakings of the issuer

Rule 2.01 sets out the undertakings of the issuer and confirmer to honour a compliant presentation by payment of a sight draft or acceptance in immediately available funds and in a "timely manner". Rule 2.05 makes it clear that the advising bank is only responsible for the authenticity of the standby.

Capable of amendment

As with documentary credits, amendments to standby letters of credit are binding on the issuer and confirmer when issued, but may be rejected by the beneficiary. However, ISP98 provides for "automatic amendment" clauses. A standby letter of credit subject to automatic amendment may be increased or decreased in value, or may have the expiry date extended without the need for consent.

Dishonour

ISP98 also contains rules in the event of dishonour (Rules 5.01–5.07), notice of which must be given in a timely manner – more than seven days being considered unreasonable.

Transferable

Standby letters of credit may be stated to be transferable, but ISP98 rules differ from UCP 600 rules in that they may not be partially transferred but may be transferred more than once (see Rule 6.02b). There are also rules covering situations where a standby letter of credit can be transferred by 'operation of law'. This might include transfer to a receiver of a company in financial difficulties (see Rules 6.11–6.14). The more likely event is that, due to the often long expiry dates for a standby letter of credit, the beneficiary may merge with (or be acquired by) another company.

According to Rule 9.01, a standby letter of credit must mention an expiry date or permit the issuer to terminate the standby upon reasonable notice or payment. Unlike with guarantees, 'open-ended' standby letters of credit are not common practice.

Proceeds

The proceeds due from claims under a standby letter of credit may be assigned by the beneficiary if the issuer and confirmer agree to – and acknowledge – the assignment.

Indemnity for the issuer

As with other forms of documentary credit, an applicant must indemnify the issuer by reimbursing it for any payments made and by paying any appropriate charges.

FACTFIND

More about ISP98

Browse through the section on ISP98 on the IIBLP website:

http://iiblp.org/banking-law-resources/isp98/ [Accessed: 22 October 2018].

ISP98 is available to read in full from the UNCITRAL website:

http://www.uncitral.org/pdf/english/texts_endorsed/ISP98_e.pdf [Accessed: 22 October 2018].

10.10 Unfair calling of guarantees and standby letters of credit

Applicants of guarantees and standby letters of credit are at a real risk of them being 'called' (ie of an unfair demand being made). This can happen even when there has not been a genuine failure on their part to have performed a contractual obligation.

Since banks deal with documents only, they are in no position to refuse a claim if the correct documents are to hand.

Guarantees issued in a foreign country will, in many cases, be subject to the laws of that country. These may be difficult to understand, or the administration of the law may be prone to bias in favour of the local beneficiary. In some instances, there may be no laws applicable to the situation.

To minimise the risk of a guarantee or a standby letter of credit being called unfairly, both the applicant and the bank will consider what documentary requirements could be included to minimise this risk. In many cases the applicant may be constrained by the regulations in the beneficiary's country and the relative bargaining strength of the two contracting parties. What the applicant and the bank will try to achieve is some independent documentation, such as:

- a notary's signature confirming that a bill of exchange is unpaid;
- an independent engineer's or architect's certificate that a contract has not been performed to specification and/or on time.

Instead of actually unfairly calling a guarantee or a standby letter of credit, a beneficiary may threaten applicants with having the guarantee or standby letter of credit called upon unless an amendment, such as an extension to the expiry date, is agreed to. This practice is called 'extend or pay', and each case will need to be carefully considered before action is taken. If the beneficiary is refused an extension on the expiry of a guarantee or standby letter of credit, it may be able to produce the documentation required to claim on the document, which would mean that payment would have to be made immediately. Extending the guarantee or standby letter of credit avoids this, or perhaps simply postpones eventual payment. Issuing banks and their clients will be mindful of the fact that extension of the facility will involve a fee and ongoing regular commissions (usually charged quarterly on a pro-rata basis for as long as the facility is outstanding) for the remainder of its validity.

10.10.1 Insurance against unfair calling risks

Some insurance companies offer protection against some of the unfair calling risks that exporters and contractors face when providing guarantees or standby letters of credit. Typically, cover includes protection against:

- a foreign government purchaser arbitrarily calling for payment;
- a call for payment that is 'legitimate' but the seller's or contractor's failure is due to political events, wars or revolutions;
- a failure by the beneficiary to honour an arbitration award.

Other insurance cover may be taken out against, for example, the expropriation of a contractor's plant and equipment.

The services of a local office or agent working for the principal can mitigate these risks.

10.11 Standby letters of credit and guarantees – credit considerations for the issuing bank

As can be seen, the issuing bank's undertaking contained in a standby letter of credit or guarantee is given with less inherent security in the transaction as there are no documents giving title or control that can be held by the bank.

With a guarantee or a standby letter of credit, a demand may be supported by little more than a written statement of default or, at best, by independent proof that the bank's customer is truly in default. Either way, reimbursement for the bank can only come from a claim on its customer's counter-indemnity.

Therefore, issuing guarantee and standby letters of credit poses a very real credit risk for the bank. The following issues will be in the mind of the bank's credit officer as well as that of the applicant for the guarantee or standby letter of credit.

- What experience does the applicant have in this specific trade?
- What experience does the applicant have in the country concerned?
- Can the applicant insist on a certificate from an independent body or arbitrator?
- Is a guarantee subject to URDG 758 or a standby letter of credit subject to ISP98 or UCP 600 acceptable to all parties?
- What is the bank's experience with the applicant and the country with respect to guarantees being called without justification?
- Are the sums involved within the applicant's capacity to meet them, without a devastating impact on its business?
- What protection can be provided for the currency exchange risk?

- Does the applicant have sufficient limits available for the issuance of guarantees or standby letters of credit? If not, what security can the applicant offer, or should the bank hold a cash deposit as security?

The bank's credit officer will be aware that one of the most common reasons for a bond being called is the insolvency of the applicant. If the applicant is unable to pay or deliver to the beneficiary under the contract, they are unlikely to be able to honour the counter-indemnity to the bank.

When the applicant is given approval, they will have to sign the bank's counter-indemnity, acknowledging, where applicable, that the guarantee will be issued subject to URDG 758 or the standby is issued subject to ISP98 or UCP 600. This may also be evidenced by the wording that appears in the application form for the issuance of the guarantee and that is signed by the applicant.

10.12 Comparison between standby letters of credit and demand guarantees

TABLE 10.1 COMPARISON OF STANDBY LETTERS OF CREDIT AND DEMAND GUARANTEES

Issue	Standby letter of credit	Guarantee
Usage	Wide range: credit replacement guarantees, back-up to other payment terms or any form of guarantee.	Mainly confined to non-performance.
Governing rules	UCP 600 or ISP98.	URDG 758, UCP 600 or ISP98.
Subject to local laws?	Yes.	Yes.
Irrevocable	Yes.	Yes.
Documentary	Yes, but no liability for genuineness or validity of documents.	Yes, but no liability for genuineness or validity of documents.

Amendment	Yes, with consent of beneficiary. Automatic amendment clauses permitted under ISP98.	Yes, with consent of beneficiary.
Transfer and/or assign	ISP98 permits transfer to more than one party, but does not allow for partial transfers. This differs from UCP 600 transfer rules (see Topic 8). The proceeds of a claim may be assigned.	URDG 758 permits assignment of the bond if specifically stated in its terms. Proceeds may, in any event, be assigned, but the guarantor shall not be obliged to pay an assignee unless it has agreed to do so.
Issuance	May be issued direct to the beneficiary via an advising bank (that only confirms apparent authenticity) that may or may not be a confirming bank. A second advising bank may be involved. Issuance of a standby letter of credit based on a counter-standby letter of credit (similar to an indirect guarantee) is possible.	May be issued direct to the beneficiary or by a bank in the beneficiary's country that issues the guarantee against a counter-guarantee from the applicant's bank (indirect guarantee).
Expiry	If subject to UCP 600/ISP98, standby letters of credit must state an expiry date.	Guarantees without expiry date or event possible. If subject to URDG 758 and without an expiry date or event, sub-article 25 (c) applies (three years from issuance).

10.13 Summary incorporating both products

- Both bank guarantees and standby letters of credit are bank undertakings that are irrevocable:
  - A standby letter of credit has many characteristics similar to a documentary credit and may be issued subject to the same UCP 600 rules or the similar but specific standby rules: ISP98.
  - Unconditional guarantees, such as bid bonds, performance bonds and advance payment guarantees, which may be (and preferably should be) issued subject to URDG rules but in many instances are not. Unconditional guarantees are primary obligations to pay.
- Conditional guarantees are secondary obligations and are subject to the usual rules concerning guarantees. They are offered by insurance companies and others but not generally by banks.
- Both standby letters of credit and unconditional guarantees are documentary in that the issuer's payment obligation is subject only to presentation of compliant documents within the expiry of the standby or guarantee (or, additionally, the expiry event for a guarantee).
- Both products pose real risks to an applicant and to the issuing bank, both of which will want to be certain that they understand the risks involved, the record of the beneficiary and the tendency for unfair calling.
- Where possible, applicants should require independent documentary evidence of non-performance (see section 10.10).

FACTFIND

Why do we have two systems for the same purpose?

Standby letters of credit were initially developed because banks in the USA had limited legal authority to issue guarantees. Today, that restriction on the issuance of guarantees only exists under limited circumstances.

Standby letters of credit are not legally distinct from demand guarantees as they also require the presentation of stipulated documents and compliance with the terms and conditions of the guarantee. The distinction lies in practice and terminology.

Read an article about this on the website of the United States Council for International Business:

https://www.uscib.org/can_us_banks_issue_guarantees/ [Accessed: 22 October 2018].

A comparison between UCP 600 and ISP98 is also available from the IIBLP website:

http://iiblp.org/wp-content/uploads/2014/12/ISP98-v.-UCP600-Key-Differences.pdf [Accessed: 22 October 2018].

Conclusion

In this topic, you learned about bank guarantees and standby letters of credit that provide an undertaking that a business or government organisation importing from, or contracting with, a bank's customer will be reimbursed in the event that the bank's customer fails to perform.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- outline the fundamental differences between conditional and unconditional guarantees?
- list some guarantees that have a primary obligation to pay?

- highlight the key characteristics of contract guarantees?
- describe the documentary nature of standby letters of credit and unconditional guarantees?
- explain whether expiry dates are relevant to a guarantee?
- discuss some of the risks that guarantees and standby letters of credit pose to the applicant?
- provide reasons for unfair calling?
- highlight the differences between bank guarantees and standby letters of credit?

Test your knowledge

?

Use these questions to assess your learning for Topic 10. Review the text if necessary.

Answers can be found at the end of this book.

1) According to URDG 758, within how many days should a guarantor honour a claim if it is a compliant demand?

   a) Seven calendar days following presentation.

   b) Seven business days following presentation.

   c) Five calendar days following presentation.

   d) Five business days following presentation.

2) Which of the following statements describe conditional guarantees? Choose all that apply.

   a) Dependent on the underlying contract.

   b) Independent of the underlying contract or reason for default.

   c) Subject to URDG 758.

   d) Guarantor has primary obligation.

   e) Guarantor has secondary obligation.

3) A primary obligation requires the beneficiary to claim on the applicant first, prior to a claim on the guarantor. True or false?

4) Which of the following types of guarantee favour the buyer? Choose all that apply.

   a) Advance payment guarantee.

   b) Performance guarantee.

   c) Retention guarantee.

   d) Tender guarantee.

5) Which of the following statements is true of standby letters of credit?

   a) Definite expiry date.

   b) May or may not have a definite expiry date or event. If no definite date or event, then cancellation is via return.

   c) They can be subject to URDG 758/UCP 600/ISP98 or local law and jurisdiction.

   d) They are subject to UCP 600 or ISP98.

   e) Amendments are allowed with the consent of the beneficiary; an automatic amendment clause is permitted under ISP98.

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Supply chain finance

Introduction

In this topic, we discuss supply chain finance in the context of the *Standard definitions for techniques of supply chain finance*, published in 2016 by the Global Supply Chain Finance Forum (GSCFF). In the sections that follow, we will refer to these as the standard definitions. When drafting the standard definitions, members of the forum took a broad, holistic view of supply chain finance that included well-established solutions as well as much newer, technology-enabled techniques. We will also explore the distinction between physical and financial supply chains and the financial consequences to business. Each solution/ technique and its application will also be clearly explained. Finally, we will touch on alternative finance and innovation in supply chain finance.

LEARNING OBJECTIVES

By the end of this topic, you will understand:

- terminology related to supply chain finance;
- business drivers that create a demand for working capital finance;
- the relationship between the physical and the financial supply chain;
- different techniques of supply chain finance and how they operate; and
- innovative approaches, new entrants and the positive impact of technology.

THINK . . .

Consider businesses your bank or financial technology firm supports. Think about the different steps in their manufacturing and distribution processes. How much cash do these businesses have to pay out prior to customers paying for their goods?

11.1 What is supply chain finance?

Representatives from many global trade finance and receivables finance organisations were involved in drafting the standard definitions. Their brief was to come up with a high-level definition of supply chain finance and its important associated characteristics.

STANDARD DEFINITIONS FOR TECHNIQUES IN SUPPLY CHAIN FINANCE

"Supply chain finance (SCF) is defined as the use of financing and risk mitigation practices and techniques to optimise the management of the working capital and liquidity invested in supply chain processes and transactions. SCF is typically applied to open account trade and is triggered by supply chain events. Visibility of underlying trade flows by the finance provider(s) is a necessary component of such financing arrangements which can be enabled by a technology platform." (GSCFF, 2016)

This definition refers to the application of supply chain finance techniques to open account trade. The term open account is generally understood to mean that:

- shipping documents are not controlled through the banking system but are sent direct by the exporter to the importer;

- the importer's bank does not make a conditional undertaking to pay upon fulfilment of specified conditions on behalf of the importer; and
- the importer settles with the exporter directly by making a clean payment after an agreed deferred credit period.

According to the ICC Banking Commission publication *Rethinking Trade & Finance*, it is estimated that up to 90 per cent of trade transactions are settled on open account terms (ICC Banking Commission, 2017).

FACTFIND

Standard definitions for techniques in supply chain finance

Explore the GSCFF website at: http://supplychainfinanceforum.org/ [Accessed: 20 October 2018].

The standard definitions are available online and also to download from the GSCFF website: http://supplychainfinanceforum.org/ICC-Standard-Definitions-for-Techniques-of-Supply-Chain-Finance-Global-SCF-Forum-2016.pdf [Accessed: 20 October 2018].

Another useful resource is the ICC Banking Commission report *Rethinking Trade & Finance*, available at: https://cdn.iccwbo.org/content/uploads/sites/3/2017/06/2017-rethinking-trade-finance.pdf [Accessed: 20 October 2018].

11.1.1 The key characteristics of supply chain finance

The GSCFF has determined that financing options with the following characteristics fall under the umbrella of its definition of supply chain finance.

Portfolio of risk mitigation techniques and practices

Supply chain finance "is a portfolio of financing and risk mitigation techniques and practices that support the trade and financial flows along end-to-end business supply and distribution chains, domestically as well as internationally. This is emphatically a 'holistic' concept that includes a broad range of established and evolving techniques for the provision of finance and the management of risk.

Open account

[SCF] is usually, but not exclusively, applied to open account trade. Open account trade refers to trade transactions between a seller and a buyer where transactions are not supported by any banking or documentary trade instrument issued on behalf of the buyer or seller. The buyer is directly responsible for meeting the payment obligation in relation to the underlying transaction. Where trading parties supply and buy goods and services on the basis of open account terms, an invoice is usually raised and the buyer pays within an agreed timeframe. Open account terms can be contrasted with trading on the basis of cash in advance, or trading utilising instruments such as documentary credits, as a means of securing payment.

Parties

Parties to [SCF] transactions consist of buyers and sellers, which are trading and collaborating with each other along the supply chain. As required, these parties work with finance providers to raise finance using various SCF techniques and other forms of finance. The parties, and especially 'anchor' parties on account of their commercial and financial strength, often have objectives to improve supply chain stability, liquidity, financial performance, risk management, and balance-sheet efficiency.

Event driven

Finance providers offer their services in the context of the financial requirements triggered by purchase orders, invoices, receivables, other claims, and related pre-shipment and post-shipment processes along the supply chain. Consequently, SCF is largely 'event driven'. Each intervention (finance, risk mitigation or payment) in the financial supply chain is driven by an event or 'trigger' in the physical supply chain. The development of advanced technologies and procedures to track and control events in the physical supply chain creates opportunities to automate the initiation of SCF interventions in the related financial supply chain.

Evolving and flexible

SCF is not a static concept but is an evolving set of practices using or combining a variety of techniques; some of these are mature and others are new or 'leading edge' techniques or variants of established techniques, and may also include the use of traditional trade finance. The techniques are often used in combination with each other and with other financial and physical supply chain services."

(GSCFF, 2016)

11.1.2 Differences between trade finance and supply chain finance

The term 'supply chain finance', unlike trade finance, is relatively new and was adopted by many finance providers as a description of a single, very narrow, payables finance product, while others used the term to refer to a much wider family of solutions, often incorporating receivables, payables and inventory.

The term 'trade finance', by contrast, has been in common usage for centuries. It is generally accepted to refer to the intermediation by banks through the control of documents relating to the shipment of the underlying goods.

The distinction between trade and supply chain finance is becoming blurred as technological developments and digitisation increase the scale of data-driven solutions for risk mitigation and finance. Nevertheless, Table 11.1 illustrates the key characteristics that tend to result in certain solutions being labelled 'trade finance' and others 'supply chain finance'.

TABLE 11.1 CHARACTERISTICS OF TRADE FINANCE AND SUPPLY CHAIN FINANCE

Characteristic	Trade finance	Supply chain finance
Level of bank intermediation (risk mitigation, finance and payment)	More likely to be **high**. Trade finance solutions incorporate all three elements through control of shipping documents.	More likely to be **low**. Supply chain finance was developed in the open account space, where bank intermediation was limited to making the payment.
Transactional security (title to goods, control of goods and security interest in receivable)	More likely to be **high**. Trade finance solutions have the potential to incorporate all three elements through control of shipping documents and associated security documentation.	More likely to be **low**. Due to the relative lack of intermediation, the potential to exercise transactional control is more limited, though a security interest in the receivable is usually achievable.
Basis of finance availability	More likely to be **transactional**. In order to benefit from transactional security, high levels of transactional control are required. This is more likely to be achievable when finance is made available on a transactional basis.	More likely to be **flow-based**. The greater efficiency and lower handling costs associated with flow-based financing are among the reasons for the trend away from traditional trade finance.
Pre- and post-shipment finance	More likely to be **high**. Trade finance instruments and structures facilitate finance across the end-to-end trade cycle, from purchase order to payment.	More likely to be restricted to **post-shipment**. Supply chain finance solutions tend to be based on invoices.

11.2 Understanding supply chains

To understand how supply chains are financed it is important that you first learn about the operation of the physical supply chain and can identify the roles played by the main parties involved.

A supply chain involves multiple entities who will interact and play their role in the sourcing, manufacturing, production and distribution of goods. It is likely that most parties will be both a buyer and a seller and each will have an interdependency on the other.

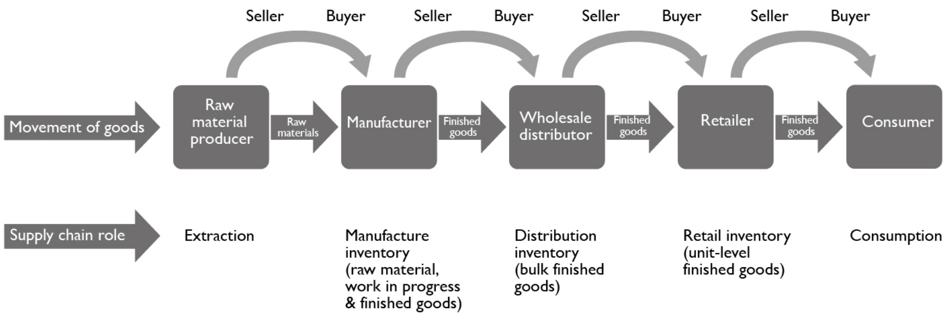
Supply chains, whether simple or complex, work on the basis of collaboration between the different entities in the chain. Their importance in the supply chain will be governed by where they are placed in the chain and the level of contribution they are expected to make for the chain to work. Some may be major corporations, while others may be small and medium-sized enterprises (SMEs). Each will have their own needs and requirements that have to be considered if the supply chain is going to work effectively.

11.2.1 The physical supply chain

The physical supply chain represents the movement of raw materials, parts and goods associated with a finished product and involves the procurement, manufacture/processing, distribution arrangements and lead times that end with the goods being in the hands of the end buyer.

A physical supply chain usually involves at least three links in the chain, with the primary parties always being the buyer and seller who combine to produce the end product. Why three links instead of two? The reason is that the seller has to source raw materials, components or finished goods that they then sell to the buyer. In practice, supply chains extend to multiple parties, as illustrated Figure 11.1 and Table 11.2.

FIGURE 11.1 PRIMARY PARTIES



Source: Bugeja and Taylor (2018)

TABLE 11.2 PARTIES AND ROLES

Party	**Supply chain role**	
Seller	Raw material producer	Extraction
Buyer and seller	Manufacturer	Manufacture Inventory (raw material, work-in-progress and finished goods)
Buyer and seller	Wholesale distributor	Distribution Inventory (bulk finished goods)
Buyer and seller	Retailer	Retail inventory (unit-level finished goods)
Buyer	Consumer	Consumption

Source: Bugeja and Taylor (2018)

This figure and table illustrate a relatively simple physical supply chain with relatively few 'links' and a linear process. In practice, supply chains tend to be more complex. Whereas, in the past, supply chains were based around a local or regional network of suppliers, the trend over many years, driven by reduced trade barriers and a greater inclination to trade internationally, has been to gain efficiencies through globalisation. That said, in recent years we have seen a move towards nearshoring and onshoring, where possible, as a result of technology developments reducing the advantage of low-labour cost economies relative to shorter transit times and lower freight costs. You learned about nearshoring in section 1.1.3.

11.2.2 The financial supply chain

The term 'financial supply chain' is used to describe the financial events that take place in parallel with the physical supply chain. The financial events commence as soon as a party in a supply chain takes an action that changes their financial position. For example, when a seller contractually commits to deliver their goods to a buyer, their financial position has changed because they are now required to source goods, undertake production, maintain inventory, undertake shipment and account for the resulting receivable.

Each event has financial consequences: sourcing has to be paid for, production costs are incurred and inventory has to be funded. The changes in financial position are not just related to liquidity and working capital, but also to risk exposure. Once a party is contractually committed to do something, they are potentially liable for failing to do it.

CHECK YOUR UNDERSTANDING 1

What is the difference between a financial and physical supply chain?

11.2.3 The information supply chain

The information supply chain represents the processes and organisation that are necessary to collect, transform and distribute information efficiently.

As noted previously, there are many stakeholders in the physical supply chain. Each stakeholder has a role to play and each action is an 'event' that generates information. Each event impacts on the seller and/or the buyer to some degree and the information relating to the event can also be relevant to the finance provider.

For example, when a carrier accepts goods for shipment and loads them onto the vessel, we can see that there is an event and there is also the related information:

- the loading on board is the 'event'; and
- the document (providing details of the shipment) to the seller confirming that the goods have been loaded on board the vessel is the 'information'.

Using another example, when an inspection agency undertakes pre-shipment inspection of the seller's goods on behalf of the buyer, there is once again an event and there is also the related information:

- the execution of the inspection itself is the 'event'; and
- the inspection report is the 'information'.

11.2.4 The relationship between the physical and financial supply chain

As you learned in section 11.2.1, the physical supply chain reflects the physical production, movement and storage of raw materials, components and finished goods while the financial supply chain reflects the financial events that support it. The events in both the physical and the financial supply chain have financial implications and consequences in terms of risk, working capital and cash flows.

The main elements that dictate the relationship between the physical and financial supply chain are derived from the sales contract/purchase order terms agreed by the primary parties in the supply chain, namely the buyers and sellers.

Sales contract

When sellers and buyers have agreed to trade, the terms will often be encapsulated in a sales contract. This is a legal agreement for the sale of goods or services by the seller and the purchase of the goods or services by the buyer. A sales contract can cover a single consignment or a number of consignments over a period of time, in which case it is common for each consignment to be the subject of an individual purchase order.

In some cases, sellers and buyers do not sign a formal contract but operate on the basis of a quotation by the seller (often known as a 'pro forma invoice') and an acceptance by the buyer in the form of a purchase order.

Purchase order

A purchase order may be issued in respect of individual consignments under a sales contract or may, effectively, perform the function of a sales contract on its own. In the absence of a formal sales contract, the terms that would normally appear in the sales contract will be incorporated into the purchase order, albeit in abbreviated form. As a minimum, a purchase order will include:

- details of seller and buyer;
- description of goods or services;
- price and payment terms;
- delivery details and shipping terms; and
- a unique purchase order number.

The purchase order is generally regarded as the first event in the financial supply chain and, as such, is an important document. The purchase order number is a unique reference that enables the reconciliation of invoices and other shipping data with the purchase order. As we look at the digitisation of the financial supply chain, you will see why the ability to match shipment data with purchase order data is a fundamental enabler for many supply chain finance solutions.

Commerical invoice

You learned about the commercial invoice in section 6.5. The invoice is also an important legal document. It is a commercial document raised by the seller and addressed to the buyer which describes the goods or services that have been delivered or despatched to the buyer and specifies the amount due by the buyer to the seller in payment. When the invoice is issued, this is reflected in the seller's accounts as a receivable (ie a debtor in their balance sheet). At the same time, the goods that have been sold to the buyer are removed from the seller's balance sheet. Once the invoice is approved by the buyer, a payable is created in their accounts (ie a current liability) and the goods are added to their balance sheet (ie a current asset is created). At this point, the buyer has an obligation to pay the seller on the due date.

Impact on liquidity and working capital

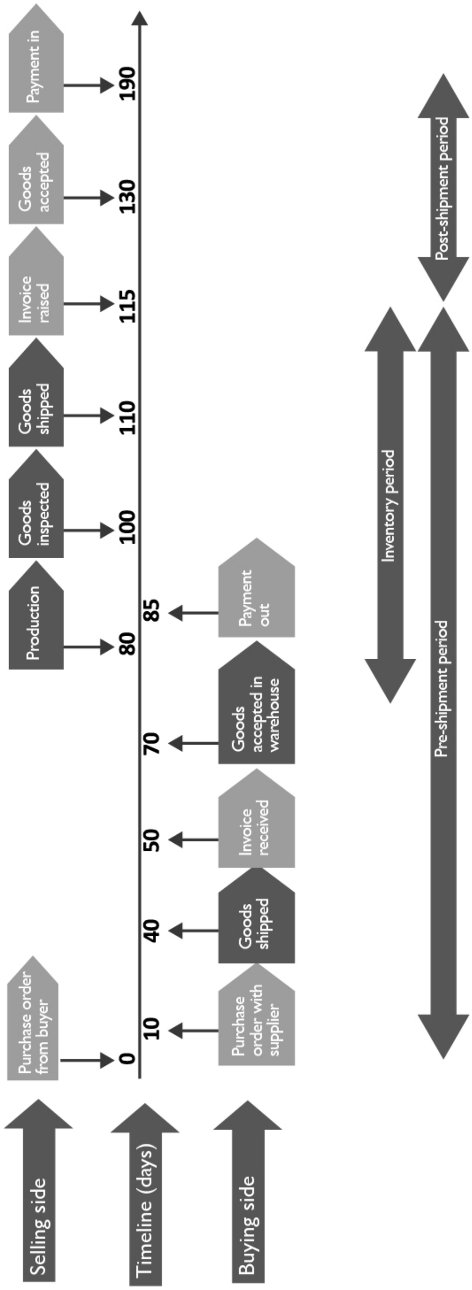
We will now look at how contracted terms of payment coupled with the practical realities of the physical supply chain have a material effect on a company's liquidity and working capital.

For example, let us take a scenario where a buyer has agreed to pay 30 per cent of the invoice value with the order (ie pre-shipment) and the remaining 70 per cent immediately upon shipment. The financial implications for the buyer will depend on a number of factors driven by the physical supply chain. These are the:

- **pre-shipment lead time** (ie the time between the order being placed and the goods being shipped);
- **transit time** (ie the time taken for the goods to arrive after despatch);
- **production time** (ie the time taken by the buyer to convert the goods sourced from their supplier into finished goods that can then be sold to their customers);
- **stockholding time** (ie the time that finished goods have to be stored by the client in anticipation of orders or call-off instructions from their customers); and
- **time taken for their customers to pay** for the goods, once delivered.

Figure 11.2 plots the physical and financial events on a single timeline. In this example, the client receives a purchase order from their buyer before placing an order for the required goods with their supplier. The selling and buying events are shown in parallel. This is a typical closed loop scenario (sometimes referred to as self-liquidating) where goods are sourced to meet specific purchase orders.

FIGURE 11.2 TYPICAL CLOSED LOOP EXAMPLE



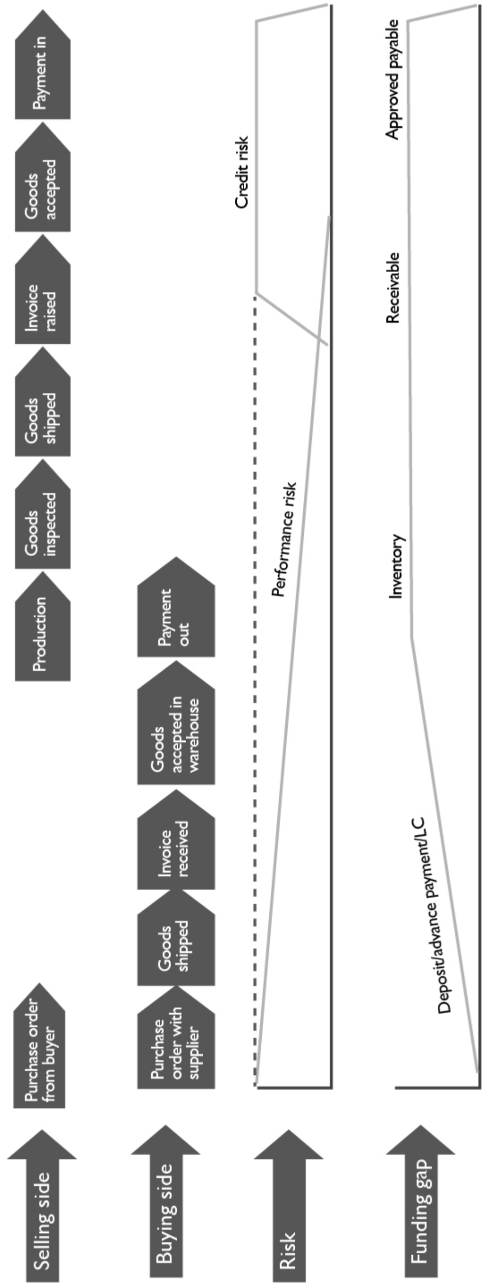
Source: Bugeja and Taylor (2018)

Performance is key to the success of the physical supply chain. A company receiving a purchase order from its customer and then having the need to purchase raw materials and parts to fulfil that order from its suppliers has to carefully manage its activities to ensure that a failure on the part of itself or its suppliers does not result in the purchase order not being fulfilled as per the required specifications and timeframes. Failure to perform in one part of the supply chain can have a knock-on effect on other parts. For example, a car manufacturer that finds a specific part is not available to support its assembly line may have to halt production until the part is delivered.

Similarly, the company should employ an equal amount of effort and planning in managing the implications of financial supply chain events. In particular, it needs to manage the risk, working capital and cash-flow implications so as not to disrupt the flow in the physical supply.

In Figure 11.3 the same scenario is used as in Figure 11.2. In this case, however, the risk and working capital implications are highlighted as well.

FIGURE 11.3 PHYSICAL AND FINANCIAL SUPPLY CHAIN COMBINED



Source: Bugeja and Taylor (2018)

As Figure 11.3 demonstrates, performance risk reduces as the different events progress within the supply chain, with credit risk becoming the primary risk later in the process. However, from the seller's perspective, credit risk becomes a real consideration from the time they receive the purchase order and start to incur cost in relation to fulfilling that order.

CHECK YOUR UNDERSTANDING 2

1) Can you identify the key physical and financial supply chain events in Figure 11.3?
2) What are the financial consequences of the events in the financial supply chain?

11.3 Understanding the customer need

Supply chain finance is relevant for all segments (major corporates, mid-market companies and SMEs). Though supply chain finance is primarily a financing solution, in some cases it can also provide a degree of risk mitigation and may incorporate the settlement process.

The benefits that companies are looking for when they adopt a supply chain finance solution depend on the segment that they occupy. While SMEs are primarily driven by the need to access finance, larger corporates tend to have a more varied set of drivers. In the mid-market segment, balance-sheet efficiency is often the primary driver.

Regardless of the segment, it is necessary to understand the business of each company and its trade cycle in order to determine which supply chain finance solution will be of most benefit to it.

11.3.1 Trade cycle analysis

The in-depth analysis of the trade cycle of a company enables the finance provider to understand the needs of its clients in terms of risk mitigation, finance and payments.

However, undertaking effective trade cycle analysis also directly benefits the client. By 'playing back' the outcome of the trade cycle analysis to the client, the finance provider is enabling the client to see the impact of their trading arrangements on their cash conversion cycle.

The trade cycle analysis process starts with a detailed analysis of the physical supply chain. The scope of this analysis will depend on the size of the client and the sector it operates in.

Understanding SMEs

For example, if an SME client is purchasing finished products from a few major suppliers in one particular region and selling those products on standard payment terms in its home market, it will be feasible to undertake an analysis of the SME client's entire business in a single view.

Understanding larger corporates

On the other hand, a larger corporate may have multiple trade cycles depending on where and how it is sourcing its products, components or raw materials, and where and how it is selling its finished products or 'sub-assemblies'. In such a case, the trade cycle analysis will be pitched at the 'line of business' level and may require a number of different analyses to be compiled. These will then have to be weighted and placed into a comprehensive summary that gives a clear picture of the client's overall business.

No matter which approach is appropriate, the intention is to add quantitative and qualitative detail to the high-level view of the client's role in the physical supply chain.

Quantitative detail

This provides clarity regarding funding gaps, risk exposures and payment flows. Areas that should be examined include:

- event timings;
- values;
- credit periods;
- lead times (the period between commitment and shipment);

- transit times;
- shipment methods;
- suppliers (including manufacturers, wholesalers, producers, growers, extractors – who they are and where they come from);
- buyers (who they are and where they come from);
- inspection; and
- insurance.

Qualitative detail

This provides a basis for risk assessment and includes the:

- reliability of any pre-sale agreements (eg is the purchase order robust?);
- nature, perishability and saleability of the goods (alternative sources of repayment);
- price volatility of the goods;
- track record of successful sourcing from suppliers (performance risk);
- track record of successful sale to buyers (credit risk and performance risk); and
- history of disputes and dispute resolution.

To achieve such quantitative and qualitative analysis will require capturing the different ‘events’ in the physical and financial supply chain from sourcing, inventory and selling data, together with the detail of financial flows. The events to be evaluated include those from past performance but also the expected pattern of trade over the period to which the finance will refer.

In addition to the preceding, time should be taken to research the sector the client operates in and, if possible, obtain relevant financial metrics from the client’s peer group.

The following metrics should be sourced:

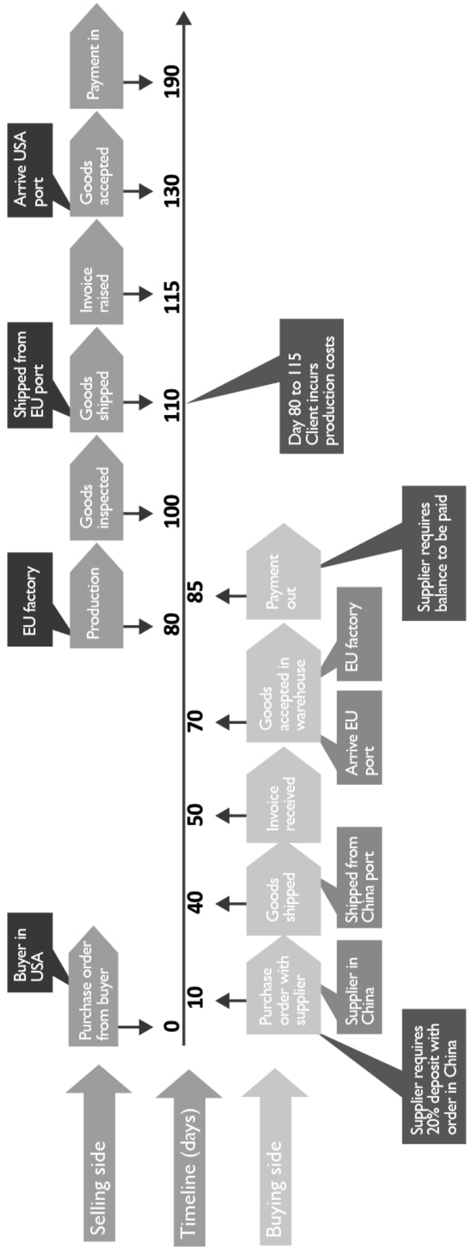
- **Days sales outstanding (DSO)** – a metric used to measure a company's average sales payment terms.
- **Days purchasing outstanding (DPO)** – a metric used to measure a company's average supplier payment terms.
- **Days inventory outstanding (DIO)** – a metric used to measure a company's average rate of stock turnover.

This information can be revealing for the client during future playback if, for example, the financier can point to sector trends that are different to the client's metrics.

11.3.2 Application of trade cycle analysis

The output from trade cycle analysis is used to finalise the supply chain finance facility structure and to specify any non-standard operational or collateral management controls that may be required. Figure 11.4 is an example of how financial consequences can be mapped to physical events in a supply chain. You will see how mapping one against the other provides a holistic view of a client's trade cycle.

FIGURE 11.4 FINANCIAL CONSEQUENCES OF PHYSICAL SUPPLY CHAIN EVENTS

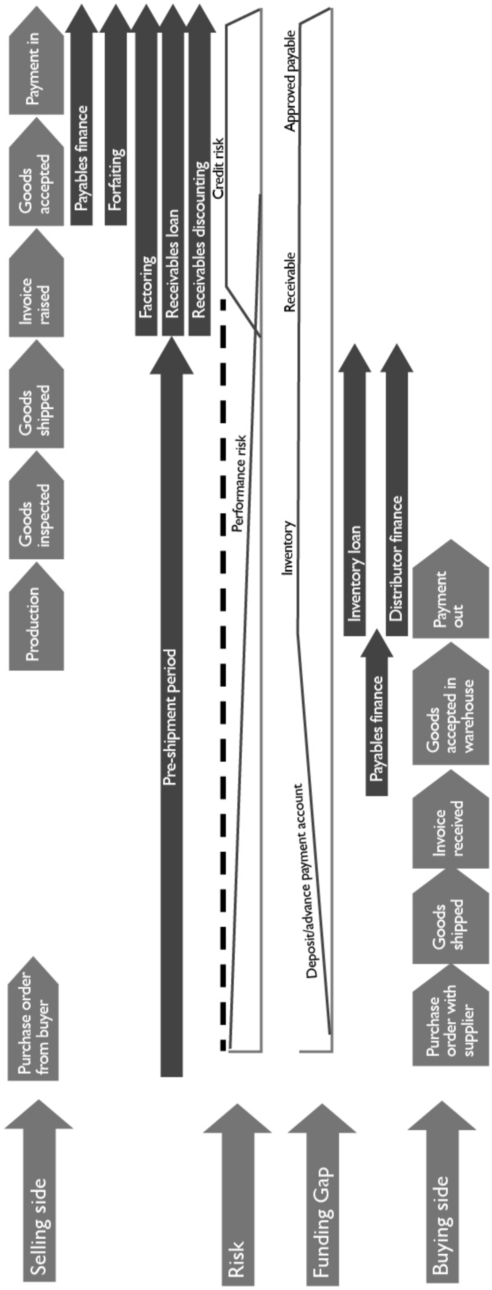


Source: Bugeja and Taylor (2018)

The natural progression from understanding a client's trade cycle is to then choose which supply chain finance solution will be most suitable to meet the client's needs.

Figure 11.5 illustrates where the main products could be used relative to a typical trade cycle. It should be noted that the trade cycle analysis might highlight risks and funding requirements that cannot be addressed using supply chain finance alone. In such cases, a finance provider might conclude that a structure incorporating trade finance as well as supply chain finance provides the optimum solution.

FIGURE 11.5 MAPPING PRODUCTS TO SUPPLY CHAIN STAGES



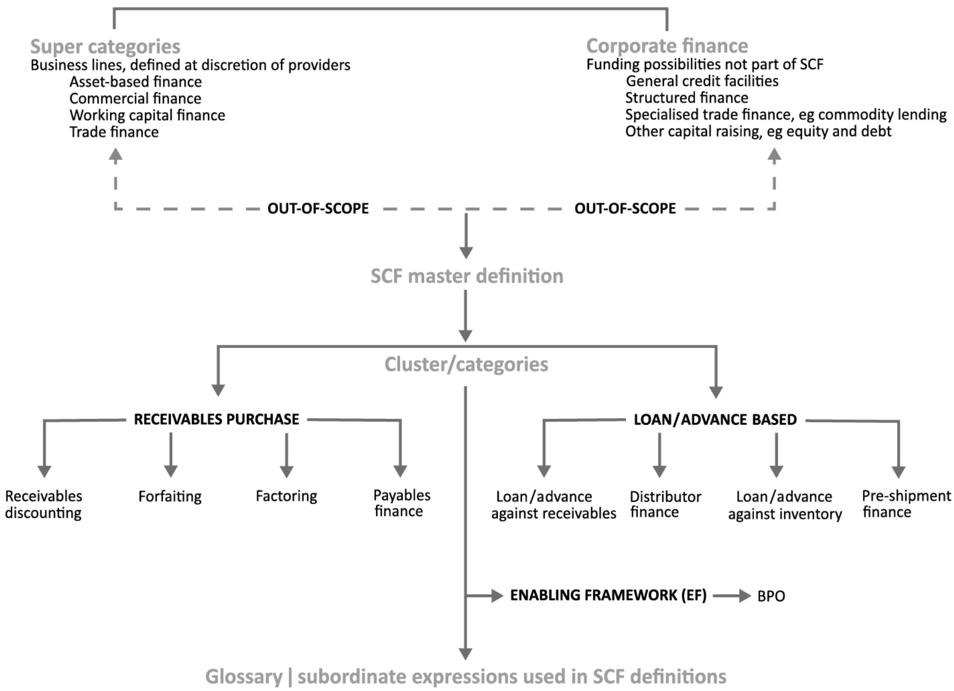
Source: Bugeja and Taylor (2018)

11.4 Categorisation of techniques

Supply chain finance techniques can be categorised in a number of ways. Figure 11.6, first published in the standard definitions, represents the industry standard and illustrates how these categories are positioned relative to other financing solutions. This hierarchical model segments the techniques into three categories:

- receivables purchase;
- loan/advance-based; and
- enabling framework.

FIGURE 11.6 SUPPLY CHAIN FINANCE CATEGORIES RELATIVE TO OTHER FINANCING SOLUTIONS



Source: GSCFF (2016, p23)

11.4.1 Receivables purchase category

The defining characteristic of this category is that the seller of goods or services obtains finance by selling all or part of the receivable relating to those goods or services to the finance provider, who becomes the owner of the receivables.

The method by which ownership of the asset is transferred to the finance provider varies depending on the jurisdiction, but involves some form of assignment of title rights. Upon execution of the assignment, the finance provider pays the seller a sum that is based on the face value of the receivable.

Key considerations

When a finance provider is contemplating the purchase of receivables, it will take the following into consideration:

- validation that the receivable exists;
- verification that the receivable is assignable in the seller's jurisdiction; and
- confirmation that the receivable is enforceable against the debtor in the debtor's jurisdiction.

The title of this category suggests that the receivable is the only asset that can be purchased by a finance provider. This is not strictly true as it is also possible to assign inventory to the finance provider and to create a 'true sale'. In practice, the agreement with the finance provider will include a repurchase clause (known as a 'repo') so that the goods are sold back to the client in order for them to sell goods to their end-customer.

A facility may be granted 'with recourse' or 'without recourse' back to the seller of the asset. In practice, however, the rights of recourse are not usually quite so clear-cut, and the receivables purchase agreement will usually specify the circumstances under which the finance provider can exercise their right of recourse.

This will have a direct bearing on the balance-sheet treatment in the client's books. The decision regarding balance-sheet treatment is always at the sole discretion of the client's auditors but, as a guiding principle, if a finance provider can exercise recourse entirely at their option, then the auditor would regard this as bank debt. In other words, the finance would be 'on balance sheet'.

KEY TERMS

True sale

"[A]n accounting and legal expression connoting that a financial asset or negotiable instrument has been sold by one party to another in the sense of no longer being recorded in the balance sheet of the seller and instead being recorded on the balance sheet of the purchaser." (GSCFF, 2016)

Recourse

"[The] legal ability [that] the purchaser of a financial asset may have to fall back on the original creditor if the current debtor defaults. For example, an account receivable sold with recourse enables the buyer of the receivable to make claim on the seller if the account doesn't pay." (Dictionary of Finance and Investment Terms, 2014)

11.4.2 Loan or advance-based category

The defining characteristic of this category is that the seller of goods or services obtains finance by borrowing from the finance provider. The loan or advance is made in the expectation that it will be repaid from proceeds of the sale of goods or services.

The finance provider may be prepared to grant the loan without taking an assignment of the receivable, deriving comfort from the knowledge that there is a good source of repayment. Alternatively, the finance provider may be secured by the assignment of the receivable. Though the process of assigning the receivable is similar to the true-sale model set out in the receivables purchase category, in this case, ownership of the asset does not transfer to the finance provider. Instead, the finance provider gets a security interest in the asset.

11.4.3 Enabling framework category

As its name suggests, this category is not a product or direct client solution but has been included in the standard definitions to make mention of the bank payment obligation (BPO).

It is worth noting that the BPO:

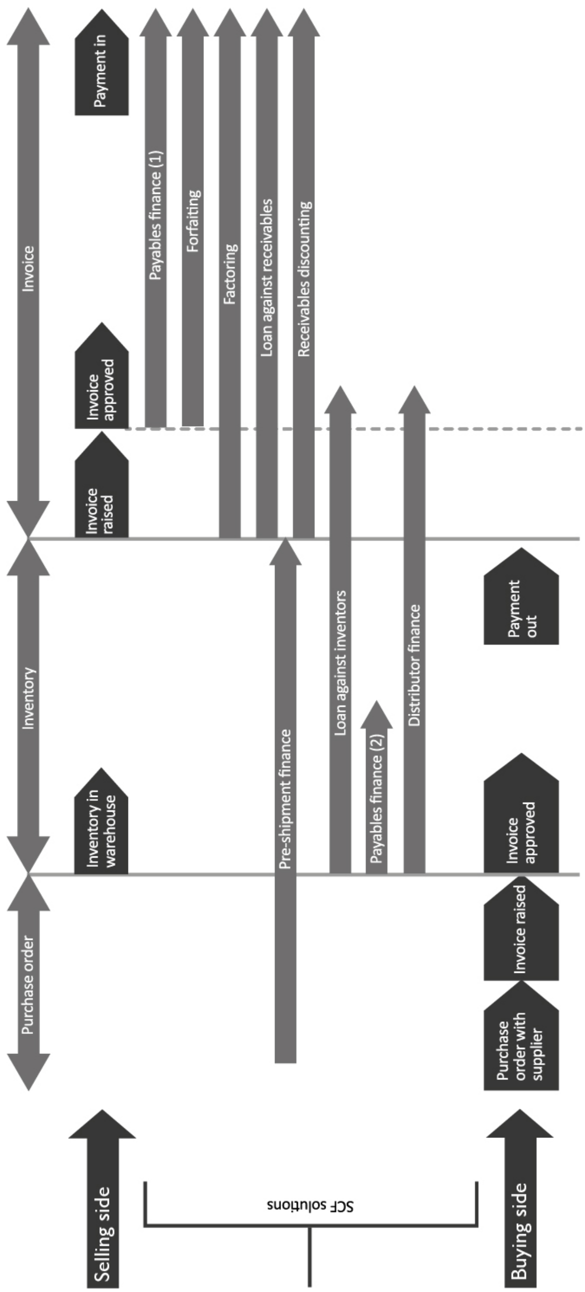
- is an interbank instrument, not a product;
- prescribes that the buyer and seller are not actually parties to the BPO itself (contrary to the indication in the standard definitions) but are able to benefit from the BPO via separate agreements with their respective banks;
- is a conditional undertaking designed to enable a bank to provide finance on a transactional basis, similar in principle to a letter of credit;
- has conditionality that, unlike a letter of credit, is based on the matching of data rather than the presentation of conforming shipping documents; and
- is subject to ongoing development to enhance its acceptability and value to clients and banks.

You will learn more about BPOs in section 15.11.

11.5 Supply chain finance solutions

The stages at which individual supply chain finance solutions may be used to meet client needs are illustrated in Figure 11.7. The supply chain is segmented into three stages: the purchase order stage, the inventory stage and the invoice stage. The invoice stage is post-shipment and the purchase order stage is pre-shipment. The inventory stage may be perceived as either pre-shipment or post-import, depending on the perspective and role of the client.

FIGURE 11.7 TECHNIQUES RELATIVE TO THE SUPPLY CHAIN STAGE



Source: Bugeja and Taylor (2018)

11.5.1 Purchase order-based finance

This focuses on supply chain finance techniques designed to be used in the pre-shipment phase of the physical supply chain.

Pre-shipment finance is relatively common in the traditional trade finance space, where the finance solution is usually initiated by the availability of a purchase order for the sale of goods by the borrowing company to their customer. In trade finance, the pre-shipment solution may be structured as either a loan or a conditional undertaking such as a letter of credit.

Purchase order-based finance is less common in an open account context due to the difficulty in securing and controlling the source of repayment. It is therefore relatively underdeveloped as a supply chain finance technique.

Common uses of pre-shipment finance

Pre-shipment finance, and specifically purchase order-based finance, is used to finance the sourcing and conversion of raw materials and components into finished goods for sale to buyers. The presence of contractually committed buyers for the goods is a strong risk mitigant, but finance providers still need to critically evaluate:

- **performance risk** (ie the risk that the buyer is not obliged to pay); and
- **credit risk** (ie the risk that the buyer cannot pay, and the client cannot, as a result, repay the advance out of their own resources).

Pre-shipment finance is usually based on the existence of a purchase order evidencing a contractually committed end-buyer, structured with an inventory finance and/or a receivables finance solution. Ensuring that the source of repayment can be relied upon and that the cash from the sale of goods is correctly applied to the pre-shipment advance requires effective structuring and transactional control.

Important considerations: sources of repayment

The existence of an acceptable source of repayment (ie through the sale of goods to the seller's customers) is an important consideration for a finance provider contemplating provision of a purchase order-based advance to a client. In many cases, the finance provider will expect to have visibility of, and a measure of control over the source of repayment and, if possible, a security interest in the associated asset (such as the receivable). Often, they will require that the credit quality of the source repayment (ie the buyer of the goods) be enhanced. This can be achieved through the use of a letter of credit, a standby letter of credit, a bank guarantee or credit insurance.

Opportunities for refinancing

On occasion, a finance provider may provide purchase order-based finance to finance inventory pending the sale of finished goods to the seller's customer. The finance provider may refinance the pre-shipment advance with an invoice-based finance solution once goods are sold. Alternatively, purchase order-based finance can be refinanced by a dedicated inventory finance solution if this is more acceptable to finance providers.

Client profile

Purchase order-based finance is an invaluable funding solution for sellers that:

- have a long cash conversion cycle, particularly during the pre-shipment period;
- have a growing order book, putting pressure on working capital prior to the point of sale to end-buyers; and
- receive large, one-off orders.

It works best for sellers when they:

- have confirmed purchase orders for the majority of their turnover;
- have short product conversion processes (if they are a manufacturer) or are effectively procuring finished goods for their end-buyers (if they are a wholesale distributor); and
- know the credit quality of the end-buyers is acceptable or can be enhanced.

Benefits to sellers

Sellers are able to finance the sourcing and conversion of goods for on-sale to their customers.

Benefits to buyers

Buyers are not a party to purchase order-based finance solutions but benefit indirectly because:

- their suppliers can accept higher-value orders from them;
- the risk that their suppliers fail to deliver, having run out of money before shipment, is reduced; and
- the need for advance payments to suppliers may be reduced or eliminated.

Benefits to finance providers

The extent to which finance providers benefit from this solution, as opposed to unstructured debt, is dependent on the structure and conditionality of the pre-shipment finance facility. Finance providers will take comfort from the successful trading relationships between parties, good track record of contractual fulfilment by sellers and the credit standing of end-buyers. They have the opportunity to derive the following benefits:

- **visibility** – they know what the advance is to be used for and the eventual source of repayment;
- **control** – they might be able to control the disbursement of funds to suppliers and collection of funds from buyers; and
- **security** – they might have a security interest in the inventory and the eventual receivable.

11.5.2 Inventory-based finance

Inventory is created when goods are:

- held for sale by a retail dealer;
- stored in a warehouse by a distributor;

- being converted into finished goods in a factory by a manufacturer; or
- in transit prior to being sold to buyers.

The inventory itself may comprise raw materials, work-in-progress and finished goods (if the client is a manufacturer) or just finished goods if they are a wholesale distributor or a retailer. In practice, inventory-based finance will usually be used to finance goods that are in a condition whereby they are ready for sale as finished goods or commodities.

Inventory finance is offered in various forms and is thus quite bespoke in its nature. As highlighted in the standard definitions, variations include:

- **asset-based lending** – "a borrowing base is [created] whereby a maximum level of finance is made available against a calculated market value of goods [. . .] being financed less a margin which will vary according to" the nature and saleability of the goods and the extent to which they are pre-sold;
- **true sale** – "where the inventory is removed from the (original) inventory owner's balance sheet [and] the finance provider enters into a" retention of title agreement for the goods being financed; and
- **floor plan finance** – a manufacturer places finished stock in the hands of a distributor or dealer with funding provided by the finance provider.

(GSCFF, 2016)

In the sections that follow, you will learn about the following techniques:

- loan or advance against inventory; and
- distributor finance.

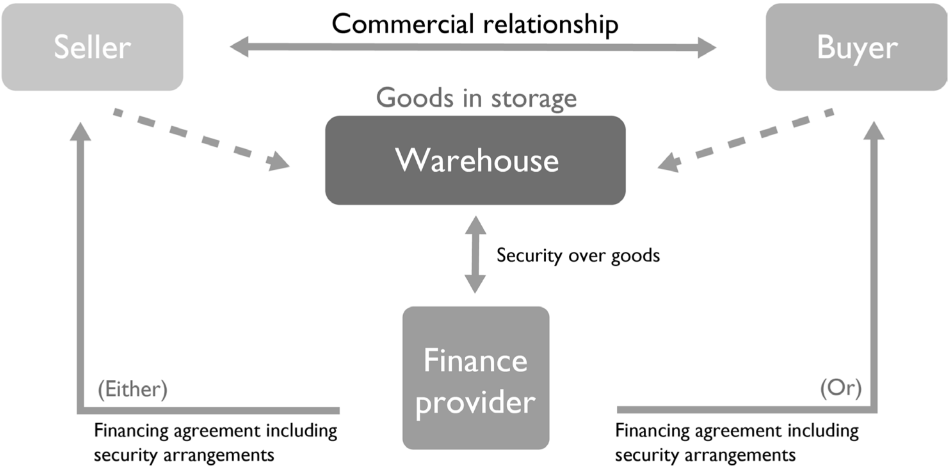
11.5.2.1 Loan or advance against inventory

This technique is described in the standard definitions as follows:

"Loan or advance against inventory is financing provided to a buyer or seller involved in a supply chain for the holding or warehousing of goods (either pre-sold, unsold, or hedged) and over which the finance provider usually takes a security interest or assignment of rights and exercises a measure of control."

(GSCFF, 2016, p56)

FIGURE 11.8 LOAN OR ADVANCE AGAINST INVENTORY



Source: GSCFF (2016, p59)

Inventory finance may be regarded as either pre-shipment (ie the client is the seller) or post-shipment (ie the client is the buyer).

The finance provider will take a security interest in, and exercise a measure of control over, the inventory. The source of repayment will be derived from the proceeds of sale of the inventory to end-buyers. The reliability of the source of repayment is, therefore, critically important to the viability of the solution.

Nature of the goods

The nature of the goods has a material impact on the reliability of the source of repayment.

- **Commodities** – finance providers are likely to readily accept commodities that are quoted on a terminal exchange, are readily saleable, and can be hedged to protect against price volatility as security.

- **Finished goods** that have been pre-sold are a more attractive proposition where there are contractually committed buyers for at least the majority of the inventory. Finance providers may be happy with a percentage of unsold goods (often known as buffer stock) and may even be prepared to finance stock that is entirely unsold if the goods are generic and there is regular demand from multiple buyers, making the goods relatively saleable.
- **Work-in-progress** is the hardest type of inventory to value and is usually not attractive to finance providers. There are, of course, exceptions, and if there are contracted orders for the finished goods and the client is a manufacturer with a strong track record of successful production of relatively generic goods, the finance provider might be prepared to proceed, although the loan-to-value percentage is likely to be relatively low.

Benefits to sellers

If a seller has inventory that is suitable for this type of finance and has an acceptable source of repayment it can obtain pre-shipment funding using this solution.

Benefits to buyers

If a buyer is holding inventory pending sale, and the suitability criteria has been met, it can use this solution to obtain funding to pay its suppliers.

Benefits to finance providers

This solution provides an opportunity to benefit from a security interest in and control of pre-sold or readily saleable goods coupled with an acceptable source of repayment.

LOAN TO VALUE

The amount advanced relative to the value of the asset securing the advance.

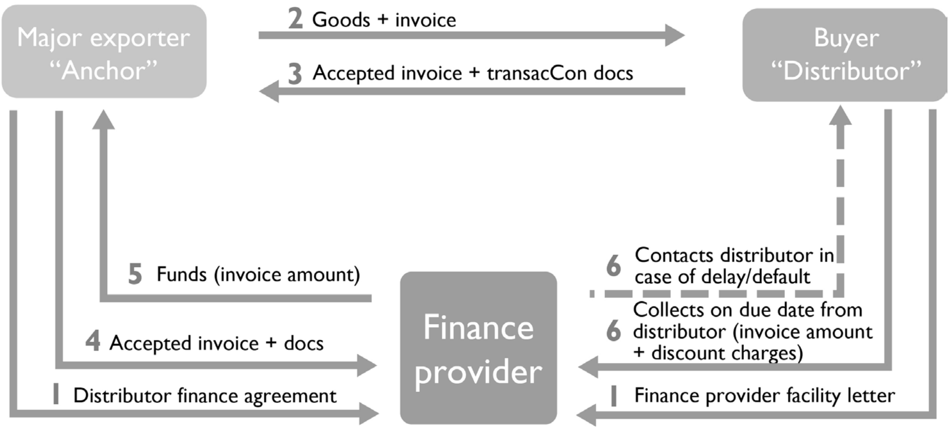
11.5.2.2 Distributor finance

This technique is described in the standard definitions as follows:

"Distributor finance is the provision of financing for a distributor of a large manufacturer to cover the holding of goods for re-sale and to bridge the liquidity gap until the receipt of funds from receivables following the sale of goods to a retailer or end-customer."

(GSCFF, 2016, p52)

FIGURE 11.9 DISTRIBUTOR FINANCE: STEPS IN THE PROCESS



Source: GSCFF (2016, p55)

Distributor finance programmes are designed to support the relationship between the manufacturer and its distributors. The finance is there to facilitate increased stocking by the distributor and onward sales to end customers. It is typically offered (primarily by banks) as a loan or advance, where the client is the onward seller of the goods, against the sales invoice generated by a major manufacturer.

Distributors attracted to this type of arrangement are typically SMEs that will be drawn to the cheaper pricing of the finance and possibly the increased 'tie-in' with the manufacturer.

The manufacturer is often called the 'anchor party' in this context, although it is not necessarily party to the financing arrangement itself. The manufacturer is central to the programme and, because it has a vested interest in the successful performance of its distributor network, it will typically sponsor the financing arrangement by having a master distributor finance agreement with the finance provider.

Such finance is typically provided by way of a loan or advance directly to the distributor to fund inventory and receivables on a short-term basis.

This finance solution addresses a particular need where there is a material timing gap between the date the distributor has to pay the manufacturer supplying them and the date the goods can be sold, and the resulting receivables converted to cash.

The following are the main features of distributor finance:

- **Master distributor finance agreement** between the manufacturer and the finance provider that will typically outline the parameters of the programme, including:
  - the agreed terms of engagement;
  - the geographies being covered;
  - the operating model and processes applying to the finance provider, anchor and the distributors; and
  - any risk sharing or agreement to buy back or find alternative outlets for inventory where a distributor fails.
- **Finance agreement** between the finance provider and distributor that will normally include an assignment of rights over inventory and receivables.

Benefits to manufacturers

Manufacturers benefit from being able to push their products out into their distributor network with guaranteed and immediate payment from their finance providers. They are also able to exercise more control and influence over their distributor network and consequently support their sales growth into new territories.

Additionally, some finance providers offer web-based platforms specifically tailored to a multinational anchor that provide programme information to distributors and can be used as an onboarding vehicle that creates visibility between the anchor, its distributor and finance provider. Some of these platforms also facilitate purchase order approvals, invoice confirmations and the handling and tracking of payments and drawdowns.

Benefits to distributors

Distributors, which are often SMEs and may be in countries with restricted access to finance, benefit from the availability of finance and pricing that reflects the involvement of the manufacturer. Such pricing will often be cheaper when compared with the cost of funding that the distributor may be able to arrange for itself.

11.5.3 Receivables based finance

The standard definitions differentiate between the legal constructs of a loan or advance against receivables and receivables purchase. These terms are defined as follows:

- **Loan or advance against receivables** – "financing made available [. . .] on the expectation of repayment from funds generated from current or future trade receivables."
- **Receivables purchase** – "sellers of goods or services obtain financing by selling all or a part of their receivables" relating to those goods or services to the finance provider.

(GSCFF, 2016)

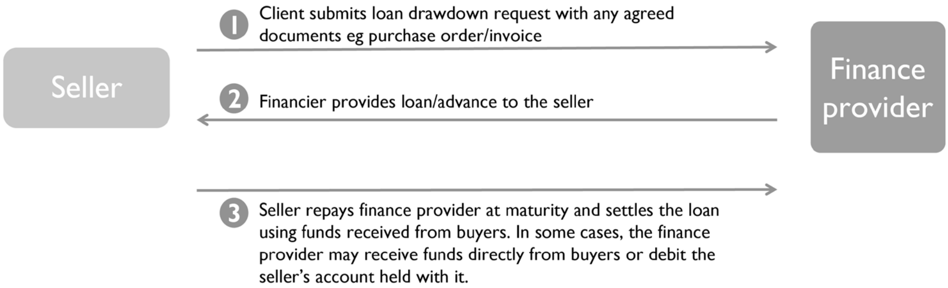
11.5.3.1 Loan or advance against receivables

This technique is described in the standard definitions as follows:

"Loan or advance against receivables is financing made available to a party involved in a supply chain on the expectation of repayment from funds generated from current or future trade receivables and is usually made against the security of such receivables, but may be unsecured."

(GSCFF, 2016, p9)

FIGURE 11.10 LOAN OR ADVANCE AGAINST RECEIVABLES



Source: GSCFF (2016, p51)

This is a loan or advance where the client is the seller of the goods or services. The finance provider regards the receivables as the source of repayment but will also retain recourse to the client in the event that the receivables are not realised or are not sufficient to fully liquidate the loan or advance.

This form of financing is provided against a receivable and is appropriate when a seller has or will acquire receivables arising from its business activities as a seller of goods or services.

Typical clients

Such loans are generally offered to sellers that are deemed very creditworthy by the finance provider and whose existing or future dated receivable is free from any potential encumbrance that may affect its validity and payment.

It is, therefore, more likely that the loan will be provided to a well-established mid-market company or a large-sized corporate that can demonstrate a good track record of performance.

Monitoring

Some finance providers, recognising that a receivables portfolio is ever-changing with new invoices raised and settlement received on an ongoing basis, may establish a borrowing base that regulates the amount they are willing to advance at any one time. Where a borrowing base is used, rigorous monitoring gives the finance provider visibility of those assets that constitute the loan's security. Such monitoring may involve self-certification by the client. The finance provider will calculate the level of the loan it is willing to advance based on its borrowing-base criteria.

Credit risk

The finance provider may also take a view on the credit risk standing of the buyers and evaluate whether the buyers are good for the amount being invoiced. In addition, they will also need to be comfortable that, should it become necessary to realise the security in the receivable in a given jurisdiction, payment of the receivable can be enforced. Some finance providers will require credit insurance to be in place as an added mitigant.

Benefits to sellers

The primary benefit to sellers is the release of working capital prior to the repayment of the receivable by their buyers.

Such a loan may be used to enable a seller to offer more attractive credit terms to their buyer in order to promote more sales, or to fund an opportunity that requires the seller to raise liquidity in advance of its normal payment terms.

Benefits to buyers

There is no direct benefit to buyers but, as mentioned, they may benefit from longer payment terms, which their seller may be able to cover through the raising of the loan.

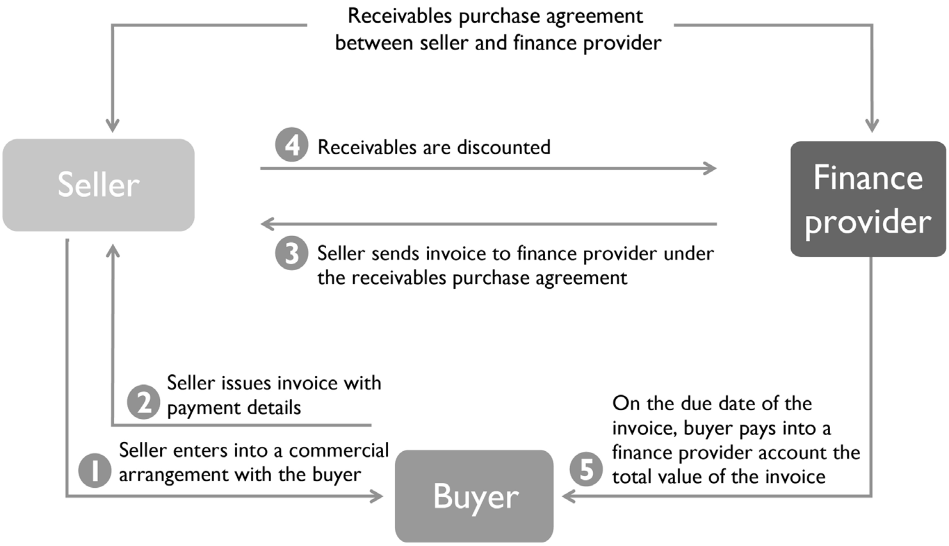
11.5.3.2 Receivables discounting

This technique is described in the standard definitions as follows:

"Receivables discounting is a form of receivables purchase, flexibly applied, in which sellers of goods and services sell individual or multiple receivables (represented by outstanding invoices) to a finance provider at a discount."

(GSCFF, 2016, p28)

FIGURE 11.11 RECEIVABLES DISCOUNTING: TRANSACTION FLOW



Source: GSCFF (2016, p33)

The fundamentals of any receivables purchase facility are that the receivable:

- exists;
- can be clearly identified and validated;
- is assignable; and
- is enforceable against the debtor in that debtor's jurisdiction.

The main feature of a receivables discounting solution is that it is not a loan but the purchase of a receivable through an assignment or pledge of that receivable.

Typical clients

The facility is generally offered to major corporates looking to remove the trade receivable from their balance sheet and avoid having the advance classified as bank debt (ie taking the financing off balance sheet). This means that the corporates will require that the facility is undisclosed to their buyers and structured on a true-sale basis with no or limited recourse back to them. They will also push for an advance based on 100 per cent of the face value of the receivable.

Achieving the desired accounting treatment is, however, at the discretion of the seller's auditor and, while the finance provider can structure the facility to fulfil what they and the buyer believe will meet the criteria for an off-balance-sheet solution, it cannot be guaranteed.

Greater complexity

It is common for this type of arrangement to be fairly complex as the major corporate may wish to structure a facility over multiple jurisdictions, involving its own overseas subsidiaries as sellers of the receivable with buyers that are also in multiple countries. This will entail a high level of legal and regulatory due diligence across the jurisdictions to ensure that the receivable exists, can be assigned and can be enforced against the debtor in their jurisdiction.

Off-balance-sheet treatment is not always a key requirement, especially with sub-investment grade or medium-sized companies. The finance provider may be willing to structure a facility on a true-sale basis but, for credit risk purposes, will require that the receivable is disclosed to the buyers of the company concerned. In such cases, the collection of the receivable may be undertaken by the finance provider or by the seller as agent for the finance provider.

Benefits to sellers

For major corporates that face the pressures of increased global competition, market scrutiny and capital adequacy regulation, receivables discounting programmes offer an alternative approach that can provide the corporate treasurer with a more cost-effective solution than is possible with more traditional bank funding.

Many of the receivables discounting programmes are now supported by technology-led platforms that allow for the greater visibility and sharing of data and automated calculation of availability within the facility. As a result, transactional control and collateral management has become a more manageable process.

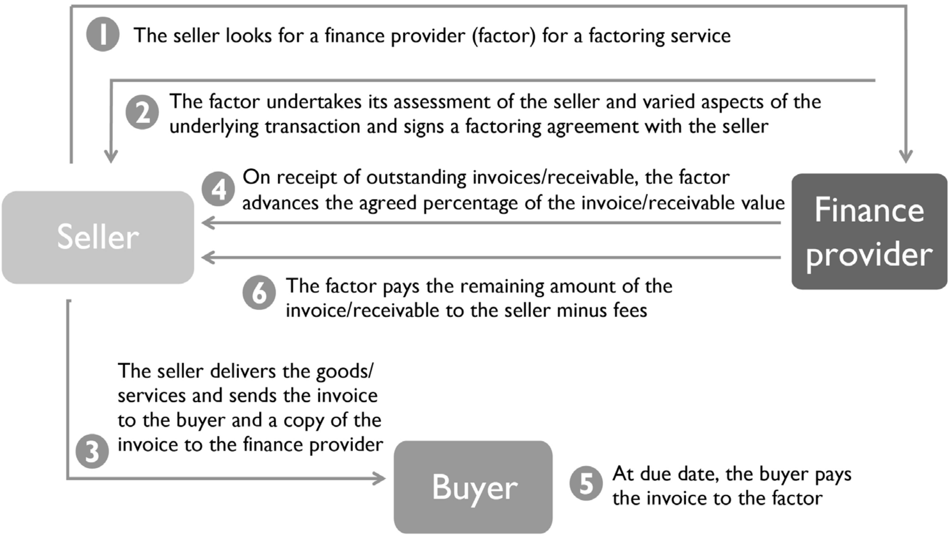
11.5.4 Factoring and invoice discounting

Factoring and its variations are described in the standard definitions as follows:

"Factoring [and factoring variations] is a form of receivables purchase, flexibly applied, in which sellers of goods and services sell their receivables (represented by outstanding invoices) at a discount to a finance provider (commonly known as the 'factor'). A key differentiator of factoring is that typically the finance provider becomes responsible for managing the debtor portfolio and collecting the payment of the underlying receivables."

(GSCFF, 2016, p39)

FIGURE 11.12 FACTORING



Source: GSCFF (2016, p42)

Key features

Invoice discounting is a variation of factoring. The main feature of both is that they do not involve a loan but instead require the purchase of a receivable through an assignment or pledge of that receivable at a discount. For many companies, the headline percentage of funding of

80–90 per cent of eligible debts may represent an actual financing of 70 per cent or less of the total receivables value. Nevertheless, the level of finance that can be raised against the value of receivables will be higher than when trying to utilise the same asset for a loan or overdraft.

The majority of factoring or invoice discounting facilities are predominantly domestically orientated and where export finance is provided, the finance provider needs to be satisfied that the debt can be enforced against the debtor in the debtor's jurisdiction.

Distinction between factoring and invoice discounting

The main distinction between factoring and invoice discounting is that, in most markets, the term factoring is used to describe a product that includes management of the debtor portfolio and collection of the payment, as well as the provision of finance. Invoice discounting, on the other hand, is generally used to describe a finance-only solution.

The factoring solution is normally disclosed to the debtors with the seller inserting a notice of assignment on the invoice that informs the debtor that the debt has been assigned to the finance provider and can only be discharged on receipt of payment by the finance provider into a designated collection account.

Invoice discounting is generally offered on an undisclosed basis, where the buyer is not informed of the assignment but is still directed by the seller to make their payment into a collection account that could be in the name of the seller but controlled by the finance provider.

Recourse or non-recourse

Both can also be offered on either a recourse or non-recourse basis to the seller in the event of a default by the buyer. Where non-recourse is offered, the finance provider may utilise credit insurance as an added mitigant to the risk of debtor default. As with other non-recourse receivables finance, the finance provider will still have rights of recourse to the seller in the event of contractual dispute.

Whole-turnover basis

The majority of factoring or invoice discounting facilities offered through banks are provided on a whole-turnover basis, where the finance provider takes ownership of all the receivables generated by the seller and creates an availability of finance against a basket of receivables that fits within the financing parameters agreed with the seller.

Other finance providers and platforms predominantly offer selected or single invoice finance, whereby the seller can sell an invoice (often through an online platform) and either the platform provider or other funders can bid to purchase the invoice. Unlike the whole-turnover arrangements, the seller is not assigning their whole receivables portfolio but, in this case, the funder must be satisfied that the invoice being funded is not already pledged elsewhere.

Benefits to sellers

The majority of companies that are attracted to factoring and invoice discounting are SMEs who may have limited access to working capital or do not have the fixed assets required by banks as security for bank loans. Having an invoice-based facility such as factoring or invoice discounting that mirrors the growth of the business is an effective way of releasing cash into the business.

Where the seller has a level of dependency on one or a few customers, depending on their creditworthiness, a non-recourse option provides some comfort and protection from customer default, which may affect the viability of the seller to continue trading.

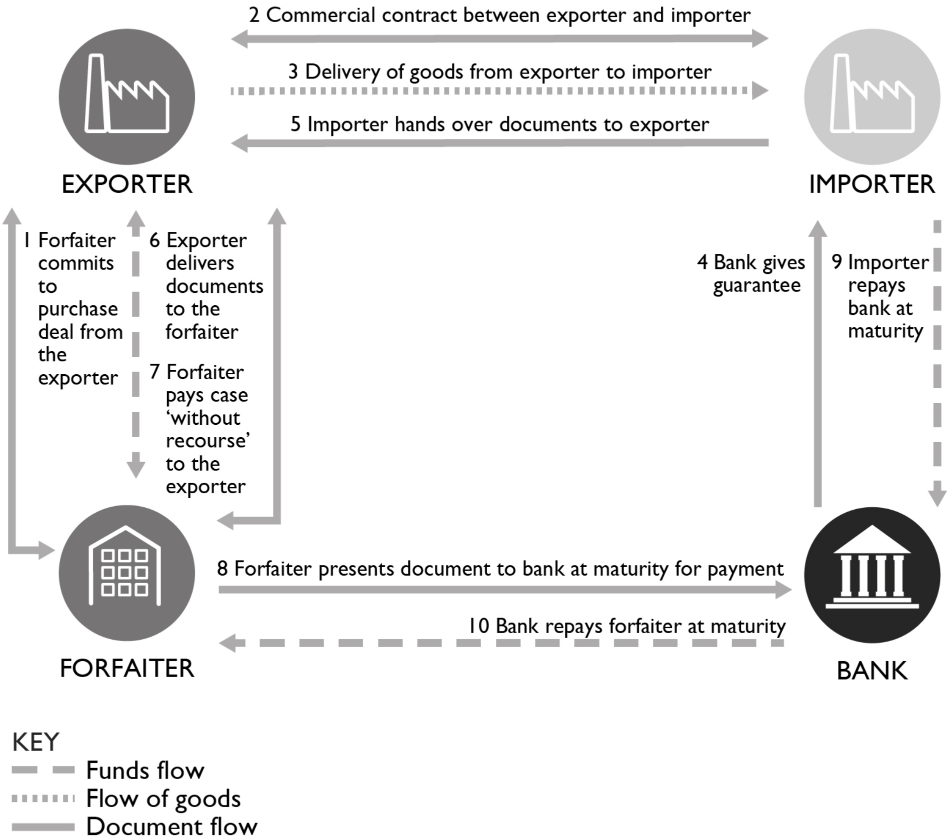
11.5.5 Forfaiting

This technique is described in the standard definitions as follows:

"Forfaiting is a form of receivables purchase, consisting of the without recourse purchase of future payment obligations represented by financial instruments or payment obligations (normally in negotiable or transferable form), at a discount or at face value in return for a financing charge."

(GSCFF, 2016, p34)

FIGURE 11.13 FORFAITING: TRANSACTION FLOW



Source: GSCFF (2016, p38)

Forfaiting was historically used to finance the export of primarily capital goods with tenors of five to seven years. Often, the payment terms would specify stage payments on, perhaps, a semi-annual basis starting after an initial grace period. These regular payment obligations would be evidenced by a 'bundle' of promissory notes bearing maturity dates that matched the payment schedule. More recently, forfaiting has been used to address short-term working capital requirements with tenors as short as six months.

Forfaiting transactions differ from other forms of receivables purchase as the finance provider is providing funding against an acceptable instrument and payment obligation, which may include a:

- bill of exchange;
- promissory note;
- deferred payment undertaking under a letter of credit; and
- receivable (provided it is evidenced by an acceptable instrument and payment obligation).

The financial instrument or payment obligation may or may not be guaranteed by a third party. With a bill of exchange or promissory note, a bank may guarantee the undertaking of the acceptor or issuer respectively by adding its aval (guarantee) to the instrument itself. Alternatively, the bank may issue a separate guarantee or standby letter of credit by which it commits to pay the holder of the instrument should it be dishonoured at maturity.

URF 800

Forfaiting transactions in the main incorporate the Uniform Rules for Forfaiting ICC Publication 800 (URF), which sets out, among other things, a limited recourse regime and standards for examining documents. Sales using the URF are designed to achieve true-sale accounting treatment.

Transactional-based solution

The use of financial instruments and the clear distinction between the payment obligation being financed and the underlying commercial contract make this an effective solution in the right circumstances. Better suited to transactional finance than flow-based finance, forfaiting is arguably a very traditional trade finance product. It justifies inclusion within the family of supply chain finance techniques because it is often seen as a more robust alternative to an open-account receivables finance solution and a tradable alternative to a letter of credit.

Forfaiting is an effective solution for clients whose businesses exhibit the following characteristics:

- goods or services are sold on deferred payment terms between 180 days and several years;

- individual transactions are of high value (eg in excess of USD100,000); and
- each transaction needs to be financed on an individual basis.

Typical clients

In addition, clients seeking to use forfaiting to finance receivables are likely to be:

- involved in contracts that specify stage payments;
- trading with customers in emerging or difficult markets; and/or
- in the mid-market and major corporate segments rather than the SME segment.

The forfaiter may well be prepared to hold the asset on their books until maturity but, if this is not attractive to them, they can sell the payment obligation in the secondary market. The ability to distribute the asset (ie sell it) on a true-sale basis is an intrinsic feature of forfaiting.

Benefits to sellers

Sellers are able to accelerate their receivables in respect of goods or services sold to customers on deferred payment terms. The seller receives discounted proceeds when they sell the financial instrument or transfer the payment obligation to forfaiters, rather than having to wait until the due date for their cash.

Off balance sheet and non-recourse

This is an off-balance-sheet solution with finance provided on a non-recourse basis. The buyer's payment obligation is the vehicle for the provision of finance and this obligation is independent of the rights and obligations under the commercial contract. This means that, once they have issued the payment obligation, the buyer is obliged to pay even if they have legitimate grounds to withhold payment under the commercial contract due to alleged contractual default by the seller.

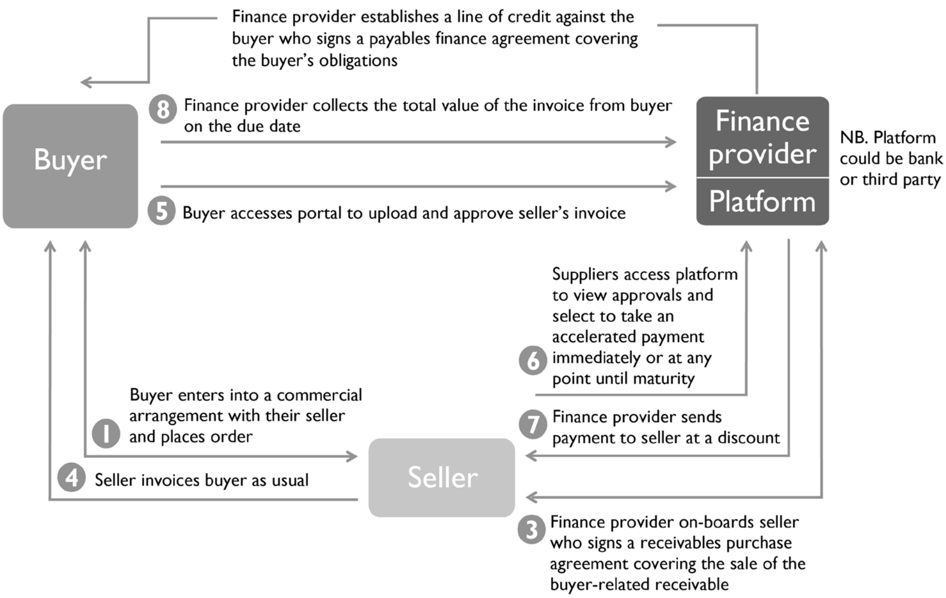
11.5.6 Payables finance

This technique is described in the standard definitions as follows:

"Payables finance is provided through a buyer-led programme within which sellers in the buyer's supply chain are able to access finance by means of a receivables purchase. The technique provides a seller of goods and services with the option of receiving discounted value of receivables (represented by outstanding invoices) prior to their actual due date and typically at a financing cost aligned with the credit risk of the buyer. The payable continues to be due by the buyer until its due date."

(GFSCF, 2016, p45)

FIGURE 11.14 PAYABLES FINANCE



Source: GSCFF (2016, p48)

The payables finance facility is agreed between the buyer and the finance provider. The sellers involved in the buyer's supply chain are invited to participate in the programme.

A buyer-centric model

This is a buyer-centric model where the buyer will look to put in place a payables finance programme with one or a number of finance providers. These programmes are geared to provide the buyer with an off-balance-sheet solution on an unsecured and uncommitted basis, with the bank marking a credit limit on the buyer and providing an accelerated payment at a discount to the seller, up to the limits set within the programme.

The approval by the buyer is predicated by an agreement between the buyer and the finance provider that includes an unconditional, irrevocable commitment to pay the finance provider on the invoice due date. The finance provider relies on this undertaking, obviating the need to consider the credit standing of the seller.

Typical clients

The majority of buyer-led programmes are put in place by investment grade buyers that are looking for finance providers to sign a receivable purchase agreement with their suppliers to purchase receivables owed by their buyers. In this way, major corporate buyers are hoping to achieve an off-balance-sheet solution and avoid an increased level of bank debt.

Onboarding

This is often a challenging and complex process for finance providers as full customer due diligence involving know your customer (KYC) and anti-money-laundering (AML) checks must be carried out on suppliers. Suppliers are unlikely to be existing customers and may be domiciled in a territory that the bank does not operate in. You have learned about required due diligence in Topic 5.

Attractiveness of non-bank providers

Non-investment grade buyers tend to enter into programmes with non-bank finance providers as the balance sheet treatment considerations are less acute. However, debt capacity and credit appetite considerations still arise. Non-bank finance providers will often obtain credit insurance against the buyer's obligations or enter into funded risk participations with other investors.

Benefits to buyers

Buyers putting in place a payables finance programme will often do so as part of their drive to:

- optimise liquidity through an extension of agreed payment terms;
- standardise terms across their supplier base; and
- achieve cost reductions within their supply chain by enabling a lower cost of finance for their suppliers.

A further potential benefit for buyers relates to the accounting treatment. The aim is typically to ensure that the payables finance programme does not result in the reclassification of trade creditors as bank debt. This is particularly important for investment grade buyers whose balance sheet ratios are analysed by investors. Any perceived increase in bank debt can have a detrimental effect on market sentiment.

Benefits to sellers

These include:

- an immediate cash benefit with the knowledge that the cost of finance provided by this type of programme will reflect their buyer's credit-standing and for most suppliers will be cheaper than their normal cost of funds; and
- a reduction in the seller's risk by, in effect, turning a major customer into the equivalent of a cash sale.

However, sellers will also have to consider that the increased tie-in with their buyers may mean more pressure to reduce their prices as their buyers will have influenced their cost of finance.

11.6 Innovation in supply chain finance

Developments in e-invoicing

The digitisation of both the physical supply chain and the financial supply chain has been the subject of a great deal of development and investment. Companies already send purchase orders to each other electronically. The growth of e-invoicing has also enabled a more immediate electronic communication between trading parties.

E-bills of lading and other electronic documents

Ongoing development to digitise other key documents, such as inspection reports, and the creation of an e-bill of lading will ease the transformation to a completely digitised and transparent trade and transaction cycle. Such developments and their effects on the world of trade and supply chain finance are covered in Topic 15.

Role of distributed ledger technology and smart contracts

Supply chain finance solutions today are predominantly invoice-driven. The advances in technology and digitisation mean the opportunity to extend supply chain finance to delivering an end-to-end solution will be possible, covering the purchase order and inventory stages of the trade cycle. However, most of the distributed ledger and smart contract collaborations in place today are more focused on improving the management and delivery of existing trade and supply chain finance solutions rather than on new product development. You will explore this in more detail in Topic 15.

Entry of digital disruptors

As a consequence of the 2007–08 global financial crisis, banks have been required to strategically review the deployment of their capital. This has created the opportunity for new entrants to become disrupters of the status quo, using their agility to capture business from banks and existing financial institutions. Many have developed or adapted new technology and e-platforms aimed at SMEs with a promise to provide a more customer-friendly and quicker service, without having to go through the laborious onboarding and credit processes employed by banks and others.

Efficient delivery of traditional solutions

However, most of these alternative finance providers have not necessarily created new product solutions and have replicated the existing post-shipment factoring and/or payables finance solutions. They have succeeded in being more flexible and providing immediate finance against an upload of single or multiple invoices, with speedier credit decisions often employing automated credit algorithms.

11.6.1 Dynamic discounting

One effective use of technology that has added to the functionality of payables finance is dynamic discounting. Although this is not one of the supply chain finance techniques included in the standard definitions, this is a positive development led by financial technology firms (fintechs).

During economic or political uncertainty, it is normal for major corporate businesses to postpone investment decisions with a preference to pay down debt or hold on to their cash reserves.

For some major corporate companies this has led to the adoption of dynamic discounting, a variation of payables finance. Here, fintechs have taken the age-old principle of settlement discount (where a buyer agrees early payment with their supplier for a discount) and used data analytics to create tools for the major corporate.

These software applications enable companies to look at how best to use free cash while offering suppliers early payment. In addition, some dynamic discounting platforms have teamed up with banks who become substitute funders when the major corporate company wishes to deploy its cash elsewhere.

Conclusion

In this topic you learned about the relationship between the physical and financial supply chains. You were also introduced to trade cycle analysis and various supply chain finance solutions and techniques as defined in the standard definitions published by the GSCFF.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- define supply chain finance?
- highlight the differences between traditional trade finance and supply chain finance?
- explain how trade cycle analysis helps finance providers understand their customers?
- distinguish between the high-level categories outlined by the GSCFF?
- discuss the benefits of particular supply chain finance techniques and solutions in various scenarios?

Test your knowledge

?

Use these questions to assess your learning for Topic 11. Review the text if necessary.

Answers can be found at the end of this book.

1) Which of the following is a characteristic of supply chain finance?

   a) Issuance of warehouse receipts for the storage of goods.

   b) Financing and risk mitigation techniques and practices that are driven by events in the physical and financial supply chains.

   c) The shipment of goods by sea, air, road or rail.

2) Which of the following statements is true?

   a) A physical supply chain usually involves at least three parties.

   b) Each party is either a buyer or a seller.

   c) The final link in the physical supply chain is the retailer.

3) With regard to trade cycle analysis, which of the following statements are true? Select all that apply.

   a) The aim of trade cycle analysis is to determine the level of gross and net profit a client is expected to make.

   b) DSO, DPO and DIO are metrics used to measure key aspects of the client's cash conversion cycle.

   c) Trade cycle analysis involves both quantitative and qualitative analysis of the financial impact of events in the physical and financial supply chains.

4) With regard to the categorisation of supply chain finance techniques by the Global Supply Chain Finance Forum, which of the following statements is true?

   a) All supply chain finance techniques involve the purchase of receivables.

   b) Supply chain finance always uses promissory notes to evidence an approved payable.

   c) The three categories are defined as receivables purchase techniques, loan/advance-based techniques and an enabling framework.

5) With regard to supply chain finance solutions, which of the following statements is true?

   a) Inventory held by a seller can be financed by a receivables discounting solution.

   b) Payables finance can be used to finance both inventory and receivables.

   c) Purchase order-based finance can usually be provided without recourse to the client.

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Further reading

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TOPIC 12

Other forms of finance

Introduction

Importers and exporters have several forms of financing available to them. In Topic 11, you learned about how supply chain finance techniques are becoming increasingly popular and that 90 per cent of international trade is financed through techniques that fall under categories defined in the standard definitions for techniques of supply chain finance, published by the Global Supply Chain Finance Forum (ICC Banking Commission, 2017). Some of these techniques can be used for medium- or long-term purposes. Others are most suitable for short-term financing.

In this topic, you will learn about other forms of finance available to importers and exporters that do not fall under any of the supply chain finance categories.

LEARNING OBJECTIVES

By the end of this topic, you will understand:

- overdrafts and revolving credit facilities;
- acceptance credits;
- produce loans for importers;
- commercial paper issues;
- government-backed medium- and long-term finance;
- the principles of Islamic finance; and
- the advantages and disadvantages of counter-trade.

THINK . . .

How do manufacturers pay for raw materials and labour if they only expect to receive payment for goods that they produce several months later?

For example, a manufacturer that has signed a contract with a buyer to produce 100 laptops expects to dispatch the goods three months later. The buyer has only agreed to pay two months after delivery. Meanwhile, the manufacturer needs to purchase raw materials and components as well as recruit skilled labour. How will the manufacturer finance this during the five-month gap before receiving payment for the laptops?

12.1 Overdrafts and revolving credit facilities

Although overdrafts are not used exclusively in trade finance, they are one of the most important and flexible sources of business finance. Overdraft facilities can be provided both in the buyer's or seller's domestic currency, as well as in a foreign currency. Foreign currency overdrafts would normally be provided when a company has both payments and receipts denominated in that currency. Some banks have the ability to provide a facility that will 'net off' the debit and credit balances of multi-currency accounts. You will learn about foreign currency accounts in further detail in Topic 14.

Some insurers, such as Coface in France, and government bodies, such as UK Export Finance, provide insurance against buyer and country risk. You will learn more about credit insurance and export credit agencies in Topic 13. It is often possible for the seller's bank to obtain an assignment of any proceeds of such policies. This means that the advance is less risky and a lower rate of interest will apply. The security is not 100 per cent guaranteed, since the lending bank's rights will be no better than those of its customer. In other words, the lending bank could only claim to the extent that the customer has a valid claim on the policy. In addition, most policies only cover up to 85–95 per cent of the loss, so that the customer will not recklessly grant credit while relying on the insurer to compensate all losses. Business lending decisions do not fall within the scope of this syllabus; however, it is worth noting that a bank would usually look to secure the overdraft facility.

It is necessary to distinguish between committed overdraft facilities and uncommitted overdraft facilities.

Committed facilities

With a committed overdraft facility, the bank formally agrees that:

- for a specified period of time it will allow the bank account to go overdrawn up to a stated amount;
- the facility will remain in place for the whole of the stated period, provided the customer is not in breach of any of the conditions of the facility.

Banks charge a commitment fee for such facilities and they are sometimes known as ‘revolving credit facilities’.

Uncommitted facilities

Banks do not charge commitment fees for uncommitted overdrafts. However, the facility can be withdrawn by the bank at any time, usually with a seven-day notice period.

12.2 Acceptance credits

Acceptance credits are documentary credits where the beneficiary draws a draft on the bank nominated to accept it.

The issuing bank will have indicated in the documentary credit that the draft is to be drawn on the nominated bank and that the credit was available with the nominated bank by acceptance. If the presentation of documents is compliant, the draft drawn on the nominated bank may be returned to the beneficiary, bearing that bank’s acceptance. With such an accepted draft in its hands, the beneficiary can easily raise finance by discounting the draft, either with the nominated bank or any other bank that is willing to discount the draft.

There may be a separate ‘acceptance credit’ facility arranged with the beneficiary’s bank, and that bank will agree to discount drafts accepted by approved banks. The rate of discount will be based on the creditworthiness of the accepting bank, as opposed to that of the customer. The credit facility will allow discounting of approved drafts up to a stated maximum maturity. This period could be anything from 30 to 180 days, depending on the creditworthiness of the acceptor and the integrity of the customer.

This method is also addressed in Topic 9.

12.3 Produce loans for importers

It is common for banks to provide customers that are importers with short-term loans to pay suppliers when the debt of the purchase is due. The term is generally between 30 and 180 days and will cover the average stockholding period for the individual customer.

Many of these loans are secured against a pledge on the assets of the company or guarantees from the directors. However, many trade financiers and some banks will still offer a stock facility that provides finance to the importer with the underlying goods being held as security. This form of finance can be referred to as a 'produce loan', an 'import loan', 'asset-based lending' or a 'warehousing loan'.

Produce loans work in various ways.

EXAMPLE OF A PRODUCE LOAN

A buyer purchases goods on the basis of a documentary collection (see Topic 8) at sight for resale to a third party in the same country. The buyer requires finance to bridge the gap between payment to the seller and receipt of funds from the ultimate buyer.

In such cases, a produce loan facility can enable the buyer's bank to advance funds against the security of goods and/or their sale proceeds.

The process is as follows:

1) **The bank carries out checks** to confirm that the supplier of the goods is competent and reputable, that the goods are of sound quality, and that the ultimate buyer is creditworthy. Depending on its knowledge of the parties involved, the bank may undertake credit checks and could possibly require a third-party inspection certificate covering the goods. In addition, the goods must be readily saleable, should the ultimate buyer not accept them.

2) **The bank pays the collection** – the bank then pays the collection in accordance with the instructions on the collection order against a signed letter of pledge that states that the documents and/or goods are pledged as security to the bank.

3) **The bank credits the customer's current account** with the agreed amount of the advance and makes a corresponding debit entry on a produce loan account in the customer's name.

4) **The goods are warehoused in the bank's name** – in accordance with the authority on the letter of pledge, the bank will arrange with its agents to have the goods warehoused in the bank's name.

5) **The agent will arrange to insure the goods** and the cost will be charged to the customer.

6) **The goods remain in warehouse** until they are due for delivery to the ultimate buyer; when that time comes, the customer must sign a 'trust receipt'. The bank will then issue a delivery order to enable the customer to obtain the goods and take them to the ultimate buyer.

7) **The bank loses physical control of the goods** – the trust receipt states that the customer holds the goods as trustee for the bank and has agreed to deliver them to the ultimate buyer.

8) **The ultimate buyer pays the bank directly** and the proceeds are used to clear the produce loan, including interest and charges.

All parties must be reputable and trustworthy in order for the lending bank to embark on such a process.

12.4 Commercial paper issues by large companies

Some very large companies can raise short-term funds by the issue of commercial paper direct to investors. Commercial paper is an "unsecured debt security that has a maturity of less than one year from the date of issue. [It] is typically issued at a discount, reflecting prevailing market interest rates" (Practical Law, 2018). Commercial paper is a form of promissory note and is discounted with investors.

As commercial paper is traded it provides a liquid investment for investors. Commercial paper facilities are available for creditworthy companies for all types of business, not just for domestic or international trade.

PROMISSORY NOTE

"A legal document between a lender and a borrower whereby the latter agrees to certain conditions for the repayment of the sum of money borrowed." (Penguin Dictionary of Economics, 2003)

12.5 Government-backed medium- and long-term finance

Medium- and long-term finance will generally be used to finance capital goods and services. While there is no hard and fast rule, lending over one to five years is normally considered medium term and more than five years is considered long term.

Some of the techniques that you learned about in Topic 11 can be used for medium- and long-term finance. In this topic, we will look at many supporting financial products created by government bodies to enable sellers from a country to offer credit terms to their buyers. Such support allows banks to finance buyers who would otherwise be unable to obtain financing in their domestic country, either due to the size of the transaction or the risks associated with long-term projects.

Each country's medium- to long-term finance products will differ. However, the majority of developed countries offer buyer and supplier credit lines from a government-backed body. You learned about government or quasi-government departments in section 2.2. If you have not already explored the government websites suggested, it is a good idea to do so now.

International agreements

There are various international agreements that cover government-supported assistance. One example is the Organisation for Economic Co-operation and Development's (OECD) Arrangement on Officially Supported Export Credits. The arrangement "stipulate[s] the most generous financial terms and conditions that members may offer when providing officially supported export credits" (OECD, 2018).

Government bodies that provide support will need to be satisfied that appropriate standards apply before they become involved in any support for sellers. Projects are reviewed against appropriate international standards and their potential environmental and social impact. You learned about sustainability and sustainable trade in section 1.1.4. Human rights should also be taken into consideration. Essentially, the government body providing financial support must be satisfied that any lending involved will represent sustainable debt for the country concerned and that anti-bribery and corruption procedures have been complied with. Compliance with required international agreements should also be ensured.

REFLECT

Are there any externally imposed regulations that affect exports from your country? Do any of these regulations prohibit your government from providing the assistance that it wishes to provide to exporters?

FACTFIND

The OECD provides a forum for discussion and co-ordination of national export credit policies. Find out more about the OECD's role in export credit arrangements here:

http://www.oecd.org/tad/xcred/aid.htm [Accessed: 22 October 2018].

12.6 Leasing and hire purchase

Leasing

Leasing of goods that are exported operates in a similar way to the leasing of goods traded within the domestic market. The leasing company (the 'lessor') buys the goods outright from the supplier and then leases them to the ultimate buyer, who has the use of the goods for an agreed period, subject to payment of the agreed rent to the lessor. There are various taxation complexities in connection with leasing, but these are out of the scope of this syllabus.

Leasing can be both domestic and international:

- **Cross-border leasing** – a lessor in the seller's country buys the goods and leases them to an overseas buyer.
- **Domestic** – a lessor in the buyer's country buys the goods and leases them to the buyer.

Most banks have subsidiary or associate leasing companies that can provide cross-border leasing facilities. These companies are also able to arrange for overseas buyers to act as lessors, where appropriate.

The benefit to the seller is that the sale is, in effect, a cash sale and that there is no recourse (see section 9.7), unless it has defaulted on its commercial contracts.

Most forms of plant and machinery, vehicles or office equipment can be leased.

RECOURSE

"[The] legal ability [that] the purchaser of a financial asset may have to fall back on the original creditor if the current debtor defaults. For example, an account receivable sold with recourse enables the buyer of the receivable to make claim on the seller if the account doesn't pay." (Dictionary of Finance and Investment Terms, 2014)

Hire purchase

Hire purchase performs a similar function to leasing; however, the buyer may be required to pay a deposit from its own resources. The legal differences between leasing and hire purchase are outside the scope of this syllabus.

12.7 Islamic finance

Islamic finance is a growing part of the international financial system with assets estimated to be worth USD2.293tr at the end of 2016 (Edbiz Consulting, 2017).

Commercial and consumer demand

While demand comes primarily from the world's Muslim economies, Islamic finance is not restricted to the Middle East and Asia alone – its reach is global. In London, Islamic finance has helped to transform the city's skyline by financing, in whole or in part, developments such as The Shard, Chelsea Barracks, Harrods and the Olympic Village.

In the retail banking sector, there is also growing demand from non-Muslim contingents. For example, a quarter of Islamic finance customers in Malaysia are non-Muslims.

Ethical investors are also attracted to Islamic finance by the emphasis on justice and publicly beneficial activity and services.

Industry forecasts

With a consistent annual growth rate, Islamic finance is likely to become an increasingly important financial market in the future. Industry forecasts estimate that Islamic investments might be worth nearly USD3tr by the end of 2020 (Edbiz Consulting, 2017).

This significant growth potential is underpinned by the fact that 10 of the world's 25 fastest-growing markets are in Muslim-majority countries. An increasingly confident Muslim population and a growing middle class are also contributory factors. In the West, the growth of Islamic finance has mainly been driven by institutions seeking to benefit from the immense liquidity and the 'petrodollars' of individuals and institutions in the Middle East who demand such products.

FACTFIND

Trends in Islamic finance

The annual Global Islamic Finance Report produced by Edbiz Consulting provides an excellent overview. Find out more from the following link:

http://www.gifr.net/publications/gifr2017/intro.pdf [Accessed: 22 October 2018].

12.7.1 General principles

The central belief around which all the Islamic concepts revolve is that the whole universe and everything therein is created and controlled by One, the only One God, who has created humans to fulfil certain objectives through obeying God's commands. These commands cover a wide range of every aspect of the human life – including finance. However, these commands are not so prescriptive that they leave no role for the human intellect, nor are they so vague that they leave every aspect of the human life to the individual's desires. Rather, the commands strike a fine balance between these two extremes: on the one hand, Islam has left a wide area of human activities to the individual's own rational judgement; on the other, Islam has subjected human activities to a set of principles that have eternal application.

The *raison d'être* for this is simple. Despite the vast capabilities of human reason, it cannot claim to have unlimited power to reach the truth. There are numerous spheres of human life where 'reason' is confused with 'desires' and where unhealthy instincts can take – and have taken – precedence. For instance, in the area of economics, in conventional finance, the profit motive, by and large, drives economic decisions.

An asset-based form of finance

In Islam, economic activities are controlled by divine injunctions. An overarching characteristic of Islamic finance is that it is an asset-backed form of financing. Apart from some special cases, Islam does not recognise money as a commodity to be traded. Money has no intrinsic utility; it is merely a medium of exchange – each unit of money is 100 per cent equal to another unit of the same currency, so there is no room for profit-making through the exchange of these units. Profit is generated when something that has intrinsic utility is sold for money or when different currencies are exchanged.

Consequently, financing in an Islamic system is always matched with corresponding goods and services, and creates real assets. This is in stark contrast with conventional finance, which does not necessarily create real assets – the supply of money through the loans advanced by financial institutions does not normally match with the real goods and services produced in society: loans create artificial money through which the money supply is increased, without creating real assets in the same quantity. This gap between the supply of money and the production of real assets creates – or fuels – inflation.

Divine guidelines in Islamic finance

Besides prohibiting profit-making through the exchange of money for money in the same currency, Islam also does not allow usury and interest (*riba*).

Other divine guidelines include the:

- prevention of excess uncertainty (*gharar*) in contracts;
- prohibition of speculative transactions (*maysir*);
- exclusion of investments that are forbidden in Islam (*muharramat*).

12.7.2 Prevention of excessive uncertainty (*gharar*) in contracts

Gharar refers to uncertainty that may lead to dispute between contracting parties. It is often defined as 'unnecessary uncertainty'.

In a commercial transaction, such uncertainty may exist as a result of the omission or lack of clear description in a contract. From a Sharia (Islamic law) point of view, any agreement that has a significant element of uncertainty is invalid, regardless of whether the parties have agreed the contract.

Scholars generally distinguish between contracts containing minor *gharar* and major *gharar*. Minor *gharar* tends to be seen as valid, while major *gharar* is generally prohibited.

An example of minor *gharar* would be in a sale of a sack of potatoes, in which it is impossible to know whether each potato in the sack is of consumable quality. As this is minor *gharar*, the sale of the sack of potatoes is generally permitted. The justifying principle invoked in this instance is the facilitation of ease, along with the absence of any clear inequality in the values of the exchanged items.

EXAMPLES: UNCERTAINTY IN FINANCIAL TRANSACTIONS

1) A person accepts an unspecified amount of money for a specific asset (ie the price is left undetermined).
2) A person offers an amount of money for an unspecified asset (ie the asset is left undetermined).

12.7.3 Structures in Islamic finance

Musharaka and *mudaraba*

The ideal instruments of Islamic finance are those based on profit-and-loss sharing concepts, namely *musharaka* and *mudaraba*. Financing on the basis of these two instruments creates real assets from which profit can be generated.

> **KEY TERMS**
>
> ***Musharaka***
>
> Sharing. In the context of commerce, it means a joint venture in which all the partners share in the profit and loss of the joint venture.
>
> ***Mudaraba***
>
> A partnership agreement in which one party invests all the capital while the other manages the business.

Salam and *istina*

However, where financing on the basis of profit-and-loss sharing is not feasible, contemporary scholars have suggested financing on the basis of *salam* and *istina*. *Salam* refers to a sales contract in which payment occurs in the present for goods to be delivered in the future. *Istina* is used to provide a facility for financing the manufacturing or construction of projects; the contract allows cash payment in advance and future delivery, or future payment and future delivery.

Ijara and *Murabaha*

In instances where *musharaka*, *mudaraba*, *salam* or *istina* are not workable, then *ijara* and *murabaha* are modes of financing that contemporary scholars have permitted.

Ijara is a leasing arrangement in which the known benefit arising from a specified asset is made available over an agreed period in exchange for an agreed payment. *Murabaha* is a particular type of sale where the seller expressly mentions to the buyer the cost of the goods purchased and adds a profit to it to arrive at the final selling price. Neither *ijara* nor *murabaha* are believed to be ideal modes of Islamic financing as their net result is often the same as the net result of interest-based transactions. They should be used only in cases of need and where the Sharia conditions prescribed for such modes of financing are fully observed.

12.7.4 Types of Islamic trade finance

Islamic trade finance could serve as a key factor for growth for the Islamic finance industry. In an increasingly globalised world, with rising trade flows, this is all the more apparent considering the natural synergy between conventional trade finance and Islamic finance. Conventional trade finance is a historically low-risk activity involving an underlying commodity, while Islamic finance promotes real economic activity, transparency and risk aversion.

From a financial point of view too, the potential for Islamic trade finance is huge, given that the member countries of the Organisation of Islamic Cooperation are some of the world's largest exporters of strategic commodities, such as oil, gas, petrochemicals and palm oil. They are also some of the world's largest importers of products such as soft commodities, white goods and a host of IT, electronic, transport and other machineries.

The widening trade corridor between the Middle East and Asia, as well as growing trade flows to and from Africa, should translate into a rise in demand for Islamic trade finance solutions.

Examples of such finance include:

- *murabaha* documentary credits;
- *murabaha* documentary collection;
- *musharaka* documentary credits; and
- *salam* pre-shipment export financing.

12.7.5 Islamic finance and UCP 600

The scope for product innovation in Islamic trade finance is limited as Islamic trade finance tools that are similar to the conventional instruments from which they are derived must adhere to ICC guidelines such as UCP 600. Consequently, conventional and Islamic trade finance must evolve within parallel rule-making parameters.

For instance, the following UCP 600 articles are in conflict with Islamic finance.

Negotiation

Article 2 states: "The purchase by the nominated bank of drafts (drawn on a bank other than the nominated bank) and/or documents under a complying presentation, by advancing or agreeing to advance funds to the beneficiary on or before the banking day on which reimbursement is due to the nominated bank."

Availability, expiry date and place of presentation

Sub-article 6 (b) states: "A credit must state whether it is available by sight payment, deferred payment, acceptance or negotiation."

Nomination

Sub-article 12 (b) states: "By nominating a bank to accept a draft or incur a deferred payment undertaking, an issuing bank authorises that nominated bank to prepay or purchase a draft accepted or a deferred payment undertaking incurred by that nominated bank."

Why are these UCP 600 articles incompatible with Islamic finance?

An Islamic bank is not permitted to undertake a documentary credit transaction for goods that are prohibited by Sharia. It is also not permitted to do so if the contract is void or irregular (according to Sharia). This can happen if the contract includes interest, either charged or paid (whether explicit or implied), as in the case of discounts or trading (payment) on drafts with deferred or delayed payments.

It is also not permissible for a bank to discount accepted drafts or deferred payment undertakings, ie to purchase drafts or to prepay undertakings before maturity at less than their nominal value.

Additionally, it is not permissible for a bank to act as an intermediary, whether by payment or notification, between the beneficiary and the issuing or confirming bank to facilitate such dealings.

12.8 Counter-trade

Counter-trade is a term used to describe a variety of trade contracts that, at least to some extent, involve an agreement by the seller to reciprocate by taking in exchange goods or services from the buyer.

It is hard to find reliable statistics showing how important this trade may be, but some estimates put the total value of various forms of counter-trade at around 9 per cent of total world trade. Counter-trade is an important element of trade with some developing countries and transition economies.

The World Trade Organization includes counter-trade in its list of 'non-tariff barriers' to trade. (Non-tariff barriers are measures designed to restrict imports by imposing special rules, regulations and quantitative restrictions.)

The various forms of counter-trade are outlined in sections 12.8.1 and 12.8.2.

12.8.1 Barter

Barter agreements are the simplest and most basic form of counter-trade. One contract is drawn up, setting out what will be exchanged for what and giving the terms of the exchange. Cash is not involved unless there is a balancing sum required.

The main difficulty for the seller is the disposal of what they have agreed to take in exchange for what has been sold.

EXAMPLE: DIFFICULTY OF DISPOSAL

A manufacturer of water purification equipment might be expected by a poor agricultural country to sell an agricultural commodity of which the seller has no knowledge or experience.

Such a seller may have to involve the services of a third party who can dispose of the agricultural products at a reasonable price on the seller's behalf.

Pure barter transactions are not common.

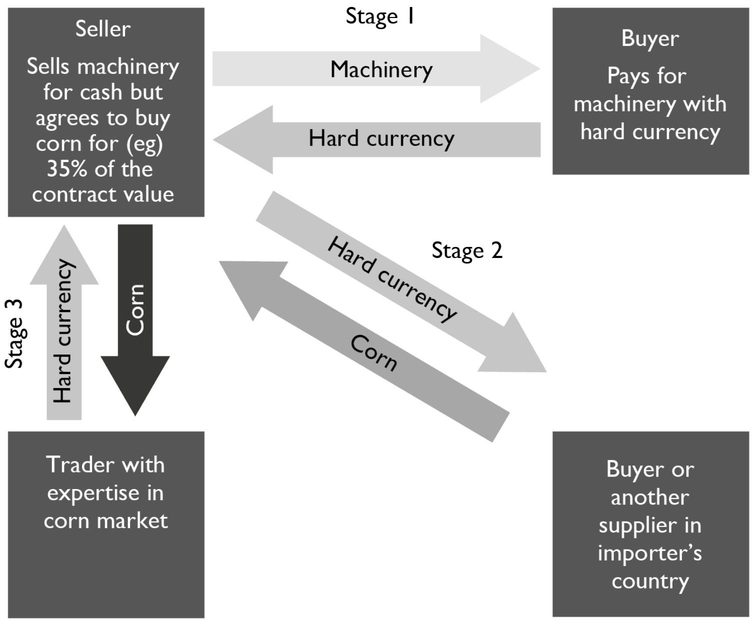
12.8.2 Counter-purchase

Counter-purchase is a more sophisticated form of barter. Two separate contracts are involved: one for the sale and one for the counter-purchase.

The seller may agree to counter-purchase anything between 9 per cent and the full value of what has been sold. The original sale goes forward in the normal way, with payment for the goods supplied. The seller's counter-purchase contract may be binding or on a 'best-efforts' basis. A third party with the expertise to market and sell what the importing country has to offer may be involved.

A transaction may involve the parties and stages outlined in Figure 12.1.

FIGURE 12.1 COUNTER-PURCHASE TRANSACTIONS



Buyback

Buyback agreements involve the supplier agreeing to take back a percentage of what has been produced. For example, a supplier of a tyre-making plant might agree to buy a certain percentage of the output. Again, the contractor may have to involve a third party that is able to dispose of the tyres for a good price.

Off-set

This method is often used where a transfer of technology is involved. The seller agrees to incorporate into the end product components or partly manufactured goods made by the buyer to off-set the full cost of the technology transfer to the buyer.

12.8.3 Advantages and disadvantages of counter-trade

For most sellers, counter-trade has no real advantages over a straightforward payment for goods or services supplied. However, a seller that can offer a contract based on counter-trade will have a competitive advantage in some countries.

For buyers based in some developing countries there are advantages:

- Counter-trade is a form of finance where the buyer makes a deferred payment by the supply of counter-trade goods at a local currency cost.
- For the buyer's country, counter-trade enables the central bank to conserve scarce hard currency.
- The buyer's country has an opportunity to market its products in the wider world with the assistance of the seller or an expert acting for the seller.

However, these benefits can be more apparent than real:

- The seller's additional costs will have to be recovered from the transaction through higher prices for what is supplied and/or lower prices for the goods taken in counter-trade.
- The complexity of these transactions often results in lengthy negotiations and deals that do not proceed in the end.

Some banks specialise in providing counter-trade expertise to their customers and become involved in helping to negotiate deals, finding businesses that can take counter-trade goods and providing the normal banking services of documentary credits, foreign exchange, payments and accounts in various currencies.

Banks may also be asked to hold 'escrow' accounts where funds can be held on behalf of all parties to a transaction. For example, in Figure 12.1, a bank may be asked to hold part of the money paid for the machinery by the buyer until the seller carries out the obligation to purchase corn. Finance may also be required: the manufacturer in Figure 12.1 may have to wait to be paid by the trader.

Conclusion

In this topic, you learned about government-backed forms of medium- and long-term finance for capital goods, and various forms of counter-trade – from barter to counter-purchase agreements where the seller agrees to buy a certain amount of goods from the buyer's country. You also learned how Islamic finance is increasingly used by both Islamic and non-Islamic countries around the world.

THINK AGAIN ...

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain the role of government-backed medium- and long-term finance?
- illustrate how counter-trade is still used today?
- define basic principles of Islamic finance?
- discuss Islamic finance in relation to UCP 600?
- list three synonyms for produce loans?
- explain the role of overdrafts and revolving credit facilities in trade finance?

Test your knowledge

?

Use these questions to assess your learning for Topic 12. Review the text if necessary.

Answers can be found at the end of this book.

1) Which form of finance can be referred to as a produce loan?

   a) Asset-based lending.

   b) Revolving credit facilities.

   c) Buyback.

   d) *Mudaraba*.

2) An overdraft facility is only provided in the company's domestic currency. True or false?

3) Under Sharia law, any agreement that has a significant element of uncertainty is void, regardless of whether the parties agreed the contract. True or false?

4) *Salam* is a type of finance used in lease agreements. True or false?

5) Which of the following is a form of barter?

   a) Overdraft.

   b) Commercial paper.

   c) Counter-purchase.

   d) *Musharaka*.

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TOPIC 13

Export credit insurance

Introduction

The previous topics have been mainly concerned with bank services, in particular with the processes that banks have developed to provide assurance to exporters that payment for goods or services supplied will be forthcoming. This topic is about an alternative method: insuring against non-payment through the use of export credit insurance.

LEARNING OBJECTIVES

By the end of this topic, you will understand:

- the role of credit insurance in international trade;
- the risks covered by export credit insurance;
- the different types of credit insurance policy.

THINK ...

A Belgian brewing company is planning to build a plant in Brazil in order to supply the market in Latin America with its beers. But this is easier said than done.

The process of building a brewery is complex, time-consuming and expensive. The brewery has found local investors in Brazil. All parties will need to have their long-term risks covered and the Brazilian investor should have the opportunity to receive financing.

It is not only banks that have a role to play here. Insurers and credit agencies should be utilised, and the various possible insurance policies and methods of financing will need to be considered in order to benefit all parties.

13.1 Credit risk summary

EXPORT CREDIT INSURANCE

"[P]rotects [a seller] against the risk of non-payment by a foreign buyer. In other words, [it] can significantly reduce the payment risks associated with doing business internationally by giving the seller conditional assurance that payment will be made if the foreign buyer is unable to pay." (export.gov, 2016)

Let's revisit the main types of risk that a seller should consider, which we discussed in Topic 2. Table 13.1 illustrates these risks and the possible sources of risk protection.

Broadly, the market for export credit insurance falls into two groups.

1) Short-term cover for credit terms of up to 180 days, offered by commercial insurers that specialise in these risks.

2) Long-term cover for risks that extend for more than 180 days.

Credit insurance can be provided by either the private sector or by government-backed bodies. Usually, government-backed bodies will provide insurance in approved cases that private sector insurers will not cover.

TABLE 13.1 MAIN AREAS OF CREDIT RISK AND SOURCES OF RISK PROTECTION

Main area of risk	Subsections of main areas of risk	Sources of risk protection
'Sovereign' governments, government agencies and local governments	Unable or unwilling to pay 'Public buyer default'	Credit insurance
	Lack of foreign currency with which to pay	Credit insurance
	Changes to import rules or licences	Credit insurance
	Changes to export rules or licences	Credit insurance
	Changes to regulations for importers to acquire hard currencies	Credit insurance
	War, civil unrest, coup d'état	Credit insurance
Credit risk	Inability of buyer to pay, or bankruptcy/liquidation of buyer	Credit insurance Documentary credit Guarantee/standby letter of credit Advance payment
	Buyer is unable to take up what has been purchased due to bankruptcy/liquidation of buyer	Credit insurance Documentary credit Guarantee/standby letter of credit Advance payment Arbitration

Credit insurance is appropriate to cover buyer and country risk in connection with open account or documentary collection terms. There is less need for this facility in the case of documentary credits that are issued or confirmed by reputable banks.

However, in some cases, banks will also use credit insurance to mitigate their risks when confirming documentary credits or issuing local guarantees based on a counter-guarantee from a foreign bank. Many multilateral development banks, such as the European Bank for Reconstruction and Development, the Asian Development Bank and the World Bank, offer such insurance policies. They will then issue a guarantee in favour of the confirming bank.

For payment in advance, credit insurance is unnecessary.

MULTILATERAL DEVELOPMENT BANKS

"[S]upranational institutions set up by sovereign states, which are their shareholders. Their remits reflect the development aid and cooperation policies set up by these states. They have the common task of fostering economic and social progress in developing countries by financing projects, supporting investment and generating capital for the benefit of all global citizens." (European Investment Bank, 2018)

Finally, lending bankers can take an assignment of a credit insurance policy as security for lending. In the event of default by the borrower, the bank would take over any rights under the insurance policy. Such an assignment would protect the bank in the case where repayment of a facility comes from the proceeds of a customer's contract. However, if the customer could not claim under the policy, the bank would have no claim either. Thus, this security would not be 'absolute'.

CASE STUDY

Find out more about the Trade Facilitation Programme from the European Bank for Reconstruction and Development (EBRD):

https://www.ebrd.com/work-with-us/trade-facilitation-programme.html [Accessed: 23 August 2018].

Want some examples? In the winter 2017/18 issue of the EBRD Trade Exchange Magazine you can find stories about, among others, Jordan and Tunisia:

http://ebrd.coastlinesolutions.com/ebrd/pdf/TFPWinter17-18_Spreads.pdf [Accessed: 23 August 2018].

Take a look at some other issues of this magazine as well – they are an interesting read:

http://ebrd.coastlinesolutions.com/ebrd/magazine.htm [Accessed: 23 August 2018].

13.2 Types of export credit insurance

Export credit insurance is a specialist field with several providers, including commercial entities as well as government credit agencies such as UK Export Finance in the UK, Coface in France and Export–Import Bank of the United States (EXIM Bank).

EXPORT CREDIT AGENCY (ECA)

"[P]ublic agencies and entities that provide government-backed loans, guarantees and insurance to corporations from their home country that seek to do business overseas in developing countries and emerging markets." (ECA Watch, no date)

A number of insurance brokers also specialise in arranging cover for clients. A good broker will endeavour to find the best match between a customer's needs and premium rates.

A variety of policies are available to suit different needs. In addition to those outlined here, there are specific policies such as those taken out by a contractor against unfair calling of a bond.

Whole turnover policies

Whole turnover insurance covers all sales on credit terms and is the traditional form of credit insurance. Policies can be written to cover both domestic and export sales. Key points include the following.

- The advantage to the insurer of such policies is the ‘spread of risk’.
- Policies are usually provided for between 80 and 95 per cent, meaning the seller is left with between 5 and 20 per cent of the risk.
- However, the insurer will impose limits on each buyer and may restrict cover in certain ‘high risk’ markets.

Specific or key customer policies

Sellers/exporters sometimes ask the insurer to write a policy specifically covering the default risk of one customer or of a small number of key customers where the seller/exporter has the largest part of its turnover. Key points include the following.

- Policies are offered at about the same level of cover, but premiums may reflect the higher risk of a smaller spread of risk. For the seller with one or two large buyers that are crucial to its business, this may be the best option, particularly where a default could be catastrophic to its business.
- Cover can be written to include work-in-progress cover, where a buyer defaults on a contract before goods are ready for shipment.

Excess or ‘catastrophe’ policies

Excess or ‘catastrophe’ policies are similar to the other policies above, but are designed for the financially strong seller with good in-house credit control and with turnover of several million pounds. Key points include the following.

- Once a certain pre-agreed level of loss has been sustained, the remaining losses in the policy period will be insured.

- Because the seller is accepting a significant risk by agreeing to an excess (the seller will cover 100 per cent of losses until a threshold is reached), the premiums will be lower.
- Such a policy can also be used in combination with sales on an open account basis (see section 7.4) with credit limits. The pre-agreed level of loss equals the height of the credit limit. The insurance will cover any loss in excess.

13.3 Risks covered in export credit insurance policies

The risks covered in export credit insurance policies depend on the detail of the policy, but the following are typically available:

- political or country risks; and
- credit risk of buyer default.

These risks have also been explained in Topic 2.

13.3.1 Political or country risks

A domestic business selling goods, providing a service, contracting to build or investing in a foreign country will be subject to the laws and government powers of the country concerned.

With two countries trading within the same region, the risk is low and there are often detailed inter-government agreements and treaties that facilitate a 'single market'.

SINGLE MARKET

A group of trading countries which operate "without any internal borders or other regulatory obstacles to the free movement of goods and services" (European Commission, 2018). The European Single Market is an example.

The risks in less stable political regimes can be substantial. A business operating overseas might face any of the following situations:

- confiscation or expropriation of machinery, goods or whole factories;
- violence caused by civil unrest, a coup d'état or a local war;
- an inability to convert local currency receipts into hard currency;
- an embargo placed on imports, or the arbitrary cancellation of an import licence after the exporter has been involved in contractual costs;
- an intervention by the government that 'frustrates' the contract through the imposition of impossible rules or insistence on involvement of a new local 'partner';
- an unfair calling of a performance or similar guarantee;
- in rare cases, the kidnap of expatriate staff.

The premium and limitations on cover will depend on the insurer's view of economic and political stability in the areas for which cover is required. Cover for some of the above risks may not be available even from government-backed agencies, depending on the circumstances of each case.

FACTFIND

Explore Coface's interactive map for country risk at the bottom of their home page:

https://www.coface.com/ [Accessed: 3 October 2018].

13.3.2 Credit risk of buyer default

It is not uncommon for a business to have a large proportion of its total assets tied up in receivables. Therefore, a business must have good credit control procedures, providing detailed understanding of the extent of money due to it from its customers – and particularly the sums overdue. Nonetheless, the risk of a large default (or several defaults) remains, and can destroy a good business.

The option of using 'without recourse' invoice discounting or factoring was covered in Topic 11. However, taking out credit insurance is an alternative – and indeed many specialist insurers provide both factoring and credit insurance services.

One of the key advantages of using specialist insurers and factors, apart from the peace of mind provided, is the access that a business has to an insurer's and/or a factor's database, which can give an early indication – before a contract is negotiated – of risks that are best avoided.

The nature and premium cost of any credit insurance purchased will take account of:

- whether or not the business has an existing policy covering domestic credit risk;
- the countries where a default may occur;
- the names of the buyers;
- the spread of risk – the more countries and customers offered to the insurer, generally the lower the average premium;
- whether the business is both willing and able to accept a higher 'excess' than average – see 'key customer' and 'excess' policies described in section 13.2.

In the event of non-payment due to buyer insolvency, the insurer will pay once the insolvency is proved. For other reasons for non-payment, the insurance pay-out may be delayed, for example until after goods have been disposed of, when the buyer has refused to take delivery.

Depending on the type of policy, insurance companies may not pay out the full amount of the loss – for example, they may only pay out 90 or 95 per cent of the value. The insured party might have to take a grace period (waiting period), usually of 180 or 360 days.

13.4 Insurance from government-backed export support agencies

In many countries, government-backed export support agencies provide insurance for sellers, especially in cases where commercial insurance may not be available.

In a typical example, a policy available from a government agency would cover the following risks in relation to occurrences abroad:

- buyer insolvency;
- the buyer's failure to pay within six months of the due date;
- default by the buyer or guarantor in meeting a final judgment or award within six months of its date;
- default in payment or default in performance of the contract by the buyer, which prevents the supplier from carrying out its part of the contract;
- statutes introduced in the buyer's country that discharge the debt if it is paid in currency other than that of the contract;
- political or economic moves that prevent the transfer of contractual payments (this would include a general moratorium on debt repayment enforced by the buyer's government);
- any action by a foreign government that prevents the performance of the contract;
- any natural disasters, wars or civil strife that prevent the performance of the contract.

In relation to events within the country of the government agency, the policy might cover:

- the non-renewal or cancellation of a supplier's export licence;
- measures introduced after the contract date that hamper the performance of the contract.

The policy will not normally provide 100 per cent cover. Typically, the policy will provide cover for 95 per cent of the insured risk, with the seller bearing the remaining 5 per cent. A grace period of 180 to 360 days might also be applicable.

13.5 ECA financing

In 2017, ECAs supported deals covering USD84.6bn worth of financing (TXF Export News, 2018). There are two main ways that ECAs provide credit: supplier credit and buyer credit.

KEY TERMS

Supplier credit

A form of post-shipment finance that applies when the seller's bank lends the money direct to the seller.

Buyer credit

Where the seller's bank makes money available for the buyer to pay the seller. It can be in the form of a direct loan to the buyer or a loan via an intermediary organisation in the buyer's country.

Buyer credit facilities benefit both parties to the transaction: the seller receives cash on delivery or acceptance of the goods or service, and the buyer has affordable medium- or long-term finance that may not have been readily available in its own country. Buyer credit is usually without recourse to the seller as it is the buyer that borrows the money. The seller also avoids the need to pay interest as the loan is made to the buyer.

Most banks have specialist departments dealing with medium- to long-term finance (see Topic 12).

Providing medium- and long-term finance for exports is very risky because of the buyer, political or country risks. Hence, such finance is usually supported by long-term insurance and/or guarantees that are mainly provided by government agencies, such as the ones listed in the factfind that follows. In effect, this means that although it is the seller's bank that lends the money, they have the comfort in knowing that a government agency will 'insure' or guarantee the debt in the event of default.

FACTFIND

Visit the website of the government agency that applies to your own country. Here are some examples:

Australia – Austrade (https://www.austrade.gov.au)

France – Coface (http://www.coface.com)

Germany – Germany Trade & Invest (www.gtai.de/GTAI/Navigation/EN/Meta/about-us.html)

[All accessed: 9 August 2018].

Identify the main criteria that must apply for these agencies to provide buyer or supplier credit facilities.

13.5.1 General features of a supplier credit finance facility

Each country will have its own individual approach, but the following features of a supplier credit finance facility generally apply.

- There is a minimum contract size for eligibility.
- There is a minimum and maximum time period for the facility.
- The seller liaises with the government agency and their bank to agree the facility in the early stages of the transaction.
- The bank providing the finance is protected by a guarantee in the event that the loan is not paid at maturity. The guarantee may be for the full amount, but could be for less, depending on the country concerned.
- Finance, possibly for up to 85 per cent of the contract value, can be provided in several internationally traded currencies and at a favourable fixed interest rate.

- Funds are made available by a bank that has been involved in arranging a facility with the government agency on the seller's behalf and are forthcoming when the exporter produces:
  - bills of exchange or promissory notes with an 'aval' or guarantee;
  - evidence of performance under the contract;
  - the bank's facility letter, duly signed.

13.5.2 General features of a buyer credit finance facility

Again, each country will have its own individual approach, but the following features of a buyer credit finance facility generally apply.

- There is a minimum contract size for eligibility.
- There is a minimum and maximum time period for the facility.
- The seller liaises with the government agency and their bank to agree the facility in the early stages of the transaction.
- The seller is paid as if a 100 per cent cash contract had been agreed:
  - a percentage from the buyer, typically 15 per cent;
  - a percentage from the buyer credit facility, typically 85 per cent.
- The buyer has time to pay the 85 per cent by borrowing at fixed or floating rates of interest.
- The funds can be made available to a bank in the buyer's country.

13.5.3 Documents required in supplier and buyer credit finance facilities

In both supplier and buyer credit facilities, a number of documents usually need to be completed. In addition to the contract, the following documents are usually required, depending on the facility being offered.

- A **premium agreement** – whereby the exporter agrees to pay a premium to the underpinning government agency.
- A **support agreement** – this is the government agency's guarantee to the lending bank for principal and interest; guarantees may be

for 100 per cent of the loan value or for a lower percentage when a lower premium will be offered.

- A **loan agreement** – between the lending bank and the buyer, setting out the terms of repayment and any preconditions, including the initial 15 per cent payment to the exporter.
- A **qualifying certificate** – as the seller fulfils the contract, usually in stages for large contracts, a qualifying certificate, usually signed by the buyer, is presented to the bank by the exporter.

Once these formalities are completed, the seller receives a cash payment for all or part of the goods or work delivered.

Large facilities may be arranged by a consortium of banks where one takes the lead – the 'lead manager' – and acts as agent for the other lenders, including receiving payments and disbursing funds to the other members of the consortium.

13.5.4 Lines of credit for loans granted by seller to buyer

LINES OF CREDIT

Facilities provided by financial institutions that enable the seller to finance its foreign buyers.

How lines of credit operate will vary from country to country, but the following examples are typical.

From a seller's point of view, lines of credit operate in a similar way to buyer credit. The lines of credit cover loans to buyers to enable them to pay on cash terms for exports of capital goods and associated services from the seller's country. The basic difference from the individual seller's point of view is that the minimum contract value (although varying with different lines of credit) can be as low as USD40,000, or currency equivalent, as opposed to the usual USD7.5m minimum contract value of a buyer credit.

A variation is the project lines of credit. These are useful for major projects in which a number of suppliers in the same country are nominated by the overseas buyer to provide goods and services. The financing entity will guarantee a loan from the seller's bank to the overseas buyer or procurement agent. The buyer can split up the loan, using it to pay various suppliers in the seller's country on individual contracts that may be worth as little as USD40,000, or currency equivalent. The total amount lent to the overseas buyer will normally exceed USD5m, but, as already shown, this sum can be divided to cover individual contracts of USD40,000, or equivalent minimum, with credit periods of one to five years.

Conclusion

As well as the bank services that can provide assurance to exporters, there are other private and government-backed institutions that can insure the exporter against certain risks. The policies will generally cover country and political risks or credit risk from buyer default.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- identify the risks that export credit insurance can help mitigate?
- explain the types of policy available?
- differentiate between private sector and government-backed sources of insurance provision?

Test your knowledge

?

Use these questions to assess your learning for Topic 13. Review the text if necessary.

Answers can be found at the end of this book.

1) Which of the following risks are typically covered by export credit insurance policies? Choose all that apply.

    a) Country risk.

    b) Credit risk.

    c) Manufacturing risk.

    d) Transport risk.

2) Export credit insurance is appropriate to cover buyer default risks in connection with which of the following methods of settlement? Choose all that apply.

    a) Documentary collection.

    b) Payment in advance.

    c) Documentary credit.

    d) Open account.

3) Which of the following risks are covered by government-backed export support agencies? Choose all that apply.

    a) Buyer insolvency.

    b) Natural disaster or civil unrest that prevents the performance of a contract.

    c) Confiscation of machinery, goods or whole factories.

    d) Failure to pay within six months of the due date.

    e) Where a buyer defaults on a contract before the goods are ready for shipment.

f) Inability to convert local currency receipts into hard currency.

4) What percentage of cover lies with the seller before a threshold is reached under excess policies?

a) 25 per cent.

b) 50 per cent.

c) 75 per cent.

d) 100 per cent.

References

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European Commission (2018) *The European Single Market* [online]. Available at: https://ec.europa.eu/growth/single-market_en [Accessed: 29 August 2018].

European Investment Bank (2018) *Multilateral development banks* [online]. Available at: http://www.eib.org/en/about/partners/development_banks/index.htm [Accessed: 2 October 2018].

export.gov (2016) *Export credit insurance* [online]. Available at: https://www.export.gov/article?id=Trade-Finance-Guide-Chapter-9-Export-Credit-Insurance [Accessed: 23 August 2018].

TXF Export News (2018) *Global export finance 2017: numbers crunched without the headache* [online]. Available at: https://www.txfnews.com/News/Article/6375/Global-export-finance-2017-Numbers-crunched-without-the-headache [Accessed: 29 August 2018].

Further reading

Austrade (2018) [online]. Available at: https://www.austrade.gov.au [Accessed: 3 October 2018].

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European Bank for Reconstruction and Development (no date) *Trade exchange magazine* [online]. Available at: http://ebrd.coastlinesolutions.com/ebrd/magazine.htm [Accessed: 23 August 2018].

European Bank for Reconstruction and Development (no date) *Trade facilitation programme: overview* [online]. Available at: https://www.ebrd.com/work-with-us/trade-facilitation-programme.html [Accessed: 23 August 2018].

European Bank for Reconstruction and Development (2018) *tfp* [pdf]. Available at: http://ebrd.coastlinesolutions.com/ebrd/pdf/TFPWinter17-18_Spreads.pdf [Accessed: 23 August 2018].

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TOPIC 14

Foreign exchange risk management

Introduction

In this topic, you will learn about services banks provide to minimise the risks that arise when currency values go up and down. Whenever companies have future payments or receipts denominated in foreign currencies, there will always be uncertainty as to the ultimate amount to be paid or received in their local currency.

LEARNING OBJECTIVES

By the end of this topic, you will understand:

- how the foreign exchange market operates;
- market size and key participants;
- factors that influence spot and forward rates;
- forward contracts and currency options;
- factors that determine whether a business should hedge its foreign exchange risks;
- how to use forward contracts and foreign currency options to reduce the foreign exchange rate risks; and
- foreign exchange risk management in practice, by way of a case study.

THINK . . .

What do you already know about foreign exchange markets and risk? Do you know what practical factors influence foreign exchange rate movements? What types of risk does foreign exchange expose a business to?

14.1 Foreign exchange (FX) market

In the two sections that follow, you will learn about:

- market size; and
- market participants.

14.1.1 Market size

The 2016 Bank for International Settlements (BIS) triennial survey showed average trading in foreign exchange markets to be approximately USD5.1tr per day. This is 25 times the trading volume in global equities. The US dollar was involved in 88 per cent of all foreign exchange transactions surveyed (BIS, 2016).

Market participants deal directly with each other via a complex network of computer and telephone links. Contract details such as amount or maturity date are negotiated between the parties. The system is known as over-the-counter (OTC).

According to BIS (2016), the largest financial centres continued to dominate activity with the UK, USA, Singapore, Hong Kong and Japan intermediating 77 per cent of foreign exchange trading in April 2016. The share of foreign exchange trading in the UK declined to 37 per cent in April 2016 from 41 per cent in 2013. "Asian financial centres, namely Tokyo, Hong Kong SAR and Singapore, increased their share of intermediation to 21 per cent from 15 per cent" (BIS, 2016). The US share fell marginally to 19 per cent.

14.1.2 Market participants

Market makers

Market makers quote bid (buying) and offer (selling) prices for the exchange of one currency for another (the two currencies involved are often referred to as a currency pair).

Market takers

Market takers must seek to 'take' the best price available from market makers. Generally, corporate and business customers will be market takers. Some large corporates that use services that are profitable to the bank, such as transaction banking, may be able to negotiate a more favourable rate than that first quoted by the market maker, especially when dealing in bulk.

EXAMPLES

- Hedge funds that may speculate on the FX market.
- Small banks with customers that have foreign exchange requirements in currency pairs in which these banks are not market makers.
- Any market maker can become a market taker if it acquires an unexpected and unwanted exposure to a currency that requires a quick reversal.
- Pension funds and insurance companies.

Central banks also participate in the FX markets at times when they wish to influence the value of their domestic currency with respect to another currency.

14.2 FX portals and dealing methods

In this section, you will learn the different trading options available to small- and medium-sized businesses as well as major corporates. There are many situations where business customers still carry out FX transactions by just telephoning their bank (see section 14.2.1). However, there are also several other online options open to major corporates as well as small- and medium-sized companies.

Most banks operate their own single FX portals while also providing their services on multi-bank portals. Most of these portals now include a range of alternative non-bank market makers as well.

In the sections that follow, you will learn about:

- algorithms employed in dealing systems;
- telephone dealing;
- single and multi-bank portals; and
- non-bank portals.

Algorithms employed in dealing systems

An algorithm is any specific method, process or set of rules that can be used to complete a clearly defined task, such as selecting the best quote from a multi-bank portal or automatically entering into a transaction or hedge. As such, the task is completed automatically, without any human intervention.

All the online portals you will learn about in sections 14.2.2 and 14.2.3 employ algorithms. An algorithm automatically assesses FX portal prices for given currency pairs in order to make a dealing decision without any human involvement. Such systems were once the preserve of market makers, but larger corporate market takers now use them, and surveys predict that their use by others will increase over time. This is not to be confused with algorithmic trading, which is often the preserve of speculative transactions/strategies undertaken by hedge funds.

14.2.1 Telephone dealing

Benefits for those with limited FX transactions

Corporates with small and/or infrequent foreign exchange dealings will usually undertake FX transactions by telephoning their bank. The initial and ongoing investment in a treasury management system or a dealing portal will not be justified by the amount of FX business in such firms. In addition, smaller businesses are unlikely to have the internal expertise to deal directly in the market and would thus benefit from having a bank provide additional advice where necessary.

Benefits for major corporates: complex structures

While corporates with larger and more frequent FX dealings might not typically call their bank for many transactions, there are occasions where this is necessary. Examples are where more complex derivative/

transaction structures need to be put in place where a typical portal/ dealing system might not have the ability to customise deals or put in place hedging structures such as collars, rolling forward contracts or barriers.

Benefits for major corporates: large deals

Furthermore, where large FX deals are needed above the normal market size (leading to many portals not being able to process such large deals), calling the bank is often the only option. While dealing in bulk in some currencies will often result in a more favourable price to that quoted on a typical dealing screen, dealing in bulk for some less liquid currencies may result in less favourable prices. Hence, it may be better to spread such bulk transactions in less liquid currencies over several deals taking place over a few days.

14.2.2 Single bank FX portals

How it works

To transact on a single bank portal, the market taker enters details of the currency to be bought and the currency to be sold, and the screen will show the bid/offer quotes from the market maker. If the market taker wishes to accept then a single click, followed by another click to confirm, is all that is required. Internally, corporates will have a strict authorisation process and dealing mandates to ensure operational risks are controlled.

Benefits for both parties

Medium- and large-sized corporates that wish to strengthen their relationship with their bank in order to access credit facilities tend to use the single bank portal provided by their bank. Banks that offer these services are, in turn, hoping to generate profitable corporate FX-related business by providing easy access through portals. This strengthens the relationship between banks and corporates, resulting in banks being more willing to grant credit facilities to these corporates as long as they remain creditworthy.

FACTFIND

Single bank FX portals

Watch the following video from HSBC that illustrates how some banks are evolving to meet dynamic market needs:

http://www.gbm.hsbc.com/evolve/overview [Accessed: 24 October 2018].

Explore various FX portals offered by banks:

Barclays – BARX Corporate: https://www.barclays corporate.com/products-and-solutions/risk-solutions/barx-corporate.html [Accessed: 24 October 2018].

Santander Flame – foreign exchange portal: https://www.santandercb.co.uk/financing/international/santander-flame-foreign-exchange-online-portal [Accessed: 24 October 2018].

Citi – electronic solutions: https://www.citifx.com/electronic-solutions/index.html [Accessed: 24 October 2018].

DBS SME Banking – online FX trading – DealOnline: https://www.dbs.com.sg/sme/treasury/foreign-exchange/online-fx-trading-dealonline [Accessed: 24 October 2018].

14.2.3 Other FX portals

Multi-bank portals

Some corporates may have a relationship with several banks and may wish to split their FX business between these banks. A multi-bank portal will enable the market taker to compare the various available quotes. This requires greater IT functionality and will often be done via a treasury management system or customised platform with data feeds flowing from various banks. In addition, records of the data can be accessed and used as an audit trail to demonstrate that the quotes accepted represent good value.

Growth in fintechs spurs further efficiencies

There has also been considerable growth in FX services offered by non-banks – these are commonly referred to as fintechs. Their entry into the FX space has resulted in the development of a range of platforms and dealing options for corporates.

FACTFIND

Multi-bank and non-bank portals

The following platforms offer a range of spot and forward transactions as well as hedging solutions. Find out more:

FX Connect – http://www.fxconnect.com/ [Accessed: 24 October 2018].

WorldFirst – https://www.worldfirst.com/uk/business/ [Accessed: 24 October 2018].

Kantox – https://www.kantox.com/en/ [Accessed: 24 October 2018].

Deutsche Börse Group: 360T – https://www.360t.com/ [Accessed: 24 October 2018].

FastMatch – https://fastmatch.com/about/who-we-are [Accessed: 24 October 2018].

Thomson Reuters: FXall – https://financial.thomsonreuters.com/en/products/trading-capabilities/foreign-exchange-markets/fxall-electronic-trading-platform.html [Accessed: 24 October 2018].

14.3 Terminology and foreign exchange conventions

International foreign currency transactions employ standard conventions about the way currencies are expressed and how quotations for exchange rates are given.

In the sections that follow, you will learn about:

- currency codes;
- how exchange rates are quoted;
- converting currencies;
- spot rates and forward rates;
- advantages and disadvantages of forward contracts; and
- close-out principles.

14.3.1 Currency codes

The International Organization for Standardization (ISO) allocates a three letter code to each currency. Some of these are introduced in Table 14.1.

TABLE 14.1 MAJOR ISO CURRENCY CODES

Australian dollar	AUD
Brazilian real	BRL
British pound	GBP
Canadian dollar	CAD
Chinese yuan renminbi	CNY
Danish krone	DKK
Euro	EUR
Hong Kong dollar	HKD

Hungarian forint	HUF
Indian rupee	INR
Japanese yen	JPY
Korean won	KRW
Malaysian ringgit	MYR
Mexican peso	MXN
New Zealand dollar	NZD
Norwegian krone	NOK
Polish zloty	PLN
Russian rouble	RUB
Saudi riyal	SAR
Singapore dollar	SGD
South African rand	ZAR
Swedish kroner	SEK
Swiss franc	CHF
Taiwan dollar	TWD
Thai bhat	THB
Turkish lira	TRY
United Arab Emirates dirham	AED
US dollar	USD

Source: ISO (no date)

FACTFIND

ISO 4217 codes

Explore the full ISO 4217 code list. Look for the code for your own country's currency and look for the codes for the two countries with which your country trades most often:

https://www.iso.org/iso-4217-currency-codes.html [Accessed: 26 October 2018].

14.3.2 How exchange rates are quoted

The first currency that is named in an exchange rate quotation is known as the base currency and the second currency is known as the underlying, term, quote or variable currency. For example, if you were looking at a quote for exchanging US dollars for euros, and if the rate quoted was EUR/USD, the euro would be the base currency and the dollar would be the underlying currency. The price represents how much of the underlying currency is needed for you to get one unit of the base currency. For example, a EUR/USD rate of 1.2132 would mean that USD1.2132 is needed to buy EUR1.0000.

For some exchange rates, the quotation for the same currency pair can be shown in two different ways, with one quote showing one currency as the base and a second quote showing the other currency as the base.

For example, for a sterling–euro quote you could see:

- EUR/GBP 0.8900; or
- GBP/EUR 1.1200.

The key point to remember is that the first currency is always the base currency and the second one is the underlying currency.

Most foreign exchange rates are quoted to four decimal places; the fourth decimal place is called a 'basis point' or sometimes a 'pip'.

14.3.3 Converting currencies

The rule for converting currencies is quite simple, and there are no exceptions. Let us use the following quote as an example: USD/EUR 0.8570.

To convert:

- base to underlying – multiply by the rate; or
- underlying to base – divide by the rate.

Thus USD100 will convert to EUR85.70, and EUR85.70 will convert to USD100.

Distinguishing between bid and offer rates

Market makers normally give two quotes for a currency pair: one is the market maker's bid rate and the other is the market maker's offer rate. For example, a market maker may quote the USD/EUR rate as follows: USD/EUR 0.8570–0.8600.

When dealing, the market maker will apply whichever of the two rates is better for itself.

Hence, if a market taker has USD100 and wishes to convert it to euros, the market maker will use 0.8570. Why? Because multiplying 100 by 0.8570 means the market maker pays out fewer euros than if the 0.8600 rate had been used.

Likewise, if the market taker wishes to convert EUR86 to US dollars, the rate applied will be 0.8600 so the market maker pays out fewer US dollars in exchange for euros.

We can therefore apply a rule here: the market maker always buys the underlying at the high rate (right-hand rate) and always sells the underlying at the low rate (left-hand rate).

NOTE

- The left-hand quote is always the lower number and the right-hand quote is always the higher number.
- If the market taker wishes to convert USD100 to euros, the market maker is selling euros at the lower quoted rate.
- If the market taker wishes to convert euros to US dollars, the market maker is buying euros at the higher quoted rate.

14.3.4 Spot rates and forward rates

Spot rate

The spot rate is concerned with buying or selling a currency on the day it is required or received. It is the rate that applies for a deal that will be settled on the same day, or within two working days.

The bank will quote a rate, as in section 14.3.3, and will 'settle' the transaction within two business days. This means that the exact day when the currency will be made available, if purchasing, must be established with the bank. For most day-to-day transactions, a bank will accept an international payment instruction and provide a foreign currency quotation at the same time. Customers can, therefore, either visit their branch or provide an electronic instruction on the bank's system to make a payment and accept an exchange rate quote at the same time. It should be noted that there has been considerable growth in non-bank FX trading platforms that enable FX transactions to be undertaken.

For large sums, the delivery of the currency may be on the second business day and that must be considered when making such transactions.

A business that permanently relies on the spot market for its foreign exchange transactions is not taking any form of hedge against possible future movements in the exchange rate.

Forward contracts

The alternative for the customer is to fix the rate as soon as they know that a payment is to be made or funds are to be received in the future. The most common fixing instrument is the forward exchange contract, commonly referred to as a forward contract.

A forward contract is a firm and binding contract between a bank and a customer whereby they agree a rate of exchange immediately for a specific foreign exchange rate transaction that is set to take place on a pre-set future date or during a pre-set future period.

Both bank and customer are bound by this agreement and the transaction must take place on the due date in accordance with the agreement and irrespective of what the actual spot rate is at that time.

14.3.5 Advantages and disadvantages of forward contracts

Advantages of forward contracts are as follows:

- Simplicity.
- Availability in most currencies.
- Quite small sums can be protected.
- Certainty: the customer knows exactly what they will get.

Disadvantages of forward contracts are as follows:

- Forward contracts are of limited flexibility, being legally binding.
- The customer does not have an opportunity to profit from favourable exchange movements as the contract cannot be cancelled. This is sometimes called an 'opportunity cost'.

Benefits for corporates over exchange traded currency futures

While financial services organisations may use exchange traded currency futures to hedge their foreign currency exposures, corporate businesses that wish to hedge their currency exposures would almost without exception use OTC forward contracts. The key reasons for this are that:

- futures require daily monitoring of positions;
- profits or losses are settled daily on futures in cash under the daily variation margins and mark to market procedures – this can result in liquidity problems if there are regular losses on the future;
- futures are standardised contracts that cannot be 'flexed' to provide an exact hedge of a specific exposure.

Currency futures are out of the scope of the syllabus and are not covered in this text.

14.3.6 Close-out principles

Close-out principles will apply in the following scenarios.

MARKET TAKERS THAT SELL CURRENCY

Scenario A – An exporter has been paid in foreign currency

If the foreign currency is not received at the maturity date of the forward contract, the bank will close out. This means that it will sell the currency to the customer at the spot rate and immediately repurchase it at the agreed forward rate. The resultant gain or loss will appear as a debit or a credit on the customer's account.

MARKET TAKERS THAT BUY CURRENCY

Scenario B – An importer with future payment obligations denominated in foreign currency

Similar close-out principles will be applied to market takers that are buyers that have, for example, arranged a forward contract and then find they do not need to make the payment. Again, the resultant gain or loss will appear as a debit or credit on the customer's bank account.

Thus, if a customer cannot fulfil the terms of the forward contract, the close-out procedure will apply. This procedure will result in either a gain or a loss, depending on the spot rate at the date of the close out. If the customer made a loss on a close out and would not or could not reimburse the bank, the bank would incur a 'bad debt'. Thus, banks treat forward contracts as a contingent liability, based on the maximum likely loss that could arise on a close out. This means that the amount the customer could have borrowed on conventional loans or overdrafts may be reduced by the amount of the contingent liability during the life of the forward contract.

14.4 How exchange rates are determined

There are whole textbooks written about exchange rate determination, but here you will learn about a few key factors.

What is a rate of exchange?

A rate of exchange is the price at which a foreign exchange transaction is agreed, or, alternatively, the price of one currency in terms of another. If we think of the foreign exchange rate as a price, understanding determination is much easier.

An infinite number of transactions influence exchange rates

There is a vast network of foreign exchange markets worldwide and a vast number of transactions take place each day. Banks, government agencies, hedge funds, international corporations and speculators all interact, buying and selling currencies. Thus, there are an infinite number of participants and transactions worldwide, all of which influence supply and demand and, hence, exchange rates. For example, if the GBP/USD moves from GBP:USD 1.3820 to 1.3830, the US dollar has depreciated (weakened) and the pound has appreciated (strengthened). The reason would be down to greater demand for sterling, or greater supply of US dollars, demonstrating how supply and demand change the price or rate of exchange.

Supply and demand

The factors that affect spot exchange rate movements, unless counteracted by government intervention, are outlined in section 14.4.1. Each factor is considered in isolation, but, in practice, one factor may impact on another. The basic principle is that if a rate of exchange is the price of one currency in terms of another, then any factor that affects supply or demand for that currency must also affect the exchange rate.

Relative levels of short-term interest rates

In ‘normal’ times, the most important factor affecting exchange rates is usually the relative levels of interest rates, or rather the anticipated short-term changes therein. For example, if the European Central Bank reduces Eurozone interest rates in ‘normal’ times, the euro tends to weaken. Similar effects have been seen in the USA when the Federal Reserve reduces US interest rates: such a move is normally followed by a weakening of the US dollar.

Thus, in ‘normal’ circumstances, short-term interest rate differentials play an important part in the determination of short-term foreign exchange rate movements. The reason for the importance of interest rates is that, other things being equal, if interest rates rise in one country and remain unchanged in another, then international investors will switch deposits into the currency with the higher interest rates. This generates additional demand for the currency with the higher interest rates and generates additional supply of the currency with the lower interest rates.

However, since the onset of the global financial crisis in 2007–08, most Western countries have kept their interest rates at record low levels, and there have been relatively few changes in these. Relative interest rate differentials have therefore been stable over the past few years, but most economists now predict that interest rates will gradually rise in the future.

Balance of payments

The balance of payments is also relevant. If a country has a deficit on its current account, then the presumption is that it imports more than it exports. This could mean that from trade flows there is more demand for foreign currency and less demand for home currency. Hence, the home currency should weaken. However, the majority of foreign exchange deals are not trade related, so the link is not always clear cut.

14.4.1 Practical factors that affect spot rates (news)

In the short term, market sentiment will influence exchange rate movements to a far greater extent than relative inflation or interest rate levels or the balance of payments position. The most obvious example of this is the effect of the UK European Union membership referendum vote on 23 June 2016 in which the UK people voted to leave the EU.

The result was not as expected by mainstream commentators and the effect on the exchange rate can be seen as follows:

- 23 June 2016: GBP/EUR 1.3065.
- 24 June 2016: GBP/EUR 1.2305.

Overnight, sterling depreciated by around 6 per cent in relation to the euro. An even more dramatic fall of 10 per cent was registered in relation to the US dollar, as shown in Figure 14.1.

FIGURE 14.1 IMPACT OF BREXIT: GBP–USD

Source: Jeffery (2018)

14.4.2 Factors that determine forward rates

Sometimes an exporter may obtain a commercial contract whereby payment is to be received in foreign currency at a specified future date. Alternatively, an importer may enter into a commercial contract whereby payment is to be made in foreign currency at a specified future date. At the time the commercial contract is entered, the party invoicing or being invoiced in foreign currency will not know the amount to be received or paid in home currency terms.

A forward contract is one method that can be used to overcome the uncertainty about the home currency amounts of future receipts or payments in foreign currency. In this topic we shall confine ourselves to examining the factors that influence forward exchange rates.

It is important to understand that the forward rate is not the bank's best guess as to what the spot rate will be at the maturity of the forward contract. The forward rate at the time it is set is founded on logical arbitrage principles based on the periodic interest rate differentials between the two currencies.

14.5 Foreign currency accounts

Where a business has regular two-way flows of foreign currencies, it is often preferable to manage the foreign exchange exposure by keeping funds in a foreign currency account. Accounts are available in euros, US dollars and most major currencies.

A business that is regularly trading in Europe, for example, may have a euro account to which euro receipts are credited and from which payments can be made to suppliers. This will act as its own partial 'hedge' at relatively little cost or risk. This is because the customer can match and net its exposures. A UK company trading with several buyers and sellers in the Eurozone (and indeed with others who are willing to trade in euros) can arrange that money received from sales is credited to the euro account from which payments to suppliers will also be made.

Advantages

- Foreign currency accounts provide ease of access and operation for the major currencies.
- Interest may be earned on the account but the rate, at times, may be lower than that paid on the home currency account.
- There will be a significant reduction in the charges as fewer purchases and sales of currency are required, and the bank's bid/offer spread is avoided.

Disadvantages

- At some point, a surplus on the account will have to be brought back into home currency or an overdrawn account put into funds and, unless the timing and amount required can be predicted and a forward contract booked, the balance is exposed to movements in spot exchange rates.
- There will be charges for operating the account.
- Borrowing facilities may be agreed in foreign currencies, subject to normal lending criteria. This may be a useful strategy when future currency proceeds are anticipated.

- Banks today offer a range of foreign currency accounts, accessible online, which allow customers to monitor movements on their accounts, transfer money between accounts and make payments to their foreign sellers.

14.6 Currency options

Pure options

Pure options are contracts that operate more like an insurance policy. The customer pays a premium in exchange for a right to buy or sell a currency at an agreed price. When the customer has purchased its right, they have no obligation to exercise it.

Purchasing options

To buy an option contract, a customer can use the services of the bank or trade on an exchange through a broker acting on its behalf. Normally bank products, ie OTC options, will be used for this purpose, as opposed to exchange traded options dealt with via a broker.

Advantages to the customer

The advantage to the customer of an option contract is flexibility and the opportunity to avoid an 'opportunity cost'. An opportunity cost occurs when the rate has been fixed by a forward contract and the actual spot rate at maturity has moved in favour of the customer. With forwards, there is no opportunity to gain from the favourable movement. However, with options the option can be allowed to lapse, so the customer can deal at the spot rate. Hence, options allow a customer to take a profit on the spot market when that exists, while insuring against a large loss.

KEY TERMS

American options

These are where the option may be exercised any time before the option matures.

European options

These may only be exercised on the maturity date.

Call options

These give the customer/purchaser the right to buy the underlying currency.

Put options

These give the customer/purchaser the right to sell the underlying currency.

Strike price

This is the price agreed for the call/purchase or put/sale.

Grantor/writer

The bank or other organisation that writes the option contract and undertakes to sell or buy at the strike price if called upon to do so.

Premium

The price paid by the purchaser for its call or put option. (The price or premium is determined by the spot price or the intrinsic value, the time period of the contract and the volatility of the currencies involved.)

Sunk cost

This refers to a premium that is non-refundable.

EXAMPLE – QUOTATION FOR AN AMERICAN OPTION

- A put option for USD against GBP.
- Underlying amount: USD35,000.
- Strike price: GBP/USD1.75.
- Period: 180 days.
- Premium: £586.89.

If the customer exercises the option at maturity, they will receive £20,000 in exchange for USD35,000 and will have already paid the premium of £586.89. If the spot value of the USD35,000 at maturity exceeds £20,000, the option will be allowed to lapse and the holder will sell at spot. The premium is non-refundable, irrespective of whether the option is subsequently exercised or whether it is allowed to lapse.

Pre-contract exposure

Options may typically be used to cover pre-contract exposure on tender to contract, where the option can be allowed to lapse if the customer fails to win the contract.

Not suitable for small trades

However, options are not suitable for small trades worth less than USD150,000 or equivalent per trade. This is because the premium will be relatively high for small sums or because option contracts are not available for small amounts.

14.7 Types of foreign exchange exposure

Foreign currency exposure is usually categorised into one of three types:

- transaction exposure;

- translation exposure; and
- economic exposure.

Translation and economic exposure

Translation exposure relates to the accountancy treatment of changes in the reported values of foreign currency denominated assets, liabilities and profits. Economic exposure relates to the effect of long-run changes in foreign exchange rates on the competitiveness of a business. These two types of exposure are outside the scope of this qualification and will not be considered any further.

14.7.1 Transaction exposure

Transaction exposure relates to the effects of changes in foreign currency rates on cash flows or profits of a business.

Post-transaction exposure

Post-transaction exposure (often simply referred to as transaction exposure) occurs whenever a business has a contractual obligation to pay or receive a known amount of foreign currency at a known future time.

The risk to the business is that it does not know and has no means of knowing what the relevant rate of exchange will be on the future date when the currency is actually received or paid out.

In this situation, the business can either:

- do nothing and convert the currency at whatever the spot rate of exchange is on the date the transaction actually takes place; or
- hedge, ie reduce, the risk by using a bank product such as a forward contract or a currency option.

Doing nothing is effectively a gamble. When the transaction actually takes place, the business may be pleasantly surprised because the rate has moved in its favour. Conversely, the surprise may be unpleasant if the rate has moved adversely. On the other hand, hedging will introduce an element of certainty since the rate will be fixed at the time the business enters into a forward contract, or the worst possible rate will be known if the business buys a currency option from its bank.

Pre-transaction exposure

This occurs:

- when a business has published price lists for its products denominated in foreign currency; and
- when a business has put in a tender for a contract denominated in foreign currency and does not know whether the contract will be awarded or not.

This is a more difficult exposure to manage because the business does not know how much it will sell at the published prices or whether it will receive any foreign currency at all in the case of tenders, since the commercial contract may not be awarded.

14.7.2 Deciding whether to hedge transaction exposure

No single set of criteria

Every business is different, so there can be no single set of criteria that determine whether a business should hedge its transaction exposure. Some studies claim that in the long run the gains and losses from unhedged currency exposure would balance out, so companies need not hedge. The rationale behind this is that for a period that could be much more than five years, a policy of hedging may give the same result as a policy of not hedging.

Stability of cash flows

However, unhedged foreign currency exposures result in volatility of cash flows or profits. As a general rule, stakeholders in a business prefer stability of cash flows and profits. The purpose of hedging is to provide stability and predictability. In addition, large losses from unhedged foreign currency exposures could result in liquidation of the business as bankers and creditors will not be willing to wait until exchange rates move favourably.

Business strength: a key factor

To sum up, financially strong companies can afford not to hedge or to hedge only part of the exposure because they have the financial resources to cope with short-term foreign currency losses. However, businesses that are not as financially strong will need to hedge as they may not be able to survive a short-term foreign currency loss.

Strategy for managing foreign exchange risk

Hence, every business needs to have a strategy and policy for managing the risk from the movement of exchange rates.

KEY QUESTIONS

- Which currencies are we exposed to in our business?
- Is the value and volume of each currency exposure likely to change?
- How often are payments made and/or received for each currency?
  - Regularly, say weekly, for purchases or sales?
  - Monthly, quarterly or annually for foreign currency loans?
  - In infrequent but large sums for, say, the repatriated profits of a subsidiary company?
- How expensive could unhedged foreign exchange exposure be for the business?
- Can the business absorb any short-term foreign exchange transaction exposures, or could any potential loss seriously damage the business?
- Do our competitors hedge their foreign currency risks?
- Are there payments in and out in the same currency?

Sensitivity analysis

It is possible to undertake a sensitivity analysis that would show the effect on cash flow or profits of a given change in the exchange rate. It is also possible to use a technique called VaR – value at risk – to forecast the probability of the change applied in the sensitivity analysis occurring. Such techniques can help a business assess the extent of its potential risk from foreign exchange rate movements.

Once a business has a clear picture of where the main exposure lies, a strategy can be drawn up to mitigate the risks using the products outlined in this topic.

When hedging is in itself a risk

With pre-transaction exposures, hedging with a forward contract is in itself a risk. This is because if the currency is not received, the bank will close out, which will result in either a gain or a loss depending on the spot rate at the relevant date. Hedging with options is safer, but the cost of the premium may be considered too high.

14.8 Case study

Agricole SA is a French company that sells its produce to a US supermarket chain. The US buyers insist on being invoiced in US dollars and also insist on 90-day post-shipment credit terms. However, the US supermarket offers a supply chain finance facility whereby Agricole is allowed to make early drawdowns at a discount.

Agricole is concerned about a particular transaction. The details are:

- face value of the shipment – USD100,000; and
- payment due date (in the absence of any early drawdown) – 90 days.

After some deliberation, Agricole has decided to arrange an early drawdown and the invoice will now be settled for USD99,000 in 60 days.

Current foreign exchange rate quotations are available as follows:

- spot rate: EUR/USD1.1700–1.1800.

- 60-day forward rate: 1.1660–1.1765

Currency options

USD put options based on USD99,000:

- strike rate: EUR/USD1.1680;
- expiry date: 60 days; and
- premium: EUR1,000.

CHECK YOUR UNDERSTANDING

1) Agricole decides to hedge the US dollar exposure by way of a forward contract. Show by calculation the amount of euros that Agricole will receive in 60 days' time when it draws down its invoice, which was in US dollars, assuming:

   a) the spot rate on that day is EUR/USD1.1560–1.1570; and

   b) the forward rate agreed on day 1 will be 1.1765.

2) Assume Agricole decided to hedge the transaction by way of a currency option. Show by calculation the amount of euros that Agricole will receive in 60 days' time when it draws down its US dollar invoice, assuming the spot rate on that day is EUR/USD1.1560–1.1570.

Conclusion

The conventions for quoting currencies place the base currency before the underlying/quote currency. Spot rates are available for immediate delivery (within two working days) on all major currencies, but always buying or selling 'spot' provides no risk protection.

Banks will quote a forward exchange rate so that customers can remove the risk of exchange rate movements between the commercial contract date and actual receipt of the currency.

Every business should have a strategy for dealing with its risk to currency movements. This strategy should take account of the extent and timing of exposures, the potential cost of not covering the risks and the competitive position of the business.

Forward contracts can be used to hedge foreign exchange transaction exposure. Foreign currency bank accounts can be used and provide convenience and a partial hedge where a business receives and pays regularly in the same currency.

Pure options are a form of insurance where, for a premium, a customer can buy a right to sell (put) or buy (call) a currency. Should the rate be more favourable on the spot market when the currency is to hand, the option may be allowed to lapse.

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- define spot rates and forward rates?
- discuss the advantages and disadvantages of foreign currency accounts?
- list types of FX portals and dealing methods?
- explain transaction exposure?
- describe the purpose of sensitivity analysis?

Test your knowledge

?

Use these questions to assess your learning for Topic 14. Review the text if necessary.

Answers can be found at the end of this book.

1) A bank quotes the following spot rate of exchange:

   - GBP/USD1.4000–1.4010.

   Which of the following is correct?

   a) The US dollar is the base currency in the quote.

   b) The bank will buy US dollars from a customer that is a UK exporter and convert to sterling at a rate of GBP/USD1.4000.

   c) The pound is the base currency in the quote.

2) Name the bank product that will lock in a worst-case foreign exchange rate but will still allow the business to benefit if the spot exchange rate at the expiry date has moved favourably.

   a) Forward contract.

   b) Foreign currency option contract.

   c) Foreign currency bank account.

3) What is the term used to describe the situation where a business hedges a foreign exchange exposure with a forward contract and subsequently the spot rate moves in favour of the business?

   a) Premium cost.

   b) Transaction loss.

   c) Opportunity cost.

4) Name the category of foreign exchange exposure used to describe the impact of changes in foreign currency rates on contracted future cash flows or profits of a business.

   a) Transaction exposure.

   b) Translation exposure.

   c) Economic exposure.

5) One month ago, a German bank quoted the following rates of exchange:

   - Spot: EUR/USD1.2170–1.2180.
   - One-month forward: EUR/USD1.2540–1.2560.

   A UK customer arranged a one-month forward contract for the customer to deliver USD50,000 to the bank in exchange for euros.

   At maturity today, the US dollars are received by the customer and delivered to the bank.

   Which of the following is the amount of euros the customer will receive?

   a) EUR39,872.

   b) EUR41,051.

   c) EUR39,809.

6) A UK customer has hedged an anticipated USD100,000 currency payment with a call option and with a strike rate of GBP/USD1.4325. The US dollars are received as expected on the expiry date of the option, when the spot rate is GBP/USD1.4500–1.4515. How much will the USD100,000 payment cost the customer in pounds?

   a) GBP69,808.

   b) GBP68,966.

   c) GBP68,894.

7) Which of the following is a factor that determines the forward exchange rates that market makers offer?

   a) The forward rate is the market maker's (bank's) best guess of what the spot rate is likely to be at the maturity of the forward contract.

   b) The forward rate is based on the current spot rate, adjusted by the interest rate differentials between the two currencies.

   c) The forward rate is determined by government decree.

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Digital disruption and innovation

Introduction

You have learned in earlier topics about the vast amounts of documentation required to complete a trade finance transaction. Even today, a large number of these documents remain in paper form resulting in cumbersome, costly and time-consuming processes.

In this topic, you will learn about digital disruptors that have already begun to change the way trade is carried out and how trade finance is processed.

LEARNING OBJECTIVES

By the end of this topic, you will understand:

- the distinction between digitalisation and digitisation;
- big data;
- distributed ledger technology (eg blockchain);
- smart contracts;
- the internet of things (smart objects);
- artificial intelligence;
- Industry 4.0;
- platformification;
- cloud computing;
- multi-banking (MT 798);

- bank payment obligations (BPOs);
- ICC developments; and
- cybersecurity.

THINK . . .

Have you encountered an electronic bill of lading? Could the workflow behind a letter of credit be made visible to all parties internationally using distributed ledger technology? What will the digital bank of the future look like?

15.1 Terminology associated with digital disruption

Digitisation

Digitisation refers to the process of converting information into a digital (ie machine-readable) format. The information in its original non-digital form does not necessarily disappear. For example, information can be stored in the form of both a physical document and in the form of data. The benefit of digitisation is the ability to automate existing, manual, paper-based processes that are inefficient and time-consuming, thus reducing elements of cost and risk.

The term 'digitisation' is often used interchangeably with the term 'digitalisation'. There is, however, a subtle difference between the two.

Digitalisation

Digitalisation most commonly refers to the transformation of a business process that has been enabled by the existence of digitised data. Digitalisation, therefore, relies on the digitisation of data. Customers of many banks and financial institutions are beginning to experience the benefits of both digitisation and the consequent transformation of business processes through digitalisation. Banks and financial institutions have been forced to rethink their operating models and how they generate revenue in order to provide better services to customers and stay ahead of the competition.

Disruption

The innovative changes that have occurred across industries as a result of both digitisation and digitalisation are often referred to as digital disruption.

MACHINE-READABLE

"Data in a data format that can be automatically read and processed by a computer, such as CSV, JSON, XML, etc. Machine-readable data must be structured" (Open Data Handbook, no date). Therefore, unstructured digital formats, such as PDF, are not machine-readable.

15.2 Digital banks

Many banks have embarked on ambitious digitalisation projects aimed at transforming existing business models through innovation. This has had an impact on the entire enterprise, affecting people, products and processes. Digital strategies are now applied not only to address existing opportunities and threats but also to promote the adoption of new business capabilities in pursuit of new revenue streams.

WHAT WILL THE DIGITAL TRADE BANK OF THE FUTURE LOOK LIKE?

"Moving forward, a truly digital bank will support paperless processing and communication to and from its customers. It will use external services to establish title of digital documents such as electronic bills of lading and to exchange digital certificates of origin, insurance certificates, invoices and purchase orders. The bank will be able to consume data that determines the location and quality of goods in transit. It will have an open architecture and ethos that enables collaboration with financial technology platforms, government agencies, system Integrators, and other service providers in order to be at the centre of an ecosystem supporting the needs of all corporate clients.

A digital bank will be advantaged because it will be able to leverage data to understand better operational, market, industry and customer risks and thereby ensure optimum use of the bank's capital. The bank will understand better and be able to predict future customer demand and therefore improve sales potential.

The bank will improve customer self-help through greater access to data whereby corporates can interface to their own ERP systems and run predictive data analytics across their working capital needs. [Digitalisation] will open new market opportunities as there will be better understanding of risk. With current data limitations banks are focusing mainly on large corporate business. Obtaining more data through digitisation and applying predictive analytics will also allow banks to manage more efficiently the risks associated with the SME market".

(ICC, 2017)

FACTFIND

BANKS IN 2025

Find out more about the digital bank of the future:

https://backbase.com/resources/banking-2025-whitepaper/ [Accessed: 23 October 2018].

https://cdn.iccwbo.org/content/uploads/sites/3/2017/06/2017-rethinking-trade-finance.pdf (Navigate to p226 and read the section 'The digitisation of trade') [Accessed: 23 October 2018].

15.3 Big data

Big data is a popular term that is used to refer to all data. It is called 'big' simply because there is so much of it. The dazzling array of data that is available in the digital universe today has already reached dizzying heights in terms of volume, variety and complexity. According to Kearney (2013), it is estimated that the volume of business data doubles approximately every 1.2 years.

Big data represents huge volumes of digitised information that can be obtained from a variety of sources in a multitude of forms, and subjected to analytical processes to derive meaningful business intelligence for enhanced insights and decision-making. The mere existence of data is, however, meaningless. It is only when this data is analysed and correctly applied to tasks that ultimately benefit consumers that the creation of value begins. Essentially, when we talk about big data, we are looking at analytical solutions that can translate volume into value. This is sometimes described as turning data 'mining' into data 'meaning'. The challenge is to analyse the right data in the right place at the right time, and for the right reasons.

The 4 Vs

There are 4 Vs to consider in the context of big data:

- **Volume**: the sheer scale of the data.
- **Velocity**: the frequency at which the data is generated, captured and shared.
- **Variety**: the unstructured nature of the data originating from multiple sources and types, eg video, audio and text.
- **Veracity**: the uncertainty of the data.

Utilising transactional data to increase efficiency

Most organisations are primarily focused on the analysis of transactional data that is sourced internally in order to extract business insights. The focus may be, for example, on enhanced operational efficiency, improved customer experience or increased market penetration.

Omnichannel approach

Making sense of data from a customer experience perspective requires a fully integrated, omnichannel approach. Data is normally gathered and stored in what is commonly known as a data lake. The lake often contains data that may be structured, semi-structured or unstructured.

Unstructured trade data

The majority of data available in the trade ecosystem is unstructured, ie not adhering to any common format. This data may be presented in an infinite variety of ways from an infinite number of sources. Developments in artificial intelligence are designed to identify patterns and attach meaning to huge volumes of unstructured data. You will learn more about artificial intelligence in section 15.7.

Data mining

Although many banks are still held back by legacy systems, others are now able to use sophisticated tools to mine external and internal sources of data resulting in highly structured business intelligence that has been categorised and summarised. “This process, often referred to as data mining, can help banks better understand the patterns, associations or relationships that emerge, providing information about historical and future trends” (Certificate in Relationship Management, 2017).

KEY TERMS

Structured data

Data that has a high level of organisation, such as information in a relational database that is easily searchable, organised and displayed by search engines.

Unstructured data

Data that does not adhere to a common format. It can be generated by machines (satellite images, seismic imagery, security, surveillance and traffic video, radar or sonar data) or humans (social media and mobile data, including text messages and location information, as well as an organisation's internal documents, logs, survey results and emails).

REFLECT

Think of all the aspects of trade finance that can potentially be enhanced or simplified by the intelligent use of big data.

How can big data help to:

- simplify the negotiation of contracts or the preparation of documents?
- reduce the potential for fraud?
- make more efficient use of credit and/or reduce the cost of financing?

15.4 Distributed ledger technology

One of the most publicised developments in digital innovation is the use of distributed ledger technology (DLT), and one of the most widely known examples of DLT is blockchain.

Blockchain

Blockchain is "a system used to make a digital record of all the occasions a cryptocurrency ([. . .] a digital currency such as bitcoin) is bought or sold, and that is constantly growing as more blocks are added" (Cambridge Dictionary, 2018). In a blockchain, transactions are bundled into blocks and chained together.

Distributed ledgers

All distributed ledgers, such as blockchain, are databases that are maintained collaboratively by a number of participants who regularly agree on a peer-to-peer basis how to perform updates using a mutual consensus verification mechanism. There is no central authority used to validate transactions or certify changes. Every participant shares the same single version of the truth. Any modifications made are secured with the help of advanced zero-knowledge cryptography, thus making the data immutable.

KEY TERMS

Zero-knowledge cryptography

"A method by which one party can prove to another party that a given statement is true, without conveying any information apart from the fact that the statement is indeed true." (Thuraisingham et al., 2015)

Mutual consensus verification

Allows "a network to agree updates to the database collectively, with a certainty that the overall dataset remains correct at all times without the need for a central governing authority." (Evershed, 2016)

How it works

Distributed ledgers make use of a structure known as the Merkle tree, in which each leaf node represents a block of data to support efficient data verification. Distributed ledgers may be public or private. In the world of financial services, implementations are invariably private with access granted to a permissioned group of known users who share control of transactional data. This leads to increased transparency and the removal of frictions that can otherwise inhibit growth and innovation.

Cost-efficient infrastructure

The replacement of outdated legacy systems with DLT has the potential to reduce infrastructure costs and strip out layers of overhead costs.

Smart contracts

"Smart contracts are coded instructions [that] execute on the occurrence of an event. These often use DLT or blockchain technology to record and execute transactions" (Clyde & Co, 2017). They have the potential to reduce operational risk by enabling "automated trustworthy workflow between parties without a central specific co-ordinator", hence reducing operational risk (Bits on Blocks, 2016). In addition, the smart contract can be used to support:

- automatic reordering of stock;
- automatic upload of purchase orders for financing (self-service);
- automated document preparation for paperless trade; and
- potential application of artificial intelligence for compliance checks.

Distributed ledger and smart objects

The use of track and trace devices enables us to monitor the location and condition of smart objects in transit, hence reducing operational risk. This technology can eventually be extended further "back into the supply chain to guarantee the provenance of goods at source in support of sustainable trade" (Paris, 2017).

FACTFIND

Blockchain and DLT: understanding the differences

Find out more about the differences and similarities between blockchain and other distributed ledgers and the consequent impact on the financial sector:

https://www.worldbank.org/en/topic/financialsector/brief/blockchain-dlt [Accessed: 23 October 2018].

https://towardsdatascience.com/the-difference-between-blockchains-distributed-ledger-technology-42715a0fa92 [Accessed: 23 October 2018].

https://thenextweb.com/hardfork/2018/07/27/distributed-ledger-technology-blockchain [Accessed: 23 October 2018].

15.4.1 DLT in trade finance

DLT will enable all stakeholders to gain access to information at the same time. This will reduce time spent on processing, validating and authenticating the same information repeatedly. It will also save on costs. Most importantly, data on a distributed ledger is immutable – it cannot be altered.

Several banks are already utilising applications based on DLT. Table 15.1 illustrates three consortia that, at the time of writing (October 2018), have been created to jointly explore possibilities on DLT. Some of these groups (we.trade and Marco Polo) have focused initially on open account business, whereas others, such as Voltron, are concentrating on traditional trade finance. The composition of the consortia is in a constant state of change as new members join and others leave.

TABLE 15.1 EXAMPLES OF TRADE FINANCE BLOCKCHAIN CONSORTIA

Consortium	Companies	Platform
Voltron	Bangkok Bank, BNP Paribas, CTBC Holding, HSBC, ING, NatWest, SEB, Standard Chartered	R3 Corda
Marco Polo	BNP Paribas, Commerzbank, ING, Standard Chartered, SMBC, DNB, OP Financial Group, Bangkok Bank, NatWest, Natixis	R3 Corda
we.trade (incorporating Batavia)	CaixaBank, Deutsche Bank, Erste Group, HSBC, KBC, Natixis, Nordea, Rabobank, Santander, Société Générale, UniCredit, UBS	IBM

Distributed ledgers can be permissioned (private) or permissionless (public). In a permissioned network only approved users can run nodes, validate blocks of data or execute smart contracts.

Business benefits

These include:

- efficiency gains and cost savings through reduced intermediation;
- reduced operational risk through increased transparency;
- improved management of the cash conversion cycle (corporate perspective);
- better use of limited amounts of regulatory capital (bank perspective);
- clarity around the legal liability of all parties involved (permissioned DLT with smart contracts);
- guaranteed authenticity ('permissioned' DLT with smart contracts); and
- easily trackable data, as nothing can be altered and the ledger is present across multiple nodes.

Smart contracts

Smart contracts (see section 15.5) are used to generate instructions for downstream processes (such as payment instructions or moving collateral) if reference conditions are met.

FACTFIND

DLT in trade finance

The following articles discuss firms and consortia that have begun exploring or using DLT in trade finance. You are not required to read all the articles. The aim is for you to understand the extent to which DLT has begun to penetrate the industry.

How banks are teaming up to bring blockchain to trade finance: https://www.cbinsights.com/research/banks-regulators-trade-finance-blockchain/ [Accessed: 23 October 2018].

Trade finance blockchain consortia: how they differ: https://www.ledgerinsights.com/trade-finance-blockchain-consortium/ [Accessed: 23 October 2018].

BBVA, on the first Blockchain based trade transaction between Europe and Latin America: https://www.tradefinanceglobal.com/posts/interview-bbva-first-blockchain-based-trade-transaction-europe-latin-america/ [Accessed: 23 October 2018].

R3 and TradeIX develop open account trade finance DLT business network: https://www.r3.com/news/r3-and-tradeix-develop-open-account-trade-finance-dlt-business-network/ [Accessed: 23 October 2018].

we.trade blockchain platform completes multiple real-time customer transactions: https://we-trade.com/article/we-trade-blockchain-platform-completes-multiple-real-time-customer-transactions [Accessed: 23 October 2018].

HSBC claims first trade-finance deal with blockchain: https://www.ft.com/content/c0670eb6-5655-11e8-bdb7-f6677d2e1ce8 [Accessed: 23 October 2018].

How blockchain trade finance is breaking proof-of-concept gridlock: https://www.coindesk.com/blockchain-trade-finance-breaking-proof-concept-gridlock/ [Accessed: 23 October 2018].

How blockchain will reshape trade finance: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/grid/trade-finance-placemat.pdf [Accessed: 23 October 2018].

Blockchain: implications for trade finance: https://www.tradefinance.training/blog/articles/blockchain-implications-for-trade-finance [Accessed: 23 October 2018].

REFLECT

The ultimate success of the distributed ledger in the world of trade and supply chain finance relies on a network effect. Hence, interoperability is needed to avoid the risk of 'digital islands'. How can collaboration lead to enhanced efficiencies, automating workflow, reducing risks and speeding up settlements?

15.4.2 Risks and uncertainties around DLT

Scalability

As DLT is still at a nascent stage, barriers to adoption, such as limited scalability, remain. The ability of the distributed ledger to handle large volumes of data is so far unproven.

Confidentiality

There are also continued question marks over confidentiality and the extent to which data integrity can be preserved while making use of the encryption techniques on which distributed ledgers rely.

Interoperability

At the same time, the various initiatives that have so far been brought to market have been siloed, resulting in digital islands that lack the interoperability to connect with one another.

CHECK YOUR UNDERSTANDING

1) What are the benefits of DLT in trade finance?
2) List some banks that have already been involved in pilot DLT trade finance projects.
3) What is the difference between blockchain and other forms of distributed ledger technology?

15.5 Smart contracts

Arguably, one of the most compelling use cases associated with DLT is the use of smart contracts to generate instructions for downstream processes, such as transfer of ownership, provided the reference conditions have been met.

USE CASE

"Use cases are built to refine a set of requirements based on a role or task. Instead of the traditional list of requirements that may not directly address the use of the solution, use cases group common requirements based on the type of role or goal." (IBM Knowledge Center, 2016)

Smart contracts "contain pre-written logic [computer code] that can be stored or replicated on a distributed ledger platform and executed by a network of computers. Smart contracts reduce operational risk through the automation of workflow" (Paris, 2017).

In a smart contract, an asset is transferred into a program that automatically executes a set of pre-encoded instructions. At a certain point in the transaction life cycle the program will automatically validate a condition and determine whether ownership of the asset should pass to one person or another. In the meantime, the DLT also stores and replicates the underlying data to provide security and immutability.

Benefits of smart contracts

- **Speed**: smart contracts use code to automate workflow, thus reducing processing time.
- **Accuracy**: automation reduces the risk of error generally associated with manual processing.
- **Trust**: data encrypted on a shared ledger is considered immutable.
- **Cost**: the removal of intermediaries reduces cost and enhances efficiency.

Smart contracts are designed to guarantee a specific set of outcomes, thus eliminating risk of uncertainty or confusion.

Potential issues or drawbacks

Disputes arising under a smart contract have not yet been tested in law. We do not yet have in place a regulatory framework to govern their use. This is tending to hold back widespread adoption. Questions remain regarding, for example, the risk of defective code or the ability to rescind a contract that is programmed to execute, no matter what.

KEY TERMS

Operational risk

"[T]he risk of loss resulting from inadequate or failed internal processes, people and systems or from external events." (BIS, 2011)

Encryption

The process of converting information or data into a code, especially to prevent unauthorised access.

FACTFIND

Smart contracts: risks and uncertainty in DLT

"[A] digitally signed contract might not be enforceable in all the jurisdictions. It is essential to establish the applicable jurisdiction, in case of conflict, and the dispute mechanisms, when a dispute arises." (EBA, 2018)

Navigate to p29–35 of the following EBA report to find out more about the prudential risks associated with using DLT in smart contracts. The report also highlights opportunities that the technology offers to trade financiers.

https://www.eba.europa.eu/documents/10180/2270909/Report+on+prudential+risks+and+opportunities+arising+for+institutions+from+FinTech.pdf [Accessed: 26 November 2018].

The following article highlights how smart contracts can be applied to "proxy voting, the settlement of securities, payments under a derivatives contract and the recording of financial data" (Allen & Overy, 2017):

http://www.allenovery.com/SiteCollectionDocuments/Smart_contracts_for_finance_parties.pdf [Accessed: 26 November 2018].

REFLECT

How can smart contracts remove some of the pain points from today's operational processes?

Will delays be prevented?

Are we likely to see a reduction in risks that are commonplace due to manual processing and the frequent intervention of multiple intermediaries?

15.6 The internet of things

The internet of things (IoT) comprises a network of smart objects connected to the internet. These objects include IoT devices and IoT-enabled physical assets (i-scoop, no date). They range from household equipment to industrial machinery to wearables (such as the smartwatch) and sensory devices that track and trace the movement of goods and livestock. Nowadays, it is possible to connect almost anything and everything to the IoT. Connecting objects to the IoT can be beneficial in terms of capturing, filtering and exchanging data, resulting in clearer communication and an ability to develop new data-driven services based on enhanced analytics.

Track and trace

There is much interest in the evolution of track and trace devices that enable us to monitor the location and condition of smart objects in transit. This reduces the operational risks commonly associated with the transportation of goods. For example, it is possible to track the location and condition of a container vessel, evidencing that the vessel has not been delayed or damaged or has not called at a watch-listed port. It is also possible to track the location and condition of the goods stored in an individual container. If the goods are perishable, it may be necessary to evidence specific conditions of storage, such as temperature, in order to support acceptable standards of quality.

IoT in supply chains

This technology can be extended even further back into the supply chain to "guarantee the provenance of goods at source in support of sustainable trade" (Paris, 2017). Examples include the use of the IoT to limit the risk of environmental degradation or modern-day slavery and corruption. The increased transparency and enhanced data insights will benefit smaller businesses that lack adequate access to finance and are usually positioned at the lower end of fragile supply chains.

Positive effects of the IoT

These include:

- increased transparency in supply chains;
- cost reductions;
- more efficient use of resources; and
- increased support for sustainable trade.

Negative effects of the IoT

These include:

- loss of privacy; and
- increased security risks.

FACTFIND

Emerging solutions for real world challenges

Watch the following video to find out how assets can be tracked using blockchain as they move through complex systems in competitive market environments:

https://www.everledger.io/about-us/about [Accessed: 26 November 2018].

The following interview illustrates how Halotrade has brought greater transparency and trackability to supply chains.

https://www.tradefinanceglobal.com/posts/sustainable-supply-chain-financing-halotrade-shona-tatchell/ [Accessed: 26 November 2018].

15.7 Artificial intelligence

Artificial intelligence is a broad term that manifests in many alternative forms, ranging from machine learning, text mining and image recognition to cognitive computing, natural language processing and even robotics and driverless vehicles. Where these developments have an impact on physical supply chains, there will likely be an associated impact on financial supply chains as well. For example, the adoption of driverless trucks or drones can reduce delivery times and hence shorten the cash conversion cycle.

KEY TERMS

Cognitive computing

The use of artificial intelligence to build models that can mimic human thought processes and assist humans in decision-making.

Machine learning

The use of statistical analyses to enable computers to learn with data, without having been explicitly programmed.

Natural language processing

The use of artificial intelligence to support interactions between computers and human languages, including speech recognition.

Robotics

The science of designing and operating machines that can perform the actions of humans.

Text mining

Analysing text to derive patterns and extract information.

Moral debate

The application of artificial intelligence today is not a piece of Hollywood fiction. Artificial intelligence is an important enabler of technological innovation in the digital transformation journey. More than any other term, however, it has provoked a moral debate as to the rights and wrongs of empowering machines to perform the work of human beings. Within this debate the term 'cognitive computing' has alternatively been promoted as a means of distinguishing use cases in which a computer may be employed to analyse and recommend, but the final decision to execute remains in the hands of a human. The debate continues.

Information intelligence

As you learned in section 15.3, businesses now have access to huge volumes of largely unstructured data. The need to capture, analyse and interpret data on such a grand scale has led to a new business paradigm in which information management is supplemented by information intelligence. Intelligent information management enables organisations to create a set of processes and underlying technology solutions to understand and manage vast amounts of data.

Cybersecurity

There was a time when corporate approaches towards cybercrime were largely defensive in nature; examples include building firewalls and developing anti-virus software. Today, the threat has become so great that the focus has shifted towards detection and prevention, demanding that attacks be predicted in advance. Artificial intelligence techniques are used proactively to detect patterns in data and anticipate potential threats. You will learn more about cybersecurity in section 15.14.

Intelligent document recognition

One area of artificial intelligence that is particularly relevant to trade finance is intelligent document recognition, making use of algorithms, semantics and statistical clustering to accelerate and enhance understanding of content and meaning.

DID YOU KNOW?

By 2020 the digital universe will have reached 44 trillion gigabytes, a tenfold increase over 2013. Artificial intelligence provides us with a new set of tools and capabilities to manage these huge volumes of data as an asset.

15.8 Industry 4.0

Industry 4.0 is a term that originated in Germany. It was first coined at the Hannover Fair in 2011 to reference the revolutionary impact of digital transformation on global value chains.

Agrarian revolution

Around 10,000 years ago the world transitioned from foraging to farming in what has become known as the agrarian revolution. By combining the efforts of animals with those of humans, vast improvements were made in production and transportation, eventually resulting in population growth and urbanisation.

Industrial revolutions

It was not until the eighteenth century that the agrarian revolution was succeeded by a series of industrial revolutions. The first of these came about as a result of the invention of the steam engine and the introduction of railroads, provoking the advent of mechanical production. The second industrial revolution saw the introduction of electricity. The third industrial revolution, involving the development of computers and adoption of the internet, did not begin until the 1960s.

'Smart' everything

It is argued that we are now undergoing a fourth industrial revolution (Industry 4.0), sometimes known as the second machine age, in which sophisticated digital technologies enable the interconnectivity of physical and virtual systems, resulting in the development of 'smart' everything. Significant breakthroughs in emerging technologies are fuelling innovation across physical, digital and biological domains at an unprecedented rate.

'Thinking' supply chains

It is widely accepted that as a result of these developments we are on the brink of a period of profound change. Industry 4.0 will take us on a journey that will eventually realise the combined benefits of many of the developments covered in this topic, including the IoT, big data, artificial intelligence and cloud computing. It is a vision of the future driven by digital transformation, innovation and integration. There can be no doubt that digital transformation is driving disruption. Successful businesses will rely more and more on digitally enabled 'thinking' supply chains, intimately connected to all open data sources, both internal and external.

Productivity, quality, flexibility and speed

Industry 4.0 promises to deliver four primary business benefits: increased productivity, enhanced quality, increased flexibility and increased speed. Businesses that fail to invest in the digital transformation journey of Industry 4.0 will be constrained and competitively disadvantaged by outdated business models and technologies.

FACTFIND

A renaissance of sorts

"Ubiquitous, mobile supercomputing. Intelligent robots. Self-driving cars. Neuro-technological brain enhancements. Genetic editing. The evidence of dramatic change is all around us and it's happening at exponential speed." (World Economic Forum, 2018)

Scroll to the bottom of the following webpage and watch the video in which Professor Klaus Schwab, Founder and Executive Chairman of the World Economic Forum, shares his vision of the revolution taking place around us:

https://www.weforum.org/about/the-fourth-industrial-revolution-by-klaus-schwab [Accessed: 26 November 2018].

15.8.1 Horizontal and vertical integration

Integration in the Industry 4.0 model comes in two forms: horizontal and vertical.

Horizontal integration

Horizontal integration refers to the end-to-end value chain from supplier to consumer, including all of the processes and information flows from development to distribution.

Vertical integration

Vertical integration refers to the IoT and enhanced interoperability across digital transformation platforms, resulting in the development of new services and ecosystems.

Augmented reality and virtual reality

One of the main areas of focus in Industry 4.0 is the convergence of the virtual and physical worlds with a particular emphasis on cyber-physical systems. There are a growing number of augmented reality and virtual reality use cases in the manufacturing industry, making use of simulation models to improve various processes such as assembly, security, testing and digital prototyping.

Augmented reality superimposes information on an existing world, whereas virtual reality uses technology to generate new environments. The former adds to an existing reality whereas the latter replaces reality with something else.

CYBER-PHYSICAL SYSTEMS

"Systems of collaborating computational entities which are in intensive connection with the surrounding physical world and its ongoing processes, providing and using, at the same time, data-accessing and data-processing services available on the internet." (ScienceDirect, 2016)

Physical supply chain megatrends

The megatrends listed here have already had an impact on the physical supply chain.

- **Autonomous vehicles** – these include aircraft, boats, cars, drones, submersibles and trucks. Their use will affect operational efficiencies and delivery methods.
- **3D printing** – whereby a physical object can be manufactured from a digital drawing or model. Already widely used in the automotive, aerospace and medical industries, 3D printing reduces time and production costs, supported by distributed manufacturing and maintenance.
- **Robotics** – supporting collaboration between humans and machines.

These trends will also affect financial supply chains and other related services.

REFLECT

Think about revolutions that have just been mentioned in this topic.

1) What are some of the differences between the current digital revolution and earlier industrial or agrarian revolutions?
2) What are some of the positive and negative impacts on trade?

15.9 Platformification

Platformification is a new type of business model that will allow multiple participants to connect and interact with one another in order to create and exchange value.

Open APIs

Technically, platformification relies on the development and deployment of open APIs (application programming interfaces). APIs are used to define the requirements that govern how applications communicate and interact. Open APIs are publicly available, opening up access to external developers and promoting wider adoption of web services. These APIs are built by fintechs and can exist on top of legacy banking systems. In this way users can access both traditional services from the bank as well as innovative value-added solutions derived from new technologies. You learned about digital banks in section 15.2.

FINTECH

A portmanteau from the phrase 'financial technology', fintech companies develop innovative applications with a focus on niche areas or specialist services. Some have even moved on to apply for full banking licences.

Increased collaboration between banks and fintechs

Platformification therefore represents a significant breakthrough in the collaborative relationship between banks and fintechs, creating a win–win situation for all. Banks are better able to service the changing needs of the market without making huge additional investments in infrastructure, while at the same time providing fintechs with access to a vast financial network.

In future, banks will be able to pick and choose the applications best suited to service the needs of their customer base. The bundling together of multiple services on one online platform creates the perfect opportunity for banks to drive improvements in performance as well as enhanced service levels.

Compliance benefits

In the world of trade finance, the opportunities exist not only for banks to collaborate with fintech but also with so-called 'regtech' (regulatory technology), in order to leverage regulatory data and enhance the ways in which regulatory compliance and the associated risks are managed.

Financial inclusion

Broader still are the opportunities to collaborate with governments and others to boost financial inclusion and close the trade finance funding gap.

FACTFIND

Open Banking in the UK

Find out about the similarities and differences between Open Banking and PSD2:

https://www.ukfinance.org.uk/open-banking-and-psd2-what-will-be-the-industry-impact/

https://www.computerworlduk.com/applications/is-2018-year-that-open-banking-becomes-reality-in-uk-3653824/

http://www.wired.co.uk/article/open-banking-cma-psd2-explained

[All accessed: 26 November 2018].

15.10 Cloud computing

Cloud computing technology is likely to play an increasingly prominent part in the transformation of banking over the coming years.

CLOUD COMPUTING

"Simply put, cloud computing is the delivery of computing services – servers, storage, databases, networking, software, analytics, intelligence and more – over the internet ('the cloud') to offer faster innovation, flexible resources and economies of scale." (Microsoft Azure, 2018)

Business benefits

The key business benefits associated with the cloud include:

- reduced operating costs;

- improved operational efficiency;
- improved customer service;
- improved flexibility and scalability; and
- enhanced disaster recovery/business continuity processes.

Deployment models

There are several types of deployment models on the cloud. These include:

- **Public cloud** – the infrastructure resides on the premises of the service provider but is subject to open use and can be operated by a user. It is easy to implement and relatively low cost.
- **Private cloud** – owned by an individual organisation and hosted either internally or externally, with high levels of security and scalability.
- **Hybrid cloud** – combines private and public cloud services, ensuring scalability and performance but requiring a reputable cloud vendor to ensure reliability. Some businesses favour hybrid as it supports BYOD (bring your own device), allowing employees easy access to business-critical applications.

Managed services

Cloud computing is generally associated with hosting or web hosting, ie the housing and maintenance of data displayed on one or more websites. There are various models for providing managed services on the cloud:

- **Platform as a service** is designed to support the entire web application development cycle, from building and testing to final deployment.
- **Infrastructure as a service** enables data centre infrastructure to be managed remotely.
- **Software as a service** is a commonly used model whereby a vendor will manage applications, data, middleware, storage and networking, making it easier for businesses to streamline maintenance and support.

A hosted service may be single tenant or multi-tenant:

- **Single tenant** services do not involve the sharing of data or software.
- **Multi-tenant** services use a single instance of software and infrastructure to serve the needs of multiple customers. Each user shares the application that is supported by a single database.

15.11 Multi-banking (MT 798)

You briefly learned about the SWIFT messaging system in section 3.8.1 and how it enables financial institutions worldwide to exchange information on financial transactions securely, in accordance with globally adopted common messaging standards.

The message types deployed by SWIFT are categorised by business area. Those messages relating to trade finance sit within Category 4 (collections) and Category 7 (letters of credit and guarantees). SWIFT is enforcing significant changes to the Category 7 message types in 2018 and 2019.

Launched in 2010, the MT 798 was designed to automate the messaging flows between corporates and banks, thus digitising the process end to end. The content of these messages generally relates to transactions involving either letters of credit or demand guarantees. Corporates can use these messages to communicate with their multiple banking service providers, for example to apply for the issuance of a letter of credit or to receive advice.

How it works

The MT 798 is sometimes described as a ‘trade envelope’, since the messages themselves are simply a wraparound for other standard Category 7 messages routinely used in bank-to-bank communications. For example, when used to request the issuance of a letter of credit, the MT 798 will contain a header and a footer with an MT 700 message sandwiched in between. On receipt of the MT 798 from the buyer, the issuing bank will open the MT 798 ‘envelope’, remove and process the MT 700 from inside and forward the details in the standard way to the advising bank. On receipt of the MT 700 message from the issuing bank, the advising bank can put the MT 700 message back inside an MT 798 envelope and forward it to the seller.

Corporates wanting to use the MT 798 message types must confirm that their banks are MT 798-enabled. MT 798 messages may be sent individually or may be incorporated into a file and sent with other attachments, including documents and images, via a complementary SWIFT service known as FileAct.

FACTFIND

Are you ready for the Category 7 changes?

Find out more about the SWIFT messaging system and imminent changes to Category 7.

https://www.swift.com/our-solutions/corporates/drive-trade-digitisation/mt-798

https://www.swift.com/standards/standards-releases/mt-release-2018

http://iiblp.org/swift-changes-2018/

[All accessed: 26 November 2018].

15.12 Bank payment obligations

The bank payment obligation (BPO) is an irrevocable undertaking given by one bank to another bank that payment shall be made on a specified date after a successful electronic matching of data according to an industry-wide set of rules.

Just as the MT 798 provides a framework to support a digitised end-to-end process for traditional trade transactions involving, for instance, letters of credit, so the BPO provides a similar framework to support transactions conducted on open account terms but requiring some form of bank assistance in terms of risk mitigation and/or financing.

A transaction-matching application

The BPO relies on a centrally managed transaction-matching application. Messages are exchanged using non-proprietary ISO20002 open XML messaging standards. The matching application commonly in use today is the Trade Services Utility (TSU) managed and operated by SWIFT. Usage of the BPO is governed by the *Uniform Rules for Bank Payment Obligations* (URBPO), published by ICC.

While the BPO is primarily focused on providing assistance to transactions conducted on open account, it does bear many of the hallmarks of a documentary credit. As you learned in Topic 9, a documentary credit creates an obligation to pay subject to the physical presentation of compliant documents. A BPO creates a similar obligation to pay subject to the electronic presentation of compliant data. Given the perceived efficiencies in data processing and matching, the BPO has in some cases been adopted in substitution of a documentary credit.

How it works

A BPO transaction begins with the establishment of a baseline in the TSU. The original baseline may or may not include a BPO. If the BPO is not included, the baseline may be amended at a later date. Once the BPO has been established, further datasets are submitted and matched to the baseline in order to crystallise the obligation to pay. If the required datasets, including the commercial invoice and transport data, match the baseline then the obligor bank (the bank that issued the BPO on behalf of the buyer) is obligated to pay the seller's bank (also known as the recipient bank) on the due date. If the datasets do not fully match, the obligor bank may nevertheless accept any mismatches and proceed accordingly with fulfilment of the obligation.

One essential difference between a BPO and a documentary credit is that the beneficiary of a BPO is always defined as the seller's bank, and not the seller.

In addition to risk mitigation and payment assurance, the BPO can also be used flexibly to support a variety of financing propositions, including pre-shipment and post-shipment.

FACTFIND

Find out more about BPOs from the SWIFT website:

https://www.swift.com/our-solutions/corporates/drive-trade-digitisation/bank-payment-obligation?tl=en#topic-tabs-menu [Accessed: 23 October 2018].

For detailed information on BPOs, the ICC *Guide to the Uniform Rules for Bank Payment Obligations* is available from the ICC store: http://store.iccwbo.org/icc-guide-to-the-uniform-rules-for-bank-payment-obligations [Accessed: 23 October 2018].

15.13 ICC developments

In its tenth annual global survey published in 2018, ICC recognised the importance of digitalisation as a means of securing future growth in the trade finance industry (ICC, 2018). The report concluded that digitalisation would not only boost economic growth but also make trade itself more inclusive by supporting sustainable development. Other conclusions drawn from the report include the potential reduction in risk as a result of increased transparency which, in turn, would lead to a wider availability of trade finance and a potential closing of the trade finance funding gap.

As a result of these findings ICC created three working groups to accelerate the adoption of digital technologies, and to realise the benefits of digital technologies, including the management of compliance and dilution of operational risk.

E-compatibility of ICC rules for trade finance

The first working group is looking at the following ICC rules and assessing them for e-compatibility and to ensure that they are e-compliant, thus enabling banks to accept data in place of documents.

- Revised *Uniform Customs and Practice for Documentary Credits* (supplement for Electronic Presentation) – eUCP. This is due for publication in April 2019.
- New *Uniform Rules for Collections* (supplement for Electronic Presentation) – eURC. This is due for publication in April 2019.
- Revised *Uniform Rules for Bank Payment Obligations* – URBPO. This is due for publication in early 2020.

The revised rules will enable banks to accept data in place of documents. You learned about the revised eURC and eUCP in Topics 8 and 9.

Standards

The second working group is charged with the publication of a minimum set of standards to support interoperability across platforms and between service providers.

Legal status

The final group is charged with the examination of legal and practical issues related to the validity of data presented in digitised form.

FACTFIND

Supporting digital transformation

Read the ICC Global Survey 2018:

https://iccwbo.org/publication/global-survey-2018-securing-future-growth/

ICC's goal is not only to increase awareness but also to provide support for the digital transformation of the industry. Find out more:

https://iccwbo.uk/pages/promoting-digital-trade-1

The following blogs provide a good introduction to various ICC digitalisation efforts:

> https://www.tradefinance.training/blog/articles/icc-digitalisation-working-group/
>
> https://www.tradefinance.training/blog/articles/update-on-developing-e-compliance-in-icc-rules-minimum-standards/
>
> https://www.tradefinance.training/blog/articles/status-update-urbpo/
>
> [All accessed: 24 August 2018].

15.14 Cybersecurity

Cybercrime is a significant systemic risk for all financial institutions today. The widespread use of digital technologies has not only increased the interconnectivity of networks and 'things' but also raised the bar in terms of security, compliance and data protection standards. Digitisation may be used maliciously by the perpetrators of cybercrime but also provides us with tools to fight this.

Banks are a natural target of cybercrime. Developments in cloud computing and Open Banking have increased the level of vulnerability. The risks are reputational as well as financial. Cyber attacks are becoming more frequent and widespread, often linked to the possibility of fraud. Consequently, cybersecurity has become a key strategic priority. Banks are investing more and more in systems and people to counter the threat posed by cybercrime, routinely invoking best practices in password protection, use of anti-virus software and data encryption.

Cybersecurity refers to protecting systems, networks and data from the threat of being attacked with malicious intent. Protective measures have been reinforced by new legislation, such as the General Data Protection Regulation (GDPR) in the EU, which has been implemented to regulate the way in which data is collected and managed. GDPR mandates severe penalties for serious breaches and demands that regulators be notified immediately of any data breach. Also in the EU, the eIDAS regulation standardises the use of electronic identification and electronic signatures cross-border.

Examples of areas that banks are investing in as a means of combating cybercrime include:

- artificial intelligence and machine learning;
- biometrics;
- electronic identification and authentication; and
- cryptography.

Biometric tools are an increasingly popular way of confirming the uniqueness of human biological features for security purposes.

Common forms of cybercrime include phishing, hacking and use of malware.

KEY TERMS

Malware

Software designed to infiltrate and damage computer systems. Examples of malware include viruses, worms, Trojan horses and spyware.

Phishing

A technique used to obtain unauthorised access to sensitive data by posing as a trusted organisation, eg a bank. It may be used to compromise systems that contain account information and/or financial data.

FACTFIND

Cybersecurity in banking

Subscribe to *The Banker* for free to find out more:

The Banker: https://www.thebanker.com/Transactions-Technology/Technology/Cyber-security-making-banking-safer [Accessed: 26 November 2018].

Conclusion

The digital age brings with it the opportunity to transform trade finance by replacing the physical processing of paper with the electronic processing of huge volumes of data.

As the volume of goods traded cross-border has grown, new trading relationships have been established, regulatory requirements have become more stringent and the administrative overhead of managing risk and compliance has multiplied. It is no longer feasible for a bank to compete or to comply without making significant strides towards digitising its trade business.

From now on, it is likely that banks will adopt a more collaborative approach, in particular by partnering with agile innovators in the field of fintech.

THINK AGAIN ...

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- highlight the key benefits of digitalisation?
- explain the differences between blockchain and distributed ledger?

- articulate the benefits of smart contracts?
- provide examples of smart objects that exist in the IoT?
- debate the rights and wrongs of artificial intelligence?
- explain the anticipated business impacts of Industry 4.0?
- describe how banks and fintechs can collaborate on platforms using open APIs?
- explain the various deployment models on cloud?
- describe how an MT 798 works?
- define a BPO?
- explain why banks are a natural target for cybercrime?

Test your knowledge

?

Use these questions to assess your learning for Topic 15. Review the text if necessary.

Answers can be found at the end of this book.

1) Digitalisation refers to the transformation of:

   a) documents.

   b) data.

   c) business processes.

   d) operating models.

2) Smart contracts reduce operational risk by:

   a) supporting a regulatory framework.

   b) enabling automated workflow management.

   c) speeding up the transfer of data.

   d) reducing transaction processing costs.

3) Smart objects and the internet of things will benefit supply chains due to:

   a) increased transparency.

   b) enhanced security.

   c) reduced cost.

   d) removing barriers to entry.

4) Natural language processing is an example of:

   a) blockchain.

   b) big data.

   c) cloud computing.

   d) artificial intelligence.

5) Industry 4.0 will result in:

   a) increased use of distributed ledger technologies and cryptocurrencies.

   b) faster bank payment obligations.

   c) enhanced cybersecurity.

   d) increased productivity, flexibility and speed, as well as enhanced quality.

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Answers to knowledge and understanding questions

Topic 1

? TEST YOUR KNOWLEDGE

1) Answer A is correct (see section 1.9). Market research and customs advice are not core ICC activities.

2) A, C and D are all correct (see section 1.8). The WTO does not advise on pricing, organise trade missions or conduct market research. Chambers of commerce organise trade missions. It is up to individual businesses to carry out market research.

3) Answer D is correct (see section 1.1.1). Obtaining products or services that are not available domestically can be a reason to carry out international trade. However, this is not a principle of comparative advantage.

4) Answer B is correct (see section 1.1.3). Globalisation refers to a trend or process whereby economies and societies become more connected across national and geographic boundaries. Nearshoring is the transfer of business processes to companies in a nearby country, where both parties expect to benefit. Comparative advantage is where an economy is able to produce goods or services at a lower cost than the economies with which it trades.

5) Answer C is correct (see section 1.6.1). The Basel Committee for Banking Supervision is not involved in setting regulations for money laundering or the trade in dual-use goods. Sanctions are imposed by national governments and not the Basel Committee.

Topic 2

✓ CHECK YOUR UNDERSTANDING 1

1) Cultural and political concerns are classified as country risks. Businesses will encounter these differences when trading internationally. Being aware and prepared will minimise these risks and help facilitate trade between countries despite the differences. Examples of cultural differences include customs, practices and etiquette. Negotiation styles, labour laws and language can also vary between countries. Examples of political issues that businesses should be aware of include bilateral and multilateral trade agreements, historical relationships between countries, political systems as well as barriers to trade. Find out more in section 2.1.1.

2) Yes. This would be a concern if the two companies were based very far away from each other – a buyer in Moscow and a supplier in Vladivostok, for example. However, if the two companies were based in cities very close to each other then transportation risk would be negligible.

3) Yes. Most multilingual countries face language risk in domestic trade. Canada, Switzerland, Belgium and India are examples of multilingual countries. Although Singapore is a multilingual country, language risk is eliminated as business is conducted in English. All citizens are bilingual in English and another language that is usually related to their ethnicity. This could be Chinese, Malay or Tamil. Many Singaporeans are trilingual.

✓ CHECK YOUR UNDERSTANDING 2

Transfer risk is the risk that the buyer is unable to transfer local currency into that of the contract. It is considered to be a country risk as it is related to economic issues such as dependence on commodities or specific services such as tourism. Find out more in section 2.1.1.

Foreign exchange risk, on the other hand, is the risk that the exchange rate of a currency moves unfavourably against that of another currency, creating a disadvantage for one of the parties. Find out more in section 2.1.4.

✓ CHECK YOUR UNDERSTANDING 3

1) Currency exchange rates, interest rates and commodity prices can be influenced by movements in financial markets.

2) Most risk mitigation methods used to counter movements in financial markets are similar to those suggested for price fluctuations. A good bargaining position is certainly an option. Otherwise forward contracts or options can mitigate these risks.

✓ CHECK YOUR UNDERSTANDING 4

1) No. Only governments can ratify a trade agreement. Chambers of commerce provide education and networking opportunities through trade missions and other events.

2) Yes. Most government departments responsible for international trade organise missions to trade shows in key export markets. Chambers of commerce are also involved in either supporting these initiatives or organising separate events.

? TEST YOUR KNOWLEDGE

1) Answer B is correct (see section 2.1).

2) False (see section 2.2.3). Credit reference agencies are commonly used to provide a range of credit references or research services, and credit rating agencies are used for credit rating reports.

3) Answer D is correct (see section 2.2.3). A status enquiry or credit reference is a report that is collated from all of the information and history available on a company.

4) Answer D is correct (see section 2.3.5). The other answers do not refer to trading under open account with limits.

5) Answer B is correct (see section 2.1.4).

Topic 3

✓ CHECK YOUR UNDERSTANDING

Direct exporting is when a company sells direct to the end user.

Indirect exporting is where the company would engage the services of an intermediary that specialises in finding foreign markets and buyers for its products.

? TEST YOUR KNOWLEDGE

1) Answer C is correct (see section 3.2.1). The others are all warning signs.
2) Answer D is correct (see section 3.3).
3) Answer D is correct (see section 3.8.1).
4) Answer A is correct (see section 3.8.7).
5) Answer D is correct (see section 3.8.4).
6) Answer A is correct (see section 3.8.3).
7) Answer D is correct (see section 3.8.4).

Topic 4

? TEST YOUR KNOWLEDGE

1) Answer A is correct (see section 4.5.1). It should be within 30 days.
2) True (see section 4.4.1). CISG is divided into four parts: I – Sphere of application and general provisions (Articles 1–13); II – Formation of the contract (Articles 14–24); III – Sale of goods (Articles 25–88); IV – Final provisions (Articles 89–101).
3) B, C and D are all correct (see section 4.1). A is incorrect because there must be an acceptance along with a firm offer.

4) True (see section 4.2).

Topic 5

? TEST YOUR KNOWLEDGE

1) Answer D is correct (see section 5.2.1). Placement, layering and integration are the three accepted stages of money laundering. In this context, 'structuring' relates to the process of dividing large amounts of cash into multiple smaller amounts.
2) Answer C is correct (see section 5.4.2).
3) Answer B is correct (see section 5.4.2.1).
4) Answer D is correct (see section 5.2.3). Sanctions will always overrule UCP and all other international trade-related rules.
5) Answer B is correct (see section 5.2.1.1).
6) Answer A is correct (see section 5.5.3).

Topic 6

✓ CHECK YOUR UNDERSTANDING

Incoterm®	Mode of transport	Moment of delivery
Ex works (EXW)	All	Named place of delivery (ie seller's premises/factory/warehouse)
Free carrier (FCA)	All	Carrier or other nominated person at the named place of delivery
Free alongside ship (FAS)	Sea and inland waterway	Seller places the goods alongside the vessel at the port of shipment

Free on board (FOB)	Sea and inland waterway	On board the vessel nominated by the buyer at the port of shipment
Cost and freight (CFR)	Sea and inland waterway	On board the vessel nominated by the buyer at the port of shipment
Cost, insurance and freight (CIF)	Sea and inland waterway	On board the vessel nominated by the buyer at the port of shipment
Carriage paid to (CPT)	All	Carrier or other nominated person at the named place of delivery
Carriage and insurance paid to (CIP)	All	Once unloaded, the seller places the goods at the buyer's disposal at a named port or place of destination
Delivered at terminal (DAT)	All	Once unloaded, the seller places the goods at buyer's disposal at a named port or place of destination
Delivered at place (DAP)	All	Seller places the goods at buyer's disposal on the arriving means of transport, ready for unloading at a named place of destination
Delivered duty paid (DDP)	All	Seller places the goods at the disposal of the buyer, cleared for import, on the arriving means of transport, ready for unloading at the named place of destination

? TEST YOUR KNOWLEDGE

1)

Financial	Transport	Commercial	Insurance
Bill of exchange	Bill of lading	Commercial invoice	Cargo insurance
Promissory note	Air waybill	Export/import licence	

2) False (see section 6.1). Goods from outside the EU may be freely traded inside the EU border.

3) Answer A is correct (see section 6.9.13). DDP places the highest obligation on the seller and EXW the least.

4) C, D, E, F, G, H, and J are correct (see section 6.9.1). Answers A, B, I and K only cover transport by sea or inland waterway.

5) True (see section 6.4.1).

6) A and B are correct (see section 6.8.1). Costs incurred due to theft and non-delivery are covered by general cargo clause A.

Topic 7

? TEST YOUR KNOWLEDGE

1) Answer D is correct (see section 7.2). The method of settlement that poses the least risk for the seller is payment in advance; open account payment poses the most risk for the seller.

2) Answer B is correct (see section 7.4). Payment will be required on a specified date in an open account transaction.

3) Answer B is correct (see section 7.5). Title documents are to be held pending payment or acceptance by the buyer in a documentary collection.

4) Answer C is correct (see section 7.6). It is provided if the seller complies with previously agreed terms and conditions.

5) Answer B is correct (see section 7.6). The title documents are sent through the banking system.

Topic 8

TEST YOUR KNOWLEDGE

1) Answer A is correct (see section 8.1.1). The main parties to a collection are the principal, the remitting bank, the collecting bank, the presenting bank and the drawee (ICC, 1995).

2) Answer A is correct (see section 8.1.1).

3) Answer B is correct (see section 8.9).

4) B, C and D are all correct (see section 8.1.1). The collecting bank presents the documents to the **drawee** (ie the buyer) for payment or acceptance.

Topic 9

CHECK YOUR UNDERSTANDING 1

1) Advantages to the beneficiary include guaranteed payment, the transfer of risks from the buyer to the issuing bank and then to the confirming bank, the availability of pre-shipment finance and the opportunity to have accepted drafts or deferred payment undertakings discounted/prepaid.

2) Disadvantages to the applicant include having to account for the credit as a contingent liability, the irrevocability of the credit, the higher costs involved and the lack of quality assurance in terms of the goods supplied.

3) The lack of quality assurance is a disadvantage to a buyer.

4) Certainty of delivery is an advantage to a buyer.

CHECK YOUR UNDERSTANDING 2

1) No, an intermediary can reside anywhere in the world and does not need to be in the same location as the seller.

2) Red clause credits were first used in the wool trade.

3) No, unlike back-to-back credits, transferable credits do not operate as separate credits. Transfers are usually for less than the full value of the original documentary credit. There can also be more than one second beneficiary, provided the documentary credit allows for partial shipments.

? TEST YOUR KNOWLEDGE

1) Answer D is correct (see article 12 in section 9.12). All the other options are part of the definition of honour in UCP 600.

2) True (see section 9.3).

3) A, D and F are correct. Answers C and E are advantages to the beneficiary; answer B is a disadvantage to the applicant; answer G is true of the advising bank and not of the applicant (see section 9.8).

4) Answer A is correct (see section 9.9.1). A transferable letter of credit may be transferred for less than the full value of the credit to more than one second beneficiary and without prior agreement of the applicant and the issuing bank.

5) A, B, D, H, I, J and L are correct (see section 9.12). Answers C, E, F, G and K are not considered to be force majeure events and are therefore not covered by article 36.

Topic 10

✓ CHECK YOUR UNDERSTANDING

1) Advantages of unconditional guarantees include the existence of governing rules, the simplicity of the process and the lack of impact on working capital (see section 10.2.3).

2) Some of the risks involved in unconditional guarantees include the independence of commercial contracts, legal issues (local laws and unfamiliar jurisdictions), potential disputes, similarities with cash deposits, creation of contingent liabilities that, in turn, have

an impact on banking facilities, and language issues (see section 10.2.3).

? TEST YOUR KNOWLEDGE

1) Answer D is correct (see section 10.5). According to article 20 of URDG 758, a guarantor has five business days following presentation to examine documents to confirm that they are compliant.

2) A and E are correct (see section 10.2.1). Unconditional guarantees are independent of the underlying contract or reason for default, subject to URDG 758. The guarantor has the primary obligation for unconditional guarantees.

3) False (see section 10.2.2). This is a description of a secondary obligation. A primary obligation is where the beneficiary can directly claim from the guarantor without a prior claim having been made on the applicant.

4) A, B and D are correct (see section 10.3). Retention guarantees favour the seller.

5) A, D and E are correct (see sections 10.9 and 10.9.1). Guarantees are subject to URDG 758/UCP 600/ISP98 or local law and jurisdiction. Standby letters of credit have a definite expiry date or event. Amendments to standby letters of credit are permitted under ISP98.

Topic 11

✓ CHECK YOUR UNDERSTANDING 1

The physical supply chain represents the movement of raw materials, parts and goods associated with a finished product and involves the procurement, manufacture/processing, distribution arrangements and lead times that end with the goods being in the hands of the end buyer. The financial supply chain, on the other hand, represents the financial events that take place in parallel with the physical supply chain.

✓ CHECK YOUR UNDERSTANDING 2

1) The key physical supply chain events are: 'production of goods', 'goods inspected', 'goods shipped' and 'goods accepted'. The key financial supply chain events are: 'purchase order from buyer', 'purchase order received by supplier', 'invoice raised', 'invoice received' and 'payment in/out'.

2) The financial consequences of events in the financial supply chain relate to risk, liquidity and payments. Each event can have a positive effect (ie risk is reduced, liquidity is increased or an incoming payment is received) or a negative effect (ie risk is increased, liquidity is reduced or an outgoing payment is made).

? TEST YOUR KNOWLEDGE

1) Answer B is correct (see section 11.1.1). Warehouse receipts for the storage of goods are data arising from an event in the physical supply chain. The shipment of goods by sea, air, road or rail may be used to support a supply chain finance solution but is not a supply chain finance technique.

2) Answer A is correct (see section 11.2.1). With the exception of the consumer, each party in the physical supply chain is both a buyer (eg buying raw materials from producers) and a seller (eg manufacturing and selling finished goods to distributors or retailers). The final link in the supply chain is the consumer.

3) B and C are correct (see section 11.3.1). Trade cycle analysis focuses on working capital, not profitability, and enables a finance provider to understand the needs of a client in terms of risk mitigation, finance and payments.

4) Answer C is correct (see section 11.4). Loan/advance techniques may involve the assignment of receivables or inventory used as security for a loan/advance, but only receivables purchase techniques involve the purchase of the receivable by the finance provider. Most supply chain finance solutions, with the exception of forfaiting, do not involve the use of promissory notes.

5) Answer B is correct (see section 11.5.1). Receivables are not created until goods are despatched from the seller's warehouse. With purchase order-based finance, the buyer's obligation to pay does not become unconditional until the goods have been received and found to conform to the terms of the purchase order. A finance provider will want to retain recourse to the seller in respect of any advance against purchase order.

Topic 12

? TEST YOUR KNOWLEDGE

1) Answer A is correct (see section 12.3). Asset-based lending is similar to a produce loan in that the underlying goods are held as security.
2) False (see section 12.1). Overdraft facilities can be provided both in the company's domestic currency and in foreign currencies.
3) True (see section 12.7.2). As excessive uncertainty in contracts is prohibited under Sharia law, such an agreement would, therefore, be void.
4) False (see section 12.7.3). *Ijara* is a type of finance used in lease agreements.
5) Answer C is correct (see section 12.8.2). Counter-purchase is a sophisticated form of barter involving two separate contracts – one for sale and the other for the counter-purchase.

Topic 13

? TEST YOUR KNOWLEDGE

1) A and B are correct (see section 13.3). Manufacturing risk and transport risk are not covered.
2) A and D are correct (see section 13.1).
3) A, B and D are correct (see section 13.4).

4) Answer D is correct (see section 13.2). Because the seller is accepting a significant risk by agreeing to an excess, it will cover 100 per cent of losses until a threshold is reached.

Topic 14

✓ CHECK YOUR UNDERSTANDING

1) Agricole is selling US dollars, the bank is buying US dollars, and the underlying currency is US dollars. So the bank will choose 1.1765.

   To convert the underlying to base, divide by the rate. Therefore, the amount received in 60 days is:

   99,000/1.1765 = EUR84,147.90

   Note: with forwards, the spot rate on the maturity of the forward contract is irrelevant. Both the bank and the customer are legally bound to deal at the agreed forward rate.

2) If the US dollars are converted at spot, the value in euros will be:

   99,000/1.1570 = EUR85,566.12

   If the US dollars are converted at option strike price, the value in euros will be:

   99,000/1.1680 = EUR84,760.27

   Hence the option will be abandoned and Agricole will convert the US dollars at the spot rate and receive EUR85,566.12.

? TEST YOUR KNOWLEDGE

1) Answer C is correct (see sections 14.3.3 and 14.3.4). The base currency is always the first currency in a foreign exchange rate quote made by a bank for an international trade transaction, so the pound is the base currency here. The second currency (the US dollar in the example) is known as the variable, underlying or quote currency. The bank would convert US dollars to pounds at 1.4010 (the high rate).

The bank wishes to pay out as few pounds as possible. To convert variable to base, divide by the rate. The bigger the denominator, the fewer pounds the customer will receive.

2) Answer B is correct (see sections 14.3.4, 14.5 and 14.6). Forwards fix the current rate for a future foreign exchange transaction. If the rate does move favourably, there is no benefit as the transaction will have to be settled at the agreed forward rate. An option allows the holder to let the option lapse if the spot rate at expiry gives a better outcome. Foreign currency bank accounts are only relevant if there is a two-way flow (receipts and payments) in a foreign currency.

3) Answer C is correct (see section 14.3.5). If the forward contract had not been taken out, the transaction would have been settled at the spot rate. The term 'opportunity cost' is used to describe this phenomenon. Opportunity costs do not show up in the published accounts, so there cannot be a transaction loss. Premiums apply to options, as opposed to forwards.

4) Answer A is correct (see section 14.7.1). Transaction exposure relates to the effects of changes in foreign currency rates on contracted future cash flows or profits of a business. Translation exposure relates to the accountancy treatment of changes in the reported values of foreign currency denominated assets, liabilities and profits. Economic exposure relates to the effect of long-run changes in foreign exchange rates on the competitiveness of a business.

5) Answer C is correct (see sections 14.3.3 and 14.3.4). The bank will use the agreed forward rate to convert US dollars to euros. As the bank is buying US dollars, it buys high, ie at 1.2560.

6) Answer B is correct (see section 14.6). If the US dollars were converted at the option strike rate of GBP/USD 1.4325, the cost would be higher for the UK customer than if the spot rate had been used. Therefore, the option will be lapsed and the UK corporate would deal at the appropriate spot rate. The bank is selling US dollars, so the low spot rate of 1.4500 will be applied.

7) Answer B is correct (see sections 14.3.4 and 14.4.2). The forward rate is not determined by a guess. It is determined by arbitrage

principles, which refers to the interest rate differentials in the two countries concerned. Governments do not normally attempt to set forward rates by legislation.

Topic 15

✓ CHECK YOUR UNDERSTANDING

1) DLT reduces the time multiple parties spend on processing, validating and authenticating the same information.

2) HSBC, ING, BNP Paribas, Commerzbank, Unicredit, Santander, Standard Chartered, Natixis, KBC.

3) In a blockchain, data is shared. In a distributed ledger, control of the data is shared.

? TEST YOUR KNOWLEDGE

1) Answer C is correct (see section 15.1). Digitisation refers to the conversion of information into a digital format. Once the data has been digitised, the opportunity exists to go one step further in the transformation of business processes. This transformation is defined as digitalisation.

2) Answer B is correct (see section 15.5). In a smart contract, an asset is transferred into a program that automatically executes a set of pre-encoded instructions. Smart contracts use code to automate workflow and reduce processing time.

3) Answer A is correct (see section 15.6). Increased transparency will enhance data insights and will be of particular benefit to smaller businesses that might otherwise lack access to finance.

4) Answer D is correct (see section 15.7). Artificial intelligence is a broad term encompassing machine learning, text mining, image recognition, cognitive computing and natural language processing.

5) Answer D is correct (see section 15.8). Industry 4.0 represents a vision of the future that combines digital transformation, innovation and integration.

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