Chapter 15

Managing Credit Risk in International Trade

Overview

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- Payment Modes Without Bank Participation
  - Simple solutions and their risks
  - Trade bills
- Documentary Payments: your bank helps
- Documentary Credit: your bank guarantees
  - The Letter of Credit
  - Advising/Confirming a L/C
- Other solutions
  - Factoring
  - Credit insurance
- Wrapping up

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Issues in this chapter

- **Physical risks** can be insured
  - contract stipulates who has to insure—e.g. cif v fob price
- **“Credit” risks** of all kinds
  - non-delivery of goods or money
  - substandard or late delivery; late payment
  - bureaucratic hick-ups; transfer risk etc

  ... all complicated by
  - distance and travel time (persons, goods)
  - different jurisdictions
- **Financing**
  - extra long delays: travel, clear thru customs

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Outline

Simple solutions and their risks

- **Payment after delivery** like in domestic trade. X's risks:
  - .
  - .
  - .
  - .
- **Payment before shipment.** M's risks:
  - .
  - .
  - .
- **Legal redress?**
  - one party faces unfamiliar language, legal system
  - court ruling comes too late
  - ruling cannot be enforced in at least one country
  - Gvmt acting as Gvmt ("prince") is beyond the courts

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Keeping scores

Scorecard

		pay after delivery	pay before shipment	D/P	D/A	L/C	confirmed L/C
				a. Exporter's risks			
a.1.	Importer refuses goods	−	+	...	...	...	...
	Importer refuses documents	...	...				
a.2.	Importer defaults	−	+				
	L/C's issuing bank defaults	...	...	...	...		
a.3.	No license to import goods	−	+				
a.4.	No license to remit payment	−	+				
				b. Importer's risks			
b.1.	Exporter doesn't send goods	+	−				
b.2.	Goods sent do not conform	+	−				
b.3.	No license to ship the goods	+	−				

Trade bills

What's a trade bill?

- like an invoice: *drawn* by seller (*drawer*) upon buyer (*drawee*)
- refers to *trade* transaction
- *accepted* bills; *acceptance*

Why do banks like them?

- negotiable (discounting, rediscounting; discount house, CB)
- CB or specialized Gt discount house used to discount export bills at subsidized rates
- protesting: ruins your creditworthiness country-wide
- secured loan: recourse on drawer, who *endorses*

Payment via acceptance upon delivery?

- Importer's risk: time to inspect goods?
- Exporter's risk: default

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Documentary Payments: your bank helps

- **Documentary credits** (of many forms) try to
  - overcome the delay/distance problem
  - lower the importer's incentive to default
  - redistribute risks towards parties better placed to
    - assess the risk
    - bear the risk
- **The bank is your friend**
  - X sends docs that { describe the goods sent / provide title / are needed for customs } to a trusted intermediary,
  - ... who { verifies whether all required docs are there / transmits them to M }
  - ... against
    { either payment (D/P) / or acceptance of a bill (D/A) (+ signing trust receipt, sometimes) }

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Frequently asked documents (fads)

Documents Needed for the Customs Administration(s):

- A regular *commercial invoice* (an original and duplicates).
- A *customs invoice*—a form for M's Customs Dpt
- A *consular invoice*—certifying there is an import license
- A *certificate of origin* by exporter's government or the local chamber of commerce
- *Phytosanitary certificates* for verification of compliance with regulations.

Documents Needed by the Importer:

- The commercial invoice.
- An *inspection certificate* item (*cif* etc:) An *insurance policy* for the individual transaction or an insurance certificate.
- (*cif, fob* etc:) A *mate's receipt*: goods have been loaded on board a vessel contract, and useful whenever evidence of shipping is needed).
- A *shipping list*, describing the parcels, crates, or containers.
- *bill of l(o)ading*: (i) title to the goods and (ii) contract between the exporter and the shipping company. Clean/dirty bill.

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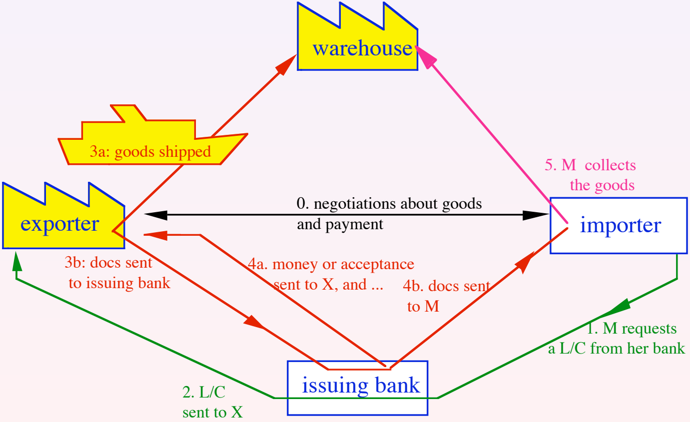
Letters of Credit: your bank guarantees

- L/C = promise to $\begin{cases} \text{pay immediately (D/P)} \\ \text{accept a bill drawn on bank (D/A)} \end{cases}$ if conformable docs arrive.
- international usance & practice (CC Paris), not codified law



Advising/Confirming

Risks not covered by regular L/C

- L/C may be counterfeited, or signed by unauthorized person, or issued by banks that are not trustworthy or hardly exist
- transfer risk, and
- default risk by issuing bank

Additional information or guarantees:

- Advised L/C: the advisory bank checks whether that bank really exists, looks sound; whether signatures seem to be OK
- Confirmed L/C: confirming bank actually guarantees the payment:
  - (D/P:) pays immediately upon receiving conformable documents
  - (D/P:) accepts a bill upon receiving conformable documents
- Forfeiting. The forfeiting company discounts, without recourse, the issuing bank's acceptance or even the customer's invoice.

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Final scores

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	Importer refuses documents	...	...	+	−	+	+
a.2.	Importer defaults	−	+	+	−	+	+
	L/C's issuing bank defaults	...	...	...	...	−	+
a.3.	No license to import goods	−	+	−	−	−	+
a.4.	No license to remit payment	−	+	−	−	−	+
		b. Importer's risks					
b.1.	Exporter doesn't send goods	+	−	+	+	+	+
b.2.	Goods sent do not conform	+	−	+?	+?	+?	+?
b.3.	No license to ship the goods	+	−	+	+	+	+

Benefits and costs

- **Benefits.** DocCredits achieve more than just risk-shifting:
  - Lower costs if default actually happens: issuing bank ...
    - is (often) wealthier & better diversified (insurance principle), and
    - operates in the same legal environment as importer (lower costs).
  - More reliable assessment of risk:
    - banks are specialized in evaluating credit/transfer risks;
    - issuing bank has inside info about importer.
    - confirming bank has more info about issuing bank.
  - Reduction of moral hazard:
    - importer will not lightly default towards its house bank,
    - idem for issuing bank towards confirming colleague
- **Costs**
  - Advisory fees: ca 0.10%, often capped
  - Confirmation fees: as of 0.10% for good risks and short maturities
  - Commissions for the actual payment or discounting: as of 0.10%

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Factoring

- **Services offered by a factor company may include:**
  - pure debt collection (with recourse; fee of e.g. 1/8-1/2%. “Export factor” & “import factor” cooperate.
  - credit insurance, sometimes up to 100%, for a fee of e.g. 0.5 to 2%.
  - accounts receivable financing, e.g., up to 85% for uninsured A/R, 100% for insured

- **Comparing with L/C’s:**
  - cannot be used on a case-by-case basis: a factor company wants to handle all sales, or at least all sales for a given market.
  - factor also first evaluates the customer and imposes credit limits per customer and/or per country.

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Credit insurance

◇ Who?

- ▷ private: Hermes, Euler: “near” exports, developed countries
- ▷ government: Eximbank, ECGD, ...: “far” exports, developing countries

◇ Coverage

- ▷ credit risk and/or transfer risk. [If the export contract is with a government body, credit risk and transfer risks are often not separated.]
- ▷ risk of contract cancellation can often be insured with government agencies.
- ▷ can be used either on a case-by-case basis, or for all contracts for a given market (better rates).
- ▷ coverage is never 100%, and depends on the type of policy.

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Wrapping up

The issues

- goods travel slowly and far $\Rightarrow$ working-capital financing issue. Trade bills provide low-risk and cheap financing.
- Direct B2B payments offer extreme distributions of risk to one party. Legal redress is difficult, costly, late.
- DocCredits reduce both probability of default and cost of bearing default, and shift risks to better-informed parties.

How financial institutions can help:

- D/P and D/A provide more balanced distributions, but there is still no insurance effect.
- Letters of credit shift risks to a bank that is better placed to assess them and to bear the costs of default. Id for confirmation. Advising may suffice.
- Factoring may combine debt collection with credit insurance and financing. Factoring does not work case by case.
- Insurance is available as a separate product, and possibly case by case (at a price). Cover is never 100%.

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