Banker's Acceptance 101

BY DANIEL KURT | Updated Jul 23, 2019

When a merchant needs financing to buy products, suppliers often rely on the business' reputation when deciding whether to extend it credit. This is relatively easy to do when the supplier has worked with the same buyers for years, or they have a strong standing in the industry.

When the business is half the world away, however, lending can be a riskier proposition. One way to resolve this issue is the use of a banker's acceptance (BA).

How It Works

Banker's acceptances are time drafts that a business can order from the bank if it wants additional security against counterparty risk. The financial institution promises to pay the exporting firm a specific amount on a specific date, at which time it recoups its money by debiting the importer's account.

A banker's acceptance works much like a post-dated check, which is simply an order for a bank to pay a specified party at a later date. If today is Jan. 1, and a

Critical Distinctions

Perhaps the most critical distinction between a banker's acceptance and a post-dated check is a real secondary market for banker's acceptances; post-dated checks don't have such a market. For this reason, banker's acceptances are considered to be investments, whereas checks are not. The holder may choose to sell the BA for a discounted price on a secondary market, giving investors a relatively safe, short-term investment.

BAs are frequently used in international trade because of advantages for both sides. Exporters often feel safer relying on payment from a reputable bank than a business with which it has little, if any, history. Once the bank verifies, or "accepts," a time draft, it becomes a primary obligation of that institution.

The importer may turn to a banker's acceptance when it has trouble obtaining other forms of financing, or when a BA is the least expensive option. The advantage of borrowing is that the importer receives the goods and has the opportunity to resell them before making payment to the bank.

> **Important:** A banker's acceptance is similar to a post-dated check which allows payment at a specified later date.

How to Obtain a Banker's Acceptance

Banker's acceptances can be created as letters of credit, documentary drafts and other financial transactions. If you are trying to obtain an acceptance, approach a bank with which you have a good working relationship. You need to be able to prove or offer collateral against, your ability to repay the bank at a future date. Many, but not all banks offer acceptances. A banker's acceptance operates much like a short-term, fixed-rate loan. You go through a credit check and possibly additional underwriting processes. You are also charged a percentage of the total acceptance to purchase it.

If you are looking to purchase a banker's acceptance for a short-term investment, there is a relatively liquid secondary market for partially aged banker's acceptances. They are normally sold at prices near or below the London Interbank Offer Rate, or LIBOR.

Discounting the Acceptance

To understand banker's acceptances as an investment, it's important to understand how businesses use them in global trade. Here's one fairly typical example. An American company, Clear Signal Electronics, decides to purchase 100 televisions from Dresner Trading, a German exporter. After completing a trade agreement, Clear Signal approaches its bank for a letter of credit. This letter of credit makes the bank the intermediary responsible for completing the transaction.

Once Dresner ships the goods, it sends the appropriate documents — typically through its own financial institution — to the paying bank in the United States. The exporter now has a couple of choices. It could keep the acceptance until maturity, or it could sell it to a third party, perhaps to the very bank responsible for making the payment. In this case, Dresner receives an amount less than the face value of the draft, but it doesn't have to wait on the funds.

When a bank buys back the acceptance at a lower price, it is said to be "discounting" the acceptance. If Clear Signal's bank does this, it essentially has the same choices that Dresner had. It could hold the draft until it matures, which is akin to extending the importer a loan. More commonly, though, it replenishes its funds by rediscounting the acceptance – in other words, selling it for a discounted price on the secondary market. It could market the BAs itself, especially if it's a larger bank, or enlist a securities brokerage to perform the task.

Acceptance as an Investment

Since acceptance is a short-term, negotiable agreement, it acts much like other money market instruments. Like a Treasury bill, the investor buys the bank draft at a discounted price and gets the full face value upon maturity. The difference between the discount and face value determines the yield. In most cases, the maturity date is within 30 to 180 days.

Banker's acceptances do not trade on an exchange, but rather through large banks and securities dealers. As such, most dealers don't supply bid and ask prices, but rather negotiate the price with the prospective investor, often a fund manager.

Pricing of these drafts largely depends on the reputation and size of the paying bank. Those with a strong credit rating can usually sell their acceptances for a lower yield, as they're believed to have little chance of defaulting on their obligation. Institutions that sell a large volume of BAs also enjoy an advantage in this regard.

While banks often sell their acceptances through dealers in New York and other major financial centers, they may use their branch network to supplement sales. The bank's staff will often contact local investors, who are generally interested in smaller transactions, not those of $1 million or more that many fund managers pursue. Local investors often accept a smaller yield and, because the bank circumvents dealers, its selling expenses can be much less.

Risks and Rewards

A banker's acceptance is a money market instrument and, like most money markets, it is relatively safe and liquid, particularly when the paying bank enjoys a strong credit rating. The bank carries primary responsibility for the payment. Because of the tremendous risk to its reputation, if it can't fund an acceptance, most banks that provide acceptances are well-known, highly rated institutions.

However, even if the bank lacks necessary cash to make the payment, the investor receives added protection from other parties involved in the transaction. The importer is secondarily liable for the acceptance, and the exporter has a contingent obligation. In fact, any investors that have bought or sold the instrument on the open market carry any obligation for the draft.

An acceptance provides the opportunity for a modest profit, with yields generally somewhere above those of T-bills. Liquidity generally isn't an issue because most banker's acceptance maturities are between one and six months. And since they don't have to be held until maturity, holders have the flexibility to resell them if they so choose.

Banker's acceptances are issued at a discount to their face value and always trade below face value, much like a T-bills. The holder of a $100,000 acceptance might not want to wait until maturity to receive those funds, so the holder can sell the acceptance to another party for, say, $990,000. While some market risk could be involved for those operating in the secondary market, the high liquidity and short maturity of these instruments make that unlikely.

The Bottom Line

A banker's acceptance can be a sound investment for those seeking to balance higher-risk investments in their portfolio, or for those focusing on asset preservation. On the risk/reward spectrum, a BA is toward the very bottom, just ahead of the Treasury bill.

Because banker's acceptance pricing is negotiated between buyer and seller, investors who do their research stand the best chance of getting a competitive rate. This is especially true given the volatile nature of BA pricing. In the course of a single day, yields can go up or down significantly. As such, it's important to look up yields on a reputable website before making a purchase. In light of the bank's primary obligation for an acceptance, any quotes should reflect its reputation and credit rating.

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