

Reprinted from

# CREDIT TODAY

TOMORROW'S TOOLS FOR TODAY'S CREDIT PROFESSIONALS

May/June 1998

## INTERNATIONAL CREDIT TODAY

### Confirmed, Irrevocable Letters of Credit Are Not Always the Answer

by Walter (Buddy) Baker, ABN AMRO Bank, Chicago

Perhaps your company has dabbled with exporting for a few years and management likes the results: increased sales, access to markets which even out seasonal and economic cycles in the U.S., new outlets for older products, *etc.* What was originally an experiment is looking like a strategy. The Sales group has been given the green light to hire more people and the objective of raising exports from 10% of annual sales to 25%. Your job in Credit Management is to protect the company from losses which may result.

Up until now, the job hasn't been too tough. By setting a policy of shipping only against cash in advance (U.S. dollars, to be sure), or confirmed, irrevocable letters of credit, you've avoided the political, economic, and commercial risks of exporting. Or perhaps the Sales folks have been limited to bringing on customers in Canada and Western Europe, whose culture and legal and accounting systems are similar to those in the U.S. But now your Sales people are going to be venturing into new markets — South America, Eastern Europe, and Asia — and you know they're going to whine that they won't be competitive unless you, in the Credit Management (often vilified as "Sales Obstruction") Department will approve more liberal terms of sale.

You know there are other ways to protect your receivables besides confirmed, irrevocable L/Cs, but what are the trade-offs? When are unconfirmed

L/Cs appropriate? How do you use forfaiting? Where can credit insurance help? What are the risks of taking bank guarantees? These are all tools and no single one is appropriate for every situation. What you need is a complete toolkit and an instructions manual which helps you identify when and how to use the hammer, the screwdriver, or the power drill.

Think of the accompanying chart as a cheat sheet. Across the top, I've listed the main categories of risk encountered in export sales. Along the left, I've listed the major risk mitigation tools. Depending on the combination of risks you are trying to cover, you use the chart to pick the tool.

#### Step 1. Quantify the Risks in the Deal.

This is no simple task, but having a list of export-related risks will give you a starting point. I believe most of the risks enumerated in the chart are fairly self-explanatory. They are derived from definitions found in credit insurance policies. The first four categories may be grouped as commercial risks while the next four are country risks. (Note that this includes natural as well as man-made disasters as either may disrupt business in a country.) I've listed "World War" as a category because it is often specified in credit insurance policies that losses due to such an event are not covered — I call this the "end of civilization" gap. The idea is to

assign a score to each of these risks based on the company you are selling to and the country in which they are located.

The final category only applies to sales made in foreign currencies. The risk of currency devaluation is treated with its own set of tools, in the form of foreign exchange forwards and options — it is not included in any of the other risk mitigants. Different currencies have different amounts of risk. I will not be addressing FX risk any further in this write-up, but your bankers can give you complete instructions for the pertinent risk mitigation tools.

#### Step 2. Decide Which Risks to Take and Which to Hedge.

Your salesman's desire to make the sale must be balanced against the company's probability of taking a loss. Your risk appetite will depend on many things, like

- what credit terms the competition is offering
- whether your products are custom-made or off-the-shelf and whether there is a ready market for them (*i.e.*, are you taking a risk by even producing the product — if the buyer changes his mind before you ship, what will happen to your sunken costs?)
- the size and frequency of your shipments and, therefore, the highest credit amount you might have outstanding at any one time
- your profit margin

# What's the Best Way to Protect your Assets?

Method of Risk Protection \ Risk	Payment/ Default	Insolvency	Ship-ment Contract Repudiation	Contract Dispute	Exchange Inconvertibility	Government Legislation	Coup/ Civil Turmoil	Exposure to Natural Disaster	Civilization?/ World War	Exchange Rate Fluctuation Devaluation
Unconfirmed, Freely Negotiable L/C										6
Unconfirmed, Non-Negotiable L/C				1						6
Confirmed L/C				1						6
Silent L/C Confirmation										6
Standby L/C				1	3	3	3	3	3	6
Independent/ Demand Guarantee				2	3	3	3	3	3	6
Ancillary/ Contract Guarantee/Surety Bond			4							6
Factoring										6
Non-Recourse Sale of Receivables										6
Forfaiting										6
Credit Insurance (Comprehensive)			5							6
FX Contracts (Forwards & Options)										

- Notes:
1. Although the bank must pay a letter of credit even if notified by the applicant that a dispute exists, it is possible for the applicant to obtain a court injunction to prevent payment if the L/C contains "straight payment," "restricted negotiation" or "deferred payment" language, as is common with confirmed L/Cs and standby L/Cs and possible even with unconfirmed L/Cs. This course of action is not available to the applicant, however, if the L/C is "freely negotiable," as is standard with L/Cs covered by silent confirmations.
  2. Some issuers of demand guarantees will not pay when there is a dispute until the dispute has either been resolved or an arbitration judgment has been issued.
  3. Country risks are covered if the L/C is confirmed by a U.S. or European bank (in the case of a demand guarantee, if the guarantee is issued by a U.S. or European bank).
  4. If the contract is repudiated, there is a significant risk of repudiation by the guarantor as well.
  5. Contract repudiation insurance is available as additional coverage, but not normally as part of comprehensive credit insurance.
  6. The exporter has no exposure to exchange rate fluctuation risk as long a sale of goods (and the related commercial L/C, standby L/C, draft, etc.) is denominated in the exporter's currency. If the sale is denominated in foreign currency, he is exposed if he has not secured an FX contract or other form of "hedge."



- freight costs (*i.e.*, can you bring the product back if the buyer changes his mind after you ship but before he takes possession, or is it cheaper to dump the product in the ocean?)
- credit practice in the country you are dealing with (don't depend on the customer for an honest answer — get your information from the FCIB-NACM or other groups of Export Credit Managers)
- credit practice in your industry
- your corporate cash flow and capacity for carrying receivables

You may find you are willing to trade one risk off for another when you get to Step 3.

### Step 3. Choose Your Tool.

This is where you pick your terms of sale: letter of credit, sight or time draft collection, or open account. Each of these terms of sale may then be combined with additional risk mitigation techniques, some with the buyer's cooperation and some without the buyer's knowledge. Be aware of the following as you read the chart and choose your tool:

- Unconfirmed L/Cs do not cover country risks, whereas confirmed ones do. It is important to pay attention to who the confirming bank is as confirmation by a branch of the issuing bank provides no protection against country risk.
- If you gave contract dispute even a moderate score in Step 1, it is best to stay away from non-negotiable L/Cs because payment can be enjoined or stopped on these L/Cs. (I've indicated that this risk is not completely covered by using dark gray instead of black and white.) Freely negotiable L/Cs are those that indicate they are "available with any bank by negotiation," thereby authorizing any bank to buy the drafts and become a "holder in due course." Banks are willing to do this because a holder in due course is protected under negotiable instrument law against injunctions, meaning you are too. You should always insist on getting freely negotiable L/Cs because it doesn't really bother the applicant and gives you a great deal of flexibility. Note

that, on the whole chart, only freely negotiable L/Cs (including silent confirmations) and forfaiting provide complete protection against contract disputes.

- A "silent confirmation" is an arrangement more properly referred to as a "commitment to negotiate drafts without recourse." It is only offered for freely negotiable L/Cs (making this one more reason to insist on getting them) and provides all the same protection as a normal confirmation—as long as documents comply, the bank is committed to purchasing them. The big benefit is that the exporter has complete freedom to choose the confirming bank rather than trusting the buyer to get the L/C confirmed by an acceptable bank. The risk protection, service, and price are usually better because you choose the bank. A side benefit is that silent confirmations cannot be enjoined in the event of a contract dispute. You also do not have to tell the buyer you are obtaining a silent confirmation, which is often more palatable than requiring a confirmed L/C. Note that this is actually the most comprehensive form of risk protection you can get.
- Standby L/Cs and independent or demand guarantees can both be used to shore up open lines of credit. They both assure payment by a bank if the applicant fails to himself pay, but they operate under slightly different rules. Most standby L/Cs are issued subject to the *Uniform Customs and Practice for Documentary Credits* (the "UCP"), the same rules as for export L/Cs. Under these rules the issuer engages to pay within 7 business days of presentation of compliant documents, no questions asked. Demand guarantees, if they are issued subject to any rules at all, are commonly subject to the *Uniform Rules for Demand Guarantees*. These rules require notification to the applicant of any drawing with payment to follow within a "reasonable time." This opens the door for the applicant to dispute payment and the issuer to extend the "reasonable time" to include obtaining

a court order or arbitration award before paying. In order to obtain protection from country risks, a standby L/C would be confirmed by a local bank while a separate demand guarantee would be issued by a local bank against a "counter-guarantee" from the applicant's bank. Neither one is going to be freely negotiable, so there is a risk of injunctions either way.

- Contract guarantees amount to someone co-signing the contract. They are subject to contract law rather than any standard international rules. For this reason, they are no good in the event of a contract dispute and their value is dubious in the event of contract repudiation. (Note the box is gray.) Furthermore, guarantors are invariably local to the party they are co-signing for, so no protection is provided against country risk. When someone offers you a "bank guarantee," it is important to determine whether it will be a contract guarantee or a demand guarantee. Be very leery of contract guarantees and try to get a standby L/C.
- Factoring is a very interesting and much misunderstood tool which provides risk protection and more for open account sales. Factoring can be characterized as the outsourcing of the Credit & Collections process. The factor approves or disapproves individual buyers and sets credit limits for each. The factor takes over the actual collection of payment and assumes responsibility for timely payment. If the buyer fails to pay, the factor pays instead. In the event of a contract dispute, however, the factor's liability is suspended. Although factoring is often equated with selling receivables by companies who cannot qualify for unsecured loans, such financing is an add-on that many cross-border factors would rather omit. Factoring is severely limited in its applicability as it can only exist in countries with the proper legal environment. Right now, this is the traditional Western economies. Another limitation is that factoring does not cover country risks, but this is

not generally a concern in the countries where factoring is available. Despite its limitations, factoring may be just the right tool for managing credit risk incurred by European sales offices. Cross-border factoring is available through a small set of banks and factoring houses in the U.S. and Europe.

- Non-recourse sale of receivables is a highly specialized and customizable combination of risk protection and financing. Due to the fact it is based on lending money to foreign companies, it is only offered by banks with offices in multiple countries. After the foreign buyer has received the goods and acknowledged to the bank its intent to pay in accordance with the terms of the underlying contract of sale, the bank takes over the financing from the exporter. Once cashed out, the exporter has no further risks, but he is completely exposed until then and finalizing arrangements may take 30 to 60 days after shipment. For this reason, this tool is only useful for open account sales with extended payment terms.
- Forfaiting is much quicker to complete than non-recourse sale of receivables and much broader in its applicability than factoring. The difference is that the foreign buyer agrees to sign a debt instrument. The debt instrument, usually in the form of a draft, may or may not be "avalized" or guaranteed by the buyer's bank in order to enhance the instrument for sale to a forfaiter. To expedite matters, a time draft collection procedure may be used where the draft is sent by the forfaiting bank to the buyer's bank along with the original shipping documents and instructions to release the documents once the draft has been accepted ("documents against acceptance") and, if necessary, avalized. The forfaiter may commit to buy the draft immediately upon acknowledgment of acceptance (and avalization). The use

of a debt instrument cuts off contract disputes and injunctions and the sale of the draft or note without recourse eliminates country risks. The only major uncovered risk with forfaiting is refusal by the buyer to accept the draft or refusal by the bank to add its aval. I have characterized these as pre-shipment risk on the chart as they usually leave the exporter with control of the goods and the risk of finding another buyer. Note that this gives the exporter the same risk protection as a sight draft ("documents against payment") but provides the buyer with financing.

- Credit insurance can be obtained for individual buyers, one at a time, or whole portfolios of exports, all at once. Credit insurance is like car insurance: you must retain part of the risk (usually at least 10% of each loss and maybe a first-loss deductible) as an incentive to avoid "accidents." Risks covered can be picked and chosen, though one usually obtains either coverage against all commercial risks, all country risks, or both (comprehensive coverage). Separate coverage is available for contract repudiation risk but there is no coverage available for contract disputes. This makes sense as the insurer should not pay if the buyer has a legitimate reason to refuse your shipment—the problem is an insurer cannot tell the difference between legitimate and fabricated reasons. If you pursue whole portfolio coverage, you would normally exclude sales made on letter-of-credit terms and possibly sales made against sight and time drafts, especially if you plan to forfeit your time drafts. Like factoring, credit insurance does not use up your customers' lines of credit with their banks. Not only do your customers not need to know you're insuring your sales to them, the insurers often prohibit you from telling them. It looks to your customers like open account, and therefore very friendly. Behind the scenes, the insurer will be

telling you what terms and credit limits you can extend to which customers.

- Be aware that all forms of risk mitigation have some sort of compliance and documentation risk. The party providing the risk protection will set conditions which must be met and documented. If the documentation is not in order, the third party will not pay. For letters of credit, the documentation is that specified in each L/C. For credit insurance, the documentation required to file a claim will be specified in the policy. A major complaint with letters of credit is the documentation required for payment. Much or all of the same documentation will be required in order to file an insurance claim, but you won't know whether it's in order until much later in the game.

I've tried to focus on the risk protection aspects of each of the tools I've described, but be aware that each has its own cash-flow implications which may be important to your company. I've also not provided any information about pricing as it is so dependent on variables particular to your export profile and risk appetite. You should contact your banker and your insurance broker for detailed information about how to use each of the tools I've described and prices. (Feel free to call me if your own banker or broker is unfamiliar with these tools as some are only offered by a small set of providers.) Hopefully, you can use this information to assemble a complete toolkit from which to take the right tool for each situation your Sales people will dish out.

*Buddy Baker is a Group Vice President and handles Risk Management for the Global Trade & Advisory group at ABN AMRO Bank. He is based in Chicago and can be reached at (312) 904-4467 or over the Internet at [buddy.baker@abnamro.com](mailto:buddy.baker@abnamro.com).*