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Financing Affordable Housing for Africa

TRADE FINANCE - INTRODUCTION

What is trade finance?

The term "Trade Finance" means, finance for Trade. For any trade transaction there should be a Seller to sell the goods or services and a Buyer who will buy the goods or use the services. Various intermediaries such as banks, Financial Institutions facilitate these trade transactions by financing the trade.

In its simplest form, an exporter requires an importer to prepay for goods shipped. The importer naturally wants to reduce risk by asking the exporter to document that the goods have been shipped. The importer’s bank assists by providing a letter of credit to the exporter (or the exporter's bank) providing for payment upon presentation of certain documents, such as a bill of lading. The exporter's bank may make a loan to the exporter based on the export contract.

The main factor in considering how a trader expects to be paid for a transaction is the potential risk that they and their customer are willing to face between them - hence there are always two sides to any situation. There are different types of risk that a Trader will face.

The main forms of trade finance include Open account, Advance payment, Documentary Collection, Letters of credit, Guarantee (Standby letters of credits),Trade Credit Insurance, Factoring , Forfaiting and Structured Finance.

Payment Risk Ladder

It is often a good idea, during, or even before contract negotiations, to consider where, on the diagram below, you and your customer will be comfortable in placing yourselves.

Payment Risk Ladder

Exporter:	**Least Secure →**	**Less Secure →**	**More Secure →**	**Most Secure**
Importer:	**Most Secure**	**← More Secure**	**← Less Secure**	**← Least Secure**
	Open Account	Bills for Collection	Documentary Credits	Advance Payment

Open Account

This is the least secure method of trading for the exporter, but the most attractive to buyers. Goods are shipped and documents are remitted directly to the buyer, with a request for payment at the appropriate time (immediately, or at an agreed future date). An exporter has little or no control over the process, except for imposing future trading terms and conditions on the buyer. Clearly, this payment method is the most advantageous for the buyer, in cash flow and cost terms. Therefore, Open Account trading should only be considered when an exporter is sufficiently confident that payment will be received.

The financial risk can often be mitigated by obtaining a credit insurance policy to cover the potential insolvency of a customer that provides reimbursement up to an agreed financial limit.

Advance Payment

The most secure method of trading for exporters and, consequently the least attractive for buyers. Payment is expected by the exporter, in full, prior to goods being shipped.

As one might imagine, having covered the two extremes on the Payment Risk Ladder, commercial decisions have to be made and this usually results in selecting one of the middle rungs of the ladder. This is where banking products such as Bills for Collection and Letters of Credit come in to play.

Bills for Collection

More secure for an exporter than Open Account trading, as the exporter's documentation is sent from his bank to the buyer's bank. This invariably occurs after shipment and contains specific instructions that must be obeyed. Should the buyer fail to comply, the exporter does, in certain circumstances, retain title to the goods, which may be recoverable. The buyer's bank will act on instructions provided by the exporter, via their own bank, and often provides a useful communication route through which disputes are resolved.

The Bills for Collection process is governed by a set of rules, published by the International Chamber of Commerce (ICC) called "Uniform Rules for Collections" document number 522 (URC522). Over 90% of the world's banks adhere to this document.

There are two types of Bill for Collection, which are usually determined by the payment terms agreed within a commercial contract. Each affords different benefits to exporters and they are covered separately below:

Documents against Payment (D/P)

Usually used where payment is expected from the buyer immediately, otherwise known as "at sight". This process is often referred to as "Cash against Documents".

The buyer's bank is instructed to release the exporter's goods only when payment has been made. Where goods have been shipped by sea freight, covered by a full set of Bills of Lading, the exporter retains title until these documents are properly released to the buyer. Unfortunately, for airfreight items, unless the goods are consigned to the buyer's bank no such control is available under an Air Waybill or Air Consignment Note, as these documents are merely "movement certificates" rather than "documents of title".

Documents against Acceptance (D/A)

Used where a credit period (e.g. 30/60/90 days - 'sight of document' or from 'date of shipment') has been agreed between the exporter and buyer. The buyer is able to collect the documents against their undertaking to pay on an agreed date in the future, rather than immediate payment. The exporter's documents are usually accompanied by a "Draft" or "Bill of Exchange" which looks something like a cheque, but is payable by (drawn on) the buyer. When a buyer (drawee) agrees to pay on a certain date, they sign (accept) the draft. It is against this acceptance that documents are released to the buyer. Up until the point of acceptance, the exporter may retain control of the goods, as in the D/P scenario above. However, after acceptance, the exporter is financially exposed until the buyer actually initiates payment through their bank.

Letters of Credit (L/Cs)

A Letter of Credit (also known as a Documentary Credit) is a bank-to-bank commitment of payment in favour of an exporter (the Beneficiary), guaranteeing that payment will be made against certain documents that, on presentation, are found to be in compliance with terms set by the buyer (the Applicant).

Like Bills for Collections, Letters of Credit are governed by a set of rules from the ICC. In this case, the document is called; "Uniform Customs and Practice" and the latest version is document number 600. In short, it is known as UCP600 and, again, over 90% of the world's banks adhere to this document.

Irrevocable: The terms and conditions within a L/C cannot be changed without the express agreement of the Beneficiary. Under UCP600, revocable L/Cs are no longer acceptable under any circumstances.

Unconfirmed: The payment commitment within the L/C is provided by the Applicant's issuing bank.

Confirmed: If an exporter has any concerns about the circumstances which may prevent payment being made from either the Issuing Bank or buyer's Country, the adding of "Confirmation" moves the bank/country risk issues to the bank which adds its confirmation (the confirming or advising bank) and notifies the DC to the exporter. The price of such a confirmation will obviously depend upon the level of perceived risks to be covered. Banks can often provide indicative pricing for confirmations prior to the arrival of the DC, so that costs can be estimated.

What does all this mean?

The exporter and buyer can agree detailed terms, as part of the commercial contract. This can include exactly what documents need to be produced and precisely what detail such documents should quote. Letters of Credit, as well as offering a bank's commitment to pay, also offer benefits in terms of finance.

Standby Letters of Credit (SBLCs) or Bank Guarantees

A Bank guarantee is an undertaking/promise given by a Bank on behalf of the Applicant and in favour of the Beneficiary. Whereas, the Bank has agreed and undertakes that, if the Applicant failed to fulfill his obligations either Financial or Performance as per the Agreement made between the Applicant and the Beneficiary, then the Guarantor Bank on behalf of the Applicant will make payment of the guarantee amount to the Beneficiary upon receipt of a demand or claim from the Beneficiary.

SBLCs are similar to Bank Guarantees, in that they sit behind a transaction and are only called upon if the buyer fails to pay in the normal course of business (which is often Open Account). They can be particularly useful to cover an underlying

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Financial risk where multiple payments are to be made, possibly as part of an agreed schedule. However, they do not offer the documentary control of Letters of Credit to buyers and, as such they are an unconditional guarantee.