Chapter 5: Financing Alternatives

Financing Alternatives

- Purpose:
  - Introduce the financing alternatives
  - Analyse pros and cons of each alternative
  - Evaluate the efficiency and carry out the right decision for specific circumstance.

Types of trade finance

I. Financing through bill of collection (Eric)

II. Negotiation of bill collection

III. Pre-shipment finance

IV. Post- shipment finance

V. Assignment and Purchase of Trade Finance

VI. Export credit insurance

I. Financing through bill of collection

- The bill for collection, as a method of settlement, is not the most popular with banks due mainly to the volume of documents which they are required to handle and the small commissions they earn.
- Exporters who cannot persuade their buyers to establish documentary credits in their favour are obliged to use the collection, which is the next best thing.

I. Financing through bill of collection

- Importers do not provide immediate payment and many exporters cannot afford to wait up to 1 month or more for settlement of collections.
- Banks are prepared to make advances to exporters secured by documents for collection on a revolving basis.
- The exporter provides the bank with a list of overseas buyers and details of the level of monthly shipments to them.

I. Financing through bill of collection

- Beneficiary of Bill of Exchange: Commercial bank
- Consignee of B/L: Commercial bank

⇒ Bank will check them thoroughly, ensuring that they are properly endorsed so as to give the bank a title to the goods

⇒ and enable it to become an endorsee of the bill of exchange.

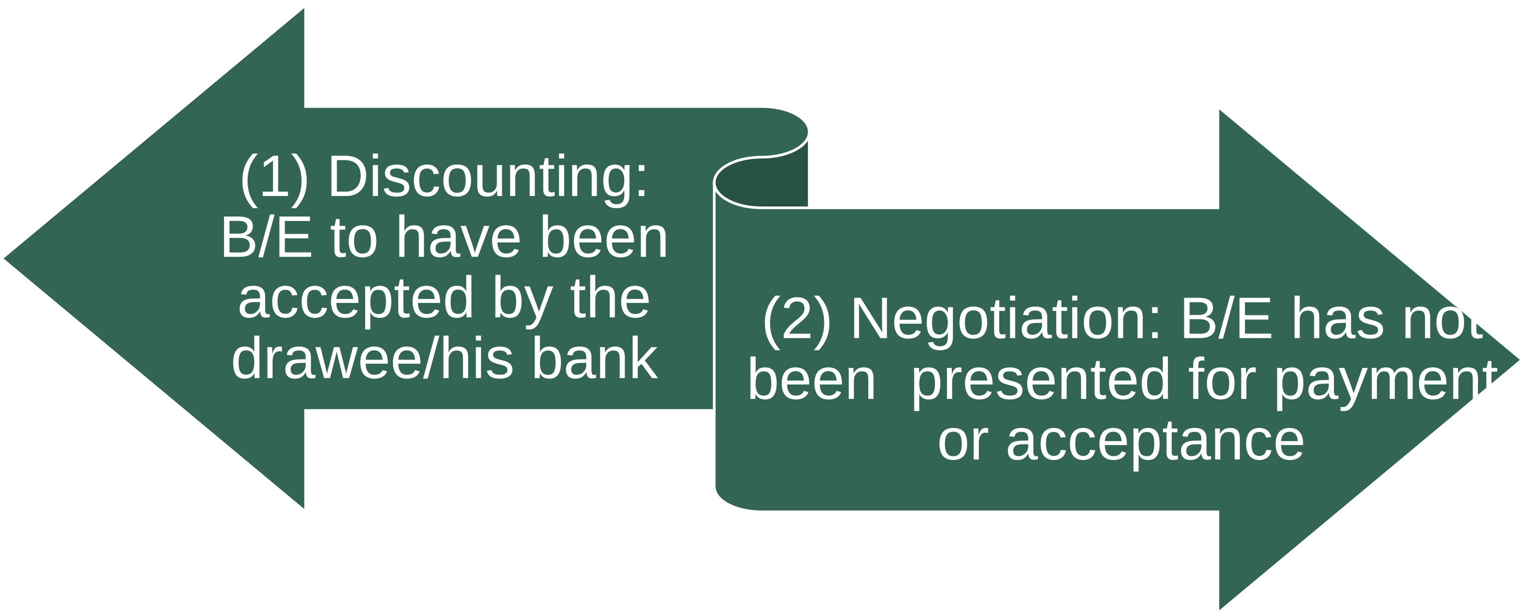
⇒ collecting bank in ensuring immediate notification of payment/non-payment and acceptance/non-acceptance.

I. Financing through bill of collection

- For undoubted exporters, collecting on approved buyers, some banks will advance against collections without seeing the documents, which it allows the customer to send directly to an approved collecting bank.
- It only remains then for the bank to periodically monitor its advances, which are liquidated by direct remittance to ensure that no items are unduly outstanding

II. Negotiation of bills for collection

- The exporter puts together a collection and draws a bill of exchange on his buyer => he is producing a source of finance.
- Banks are always prepared to negotiate collections, which means they actually buy the documents.



II. Negotiation of bills for collection

- Negotiation of bills for collection is different from advances against them in that the exporter or drawer is able to obtain 100% face value of the documents.
- The bank negotiates with full recourse to the drawer and credits him immediately
- When a collection is unpaid and protective action taken, the bank will ask its customer to repay the amount of the negotiation and leave him to deal with any legal action against the drawee, intervention by the case of need and possible resale of the goods

II. Negotiation of bills for collection

- Whenever banks take collections as security, they examine the documents to ensure that they are correctly drawn and by endorsement pass a title to themselves.
- The possibility of non-payment/non-acceptance and the resultant actions required to protect the goods mean that the bank will include protective clauses in its instructions to the collecting bank.
- When a collection is unpaid and protective action taken, the bank will ask its customer to repay the amount of the negotiation

III. Pre-shipment finance

- Exporters preparing consignments for shipment or purchasing goods for resale to overseas buyers
- A number of instruments which assist exporters in this respect:
  - the red and green clause credits
  - advance payment credits

Red clause L/C

- A red clause L/C is a credit with a special clause incorporated into it that authorizes the advising bank/issuing bank to provide a credit facility by way of advance against the L/C for the purchase of raw material or for working capital.
- The clause also stipulates the cover i.e. security for such advance and is incorporated at the specific request of the applicant
- A method of providing the seller with funds prior to shipment of goods → Great value to middlemen that require pre-shipment finance where the buyer would be willing to meet this special request from the seller/beneficiary.

Advance payment

Advance payment is:

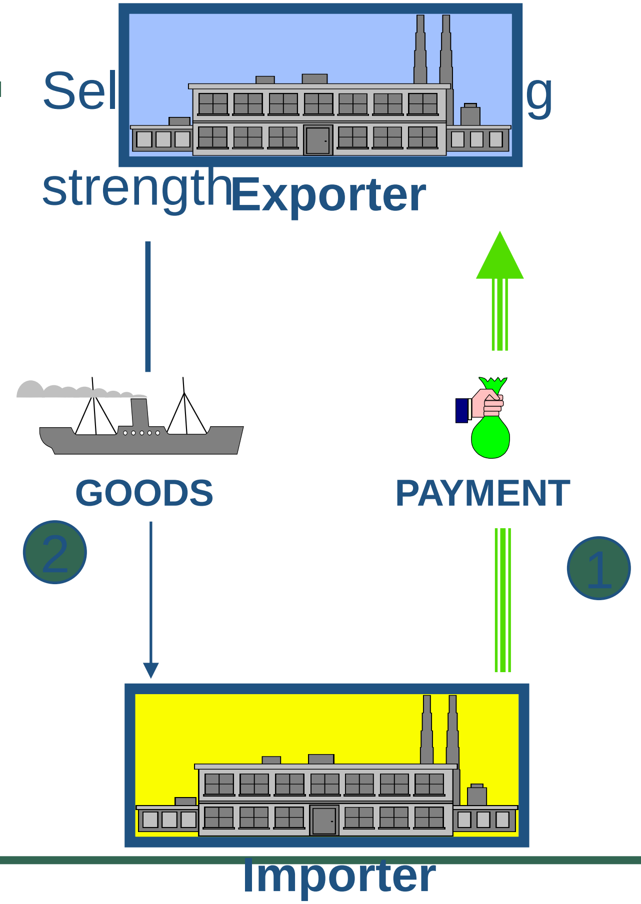
- a method of payment by which applicant (buyer) requires his/her bank to transfer an amount of money to the beneficiary (seller) at a certain place before delivery of goods.
- a method of payment thereby buyer requires his or her bank to remit/transfer an amount of money to seller at seller’s bank.

a- Cash In Advance

PAYMENT IN ADVANCE: The Importer sends payment directly to the Exporter and waits for the Exporter to send the goods and documents.

- Time of Payment
  - Before Shipment
- Goods Available to Buyer
  - After Payment
- Risks to Seller
  - None
- When Appropriate

- Sel g strength



A. FORMULA OF DISCOUNT FOR GOODS

Discount per one unit is calculated as follows:

$$DP = \frac{PA\{(1+R)^N - 1\}}{Q}$$

In which:

- ✓ DP: Discount price/unit
- ✓ PA: Payment in advance
- ✓ R: Interest rate
- ✓ N: time of advance payment
- ✓ Q: Quantity

III. Pre-shipment finance

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- A number of instruments which assist exporters in this respect:
  - the red and green clause credits
  - advance payment credits

=> Not all exporters can get the support

III. Pre-shipment finance

- Banks are able to provide finance in anticipation of eventual receipt of sale proceeds.

- First scenario: term of payment D/P (CFR shipment)

- The bank advances the necessary funds to the exporter provided the goods are dispatched to the bank's order

- The bank satisfies itself the creditworthiness of the overseas buyer and asks the exporter to telex for confirmation regarding the settlement by D/P collection.

- The bank becomes a secured lender and handles the collection as remitting bank.

III. Pre-shipment finance

- Banks are able to provide finance in anticipation of eventual receipt of sale proceeds.

- Second scenario: 60 day D/A collection.(CFR shipment)

- Exporter buys goods from local supplier: Not credit
- Exporter sells goods to overseas buyer: 60 days
- Bank’s decision whether or not to finance:
    - Non-payment risk: B/E accepted by drawee
    - Political risk: => The bank makes its decision based entirely on the political risk and, if it is acceptable, proceeds to arrange finance for the exporter.

III. Pre-shipment finance

Second scenario: 60 day D/A collection.(CFR shipment)

- the bank insists that any goods purchased by the exporter are stored in an approved warehouse against warehouse warrants in the bank’s name.
- That warehouse isappointed to pack the container, have it marked to the overseas buyer and delivered it to the port of shipment by a forwarding agent.
- Bank control the shippings documents and the goods => make sure the export uses advances rightly

III. Pre-shipment finance

- Third scenario:
  - L/C, non- transferable
  - not allow pre-shipment advances,
  - supplier wishes to be paid at sight.
- It is important to stress that a documentary credit cannot itself be assigned and, although assignment of its proceeds is permitted, the fact that a credit is a conditional guarantee means that an assignee must rely on the beneficiary complying fully with its terms.

III. Pre-shipment finance

- In the case which we are considering, the assignment can be executed two ways.
  - The proceeds may be assigned to the exporter’s suppliers, but they will not be paid until documents are presented under the credit.
  - A more satisfactory solution is for the assignment to be in favour of the bank, who can then advance funds to pay local suppliers.

III. Pre-shipment finance

Pre-delivery finance requirements is:

- through existing or additional bank credit limits, without involving the specific sales contract
- and/or the additional security, if any, created by the method of payment
  - L/C: irrevocable, red clause, transferable,
  - D/P
  - D/A
  - Open account/ Clean collection + payment guarantee

IV. Post-shipment finance

- Exporter’s perspertive:
- Importer’s perspective:

IV. Post-shipment finance

- Whatever the means are by which an importer expects to be paid by his buyers, and despite any credit he is extending to them, banks can generally finance the gap between import and final receipt of proceeds.

IV. Post-shipment finance

- In many cases, credits are issued covering goods consigned direct to countries outside the applicant’s country of residence; this is trading or merchanting and it can only be financed if the issuing bank is satisfied with the method of payment by the foreign buyer.
- Although the procedures are similar to those applied to domestic sales, the possibility of political risk arises.

IV. Post-shipment finance

- Consequently an issuing bank relying on a foreign credit or a collection has to assess that risk before entering into the transaction. It may, for example, insist that the foreign credit be confirmed or that a collection be avalized and any insurance on the buyer assigned to the bank.

V. Assignments and Purchase of Trade Receivables

- This type of facility, which is operated by **both banks and factoring companie**s, does not rely on the use of bills of exchange.
- It is a straightforward financing of an exporter’s book debts.
- The main features are that the bank or factoring company is providing credit to exporters and buyers against the security of the exporter’s claim on the overseas buyers in open account trading.

V. Assignments and Purchase of Trade Receivables

- It is a revolving facility linked to the value of total debts outstanding at any one time and credit is given for an agreed percentage of those debts.
- There are, however, important differences between the facilities operated by banks and those operated by factors.
- *First and foremost, banks provide credit to the seller (exporter) and factors provide credit to the buyer (importer)*

VI. Export credit insurance

- **Export credit** refers to the credit that the seller offers the buyer in the contract for sale of goods and services (ie a supplier credit) or credits given to finance such a sale (ie a buyer credit).
- Export credit insurance is normally divisible into commercial and political risks.

VI. Export credit insurance

- **The commercial risk** is that which rests with the buyer, ie their ability to pay for what has been purchased.
- **The political risk** is that associated with the buyer's country and includes losses arising from such events as *the cancellation of an import licence, war and the prevention by the authorities in the buyer's country of the transfer of the foreign exchange required to pay the seller.*

VI. Export credit insurance

- **Many forms** of export credit insurance have been created to ***cover different parts of the transaction***, for example coverage from shipment only or also including the production period.
- Each insurance cover is based on special terms and conditions, which the seller has to check with the preconditions applicable to the individual transaction.

Risks not covered by export credit insurance

- Export credit insurance cover is, in principle, limited by two main factors:
- 1) the percentage of coverage, or inverted, the uninsured percentage that the seller is not allowed to lay off to any third party; and
- 2) the qualifying period – the period before settlement of the claim takes place.

VI. Export credit insurance

VI. Export credit insurance **(Anders Grath)**

6.1 Definition

6.2 Risks not covered by ECI

6.3 The private sector insurance market

6.4 Standard export credit insurance

6.5 Export credit agencies (ECA)

6.6 Some general principles of ECAs

6.7 Different forms of insurance/guarantees

6.8 Export credit insurance – a summary

Export Credit Agency - SUMMARY

It is generally recommended that the exporter should establish a basic risk strategy and a policy on how to make use of insurance cover when the commercial/political risks involved cannot be fully covered through the proposed or agreed terms of payment.

The private insurance market covers primarily short-term commercial risk, sometimes in combination with political risk, but mainly for shorter periods up to two years, and is most competitive for a package of export risks and not just individual transactions.

The export credit agencies generally only cover the longer periods, with a minimum of six months up to two years, depending on the status of the importing country, where the private insurance market is less competitive. However, for most OECD countries (with some exceptions) they are only allowed to cover the commercial risk on periods of two years and more.