LEARNING OBJECTIVES

◆ Learn how international trade alters both the supply chain and general value chain of the domestic firm, thereby beginning the globalization process in the trade phase.

◆ Consider what the key elements of an import or export transaction are in business.

◆ Discover how the three key documents in import/export, the letter of credit, the draft, and the bill of lading, combine to both finance the transaction and to manage its risks.

◆ Identify what the documentation sequence is for a typical international trade transaction.

◆ Learn how the various stages and their costs impact the ability of an exporter to enter a foreign market and potentially compete in both credit terms and pricing.

◆ See what organizations and resources are available for exporters to aid in managing trade risk and financing.

◆ Examine the various trade financing alternatives.

The purpose of this chapter is to explain how international trade, exports and imports, is financed. The contents are of direct practical relevance to both domestic firms that just import and export and to multinational firms that trade with related and unrelated entities.

The chapter begins by explaining the types of trade relationships that exist. Next, we explain the trade dilemma: exporters want to be paid before they export and importers do not want to pay until they receive the goods. The next section explains the benefits of the current international trade protocols. This is followed by a section describing the elements of a trade transaction and the various documents that are used to facilitate the trade’s completion and financing. The next section identifies international trade risks, namely, currency risk and noncompletion risk. The following sections describe the key trade documents, including letter of credit, draft, and bill of lading. The next section summarizes the documentation of a typical trade transaction. This is followed by a description of government programs to help finance exports, including export credit insurance and specialized banks such as the U.S. Export-Import Bank. Next, we compare the various types of short-term receivables financing and then the use of forfaiting for longer term receivables. The Mini-Case at the end of the chapter, Crosswell International and Brazil, illustrates how an export requires the integration of management, marketing, and finance.
The Trade Relationship

As we saw in Chapter 1, the first significant global activity by a domestic firm is the importing and exporting of goods and services. The purpose of this chapter is to analyze the international trade phase for a domestic firm that begins to import goods and services from foreign suppliers and to export to foreign buyers. In the case of Trident, this trade phase began with suppliers from Mexico and buyers from Canada.

Trade financing shares a number of common characteristics with the traditional value chain activities conducted by all firms. All companies must search out suppliers for the many goods and services required as inputs to their own goods production or service provision processes. Trident’s Purchasing and Procurement Department must determine whether each potential supplier is capable of producing the product to required quality specifications, producing and delivering in a timely and reliable manner, and continuing to work with Trident in the ongoing process of product and process improvement for continued competitiveness. All must be at an acceptable price and payment terms. As illustrated in Exhibit 19.1, this same series of issues applies to potential customers, as their continued business is equally as critical to Trident’s operations and success.

The nature of the relationship between the exporter and the importer is critical to understanding the methods for import-export financing utilized in industry. Exhibit 19.2 provides an overview of the three categories of relationships: unaffiliated unknown, unaffiliated known, and affiliated.

◆ A foreign importer with which Trident has not previously conducted business would be considered unaffiliated unknown. In this case, the two parties would need to enter into a detailed sales contract, outlining the specific responsibilities and expectations of the business agreement. Trident would also need to seek out protection against the possibility that the importer would not make payment in full in a timely fashion.

◆ A foreign importer with which Trident has previously conducted business successfully would be considered unaffiliated known. In this case, the two parties may still enter into a detailed sales contract, but specific terms and shipments or provisions of services may be significantly looser in definition. Depending on the depth of the relationship, Trident may
seek some third-party protection against noncompletion or conduct the business on an open account basis.

A foreign importer which is a subsidiary business unit of Trident, such as Trident Brazil, would be an affiliated party (sometime referred to as intrafirm trade). Because both businesses are part of the same MNE, the most common practice would be to conduct the trade transaction without a contract or protection against nonpayment. This is not, however, always the case. In a variety of international business situations it may still be in Trident’s best interest to detail the conditions for the business transaction, and to possibly protect against any political or country-based interruption to the completion of the trade transaction.

The Trade Dilemma

International trade must work around a fundamental dilemma. Imagine an importer and an exporter who would like to do business with one another. Because of the distance between the two, it is not possible to simultaneously hand over goods with one hand and accept payment with the other. The importer would prefer the arrangement at the top of Exhibit 19.3, while the exporter’s preference is shown at the bottom.

The fundamental dilemma of being unwilling to trust a stranger in a foreign land is solved by using a highly respected bank as intermediary. A greatly simplified view is described in Exhibit 19.4. In this simplified view, the importer obtains the bank’s promise to pay on its behalf, knowing that the exporter will trust the bank. The bank’s promise to pay is called a letter of credit.

The exporter ships the merchandise to the importer’s country. Title to the merchandise is given to the bank on a document called an order bill of lading. The exporter asks
the bank to pay for the goods, and the bank does so. The document to request payment is a *sight draft*. The bank, having paid for the goods, now passes title to the importer, whom the bank trusts. At that time or later, depending on their agreement, the importer reimburses the bank.

Financial managers of MNEs must understand these three basic documents. It is because their firms will often trade with unaffiliated parties, but also because the system of documentation provides a source of short-term capital that can be drawn upon even when shipments are to sister subsidiaries.
Benefits of the System

The three key documents and their interaction will be described later in this chapter. They constitute a system developed and modified over centuries to protect both importer and exporter from the risk of noncompletion and foreign exchange risk, as well as to provide a means of financing.

Protection against Risk of Noncompletion

As stated above, once importer and exporter agree on terms, the seller usually prefers to maintain legal title to the goods until paid, or at least until assured of payment. The buyer, however, will be reluctant to pay before receiving the goods, or at least before receiving title to them. Each wants assurance that the other party will complete its portion of the transaction. The letter of credit, sight draft, and bill of lading are part of a system carefully constructed to determine who bears the financial loss if one of the parties defaults at any time.

Protection against Foreign Exchange Risk

In international trade, foreign exchange risk arises from transaction exposure. If the transaction requires payment in the exporter’s currency, the importer carries the foreign exchange risk. If the transaction calls for payment in the importer’s currency, the exporter has the foreign exchange risk.

Transaction exposure can be hedged by the techniques described in Chapter 10, but in order to hedge, the exposed party must be certain that payment of a specified amount will be made on or near a particular date. The three key documents described in this chapter ensure both amount and time of payment and thus lay the groundwork for effective hedging.

The risk of noncompletion and foreign exchange risk are most important when the international trade is episodic, with no outstanding agreement for recurring shipments and no sustained relationship between buyer and seller. When the import/export relationship is of a recurring nature, as in the case of manufactured goods shipped weekly or monthly to a final assembly or retail outlet in another country, and when it is between countries whose currencies are considered strong, the exporter may well bill the importer on open account after a normal credit check. Banks provide credit information and collection services outside of the system of processing drafts drawn against letters of credit.

Financing the Trade

Most international trade involves a time lag during which funds are tied up while the merchandise is in transit. Once the risks of noncompletion and of exchange rate changes are disposed of, banks are willing to finance goods in transit. A bank can finance goods in transit, as well as goods held for sale, based on the key documents, without exposing itself to questions about the quality of the merchandise or other physical aspects of the shipment.

International Trade: Timeline and Structure

In order to understand the risks associated with international trade transactions, it is helpful to understand the sequence of events in any such transaction. Exhibit 19.5 illustrates, in principle, the series of events associated with a single export transaction.

From a financial management perspective, the two primary risks associated with an international trade transaction are currency risk and risk of noncompletion. Exhibit 19.5 illustrates the traditional business problem of credit management: the exporter quotes a price, finalizes a contract, and ships the goods, losing physical control over the goods based on trust of the buyer or the promise of a bank to pay based on documents presented. The risk of default on the part of the importer is present as soon as the financing period begins, as depicted in Exhibit 19.5.
In many cases, the initial task of analyzing the creditworth of foreign customers is similar to procedures for analyzing domestic customers. If Trident has had no experience with a foreign customer but that customer is a large, well-known firm in its home country, Trident may simply ask for a bank credit report on that firm. Trident may also talk to other firms that have had dealings with the foreign customer. If these investigations show the foreign customer (and country) to be completely trustworthy, Trident would likely ship to them on open account, with a credit limit, just as they would for a domestic customer. This is the least costly method of handling exports because there are no heavy documentation or bank charges. However, before a regular trading relationship has been established with a new or unknown firm, Trident must face the possibility of nonpayment for its exports or noncompletion of its imports. The risk of nonpayment can be eliminated through the use of a letter of credit issued by a creditworthy bank.

**Key Documents**

The three key documents described in the following pages—the *letter of credit*, *draft*, and *bill of lading*—constitute a system developed and modified over centuries to protect both importer and exporter from the risk of noncompletion of the trade transaction as well as to provide a means of financing. The three key trade documents are part of a carefully constructed system to determine who bears the financial loss if one of the parties defaults at any time.

**Letter of Credit (L/C)**

A *letter of credit* (L/C), is a bank’s promise to pay issued by a bank at the request of an importer (the applicant/buyer), in which the bank promises to pay an exporter (the beneficiary of the letter) upon presentation of documents specified in the L/C. An L/C reduces the risk of noncompletion, because the bank agrees to pay against documents rather than actual merchandise. The relationship between the three parties can be seen in Exhibit 19.6.
An importer (buyer) and exporter (seller) agree on a transaction and the importer then applies to its local bank for the issuance of an L/C. The importer’s bank issues an L/C and cuts a sales contract based on its assessment of the importer’s creditworthiness, or the bank might require a cash deposit or other collateral from the importer in advance. The importer’s bank will want to know the type of transaction, the amount of money involved, and what documents must accompany the draft that will be drawn against the L/C.

If the importer’s bank is satisfied with the credit standing of the applicant, it will issue an L/C guaranteeing to pay for the merchandise if shipped in accordance with the instructions and conditions contained in the L/C.

The essence of an L/C is the promise of the issuing bank to pay against specified documents, which must accompany any draft drawn against the credit. The L/C is not a guarantee of the underlying commercial transaction. Indeed, the L/C is a separate transaction from any sales or other contracts on which it might be based. To constitute a true L/C transaction, the following elements must be present with respect to the issuing bank:

1. The issuing bank must receive a fee or other valid business consideration for issuing the L/C.
2. The bank’s L/C must contain a specified expiration date or a definite maturity.
3. The bank’s commitment must have a stated maximum amount of money.
4. The bank’s obligation to pay must arise only on the presentation of specific documents, and the bank must not be called on to determine disputed questions of fact or law.
5. The bank’s customer must have an unqualified obligation to reimburse the bank on the same condition as the bank has paid.

Commercial letters of credit are also classified as follows:

**Irrevocable versus Revocable.** An irrevocable L/C obligates the issuing bank to honor drafts drawn in compliance with the credit and can be neither canceled nor modified without the consent of all parties, including in particular the beneficiary (exporter). A revocable L/C can be canceled or amended at any time before payment; it is intended to serve as a means of arranging payment but not as a guarantee of payment.

**Confirmed versus Unconfirmed.** An L/C issued by one bank can be confirmed by another, in which case the confirming bank undertakes to honor drafts drawn in compliance with the
credit. An unconfirmed L/C is the obligation only of the issuing bank. An exporter is likely to want a foreign bank’s L/C confirmed by a domestic bank when the exporter has doubts about the foreign bank’s ability to pay. Such doubts can arise when the exporter is unsure of the financial standing of the foreign bank, or if political or economic conditions in the foreign country are unstable. The essence of an L/C is shown in Exhibit 19.7.

Most commercial letters of credit are documentary, meaning that certain documents must be included with drafts drawn under their terms. Required documents usually include an order bill of lading (discussed in more detail later in the chapter), a commercial invoice, and any of the following: consular invoice, insurance certificate or policy, and packing list.

**Advantages and Disadvantages of Letters of Credit**

The primary advantage of an L/C is that it reduces risk—the exporter can sell against a bank’s promise to pay rather than against the promise of a commercial firm. The exporter is also in a more secure position as to the availability of foreign exchange to pay for the sale, since banks are more likely to be aware of foreign exchange conditions and rules than is the importing firm itself. If the importing country should change its foreign exchange rules during the course of a transaction, the government is likely to allow already outstanding bank letters of credit to be honored for fear of throwing its own domestic banks into international disrepute. Of course, if the L/C is confirmed by a bank in the exporter’s country, the exporter avoids any problem of blocked foreign exchange.

An exporter may find that an order backed by an irrevocable L/C will facilitate obtaining pre-export financing in the home country. If the exporter’s reputation for delivery is good, a local bank may lend funds to process and prepare the merchandise for shipment. Once the merchandise is shipped in compliance with the terms and conditions of the credit, payment for the business transaction is made and funds will be generated to repay the pre-export loan.

**EXHIBIT 19.7 Essence of a Letter of Credit (L/C)**

```
Bank of the East, Ltd.
[Name of Issuing Bank]

Date: September 18, 2011
L/C Number 123456

Bank of the East, Ltd. hereby issues this irrevocable documentary Letter of Credit to Jones Company [name of exporter] for US$500,000, payable 90 days after sight by a draft drawn against Bank of the East, Ltd., in accordance with Letter of Credit number 123456.

The draft is to be accompanied by the following documents:

1. Commercial invoice in triplicate
2. Packing list
3. Clean on board order bill of lading
4. Insurance documents, paid for by buyer

At maturity Bank of the East, Ltd. will pay the face amount of the draft to the bearer of that draft.

Authorized Signature
```
The major advantage of an L/C to the importer is that the importer need not pay out funds until the documents have arrived at a local port or airfield and unless all conditions stated in the credit have been fulfilled. The main disadvantages are the fee charged by the importer’s bank for issuing its L/C, and the possibility that the L/C reduces the importer’s borrowing line of credit with its bank. It may, in fact, be a competitive disadvantage for the exporter to demand automatically an L/C from an importer, especially if the importer has a good credit record and there is no concern regarding the economic or political conditions of the importer’s country.

Draft

A draft, sometimes called a bill of exchange (B/E), is the instrument normally used in international commerce to effect payment. A draft is simply an order written by an exporter (seller) instructing an importer (buyer) or its agent to pay a specified amount of money at a specified time. Thus, it is the exporter’s formal demand for payment from the importer.

The person or business initiating the draft is known as the maker, drawer, or originator. Normally, this is the exporter who sells and ships the merchandise. The party to whom the draft is addressed is the drawee. The drawee is asked to honor the draft, that is, to pay the amount requested according to the stated terms. In commercial transactions, the drawee is either the buyer, in which case the draft is called a trade draft, or the buyer’s bank, in which case the draft is called a bank draft. Bank drafts are usually drawn according to the terms of an L/C. A draft may be drawn as a bearer instrument, or it may designate a person to whom payment is to be made. This person, known as the payee, may be the drawer itself or it may be some other party such as the drawer’s bank.

Negotiable Instruments

If properly drawn, drafts can become negotiable instruments. As such, they provide a convenient instrument for financing the international movement of the merchandise. To become a negotiable instrument, a draft must conform to the following requirements (Uniform Commercial Code, Section 3104(1)):

1. It must be in writing and signed by the maker or drawer.
2. It must contain an unconditional promise or order to pay a definite sum of money.
3. It must be payable on demand or at a fixed or determinable future date.
4. It must be payable to order or to bearer.

If a draft is drawn in conformity with the above requirements, a person receiving it with proper endorsements becomes a “holder in due course.” This is a privileged legal status that enables the holder to receive payment despite any personal disagreements between drawee and maker because of controversy over the underlying transaction. If the drawee dishonors the draft, payment must be made to any holder in due course by any prior endorser or by the maker. This clear definition of the rights of parties who hold a negotiable instrument as a holder in due course has contributed significantly to the widespread acceptance of various forms of drafts, including personal checks.

Types of Drafts

Drafts are of two types: sight drafts and time drafts. A sight draft is payable on presentation to the drawee; the drawee must pay at once or dishonor the draft. A time draft, also called a usance draft, allows a delay in payment. It is presented to the drawee, who accepts it by
writing or stamping a notice of acceptance on its face. Once accepted, the time draft becomes a promise to pay by the accepting party (the buyer). When a time draft is drawn on and accepted by a bank, it becomes a banker’s acceptance; when drawn on and accepted by a business firm, a trade acceptance.

The time period of a draft is referred to as its tenor. To qualify as a negotiable instrument, and so be attractive to a holder in due course, a draft must be payable on a fixed or determinable future date. For example, “60 days after sight” is a fixed date, which is established precisely at the time the draft is accepted. However, payment “on arrival of goods” is not determinable since the date of arrival cannot be known in advance. Indeed, there is no assurance that the goods will arrive at all.

**Bankers’ Acceptances**

When a draft is accepted by a bank, it becomes a bankers’ acceptance. As such it is the unconditional promise of that bank to make payment on the draft when it matures. In quality the bankers’ acceptance is practically identical to a marketable bank certificate of deposit (CD). The holder of a bankers’ acceptance need not wait until maturity to liquidate the investment, but may sell the acceptance in the money market, where constant trading in such instruments occurs. The amount of the discount depends entirely on the credit rating of the bank that signs the acceptance, or another bank that reconfirmed the bankers’ acceptance, for a fee. The all-in cost of using a bankers’ acceptance compared to other short-term financing instruments is analyzed later in this chapter.

**Bill of Lading (B/L)**

The third key document for financing international trade is the bill of lading (B/L). The bill of lading is issued to the exporter by a common carrier transporting the merchandise. It serves three purposes: a receipt, a contract, and a document of title.

As a receipt, the bill of lading indicates that the carrier has received the merchandise described on the face of the document. The carrier is not responsible for ascertaining that the containers hold what is alleged to be their contents, so descriptions of merchandise on bills of lading are usually short and simple. If shipping charges are paid in advance, the bill of lading will usually be stamped “freight paid” or “freight prepaid.” If merchandise is shipped collect—a less common procedure internationally than domestically—the carrier maintains a lien on the goods until freight is paid.

As a contract, the bill of lading indicates the obligation of the carrier to provide certain transportation in return for certain charges. Common carriers cannot disclaim responsibility for their negligence through inserting special clauses in a bill of lading. The bill of lading may specify alternative ports in the event that delivery cannot be made to the designated port, or it may specify that the goods will be returned to the exporter at the exporter’s expense.

As a document of title, the bill of lading is used to obtain payment or a written promise of payment before the merchandise is released to the importer. The bill of lading can also function as collateral against which funds may be advanced to the exporter by its local bank prior to or during shipment and before final payment by the importer.

**Characteristics of the Bill of Lading**

The bill of lading is typically made payable to the order of the exporter, who thus retains title to the goods after they have been handed to the carrier. Title to the merchandise remains with the exporter until payment is received, at which time the exporter endorses the order bill of lading (which is negotiable) in blank or to the party making the payment, usually a bank. The most common procedure would be for payment to be advanced against a
documentary draft accompanied by the endorsed order bill of lading. After paying the draft, the exporter’s bank forwards the documents through bank clearing channels to the bank of the importer. The importer’s bank, in turn, releases the documents to the importer after payment (sight drafts); after acceptance (time drafts addressed to the importer and marked D/A); or after payment terms have been agreed upon (drafts drawn on the importer’s bank under provisions of an L/C).

**Example: Documentation in a Typical Trade Transaction**

Although a trade transaction could conceivably be handled in many ways, we shall now turn to a hypothetical example that illustrates the interaction of the various documents. Assume that Trident U.S. receives an order from a Canadian Buyer. For Trident, this will be an export financed under an L/C requiring a bill of lading, with the exporter collecting via a time draft accepted by the Canadian Buyer’s bank. Such a transaction is illustrated in Exhibit 19.8.

1. The Canadian Buyer (the **Importer** in Exhibit 19.8) places an order with Trident (the **Exporter** in Exhibit 19.8), asking if Trident is willing to ship under an L/C.
2. Trident agrees to ship under an L/C and specifies relevant information such as prices and terms.

**EXHIBIT 19.8** Steps in a Typical Trade Transaction

1. **Importer** orders goods.
2. **Exporter** agrees to fill order.
3. **Importer** arranges L/C with its bank.
4. **Bank I** sends L/C to **Bank X**.
5. **Bank X** advises exporter of L/C.
6. **Exporter** ships goods to **Importer**.
7. **Exporter** presents draft and documents to its bank, **Bank X**.
8. **Bank X** presents draft and documents to **Bank I**.
9. **Bank I** accepts draft, promising to pay in 60 days, and returns accepted draft to **Bank X**.
10. **Bank X** sells acceptance to **Investor**.
11. **Bank X** pays exporter.
12. **Bank I** obtains importer’s note and releases shipment.
13. **Importer** pays its bank.
14. **Investor** presents acceptance and is paid by **Bank I**.
3. The Canadian Buyer applies to its bank, Northland Bank, for an L/C to be issued in favor of Trident for the merchandise it wishes to buy.

4. Northland Bank issues the L/C in favor of Trident and sends it to the Southland Bank (Trident’s bank).

5. Southland Bank advises Trident of the opening of an L/C in Trident’s favor. Southland Bank may or may not confirm the L/C to add its own guarantee to the document.

6. Trident ships the goods to the Canadian Buyer.

7. Trident prepares a time draft and presents it to Southland Bank (Trident’s bank). The draft is drawn (i.e., addressed to) Northland Bank in accordance with Northland Bank’s L/C and accompanied by other documents as required, including the bill of lading. Trident endorses the bill of lading in blank (making it a bearer instrument) so that title to the goods goes with the holder of the documents—Southland Bank at this point in the transaction.

8. Southland Bank presents the draft and documents to Northland Bank for acceptance. Northland Bank accepts the draft by stamping and signing it making it a bankers acceptance, takes possession of the documents, and promises to pay the now-accepted draft at maturity—say, 60 days.

9. Northland Bank returns the accepted draft to Southland Bank. Alternatively, Southland Bank might ask Northland Bank to accept and discount the draft. Should this occur, Northland Bank would remit the cash less a discount fee rather than return the accepted draft to Southland Bank.

10. Southland Bank, having received back the accepted draft, now a bankers’ acceptance, may choose between several alternatives. Southland Bank may sell the acceptance in the open market at a discount to an investor, typically a corporation or financial institution with excess cash it wants to invest for a short period of time. Southland Bank may also hold the acceptance in its own portfolio.

11. If Southland Bank discounted the acceptance with Northland Bank (mentioned in step 9) or discounted it in the local money market, Southland Bank will transfer the proceeds less any fees and discount to Trident. Another possibility would be for Trident itself to take possession of the acceptance, hold it for 60 days, and present it for collection. Normally, however, exporters prefer to receive the discounted cash value of the acceptance at once rather than wait for the acceptance to mature and receive a slightly greater amount of cash at a later date.

12. Northland Bank notifies the Canadian Buyer of the arrival of the documents. The Canadian Buyer signs a note or makes some other agreed upon plan to pay Northland Bank for the merchandise in 60 days, Northland Bank releases the underlying documents so that the Canadian Buyer can obtain physical possession of the shipment at once.

13. After 60 days, Northland Bank receives from the Canadian Buyer funds to pay the maturing acceptance.

14. On the same day, the 60th day after acceptance, the holder of the matured acceptance presents it for payment and receives its face value. The holder may present it directly to Northland Bank, or return it to Southland Bank and have Southland Bank collect it through normal banking channels.

Although this is a typical transaction involving an L/C, few international trade transactions are probably ever truly typical. Business, and more specifically international business, requires flexibility and creativity by management at all times. The Mini-Case at the end of
this chapter presents an application of the mechanics of a real business situation. The result is a classic challenge to management: when and on what basis do you compromise typical procedure in order to accomplish strategic goals?

**Government Programs to Help Finance Exports**

Governments of most export-oriented industrialized countries have special financial institutions that provide some form of subsidized credit to their own national exporters. These export finance institutions offer terms that are better than those generally available from the private sector. Thus, domestic taxpayers are subsidizing sales to foreign buyers in order to create employment and maintain a technological edge. The most important institutions usually offer export credit insurance and a government supported bank for export financing.

**Export Credit Insurance**

The exporter who insists on cash or an L/C payment for foreign shipments is likely to lose orders to competitors from other countries that provide more favorable credit terms. Better credit terms are often made possible by means of export credit insurance, which provides assurance to the exporter or the exporter’s bank that, should the foreign customer default on payment, the insurance company will pay for a major portion of the loss. Because of the availability of export credit insurance, commercial banks are willing to provide medium- to long-term financing (five to seven years) for exports. Importers prefer that the exporter purchase export credit insurance to pay for nonperformance risk by the importer. In this way, the importer does not need to pay to have an L/C issued and does not reduce its credit line.

Competition between nations to increase exports by lengthening the period for which credit transactions can be insured may lead to a credit war and to unsound credit decisions. To prevent such an unhealthy development, a number of leading trading nations joined together in 1934 to create the Berne Union (officially, the Union d’Assureurs des Credits Internationaux) for the purpose of establishing a voluntary international understanding on export credit terms. The Berne Union recommends maximum credit terms for many items including, for example, heavy capital goods (five years), light capital goods (three years), and consumer durable goods (one year).

**Export Credit Insurance in the United States**

In the United States, export credit insurance is provided by the Foreign Credit Insurance Association (FCIA). This is an unincorporated association of private commercial insurance companies operating in cooperation with the Export-Import Bank (see below).

The FCIA provides policies protecting U.S. exporters against the risk of nonpayment by foreign debtors as a result of commercial and political risks. Losses due to commercial risk are those that result from the insolvency or protracted payment default of the buyer. Political losses arise from actions of governments beyond the control of buyer or seller.

**Export-Import Bank and Export Financing**

The Export-Import Bank (also called Eximbank) is another independent agency of the U.S. government, established in 1934 to stimulate and facilitate the foreign trade of the United States. Interestingly, the Eximbank was originally created primarily to facilitate exports to the Soviet Union. In 1945, the Eximbank was re-chartered “to aid in financing and to facilitate exports and imports and the exchange of commodities between the United States and any foreign country or the agencies or nationals thereof.”
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The Eximbank facilitates the financing of U.S. exports through various loan guarantee and insurance programs. The Eximbank guarantees repayment of medium-term (181 days to five years) and long-term (five years to ten years) export loans extended by U.S. banks to foreign borrowers. The Eximbank’s medium- and long-term, direct-lending operation is based on participation with private sources of funds. Essentially, the Eximbank lends dollars to borrowers outside the United States for the purchase of U.S. goods and services. Proceeds of such loans are paid to U.S. suppliers. The loans themselves are repaid with interest in dollars to the Eximbank. The Eximbank requires private participation in these direct loans in order to: 1) ensure that it complements rather than competes with private sources of export financing; 2) spread its resources more broadly; and 3) ensure that private financial institutions will continue to provide export credit.

The Eximbank also guarantees lease transactions, finances the costs involved in the preparation by U.S. firms of engineering, planning, and feasibility studies for non-U.S. clients on large capital projects; and supplies counseling for exporters, banks, or others needing help in finding financing for U.S. goods.

Trade Financing Alternatives

In order to finance international trade receivables, firms use the same financing instruments as they use for domestic trade receivables, plus a few specialized instruments that are only available for financing international trade. Exhibit 19.9 identifies the main short-term financing instruments and their approximate costs. The last section describes a longer term instrument called forfaiting.

**Bankers’ Acceptances.** Bankers’ acceptances, described earlier in this chapter can be used to finance both domestic and international trade receivables. Exhibit 19.9 shows that bankers’ acceptances earn a yield comparable to other money market instruments, especially marketable bank certificates of deposit. However, the all-in cost to a firm of creating and discounting a bankers’ acceptance also depends upon the commission charged by the bank that accepts the firm’s draft.

The first owner of the bankers’ acceptance created from an international trade transaction will be the exporter, who receives the accepted draft back after the bank has stamped it “accepted.” The exporter may hold the acceptance until maturity and then collect. On an acceptance of, say, $100,000 for three months the exporter would receive the face amount less the bank’s acceptance commission of 1.5% per annum:

**EXHIBIT 19.9** Instruments for Financing Short-Term Domestic and International Trade Receivables

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Cost or Yield for 3-Month Maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bankers’ acceptances*</td>
<td>1.14% yield annualized</td>
</tr>
<tr>
<td>Trade acceptances*</td>
<td>1.17% yield annualized</td>
</tr>
<tr>
<td>Factoring</td>
<td>Variable rate but much higher cost than bank credit lines</td>
</tr>
<tr>
<td>Securitization</td>
<td>Variable rate but competitive with bank credit lines</td>
</tr>
<tr>
<td>Bank credit lines</td>
<td>4.25% plus points (fewer points if covered by export credit insurance)</td>
</tr>
<tr>
<td>Commercial paper*</td>
<td>1.15% yield annualized</td>
</tr>
</tbody>
</table>

*These instruments compete with 3-month marketable bank time certificates of deposit that yield 1.17%.
Alternatively, the exporter may “discount”—that is, sell at a reduced price—the acceptance to its bank in order to receive funds at once. The exporter will then receive the face amount of the acceptance less both the acceptance fee and the going market rate of discount for bankers’ acceptances. If the discount rate were 1.14% per annum as shown in Exhibit 19.9, the exporter would receive the following:

\[
\text{Amount received by exporter at once} = \text{Face amount of the acceptance} - 1.5\% \text{ per annum commission for three months} - 1.14\% \text{ per annum discount rate for three months}
\]

\[
= \$100,000 - 3.75\times \frac{3}{12} \times \$100,000 - 2.85\times \frac{3}{12} \times \$100,000
\]

\[
= \$99,340
\]

Therefore, the annualized all-in cost of financing this bankers’ acceptance is as follows:

\[
\frac{\text{Commission + discount}}{\text{Proceeds}} \times \frac{360}{90} = \frac{3.75 + 2.85}{\$99,340} \times \frac{360}{90} = .0266 \text{ or } 2.66\%
\]

The discounting bank may hold the acceptance in its own portfolio, earning for itself the 1.14% per annum discount rate, or the acceptance may be resold in the acceptance market to portfolio investors. Investors buying bankers’ acceptances provide the funds that finance the transaction.

**Trade Acceptances.** Trade acceptances are similar to bankers’ acceptances except that the accepting entity is a commercial firm, like General Motors Acceptance Corporation (GMAC), rather than a bank. The cost of a trade acceptance depends on the credit rating of the accepting firm plus the commission it charges. Like bankers’ acceptances, trade acceptances are sold at a discount to banks and other investors at a rate that is competitive with other money market instruments (see Exhibit 19.9).

**Factoring.** Specialized firms, known as factors, purchase receivables at a discount on either a non-recourse or recourse basis. Non-recourse means that the factor assumes the credit, political, and foreign exchange risk of the receivables it purchases. Recourse means that the factor can give back receivables that are not collectable. Since the factor must bear the cost and risk of assessing the creditworth of each receivable, the cost of factoring is usually quite high. It is more than borrowing at the prime rate plus points.

The all-in cost of factoring non-recourse receivables is similar in structure to acceptances. The factor charges a commission to cover the non-recourse risk, typically 1.5%–2.5%, plus interest deducted as a discount from the initial proceeds. On the other hand, the firm selling the non-recourse receivables avoids the cost of determining creditworth of its customers. It also does not have to show debt borrowed to finance these receivables on its balance sheet. Furthermore, the firm avoids both foreign exchange and political risk on these non-recourse receivables. **Global Finance in Practice 19.1** provides an example of the costs.

**Securitization.** The securitization of export receivables for financing trade is an attractive supplement to bankers’ acceptance financing and factoring. A firm can securitize its export receivables by selling them to a legal entity established to create marketable securities based
Factoring in Practice

A U.S.-based manufacturer that may have suffered significant losses during the global credit crisis and the following global recession is cash-short. Sales, profits, and cash flows have fallen. The company is now struggling to service its high levels of debt. It does, however, have a number of new sales agreements. It is considering factoring one of its biggest new sales, a sale for $5 million to a Japanese company. The receivable is due in 90 days. After contacting a factoring agent, it is quoted the numbers in the table.

If the company wishes to factor its receivable it will net $4.55 million, 91% of the face amount. Although this may at first sight appear expensive, the firm would net the proceeds in cash up-front, not having to wait 90 days for payment. And it would not be responsible for collecting on the receivable. If the firm were able to "factor-in" the cost of factoring in the initial sale, all the better. Alternatively, it might offer a discount for cash paid in the first 10 days after shipment.

| Face amount of receivable | $5,000,000 |
| Non-recourse fee (1.5%) | $75,000 |
| Factoring fee (2.5% per month × 3 months) | $375,000 |
| Net proceeds on sale (received now) | $4,550,000 |

on a package of individual export receivables. An advantage of this technique is to remove the export receivables from the exporter’s balance sheet because they have been sold without recourse.

The receivables are normally sold at a discount. The size of the discount depends on four factors:

1. The historic collection risk of the exporter
2. The cost of credit insurance
3. The cost of securing the desirable cash flow stream to the investors
4. The size of the financing and services fees

Securitization is more cost effective if there is a large value of transactions with a known credit history and default probability. A large exporter could establish its own securitization entity. While the initial setup cost is high, the entity can be used on an ongoing basis. As an alternative, smaller exporters could use a common securitization entity provided by a financial institution, thereby saving the expensive setup costs.

Bank Credit Line Covered by Export Credit Insurance. A firm’s bank credit line can typically be used to finance up to a fixed upper limit, say 80%, of accounts receivable. Export receivables can be eligible for inclusion in bank credit line financing. However, credit information on foreign customers may be more difficult to collect and assess. If a firm covers its export receivables with export credit insurance, it can greatly reduce the credit risk of those receivables. This insurance enables the bank credit line to cover more export receivables and lower the interest rate for that coverage. Of course, any foreign exchange risk must be handled by the transaction exposure techniques described in Chapter 10.

The cost of using a bank credit line is usually the prime rate of interest plus points to reflect a particular firm’s credit risk. As usual, 100 points is equal to 1%. In the United States, borrowers are also expected to maintain a compensating deposit balance at the lending institution. In Europe and many other places, lending is done on an overdraft basis. An overdraft agreement allows a firm to overdraw its bank account up to the limit of its credit line. Interest at prime plus points is based only on the amount of overdraft borrowed. In either case, the all-in cost of bank borrowing using a credit line is higher than acceptance financing as shown in Exhibit 19.9.
PART 6  Topics in International Finance

Commercial Paper. A firm can issue commercial paper—unsecured promissory notes—to fund its short-term financing needs, including both domestic and export receivables. However, it is only the large well-known firms with favorable credit ratings that have access to either the domestic or euro commercial paper market. As shown in Exhibit 19.9, commercial paper interest rates lie at the low end of the yield curve and compete directly with marketable bank time certificates of deposit.

Forfaiting: Medium- and Long-Term Financing

Forfaiting is a specialized technique to eliminate the risk of nonpayment by importers in instances where the importing firm and/or its government is perceived by the exporter to be too risky for open account credit. The name of the technique comes from the French à forfait, a term that implies “to forfeit or surrender a right.”

Role of the Forfaiter

The essence of forfaiting is the non-recourse sale by an exporter of bank-guaranteed promissory notes, bills of exchange, or similar documents received from an importer in another country. The exporter receives cash at the time of the transaction by selling the notes or bills at a discount from their face value to a specialized finance firm called a forfaiter. The forfaiter arranges the entire operation prior to the actual transaction taking place. Although the exporting firm is responsible for the quality of delivered goods, it receives a clear and unconditional cash payment at the time of the transaction. All political and commercial risk of non-payment by the importer is carried by the guaranteeing bank. Small exporters who trust their clients to pay find the forfaiting technique invaluable because it eases cash flow problems.

During the Soviet era expertise in the technique was centered in German and Austrian banks, which used forfaiting to finance sales of capital equipment to eastern European, “Soviet Bloc,” countries. British, Scandinavian, Italian, Spanish, and French exporters have now adopted the technique, but U.S. and Canadian exporters are reported to be slow to use forfaiting, possibly because they are suspicious of its simplicity and lack of complex documentation. Nevertheless, some American firms now specialize in the technique, and the Association of Forfaiters in the Americas (AFIA) has more than 20 members. Major export destinations financed via the forfaiting technique are Asia, Eastern Europe, the Middle East, and Latin America.

A Typical Forfaiting Transaction

A typical forfaiting transaction involves five parties, as shown in Exhibit 19.10. The steps in the process are as follows:

Step 1: Agreement. Importer and exporter agree between themselves on a series of imports to be paid for over a period of time, typically three to five years. However, periods up to 10 years or as short as 180 days have been financed by the technique. The normal minimum size for a transaction is $100,000. The importer agrees to make periodic payments, often against progress on delivery or completion of a project.

Step 2: Commitment. The forfaiter promises to finance the transaction at a fixed discount rate, with payment to be made when the exporter delivers to the forfaiter the appropriate

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2Association of Forfaiters in the Americas (AFIA), 2 Park Avenue, Suite 1522, New York, NY, 10016.
promissory notes or other specified paper. The agreed-upon discount rate is based on the cost of funds in the Euromarket, usually on LIBOR for the average life of the transaction, plus a margin over LIBOR to reflect the perceived risk in the deal. This risk premium is influenced by the size and tenor of the deal, country risk, and the quality of the guarantor institution. On a five-year deal, for example, with 10 semiannual payments, the rate used would be based on the 21/4 year LIBOR rate. This discount rate is normally added to the invoice value of the transaction so that the cost of financing is ultimately borne by the importer. The forfaiter charges an additional commitment fee of from 0.5% per annum to as high as 6.0% per annum from the date of its commitment to finance until receipt of the actual discount paper issued in accordance with the finance contract. This fee is also normally added to the invoice cost and passed on to the importer.

**Step 3: Aval or Guarantee.** The importer obligates itself to pay for its purchases by issuing a series of promissory notes, usually maturing every six or twelve months, against progress on delivery or completion of the project. These promissory notes are first delivered to the importer’s bank where they are endorsed (that is, guaranteed) by that bank. In Europe, this unconditional guarantee is referred to as an **aval**, which translates into English as “backing.” At this point, the importer’s bank becomes the primary obligor in the eyes of all subsequent holders of the notes. The bank’s aval or guarantee must be irrevocable, unconditional, divisible, and assignable. Because U.S. banks do not issue avals, U.S. transactions are guaranteed by a standby letter of credit (L/C), which is functionally similar to an aval but more cumbersome. For example, L/Cs can normally be transferred only once.

**Step 4: Delivery of Notes.** The now-endorsed promissory notes are delivered to the exporter.

**Step 5: Discounting.** The exporter endorses the notes “without recourse” and discounts them with the forfaiter, receiving the agreed-upon proceeds. Proceeds are usually received two days after the documents are presented. By endorsing the notes “without recourse,” the exporter frees itself from any liability for future payment on the notes and thus receives the discounted proceeds without having to worry about any further payment difficulties.

**Step 6: Investment.** The forfaiting bank either holds the notes until full maturity as an investment or endorses and rediscounts them in the international money market. Such subsequent sale by the forfaiter is usually without recourse. The major rediscount markets are in London and Switzerland, plus New York for notes issued in conjunction with Latin American business.
PART 6  Topics in International Finance

Step 7: Maturity. At maturity, the investor holding the notes presents them for collection to the importer or to the importer’s bank. The promise of the importer’s bank is what gives the documents their value.

In effect, the forfaiter functions both as a money market firm and a specialist in packaging financial deals involving country risk. As a money market firm, the forfaiter divides the discounted notes into appropriately sized packages and resells them to various investors having different maturity preferences. As a country risk specialist, the forfaiter assesses the risk that the notes will eventually be paid by the importer or the importer’s bank and puts together a deal that satisfies the needs of both exporter and importer.

Success of the forfaiting technique springs from the belief that the aval or guarantee of a commercial bank can be depended on. Although commercial banks are the normal and preferred guarantors, guarantees by government banks or government ministries of finance are accepted in some cases. On occasion, large commercial enterprises have been accepted as debtors without a bank guarantee. An additional aspect of the technique is that the endorsing bank’s aval is perceived to be an “off balance sheet” obligation, the debt is presumably not considered by others in assessing the financial structure of the commercial banks.

Summary of Learning Objectives

Learn how international trade alters both the supply chain and general value chain of the domestic firm, thereby beginning the globalization process in the trade phase.

◆ International trade takes place between three categories of relationships: unaffiliated unknown parties, unaffiliated known parties, and affiliated parties.
◆ International trade transactions between affiliated parties typically do not require contractual arrangements or external financing. Trade transactions between unaffiliated parties typically require contracts and some type of external financing, such as that available through letters of credit.

Consider what the key elements of an import or export transaction are in business.

◆ Over many years, established procedures have arisen to finance international trade. The basic procedure rests on the interrelationship between three key documents, the L/C, the draft, and the bill of lading.
◆ Variations in each of the three key documents, the L/C, the draft, and the bill of lading, provide a variety of ways to accommodate any type of transaction.

Discover how the three key documents in import/export, the letter of credit, the draft, and the bill of lading, combine to both finance the transaction and to manage its risks.

◆ In the simplest transaction, in which all three documents are used and in which financing is desirable, an importer applies for and receives an L/C from its bank.
◆ In the L/C, the bank substitutes its credit for that of the importer and promises to pay if certain documents are submitted to the bank. The exporter may now rely on the promise of the bank rather than on the promise of the importer.

Identify what the documentation sequence is for a typical international trade transaction.

◆ The exporter typically ships on an order bill of lading, attaches the order bill of lading to a draft ordering payment from the importer’s bank, and presents these documents, plus any of a number of additional documents, through its own bank to the importer’s bank.
◆ If the documents are in order, the importer’s bank either pays the draft (a sight draft) or accepts the draft (a time draft). In the latter case, the bank promises to pay in the future. At this step, the importer’s bank acquires title to the merchandise through the bill of lading, and it then releases the merchandise to the importer against payment or promise of future payment.
◆ If a sight draft is used, the exporter is paid at once. If a time draft is used, the exporter receives the accepted draft, now a bankers’ acceptance, back from the bank. The exporter may hold the bankers’ acceptance until maturity or sell it at a discount in the money market.

Learn how the various stages and their costs impact the ability of an exporter to enter a foreign market and potentially compete in both credit terms and pricing.

◆ The total costs of an exporter entering a foreign market include the transaction costs of the trade financing,
the import and export duties and tariffs applied by exporting and importing nations, and the costs of foreign market penetration, which include distribution expenses, inventory costs, and transportation expenses.

See what organizations and resources are available for exporters to aid in managing trade risk and financing.

- Export credit insurance provides assurance to exporters (or exporters’ banks) that should the foreign customer default on payment, the insurance company will pay for a major portion of the loss.
- In the United States, export credit insurance is provided by the Foreign Credit Insurance Association (FCIA), an unincorporated association of private commercial insurance companies operating in cooperation with the Export-Import Bank of the U.S. government.
- The Export-Import Bank of the U.S. government (Eximbank) is an independent agency established to stimulate and facilitate the foreign trade of the United States.

Examine the various trade financing alternatives.

- Trade financing uses the same financing instruments as in domestic receivables financing, plus some specialized instruments that are only available for financing international trade.
- A popular instrument for short-term financing is a bankers’ acceptance. Its all-in cost is comparable to other money market instruments, such as marketable bank certificates of deposit.
- Other short-term financing instruments with a domestic counterpart are trade acceptances, factoring, securitization, bank credit lines (usually covered by export credit insurance), and commercial paper.
- Forfaiting is an international trade technique that can provide medium- and long-term financing.

MINI-CASE

Crosswell International and Brazil

Crosswell International is a U.S.-based manufacturer and distributor of health care products, including children’s diapers. Crosswell has been approached by Leonardo Sousa, the president of Material Hospitalar, a distributor of health care products throughout Brazil. Sousa is interested in distributing Crosswell’s major diaper product, Precious, but only if an acceptable arrangement regarding pricing and payment terms can be reached.

Exporting to Brazil

Crosswell’s manager for export operations, Geoff Mathieux, followed up the preliminary discussions by putting together an estimate of export costs and pricing for discussion purposes with Sousa. Crosswell needs to know all of the costs and pricing assumptions for the entire supply and value chain as it reaches the consumer. Mathieux believes it critical that any arrangement that Crosswell enters into results in a price to consumers in the Brazilian marketplace that is both fair to all parties involved and competitive, given the market niche Crosswell hopes to penetrate. This first cut on pricing Precious diapers into Brazil is presented in Exhibit 1.

Crosswell proposes to sell the basic diaper line to the Brazilian distributor for $34.00 per case, FAS (free alongside ship) Miami docks. This means that the seller, Crosswell, agrees to cover all costs associated with getting the diapers to the Miami docks. The cost of loading the diapers aboard ship, the actual cost of shipping (freight), and associated documents is $4.32 per case. The running subtotal, $38.32 per case, is termed CFR (cost and freight). Finally, the insurance expenses related to the potential loss of the goods while in transit to final port of destination, export insurance, are $0.86 per case. The total CIF (cost, insurance, and freight) is $39.18 per case, or 97.95 Brazilian real per case, assuming an exchange rate of 2.50 Brazilian real (R$) per U.S. dollar ($). In summary, the CIF cost of R$97.95 is the price charged by the exporter to the importer on arrival in Brazil, and is calculated as follows:

\[
CIF = FAS + \text{freight} + \text{export insurance} \\
= ($34.00 + 4.32 + 0.86) \times \text{R$2.50} \\
= \text{R$97.95}
\]

The actual cost to the distributor in getting the diapers through the port and customs warehouses must also be calculated in terms of what Leonardo Sousa’s costs are in reality. The various fees and taxes detailed in Exhibit 1 raise the fully landed cost of the Precious diapers to R$107.63 per case. The distributor would now bear storage and inventory costs totaling R$8.33 per case, which would bring the costs to R$115.96. The distributor then adds a margin for distribution services of 20% (R$23.19), raising the price as sold to the final retailer to R$139.15 per case.

Finally, the retailer (a supermarket or other retailer of consumer health care products) would include its expenses, taxes, and markup to reach the final shelf price to the customer of R$245.48 per case. This final retail price estimate now allows both Crosswell and Material Hospitalar to evaluate the price competitiveness of the Precious Ultra-Thin Diaper in the Brazilian marketplace, and provides a basis for further negotiations between the two parties.
Mathieux provides the above export price quotation, an outline of a potential representation agreement (for Sousa to represent Crosswell’s product lines in the Brazilian marketplace), and payment and credit terms to Leonardo Sousa. Crosswell’s payment and credit terms are that Sousa either pay in full in cash in advance, or with a confirmed irrevocable documentary L/C with a time draft specifying a tenor of 60 days.

Crosswell also requests from Sousa financial statements, banking references, foreign commercial references, descriptions of regional sales forces, and sales forecasts for the Precious diaper line. These last requests by Crosswell are very important for Crosswell to be able to assess Material Hospitalar’s ability to be a dependable, credit-worthy, and capable long-term partner and representative of the firm in the Brazilian marketplace. The discussions that follow focus on finding acceptable common ground between the two parties and working to increase the competitiveness of the Precious diaper in the Brazilian marketplace.

EXHIBIT 1 Export Pricing for the Precious Diaper Line to Brazil

The Precious Ultra-Thin Diaper will be shipped via container. Each container will hold 968 cases of diapers. The costs and prices below are calculated on a per case basis, although some costs and fees are assessed by container.

<table>
<thead>
<tr>
<th>Exports Costs and Pricing to Brazil</th>
<th>Per Case</th>
<th>Rates and Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>FAS price per case, Miami</td>
<td>$34.00</td>
<td></td>
</tr>
<tr>
<td>Freight, loading and documentation</td>
<td>4.32</td>
<td>$4180 per container/968 = $4.32</td>
</tr>
<tr>
<td>CFR price per case, Brazilian port (Santos)</td>
<td>$38.32</td>
<td></td>
</tr>
<tr>
<td>Export insurance</td>
<td>0.86</td>
<td>2.25% of CIF</td>
</tr>
<tr>
<td>CIF to Brazilian port</td>
<td>$39.18</td>
<td></td>
</tr>
<tr>
<td>CIF to Brazilian port, in Brazilian real/</td>
<td>R$97.95</td>
<td>2.50 Real/US$ × $39.18</td>
</tr>
</tbody>
</table>

**Brazilian Importation Costs**

- Import duties: 1.96 2.00% of CIF
- Merchant marine renovation fee: 2.70 25.00% of freight
- Port storage fees: 1.27 1.30% of CIF
- Port handling fees: 0.01 R$12 per container
- Additional handling fees: 0.26 20.00% of storage and handling
- Customs brokerage fees: 1.96 2.00% of CIF
- Import license fee: 0.05 R$50 per container
- Local transportation charges: 1.47 1.50% of CIF

Total cost to distributor in real/ R$107.63

**Distributor’s Costs and Pricing**

- Storage cost: 1.47 1.50% of CIF × months
- Cost of financing diaper inventory: 6.86 7.00% of CIF × months
- Distributor’s margin: 23.19 20.00% of Price + storage + financing

Price to retailer in real/ R$139.15

**Brazilian Retailer Costs and Pricing**

- Industrial product tax (IPT): 20.87 15.00% of price to retailer
- Mercantile circulation services tax (MCS): 28.80 18.00% of price + IPT
- Retailer costs and markup: 56.65 30.00% of price + IPT + MCS

Price to consumer in real/ R$245.48

**Diaper Prices to Consumers**

<table>
<thead>
<tr>
<th>Diaper Prices to Consumers</th>
<th>Diapers Per Case</th>
<th>Price Per Diaper</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small size</td>
<td>352</td>
<td>R$0.70</td>
</tr>
<tr>
<td>Medium size</td>
<td>256</td>
<td>R$0.96</td>
</tr>
<tr>
<td>Large size</td>
<td>192</td>
<td>R$1.28</td>
</tr>
</tbody>
</table>
**Crosswell’s Proposal**

The proposed sale by Crosswell to Material Hospitalar, at least in the initial shipment, is for 10 containers of 968 cases of diapers at $39.18 per case, CIF Brazil, payable in U.S. dollars. This is a total invoice amount of $379,262.40. Payment terms are that a confirmed L/C will be required of Material Hospitalar on a U.S. bank. The payment will be based on a time draft of 60 days, presentation to the bank for acceptance with other documents on the date of shipment. Both the exporter and the exporter’s bank will expect payment from the importer or importer’s bank 60 days from this date of shipment.

**What Should Crosswell Expect?** Assuming Material Hospitalar acquires the L/C and it is confirmed by Crosswell’s bank in the United States, Crosswell will ship the goods after the initial agreement, say 15 days, as illustrated in Exhibit 2.

Simultaneous with the shipment, in which Crosswell has lost physical control over the goods, Crosswell will present the bill of lading acquired at the time of shipment with the other needed documents to its bank requesting payment. Because the export is under a confirmed L/C, assuming all documents are in order, Crosswell’s bank will give Crosswell two choices:

1. Wait the full time period of the time draft of 60 days and receive the entire payment in full ($379,262.40).
2. Receive the discounted value of this amount today. The discounted amount, assuming U.S. dollar interest rate of 6.00% per annum (1.00% per 60 days):

   \[
   \text{Discounted Amount} = \frac{379,262.40}{(1 + 0.01)^{60}} = 375,507.33
   \]

   Because the invoice is denominated in U.S. dollars, Crosswell need not worry about currency value changes (currency risk). And because its bank has confirmed the L/C, it is protected against changes or deteriorations in Material Hospitalar’s ability to pay on the future date.

**What Should Material Hospitalar Expect?** Material Hospitalar will receive the goods on or before day 60. It will then move the goods through its distribution system to retailers. Depending on the payment terms between Material Hospitalar and its buyers (retailers), it could either receive cash or terms for payment for the goods. Because Material Hospitalar purchased the goods via the 60-day time draft and an L/C from its Brazilian bank, total payment of $379,262.40 is due on day 90 (shipment and

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**EXHIBIT 2** Export Payment Terms on Crosswell’s Export to Brazil

<table>
<thead>
<tr>
<th>Time (day count) and Events</th>
<th>Period of outstanding account receivable (60-day time draft)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>Crosswell agrees to ship under an L/C</td>
</tr>
<tr>
<td>3</td>
<td>Material Hospitalar applies to its bank in São Paulo for an L/C</td>
</tr>
<tr>
<td>10</td>
<td>Crosswell’s bank confirms L/C and notifies Crosswell</td>
</tr>
<tr>
<td>15</td>
<td>Crosswell ships goods</td>
</tr>
<tr>
<td>30</td>
<td>Goods arrive at Brazilian port</td>
</tr>
<tr>
<td>60</td>
<td>Crosswell presents documents to its bank for acceptance and payment of $379,262 (today is “sight”)</td>
</tr>
<tr>
<td>90</td>
<td>Crosswell’s bank pays discounted value of acceptance of $375,507</td>
</tr>
<tr>
<td></td>
<td>Material Hospitalar makes payment to its bank of $379,262</td>
</tr>
</tbody>
</table>
presentation of documents was on day 30 + 60 day time draft) to the Brazilian bank. Material Hospitalar, because it is a Brazilian-based company and has agreed to make payment in U.S. dollars (foreign currency), carries the currency risk of the transaction.

Crosswell/Material Hospitalar’s Concern
The concern the two companies hold, however, is that the total price to the consumer in Brazil, R$245.48 per case, or R$0.70/diaper (small size), is too high. The major competitors in the Brazilian market for premium quality diapers, Kenko do Brasil (Japan), Johnson and Johnson (U.S.), and Procter and Gamble (U.S.), are cheaper (see Exhibit 3). The competitors all manufacture in-country, thus avoiding the series of import duties and tariffs, which, have added significantly to Crosswell’s landed prices in the Brazilian marketplace.

### CASE QUESTIONS

1. How are pricing, currency of denomination, and financing interrelated in the value-chain for Crosswell’s penetration of the Brazilian market? Can you summarize them using Exhibit 2?

2. How important is Sosa to the value-chain of Crosswell? What worries might Crosswell have regarding Sosa’s ability to fulfill his obligations?

3. If Crosswell is to penetrate the market, some way of reducing its prices will be required. What do you suggest?

### EXHIBIT 3

**Competitive Diaper Prices in the Brazilian Market (in Brazilian real)**

<table>
<thead>
<tr>
<th>Company (Country)</th>
<th>Brand</th>
<th>Price per diaper by size</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Small</td>
</tr>
<tr>
<td>Kenko (Japan)</td>
<td>Monica Plus</td>
<td>0.68</td>
</tr>
<tr>
<td>Johnson and Johnson (U.S.)</td>
<td>Sempre Seca Plus</td>
<td>0.65</td>
</tr>
<tr>
<td>Procter and Gamble (U.S.)</td>
<td>Pampers Uni</td>
<td>0.65</td>
</tr>
<tr>
<td>Crosswell (U.S.)</td>
<td>Precious</td>
<td>0.70</td>
</tr>
</tbody>
</table>

### Questions

1. **Unaffiliated Buyers.** Why might different documentation be used for an export to a non-affiliated foreign buyer who is a new customer as compared to an export to a non-affiliated foreign buyer to whom the exporter has been selling for many years?

2. **Affiliated Buyers.** For what reason might an exporter use standard international trade documentation (letter of credit, draft, order bill of lading) on an intrafirm export to its parent or sister subsidiary?

3. **Related Party Trade.** What reasons can you give for the observation that intrafirm trade is now greater than trade between non-affiliated exporters and importers?

4. **Documents.** Explain the difference between a letter of credit (L/C) and a draft. How are they linked?

5. **Risks.** What is the major difference between “currency risk” and “risk of noncompletion”? How are these risks handled in a typical international trade transaction?

6. **Letter of Credit.** Identify each party to a letter of credit (L/C) and indicate its responsibility.

7. **Confirming a Letter of Credit.** Why would an exporter insist on a confirmed letter of credit?

8. **Documenting an Export of Hard Drives.** List the steps involved in the export of computer hard disk drives from Penang, Malaysia, to San Jose, California, using an unconfirmed letter of credit authorizing payment on sight.

9. **Documenting an Export of Lumber from Portland to Yokohama.** List the steps involved in the export of lumber from Portland, Oregon, to Yokohama, Japan, using a confirmed letter of credit, payment to be made in 120 days.

10. **Inca Breweries of Peru.** Inca Breweries of Lima, Peru, has received an order for 10,000 cartons of beer from Alicante Importers of Alicante, Spain. The beer will be exported to Spain under the terms of a letter of credit issued by a Madrid bank on behalf of Alicante Importers. The letter of credit specifies that the face value of the shipment, $720,000 U.S. dollars,
will be paid 90 days after the Madrid bank accepts a draft drawn by Inca Breweries in accordance with the terms of the letter of credit.

The current discount rate on 3-month bankers’ acceptance is 8% per annum, and Inca Breweries estimate its weighted average cost of capital to be 20% per annum. The commission for selling a bankers’ acceptance in the discount market is 1.2% of the face amount.

How much cash will Inca Breweries receive from the sale if it holds the acceptance until maturity? Do you recommend that Inca Breweries hold the acceptance until maturity or discount it at once in the U.S. bankers’ acceptance market?

11. Swishing Shoe Company. Swishing Shoe Company of Durham, North Carolina, has received an order for 50,000 cartons of athletic shoes from Southampton Footware, Ltd., of England, payment to be in British pounds sterling. The shoes will be shipped to Southampton Footware under the terms of a letter of credit issued by a London Bank on behalf of Southampton Footware. The letter of credit specifies that the face value of the shipment, £400,000, will be paid 120 days after the London bank accepts a draft drawn by Southampton Footware in accordance with the terms of the letter of credit.

The current discount rate in London on 120-day bankers’ acceptances is 12% per annum, and Southampton Footware estimates its weighted average cost of capital to be 18% per annum. The commission for selling a bankers’ acceptance in the discount market is 2.0% of the face amount.

a. Would Swishing Shoe Company gain by holding the acceptance to maturity, as compared to discounting the bankers’ acceptance at once?
b. Does Swishing Shoe Company incur any other risks in this transaction?

12. Going Abroad. Assume that Great Britain charges an import duty of 10% on shoes imported into the United Kingdom. Swishing Shoe Company, in question 11, discovers that it can manufacture shoes in Ireland and import them into Britain free of any import duty. What factors should Swishing Shoe Company consider in deciding to continue to export shoes from North Carolina versus manufacture them in Ireland?

13. Governmentally Supplied Credit. Various governments have established agencies to insure against nonpayment for exports and/or to provide export credit. This shifts credit risk away from private banks and to the citizen taxpayers of the country whose government created and backs the agency. Why would such an arrangement be of benefit to the citizens of that country?

Problems

1. Nikken Microsystems (A). Assume Nikken Microsystems has sold Internet servers to Telecom España for €700,000. Payment is due in three months and will be made with a trade acceptance from Telecom España Acceptance. The acceptance fee is 1.0% per annum of the face amount of the note. This acceptance will be sold at a 4% per annum discount. What is the annualized percentage all-in cost in euros of this method of trade financing?

2. Nikken Microsystems (B). Assume that Nikken Microsystems prefers to receive U.S. dollars rather than euros for the trade transaction described in problem 2. It is considering two alternatives: 1) sell the acceptance for euros at once and convert the euros immediately to U.S. dollars at the spot rate of exchange of $1.00/€ or 2) hold the euro acceptance until maturity but at the start sell the expected euro proceeds forward for dollars at the 3-month forward rate of $1.02/€.

a. What are the U.S. dollar net proceeds received at once from the discounted trade acceptance in alternative 1?
b. What are the U.S. dollar net proceeds received in three months in alternative 2?
c. What is the break-even investment rate that would equalize the net U.S. dollar proceeds from both alternatives?
d. Which alternative should Nikken Microsystems choose?

3. Motoguzzie (A). Motoguzzie exports large-engine motorcycles (greater than 700cc) to Australia and invoices its customers in U.S. dollars. Sydney Wholesale Imports has purchased $3,000,000 of merchandise from Motoguzzie, with payment due in six months. The payment will be made with a bankers’ acceptance issued by Charter Bank of Sydney at a fee of 1.75% per annum. Motoguzzie has a weighted average cost of capital of 10%. If Motoguzzie holds this acceptance to maturity, what is its annualized percentage all-in cost? What is its annualized percentage all-in cost?

4. Motoguzzie (B). Assuming the facts in problem 1, Bank of America is now willing to buy Motoguzzie’s bankers’ acceptance for a discount of 6% per annum. What would be Motoguzzie’s annualized percentage all-in cost of financing its $3,000,000 Australian receivable?

5. Nakatomi Toyota. Nakatomi Toyota buys its cars from Toyota Motors (U.S.), and sells them to U.S. customers. One of its customers is EcoHire, a car rental firm that buys cars from Nakatomi Toyota at a wholesale price.
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Final payment is due to Nakatomi Toyota in six months. EcoHire has bought $200,000 worth of cars from Nakatomi, with a cash down payment of $40,000 and the balance due in six months without any interest charged as a sales incentive. Nakatomi Toyota will have the EcoHire receivable accepted by Alliance Acceptance for a 2% fee, and then sell it at a 3% per annum discount to Wells Fargo Bank.

a. What is the annualized percentage all-in cost to Nakatomi Toyota?
b. What are Nakatomi’s net cash proceeds, including the cash down payment?

6. Forfaiting at Umaru Oil (Nigeria). Umaru Oil of Nigeria has purchased $1,000,000 of oil drilling equipment from Gunslinger Drilling of Houston, Texas. Umaru Oil must pay for this purchase over the next five years at a rate of $200,000 per year due on March 1 of each year.

Bank of Zurich, a Swiss forfaiter, has agreed to buy the five notes of $200,000 each at a discount. The discount rate would be approximately 8% per annum based on the expected 3-year LIBOR rate plus 200 basis points, paid by Umaru Oil. Bank of Zurich also would charge Umaru Oil an additional commitment fee of 2% per annum from the date of its commitment to finance until receipt of the actual discounted notes issued in accordance with the financing contract. The $200,000 promissory notes will come due on March 1 in successive years.

The promissory notes issued by Umaru Oil will be endorsed by their bank, Lagos City Bank, for a 1% fee and delivered to Gunslinger Drilling. At this point, Gunslinger Drilling will endorse the notes without recourse and discount them with the forfaiter, Bank of Zurich, receiving the full $200,000 principal amount. Bank of Zurich will sell the notes by re-discounting them to investors in the international money market without recourse. At maturity, the investors holding the notes will present them for collection at Lagos City Bank. If Lagos City Bank defaults on payment, the investors will collect on the notes from Bank of Zurich.

a. What is the annualized percentage all-in cost to Umaru Oil of financing the first $200,000 note due March 1, 2011?
b. What might motivate Umaru Oil to use this relatively expensive alternative for financing?

7. Sunny Coast Enterprises (A). Sunny Coast Enterprises has sold a combination of films and DVDs to Hong Kong Media Incorporated for US$100,000, with payment due in six months. Sunny Coast Enterprises has the following alternatives for financing this receivable: 1) Use its bank credit line.

Interest would be at the prime rate of 5% plus 150 basis points per annum. Sunny Coast Enterprises would need to maintain a compensating balance of 20% of the loan’s face amount. No interest will be paid on the compensating balance by the bank or 2) Use its bank credit line but purchase export credit insurance for a 1% fee. Because of the reduced risk, the bank interest rate would be reduced to 5% per annum without any points.

a. What are the annualized percentage all-in costs of each alternative?
b. What are the advantages and disadvantages of each alternative?
c. Which alternative would you recommend?

8. Sunny Coast Enterprises (B). Sunny Coast Enterprises has been approached by a factor that offers to purchase the Hong Kong Media Imports receivable at a 16% per annum discount plus a 2% charge for a non-recourse clause.

a. What is the annualized percentage all-in cost of this factoring alternative?
b. What are the advantages and disadvantages of the factoring alternative compared to the alternatives in Sunny Coast Enterprises (A)?

c. Which alternative would you recommend?

9. Whatchamacallit Sports (A). Whatchamacallit Sports (Whatchamacallit) is considering bidding to sell $100,000 of ski equipment to Phang Family Enterprises of Seoul, Korea. Payment would be due in six months. Since Whatchamacallit cannot find good credit information on Phang, Whatchamacallit wants to protect its credit risk. It is considering the following financing solution.

Phang’s bank issues a letter of credit on behalf of Phang and agrees to accept Whatchamacallit’s draft for $100,000 due in six months. The acceptance fee would cost Whatchamacallit $500, plus reduce Phang’s available credit line by $100,000. The bankers’ acceptance note of $100,000 would be sold at a 2% per annum discount in the money market. What is the annualized percentage all-in cost to Whatchamacallit of this bankers’ acceptance financing?

10. Whatchamacallit Sports (B). Whatchamacallit could also buy export credit insurance from FCIA for a 1.5% premium. It finances the $100,000 receivable from Phang from its credit line at 6% per annum interest. No compensating bank balance would be required.

a. What is Whatchamacallit’s annualized percentage all-in cost of financing?
b. What are Phang’s costs?
c. What are the advantages and disadvantages of this alternative compared to the bankers’ acceptance financing in Whatchamacallit (A)? Which alternative would you recommend?
CHAPTER 19 International Trade Finance

Internet Exercises

1. **Letter of Credit Services.** Commercial banks worldwide provide a variety of services to aid in the financing of foreign trade. Contact any of the many major multinational banks (a few are listed below) and determine what types of letter of credit services and other trade financing services which they are able to provide.

   - Bank of America www.bankamerica.com
   - Barclays www.barclays.com
   - Deutsche Bank www.deutschebank.com
   - Union Bank of Switzerland www.unionbank.com
   - Swiss Bank Corporation www.swissbank.com

2. **Export-Import Bank of the United States.** The EXIM Bank of the United States provides financing for U.S.-based exporters. Like most major industrial country trade-financing organizations, it is intended to aid in the export sale of products in which the buyer needs attractive financing terms. Use the EXIM Bank’s Web site to determine the current country limits, fees, and other restrictions which currently apply. (Added note, the Export-Import Bank’s Web page provides some of the best Web site links in international business and statistics.)

   Export-Import Bank www.exim.gov

3. **Finance 3.0.** The Finance 3.0 Web site is the equivalent of a social networking site for those interested in discussing a multitude of financial issues in greater depth and breadth. There is no limit to breadth of topics in finance and financial management which are posted and discussed.

   Finance 3.0 www.finance30.com/forum/
categories/corporate-finance-valuation/listForCategory

4. **Global Reach.** This Web site is the official blog for the United States Census Bureau’s Office of Foreign Trade. The site carries a multitude of resources including helpful guides on expanding start-up export businesses, the latest in U.S. trade statistics, and helpful planning practices for exporting products to a variety of countries.

   Global Reach blogs.census.gov/globalreach