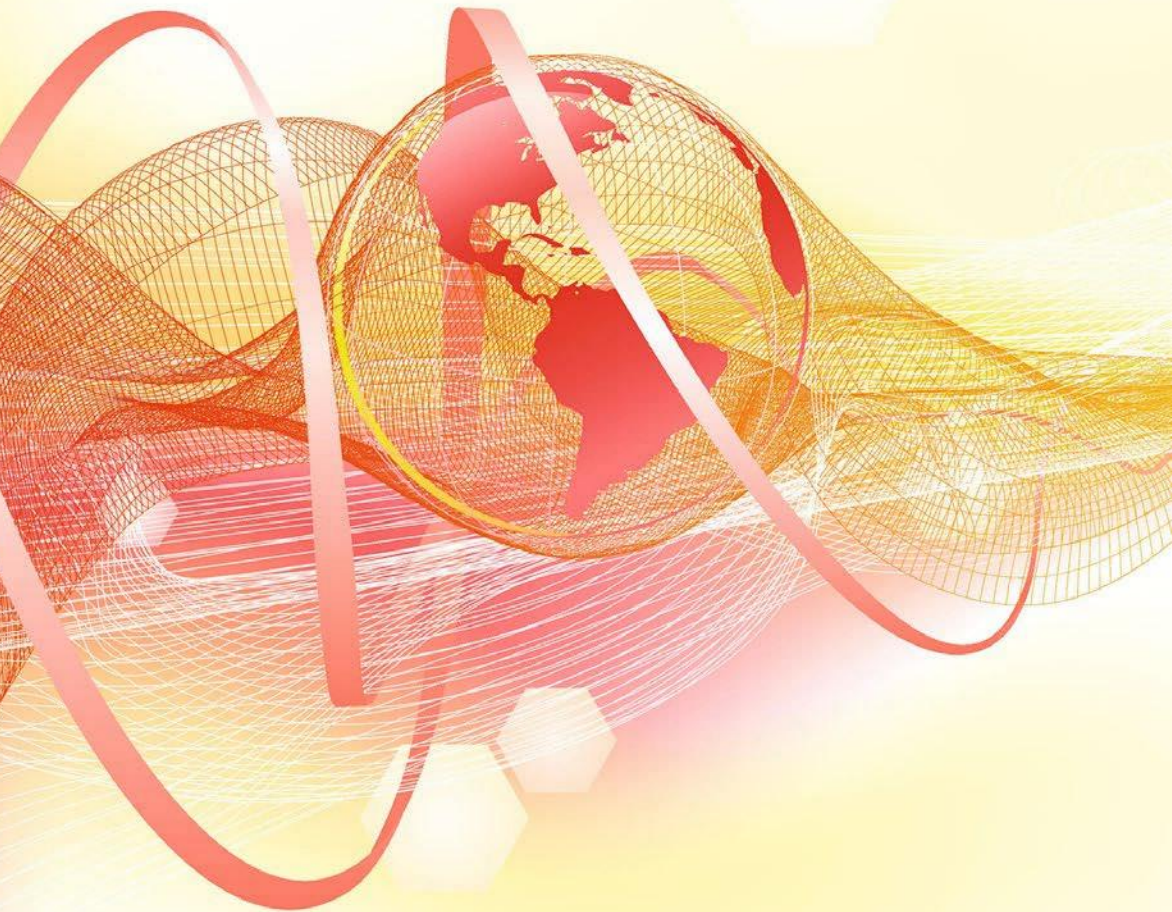


# THE TRADE AND RECEIVABLES FINANCE COMPANION

A COLLECTION OF  
CASE STUDIES AND SOLUTIONS



**STEPHEN A. JONES**



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and Solutions

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# 12

## Pre-Shipment Finance Funding the Manufacturer

The term 'pre-shipment finance' refers to the financing of payments which need to be made to suppliers for the purchase of raw materials, components or finished product prior to the client's delivery of goods to an end-buyer.

In this chapter, we shall examine the requirements of a client who needs to purchase components from their supply chain to enable them to manufacture a machine which is pre-sold to an end-buyer.

Pre-shipment finance involves considerable performance risks. Whilst there is reliance on the timely supply of components from suppliers, the financier is also exposed to the capability of their client to manufacture the machine to the required specification, quality, functionality and timeframe. There is therefore a need to carefully evaluate the ability of the client to perform.

Performance relies not only upon the client's expertise, availability of skilled manpower and manufacturing capacity, but also to be appropriately funded to pay the operational costs of the business and thereby 'keep the lights on' and remain a 'going concern' during the period of manufacture. Whilst trade finance can be used to fund the purchase of components, it does not fund the overheads of the client such as the payment of wages, gas, electricity and so forth. This requires the client's own resources or other forms of finance.

Prior to the provision of pre-shipment finance, the manufacturing client must have an identifiable and reliable source of payment for the finished goods. Furthermore, on a structured self-liquidating facility, the financier must be able to capture the trade receivable proceeds ring-fenced away from the client's use.

<b>PRE-SHIPMENT FINANCE; FUNDING THE MANUFACTURER KEYNOTES</b>	
<b>USAGE</b>	<ul style="list-style-type: none"> <li>▪ To fund the manufacturer's purchase of components</li> </ul>
<b>CRITERIA</b>	<ul style="list-style-type: none"> <li>▪ The goods to be manufactured must be pre-sold to an end-buyer of acceptable credit status or sales proceeds secured by a letter of credit or payment demand guarantee which mitigates the risk of non-payment, or by the use of credit insurance which provides monetary compensation covering insolvency, country transfer and political risks</li> <li>▪ The client and their supply chain must have a proven track record of the successful delivery of components and finished goods of the type to be financed</li> <li>▪ The manufacturing client should be appropriately funded with no evidence of creditor pressure; they must be able to remain a 'going concern' during the period of manufacture (and subsequent sales invoice credit period in the case of open account settlement)</li> <li>▪ Pre-shipment finance works best when the source of repayment is a well-structured letter of credit which protects the payment flow from dispute, subject to a complying presentation of documents</li> </ul>

**Fig. 12.1** Pre-shipment finance: funding the manufacturer: keynotes

In this chapter, we shall look at the evaluation of the risks faced by the pre-shipment financier on the manufacture and delivery of a machine where the source of repayment is a letter of credit. In Sect. 12.8, we also consider the risks if the machine was sold on open account terms. A summary of the required criteria to fund the manufacturer by pre-shipment finance is provided in Fig. 12.1.

## 12.1 Case Study: Lou Rawls Machinery

The bank (referred to in this chapter as the 'trade finance bank' or 'trade financier') has been requested to provide pre-shipment finance of USD 0.972m on a transactional basis to a non-banked potential new client. This is to fund the purchase of components to enable the manufacture of a paper cutting and rolling machine for export to Mexico for a sales value of USD 2.430m.

Lou Rawls Machinery (LRM) are a long-established manufacturer of this type of machine. Following a period of low sales and the accumulation of losses, resulting in a significant deficit in tangible net worth, currently (GBP 0.826m), they have been profitable for the past 3 years. LRM hold their account with another bank ('house bank').

The house bank provide banking facilities to the parent company of LRM, Lou Rawls Group Investments Limited 'LRGI' comprising general loans and overdraft totalling GBP 2.318m. Current general facility utilisation is GBP 2.269m. The 'house bank' is secured on property assets recently valued at GBP 3.755m. The facilities made available to the group therefore represent a loan to value ratio of 62% (being banking facilities of GBP 2.318m/security value GBP 3.755m  $\times$  100). LRGI have a net worth of GBP 3.798m.

LRGI manage real estate which was purchased using the profits generated by their manufacturing subsidiary, LRM, over many years. Stable and therefore predictable rental income is received by LRGI. These assets include the manufacturing site on which LRM are based.

The trade finance bank has developed a good dialogue with LRM over the past 12 months and has now been presented with an opportunity to provide pre-shipment finance in respect of the manufacture of one of their largest machines. A copy of the export letter of credit which has been received by the trade finance bank in its capacity as advising bank is provided in Fig. 12.4.

The order value is USD 2.43m with mixed payment terms as follows.

Letter of credit:

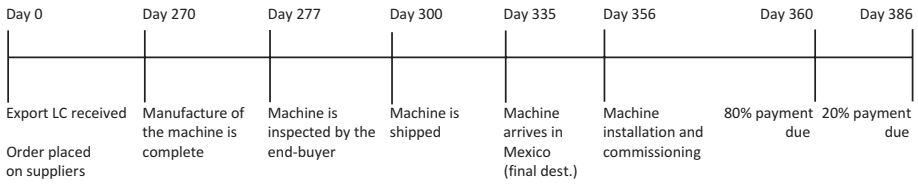
80% payable 60 days after the date of shipment

20% payable 30 days after the installation and commissioning of the machine in Mexico (by LRM engineers)

The manufacturing period is 9 months. Components will be purchased from various suppliers in the UK, USA and Italy. A one-day operational test will take place 1 week after manufacturing completion in the presence of the inspection team of the end-buyer. An acceptance certificate will be issued by the end-buyer on successful inspection. The machine will be shipped to Mexico 1 month after the date of manufacturing completion.

Transit of the machine from England to the discharge port in Mexico will take 30 days plus another 5 days for customs clearance and onward travel to the final destination. Installation and commissioning will be completed 21 days after arrival of the machine at its final destination in Mexico.

The trade cycle timeline of the transaction is shown in Fig. 12.2. This assumes that the manufacturing process commences from the date of issuance of the export letter of credit.

**Note**

For the purposes of calculation, a month is taken as 30 days

**Fig. 12.2** Trade cycle timeline

## 12.2 Conventional Lending Assessment

LRM have been trading profitably for the past 3 years, but continue to have a negative net worth, albeit this is gradually reducing as profits are generated and retained. The primary assets are owned by their parent and used to provide security to the house bank for the general banking facilities.

Due to the negative net worth, a loan request of USD 0.972m would be declined on a balance sheet assessment basis. LRM do not have sufficient assets which can be realised to cover their liabilities and thus are unable to demonstrate the ability to repay a conventional lender. Given the negative asset position, where LRM owe more than they own, there is a risk that the company could collapse during manufacture due to lack of cash, or that sales proceeds are diverted to pay pressing creditors, rather than used to repay the trade financier.

The house bank is comfortably secured at a lending value of 62% (facilities made available versus security value). However, there is no material capacity to lend any more against this security, and certainly no appetite for the house bank to enter into a security sharing arrangement with the trade finance bank.

It would be easy therefore to decline this proposition on a conventional lending basis. A structured trade finance facility may however be feasible.

## 12.3 Structured Trade Finance Lending Assessment

The financial assessment of the borrower on a structured trade finance facility is different to that made on a conventional balance sheet lending basis. The primary source of repayment on a structured self-liquidating facility is the proceeds of the transaction itself, rather than the borrower's ability to repay.

An assessment is therefore required of the:

1. Source of repayment: ability and willingness of the end-buyer to pay for the machine;
2. Performance: ability of the supply chain to deliver the required components on a timely basis and the capability of LRM to manufacture the machine which meets the requirements of the end-buyer and to ship it within the required timescale;
3. Solvency: availability of financial resources and/or credit facilities to enable LRM to remain in business and function as a 'going concern' during the manufacturing period (and remain solvent throughout any subsequent open account invoiced trade credit period provided to the end-buyer)

### 12.3.1 Source of Repayment

#### Export Letter of Credit

On a structured self-liquidating facility, the financier must have an identifiable and reliable source of transactional repayment. On this transaction, this is an export letter of credit (also referred to in this chapter as an 'LC' or 'credit'). Whilst a letter of credit can be an excellent source of repayment for the financier, it must be structured in the right way and contain documentary terms that can be comfortably achieved by the beneficiary (borrower).

The trade finance bank will therefore need to evaluate whether it provides the required security of payment. This is explored in Sect. 12.5.

#### Disbursement of Loan Monies

It is important that the pre-shipment finance is used for its intended purpose. If these monies are mis-applied, LRM will not have funds to pay their suppliers for the necessary components, the machine will not be built/completed and therefore the trade finance bank's primary source of repayment will not materialise.

The trade finance bank ought therefore to control the drawdown of the loan and ensure the funds are used for their correct purpose. The trade finance bank could pay the supplier(s) direct having received a completed and signed payment instruction from LRM or retrospectively reimburse LRM for their own payment to the supplier(s) evidenced by a copy of the payment/remittance advice. In both cases, the trade finance bank would require a copy of the supplier invoice and LRM's confirmation of timely receipt of satisfactory components.

### Currency Risk

Components are to be supplied from several countries. We are not told the currency of purchase but can assume that these will be in the currency of the supplier.

The loan is to be drawn in US dollars. This is matched by the currency of the letter of credit proceeds. The borrowing will therefore be repaid in the same currency and thus avoids exchange rate exposure between different currencies. However, there will be exposure to the potential of adverse exchange rate movements on the purchase of components in currencies other than US dollars. The margin between gross sales proceeds (USD 2.43m) and the required amount of finance (USD 0.972m) is a comfortable 60% (the borrowing represents just 40% of the machine sales value). This is a significant buffer to accommodate any unforeseen costs.

In situations where the ratio of borrowing to sales value is high and there is no matching currency of purchase and/or borrowing to sales proceeds, the financier would need to insist on foreign exchange hedging protection as a condition of credit facility approval. Adverse currency exchange rate movements could erode any profit margin and result in insufficient trade receivable proceeds to repay the borrowing, interest, fees and charges.

### 12.3.2 Performance

Other than the credit status of the transactional source of repayment, a key risk on pre-shipment finance is performance. If LRM fail to build and ship the machine, there will be no sales proceeds with which to repay the loan. Whilst the trade finance bank may be able to take possession of the purchased components or partly manufactured machine with the aim of selling these as a secondary source of repayment, in reality these may have little or no value in their incomplete or component state.

The capability of LRM to manufacture the machine to the required specification must be evaluated. This assessment should include expertise, manpower and manufacturing capacity. Where a standard build machine needs to be adapted to the requirements of the end-buyer, this increases the risk of dispute.

One of the most common performance risks is a delay in manufacture which results in a late shipment of goods in contravention of the terms of the letter of credit. Timely manufacturing progress should be carefully monitored by the receipt of progress reports supplemented by periodic site visits. This is

particularly important when a standard build machine is to be adapted or a machine manufactured on a bespoke basis; much could go wrong resulting in potentially significant delays and cost overruns. The secondary market for such a machine will also be limited.

Monitoring the machine build can be assisted by requiring LRM to produce a detailed cash flow forecast of the manufacturing project. This should contain names of the key suppliers, credit terms, purchase cost and a schedule of when invoices will be due for payment. This enables the trade finance bank to monitor supplier payment loan requests against the cash flow forecast. Any slippage in component supply will be highlighted by a mismatch between the scheduled cash flow payment plan and the request for supplier payment.

The major suppliers (i.e. those representing 80% of purchases plus any that are supplying unique high dependency components) will need to be approved by the trade finance bank following desktop analysis of their status (obtained via credit reports), reputation (internet-based publicity and press reports) and feedback from LRM regarding their track record of supply.

Funding will be withheld for any unapproved supplier and critical analysis undertaken of LRM's dependency on them for manufacture.

It is important that the received components conform to the correct specification and quality. LRM ought to be challenged to provide demonstrable evidence of the satisfactory track record and/or competence of key suppliers. A condition of loan drawing should be that LRM provide their signed and dated certification to the trade finance bank that the invoiced components have been received to the required specification and quality in conformity with their purchase order and in good time to fulfil the manufacturing build plan.

Caution should be exercised where there is a dependency on a key supplier, perhaps for a unique component. Their credit status, reputation and track record ought to be assessed. LRM should be required to provide their contingency plan in case of the supplier's failure. This must be acceptable to the trade financier. The implications of any 'work around', such as potential cost escalation, production build delay and impact on the functionality of the machine, must be carefully assessed.

Restriction of cash may result in LRM taking short-cuts in the manufacturing process or using cheaper inferior components which produce a machine that does not operate to the required standard. Whilst the receipt of a letter of credit mitigates the risk of dispute because the bank's undertaking to pay is based solely on the presentation of documents, these must be interpreted by the bank as complying fully with the terms of the letter of credit and applicable rules.

### 12.3.3 Solvency

If LRM run out of cash and cannot pay their workforce, face restriction in supply, debt enforcement, insolvency or liquidation proceedings by a pressing creditor, completion of the machine will be in severe doubt, even though the trade finance bank has funded the purchase of components. It is important to note that trade finance does not fund overheads as these are not tangible costs directly associated with the production of the machine. Examples of non-trade financed overhead costs are heating, lighting, rental payments, wages and so forth.

It is vitally important therefore that LRM have sufficient working capital to remain a 'going concern' during the manufacturing, shipment and installation process.

Any sign of liquidity pressure, represented by the inability of LRM to pay creditors, will be a warning sign. This can be identified by examination of LRM's aged creditor list. The aged creditor list should record all supplier invoices which are outstanding and awaiting settlement. The ageing of each supplier invoice ought to be shown either from the date of the invoice, or its due date for payment.

Any supplier invoice which remains outstanding 30 days or more beyond the due date for payment is a cause of significant concern. This may indicate a lack of cash or insufficient headroom in the credit facilities to pay the invoice, or a refusal to pay because of the receipt of inferior components. The trade finance bank relies upon the continuing ability of the borrower, LRM, to pay creditors as debts fall due for payment, and thus operate without restriction of supply, and the capability of their supply chain to provide acceptable components.

Because of the negative net worth balance sheet position of LRM, the trade finance bank will need to conclude in their assessment that there is no creditor pressure, and that LRM have a sustainable and positive cash flow and/or access to available credit facilities. The trade finance bank will also need to be convinced that the parent company will be willing and able to provide financial support, if and when required. A parental guarantee must be obtained.

#### **Cash Flow Forecast**

LRM's cash flow forecast will need to be reviewed and the basis of its preparation exposed to scrutiny. Even when conservatively and judiciously prepared, unforeseen events may occur which blow the forecast off course. The trade finance bank will need to be satisfied that the cash flow forecast shows that LRM have the financial resources or access to general credit facilities of their parent to fund overheads, pay creditors and continue to operate during the period of manufacture of the machine.

### **Other Credit Facilities**

A key part of pre-shipment finance assessment is examination of the other credit facilities which are available to the borrower. This will take in the type of facility, limit and headroom (remaining availability to be drawn). The terms and conditions of each of the facilities ought to be reviewed, particularly if the provider is another lender. This will cover the financial and non-financial covenants, security provided, loan repayments and facility renewal/expiry date.

The financier must ensure as far as they can that these other facilities are sufficient for the needs of the borrower; in particular that there is headroom for additional drawings. If these facilities are already close to or at full utilisation, the borrower could very quickly run out of cash; this would place in jeopardy the successful conclusion of the trade financed transaction.

When the borrower is dependent on the continued availability of other sources of finance, the trade finance bank should monitor the performance of their client against the covenants of those other lending facilities. Breach of these could give rise to termination of the facility or a hardening of the terms. Monitoring will provide an early warning signal of trouble ahead and the possibility of facility withdrawal or restriction.

The review or expiry date of these other facilities should not fall within the manufacturing period of the proposed transaction. When the continued availability of these facilities is critically important to the successful conclusion of the trade transaction, the borrower should be required to negotiate the extension of these facilities as a condition precedent to trade finance inception; this ought to cover the manufacturing period, as a minimum. Alternatively, the process of renewal should be closely monitored to ascertain the outcome, and any changes in their terms or credit limit.

Restriction, withdrawal or non-renewal of a general financing facility, such as revolving loans, overdraft or invoice finance could impact upon the ability of the borrower to remain a going concern and thus impair completion of the trade financed transaction.

On the basis of the information provided, it is likely that LRM are dependent upon the credit facilities provided to LRG1 by the house bank. The trade finance bank will therefore need to be satisfied that LRM have ongoing access to available credit facilities to cover their overheads, to include payment of wages, during the period of manufacture, shipping and installation of the machine.

### 12.3.4 Security

We can assume that the transactional assets of the proposed transaction will be captured by the house bank through their security.

These assets must be carved out of the existing security arrangements by a waiver from the house bank, so that the trade finance bank enjoys property rights over the components, machine and sales proceeds of the financed transaction. Alternatively, a deed of priority could be agreed determining the ranking and distribution of realised monies of these assets between the house bank and the trade finance bank.

### 12.3.5 Risk Appraisal Summary

A summary of the risk appraisal is shown in Fig. 12.3.

Whilst there are a number of negative aspects with this proposition, it can be reasonably concluded that, subject to the ongoing provision of credit facilities via the house bank, LRM have the competence and capability to build and deliver the machine.

This transaction would appear to be highly profitable (given a component cost of USD 0.972m and sales price of USD 2.430m) and therefore transformative to LRM, with the potential to eliminate or substantially reduce the present negative net worth balance sheet position of (GBP 0.826m).

Trade finance can be used successfully to provide a transactional line of funding to a non-banked client as a 'wedge' from which a fuller banking relationship may be developed. The transactional banker however does not enjoy

#### Risk appraisal summary

- ✗ Negative tangible net worth
- ✗ House bank has tangible security
- ✗ Dependency on external bank finance
- ✗ Requirement for pre-shipment finance
- ✗ Transactional finance
- ✓ Competency to build machine
- ✓ Profitable for past 3 years
- ✓ Parental support
- ✓ Highly profitable transaction

#### Reliable source of repayment?

Fig. 12.3 Risk appraisal summary

the information flow; of monies in and out of the general banking accounts and sight of the daily utilisation of credit facilities. These can provide an early warning of potential liquidity problems. At best the trade finance bank will only be able to monitor these periodically.

The transactional banker must therefore be clear on the nature of information it needs, why it wants this, how it is to be used and when required (periodicity).

## 12.4 Export Letter of Credit: Documentary Performance

Where pre-shipment trade finance has been approved on the basis that an export letter of credit will be the primary source of repayment, this must be held in a form acceptable to the financier, (and proceeds assigned to them), prior to allowing the drawing of the facility.

The issuing bank must be of acceptable credit quality, the country of issuance economically and politically sound, and the beneficiary able to present documents which comply with the terms of the credit and applicable UCP rules. It is often said that when a letter of credit is involved, the documents are more important than the goods!

The track record of LRM's presentation of documents under letters of credit must be evaluated, such as the percentage that were complying. A record of presentations made by LRM (through all banks) over a reasonable period of activity should be sought indicating the date of presentation and either date of payment (on sight or negotiable credits) or date of advice of draft acceptance or deferred payment undertaking on usance credits. The list should be split between those credits that were confirmed and those unconfirmed. If the period between date of presentation and sight payment, negotiation or advice of acceptance/deferred payment was greater than 5 days on a confirmed credit, this could indicate a discrepant presentation; on an unconfirmed credit, a delay greater than 10 days would be cause for concern. Alternatively, where a more definitive assessment is required, the analyst could work through the client's letter of credit files.

A discrepant presentation will result in the rejection and return of documents by the issuing bank (and confirming bank where applicable) unless the discrepancies are waived (approved) by the LC applicant, and their waiver is accepted by the issuing bank. Ultimately, the issuing bank will determine whether the applicant will be invited to waive the discrepancies and then whether they, the issuing bank, are prepared to accept the waiver.

The greater the level of non-complying (discrepant) presentations, the more involved the financier will need to be in overseeing the preparation of documents and examining draft and specimen documents prior to shipment. This will seek to ensure that the documents comply with the letter of credit, when presented in their final and original form.

Because interpretation of the documentary terms can vary from one bank to another, it is important that the financier is authorised by the issuing bank to examine documents and make payment (subject to the receipt of a complying presentation). To achieve this, the credit will need to be made available with the financier (as the nominated bank) by payment, draft acceptance, deferred payment or negotiation.

Whilst the issuing bank may make a different interpretation of the letter of credit requirements, consider the documents discrepant and reject them, the nominated bank can challenge this, and if necessary, seek independent arbitration. The financier will benefit from leverage over the issuing bank if they have already obtained reimbursement for payment made under a sight letter of credit (in accordance with the instructions contained within the LC), or hold irrevocable authority to obtain reimbursement on the due date for payment.

It is also important that the LC expires in the country of the financier. This enables them to determine whether the documents have been presented to the place of expiry (their country/counter) within the time stipulated in the letter of credit. Export letters of credit are discussed in more detail in Chap. 6.

## 12.5 Export Letter of Credit: Structure and Terms

A copy of the export letter of credit received by LRM is provided in Fig. 12.4. This has been issued by the buyer's bank in Mexico and sent to the trade finance bank (in the capacity of advising bank). An advising bank has little involvement in an LC other than checking the apparent authenticity of the credit and performing the role of messenger between the beneficiary and issuing bank. In this case, however, the advising bank (the trade finance bank) has been requested by the beneficiary, LRM, to provide pre-shipment finance and thus has a material interest in how the LC is structured.

It should be noted that reference to the 'trade finance bank' in the remainder of this chapter also refers to them as the advising bank.

We shall now work through the terms and conditions of the credit in Fig. 12.4 to assess whether this is acceptable to LRM and if it provides a suitable and reliable source of repayment to the trade finance bank. Any changes (amendments) required to the terms will be described. By way of comparison, a revised version

## TRADE FINANCE BANK 'ADVISING' LETTER

LOU RAWLS MACHINERY  
 UNIT 5 WOODBRIDGE INDUSTRIAL ESTATE  
 STEPHEN'S STREET, DUDLEY  
 WEST MIDLANDS, UNITED KINGDOM

14JAN20

Dear Sirs,

In accordance with the version of the UCP rules (issued by the ICC) as specified in the credit, we advise having received the following transmission from

BUYER'S BANK, MEXICO (SWIFT ADDRESS: ANYBMXMM)

40A	FORM OF LC:	IRREVOCABLE
20	LC NO:	0157/140120
31C	DATE OF ISSUE:	14JAN20
40E	APPLICABLE RULES:	UCP LATEST VERSION
31D	EXPIRY DATE AND PLACE:	17NOV20 <b>4</b> MEXICO <b>2</b>
50	APPLICANT:	BUYER PRIMERO STRACO, TIJUANA MEXICO
59	BENEFICIARY:	LOU RAWLS MACHINERY UNIT 5 WOODBRIDGE INDUSTRIAL ESTATE STEPHEN'S STREET, DUDLEY, WEST MIDLANDS, UK
32B	AMOUNT:	USD 2430000
39B	MAX CR AMT:	NOT EXCEEDING
41A	AVAILABLE WITH/BY:	ISSUING BANK <b>1</b> BY DEFERRED PAYMENT REFER CLAUSE 47A FOR PAYMENT DETAILS
43P	PARTIAL SHIPMENTS:	NOT ALLOWED
43T	TRANSHIPMENT:	NOT ALLOWED
44E	LOADING PORT:	ANY UK PORT
44F	DISCHARGE PORT:	ROSARITO, MEXICO
44C	LATEST DATE OF SHIPMENT:	02OCT20 <b>3</b>
45A	GOODS:	PAPER CUTTING AND ROLLING MACHINE PER CONTRACT NO. 407250 SHIPPING TERM: COST AND FREIGHT ROSARITO, MEXICO
46A	DOCUMENTS REQUIRED:	<ol style="list-style-type: none"> <li>1. ONE ORIGINAL MANUALLY SIGNED COMMERCIAL INVOICE</li> <li>2. TWO OUT OF THREE ORIGINAL CLEAN SHIPPED ON BOARD MARINE BILLS OF LADING CONSIGNED TO THE ORDER OF APPLICANT <b>8</b> SHOWING FREIGHT PREPAID BEARING THIS LC NUMBER AND DATE OF ISSUE</li> <li>3. PACKING LIST IN DUPLICATE SHOWING NET AND GROSS WEIGHT</li> </ol>

Fig. 12.4 Export letter of credit

4. ONE ORIGINAL ACCEPTANCE CERTIFICATE OF THE TRIAL RUN OF THE MACHINE ISSUED AND SIGNED BY THE INSPECTION TEAM OF THE APPLICANT **5**
5. CERTIFICATE OF ORIGIN ISSUED BY THE CHAMBER OF COMMERCE IN EXPORTER'S COUNTRY CERTIFYING THAT GOODS ARE FULLY OF UK ORIGIN **6**
6. STATEMENT OF THE BENEFICIARY CERTIFYING THAT ONE ORIGINAL SET OF ALL OF THE DOCUMENTS **7** STIPULATED IN THIS CREDIT HAVE BEEN DESPACHED TO THE APPLICANT WITHIN SEVEN DAYS OF SHIPMENT  
COURIER RECEIPT TO ACCOMPANY BENEFICIARY STATEMENT
7. ONE ORIGINAL INSTALLATION AND ACCEPTANCE CERTIFICATE ISSUED AND SIGNED BY THE APPLICANT **9**
- 47A ADDITIONAL CONDITIONS:
  1. PAYMENT TERMS
    - A) 80 PCT OF LC VALUE WILL BE PAID AT 60 DAYS FROM DATE OF SHIPMENT UPON PRESENTATION OF THE DOCUMENTS AS SPECIFIED UNDER FIELD 46A CLAUSES 1 TO 6 OF THIS LC
    - B) 20 PCT OF LC VALUE WILL BE PAID AT 30 DAYS FROM DATE OF INSTALLATION AND ACCEPTANCE CERTIFICATE UPON PRESENTATION OF THE DOCUMENTS AS SPECIFIED UNDER FIELD 46A IN CLAUSES 1 AND 7 OF THIS LC
  2. INSURANCE TO BE COVERED BY THE APPLICANT **10**
  3. ALL DOCUMENTS MUST QUOTE THIS LC NUMBER, DATE OF ISSUE, BILL OF LADING NUMBER **11** AND CONTRACT NUMBER
  4. BILL OF LADING MUST CONTAIN NAME, ADDRESS, TELEPHONE AND FAX NUMBER(S) OF THE CARRYING VESSEL'S AGENT AT THE PORT OF DESTINATION
- 48 PERIOD FOR PRESENTATION: DOCUMENTS TO BE PRESENTED WITHIN  
10 DAYS **12** AFTER THE DATE OF SHIPMENT  
BUT WITHIN THE VALIDITY OF THE CREDIT
- 71B ALL BANKING CHARGES OTHER THAN THE ISSUING CHARGES ARE FOR ACCOUNT OF THE BENEFICIARY
- 49 CONFIRMATION INSTRUCTIONS: WITHOUT **13**
- 78 INFORMATION TO PRESENTING BANK: **14**  
UPON RECEIPT OF COMPLYING DOCUMENTS AT BUYER'S BANK ADDRESS PROVIDED HEREIN, BUYER'S BANK WILL REMIT PROCEEDS IN ACCORDANCE WITH YOUR INSTRUCTIONS AT THE PAYMENT MATURITY DATE AS SPECIFIED WITHIN CLAUSE 47A 1  
DOCUMENTS MUST BE DESPACHED TO BUYER'S BANK, MEXICO IN ONE LOT BY COURIER

---

Fig. 12.4 (continued)

of the export letter of credit containing the solutions described in this section can be found in Fig. 12.6.

The key requirements of the trade finance bank are that the LC is available with them, and that they have appetite and capacity to take credit risk on the issuing bank and the country in which the issuing bank is situated.

### 12.5.1 Availability [1]

One of the most important aspects of the letter of credit structure is who is authorised to examine documents and make payment to the beneficiary.

The letter of credit is available only with the issuing bank in Mexico. The trade finance bank has been granted no powers of availability and thus has no authority to examine documents. An undertaking to pay will only be given once the issuing bank has received the documentary presentation in Mexico and judged this to fully comply with the LC terms and UCP rules.

This exposes LRM to documentary, payment and liquidity risk.

#### **Documentary Risk**

The trade finance bank has no authority to examine documents. The first time that the documents will be formally checked is on arrival at the counters of the issuing bank in Mexico. LRM are therefore directly exposed to the issuing bank's interpretation of the documents. If a small mistake has been made (discrepancy), it will be too late to represent a corrected document. This is because any submission of corrected or replacement documents must be received by the issuing bank in Mexico within the presentation period allowed in the letter of credit; in this example, 10 days from the date of shipment.

It is also possible that the issuing bank will scrutinise the documents more closely if their client, the buyer (applicant), is in financial difficulty. (A period of 10 months will have elapsed between the issuance of the credit and shipment.) If the issuing bank can find a discrepancy, they can reject the documents and avoid payment.

Whilst rejection of documents by the issuing bank is also a possibility when the credit is made available with a local nominated bank, the beneficiary can eliminate this risk when the credit has been confirmed and where the confirming bank has interpreted the documents as complying. On a confirmed credit, payment is made without recourse to the beneficiary, or a payment undertaking given irrevocably. The matter of a difference in interpretation is thus handled between the confirming bank, who risks not receiving reimbursement or being required to refund any reimbursement received, and the

issuing bank who has rejected the documents. In this situation, the beneficiary is protected.

### **Payment Risk**

LRM have only the payment undertaking of the issuing bank (subject to a complying presentation of documents). If the issuing bank is insolvent or there are foreign exchange restrictions or political measures which prevent or delay transfer, LRM are exposed to the risk of non-payment, or delayed settlement.

### **Liquidity Risk**

Because the trade finance bank has been given no authority by the issuing bank to negotiate documents (i.e. to examine documents and subject to a complying presentation, to advance proceeds to LRM under the credit), LRM will need to wait until the deferred payment undertaking has been provided by the issuing bank and then sell this debt obligation to the trade finance bank or elsewhere to receive the proceeds.

This process will not be straightforward because a deferred payment undertaking is not a negotiable instrument. The trade finance bank will require the proceeds of the issuing bank's undertaking to be assigned to them. This will take time and may even result in the refusal of the issuing bank to acknowledge and agree to the assignment of proceeds.

Alternatively, LRM could request the issuing bank to purchase their own deferred payment undertaking and pay discounted proceeds to them prior to the due date; this may not be available.

Failure of LRM to accelerate the receipt of proceeds will mean that they will need to wait for payment maturity, that is, timeline Day 360 as shown in Fig. 12.2. Not only does this expose LRM to liquidity issues but also the risk that the issuing bank becomes insolvent in the meantime, or that foreign exchange restrictions, monetary regulation or political measures prevent or delay payment at maturity.

### **Solution**

The letter of credit must be changed and made available with the trade finance bank, by deferred payment, acceptance or negotiation (in that order of preference). This will authorise the trade finance bank (as the nominated bank) to examine documents and undertake to make payment to LRM under the terms of the credit (subject to the trade finance bank's willingness to confirm the credit, as discussed in Sect. 12.5.13, suitable bank to bank reimbursement instructions as described in Sect. 12.5.14, and a complying presentation of documents).

### 12.5.2 Place of Expiry [2]

The place of expiry is where the documents need to reach within the presentation period stipulated in the letter of credit. This means that documents have to be received by the issuing bank in Mexico within 10 days from the date of shipment. This will be difficult to achieve and will certainly leave no remaining time for resubmission of any corrected documents in the event of a discrepant presentation.

If the availability of the credit is amended in accordance with the recommendation in Sect. 12.5.1 but the place of expiry remains unchanged, the trade finance bank will not be able to ascertain whether the documents comply when received at their counter because one of the tests (documents received at the place of expiry being Mexico within the time period stipulated) will not be determined until the documents reach the issuing bank. The trade finance bank will not therefore be able to issue a deferred payment undertaking, accept a draft or negotiate until the issuing bank has confirmed their receipt of documents within the stipulated timeframe.

#### **Solution**

The place of expiry in Fig. 12.4 must be changed from Mexico to the UK to be consistent with the revised terms of availability as described in Sect. 12.5.1. This will enable the trade finance bank to establish that the documents have been received at their counter within the period allowed by the letter of credit. This will also potentially provide additional time for LRM to resubmit any corrections because the documents only have to reach the counter of the trade finance bank in the UK to satisfy the stipulated presentation period, rather than Mexico.

### 12.5.3 Latest Date of Shipment [3]

The latest shipment date of 2 October is not long enough. The trade cycle timeline in Fig. 12.2 shows that the machine will be shipped on Day 300. Assuming production commences on the date of LC issuance, the latest date for shipment allows only 261 days for manufacture and shipping.

#### **Solution**

The latest date of shipment will need to be set at 300 days from the date of the letter of credit, being 10 November.

There is always a risk of delays during a manufacturing process, particularly when this is scheduled to take several months. It would therefore be prudent for the latest date of shipment to be extended further to build in additional time for unforeseen slippage.

#### 12.5.4 Expiry Date [4]

The expiry date is the latest that the letter of credit can be utilised by documentary presentation. The expiry date needs to cover manufacture, shipment, installation and commissioning of the machine and presentation of the documentation to the bank at the place of expiry. This is presently not long enough.

The trade cycle timeline in Fig. 12.2 shows that installation and commissioning of the machine will take place on Day 356. Once this has been completed, LRM will need to wait for receipt of the buyer's installation and acceptance certificate. It would therefore be prudent to allow a period of say 30 days after installation for the receipt and presentation of the certificate to the bank at the place of expiry.

#### **Solution**

The letter of credit presently expires 307 days after the date of issuance. This needs to be changed to 386 days, that is, bear an expiry date of 4 February the following year (being Day 356 for installation and commissioning plus 30 days to obtain and present the installation and acceptance certificate or installation and commissioning certificate as proposed in Sect. 12.5.9).

#### 12.5.5 Acceptance Certificate [5]

It is important that LRM have control over the documents which need to be presented under the letter of credit. Where any of the documents are to be issued or signed by the applicant, the buyer can control whether LRM are able to present a complying set of documents to the bank. The buyer can therefore frustrate and prevent payment.

One of the documents that LRM need to present in Fig. 12.4 is the applicant's acceptance certificate in respect of the trial run of the machine; this will only be issued once the buyer is satisfied. The buyer can prevent LRM achieving a complying presentation of documents under the letter of credit by not

issuing the certificate or releasing it too late. The non-issuance or late release may be due to circumstances beyond the control of the buyer, such as a rejection or delay in the visa entry application for the inspection team.

The contingency arrangements of LRM need to be understood and in place to cover the non-availability of the inspection team or non-receipt of the acceptance certificate. Any visa requirements ought to be monitored by LRM to ensure all goes smoothly. The trade finance bank should seek to ensure that there is acceptable provision and remedy in the contract for this risk. The letter of credit latest shipment date should incorporate a buffer to accommodate any unforeseen delays.

### **Solution**

Ideally, the LC requirement for the buyer's acceptance certificate in Fig. 12.4 should be removed. This could be replaced by a machine running certificate issued by LRM. Since this self-certification may not be acceptable to the buyer, this could be supported by LRM's provision of a bank performance guarantee of say 5% of the shipment drawing value (the guarantee issued by the trade finance bank or house bank).

The performance guarantee could be stipulated as one of the documents that needs to be presented under the credit accompanied by the shipping documents as shown in the export letter of credit solution in Fig. 12.6 [5.1].

Whilst the provision of a bank performance guarantee will require a credit facility to cover the liability and is vulnerable to an unjustifiable (but complying) claim, the self-certification by LRM of the machine running test would vest control to them in the documentation required to trigger the 80% shipment stage payment and may therefore be considered a price worth paying.

Alternatively, the applicant's acceptance certificate could be replaced with an inspection certificate issued by a specified independent inspectorate. Whilst this would be better than that of the applicant's own certificate, the inspectorate would most likely be contracted by the buyer. The timely release of the certificate to LRM will therefore remain under the control of the buyer (i.e. receipt of the certificate by LRM will rely upon either the buyer's provision of the document or the buyer's instruction to the inspectorate to release the certificate to LRM). The seller, LRM, should therefore obtain a copy of the buyer's written irrevocable instruction to the inspectorate to provide LRM with the original of the certificate immediately on its issuance. A copy of the inspectorate's acknowledgement of the instruction ought also to be held. It would of course be preferable for LRM to arrange and contract the inspection.

### 12.5.6 Certificate of Origin [6]

The letter of credit requires a certificate of origin issued by a chamber of commerce which certifies that the goods are fully of UK origin. Components will be supplied by companies in the UK, the USA and Italy and thus the goods will not be ‘fully’ of UK origin, as required by the letter of credit.

LRM will need to understand the goods origin certification validation process of the chamber of commerce and change the letter of credit accordingly. As a minimum, the word ‘fully’ must be removed from the certificate of origin requirements.

### 12.5.7 Beneficiary Statement [7]

Figure 12.4 clause 46A item 6 [7] of the letter of credit requires LRM to present a statement certifying that one original set of *ALL* the documents stipulated in the credit have been dispatched to the applicant within 7 days of shipment. Whilst it is possible for LRM to produce a statement, they cannot truthfully provide the required certification. This is because the installation and acceptance certificate required in 46A item 7 [9] will not be produced until the machine has been installed and commissioned in Mexico some 7 weeks later!

It will be a matter for the trade finance bank and issuing bank as to whether they will accept a statement from LRM that this condition has been complied with given that it is not physically possible to satisfy the underlying action at the time of shipment.

The requirement to send one original of all the documents (to include a bill of lading) will also mean that LRM will lose control of the machine (as discussed in Sect. 12.5.8).

#### **Solution**

This requirement must be changed to ‘statement of the beneficiary certifying that one *copy* of the documents relating to 46A items 1 to 7 (of the letter of credit solution in Fig. 12.6) have been dispatched to the applicant within seven days of shipment...’

### 12.5.8 Bills of Lading (Control of the Machine) [8]

The most important document in international trade is the bill of lading. When this is issued in a set of originals, in negotiable form (consigned with the words ‘to order’) and where it states in the small print that one original

must be presented to the carrier for release of the cargo, this can be used to exercise control over the goods.

It is important that LRM exercise control over the machine by sending a full set of original negotiable bills of lading to the bank under the protection of the letter of credit. This means that an original bill of lading will not be released to the applicant until the documents presented under the letter of credit are deemed to comply by the issuing bank, or upon their approval of the applicant's discrepancy waiver. This will also provide leverage in the event of a discrepant presentation since the applicant cannot obtain the machine from the carrier without issuing their discrepancy waiver.

The despatch of an original bill of lading to the applicant as required in clause 46A item 6 [7] (and item 2 [8] which stipulates that only 2 of the 3 original bills of lading are to be presented under the letter of credit) will result in loss of control of the machine. Because the bill of lading is to be consigned to the order of the applicant, the buyer will be able to use the original bill of lading received outside of the letter of credit to obtain the machine by presenting this to the carrier, irrespective of whether a discrepant presentation is waived and approved. It is therefore possible for discrepant LC documents to be rejected and payment refused under the letter of credit even though the machine has been obtained by the buyer.

### **Solution**

Number of original bills of lading.

Figure 12.4 clause 46A item 2 [8] must stipulate that a full set of original bills of lading are to be presented under the letter of credit (and the requirement to present a beneficiary statement certifying that one original has been sent to the applicant changed to a copy only per Sect. 12.5.7). If the presentation is discrepant, LRM/the trade finance bank retain control of the machine via the bills of lading until such time that the discrepancies are waived by the applicant, and the waiver accepted by the issuing bank.

### **Consignee Party**

The requirement for the bills of lading to be consigned to the order of the applicant in 46A item 2 [8] should be changed.

The choice of consignee details will be determined by whether the full set of bills of lading will be sent under the protection of the letter of credit, or whether one original needs to be sent direct to the applicant, as required in Fig. 12.4.

### ***All Original Bills of Lading Presented Under the Letter of Credit***

In the case that all of the original bills of lading are to be presented under the letter of credit, the best option for LRM is for the bills of lading to be consigned 'to order' and endorsed on the reverse in blank by the shipper ('blank endorsed'), as shown in Fig. 12.6.

Should the documents be discrepant and rejected by the LC issuing bank, bills of lading which are openly endorsed will enable LRM or their local agent to obtain release of the machine from the carrier by presentation of the rejected original bills of lading without further endorsement.

There is however a risk that should any one original of these blank endorsed 'bearer' bills of lading fall into the wrong hands, it can be used by the holder to obtain release of the goods from the carrier.

### ***One Original Bill of Lading Sent Direct***

If one original bill of lading is to be sent direct to the applicant, the consignee details required by the letter of credit should be changed from 'to the order of applicant' to 'to the order of buyer's bank' (LC issuing bank). This means that even if an original bill of lading is sent to the applicant, the buyer will not be able to legitimately present the bill of lading to the carrier in exchange for the machine, because they are not the named consignee party.

The bill of lading would need to be endorsed by the LC issuing bank over to the applicant. The issuing bank should only do this when the letter of credit documentary presentation has been examined at their counter and found to comply, or upon the receipt and their acceptance of the applicant's discrepancy waiver.

Receipt by the buyer of one original bill of lading consigned to the bank's order would not therefore be enough in itself to obtain clearance and possession of the machine. (There is however a risk of fraudulent conversion where the buyer falsifies the endorsement of the bank or presents themselves as representing the bank.)

Consigning bills of lading to the order of the issuing bank can however present a problem in the event of a discrepant presentation and rejection of documents. LRM would need the issuing bank to endorse the bills of lading on the reverse to the order of either LRM, their local agent or the financing bank, to enable the release of the machine from the carrier for resale, auction, reshipment or return to the country of despatch. The issuing bank may not be prepared to do this.

If it is not possible to obtain a change to the bill of lading conditions within the letter of credit, because of the refusal of the buyer, their bank, regulations or local customs and practice, it is extremely important that a complying presentation of documents is achieved.

Where one original bill of lading must be sent direct and consigned to the order of the applicant, a practical solution should be considered that vests control to LRM. For example, as contingency in case of a discrepant presentation, LRM will need to consider how the machine may be disabled by, for example, the configuration of the control panel requiring the input of a unique code to render the machine operable. The code could be withheld by LRM and released only to the buyer on receipt of the issuing bank's (or confirming bank's) undertaking to pay. This would provide a lever over the LC applicant to issue their discrepancy waiver (the waiver would however need to be approved by the issuing bank).

### **12.5.9 Installation and Acceptance Certificate [9]**

The installation and commissioning stage of a contract is vulnerable to dispute and non-payment. A factory extension or infrastructure which is to house the machine may not have been completed by the buyer. This will delay the installation and commissioning of the machine, through no fault of LRM; this may result in the expiry of the LC before the installation and acceptance certificate is made available.

If the installation does not take place, or the buyer is not satisfied with the commissioning of the machine (which can be vulnerable when reassembled after the stress of disassembly and shipment), the certificate will not be issued by the applicant, or at best delayed until they are satisfied.

It is therefore advisable for the seller to attempt to negotiate the maximum percentage value against shipment (which is largely under their control) and to minimise the subsequent installation stage payment value.

Without the timely receipt of the applicant's installation and acceptance certificate, LRM cannot make the final drawing under the letter of credit.

#### **Solution**

It is best therefore that the required LC document is an installation and commissioning certificate issued by an independent inspectorate or surveyor. Whilst the risk of being unable to complete the installation and successfully commission the machine would remain, it would eradicate the risk of the buyer frustrating LC payment by refusing or delaying the issuance of their

own certificate, subject to the provisions for release of the inspectorate's certificate as suggested in Sect. 12.5.5.

Where a financier is to provide a pre-shipment finance facility, they should only rely upon the shipment value drawing (80% of the LC value in this case study) as their primary source of repayment. The 20% installation stage payment should be ignored by the financier in case this does not happen.

### 12.5.10 Cargo Insurance [10]

While the goods are in transit, they are vulnerable to loss or damage. It is important therefore that suitable insurance is taken out to compensate for this.

The letter of credit in Fig. 12.4 states in Clause 47A item 2 [10] that insurance is to be covered by the applicant. Whilst this is consistent with the cost and freight shipping term shown in clause 45A where the risk of loss or damage to the machine passes to the buyer when loaded on board the vessel, if the LC documents are discrepant and rejected, LRM will continue to retain a financial interest in the machine until paid (subject to the terms of the underlying commercial contract).

There is no certainty that the applicant will insure the machine, and even if they do, it is unlikely that the insured benefit will be passed to LRM should documents be rejected under the LC. It is important therefore that LRM have insured protection against the loss or damage to the machine until they receive discounted proceeds on a without recourse basis pursuant to the irrevocable undertaking of the issuing bank (or confirming bank, where applicable) to pay, or in the case of document rejection, resale and receipt of sales proceeds.

#### **Solution**

The underlying commercial contract should stipulate that ownership of the machine does not pass to the buyer until the receipt of cleared funds by LRM in the UK. Until the machine is paid for, LRM will retain a financial and thereby insurable interest in the machine. In the case that a discrepant presentation is rejected by the issuing bank, the documents will be returned and LRM will need to use these to obtain release of the machine from the carrier and then to resell it to someone else.

If the machine is lost or damaged during transit to Mexico, it is important that LRM, or the trade finance bank, are able to claim compensation from the insurer. LRM should renegotiate the terms of the commercial contract to a

cost, insurance and freight shipping term, and have the LC amended to require the presentation of a negotiable insurance policy or certificate. This means that LRM will be responsible for the contract of insurance and can arrange this for the appropriate value and risks. In the event of rejection of discrepant documents, and where the machine is found to have been damaged in transit, the return of documents to include the negotiable insurance policy/certificate will provide LRM (or the trade finance bank) with the ability to make a claim for the loss from the insurer.

Alternatively, LRM ought to arrange contingent 'seller's interest' cover. Specialist insurance advice will be required because if the machine is insured twice this can invalidate cover. (An insurer will require the benefit of 'salvage' of the damaged machine to reduce the value of the claim payable or to recover part of the claim amount paid; this cannot be done where the machine is insured by two different insurers!)

The insurer/underwriter of the policy will need to be acceptable to the trade finance bank and the insured risks and value of insurance cover satisfactory.

### 12.5.11 Bill of Lading Number [11]

Clause 47A item 3 [11] requires the bill of lading number to be quoted on all documents. This is not technically possible as the acceptance certificate will be issued prior to shipment (at which point the bill of lading will not exist and therefore neither will its number); it is also likely that the certificate of origin will be issued prior to shipment.

#### **Solution**

The requirement for the bill of lading number to be quoted on all documents as specified in Fig. 12.4 clause 47A item 3 [11] must be removed, or as a minimum the LC should state that this need not be quoted on the acceptance certificates and certificate of origin.

### 12.5.12 Presentation Period [12]

The principal purpose of the period for presentation of documents is to allow the bills of lading to be processed under the letter of credit and released to the applicant in time for the arrival of the vessel. The period in which documents may be presented is therefore limited as specified by the LC, or in the absence of stipulation, as determined by the UCP rules.

The letter of credit allows only 10 days after the date of shipment for the documents to be received by the issuing bank in Mexico. Within the 10-day period after shipment, the bills of lading will need to be obtained from the carrier, presented to the trade finance bank in the UK, processed and then couriered to the issuing bank in Mexico. Even if this can be achieved, it will leave very little, if any, remaining time for the resubmission of any corrected documents in the event of a discrepant presentation.

The stipulated 10-day period is despite a port to port transit time of 30 days. This provides ample opportunity to allow a longer period for the presentation of documents. There is a concern that the stipulation of such a short period relative to the journey is a tactic to make it difficult for LRM to achieve a complying presentation.

**Solution: Shipping Documents**

The period for presentation in clause 48 [12] should be amended to 17 days after the date of shipment based upon the place of expiry being changed to UK as discussed in Sect. 12.5.2. This is calculated on the assumption that it will take the trade finance bank (nominated bank) and the LC issuing bank 5 calendar days each to examine and process the documents plus 2 days courier time. This will enable the release of complying documents to the applicant 1 day before arrival of the vessel at the discharge port in Mexico. This calculation is shown in Fig. 12.5.

If the LC remains available only with the issuing bank with the place of expiry in Mexico, the period allowed for presentation of documents can be increased to 24 days as shown in Fig. 12.5.

NOMINATED BANK	COURIER	ISSUING BANK	APPLICANT
5 days	2 days	5 days	1 day
Day 17	Day 22	Day 24	Day 29      Day 30
LC expires at the nominated bank Latest date for presentation of documents to the nominated bank 17 days after date of shipment		LC expires at the issuing bank Latest date for presentation of documents to the issuing bank 24 days after date of shipment	Vessel arrival

Note

The five-day period indicated for the processing of documents by each bank is a working assumption on how long this may take rather than the maximum period allowed by the UCP rules

**Fig. 12.5** Presentation period calculation

**Solution: Installation and Commissioning Certificate**

Further to the solution presented in Sect. 12.5.9, it would be prudent to allow additional time for the presentation of the certificate under the letter of credit. Presentation is not time critical to the buyer because they already have the machine installed and commissioned (unlike bills of lading which must be received and used by the buyer to achieve timely release of the machine from the carrier). The period for presentation should therefore be stipulated as say 30 days to provide sufficient time to receive the certificate and to present this under the LC. The expiry date will need to accommodate this (as provided for in Sect. 12.5.4).

**12.5.13 Confirmation [13]**

Confirmation is where the nominated bank provides its own separate and independent undertaking to pay or honour the letter of credit in addition to that of the issuing bank. This will be pursuant to an instruction contained within the credit, and subject to the nominated bank's risk appetite and capacity to take credit exposure on the issuing bank and country.

When a bank is relying on the proceeds of an export letter of credit as their primary source of repayment, they need to ensure that the credit quality of the obligor, (LC issuing bank) and country is acceptable. In taking the letter of credit as the means of facility repayment, the bank is exposed to the risk that the issuing bank may be insolvent and unable to pay, or their country cannot transfer the currency value on the due date.

The risk exposure should be recorded against an internal credit limit in the name of the issuing bank and the country in which they are situated. Whether the trade finance bank is confirming the credit or not, it is exposed to the risk of not receiving proceeds with which to repay LRM's pre-shipment loan.

The letter of credit shown in Fig. 12.4 has not been made available with the trade finance bank (as discussed in Sect. 12.5.1) and does not therefore instruct them to add their confirmation. This is because the issuing bank has not granted them any powers; the trade finance bank is acting in the capacity of a 'messenger' only.

When the trade finance bank sends the letter of credit to LRM in their capacity as an advising bank (with no authority to examine documents), they will state in their covering letter that it is conveyed by them without financial engagement or responsibility, that is, unconfirmed. LRM have only the undertaking of the issuing bank in Mexico to honour the credit and are thus exposed to the insolvency of the issuing bank, the inability of Mexico to trans-

fer currency proceeds due to foreign exchange shortage, political measures which frustrate or prevent payment and the risk that the issuing bank identifies discrepancies and rejects the documents.

Because the trade finance bank (acting only in the capacity of an advising bank) has been given no power to make payment, the issuing bank has no financial obligation to them. The issuing bank's obligation is to remit proceeds on the due date for credit to the beneficiary, LRM, pursuant to the issuance of their deferred payment undertaking (subject to the receipt of a complying presentation of documents).

### **Solution**

A credit which instructs a bank to add its confirmation is preferable because this places the nominated bank in the strongest possible position to pursue debt recovery against the issuing bank for reimbursement in respect of their financial engagement made on the instruction of the LC issuing bank.

The credit must therefore be amended to make it available with the trade finance bank as described in Sect. 12.5.1 and clause 49 [13] in the letter of credit changed to 'confirm'.

### **12.5.14 Bank to Bank Reimbursement [14]**

In the letter of credit shown in Fig. 12.4, the bank to bank information in clause 78 [14] indicates that the issuing bank will remit proceeds at payment maturity, subject to a complying presentation of documents to their counter. (The trade finance bank has no authority to claim reimbursement. This is because the only bank authorised to examine documents and to make payment is the issuing bank.)

When an LC issuing bank makes the credit available with a nominated bank, it authorises the nominated bank to make payment to the beneficiary (or make an advance of proceeds in the case of negotiation) or provide its undertaking to pay on the due date, subject to the receipt of complying documents. The LC issuing bank therefore has an obligation to provide reimbursement to the nominated bank for the payment (or advance) it has made.

When the credit is made available with a nominated bank, the bank to bank reimbursement clause will range from an undertaking to reimburse the nominated bank in accordance with their instructions upon receipt of complying documents at the counter of the issuing bank (typically used on credits available by negotiation), authority for the nominated bank to debit the account of the issuing bank held with them (when their account is held in the

currency of the credit), or an authority to claim reimbursement from a specified reimbursing bank, known as a 'reimbursement authority'. In each case, reimbursement will only be effected in accordance with the payment term stipulated in the letter of credit.

In some cases, the reimbursing bank will be instructed to provide the nominated bank with its own irrevocable undertaking that reimbursement will be made on receipt of a claim, known as a 'reimbursement undertaking'; subject to their status this can enhance the quality of the source of repayment when the reimbursing bank's credit standing is better than that of the LC issuing bank.

Once the letter of credit is amended making it available with the trade finance bank ('nominated bank'), the bank to bank reimbursement instruction in clause 78 must also be changed reflecting the issuing bank's obligation to reimburse the trade finance bank for payment made.

Reimbursement authority should be provided in the LC to debit the 'nostro' bank account of the issuing bank held with trade finance bank (if and where held in the currency of the credit), or to claim reimbursement from a named reimbursing bank (this authority should be independent to and not reliant upon the issuing bank's receipt and examination of complying documents at their counter). Reimbursement may only be taken or claimed in accordance with the payment term and reimbursement instructions contained within the credit. A revised reimbursement clause is shown in Fig. 12.6 [14].

## 12.6 Financing Solution

In order to provide a pre-shipment finance facility to LRM, the terms of the export letter of credit will need to be changed as described in Sect. 12.5 and shown in Fig. 12.6.

A 'pre-shipment' trade loan will be drawn to fund payments to the suppliers. Drawing requests from LRM will be compared against the payment schedule in their detailed cash flow forecast. Requests to settle supplier invoices later than scheduled in the forecast will identify slippage in component supply.

With the aim of minimising the period of credit risk exposure to the borrower, LRM, the trade finance bank, as LC confirming bank, will discount their deferred payment undertaking issued in respect of a complying presentation of documents. The discounted proceeds generated by the bank's purchase of their own deferred payment obligation will be used to repay the 'pre-shipment' trade loan and settle accrued interest, fees and charges. The dis-

## TRADE FINANCE BANK 'ADVISING' LETTER

LOU RAWLS MACHINERY  
 UNIT 5 WOODBRIDGE INDUSTRIAL ESTATE  
 STEPHEN'S STREET, DUDLEY  
 WEST MIDLANDS, UNITED KINGDOM

14JAN20

Dear Sirs,

In accordance with the version of the UCP rules (issued by the ICC) as specified in the credit, we advise having received the following transmission from

BUYER'S BANK, MEXICO (SWIFT ADDRESS: ANYBMXMM)

40A	FORM OF LC:	IRREVOCABLE
20	LC NO:	0157/140120
31C	DATE OF ISSUE:	14JAN20
40E	APPLICABLE RULES:	UCP LATEST VERSION
31D	EXPIRY DATE AND PLACE:	04FEB20 (FOLLOWING YEAR) <b>4</b> UK <b>2</b>
50	APPLICANT:	BUYER PRIMERO STRACO, TIJUANA MEXICO
59	BENEFICIARY:	LOU RAWLS MACHINERY UNIT 5 WOODBRIDGE INDUSTRIAL ESTATE STEPHEN'S STREET, DUDLEY, WEST MIDLANDS, UK
32B	AMOUNT:	USD 2430000
39B	MAX CR AMT:	NOT EXCEEDING
41A	AVAILABLE WITH/BY:	TRADE FINANCE BANK <b>1</b> BY DEFERRED PAYMENT REFER CLAUSE 47A FOR PAYMENT DETAILS
43P	PARTIAL SHIPMENTS:	NOT ALLOWED
43T	TRANSHIPMENT:	NOT ALLOWED
44E	LOADING PORT:	ANY UK PORT
44F	DISCHARGE PORT:	ROSARITO, MEXICO
44C	LATEST DATE OF SHIPMENT:	10NOV20 <b>3</b>
45A	GOODS:	PAPER CUTTING AND ROLLING MACHINE PER CONTRACT NO. 407250 SHIPPING TERM: COST INSURANCE AND FREIGHT ROSARITO, MEXICO
46A	DOCUMENTS REQUIRED:	1. ONE ORIGINAL MANUALLY SIGNED COMMERCIAL INVOICE 2. FULL SET OF ORIGINAL CLEAN SHIPPED ON BOARD MARINE BILLS OF LADING CONSIGNED TO ORDER BLANK ENDORSED <b>8</b> SHOWING FREIGHT PREPAID BEARING THIS LC NUMBER AND DATE OF ISSUE

Fig. 12.6 Export letter of credit solution

3. MARINE INSURANCE POLICY OR CERTIFICATE ISSUED IN NEGOTIABLE FORM, BLANK ENDORSED, IN THE CURRENCY OF THIS CREDIT FOR MINIMUM 110 PER CENT OF INVOICE VALUE COVERING RISKS AS PER INSTITUTE CARGO CLAUSE 'A', FROM WAREHOUSE TO WAREHOUSE **10**
  4. PACKING LIST IN DUPLICATE SHOWING NET AND GROSS WEIGHT
  5. ONE ORIGINAL MACHINE RUNNING CERTIFICATE **5** ISSUED AND SIGNED BY THE BENEFICIARY
  6. PERFORMANCE GUARANTEE FOR 5% OF LC DRAWING VALUE PER 47A 1 (A) **5.1**
  7. CERTIFICATE OF ORIGIN ISSUED BY THE CHAMBER OF COMMERCE IN EXPORTER'S COUNTRY CERTIFYING THAT GOODS ARE OF UK ORIGIN **6**
  8. STATEMENT OF THE BENEFICIARY CERTIFYING THAT ONE COPY OF THE DOCUMENTS RELATING TO 46A ITEMS ONE TO SEVEN OF THIS CREDIT HAVE BEEN DESPATCHED TO THE APPLICANT WITHIN SEVEN DAYS OF SHIPMENT **7** COURIER RECEIPT TO ACCOMPANY BENEFICIARY STATEMENT
  9. ONE ORIGINAL INSTALLATION AND COMMISSIONING CERTIFICATE ISSUED BY AGENCIA INSPECTORATE **9**
- 47A ADDITIONAL CONDITIONS:
1. PAYMENT TERMS
    - A) 80 PCT OF LC VALUE WILL BE PAID AT 60 DAYS FROM DATE OF SHIPMENT UPON PRESENTATION OF THE DOCUMENTS AS SPECIFIED UNDER FIELD 46A CLAUSES 1 TO 8 OF THIS LC
    - B) 20 PCT OF LC VALUE WILL BE PAID AT 30 DAYS FROM DATE OF INSTALLATION AND COMMISSIONING CERTIFICATE UPON PRESENTATION OF THE DOCUMENTS AS SPECIFIED UNDER FIELD 46A IN CLAUSES 1 AND 9 OF THIS LC
  2. ALL DOCUMENTS MUST QUOTE THIS LC NUMBER, DATE OF ISSUE, AND CONTRACT NUMBER **11**
  3. BILL OF LADING MUST CONTAIN NAME, ADDRESS, TELEPHONE AND FAX NUMBER(S) OF THE CARRYING VESSEL'S AGENT AT THE PORT OF DESTINATION
- 48 PERIOD FOR PRESENTATION:  
DOCUMENTS TO BE PRESENTED AS FOLLOWS:  
DRAWING IN RESPECT OF 47A 1 (A) WITHIN 17 DAYS **12** AFTER THE DATE OF SHIPMENT BUT WITHIN THE VALIDITY OF THE CREDIT  
DRAWING IN RESPECT OF 47A 1 (B) WITHIN 30 DAYS AFTER THE DATE OF INSTALLATION AND COMMISSIONING CERTIFICATE BUT WITHIN THE VALIDITY OF THE CREDIT
- 71B CHARGES ALL BANKING CHARGES OTHER THAN THE ISSUING CHARGES ARE FOR BENEFICIARY'S ACCOUNT
- 49 CONFIRMATION INSTRUCTIONS: CONFIRM **13**
- 53A REIMBURSING BANK: AMERUS33
- 78 INSTRUCTIONS TO THE PAYING BANK: **14**  
PROVIDING DOCUMENTS ARE IN STRICT CONFORMITY WITH THE TERMS OF THIS CREDIT, AT MATURITY YOU ARE AUTHORISED TO REIMBURSE YOURSELVES FROM OUR ACCOUNT NO. 111265778 WITH AMERICAN BANK NEW YORK (AMERUS33)

Fig. 12.6 (continued)

QUOTING THIS LC REFERENCE UNDER SEPARATE AUTHENTICATED SWIFT ADVICE  
TO US AT LEAST 3 BANKING DAYS PRIOR TO YOUR CLAIM STATING AMOUNT  
CLAIMED AND VALUE DATE  
DOCUMENTS MUST BE DESPATCHED TO BUYER'S BANK, MEXICO IN ONE  
LOT BY COURIER

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**Fig. 12.6** (continued)

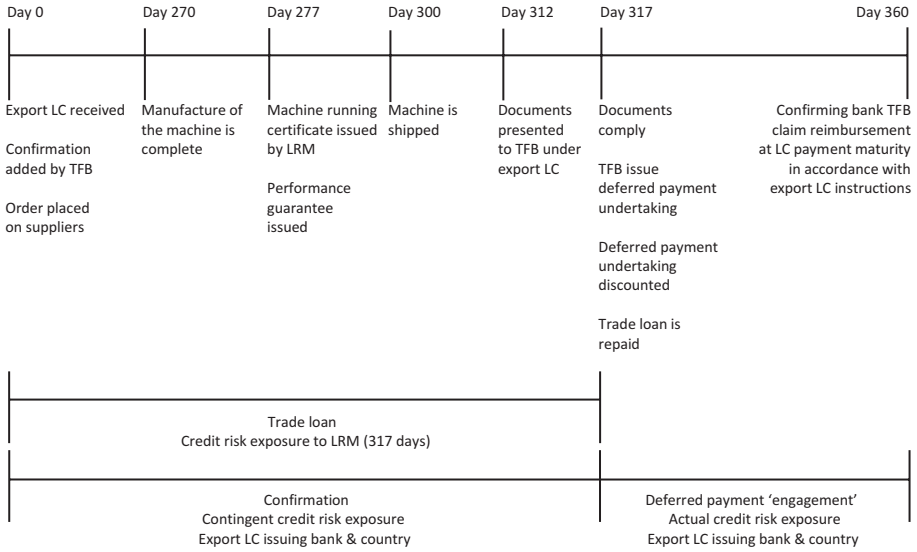
count purchase will be made without recourse to LRM (in confirming the credit the trade finance bank will have taken contingent liability credit risk exposure on the issuing bank and country).

Once the deferred payment undertaking is issued by the trade finance bank, the contingent liability that the trade finance bank had previously marked against the LC issuing bank and country at the time of adding their confirmation to the credit, will become an actual liability engagement (hard credit risk exposure). This is because the trade finance bank is irrevocably committed to pay their debt obligation (deferred payment undertaking) at maturity even if the issuing bank and country are unable to provide or make available reimbursement monies.

Whilst the discount purchase prepayment could be made for the face value of the deferred payment undertaking and surplus discounted net proceeds, (after repayment of the loan, interest and fees), paid to LRM, it would be prudent to only perform a partial discount prepayment for sufficient monies to repay the trade loan. The balance of the deferred payment undertaking will be discounted and paid to LRM upon advice of take up of the documents by the issuing bank. This will keep LRM incentivised to resolve any issues should the issuing bank reject documents because they had found a discrepancy not identified by the trade finance bank. The timeline of the proposed solution in respect of the shipment phase is shown in Fig. 12.7.

The purchase of the deferred payment undertaking and application of the discounted proceeds in repayment of the trade loan will extinguish the bank's credit exposure to LRM.

If the credit was not confirmed by the trade finance bank, the trade loan repayment date would be aligned to the expected receipt of discounted proceeds from the issuing bank's purchase of their deferred payment undertaking (preferable), or receipt of proceeds at LC maturity. In each case it is important that documents are presented only to the trade finance bank so that these can be forwarded under their control to the issuing bank for collection and receipt of the LC proceeds.



Notes

Trade finance bank ‘TFB’

Letter of credit is confirmed by TFB

It is assumed that documents are presented 12 days after shipment (the revised LC in Fig. 12.6 allows up to 17 days)

For the purposes of calculation, a month is taken as 30 days

Fig. 12.7 Trade cycle timeline solution

## 12.7 Deal Sheet

A summary of the proposed terms of the pre-shipment finance facility is provided in Fig. 12.8. In practice this will form part of a more extensive agreement which contains full terms and conditions of the facility granted. A copy will be provided to the trade finance bank’s operations department together with a Transactional Control Matrix which sets out the instructions for administration of the structured facility.

## 12.8 Open Account Sale

We have seen that an export letter of credit can be a good source of repayment for the pre-shipment financier, subject to documentary performance and the credit status of the issuing bank and country.

Because a letter of credit is an independent irrevocable mechanism where payment, or a bank undertaking to pay, is triggered by the presentation of complying documents, it protects the seller and their financier from a refusal of the end-buyer to pay or their insolvency.

DEAL SHEET	
Borrower	Lou Rawls Machinery 'LRM' ('borrower')
Type of facility	Pre-shipment finance (uncommitted)
Facility limit	USD 0.972m
Facility sub-limits	N/A
Payment instrument (Source of repayment)	Export letter of credit Issued by [insert issuing bank & country] Available with the trade finance bank by deferred payment Min. 80% of LC value payable 60 days from date of shipment Place of expiry UK Latest date of shipment to be a minimum of 300 days from the date of LC issuance Expiry date to be a minimum of 386 days from the date of LC issuance Requirement for a full set of original bills of lading Confirmation instructions; 'confirm' Acceptable bank to bank reimbursement authority Terms and conditions of the export LC must be fully acceptable to the trade finance bank (per Fig. 12.6)
LC applicant Country	Buyer Mexico
Transactional risk exposure	Issuing bank/country; maximum 360 days <sup>1</sup> ( <sup>1</sup> Calculated to latest date of shipment per Fig. 12.6 plus shipment payment period of 60 days) LRM (borrower); maximum 317 days <sup>2</sup> ( <sup>2</sup> Calculated to latest date of shipment plus maximum presentation period per Fig. 12.6 assuming a complying presentation of documents and discount)
Credit insurance Joint insured or loss payee	None N/A
Security (new)	Parental guarantee General letter of pledge House bank waiver over the transactional assets (components, machine & LC proceeds) Assignment of export LC proceeds
Financing ratio	40% of export letter of credit value
Pre-commencement conditions	<ul style="list-style-type: none"> <li>▪ Receipt of export letter of credit in conformity with Fig. 12.6</li> <li>▪ Available risk appetite and capacity on the issuing bank and country (for minimum 80% LC value)</li> <li>▪ Possession and retention of the original letter of credit</li> <li>▪ Undertaking held from the borrower that documents will be presented only to the trade finance bank and in strict conformity to the LC terms &amp; conditions and applicable ICC rules</li> </ul>
Post commencement conditions	<ul style="list-style-type: none"> <li>▪ Specimen/draft LC documents to be provided to the trade finance bank by the borrower no less than 15 days prior to shipment (to check these comply with the LC terms and UCP rules prior to actual presentation)</li> <li>▪ Provision of the following information (by 10<sup>th</sup> monthly):               <ul style="list-style-type: none"> <li>- Aged debtor and creditor listings</li> </ul> </li> </ul>

**Fig. 12.8** Deal sheet: pre-shipment finance

	<ul style="list-style-type: none"> <li>- Bank statements (house bank)</li> <li>- Facility utilisation summary (house bank) accompanied by supporting statements/evidence (showing type of facility, limit, utilisation &amp; expiry)</li> <li>▪ Provision of the following information (quarterly):</li> <li>- Updated cash flow forecast (general &amp; machine build)</li> </ul> <p>Plus any other specified information required to monitor facility covenant performance (trade finance bank &amp; house bank credit facilities)</p>
Lending structure	<ul style="list-style-type: none"> <li>▪ Pre-shipment finance for 100% of 'approved' supplier invoices subject to a maximum aggregate drawing amount of USD 972,000</li> <li>▪ Drawings must be consistent with detailed cash flow showing suppliers, term, value and payment schedule</li> <li>▪ 'Pre-shipment' trade loan; drawings to be made in US dollars to the debit of the trade loan with maximum repayment term of 317 days<sup>3</sup> from the date of export LC (<sup>3</sup>Expected date of discount of complying documents)</li> </ul>
Drawing documentation	<ul style="list-style-type: none"> <li>▪ Trade loan drawings in respect of payment to approved suppliers to be made against presentation to the trade finance bank of the following drawdown documentation:</li> </ul> <p>Option 1</p> <ol style="list-style-type: none"> <li>1. Application for trade loan drawing by borrower;</li> <li>2. Supplier invoice;</li> <li>3. Signed and dated confirmation from borrower that components have been received, in conformity to specification, quantity and quality in accordance with their purchase order and in good time to meet the machine build plan</li> <li>4. Signed and completed instruction to pay the supplier<sup>4</sup></li> </ol> <p>Option 2</p> <p>Documents 1 to 3 in Option 1 plus;</p> <ul style="list-style-type: none"> <li>- Payment/remittance advice evidencing payment to the supplier<sup>4</sup></li> </ul> <p><sup>4</sup>Supplier must be on the approved list</p>
Disbursement	Trade loan drawn monies used by the trade finance bank to pay supplier invoices (Option 1) or credited to the bank account of the borrower (Option 2)
Repayment	<p>Partial discount prepayment of deferred payment undertaking (of a value to cover the trade loan, accrued interest, fees and charges) resulting from a presentation of documents strictly in compliance with the export LC and applicable UCP rules</p> <p>Discount proceeds to be applied to repayment of the 'pre-shipment' trade loan, interest, fees and charges</p>

Fig. 12.8 (continued)

	Surplus balance, if any, of the deferred payment undertaking value to be discounted and net proceeds paid to the borrower on take up of the LC documents by the issuing bank
Rights of recourse	Trade loan drawing; full recourse to the borrower Discount purchase of deferred payment undertaking; without recourse to the borrower
Fees & interest	[To be specified]
Nature of goods	Paper cutting and rolling machine

Fig. 12.8 (continued)

In this case study, if the machine was being sold on open account terms, with no supporting bank payment guarantee or standby letter of credit, the receipt of full and timely sales proceeds would be reliant entirely upon the ability and willingness of the end-buyer to pay.

### 12.8.1 Performance Risk

A dispute or dissatisfaction with the functionality or operation of the machine could result in refusal of the end-buyer to pay, or the receipt of a reduced settlement amount. A sales invoice is issued as part of the commercial contract and thus its payment relies upon satisfactory performance by the seller, and of course the ability of the end-buyer to pay.

If an adapted or bespoke machine is rejected by the end-buyer because it does not perform to the required level, there is likely to be a limited re-sale market resulting in a considerable delay before it can be disposed of, and potentially at a significant discount in price. A delay will mean increased financing costs and a discounted sale price may not generate enough monies to repay the financier on a self-liquidating basis.

In this case study, the sale of the machine on open account terms would present huge performance risk to LRM and the trade finance bank. This is because the shipment stage payment due on timeline Day 360 is 4 days after the installation and commissioning of the machine on Day 356. If there is any dispute or dissatisfaction on the installation and commissioning of the machine, it is likely that the end-buyer will withhold payment of the shipment stage payment until any issues have been resolved, even though each payment represents a separate stage of the contract.

If the contract is stated to be entire, the end-buyer would only be legally obliged to pay once the whole of the contract had been completed, whilst a divisible contract would render each stage payment enforceable in its own right (subject to applicable law).

If the sale was conducted on open account, the credit term of the shipment stage would therefore need to be reduced bringing forward the due date for payment so it is much earlier than machine installation (and the commercial contract made divisible).

### 12.8.2 Credit Quality of the End-Buyer

As the primary source of repayment, the credit quality of the end-buyer is vitally important. This should be assessed on a conventional 'balance sheet' basis using publicly available financial statements. This can be supplemented by credit reference reports. Focus will be on their payment record, profitability and solvency indicated by working capital ratio trends relating to debtors, creditors and stock, looking for signs of potential liquidity restriction, and any adverse publicity or news.

The risk assessment and financing of sales invoices is described in Chap. 16.

## 12.9 Conclusion

An export letter of credit can be a good source of primary repayment for a financier. Whilst it is a separate and identifiable source of monies, its reliability depends upon the capability of the borrower (LC beneficiary) to present documents in strict compliance with the letter of credit terms and applicable UCP rules.

Pre-shipment finance carries significant performance risk for the financier. If the supply chain fail to deliver the required components (and on time) and/or the borrower is unable to complete the manufacture, there will be no LC proceeds and thus full reliance will be placed on the borrower's ability to repay the financier.

Even where the goods are shipped, failure of the borrower to make a complying presentation in accordance with the terms of the credit and applicable UCP rules can result in rejection of documents by the issuing bank and non-payment.

The terms of the letter of credit must be structured to provide the borrower with full control over the creation or availability of the stipulated documents, a latest date for shipment which can be comfortably achieved and an expiry date which provides enough time for the procurement and presentation of documents to the place of expiry. Additional time should be incorporated to accommodate any unforeseen slippage in manufacture and for re-submission of any corrected documents.

The financier should be the nominated bank so that it is a party to the credit with authority to examine documents and issue its undertaking to pay which can be discounted to accelerate repayment of the loan. This reduces the period of credit risk exposure to the borrower which is substituted by credit risk of better quality, being the LC issuing bank and country.

The capability of the borrower must be carefully evaluated to include an assessment of their financial resources. This is to ensure they have positive cash flow and/or ongoing access to general credit facilities to remain a 'going concern' during the manufacturing and shipment period (as a minimum).

Drawdown of the facility should be carefully controlled and monitored to highlight any slippage in supply or manufacture which may impair the ability of the borrower to achieve a fully complying presentation under the letter of credit. An examination of draft documents prior to shipment ought to be pre-conditioned to reduce the risk of discrepant documents.

Whilst a credit facility will need to be approved and recorded against the borrower and right of recourse preserved until complying documents have been presented and taken up under a confirmed letter of credit, this form of finance can release additional credit appetite to provide essential funding which otherwise may not be available through conventional balance sheet lending, enabling a hard won order to be fulfilled.