

# Alternatives in Trade Finance Tools

by Jee Meng Chen

**L**etters of credit are no longer the only game in town, and commercial banks are examining and using alternative tools in their international trade financing. This article looks at the applications and risks of alternative structures.



**S**ome 70% of business is transacted on an open-account basis, with only 30% still relying on traditional letters of credit (LCs).<sup>1</sup> Indeed, large importers prefer to trade on open-account terms instead of using the LC, which is seen as unduly cumbersome and costly. Large U.S. and European importers, especially those in the electronics and chemical sectors, now insist that their Asian suppliers sell goods on open-account terms.<sup>2</sup> J.C. Penney also announced its intention to dispense with LCs in favor of open-account deals supported by Internet-based trading platforms such as TradeCard.<sup>3</sup>

The decline of the traditional trade-financing model has two key implications for traders and commercial banks:

1. Exporters will have to reconsider their buyer risk expo-

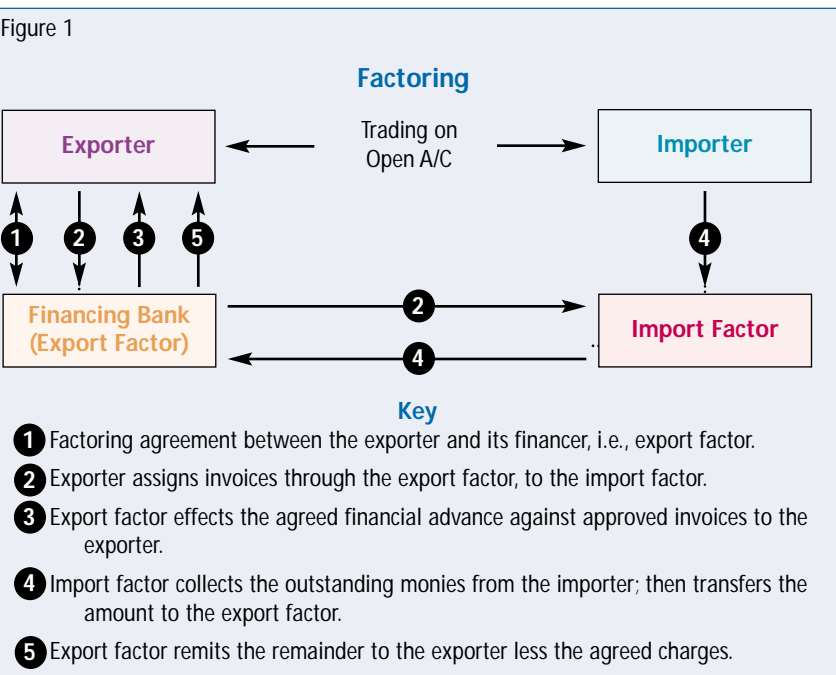
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sure and funding requirements. No longer the beneficiaries of LCs, exporters not only lose the guarantee of payment, but they also have to source for alternative financing arrangements, balancing between inherent risks and costs of protection. Similarly, importers should not restrict themselves to LCs alone. Going forward, the successful consummation of trade deals may hinge critically on finding the right banking partner to come up with the appropriate trade solution.

2. Edward de Bono says, “An opportunity is as real an ingredient in business as raw material, labor, or finance, but it exists only when you see it.” Commercial banks must remain responsive to the financing needs of their customers. The customer-retention rule is simple: If you don’t do it, someone else will, and you will likely lose the customer forever.

### Structured Flexible Financing

Notwithstanding the intricacies embedded within the UCP500<sup>4</sup> rules, financial institutions using the documentary credit system know that as long as documentation is compliant, reimbursement is guaranteed. But open-account trading offers no tangible form of security beyond recourse to the exporter, and risks increase significantly for working-capital transactions that are poorly structured. The financier, then, is challenged to offer a competitive financing package to the exporter while mitigating potential finan-



cial default risk. Perhaps, it is time to revisit what has been referred to as the “F” word in many circles—*factoring*. Factoring continues to be a growth industry, and the turnover globally is estimated at US\$700 billion a year—with 12% annual growth.

Under a factoring arrangement, the business firm sells its short-term account receivables to a factor or financial institution on a *with-* or *without-recourse* basis. The factor provides a comprehensive range of services, including collection, credit management service, credit risk protection, and more. Its perceived complexity comes from its flexibility. This facility can be broadly tailored along four dimensions: 1) payment, 2) advance or maturity, 3) recourse or nonrecourse, and 4) with or without notification to meet the specific needs of the trader.

While factoring is generally associated with the financing of consumer goods and services, it

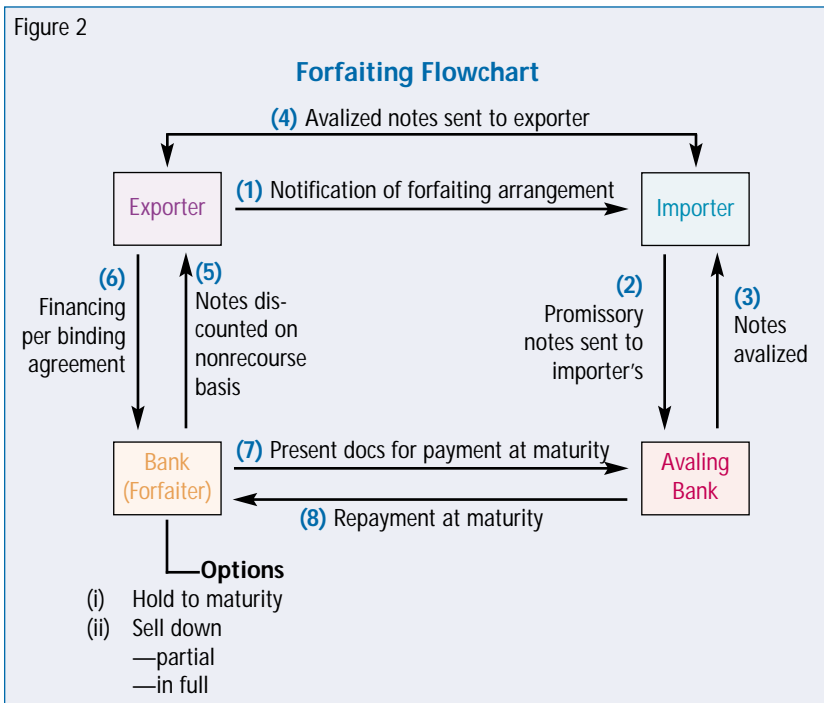
can be applied in international trading as well. International factoring is similar to domestic factoring except that it involves a two-factor system (see Figure 1).<sup>5</sup>

Commercial banks have shown increasing interest in providing factoring services, as financiers are looking at alternative “securities” to support their lending. In fact, receivables with a good spread of debts may qualify nicely. However, the factoring business is not easy, as it involves more than just lending and debt collecting. In the words of Terry Haydon (managing director, Commercial Factors Limited), “It’s not an industry for the faint-hearted.”

### Long-tenored Financing in Emerging Markets

Competition and market saturation inevitably drive many companies to venture abroad—often to unfamiliar but potentially lucrative territories. Consider the

Figure 2



dilemma of an exporter who is thinking about extending medium-term financing—say, five years—for the sale of heavy industry equipment to an importer domiciled in an emerging market. What’s the best way to mitigate financial default risk considering the length of time involved? Issuing usance documentary credits is an unlikely option, given that the conventional LC seldom caters to a financing period exceeding 360 days except for structured financing. And unless the margins are sufficiently lucrative, the all-in costs of credit structuring (not to mention the legal fees) are likely to erode the trader’s profit. A less complex option is *forfaiting*.

Forfaiting is a post-shipment finance instrument. It is the purchase of receivables (arising from an underlying export of goods and services), guaranteed (avalized) by the importer’s bank, without

recourse to the exporter. Figure 2 illustrates a simplified financing flowchart.

The importer may choose to issue 10 semiannual promissory notes, or bills of exchange, which will be payable sequentially at six-month intervals. The importer will request its financing bank to avalize the notes. The avalizing bank becomes the primary obligor. The avalized notes will be issued to the exporter, who will discount the notes with the financing bank (forfeiter) in accordance with the forfaiting agreement. By the process of forfaiting, the forfeiter advances cash (100% of the present value) on a non-recourse basis to the exporter in exchange for the notes. In this example, a bank aval is used as collateral. In practice, the underlying claims can be collateralized against other forms of security, namely, bank-issued guarantees and the deferred-payment LC.

The advantages to the exporter are the speed of setting up transactions as well as medium- to long-term nonrecourse financing. Also, from a balance-sheet-management perspective, the contingent liability is converted to cash up front. Forfaiting, however, can be expensive. But as one forfaiter candidly puts it, a taxi may be expensive at 2 a.m., but there aren’t many alternatives.

For the forfeiter, two choices are available.

1. It can retain the exposure on its banking book until maturity of the promissory notes.
2. It may “sell down” the notes either wholly or in specific tranches to interested investors in the secondary market.

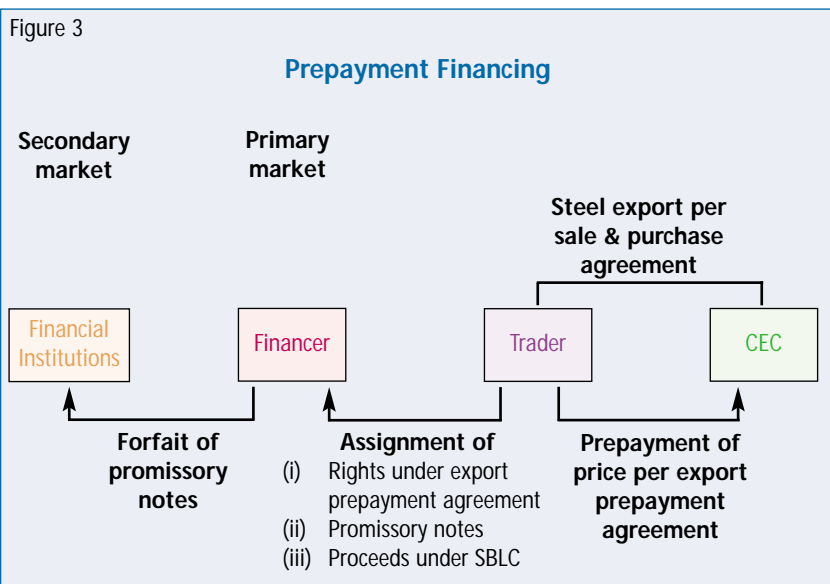
This choice offers flexibility to the forfeiter, especially when the bank is running low on its credit risk limits. Instead of being constrained by facility limits, the forfeiter could take on the transaction in anticipation of selling down the deal subsequently.

### Risk Management Techniques

Bankers are generally interested in risk-mitigating tools, but structured trade finance (STF) is seldom used. An STF transaction<sup>6</sup> is perceived as high risk; however, the underlying risks should be more palatable to lenders since a carefully structured transaction substitutes country risk and the buyer’s risks for the risk profile of the structure. STF makes it possible to go directly to the roots of the problem by isolating the various risks involved in the financing and systematically mitigating each. Let’s explore one variation of pre-export financing.

Suppose a commodity-trading intermediary (trader) predicts that steel prices will increase in the near term and enters into a 24-month supply contract for steel for US\$30million with Citec-com Engineering and Construction (CEC), a hypothetical end-supplier domiciled in South Korea. However, CEC is strapped for cash and requires up-front financing to begin production work. A conventional lending officer may suggest advance payment through a red-clause LC. However, the risks of non-shipment or diversion of funds would deter most banks from issuing red-clause credits. A more complex but safer technique involves the combination of green-clause LC and warehouse receipt financing. However, this arrangement brings in additional operational considerations. Besides, LCs do not come cheap. One viable financing strategy that circumvents the LCs is *prepayment financing*, as illustrated in Figure 3.

The financier would discount US\$30 million upfront and make the funds available to CEC in the form of a prepayment. CEC would repay the funds through steel shipments (which represents a performance risk) to the client in accordance with an agreed delivery schedule (sale & purchase agreement). To mitigate nonperformance risk, the financier may request in its favor a standby letter of credit from a South Korean issuing bank that has an acceptable credit rating. Upon each shipment, the client would repay the financier the respective amount due in cash (which represents a payment risk). Through use of structuring techniques, the



nature and extent of risks are virtually transformed, as illustrated in Figure 4.<sup>7</sup>

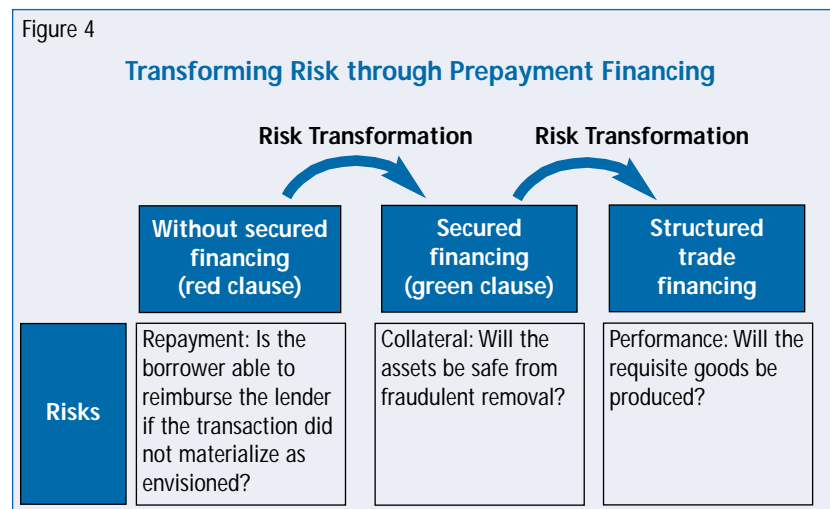
Under this financing structure, while the financial institution is providing working capital finance to CEC, payment risk is effectively transferred to the trader. Therefore, to minimize payment risk, the financier may stipulate that the goods have to be presold to acceptable buyers on firm fixed-price contracts. The financing structure may be further secured by the assignment of

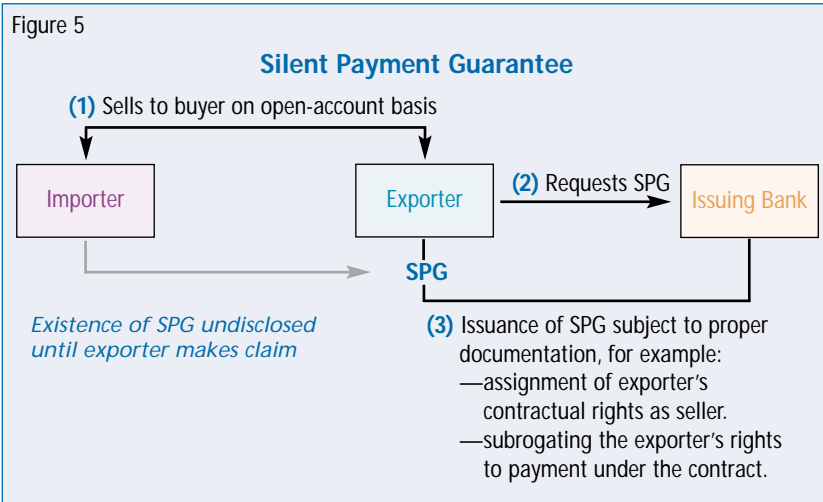
firm contracts.

Going forward, plain-vanilla lending will give way to structured financing. Bankers contemplating STF must understand performance risk and be able to mitigate such risk effectively.

#### Alternative Guarantee

Traditionally, exporters have relied on export credit insurance, be it government-backed or private contracts (e.g., Coface, Euler Trade Indemnity), to mitigate buyer and country risks. The





growth of financial engineering subsequently gave rise to a class of instruments known as credit derivatives, which were commonly used to hedge against counterparty risks. Financial innovativeness never ends, however. In recent years, the *silent payment guarantee* (SPG)<sup>8</sup> evolved to meet the needs of exporters, particularly oil traders who are unable to obtain the security of an LC.

In essence, the SPG is a conditional financial guarantee issued by a bank in favor of the exporter, indemnifying the latter against default by the importer. The SPG, however, does not cover performance risk or contractual disputes. It mainly covers financial payment risk. As the name suggests, this guarantee is issued in favor of the seller without the knowledge of the buyer. Figure 5 depicts the mechanics of the SPG.

While the SPG is no more complex than its counterparts such as credit risk insurance, strong documentation is a critical success factor.

### Conclusion

Gone are the days of “Take it or leave it.” Armed with the latest know-how, traders are equally competent to work alongside their banking counterparts to come up with appropriate trade solutions to suit the occasion. On the other end, whether you would like to call it the “emperor’s new clothes” or “old wine in new bottles,” product innovation is the key to surviving in the seas of change. Banks stuck in the old paradigm of lending operations, where financing is predicated on the firm’s balance sheet and/or backing of tangible collateral, would probably find themselves in difficulty at the moment of exit. But that said, banks should not create a new lending portfolio without having understood the intricacies of the trade product concerned, its idiosyncratic risks, and the requisite risk management controls. Any attempt to do so may lead to short-term profits but could be a long-term recipe for disaster. □

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### Notes

- 1 “Trade Finance Trends Favor Open Account,” *Documentary Credit World*, October 2003.
- 2 Moiseiwitsch, Jasper, “Time Bandits,” from “November 2001 Spotlight—Trade Finance,” *CFO Asia*, [www.cfoasia.com/archives/200111-03.htm](http://www.cfoasia.com/archives/200111-03.htm).
- 3 Clennam, Arthur, “A Whole New Trade,” from “September 2004 Spotlight—Trade Finance,” *CFO Asia*, [www.cfoasia.com/archives/200409-08.htm](http://www.cfoasia.com/archives/200409-08.htm).
- 4 *The Uniform Customs and Practice for Documentary Credits* (1993 Revision, ICC Publication No. 500) is comprised of 49 articles governing international trade published by the International Chamber of Commerce. See [www.ykl.co.kr/eng/logis/ucp.html](http://www.ykl.co.kr/eng/logis/ucp.html) or [www.iccwbo.org](http://www.iccwbo.org).
- 5 Interested readers may refer to [www.factoringkb.cz/english/Export.html](http://www.factoringkb.cz/english/Export.html).
- 6 *STF* is commonly described by practitioners as the art of transferring risks in trade financing from parties less able to bear those risks to those more equipped to bear them in a manner that ensures automatic reimbursement of advances from the underlying assets.
- 7 Adapted from UNCTAD (United Nations Conference on Trade and Development), [www.unctad.org](http://www.unctad.org).
- 8 For details on this product, readers may refer to Balasingham, Arjuna, “Alternative Financial Products: The Silent Payment Guarantee,” *DCInsight*, October-December 2002.

