Chapter 15
Managing Credit Risk in International Trade
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Issues in this chapter

- **Physical risks** can be insured
  - contract stipulates who has to insure—e.g. cif v fob price

- **“Credit” risks** of all kinds
  - non-delivery of goods or money
  - substandard or late delivery; late payment
  - bureaucratic hick-ups; transfer risk etc

  ... all complicated by
  - distance and travel time (persons, goods)
  - different jurisdictions

- **Financing**
  - extra long delays: travel, clear thru customs
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◊ **Payment before shipment.** M’s risks:
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◊ **Legal redress?**
  - one party faces unfamiliar language, legal system
  - court ruling comes too late
  - ruling cannot be enforced in at least one country
  - Gvmt acting as Gvmt (“prince”) is beyond the courts
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## Keeping scores

### Scorecard

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<td></td>
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  - like an invoice: *drawn* by seller (*drawer*) upon buyer (*drawee*)
  - refers to *trade* transaction
  - *accepted* bills; *acceptance*

◊ **Why do banks like them?**
  - negotiable (discounting, rediscounting; discount house, CB)
  - CB or specialized Gt discount house used to discount export bills at subsidized rates
  - protesting: ruins your creditworthiness country-wide
  - secured loan: recourse on drawer, who *endorses*

◊ **Payment via acceptance upon delivery?**
  - Importer’s risk: time to inspect goods?
  - Exporter’s risk: default
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♢ Documentary credits  (of many forms) try to
  ▶ overcome the delay/distance problem
  ▶ lower the importer’s incentive to default
  ▶ redistribute risks towards parties better placed to
    – assess the risk
    – bear the risk

♢ The bank is your friend

♢ X sends docs that describe the goods sent
  ♢ provide title
  ♢ are needed for customs
  ♢ to a trusted intermediary,

♢ ... who verifies whether all required docs are there
  ♢ transmits them to M

♢ ... against
  ♢ either payment (D/P)
  ♢ or acceptance of a bill (D/A) (+ signing trust receipt, sometimes)
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Frequently asked documents (fads)

Documents Needed for the Customs Administration(s):

- A regular *commercial invoice* (an original and duplicates).
- A *customs invoice*—a form for M’s Customs Dpt
- A *consular invoice*—certifying there is an import license
- A *certificate of origin* by exporter’s government or the local chamber of commerce
- *Phytosanitary certificates* for verification of compliance with regulations.

Documents Needed by the Importer:

- The commercial invoice.
- An *inspection certificate* item (*cif* etc.) An *insurance policy* for the individual transaction or an insurance certificate.
- (*cif, fob* etc:) A *mate’s receipt*: goods have been loaded on board a vessel contract, and useful whenever evidence of shipping is needed.
- A *shipping list*, describing the parcels, crates, or containers.
- *Bill of lading*: (i) title to the goods and (ii) contract between the exporter and the shipping company. Clean/dirty bill.
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Letters of Credit: your bank guarantees

- **L/C** = promise to \( \{ \) pay immediately (D/P) accept a bill drawn on bank (D/A) \( \} \) if conformable docs arrive.

- international usance & practice (CC Paris), not codified law

Diagram:

1. M requests a L/C from her bank
2. L/C sent to X
3a: goods shipped
3b: docs sent to issuing bank
4a. money or acceptance sent to X, and ...
4b. docs sent to M
5. M collects the goods

Roles:
- **Exporter**
- **Importer**
- **Issuing Bank**
- **Warehouse**
Advising/Confirming

◊ **Risks not covered by regular L/C**

▷ L/C may be counterfeited, or signed by unauthorized person, or issued by banks that are not trustworthy or hardly exist

▷ transfer risk, and

▷ default risk by issuing bank

◊ **Additional information or guarantees:**

▷ **Advised L/C:** the advisory bank checks whether that bank really exists, looks sound; whether signatures seem to be OK

▷ **Confirmed L/C:** confirming bank actually guarantees the payment:

   - (D/P:) pays immediately upon receiving conformable documents
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**Benefits.** DocCredits achieve more than just risk-shifting:
- **Lower costs if default actually happens:** issuing bank ...
  - is (often) wealthier & better diversified (insurance principle), and
  - operates in the same legal environment as importer (lower costs).
- **More reliable assessment of risk:**
  - banks are specialized in evaluating credit/transfer risks;
  - issuing bank has inside info about importer.
  - confirming bank has more info about issuing bank.
- **Reduction of moral hazard:**
  - importer will not lightly default towards its house bank,
  - idem for issuing bank towards confirming colleague

**Costs**
- **Advisory fees:** ca 0.10%, often capped
- **Confirmation fees:** as of 0.10% for good risks and short maturities
- **Commissions for the actual payment or discounting:** as of 0.10%
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Services offered by a factor company may include:

- pure debt collection (with recourse; fee of e.g. 1/8-1/2%. “Export factor” & “import factor” cooperate.
- credit insurance, sometimes up to 100%, for a fee of e.g. 0.5 to 2%.
- accounts receivable financing, e.g., up to 85% for uninsured A/R, 100% for insured

Comparing with L/C’s:

- cannot be used on a case-by-case basis: a factor company wants to handle all sales, or at least all sales for a given market.
- factor also first evaluates the customer and imposes credit limits per customer and/or per country.
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Credit insurance

◊ **Who?**
  - private: Hermes, Euler: “near” exports, developed countries
  - government: Eximbank, ECGD, ...: “far” exports, developing countries

◊ **Coverage**
  - credit risk and/or transfer risk. [If the export contract is with a government body, credit risk and transfer risks are often not separated.]
  - risk of contract cancellation can often be insured with government agencies.
  - can be used either on a case-by-case basis, or for all contracts for a given market (better rates).
  - coverage is never 100%, and depends on the type of policy.
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◊ The issues

▷ goods travel slowly and far ⇒ working-capital financing issue. Trade bills provide low-risk and cheap financing.

▷ Direct B2B payments offer extreme distributions of risk to one party. Legal redress is difficult, costly, late.

▷ DocCredits reduce both probability of default and cost of bearing default, and shift risks to better-informed parties.

◊ How financial institutions can help:

▷ D/P and D/A provide more balanced distributions, but there is still no insurance effect.

▷ Letters of credit shift risks to a bank that is better placed to assess them and to bear the costs of default. Id for confirmation. Advising may suffice.

▷ Factoring may combine debt collection with credit insurance and financing. Factoring does not work case by case.

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