TRADE FINANCE - A USER GUIDE

This user guide is intended as a reference work for practitioners of Trade Finance and has been written for intended audiences in the United Kingdom and North America. Some of the practices mentioned herein may be related to regional or country and not applicable on a global basis.

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Overview of Trade Finance – History and importance in Banking

Many Banks have been founded to support the trading of their local customer base. The products that we still use today were used hundred years ago to assist the banks customers increase their sales and market share; products like loans, overdrafts, guarantees and the avalisation of Bills of Exchange were irreplaceable aids to the businessmen who wanted to carve a market for their products and obtain the cash flow funding needed to manufacture and ship to their buyers.

As the local markets dried up in terms of new business opportunities, the canny businessmen of the time looked further afield to international markets. This expansion brought with it many new challenges. The logistical problems of physically moving their goods across the seas and obtaining payment from foreign buyers became the focus of their attention.

To address this issue the business community turned to their bankers. Bills of Exchange had been in existence since the 14th century and were used as a way of transferring money without physically moving large boxes of coins, or the recently developed paper money. The Bill of Exchange was a simple document, drawn by the seller on the buyer for a fixed sum payable on a fixed date. Its main benefit was that it was negotiable and transferable. By a simple notation on the reverse, the seller could transfer his rights under the Bill to another party. In this was, the merchant bankers could purchase the Bill from the seller at the time of shipment (usually for a discounted figure, taking into account the period of time before the buyer would repay them and also the risk premium in case payment was not forthcoming).

Now banks at this time were no more adventurous when it came to risk than they are today, so they devised a method to reduce the payment risk posed by the foreign buyer. Prior to the underlying shipment taking place, the seller's bank would forward the completed Bill of Exchange to the buyer's bank for acceptance by the buyer and also endorsement by the buyer's bank. This endorsement read:

"Bon pour aval"

This, loosely translated as "Guaranteed for payment", became know as a bank Aval. This transferred the risk of payment from the buyer to that of the buyer's bank, which was preferable. Thus, for the first time, two banks in two countries were assisting the financing of international trade.

Where are we today?

Over the succeeding centuries, the advancements in shipping techniques, developments in maritime law, contract law and the veritable explosion in the sophistication of the manufactured goods being moved around the globe have brought new challenges to the banking community that supports this business.

The banking products that are used today have been developed and honed over many years of use to protect all parties in international trade and assist with the movement of goods and the payment thereof. We will now look in some depth at these products and at their benefits and limitations.

Documentation supporting International transactions

As the complexity of International transactions has increased, so has the documentary requirements supporting them. In this section we will look at the major documentary requirements and the roles they play :-

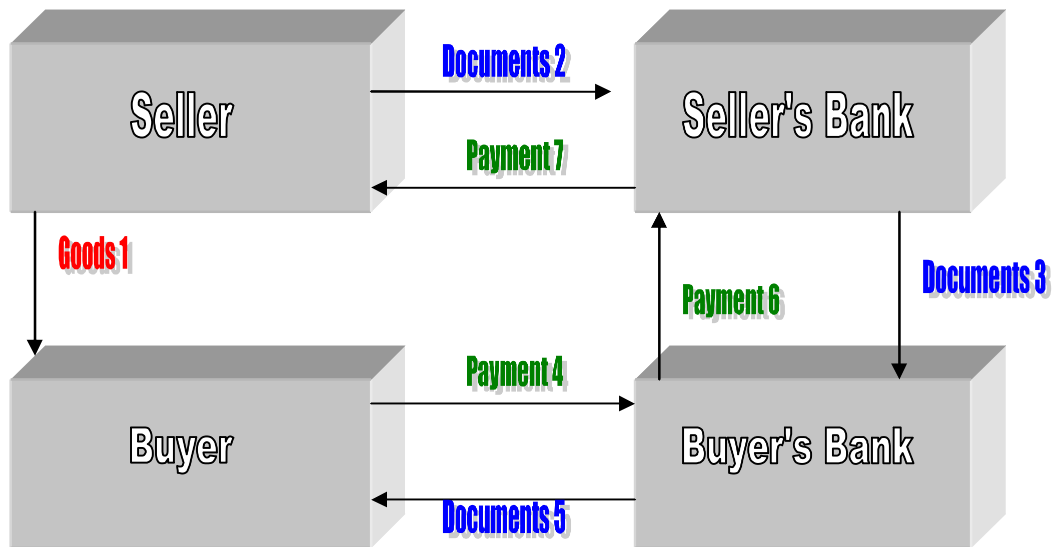
Document	Purpose
Bill of Exchange (Draft)	Issued by the Seller (Drawer) to the Buyer (Drawee), shows amount due in figures and in words and the payment due date, either as a fixed date, a future date or at sight.
Commercial Invoice	Issued by the Seller to the Buyer, details goods shipped, individual prices, total value, shipping terms, sales terms etc.
Bill of Lading	A negotiable document of title covering shipment by sea. Will show the shipper, consignee, notify party, description of goods along with their net and gross weight and piece count, port of loading and unloading. Bills of Lading are normally issued in sets of three originals (in case of loss). The holder of a Bill of Lading (if “to order” or through endorsement) has title to the goods and can obtain their release upon presentation of the originals.
Air Waybill	Performs the function of a Bill of Lading but for air shipments. An Air Waybill is not a document of title and is not negotiable. It will show many of the details contained in the Bill of Lading.
Certificate of Origin	Certifies as to the origin of the goods. Most nations have pre-printed forms provided by Chambers of Commerce that are accepted internationally as evidence of origin.
Packing List	Normally provided by the seller on his headed paper, this document provides details of individual weights and dimensions as

well as packing specifications as called for in the sales contract.

Insurance Certificate	If, under the contract, the seller is responsible for insuring the transport of the goods he will have to provide evidence of insurance. The Insurance Certificate is normally issued against an "Open Cover" policy and details the goods, insured value, details of the shipment, risks covered etc. Exclusions are contained in the underlying Policy. The Insurance Certificate is also negotiable and can be endorsed by the insured to another party who becomes the beneficiary of the cover by endorsement.
Shipment advice	Where the buyer is responsible for insurance, he often requires detailed notification of the shipment to arrange adequate coverage with his broker/insurer.

Clean and Documentary Collections

A Clean Collection is one where the only document presented for payment is the Bill of Exchange. A Documentary Collection covers the presentation of all shipping documents. Here is the life-cycle of a Documentary Collection:



Following the flow above we see the following:

Goods 1	Seller ships his goods to the buyer
Documents 2	Seller sends shipping documents to his Bank for collection
Documents 3	Sellers Bank sends documents to Buyers Bank
Payment 4	Buyer remits funds to his Bank
Documents 5	Buyers Bank sends documents to Buyer
Payment 6 and 7	Funds are transferred to the Seller via his Bank

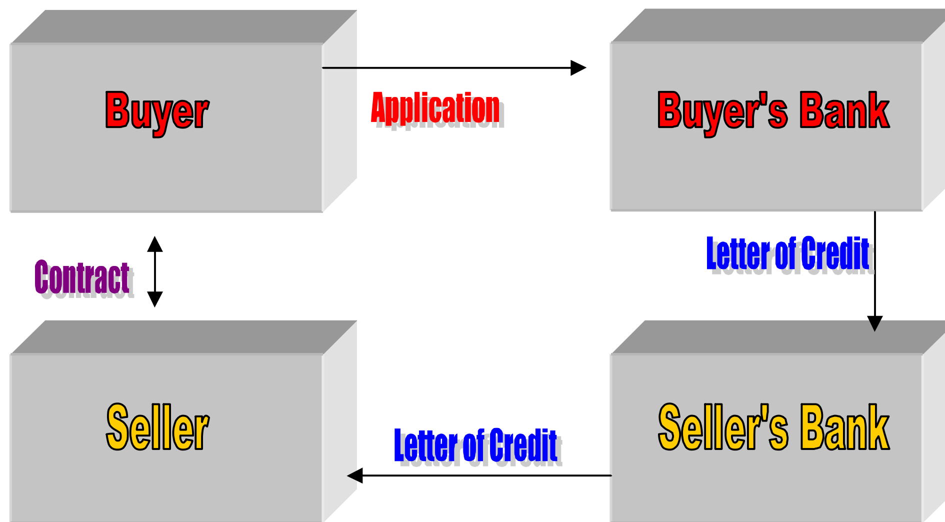
Benefits to the Buyer and Seller

The use of a Documentary Collection is normally undertaken between parties that have already established a trading history and there is a certain amount of trust built between them. The main benefit to the Seller is that the Buyer cannot get hold of the documents until he has paid for them (or accepted a Bill of Exchange to pay at a future date if that is

the underlying payment agreement). The Buyer benefits from not having to pay for the goods in advance.

Letters of Credit

Whereas Documentary Collections are used by parties who have built some level of trust in their dealings, Letters of Credit are used primarily by Buyers and Sellers where that trust is yet to be established. This method of financing trade has been developed over the years to provide the maximum benefit to both Buyer and Seller by removing the corporate risk of payment and the shipment of goods other than those ordered. This has been achieved by placing, again, two banks between the contracting parties and those banks deal solely in the documents as presented under the Letter of Credit without being influenced by the goods or the underlying contract. The following diagram shows the flow of the Letter of Credit process from the Application, to issuance and advising to the Seller:



The original Application for the Letter of Credit is completed by the Buyer, reflecting the terms in the underlying Contract. In Letter of Credit parlance the Buyer is known as the Applicant and the Seller is the Beneficiary. The Buyer's Bank will draft the Letter of Credit in accordance with the Application and send it to the Seller's Bank. If the Seller's Bank (known as the Advising or Confirming Bank) is not adding their Confirmation, they will forward the Letter of Credit to the Beneficiary.

What do the Banks add?

At this point, let us look at the possible role of the Banks. In the above paragraph we mention that the Sellers Bank can act as either the Advising Bank or the Confirming Bank. This alludes to the two possible roles that the Seller's Bank can play in this process. By merely being an Advising Bank, they are passing on the terms of the Letter of Credit to the Beneficiary without any undertaking on their part; by adding their Confirmation they are taking on the same obligations as that of the Issuing Bank (Buyer's Bank).

Within the body of the Letter of Credit will be an undertaking from the Buyer's Bank that provided they receive documents strictly in accordance with the terms and conditions of the Letter of Credit, then that Bank will effect payment or acceptance. When the Advising Bank adds their confirmation, this wording is mirrored in the covering letter to the Beneficiary as follows:

"This Letter of Credit bears our confirmation and we hereby undertake that upon presentation to us of documents strictly in compliance with the terms and conditions of this Letter of Credit we shall effect payment/acceptance in accordance with your instructions"

The confirmation by the Advising Bank does not merely reduce the Buyer risk for the Seller; a full Confirmation provides the following benefits:

1. The Seller will be dealing with a Bank in his own Country (usually in his own town or city) and therefore will be saving time in the presentation of documents, working within his own domestic market place with no language or foreign practice problems.
2. The Confirming Bank will be taking on the credit risk of the Issuing Bank as well as county/political risk

As you can see, the benefits to the Seller are considerable. The Confirming Bank will calculate the fee payable for its undertaking and charge the appropriate party (as stated in the Letter of Credit).

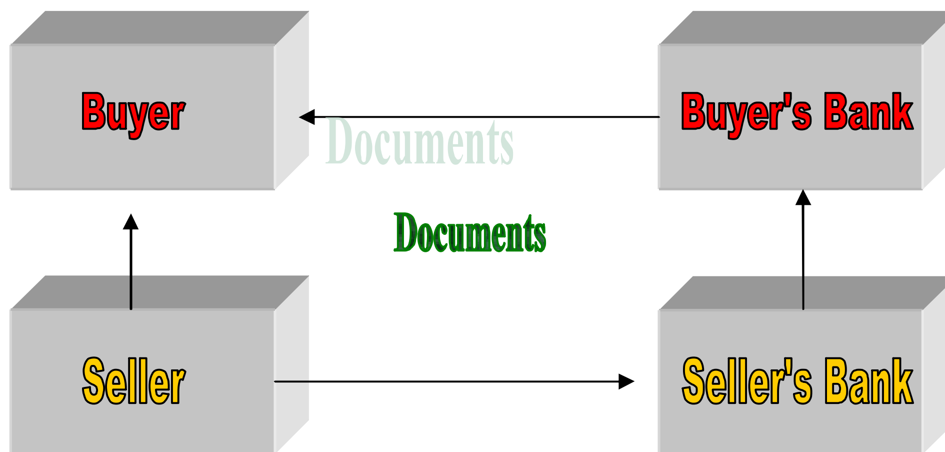
Revocable vs. Irrevocable

A Revocable Letter of Credit means that the Letter of Credit (in total or in part) can be amended or revoked at the request of the Applicant without approval from the Beneficiary. It is very unusual nowadays to receive a Revocable Letter of Credit as it provides very limited security for the Seller. An Irrevocable Letter of Credit requires the consent of both the Buyer and Seller for any amendment or cancellation

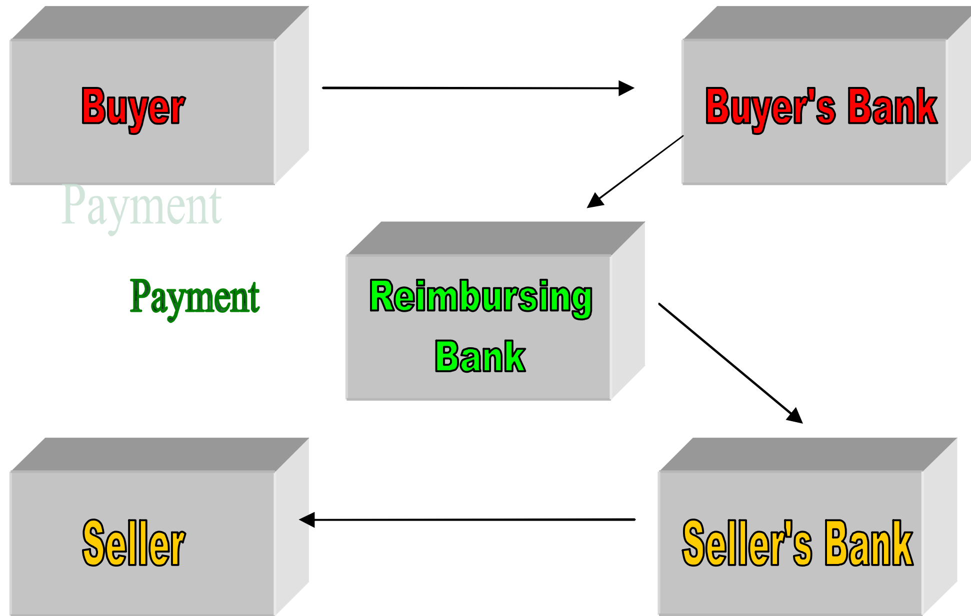
Shipment – Documents and Payment

It is incumbent on the Beneficiary to carefully check the terms of the Letter of Credit are consistent with the terms of the underlying Sales Contract. If there is any conflict, the Beneficiary can request an amendment directly from the Applicant. Once issued, the amendment becomes an integral part of the Letter of Credit.

Now that the Seller has a fully acceptable Letter of Credit in his favour he can move to the next step of preparing his merchandise for shipment. Once shipment has been effected, the Seller will complete all of the documentary requirements of the Letter of Credit and present them to the Advising/Confirming Bank. The following shows the document flow:



The documents are presented by the Seller to the Advising/Confirming Bank who check them against the terms of the Letter of Credit. If correct, the documents are then sent to the Issuing Bank who forward them to the Buyer. It is also common that the Letter of Credit will require the Seller to forward some documents (copy of Invoice, Bill of Lading, advice of shipment etc.) directly to the Buyer. Payment for the documents flows in the opposite direction as follows:



You will notice at this point that another bank has been introduced during the payment cycle. It is often the case the Letter of Credit is denominated in a currency other that of the country of the Issuing Bank (US Dollars for example). In this case the Letter of Credit will authorize the Advising/Confirming to claim the funds from the Reimbursing Bank which is the account holder of the Issuing Bank for that particular currency. Notification will have to be sent from the Advising/Confirming Bank of their intention to claim from the Reimbursing Bank giving sufficient time to allow the Issuing Bank to place sufficient funds in the account. This is known as the Reimbursement Period and can be anything from two to ten working days.

Once the Seller's Bank has claimed reimbursement and received the funds, it will deduct any charges payable by the Seller and remit the balance to the Seller in accordance with his instructions. If the Seller's Banks charges are payable by the Buyer, then these will be claimed over and above the documents value from the Issuing/Reimbursing Bank.

The "Red Clause" Letter of Credit

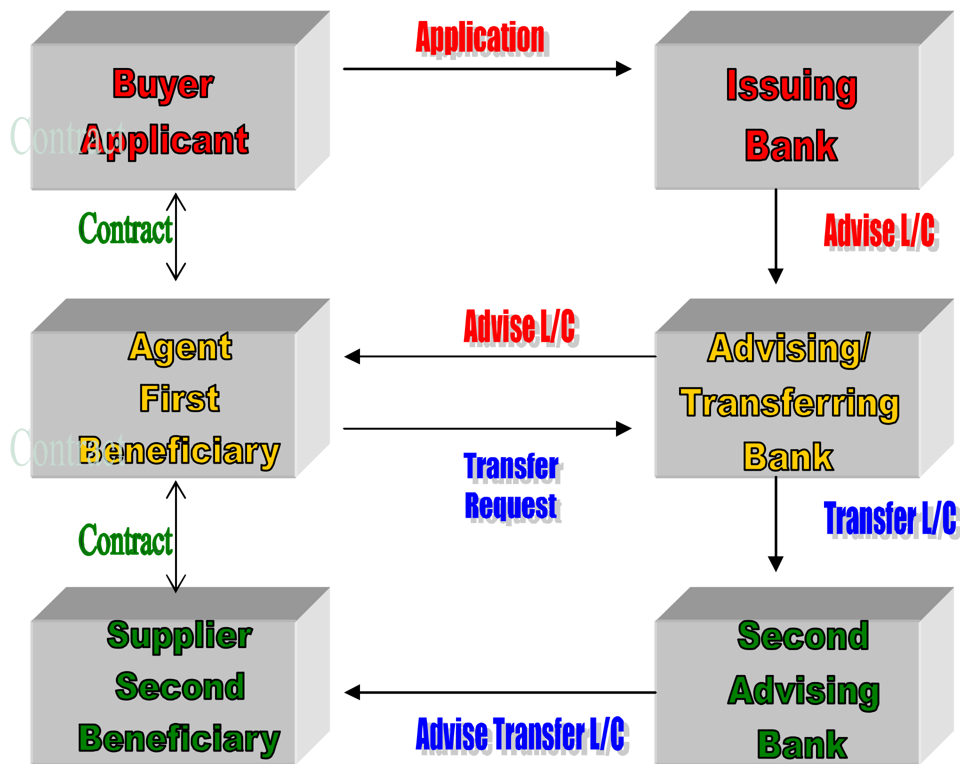
This type of Letter of Credit was introduced to provide pre-shipment finance to the exporter. A clause was added to the Letter of Credit to the effect that a certain amount, or percentage of the Letter of Credit value, was available for immediate drawdown against an invoice and simple receipt. These funds would be used by the exporter for costs associated with manufacturing/delivery the goods to the load port.

The Red Clause Letter of Credit was originally used by sheep farmers in Australia who faced the high cost of shipping their sheep from the Australian interior to the load port on the coast. By drawing the advance funds from the Letter of Credit they were able to finance this part of the shipment and allow the sheep to be exported. The reason it is called a Red Clause Letter of Credit is simply that, originally, the clause relating to the advance funds was written in red ink.

Transferable Letters of Credit

If you are fulfilling the role of agent/middle man in an export transaction you are faced with a number of problems. As you are not the supplier of the goods or services you have to provide a suitable payment structure to that supplier whilst retaining control of the flow of funds so that your margin can be extracted from the proceeds. This is where a Transferable Letter of Credit is used.

A Transferable Letter of Credit will state that it is transferable and is issued in favour of the agent/middle man. Upon receipt, he can then request that a portion of the Credit value/benefit be transferred to the actual supplier. In this way, the supplier will receive all the benefits of exporting against a Letter of Credit and the agent/middle man controls the flow of funds upon successful negotiation of the documents. The following diagram shows how the process works:



The Applicant sends the application to the Issuing Bank requesting that a Transferable Letter of Credit be issued in favour of the Agent. The Advising Bank reviews the Letter of Credit for authenticity and workability and advises to the Agent, who is known as the First Beneficiary. The First Beneficiary, after checking the Letter of Credit for compliance with the underlying contract, forwards a transfer request to the Advising Bank. There are certain things that can be changed in the transfer to the Second Beneficiary, these are:

- the amount of the Letter of Credit
- any unit price stated therein
- the expiry date
- the last date for presentation of documents
- the period of shipment

The intent of the First Beneficiary is to receive documents under the transfer portion from the Second Beneficiary in ample time to allow him to also present the documents under the main Letter of Credit.

The Advising Bank will advise the transferred portion to the Second Beneficiaries bank who, in turn, advise the Second Beneficiary. To illustrate how the transfer operates, let's look at some of the specifics of the main Letter of Credit and compare them to those of the transfer portion:

Main Letter of Credit	Transfer Portion
Value US$1,000,000	US$900,000
Goods 1,000 units Piping	1,000 units Piping
Unit cost US$1,000	Unit cost USD900
Expiry date: 30.09.2005	24.09.2005
Presentation days 21	15

From this, we can deduce the following:
The actual cost of the goods from the Supplier is US$900,000 at a unit cost of US$900 each. The Agent (First Beneficiary) has marked-up the sale price to the end Buyer (Applicant) by US$100 per unit for a total gross profit of US$100,000

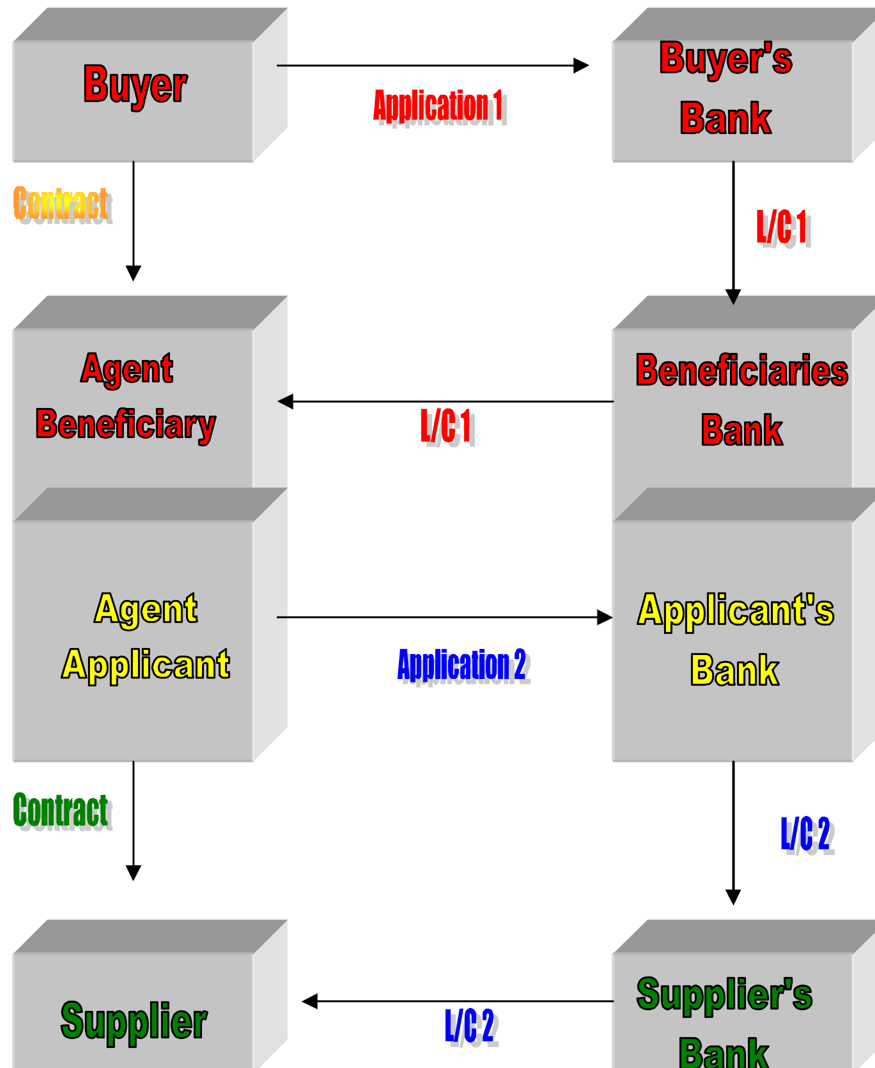
The Second Beneficiary ships the goods directly to the Applicant and presents his documents to the Second Advising Bank where they are checked against the terms of the Transfer Portion of the Letter of Credit. If the documents are correct, they are forwarded to the First Advising Bank. The First Beneficiary is notified of their receipt and he forwards his replacement Invoice to the First Advising Bank showing the increased goods value. These documents are then checked against the main Letter of Credit and, if correct, reimbursement is claimed. Because the payment flows into the First Advising Bank, they pay the Second Beneficiary and the First Beneficiary their respective sums.

You will have noticed that the details of the end buyer (the Applicant) are contained in both the Main Letter of Credit and the Transfer Portion, so that the actual Supplier (Second Beneficiary) will become aware of the party that the goods are being sold to. These types of Letter of Credit are therefore normally used where the First Beneficiary has an exclusive distribution contract with the Supplier for a certain geographic region, otherwise the Supplier can contact the Buyer directly and cut out the Agent.

For those transactions where the Agent does not want details of the end Buyer to be known to the Supplier, hew would use a Back-to-Back Letter of Credit.

Back – to – Back Letter of Credit

This transaction is supported by two separate Letters of Credit. Instead of transferring a portion of the benefit of a transferable Letter of Credit, the Beneficiary (Agent) issued a second Letter of Credit to the Supplier as follows:



There are two separate underlying contracts here. The first contract is between the Buyer and the Agent. The Agent then sources the supply of the goods and issues a second contract to the Supplier. It is vitally important that the terms of both of these contracts comply with each other. Once the contracts are in place, the Buyer will forward an application for the issuance of a Letter of Credit to his Bank, and they, in turn, will issue the Letter of Credit in favour of the Agent through his Bank. Once this has been received and checked against the terms of the first contract, the Agent will forward his own

application for the issuance of a second Letter of Credit to his Bank who will issue the second Letter of Credit in favour of the Supplier through his Bank.

So now we have two Letters of Credit; the Agent is the Beneficiary of the first Letter of Credit and the Applicant of the second Letter of Credit. Because the Agent will be utilizing some of the documents presented under the second Letter of Credit to also present under the first Letter of Credit, it is again imperative that the terms of both Letters of Credit are very carefully structured. Using this structure, it is possible for the Agent to hide both the identity of the Buyer and the final sales price.

From a banking perspective, it is very unusual today that a bank acting for the Agent will rely solely on the payment of the first Letter of Credit as collateral for the issuance of the second Letter of Credit. It is entirely possible that the Supplier will provide credit complying documents under the second Letter of Credit and the Agent fails to do the same under the first Letter of Credit. It is for this reason that RBC insists on other collateral (usually 100% cash deposit) for the issuance of the second Letter of Credit.

Assignment of Proceeds

Another method of paying a Supplier is for the Beneficiary of a Letter of Credit to assign a part of the proceeds. The Beneficiary (Agent) will provide written, irrevocable instructions to the Advising Bank to the effect that upon successful negotiation and payment of documents under the Letter of Credit, the Bank is instructed to pay $XXX to the Supplier.

This is not always acceptable to the Supplier as he is relying on the Agent to provide credit conforming documents to obtain payment under the Letter of Credit. If no payment comes through the Letter of Credit then the assignment of proceeds is worthless.

UCP 600

To assist the parties involved in Letter of Credit transactions, the International Chamber of Commerce has published the Uniform Customs and Practice for Documentary Credits. These guidelines have gone through many revisions and the current version is Publication 600 revised in 2007.

Adherence to these guidelines is not compulsory, but they are now almost universally accepted around the trading world.

Guarantees

Unlike a Letter of Credit, which is a primary payment instrument, a Guarantee is a bank undertaking to pay in the event of default. Guarantees can be issued to cover, literally, any eventuality where the beneficiary requires a method of financial recompense should a default occur.

In the following diagrams and text we are going to look at contractual guarantees that may be expected to support the building of a new bridge for a local government office (LGO).

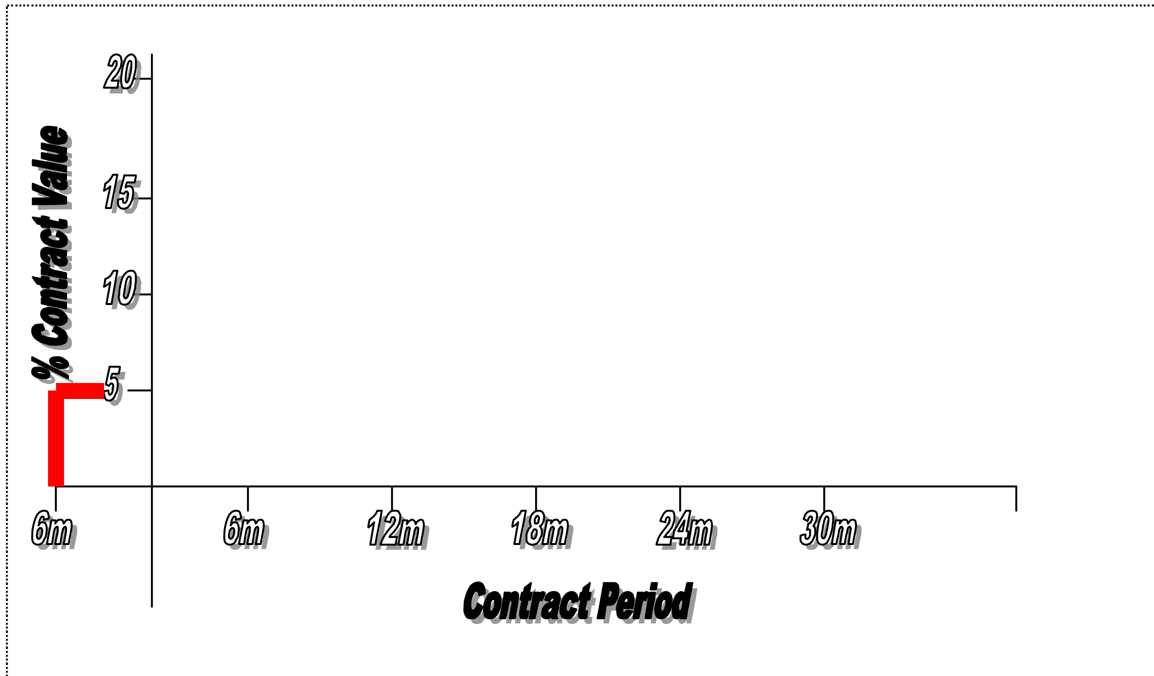
The LGO has identified that a bridge over a railway line within their remit will no longer be able to meet enhanced safety standards and projected volume of traffic; they therefore decide that the existing bridge must be removed and a new, larger bridge be erected in its place. The local government planning and surveyors office provides the schematics and detailed plans and a budget is fixed to cover the project. They now have to find a suitable contractor that will be able to complete the work to timescale, standard and budget.

The Bid or Tender Guarantee

The LGO now advertise in the National/International trade press to attract bids for the contract. Within this advertisement is the requirement that any bid must be supported by a Bid Guarantee for 5% of the bid amount, issued by a bank acceptable to the LGO and in an acceptable format. The Bid Guarantee should be valid from its date of issue until contract signing has taken place.

The requirement for a Bid Guarantee is that the LGO has gone to a lot of trouble and expense to reach the stage of advertising for contractors. As, at the time of the bid, there is no contractual agreement between the LGO and the bidder, it would be very difficult for the LGO to obtain recompense should the successful bidder decide to pull out before the contract is signed. With the Bid Guarantee in place, should the successful bidder fail to take up the contract the LGO would claim on the Guarantee to reimburse itself for its costs, and thus be able to fund the re-advertising.

This type of Guarantee is also often referred to as a Tender Guarantee. It can be issued for any amount deemed adequate by the beneficiary.

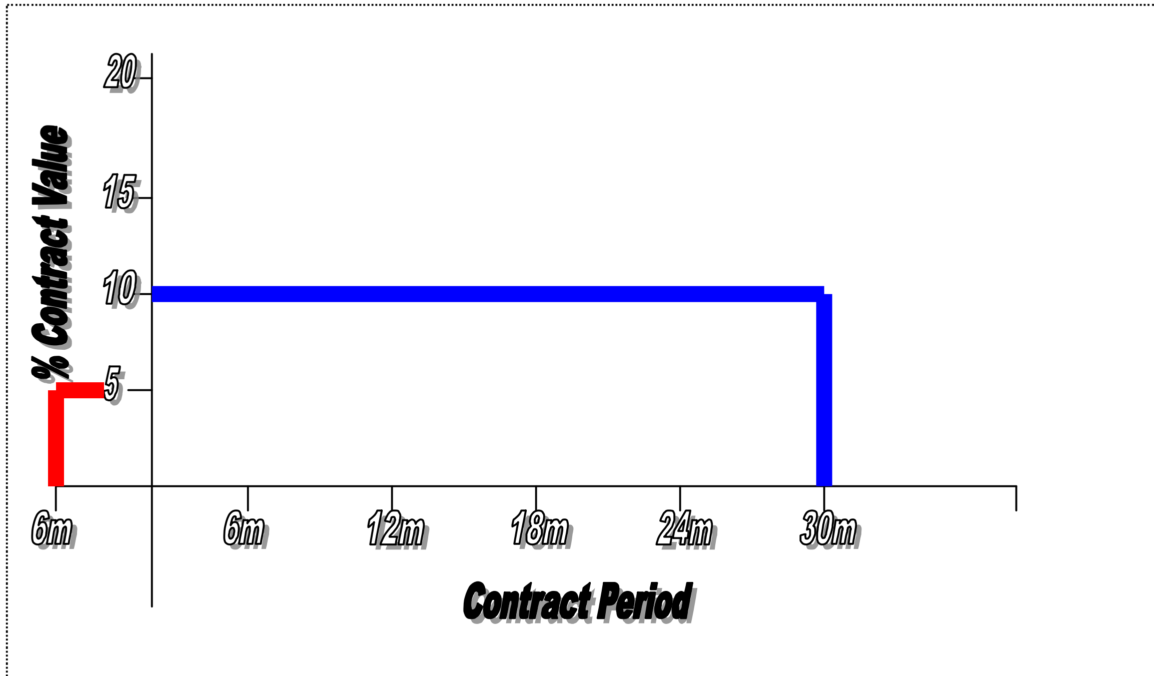


The Bid Guarantee would be issued at the same time as the Bid and valid until signing of the contract. Given the amount of effort involved in comparing complicated bids and obtaining satisfactory references etc., this can take anything up to six months.

Once the selected contractor signs the contract, the Bid Guarantee expires. However, the contract will contain requirements for more Guarantees to be issued to support the contractor's obligations; the next of which would be the Performance Guarantee.

The Performance Guarantee

The contract will contain many clauses relating to the performance required of the contractor. If any of these performance criteria are not met it can potentially delay the building and add more cost to the project. As an incentive for the contractor to perform properly they are required to provide a Performance Guarantee from their bank which states that if they fail to perform under the contract the LGO has the right to claim against the Guarantee. These types of guarantee are usually for 10 – 15% of the overall contract value and valid for the life of the contract.



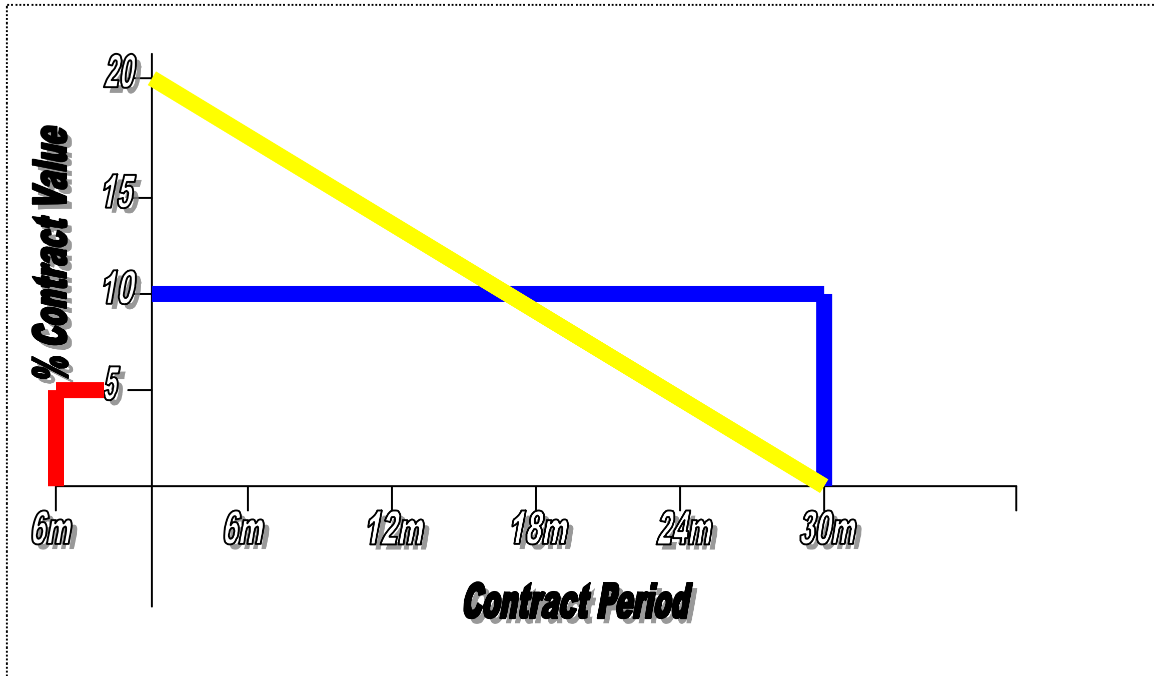
In some instances, the value of the Guarantee is tied to milestones in the contract. For example, the guarantee can be reduced by 10% of its value upon completion of the bridge foundations, a further 10% reduction when the bridge superstructure arrives on site etc.

In this way the liability under the Guarantee "steps" down over the life of the contract.

The Advance Payment Guarantee

At the time that the contract is signed, it may well be the case that the selected contractor does not have sufficient liquidity to pay for all the up-front requirements to get the contract underway; such as workforce, delivery of machinery/equipment, delivery of building materials etc. Some contracts provide a solution to this by allowing the contractor to request an up-front payment from the contract funds to cover these initial costs. To cover the LGO in providing this service they will require an Advance Payment Guarantee.

This guarantee can be for any amount but is usually between 10 and 20% of the total contract value. As with the Performance Guarantee, the Advance Payment Guarantee can "step" down in value with milestones or reduce by set amounts over the life of the contract.



The Retention or Warranty Guarantee

In the diagrams above we are showing that the contract period is 30 months. At the end of this period the bridge would have been built and the contractor released from his liabilities under the Performance Guarantee and the Advance Payment Guarantee.

We now enter a testing phase. The LGO will want to be sure that the bridge can perform as designed and if there is any remedial work to be done will also want to ensure that the contractor will do these. There are two ways in which this is covered:

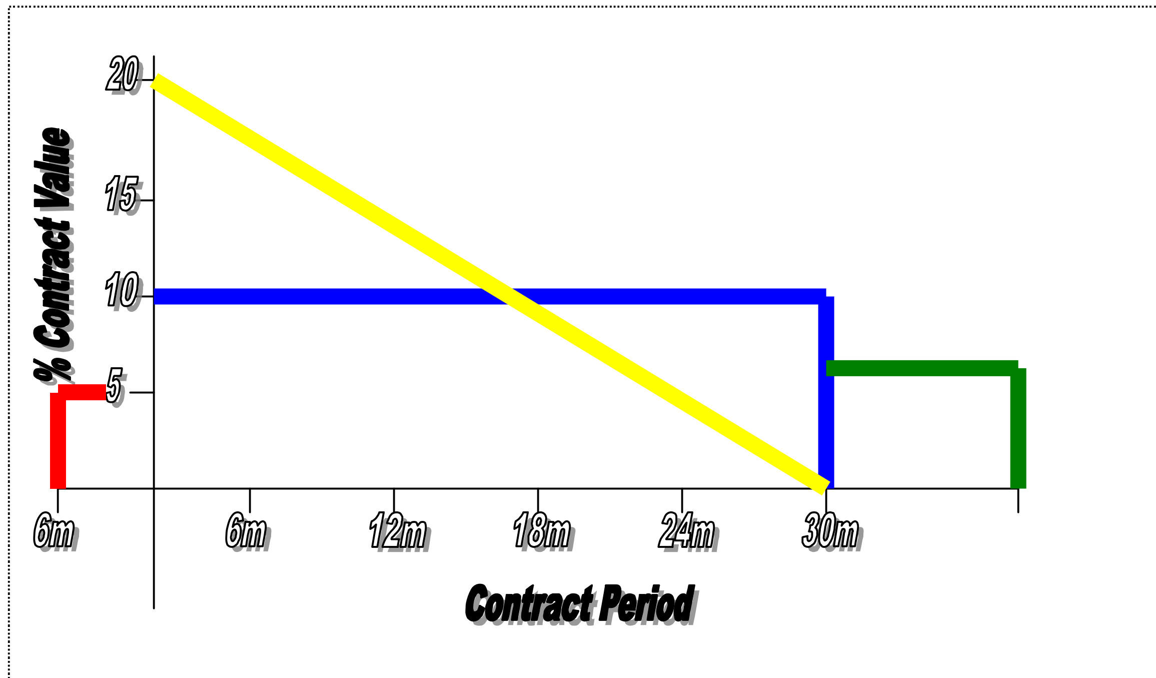
- Retention
  A certain amount of the contract value can be retained by the LGO until the testing is complete

- Warranty
  An undertaking is given by the contractor that any defective workmanship will be corrected at their own cost.

In the event of retention, the contractor can obtain final payment by providing the LGO with a Retention Guarantee. This unlocks the final payment (which is usually where the contractor's profit margin is) and provides the LGO with the surety that if the contractor does not perform any required remedial work they and claim under the guarantee for financial recompense.

For Warranty, the LGO will require a Warranty Guarantee to support the contractor's undertaking.

For both of these final types of guarantee, the value is normally in the 5% contract value range and can be valid for 6 months or more after completion of the contract.



Financial Vs. Non-Financial (Performance)

For every Dollar's worth of business that a bank enters into, it must set aside capital to support that business; in this way the Central Bank ensures that banks are not overtrading. The ratio of business to capital is not always 1 : 1, it depends on the type of transaction, duration, type of collateral held etc. Financial guarantees require more capital support than non-financial and so are recorded differently in the bank's books.

The guarantee examples shown above fall into the following categories:

Bid Guarantee – Non-Financial
Performance Guarantee – Non-Financial
Advance Payment Guarantee – Financial
Retention Guarantee – Financial
Warranty Guarantee – Non-Financial

The rationale being that if the event of default is due to a performance issue, then the guarantee is a performance guarantee; if the event of default is non-payment of a financial obligation, then the guarantee is a financial guarantee.

Legal Points Concerning Guarantees

There is no such thing as a standard guarantee; different banks will have different wordings and procedures and local customs and business practice also have an impact on their final form. There are, however, some fundamentals that all guarantees must have in order for them to be enforceable in law:

a. Legal Consideration

If a guarantee is issued "gratuitously", meaning that no obvious reason for its existence can be derived from the text, then the guarantee may not be enforceable. Contract guarantees will always show in the text a phrase that starts:

"In consideration of…………."

This is stating the legal consideration. It may continue (as in the demonstrated case above) "…………..your having awarded a contract for the construction of a bridge to our customer…………" so now the reason for the guarantee issuance is clearly understood and cannot be contested.

b. Fixed Determinable Amount

Banks do not like to issue guarantees where the maximum aggregate amount of potential claims is unknown. They will be taking collateral from their client to offset the guarantee risk and there must be a stated upper-limit to the potential claims.

c. Applicable Law and Legal Jurisdiction

Guarantees will always be subject, in the final examination, to a legal process in the event of any dispute under the guarantee. In many cases the beneficiary of the guarantee may be in a different country than that of the issuing bank and the question of which law and which venue will arise. For this reason guarantees will contain a clause which covers this, usually in following format (or similar to):

"This Guarantee is issued subject to and in accordance with the laws of [Country] and the parties hereto hereby irrevocably submit to the exclusive jurisdiction of the [Country] Courts."

d. Fixed Expiry

The issuing bank will also want to know the length of their commitment. Open-ended guarantees are not usually issued; instead, they will show a fixed expiry date before which all claims are to be received in order to be valid.

In some cases the bank can received what is known as an "extend or pay" claim. This indicates that either the guarantee validity must be extended to a set future date or the bank must pay the guarantee amount to the beneficiary. What must be remembered here is that for an extend or pay claim to be valid, there must be an event of default under the contract. For example, if the contractor has not finished his work on time and requires one more month, the beneficiary may agree to an extension of the contract period as long as the guarantee is similarly extended.

Standby Letters of Credit

Standby Letters of Credit fulfill the same function as a guarantee. They originally came into use to get around the problem of State Law in the U.S.A. These laws often conflicted, especially contract law, and as a result, U.S. banks were prohibited from issuing inter-state guarantees. Standby Letters of Credit were initially issued subject to the Uniform Customs and Practice for Documentary Credits, which got around the first level of legal problems. Later, the International Chamber of Commerce produced guidelines solely for Standby Letters of Credit, ISP98 (International Standby Practices)

Many U.S. banks misuse Standby Letters of Credit by drafting them as instruments of payment instead of instruments of guarantee and also name them Letters of Credit instead of Standby Letters of Credit. There has, therefore, developed a kind of hybrid document containing components of both types of instrument.