**INTERNATIONAL TRADE FINANCE – NOV 2014 MODEL ANSWERS**

**QUESTION 1**

(a) Mercantilist Theory of Trade advocates that the Government should stimulate exports and restrict imports. Malawi is currently a predominantly importing country and this has led to dwindling Balance of Payment position and culminating into foreign exchange rate pressures. Stimulation of exports would improve the BOP, make enough foreign exchange available and therefore stabilize the Exchange Rate. Stabilization of the exchange rate would also lead to lowering of inflationary pressure. Stable inflation rates and exchange would also have a stabilizing effect on interest rates. Such a position would lead to macroeconomic stability and improve the growth of the Industrial Sector. Malawi has the potential to export tourism by developing the Lake shore area to international standards and Malawi has got a lot of minerals which it can develop and export.

(b) There are four risks involved in foreign trade:-

* The laws, languages and customs of most overseas markets are likely to be unfamiliar and there could also be unfamiliarity with particular commercial and specification requirements by overseas buyers.
* Shipment periods are longer and exporters can lose control over their goods once shipped, yet they need to ensure prompt and secure payment from distant buyers.
* Payments in foreign currency coupled with fluctuating exchange rates create uncertainty about the value, which exporters will finally receive.
* Foreign governments may impose exchange control restrictions, which slow down the receipt of proceeds from buyers.

**QUESTION 2**

The mechanics of a **Documentary Collection** are easily understood when separated into the following three steps:

* Flow of Goods
* Flow of Documents
* Flow of Payment

**Flow of Goods**

After the Importer and the Exporter have established a sales contract and agree on a **Documentary Collection** as the method of payment, the Exporter ships the goods. In a Documentary Collection, the Importer is known as the *“drawee”* and the Exporter as the *“drawer”.* The exporter (seller, drawer, remitter) concludes a sales contract with the importer (drawee, buyer) and stipulates various aspects related to the transaction such as the price of products, quantity and quality, shipment method and insurance. According to the contract between the buyer and the seller, the seller remits the trade-related documents outlined in the sales contract to a bank with instructions to present the documents to the buyer.



**GOODS**



**Exporter/Drawer**



**Importer/Drawee**

**Flow of Documents**

After the goods are shipped, documents originating with the Exporter *(e.g. commercial invoice)* and the transport company *(e.g. bill of lading)* are delivered to a bank, called the Remitting Bank in the Collection process. The role of the Remitting Bank is to send these documents accompanied by a Collection Instruction/order giving complete and precise instructions to a bank in the Importer’s country, referred to as the Collecting/ Presenting Bank in the Collection process. As part of the collection order, the full name and address of the importer must be provided as well as details of documents to be included in the collection. The collection order further emphasizes whether the documents are to be released against payment or against acceptance.

The Collecting/ Presenting Bank acts in accordance with the instructions given in the Collection Instruction and releases the documents to the Importer against payment or acceptance, according to the Remitting Bank’s Collection instructions.



**GOODS**

Documents

Documents

Documents

**Note**: The Exporter’s Bank and the Remitting Bank need not be the same. Also, the Collecting Bank and Presenting Bank need not be the same. Each role could be performed by a different bank.

**Flow of Payment**

The collecting bank then notifies and presents the buyer (drawee) with the documents received from the remitting bank. If the documents are in order the drawee makes payment to the collecting bank where after the collecting bank provides payment to the remitting bank.If the buyer draws the documents against acceptance of a bill of exchange, the collecting bank sends the acceptance back to the remitting bank or retains it on fiduciary basis up to maturity. On maturity, the collecting bank collects the bill and transfers the process to the remitting bank for payment to the seller. As far as possible, the banks monitor the proper processing of collection orders until the documents are redeemed



**Remitting Bank**



**Presenting/Collecting Bank**



**Exporter/Drawer**



**Importer/Drawee**

Documents



**GOODS**

**QUESTION 3**

1. (a) A bill of lading, however named, containing an indication that it is subject to a charter party (charter party bill of lading), must appear to be signed by:

* the master or a named agent for or on behalf of the master, or
* the owner or a named agent for or on behalf of the owner, or
* the charterer or a named agent for or on behalf of the charterer.

Any signature by the master, owner, charterer or agent must be identified as that of the master, owner, charterer or agent.

(b) A bill of lading, however named, must appear to:

* indicate the name of the carrier and be signed by: the carrier or a named agent for or on behalf of the carrier, or the master or a named agent for or on behalf of the master.
* indicate that the goods have been shipped on board a named vessel at the port of loading stated in the credit by: pre-printed wording, or an on board notation indicating the date on which the goods have been shipped on board.
* indicate shipment from the port of loading to the port of discharge stated in the credit. If the bill of lading does not indicate the port of loading stated in the credit as the port of loading, or if it contains the indication “intended” or similar qualification in relation to the port of loading, an on board notation indicating the port of loading as stated in the credit, the date of shipment and the name of the vessel is required. This provision applies even when loading on board or shipment on a named vessel is indicated by pre-printed wording on the bill of lading.
* be the sole original bill of lading or, if issued in more than one original, be the full set as indicated on the bill of lading.
* contain terms and conditions of carriage or make reference to another source containing the terms and conditions of carriage (short form or blank back bill of lading). Contents of terms and conditions of carriage will not be examined.
* contain no indication that it is subject to a charter party.

(c) (i) CPT - Buyer

(ii) DEQ - Seller

(iii) FCA - Buyer

**QUESTION 4**

(a) **Financial Documents** means bills of exchange, promissory notes, cheques, or other similar instruments for obtaining the payment of money.

**Commercial Documents** means invoices, transport documents, documents of title or other similar documents whatsoever, not being financial documents.

(b) 

(c ) Avalisation is defined as “the adding of a bank’s name to a bill of exchange with the intention of guaranteeing payment at maturity” Avalisation involves a contingent liability and a bank will consider the granting of such a facility in the same way as it considers a lending facility. In other words the bank will consider the credtwothness of its customer. If a bank avalises a bill of exchange, it will require the customer to complete an authority where the bank is irrevocably authorized to debt the customer’s account upon presentation of the bill at maturity

**SECTION B**

**QUESTION 5**

***Benefits of forfaiting to the exporter***

* The facility is flexible. The documentation can be set up in a matter of hours, whereas buyer credit facilities can take up to three months to arrange. In suitable cases, the forfait facility can cover the full amount of the contract price.
* The rate of discount applied by the forfeitist is fixed, and subsequent changes in the general level of interest rates do not affect the discount.
* The finance is without recourse, so there is no need for any contingent liability on the Exporter’s balance sheet. Forfaiting does not affect any other facilities, e.g. Overdraft.
* All exchange risks, buyer risks, and country risks are removed.
* The Exporter receives cash in full at the outset.
* The finance costs can be passed on to the buyer if the Exporter is in a strong position to bargain.
* Administration and collection problems are eliminated.

***Disadvantages of forfaiting***

* Costs can be high, and there is no interest rate subsidy.
* It may be difficult to find an institution, which will be prepared to guarantee the Importer’s liabilities. Sometimes the guarantor institution may charge a high commitment fee if the buyer is not considered undoubted.
* Many business opportunities come with an associated challenge. For most entrepreneurial businesses, the greatest challenge is financing the business opportunities created by your sales efforts. What are your options if you have a sales opportunity that is clearly too large for your normal scale of operations? Will your bank provide the necessary financing? Is your business a startup, or too new to meet the bank’s requirements? Can you tap into a commercial real estate loan or a home equity loan in sufficient time to conclude the transaction? Do you decline the order? Fortunately there is an alternative way to meet this challenge: You can use Purchase Order Financing & Letter of Credit financing to deliver the product and close the sale. **Explain 7 advantages and 3 disadvantages. .**

**QUESTION 6**

( a ) Incorrect structure of the guarantee could result in:-

* losses to the principal if the beneficiary makes an abusive or unfair call under the guarantee;
* the principal losing a contract or tender due to a technicality
* Guarantee issued contrary to instructions of the principal
* if a guarantee is issued contrary to the instructions of the principal, the bank may have to settle a call without recourse to the principal
  + if the bank changes the wording of a guarantee, they must first obtain the principal’s approval before issuing
* Guarantee does not reflect the terms of the main contract
* the wording of a guarantee sometimes refers to clauses in the main contract
  + the bank must ask the principal for copies of the relevant clauses to ensure that it is not contradictory to the structure of the guarantee
* Late issuance of a guarantee
* guarantees should be issued without delay
  + if a guarantee is not issued in time, it could result in the principal losing a tender or contract
* Using an incompetent bank to issue guarantees
* if the guarantee must be issued by a bank in the beneficiary’s country, the instructing bank must ensure that they select a competent bank that would look after the interests of the principal and the instructing bank.
* Non-payment of calls by the instructing bank under a counter-guarantee
* if a bank is requested by another bank to issue a guarantee on the strength of a counter-guarantee, it must consider the financial standing of the instructing bank and the country of issue

( b) The essential contents of a demand guarantee are:

* **Short description of the project/contract:** The guarantee should identify the purpose for which it is issued.
* **Maximum amount and currency**: Liability must be restricted to a specified maximum amount. If other costs or interest are to be part and parcel of the guarantee, it is only prudent to specify that the maximum amount includes all other costs. Where possible, a reduction mechanism should be built into the text of the guarantee so that the maximum amount reduces as the contract progresses.
* **Entry into force:** Sometimes one of the parties first need to perform some act before the guarantee should enter into force. An example is where the beneficiary must make an advance payment. When the principal issues an advance payment guarantee through his bank, a clause is usually inserted stating that the guarantee will only enter into force once the money has been received in the account of the principal.
* **Expiry date or clause:** The guarantee should:
* be worded to expire on a specific date; and
* state that claims received after the expiry date would not be considered; and
* state the place for presentation of the demand
* **Call mechanism / documentary requirements**: Wherever possible the guarantee should not allow the beneficiary to call the guarantee by making a simple demand. Principals should negotiate for third party documents proving default to be presented when a demand is made. The beneficiary must also be required to submit any demand in writing.
* **Right of assignment to third parties**: Guarantees are not negotiable and not transferable. Banks in general don’t like assignments where the beneficiary assigns his rights under the guarantee to another party. Such an assignment greatly increases the risk from the principal’s point of view. The principal may have done his/her homework on the reputation and standing of the original beneficiary, but has no knowledge of the reputation and standing of the party to whom the guarantee is being assigned. It is common for guarantees to exclude the right of assignment. This does not prevent the beneficiary from assigning the rights to the proceeds of a demand to another party as the original beneficiary would still make the claim.
* **Legal issues:** There are very few countries that have statutory laws governing guarantees. Guarantees are governed by general legal principles, interpretation by judges, common law and their own terms. Although the ICC introduced the Uniform Rules for Demand Guarantees, they have not been widely accepted.

**Student to mention all 7 points to get full marks**

( c )) MT767 - Guarantee amendment

(ii) MT756 - Advice of reimbursement or payment

(iii) MT720 - Transfer of a documentary credit

(iv) MT740 - Authorisation to reimburse

**QUESTION 7**

( a ) A Standby Letter of Credit (Standby LC) is a written undertaking given by an issuing bank, at the request of an applicant, to pay the beneficiary a certain amount of money in the event of the applicant being in breach of its contractual obligations. Standby L/C’s are used as security to cover applicants’ contractual obligations to beneficiaries.

***How it operates?***

(1) The applicant and beneficiary conclude the sales contract

(2) The applicant applies to the issuing bank to issue a Standby LC in accordance with the terms and conditions agreed upon between the parties

(3) The issuing bank issues the Standby LC in favour of the beneficiary

(4) The advising bank authenticates the validity of the Standby LC and advises (informs) the beneficiary of the Standby LC that was issued in the beneficiary’s favour

(4.1) the issuing bank may authorise the advising bank or another bank to add its confirmation to the Standby LC

(5) The beneficiary ships the goods and sends the documents directly to the applicant

(6) The applicant clears the goods upon arrival

(7) The applicant instructs his bank to pay and payment takes place as per normal open account terms

(8) If the applicant does not pay as per the sales contract, the beneficiary submits a claim under the Standby LC by presenting the documents called for under the Standby LC

(9) The nominated/confirming bank checks the documents and submits a claim to the issuing bank

(10) The issuing bank checks the documents and obtains payment from the applicant, if it complies with the terms and conditions of the Standby LC

(10.1)the issuing bank pays the nominated/confirming bank

(10.2) the nominated/confirming bank pays the beneficiary

( b ) By taxing the foreign money required to purchase foreign goods and services, exchange controls cut the quantity of imports and/or raise the domestic relative price of imports;

* By allocating foreign exchange according to non-competitive rules, low-valued uses often get approved instead of higher valued ones, thereby reducing trade further;
* They often raise transaction and other related costs;
* They stifle the development of a liquid and efficient foreign exchange market and modern payment instruments, the cost of which trickles down to the final cost of imports;
* They reduce export trade by limiting the transfer of technology, managerial expertise and skills through direct foreign investment controls. Controls on profits or dividends are likely to discourage foreign direct investment and thus limit dissemination of technological and managerial knowledge;
* Exchange controls often limit business opportunities for hedging foreign exchange risks, financing trade as well as managing assets and liabilities. In the presence of controls, financial intermediation is less efficient and local financial institutions often enjoy substantial market power. The range of available products and services tends to be narrow.
* Limited opportunities for obtaining forward cover and commercial credits may inhibit trade;
* Exchange controls may lead to an overvaluation of the exchange rate which may inhibit exports;**.**

**QUESTION 8**

(a) Four ways in which banks could reduce foreign exchange exposure

* ***Forward exchange contracts: A*** bank will agree to sell or buy a certain quality of foreign exchange at a fixed rate of exchange for delivery at a future date, some could be in months or even years ahead. Exporters and importers can, therefore, eliminate their foreign exchange exposure by fixing now with their bank the rate of exchange for future foreign currency revenue or payments
* ***Pure foreign currency options:*** an alternative for foreign exchange contracts, which are provided by banks for customers who want, are currency options. They give the holder the right but not the obligation to buy or sell in the future a given quantity of foreign currency at a fixed rate of exchange, either on or before the expiry of the option period.
* ***Foreign currency borrowing:*** Banks also provide various trading finance facilities. For instance, due to cash flow problems, an importer may not have enough funds to pay for particular imports that he requires. In this case, he may approach his bank for a loan to finance the required imports which the exporter can then exchange for his own domestic currency at the current (spot) rate of exchange, and the exporter can then repay the loan out of future income received in the same foreign currency from his foreign buyers. This way, the exporter eliminates his exposure by matching his foreign currency assets (future income from debtors) against foreign liabilities (the loan). Alternatively, where he decides to raise the finance through the secondary market), he may issue a paper and ask his bank to endorse it so that it becomes a bankers acceptance. In yet another case, the importer may agree with the exporter to pay for the imports through a letter of credit. In this case, an importer will approach his bank to arrange a letter of credit which will be issued in line with the agreement between the importer and exporter.
* ***Foreign currency bank accounts***: in some cases, where companies have both income and payments in foreign currency, it may help for them to have a foreign currency denominated bank account (FCDA) with their bank. This would avoid the need for selling and buying currency to the extent that foreign currency receipts and payments can be matched (and so exposure eliminated).

(b) **Off balance sheet:** refers to transaction that on occurrence, do not have any effect on the bank’s balance sheet and are not booked, that is, entries are not passed that would affect the bank’s position. The following example illustrates what off-balance sheet is;

A customer applies for an Uncovered Letter of Credit (in simple terms, this means that the customer is not debited upfront, but this is covered in detail later) for US$ 1 million. On day 1 of establishment of the LC, the following entries are passed;

* Dr liability account (this is an internal account which can be termed as a suspense or holding account) with the equivalent in local currency: The customer’s account is not debited, instead, a contingent liability (aconfirmed and unavoidable obligation to pay) exists immediately and the bank has to pass an entry to reflect this. Normally, for an LC that is uncovered, an authority would have been given by the Credit Division to proceed with the transaction since in effect, the bank would be granting a loan facility to the customer.
* Cr a control account with the local currency equivalent

**On-balance sheet:** For one to understand this clearly, an example needs to be given; On a sale of foreign exchange via open account, the following entries are likely to be passed;

* Dr customer’s account with the local currency (MWK) equivalent of the foreign exchange allocated
* Cr the bank’s Nostro Ledger or mirror account.

When this debit on the customer’s account happens, let us assume the account is current account, then the total balances in current accounts on the liability (deposits) side of the balance sheet drop by the sum debited, on the other hand, the credit on the Nostro account, which is the local currency equivalent of the foreign currency allocated, reduces the balance of Nostro positions.

( c ) The company should not borrow in Dollars because they do not have a foreign market where they can export and earn Dollars. Borrowing in US Dollars would create a foreign exchange risk for the Company. In Malawi, exchange rates are quite volatile to the extent that taking this exposure would be too risky for the company