International Trade Centre

SheTrades

SheTrades MENA

DUBAI Economy and Tourism

SHETRADES MENA GUIDEBOOK TRAINING MATERIALS

HOW TO EXPORT GUIDE: TRADE FINANCE

This exporting guide has been produced by SheTrades MENA hosted by the Dubai Department of Economy and Tourism

TRADE FINANCE

Methods of Payment

The settlement of international commercial indebtedness takes place in one of the following ways:

- Direct remittance
- Documentary collection
- Documentary letter of credit
- Open account trade
- Advance payments

Direct Remittance
The seller sends the goods to the importer and forwards the documents to him to facilitate the latter to clear the goods. Based upon these documents, the buyer remits the cost of goods directly to the seller by draft or telegraphic transfer through banking channels. This mode of settlement pre-supposes seller's trust in buyers and his ability to settle the payment.

Documentary Collection
In this case, the seller ships the goods as per the contract and presents the relative shipping documents to his bank for presentation to the importer through his bank. The instruction may be to deliver documents to the buyer against payment or alternatively if he is trustworthy and well known to the seller, the documents may be delivered against acceptance of the usance draft for payment on the due date of the bill.

Financing Terms

In order to establish the amount of financing needed for an export transaction, it is important to assess financial needs. The exporter can do this by separating financial needs for a specific transaction (short-term) from those permanent activities required to maintain operations (long term).

Short-term financing. If the funds needed would be used to finance current operating activities, such as the purchase of goods or services, the payment of wages and interests on debt, or the extension of trade credit, short-term financing will be needed. Analysis of the production cycle from the purchase of raw materials to the delivery of finished goods will determine the that the financing needs are required to cover a larger range of direct costs. One way for the exporter to reduce financing needs is to request the buyer to make faster payments. As a general rule, short-term financing needs should be met by short-term sources of financing, such as overdraft and short-term loans.

Medium or long term financing. Investments such as purchasing new machinery, modernizing existing equipment, or construction of a new building may require medium-term financing. The exporter can obtain this by inducting new shareholders to increase the equity position; finding investors willing to invest in preference shares, debentures; or by borrowing from banks or other financial institutions.

For medium or long term financing, it is important that the exporter does a detailed feasibility analysis covering technical aspects, market analysis, profitability estimates and forecasted cash flows. Medium-or long-term financial needs should be covered either by equity or term loans or a combination of both. The more equity an exporter has invested in a project, the greater the level of financial protection against external event. In order to avoid weakening of the financial structure of the firm, it is critically important to maintain the overall credit exposure under a certain limit.

Letter of Credit

A letter of credit (L/C) is an arrangement whereby a bank (the issuing or opening bank) guarantees on behalf of its customer (the applicant or importer), to make payment to the exporter (beneficiary) upon presentation of the documents specified in the credit, under specified terms and conditions. The financial transaction can be secured by the intervention of another bank which informs the exporter of the issue of the L/C. By adding its confirmation to the credit, the payment is guaranteed against the risk of the issuing bank defaulting. The L/C is a precise document, usually created using an international standard form. It contains a brief description of the goods, a listing of documents required to obtain payment, the shipping date, and the expiration date, after which payment will no longer be made. The L/C guarantees that the exporter will be paid only after fulfilling certain terms and conditions. Upon fulfillment of all the conditions set down in the L/C, the exporter can submit appropriate shipping documents to his or her bank to collect payment. The following documents are required to be submitted in order to obtain payment according to the L/C:

- Commercial invoice.
- Bill of lading (B/L) or another multi-modal transport document proving that the goods have been embarked for transport. Sometimes also providing evidence that the freight has been pre-paid.
- Insurance document.
- Certificate of origin.
- Inspection certificate showing conformity to quality, quantity, packaging requirements.
- Packing list.

Unless the exporter has a long-standing relationship with the foreign buyer, the L/C is the easiest way of getting paid whilst protecting the exporter's interests. The most commonly used forms of L/C are discussed below:

Irrevocable Documentary L/C. The irrevocable documentary L/C cannot be cancelled or modified without agreement of all parties involved. Payment is guaranteed by the bank provided that the exporter fulfils all the terms and conditions highlighted in the contract, including the presentation of the required documents.

Revocable L/C. The revocable L/C offers fewer guarantees than the irrevocable documentary L/C, but is more flexible as it can be cancelled or modified at any time without the knowledge of the beneficiary.

Revolving L/C. The revolving L/C makes funds available for repeated trade transactions with the same client, usually under the same terms without having to issue a new L/C.

amount of finance the exporter needs to borrow and for how long. The exporter might find that financing needs are limited to those needed to purchase raw materials or, on the contrary,

Payment and Risks with Letter of Credits:

	Time of Payment	Goods Available to Importer	Risk to Exporter	Risk to Importer
Irrevocable	At sight of presentation of documents to issuing bank; or specified number of days after acceptance by issuing bank	After Payment	Risk lies with UAE confirming bank	None
Revocable	Same as Confirmed	After payment	Risk lies with foreign issuing bank and economic conditions of issuing bank	None
Sight	When shipment is made	After payment	Risk lies with local confirming bank	Assured shipment is made, but relies on exporter to ship goods described in the documents
Time Draft	At maturity of draft, may or may not be discounted	Usually before payment	Risk lies with local confirming bank	Assured shipment is made, but relies on exporter to ship goods described in the documents
Red Clause	A percentage of total amount before shipment. Balance is same as type of L/C	After payment	See irrevocable and revocable	The percentage of payment in advance is at total risk. Balance same as type of L/C
Revolving Letter of Credit	Variable	Variable	See irrevocable and revocable	None
Standby Letter of Credit	At time shipment is received	Usually before payment	Delay in payment. Also see irrevocable	None

	Time of Payment	Goods Available to Importer	Risk to Exporter	Risk to Importer
Back-to-back	Same as irrevocable	After payment	None	None
Transferable	Same as irrevocable	After payment	Same as irrevocable	None
Assignment of Proceeds	Same as irrevocable	After payment	Same as irrevocable	None

Common Problems with LCs

The letter of credit and particularly the documentary irrevocable letter of credit is considered among the safest methods of international trade payment. However, the exporter should be aware that foreign buyers can refuse to honour their obligations if they find or claim to find, that there are discrepancies in the documents submitted. To prevent this from occurring, the exporter should:

- Crosscheck all terms with the foreign buyer, in order to clearly and completely define which documents should be presented before the L/C is used.
- Ensure that every word in the documentary credit is related to and checked against the documents.
- Check whether the documents are consistent with each other and that they have been drawn up in compliance with the ICC's Uniform Customs and Practice for Documentary Credits.
- Present documents within the time limits.
- Make sure that any corrections are authenticated by the issuer.

If the buyer's claims are in bad faith, the exporter can initiate legal proceedings and demonstrate that he or she has met all the terms of the credit. However, the exporter should be aware that legal actions against a buyer in a foreign country are onerous, take a long time to process, and are costly. In addition, the exporter's bank could ask for reimbursement of the funds extended as an advance of a discounted L/C. In order to avoid such problems, exporters must carefully evaluate the creditworthiness of the foreign buyer. The exporter can protect themselves against the risk of default by the bank issuing the L/C by asking another bank in the exporter's country to add its confirmation to the L/C. Once this confirmation is added, the confirming bank will give an assurance similar to that of the issuing bank. The exporter then has a double assurance of payment. He or she should bear in mind however, that this bank will be willing to add its confirmation only if the L/C is irrevocable and freely negotiable.

Problems in Letter of Credit process -Common Defects in Documentation
About half of all drawings presented contain discrepancies. A discrepancy is an irregularity in the documents that causes them to be in non-compliance to the letter of credit. Requirements set forth in the letter of credit cannot be waived or altered by the issuing bank without the express consent of the customer. The beneficiary should prepare and examine all documents carefully before presentation to the paying bank to avoid any delay in receipt of payment. Commonly found discrepancies between the letter of credit and supporting documents include:

- Letter of Credit has expired prior to presentation of draft.
- Bill of Lading evidences delivery prior to or after the date range stated in the credit.
- Stale dated documents.
- Changes included in the invoice not authorized in the credit.
- Inconsistent description of goods.
- Insurance document errors.
- Invoice amount not equal to draft amount.
- Ports of loading and destination not as specified in the credit.
- Description of merchandise is not as stated in credit.
- A document required by the credit is not presented.
- Documents are inconsistent as to general information such as volume, quality, etc.
- Names of documents not exact as described in the credit. Beneficiary information must be exact.
- Invoice or statement is not signed as stipulated in the letter of credit.

When a discrepancy is detected by the negotiating bank, a correction to the document may be allowed if it can be done quickly while remaining in the control of the bank. If time is not a factor, the exporter should request that the negotiating bank return the documents for corrections. If there is not enough time to make corrections, the exporter should request that the negotiating bank send the documents to the issuing bank on an approval basis or notify the issuing bank by wire, outline the discrepancies, and request authority to pay. Payment cannot be made until all parties have agreed to jointly waive the discrepancy.

Tips for Exporters
The general tips for exporters as far as letters of credit are concerned are as follows:

Communicate with your customers in detail before they apply for letters of credit.
Consider whether a confirmed letter of credit is needed.
Ask for a copy of the application to be fax to you, so you can check for terms or conditions that may cause you problems in compliance.
Upon first advice of the letter of credit, check that all its terms and conditions can be complied with within the prescribed time limits. Many presentations of documents run into problems with time-limits. You must be aware of at least three time constraints - the expiration date of the credit, the latest shipping date and the maximum time allowed between dispatch and presentation.
If the letter of credit calls for documents supplied by third parties, make reasonable allowance for the time this may take to complete. After dispatch of the goods, check all the documents both against the terms of the credit and against each other for internal consistency.

Documents Required for LCs

(Break down this long sentence. It is difficult to understand) The documents generally required by the bank to negotiate or collect necessary payment from abroad and those required by the exporter are the following:

- Bill of Exchange (First of Exchange and Second of Exchange)
- Full set of Bill of Lading / Air Way bill (all negotiable copies plus one non-negotiable copy) / Post Parcel Receipt / Combined Transport Document, as the case may be
- Commercial invoice including one copy duly certified by the Customs.
- Original letter of credit, if any
- Customs invoice / Consular Invoice
- Certificate of Origin
- Insurance policy/certificate with complete set (brokers cover note should not be sent) Packing List
- Other documents like certificate of analysis/inspection certificate.

Discrepant Documents

Once the discrepant documents are tendered to the negotiating bank, the element of delay is introduced in the transaction and if the discrepancies are beyond correction, the security afforded by the documentary credit is lost. The negotiating bank is not normally prepared to negotiate the discrepant documents. Then the beneficiary has to carry out the rescue operation, including the bank to negotiate against indemnity. This indemnity is accepted with the clear understanding that the documents will be accepted by the buyer despite discrepancies. However, if the buyer refuses to take up the documents, then the exporter beneficiary will refund the amount. The negotiating bank may choose not to negotiate the documents because of serious discrepancies. The alternative is to seek authorisation from the issuing bank to negotiate the documents despite discrepancies at the specific request of the L/C beneficiary. In view of foregoing, the beneficiary has to incur contingent liability apart from charges for furnishing indemnity to the bank, interest lost on account of delays, administrative costs and cost of telex messages if authorised to negotiate is to be obtained from the negotiating bank.

The credit offered by the L/C is lost when the discrepant documents are sent forward to the L/C issuing bank for settlement. The seller is solely at mercy of the buyer. There is no longer in existence independent promise of solvent pay master. The buyer has the following options available to him. Firstly, the buyer may take the documents despite discrepancies. The transaction may follow its natural course but there may be delay in settlement as the issuing bank has to refer it to the buyer for his approval. Secondly, the buyer may use discrepant documents as a means to delay the payment. Thirdly, one of the virtues of L/C is "insurance against renegotiation". In case the documents do not meet the requirements, the buyer has the option to renegotiate the price, and compel the seller to agree for discount. Furthermore, the buyer might like to withdraw from the transaction seeking shelter under discrepancies if it turns out to be a bad business bargain. It is difficult to find an alternate buyer for the distressed merchandise. The goods might have to be disposed off at a 50% or even at a lesser rate. In certain cases, there is no alternative except to re-import the goods, and bear the costs thereof. The discrepant set of documents sets into motion the vicious circle which imposes the following penalties on the exporter-beneficiary of the L/C. Apart from these direct costs, the consequential costs are also imposed on the beneficiary. The delay in payment might affect the cash flow planning. The optimum utilisation of credit lines is so impaired that the beneficiary might have to borrow over and above the normal needs. The exporter might lose further business as his performance goes down.

Effective Financial Management

If exporters have short-term financial needs that do not normally involve large amounts of capital, they can start improving their liquidity by:

- Reducing current assets. Exporters can reduce their stock of raw materials, consumables, or commodities, by increasing the frequency of deliveries and dealing with reliable suppliers. Stocks of finished goods or inventories can be cut; work-in-progress can be speeded up; and receivables can be reduced.

- Reducing fixed assets. Exporters should consider the possibility of selling unproductive assets or assets that need not be owned but can be leased (e.g., unused buildings, land, equipment, or employees).

- Increasing current liabilities. Other options are to attempt to obtain longer payment terms from suppliers (i.e. extending payment dates for raw materials), seek a change in due date for paying taxes, or obtain postponements of loan repayment dates. For medium- or long-term financing needs, exporters should approach banks or other financial institutions, or modify the firm's financial structure by:

    - Optimising equity structure. The equity structure can be optimised by slowing down or reducing the distribution of profits, by increasing share capital, or by the release of bonds and preference shares.
    - Changing the ratio between liabilities and equity. It is advisable for exporters to obtain proper advice from their bank.

Financing Purchase of Raw Materials

When an exporter has orders from customers, but is short of cash to buy the goods and services required to produce and deliver the orders, a promissory note can be issued. A promissory note is a written promise to pay the supplier in the future. It is also possible to countersign a bill of exchange, which is normal practice if the supplier does not know the exporter. In this case, the supplier may also ask the exporter to provide a guarantee. The exporter must respect the payment dates specified in the bill of exchange, or face possible legal action. If exporters need a more permanent external source of financing to pay for goods and services, they can apply to financial institutions for short-term capital in the form of an overdraft or letter of credit.

- Overdraft. The bank opens a current account in the exporter's name and allows the account to be overdrawn up to an agreed maximum level, over an agreed period of time.

- Letter of Credit. A letter of credit opened by the bank of the foreign buyer, enables the exporter to obtain an advance of up to 80% of a sales contract. The exporter can also ask for pre-shipment financing on the basis of a red clause letter of credit, or a green clause letter of credit.

With all forms of financing, exporters typically provide security in the form of assets to be pledged to a bank, together with legal documents, in order to obtain a revolving credit. At the end of the loan period, if both parties are satisfied, the facility can be renewed without major changes to the security or contracts.

Discounting LCs

Extending credit to foreign buyers enhances the exporter's competitiveness in the foreign market, but reduces his or her liquidity. Unless the exporter is able to arrange for an immediate inflow of working capital, the production cycle could be disrupted. Some of the methods whereby an exporter can extend credit and yet not face a drop in liquidity are described below.

Discounting of receivables. An exporter's receivables (e.g., bills of exchange, promissory notes, L/Cs and invoices) can be discounted, that is to say, the bank immediately pays the exporter an amount equal to the value of the receivable, less interest and fees. This form of discounting can be with or without recourse. It is advantageous as it is quick, and gives exporters flexibility. They can propose the receivables to discount, and when to discount them. Moreover, procedures are simple and the exporter does not have to provide the bank with special legal documents or security.

Factoring. Factoring is the sale at a discount of accounts receivable on a daily, weekly, or monthly basis to a factoring house (usually a bank). A factoring house purchases the trade debts of its clients, and collects these debts on its own behalf. Factoring with recourse means that the supplier (exporter) will carry the credit risk in respect of receivables sold to the factor. The factor will have recourse in the event of non-payment for whatever reason, including financial inability of the customer to pay. In factoring without recourse, bad debts are borne by the factoring agents, and not surprisingly, commissions are higher.

Forfeiting. Forfeiting can help the exporter maintain his or her cash flow when credit is extended to importers. Forfeiting is the non-recourse discounting of export receivables. In a forfeiting transaction, the exporter surrenders, without recourse, the right to claim payment on goods delivered to an importer, in return for immediate cash payment from a forfeiter. Receivables can be in the form of bills of exchange issued by the exporter and promissory notes issued by the importer. Once the goods have been delivered, and the contract fulfilled, the exporter can sell receivables to a forfeiter who will assume all risks without recourse, and give the exporter cash after deducting fees. All exports of capital goods and other goods made on medium to long-term credit can be financed through forfeiting.

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