

Chapter

19

Financing International Trade



Merchandise Trade

- Merchandise trade, i.e., exports and imports of goods is the oldest and least risky form of international business.
- Of concern to the exporter is the risk of non-payment by the importer of goods.
- Of concern to the importer is the risk that the exporter may not ship the products that have been paid for.
- In trade finance banks act as intermediaries to ensure that the exporter gets paid while the importer receives the merchandise.

Chapter Objectives

- To describe the methods of payment for international trade;
- To explain common trade finance methods; and
- To describe the major agencies that facilitate international trade with export insurance and/or loan programs.

Payment Methods for International Trade

- In any international trade transaction, credit is provided by either
 - the supplier (exporter),
 - the buyer (importer),
 - one or more financial institutions, or
 - any combination of the above.
- The form of credit whereby the supplier funds the entire trade cycle is known as **supplier credit**.

Payment Methods for International Trade

Method ① : Prepayments

- The goods will not be shipped until the buyer has paid the seller.
- *Time of payment* : Before shipment
- *Goods available to buyers* : After payment
- *Risk to exporter* : None
- *Risk to importer* : Relies completely on exporter to ship goods as ordered

Payment Methods for International Trade

Method ② : Letters of credit (L/C)

- These are issued by a bank on behalf of the importer promising to pay the exporter upon presentation of the shipping documents.
- *Time of payment* : When shipment is made
- *Goods available to buyers* : After payment
- *Risk to exporter* : Very little or none
- *Risk to importer* : Relies on exporter to ship goods as described in documents

Payment Methods for International Trade

Method ③ : Drafts (Bills of Exchange)

- These are unconditional promises drawn by the exporter instructing the buyer to pay the face amount of the drafts.
- Banks on both ends usually act as intermediaries in the processing of shipping documents and the collection of payment. In banking terminology, the transactions are known as *documentary collections*.

Payment Methods for International Trade

Method ③ : Drafts (Bills of Exchange)

- *Sight drafts (documents against payment)* : When the shipment has been made, the draft is presented to the buyer for payment.
- *Time of payment* : On presentation of draft
- *Goods available to buyers* : After payment
- *Risk to exporter* : Disposal of unpaid goods
- *Risk to importer* : Relies on exporter to ship goods as described in documents

Payment Methods for International Trade

Method ③ : **Drafts (Bills of Exchange)**

- *Time drafts (documents against acceptance)* : When the shipment has been made, the buyer accepts (signs) the presented draft.
- *Time of payment* : On maturity of draft
- *Goods available to buyers* : Before payment
- *Risk to exporter* : Relies on buyer to pay
- *Risk to importer* : Relies on exporter to ship goods as described in documents

Payment Methods for International Trade

Method ④ : **Consignments**

- The exporter retains actual title to the goods that are shipped to the importer.
- *Time of payment* : At time of sale by buyer to third party
- *Goods available to buyers* : Before payment
- *Risk to exporter* : Allows importer to sell inventory before paying exporter
- *Risk to importer* : None

Payment Methods for International Trade

Method ⑤ : Open Accounts

- The exporter ships the merchandise and expects the buyer to remit payment according to the agreed-upon terms.
- *Time of payment* : As agreed upon
- *Goods available to buyers* : Before payment
- *Risk to exporter* : Relies completely on buyer to pay account as agreed upon
- *Risk to importer* : None

Comparison of Payment Methods

Method	Usual Time of Payment	Goods Available to Buyers	Risk to Exporter	Risk to Importer
Prepayment	Before shipment	After payment	None	Relies completely on exporter to ship goods as ordered
Letter of credit	When shipment is made	After payment	Very little or none, depending on credit terms	Assured shipment made, but relies on exporter to ship goods described in documents
Sight draft; documents against payment	On presentation of draft to buyer	After payment	If draft unpaid, must dispose of goods	Same as above unless importer can inspect goods before payment
Time draft; documents against acceptance	On maturity of drafts	Before payment	Relies on buyer to pay drafts	Same as above
Consignment	At time of sale by buyer	Before payment	Allows importer to sell inventory before paying exporter	None; improves cash flow of buyer
Open account	As agreed	Before payment	Relies completely on buyer to pay account as agreed	None

Financing International Trade

① Accounts Receivable Financing

- An exporter that needs funds immediately may obtain a bank loan that is secured by an assignment of the account receivable.

② Factoring (Cross-Border Factoring)

- The accounts receivable are sold to a third party (the factor), that then assumes all the responsibilities and exposure associated with collecting from the buyer.

Financing International Trade

③ Letters of Credit (L/C)

- These are issued by a bank on behalf of the importer promising to pay the exporter upon presentation of the shipping documents.
- The importer pays the issuing bank the amount of the L/C plus associated fees.
- Commercial or import/export L/Cs are usually *irrevocable*.

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3 Letters of Credit (L/C)

- α The required documents typically include a draft (sight or time), a commercial invoice, and a bill of lading (receipt for shipment).
- Sometimes, the exporter may request that a local bank confirm (guarantee) the L/C.

Example of an Irrevocable Letter of Credit

Name of issuing bank

Address of issuing bank

Name of exporter

Address of exporter

We establish our irrevocable letter of credit:

for the account of (*importer name*),

in the amount of (*value of exports*),

expiring (*date*),

available by your draft at (*time period*) days sight and accompanied by: (any invoices, packing lists, bills of lading, etc., that need to be presented with the letter of credit)

Insurance provided by (*exporter or importer*)

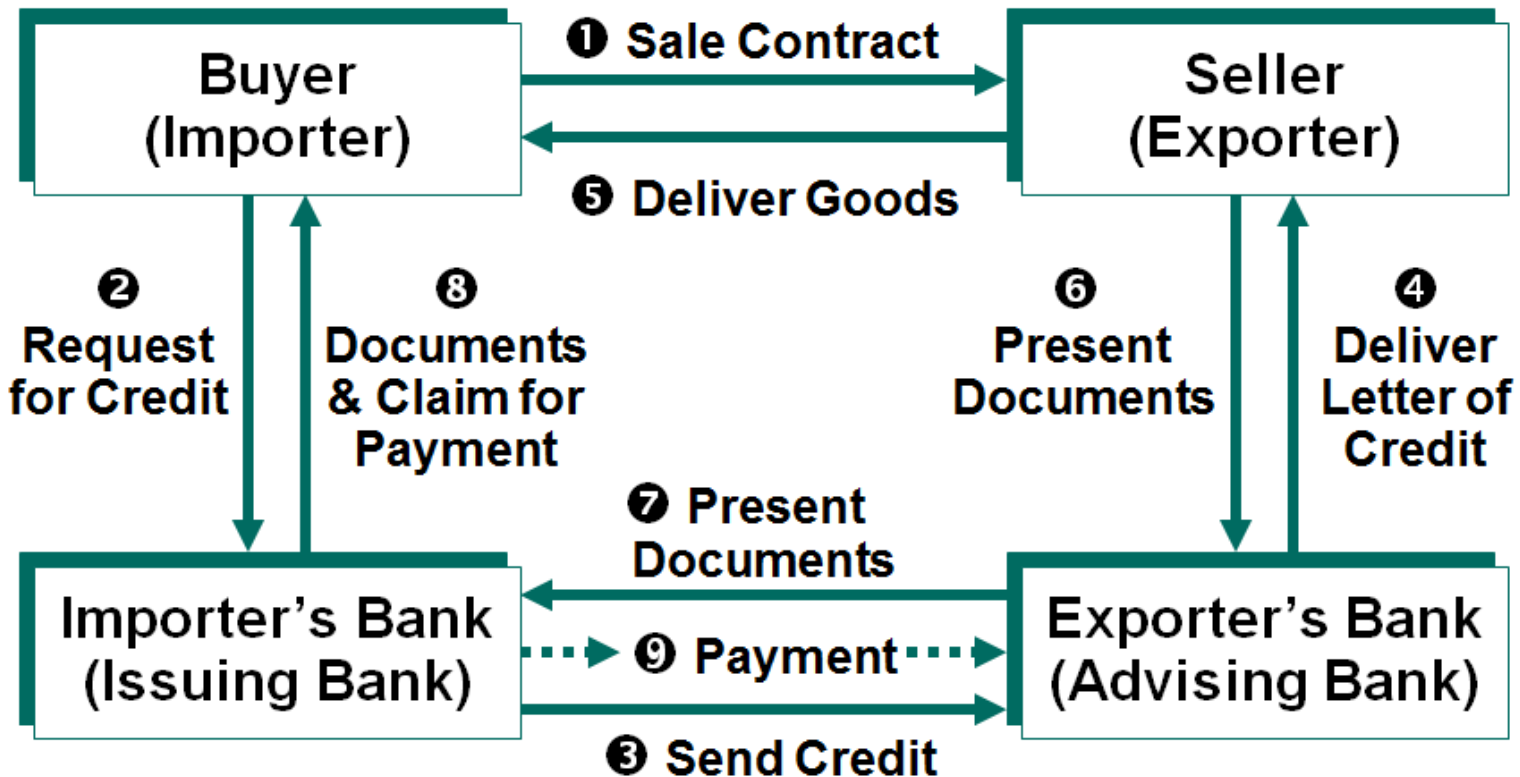
covering shipment of (*merchandise description*)

From: (*port of shipment*)

To: (*port of arrival*)

(*Authorized Signature*)

Documentary Credit Procedure



Financing International Trade

③ Letters of Credit (L/C)

- Variations include
 - *standby L/Cs* : funded only if the buyer does not pay the seller as agreed upon
 - *transferable L/Cs* : the first beneficiary can transfer all or part of the original L/C to a third party
 - *assignments of proceeds under an L/C* : the original beneficiary assigns the proceeds to the end supplier

Financing International Trade

4 Banker's Acceptance (BA)

- This is a time draft that is drawn on and accepted by a bank (the importer's bank). The accepting bank is obliged to pay the holder of the draft at maturity.
- If the exporter does not want to wait for payment, it can request that the BA be sold in the money market. Trade financing is provided by the holder of the BA.

Banker's Acceptance

DRAFT

\$ 1,000,000		January 15	2005
Ninety (90)		Days after sight	Pay to the
Order of		Colombian Coffee Traders Ltd.	
		One Million and 00/100	Dollars
		Drawn under International Bank L/C #155	
To	International Bank, N.A.	Value received and charge the same account of	Colombian Coffee Traders Ltd/
			Bogota, Colombia

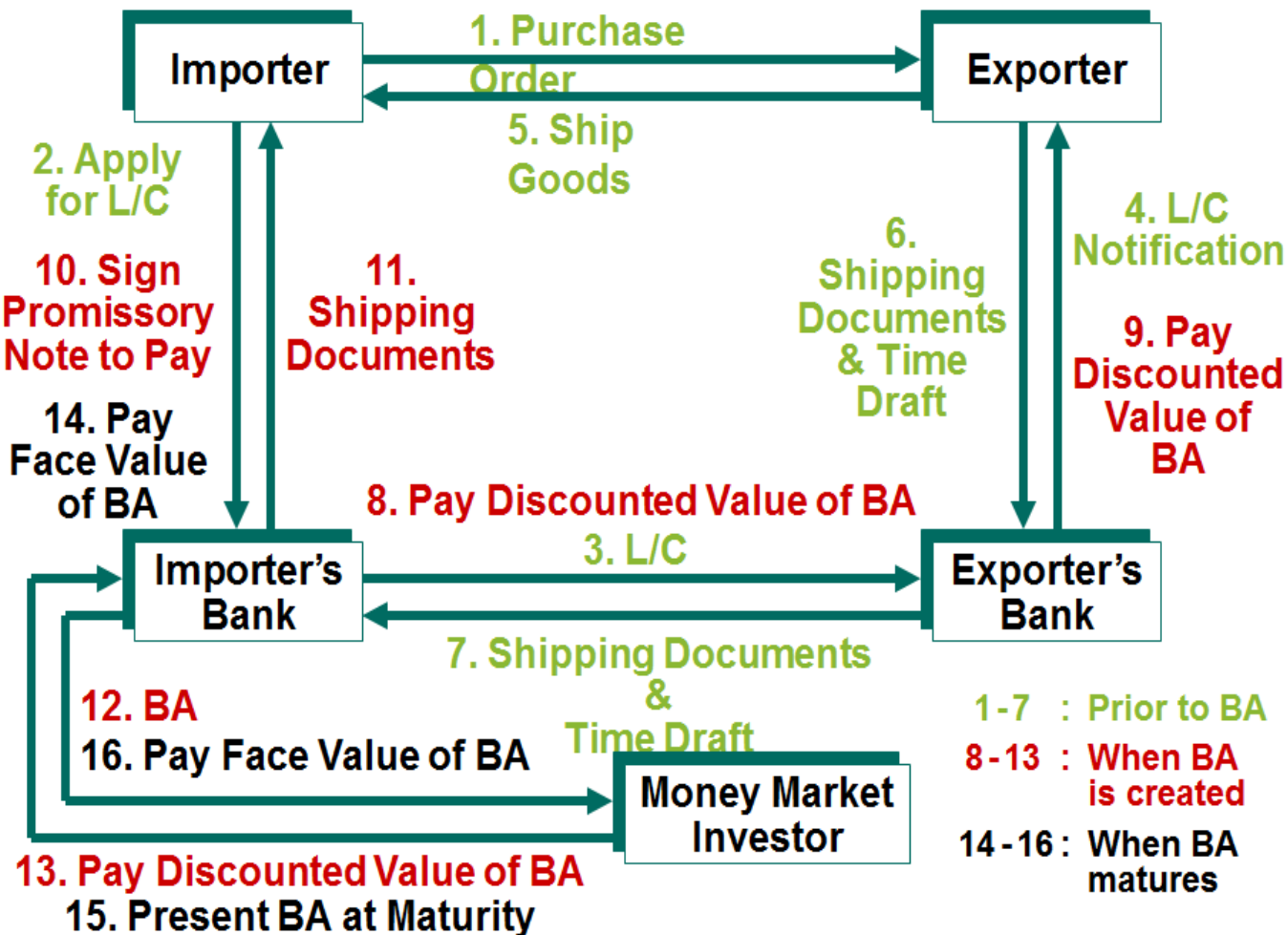
ACCEPTED

Banker's Acceptance

④ Banker's Acceptance (BA)

- ⌘ The bank accepting the drafts charges an *all-in-rate* (interest rate) that consists of the discount rate plus the acceptance commission.
- In general, all-in-rates are lower than bank loan rates. They usually fall between the rates of short-term Treasury bills and commercial papers.

Life Cycle of a Typical Banker's Acceptance



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5 Working Capital Financing

- Banks may provide short-term loans that finance the working capital cycle, from the purchase of inventory until the eventual conversion to cash.

Financing International Trade

⑥ Medium-Term Capital Goods Financing (Forfaiting)

- The importer issues a promissory note to the exporter to pay for its imported capital goods over a period that generally ranges from three to seven years.
- The exporter then sells the note, without recourse, to a bank (the forfaiting bank).

Financing International Trade

7 Countertrade

- These are foreign trade transactions in which the sale of goods to one country is linked to the purchase or exchange of goods from that same country.
- Common countertrade types include barter, compensation (product buy-back), and counterpurchase.
- The primary participants are governments and MNCs.

Agencies that Promote International Trade

- Because of the important role that international trade plays in the economic growth of most countries, government institutions and private sector organizations offer various forms of export credit, export finance, and insurance guarantee programs to stimulate trade and reduce risk.

Agencies that Promote International Trade

Export-Import Bank of the U.S. (Ex-Im Bank)

- This U.S. government agency aims to create domestic jobs by financing and facilitating the export of U.S. goods and services and maintaining the competitiveness of U.S. companies in overseas markets.
- It offers guarantees of commercial loans, direct loans, and export credit insurance.

Agencies that Promote International Trade

Private Export Funding Corporation (PEFCO)

- PEFCO is a private corporation that is owned by a consortium of commercial banks and industrial companies.
- In cooperation with Ex-Im Bank, PEFCO provides medium- and long-term fixed-rate financing for foreign buyers through the issuance of long-term bonds.

Agencies that Promote International Trade

Overseas Private Investment Corporation (OPIC)

- OPIC is a U.S. government agency that assists U.S. investors by insuring their overseas investments against a broad range of political risks.
- It also provides financing for overseas businesses through loans and loan guaranties.