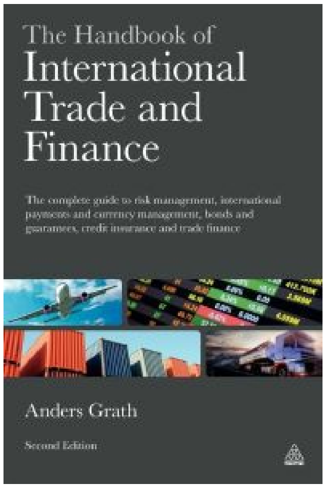

Book The Handbook of International Trade and Finance

The Complete Guide to Risk Management, International Payments and Currency Management, Bonds and Guarantees, Credit Insurance and Trade Finance

Anders Grath
Kogan Page, 2012
First Edition:2005
Listen now

- play
- pause

00:00
00:00

Recommendation

International trade and trade finance are specialized sectors of business and banking, requiring particular knowledge and expertise. Here, trade expert Anders Grath provides a compact, complete guide to the fundamentals of this crucial aspect of global commerce. Grath walks you through the basics of risk management, financing techniques and payment methods that ensure safe and profitable import and export transactions. Though somewhat dry, his clear information is crucial for any firm buying and selling internationally. *BooksInShort* recommends Grath's guidance to bankers, entrepreneurs or executives involved in overseas trade.

Take-Aways

- Buying and selling across national borders adds layers of new risks to business.
- The hazards in international trade transactions include "product, commercial, adverse business, political, currency" and "financial" risks.
- Any exporter's goal is swift and safe payment.
- Buyers must make sure their suppliers are reliable.
- The International Chamber of Commerce sets international trade rules and standards.
- Depending on the transaction, international trade uses one of four payment methods: "bank transfer, check payment, documentary collection and letter of credit" (L/C).
- "Bonds, guarantees and standby L/Cs" commit banks to pay based on a sales contract.
- Firms working overseas must manage their foreign currency exchange exposure.
- When the risk is too great for standard terms, importers and exporters turn to the export credit insurance market.
- International banks or trade organizations can assist clients in structuring trade deals.

Summary

International Trade

Buying and selling beyond your national borders add a layer of new risks to those of day-to-day domestic business. For all the technological advances that seemingly shrink the globe, transacting from a distance with an unknown customer or supplier still presents major headaches, and even potential losses. You must identify and plan for anything that could go wrong.

"Sell more – win market share – enter new markets...the problem is often not making the sale but ensuring that you get paid."

This risk-identification process begins with your first business negotiation with a counter party. If you're the vendor, you want to get terms that maximize your profits while curtailing your risks. You might have to compromise if you're competing with others for a sale. As a buyer, you want to ensure that you're dealing with a reputable and reliable supplier who will deliver the products you want in a timely fashion.

"Each area of international trade requires its own knowledge...from the first contacts between buyer and seller to final payment."

To provide common standards for trade in the cross-border market – beyond the reach of national laws and regulations – the International Chamber of Commerce (ICC) establishes the rules of global trade and investment. Its members include firms of all sizes in various industries and fields in more than 130 countries. As "the world's only truly global business organization and...the voice of international business," the ICC sets procedures and policies governing delivery, financing and payments, and establishes nomenclature for common trade terms that define delivery and payment conditions. It issues International Commercial Terms ("Incoterms") that guide all parties in interpreting expressions found in trade contracts, such as "delivered duty paid" (DDP), "cost, insurance and freight" (CIF), and "free on board" (FOB). In addition to defining the terms of delivery and the terms of payment, any cross-border agreement should account for the "commercial documentation and official requirements" necessary to effect a smooth sale.

Trade Risks

While different kinds of business dealings present different types of complexity, several distinct categories of risk can arise in an international trading transaction:

- **"Product, production and transport risks"** – These risks concern the proper operation and performance of a product and its delivery, as well as its maintenance and warranties. Large projects or an ongoing series of transactions amplify these risks, as does the customization of an order for a particular client: If the buyer reneges, the seller may not find alternate buyers for the special order. The conveyance of goods should be clear from the contract; for instance, both buyer and seller must explicitly state at which point cargo insurance takes effect to avoid a scenario where, say, cargo gets damaged in transit but insurance coverage doesn't kick in until delivery.
- **"Commercial risks"** – As a seller, you assume the risk of a client failing to execute the trade contract due to bankruptcy or other failings. Thus, you should obtain and analyze credit information about your buyers. A number of internationally recognized firms, such as Coface, D&B and Experian, provide exporters with commercial and financial data on importers.
- **"Adverse business risks"** – Bribery, money laundering and "facilitation payments" present challenges to firms that may be unfamiliar with local practices or criminal activity in overseas markets. Companies should watch for suspicious transactions when dealing with new clients or with existing customers who alter their usual ways of doing business. Among the variety of giveaways that signal potentially shady practices, look for "unusual payment settlements," "secretiveness" and "complicated accounts structures."
- **"Political risks"** – Unexpected governmental actions "along the route of transport" can present sellers with extraordinary risk. Revisions in taxes, import levies or currency movements can render a sales contract inoperable, as can new trade barriers, environmental clauses and product criteria. Reports on a country's political, social and economic situation from third-party providers can give exporters advanced knowledge about the market they're entering.
- **"Currency risks"** – When an exporting company sells in a foreign currency, it faces a currency exchange risk. Fluctuations in the value of the buyer's currency relative to the sellers' could endanger the transaction's profitability. With globalization, much of the world's trade now takes place using the US dollar and the euro, as well as other "strong currencies," such as the Japanese yen and the Swiss franc.
- **"Financial risks"** – Every aspect of a business transaction involves financing risks, which increase "in line with the prolonged commercial and/or political risk." Trade parties should clearly express the terms of payment and time frames in their sales contracts so they don't incur liquidity problems or capital losses.

Show Me the Money

The end goal for any exporter is swift and safe payment. Ideally, notwithstanding competitive pressures, a seller generally prefers payment – in order of security – first, by "cash in advance before delivery"; second, through a "documentary letter of credit"; third, via a "documentary collection"; fourth, by a "bank transfer (based on open account trading terms)"; and fifth, through "other payment or settlement procedures, such as barter or countertrade." In reality, four "methods of payment" are most common, based on a transaction's characteristics:

1. **"Bank transfer"** – In most trading transactions, a seller advances goods to the buyer, who instructs a bank to pay the seller. This "open account" method is based on a pre-existing sales contract between the two parties, and the seller sends an invoice after shipping the product. These "clean payments" constitute "more than 80% of all commercial international payments." Most cross-border trade happens regionally, so proximity allows for this relatively unsecured selling practice to dominate.
2. **"Check payment"** – Though electronic payments have all but eclipsed the use of checks in international trade, a small percentage of firms still use them. Risks include postal and funds availability delays. Sellers and buyers should agree in their contracts on whether they'll use bank or corporate checks.
3. **"Documentary collection"** – In this payment, banks act as intermediaries and present the seller's shipping documents to the buyer as proof of merchandise transfer. The buyer pays based on the documents, not necessarily on verification of the goods themselves. To mitigate risk, buyers can contract for an inspection prior to payment.
4. **"Letter of credit (L/C)"** – In a documentary credit, a buyer asks a bank to issue an L/C in favor of a seller. The issuing bank must pay the seller once it receives and verifies the proper "complying presentation" of documents underlying the trade. Though an additional expense for the buyer, the L/C gives the buyer assurance that the seller has fulfilled the contract. Similarly, the seller no longer bears the risk of the buyer not paying, because the bank has a binding obligation to pay. The bank must pay based only on documents, not physical goods. All parties need to be vigilant against fraud. The L/C must specify a "period of validity," a "time for payment" and a "place of presentation of documents." If the selling company doesn't know the issuing bank, it can request that its own bank add its confirmation to the L/C. The confirming bank takes on the risk of the issuing bank.

   "An international trade transaction...is not completed until delivery has taken place, any other obligations have been fulfilled and the seller has received payment."

"Bonds, guarantees and standby L/Cs" are forms of surety in multipart deals that counter parties usually can assume will cover "installation, future performance, warranty periods" and long-term projects. These undertakings – the three are essentially the same, though US regulations preclude American banks from issuing guarantees, so they issue standby L/Cs instead – commit a bank to pay according to the terms of a contract. Companies vying for big contracts usually need to present "bid bonds" to demonstrate their ability to execute should they win. "Performance guarantees" assure a buyer that a seller will act as the sales contract demands.

"Currency Risk Management"

Corporations that do business overseas need to manage their currency exposure. They buy and sell currencies in the foreign exchange market, usually through a bank, to settle their trade transactions. A "spot trade" means you can buy or sell a currency against another currency at the current price; payment and delivery of the money happens two days after the trade. To lock in a price on a currency for a future need, as most international trade deals require, you can get a "forward contract" that specifies how much of the currency you need and on what date. That contract gives you a price today for your future receipt or delivery of the currency.

> "All forms of business contain elements of risk, but when it comes to international trade, the risk profile enters a new dimension."

Consider various factors when determining which currency to invoice. Unless your deal is in US dollars or euros, think about whether the currency is stable, "freely convertible and actively traded." Those criteria make it easier to get the amounts you'll need when you need them, and at the right prices.

> "Documentary payment through banks is a matter of dealing in documents and not in goods or services."

Different firms handle currency exposures in different ways: Some attempt to lessen their exposure at all times. Others have preset limits on how much risk they'll take and hold in each of the currencies they use for transactions. Companies can hedge their foreign exchange exposures by using forward contracts, currency options and currency swaps.

Export Credit Insurance

When the risk is too great for standard terms of trade and payment, importers and exporters turn to the export credit insurance market. Both parties can approach either private insurance companies, which will indemnify against political risk in short-term deals, or government-sponsored "export credit agencies" (ECAs) for more extended transactions.

> "Ask for help or assistance from your bank or the domestic trade organization when it comes to detailed terms of payment."

These official entities encourage national exports. Most developed and developing countries maintain ECAs – for instance, the United States' Exim Bank and Switzerland's Swiss Export Risk Insurance SERV – that are responsible for handling projects and transactions that the private market may be unwilling to insure. To prevent ECAs from undercutting one another in a race to the bottom, the Organization for Economic Co-operation and Development (OECD) regulates the types and tenors of export credit under the "Consensus" agreement. ECAs offer many financing options, including pre-export guarantees, foreign currency insurance and supplier credits.

Standard and Structured Trade Finance

Companies finance trade deals in various ways. Banks normally extend credit lines for trade transactions for up to 180 days. Long-term financing is also available. Banks regard trade finance as a more secure loan, because the extension of credit is "self-liquidating" – that is, the cash flows of the deals themselves repay the loans. To finance trade-related operations, sellers can secure "pre-shipment finance" or "working capital insurance and guarantees." For the same purpose, buyers can obtain short- and long-term credits. Financial institutions also extend credit in exchange for other kinds of security, such as invoices, short-term receivables, "factoring," and discount trade bills.

> "In every new transaction, one has to take it for granted that, from the outset, the parties will have different views about the various aspects of the terms of payment."

Structured trade finance underwrites complex cross-border operations. International leasing requires specialized financing with particular legal, tax and documentary aspects. Project finance develops long-term infrastructure programs and physical plants overseas. These undertakings can last 20 years, with repayment coming from the proceeds of the project itself. Multilateral development banks, such as the World Bank's International Bank for Reconstruction and Development (IBRD), either directly finance or act as credit conduits for developing countries' investments in education, health, telecommunications and infrastructure. Many regions have set up their own development banks, such as the African Development Bank, the Islamic Development Bank and the Nordic Investment Bank. The European Bank for Reconstruction and Development (EBRD) sponsors projects to benefit small businesses in Central Europe and Central Asia, providing guarantees and credit for deals that bolster the local private sector.

Don't Go It Alone

Global trade generally operates with precisely defined terms and rules promulgated by supranational organizations. Complicated deals, long-term projects and unfamiliar countries can challenge any exporter. Consult with banks that operate internationally or with your local trade organization for information and counsel on how to conduct your international trade transactions securely and profitably.

> "Bribery, money laundering and any other form of corrupt behavior is bad for business; it distorts the normal trade patterns and gives unfair advantages to those involved in it."

About the Author

Anders Grath, a banker and trade finance specialist, is a consultant to banks and trade councils in Europe.