Module - 32
Financing of International Trade

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With the globalization and advent of e-commerce, international trade flows have increased manifold. With increased opportunities of export and import, the attendant risk associated with international trade flow has also increased. Not that the risk associated with international was always there.

As exporters and importers from different countries, separated not only by physical distance but by socio-political conditions, international trade was always been quite risky. In this module, different types of risk faced by parties in international trade have been discussed as well as how parties mitigate these risks has been focused upon.

**Learning Objectives:**

This session covers:

- **International Trade and Documentary Credit**
- **Features of Letters of Credit.**
- **Pre and Post Shipment Export Finance**
  - Packing Credit
  - Advance against Cheques/Draft received by the exporter as Advance Payments.
- **Export Credit Insurance**
In international trade, as buyers and sellers belong to two different countries, there exists a great degree of **credit risk**. The seller may not comfortable to ship goods and not worry about buyer defaulting on payment. Documentary credit facilities offered by banks solve these types concerns of the exporters.

Once the seller and buyer agree to the terms of a sale (quantity, quality, delivery date, delivery mechanism, pricing details as mentioned in Section 7), the buyer requests its bank to undertake payment obligation on the buyer’s behalf in favour of a seller. In other words, a bank on behalf of the buyer undertakes the payment obligation to seller subject to seller fulfilling certain documentary conditions. This arrangement is known as **letter of credit** or **LC**.

In a typical **Letter of Credit (LC)**, on behalf of the buyer, a bank (known as issuing bank) agrees to pay the seller a specific amount of money once the seller presents documentary evidence indicating that the seller as sent the goods/ deposited the goods as per the terms of sale as mentioned in the LC.

The seller is known as the **beneficiary as the seller is going to receive the export consideration**. The issuing bank releases the amount due to the beneficiary as long as the beneficiary provides documentary evidence. If the buyer is unhappy with any acts and omission by the seller but bank perceives that the seller has fulfilled his obligations as mentioned by the LC, the issuing bank is obligated to release money to the beneficiary. This means that the LC has a distinct existence from the terms of sale contract agreed by the buyer and seller. The issuing bank examines the details given in the LC before it releases payment to the seller. Documents, which are to be produced by the seller, are commercial invoice, transport document such as a bill of lading or airway bill and an insurance document if the seller pays for the insurance. Hence, it becomes important for both the buyer and seller to ensure that the details given in LC is as per the terms sale.
After paying to the beneficiary (seller), the issuing bank in turn collects the payment from the buyer. Besides the issuing banks, some other entities are involved in the whole process of LC issuance and payment. These are **advising bank** and **confirming bank**.

The advising bank is correspondent bank of LC issuing bank. The advising bank helps the beneficiary and is a bank in the country of residence of the beneficiary. The advising bank helps the seller in sending the LC documents to the issuing bank. The advisory bank does not have any obligation in the whole process. For any reason, if the issuing bank does not pay to the beneficiary, the advising bank is not obligated to pay any amount.

Theconfirming bank is a correspondent bank of LC issuing bank. Like a advising bank, the confirming bank is a local bank operating in the country of residence of the seller. The confirming bank may confirm the LC payment to the seller. The confirming bank confirms only when it is sure that issuing bank is going to pay for the LC. Not only the relationship between the confirming bank and issuing bank is crucial factor, but the country of origin of the LC is vital. If a confirming bank feels that the buyer’s reputation is at stake, a bank may decline to act as a confirming bank and merely act a advising bank.

### 32.2: Features of Letters of Credit:

In this section, we discuss other features associated with LCs. LCs can be of sight or time draft in nature, can be negotiable, can be revocable can be revolving. In the **Annexure 15.1**, features of LCs issued by **Barkley’s Bank** are given.

All LCs require the seller (beneficiary) to present a draft and **specified documents** in order to receive payments from the issuing bank. A draft is a written order, where by the buyer orders the LC issuing bank to pay money to the seller. This draft is known as a “**bill of exchange**”. The bill of exchange can be of sight or time in nature. In a **sight bill of exchange**, the seller receives payment from the issuing bank, as soon as it is presented for payment. The bank reviews document within some given number of days and then makes payment.
In case of time bill of exchange, the issuing bank does not release payment to the seller (beneficiary) till a specific period time has lapsed. Even if the seller presents the bill of exchange, the issuing bank pays only after the maturity.

In a **negotiable LC**, the issuing bank is obligated not only to pay to the seller (beneficiary) but also any bank nominated by the beneficiary. Negotiability feature ensures that the ownership of these LCs can be passed freely from one party to another party. The issuing bank is obligated to pay the party who is presenting the LCs.

If a LC is **revocable**, then the features of the LC can be changed at any time by the issuing bank without consulting the seller (beneficiary). The **irrevocable letter of credit** cannot be modified without the agreement of the issuing bank, the confirming bank, and the beneficiary. An irrevocable letter of credit from the issuing bank insures that all the documents are in proper order, then the issuing bank is obligated to make repayment. Whether a LC is revocable or irrevocable, it is very clearly mentioned on the LC issued by the bank.

A **revolving LC** is issued when the seller (beneficiary) sends regular shipments to a particular buyer as part of long-term supply contract, instead of entering into a LC contract for every order, an issuing bank guarantees payment for a series of shipments to be covered under a single LC. Once the buyer reimburses the amount paid to seller by the issuing bank, the LC amount is reinstated. In other words, the buyer gets the benefit of LC, till the total amount sanctioned for LC by the issuing bank is not utilized by the seller.

To summarize, the **steps involved in the letter of credit:**

- The seller and buyer negotiate the terms of sale.
- The seller deposits the goods at the carrier or ships it.
• The seller collects the necessary document indicating that the goods have been shipped.
• The seller presents a “bill of exchange” which the buyer ratifies.
• The seller presents the bill of exchange and other supporting documents to a local bank or a correspondent bank. The correspondent bank in turn forwards these documents to issuing bank.
• Once issuing bank checks the document, the correspondent bank releases money to the seller.
• The correspondent bank then reimburses the payment from the issuing bank.
• The issuing bank contacts the buyer and the buyer pays the due amount to the issuing bank.
• The issuing bank, then releases the original document to the buyer.
• Using the original document, the buyer releases the goods from the carrier.

The rules pertaining to the letter of credit is governed by the “International Chamber of Commerce (ICC)”. ICC has a standard set of rules known as “The uniform Customs and Practice (UCP) for Documentary Credit”. From time to time ICC revises UCP rules. The last revision was approved by the Banking Commission of the ICC during October 2006. This latest version, which is known as UCP600, came into existence in 1 July 2007. Banks of around 175 countries use the UCP600 standard for handling LCs. The guidelines for handling of electronic LCs is given by separate set of guidelines issued by ICC.

32.3: Pre and Post Shipment Export Finance:
To promote export, all most countries have specific financial institution to provide credit to exporters. The export credit is broadly classified as pre and post shipment export finance.
As there could be considerable lag in receiving the actual exporter order and final payment from the overseas importer, financial institutions provide loans so as to facilitate export.
In fact each and every country has a dedicated financial institution to promote international trade. The Export and Import Bank of India was started with the sole purpose of promoting international trade. The objectives of Export and Import Bank of India is given in **Box 32.1**

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<th>Box 32.1: Objectives of Export Import Bank of India</th>
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<td><strong>Source:</strong> <a href="http://www.eximbankindia.com/objective.asp">http://www.eximbankindia.com/objective.asp</a></td>
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“… for providing financial assistance to exporters and importers, and for functioning as the principal financial institution for coordinating the working of institutions engaged in financing export and import of goods and services with a view to promoting the country’s international trade…”

“… shall act on business principles with due regard to public interest”

: The Export-Import Bank of India Act, 1981

In this section, pre and post export finance aspects are discussed in detail.

### 32.3.1: Pre Shipment Export Finance:

Pre shipment loan is provided by banks and financial institutions to an exporter even before the exporter has exported goods. Basically the loan is nothing but a working capital loan. The exporter uses the loan to

- Procurement of raw materials.
- Incur expenses towards manufacturing and other expenses
- Process and pack the goods.
- Ship the goods to the overseas importer.
- Meet other financial cost of the business.

Pre shipment loan is normally given to parties having confirmed export orders in their name in hand. Sometimes, even without a confirmed order in their name, financial institutions may grant loan but only when the exporter is a third party supplier to another exporter having a confirmed order in their name. For example, manufacturer A is a
supplier to manufacturer B. Manufacturer B has got a confirmed export in its name. In this case, both manufacturer A and B are eligible to get pre shipment export credit.

Pre shipment credit can be two types.

- **Packing Credit**

- **Advance against Cheques/Draft received by the exporter as Advance Payments.**

Packing credit is the generic term used to provide loans to finance the activities related to exporting goods. Packing credit is provided only when the exporter produces documents. These are:

- The confirmed order received from the overseas importer and should have detailed information about the overseas importer, description, quantity and value of goods (FOB or CIF etc.), destination port and the last date of payment.
- Firm order or irrevocable L/C or original cable / fax / telex message exchange between the exporter and the overseas importer.
- License issued by **DGFT (Directorate General of Foreign Trade)** if the goods to be exported fall under the restricted category. If the item falls under quota system, proper quota allotment proof needs to be submitted.

### 32.3.2: Post Shipment Finance

**Post shipment is a loan provided by a bank to an exporter after the shipment of good has happened.** As there is a time lag between the date of shipment and receipt of money from the buyer, exporters get financial facilities during this interim period. In other words, banks or financial institutions provide finance for export sales receivable after the date of shipment of goods to the date of realization of exports proceeds. As part of the export financing, the banks obtain the documents of the title of the goods from the exporters. Since the finance is extended against, evidence of export shipment and bank obtains the documents of title of goods.
If the export bill purchased/negotiated/discounted is not realized on due date, these obligations are converted to rupee obligation. This is known as **crystallization of export bill**.

Besides providing pre and post shipment loan facilities, financial institutions of all most all countries provide insurance cover for different types of risk faced by exporters.

### 32.3 Export Credit Insurance:

The Export Credit Guarantee Corporation of India Limited (ECGC) provides export credit insurance support to Indian exporters. One of the primary objectives of ECGC is to credit risk insurance covers to exporters against loss in export of goods and services. **Box 33.2** shows how ECGC provides insurance cover to Indian exporters. ECGC also has started providing export covered for IT exports.
Box 33.2 Grape exporters get ECGC compensation: Pays Rs 60 lakh as buyers default payment

February 10, 2006


Export Credit Guarantee Corporation of India (ECGC) recently settled claims of around Rs 60 lakh in favour of grape exporters in Pune and Nashik after buyers abroad defaulted on payment for their crop.

Releasing the cheques in a meeting of grape exporters and bankers in Pune today, M Kumar, regional manager (west) of ECGC stated that the corporation was keen to provide its best support to exporters of grape, pomegranate and other fruits and vegetables in order to promote export.

There is tremendous potential for export of these agro-products from western India, particularly, Pune and Nashik areas, given the suitable soil and weather conditions, marketing facilities and infrastructure.

However, since exporters here are the farmer themselves, they concentrate primarily on production of the crop. There is thus precious little time for them to learn about the contractual and commercial procedures of export.

Often buyers abroad take advantage of weak and vague sale contract terms and refuse payment citing quality problems and poor market conditions. Perishable nature of the fruits and vegetables and seasonal availability further complicate the problem.

In a recent case, one particular buyer from the Netherlands defaulted on payment of almost Rs 2 crore to five grape and pomegranate exporters from Pune and Nashik.

ECGC, on its part, is compensating those exporters who had covered their exports under its policy by obtaining suitable credit limits on the buyer and by paying a premium.
Short Questions:

1. What are different groups in INCOTERMS?
2. What are the features of letters of credit?
3. Why companies/exporters solicit pre as well as post shipment export credit?
4. What are the difference between revocable and irrevocable LC?
5. What roles do ECGC play?

References:

  http://www.allacademic.com/meta/p_mla_apa_research_citation/1/6/7/9/6/p167964_index.html

- BRIEF SPECIMEN CONTRACT FORM FOR SALE PURCHASE TRANSACTIONS
  http://www.indiandata.com/trade_policy/export_procedures.html#7

- INCOTERMS, Source: FEDAI Handbook on “Documentary Credits & Standby Credits”.


- Grape exporters get ECGC compensation: Pays Rs 60 lakh as buyers default payment, Source:

Documentary Letters of Credit

A Documentary Letter of Credit (LC) is a written undertaking given by a bank on behalf of an overseas importer to pay the exporter a given sum of money within a specified time, providing that the Exporter presents documents which comply with the terms laid down in the Letter of Credit.

Letters of Credit can be for any amount, in any freely traded currency, and, subject to the presentation of compliant documents, may be payable:

- **at sight**, which means as soon as a compliant set of documents are presented to the paying bank; or,
- **after a specified term**, e.g. at 30, 60, 90 or 180 days of sight or Bill of Lading date.

If the documents are not presented exactly as specified in the Letter of Credit, payment will not be made unless the overseas importer gives their authority to waive or amend the specified condition.

A fundamental principle of Letters of Credit is that banks deal with documents and not with the goods to which the documents refer.

For example, if the overseas importer is not happy with the quality of the goods but the documents comply with the terms and conditions of the Letter of Credit, the overseas importer's bank is obliged to pay the Exporter.

In the process of a Letter of Credit transaction, there are essentially four parties involved. These parties can be referred to by a number of terms, outlined below.

**Buyer meaning Importer, Applicant, Accountee or Accreditor.**

In this guide we use the term Importer. Seller meaning Exporter or Beneficiary; here we use the term Exporter.

The Issuing or Opening Bank (Importers Bank)

The Advising/Confirming Bank - usually a bank in the Exporters country which may or may not be the Exporters Bank.
Types of Letter of Credit

Revocable
This is an LC that can be cancelled or amended by the applicant or the Opening Bank without prior notice to the Exporter.

Irrevocable
With an irrevocable Letter of Credit the Issuing Bank gives its irrevocable undertaking to pay if all the terms of the LC are met. The Issuing Bank can only amend or cancel its undertaking if all parties to the LC consent to the change.

NB: Although there are two types of Letter of Credit: revocable and irrevocable, LCs dealt with by Barclays are irrevocable. Under UCP600 (Uniform Customs and Practice for Documentary Credits), LCs are assumed to be irrevocable.

Confirmed
A Confirmed LC is one to which a second bank, usually in the Exporter's country and at the Exporter's request, adds its own commitment (confirmation) that payment will be made. Confirmation is generally used when there is perceived to be some risk that the bank issuing the Letter of Credit may not be able to fulfil its obligation to pay. This could be due to bank failure or instability in the country of the Issuing Bank.

Unconfirmed
If the LC is unconfirmed, the Advising Bank merely informs the Exporter of the terms and conditions of the LC without adding its own undertaking to pay or accept under the terms of the LC.

Transferable
A Transferable Letter of Credit is one that can be transferred from the first Beneficiary to one or more additional Beneficiaries by the Transferring Bank.

It is normally used in situations where a supplier sells through an intermediary or 'middleman' to the ultimate Importer and is in a strong enough bargaining position to insist upon payment by Letter of Credit. By using a Transferable Letter of Credit, the intermediary is able to provide payment by LC to their supplier without the need for their own credit line with the transferring bank. An LC is only transferable if it is expressly stated to be so by the Issuing Bank.

Others
There are other less commonly used variations of Letter of Credit, for example Back-to-Back, Red Clause and Revolving. Barclays can advise you of the type of Letter of Credit best suited to meet your needs. More detailed information on other types of LC.