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Financing Trade with Letters of Credit

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ICC Commercial Crime Services
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Agenda

- Characteristics of Trade
- Why is Trade attractive to banks?
- Letters of Credit
- Types of LC
- The Rules – UCP history and the ISBP
- Evolution of LCs
- LCs as security
- Banks deal in documents not goods!
- What do we think of LCs?
- Do LCs work?
- Recent LC-related Issues
- Challenges from a banker's standpoint
- Key learning points
- Appendices

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Characteristics of Trade

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Characteristics of Trade

Trade Finance is the provision of services, finance and risk covering the movement of goods or services.

It should be remembered that every company engages in Trade in some form or another.

Trade Finance can be described as being fundamentally about four things:

- Enabling secure and timely payment across borders
- Providing liquidity and financing for the importer, the exporter, or both
- Enabling effective mitigation of risk
- Facilitating a flow of information about the physical and/or financial flows in a transaction.

Official definitions of Trade

- 'Trade Finance' means financing, including guarantees, connected to the exchange of goods and services through financial products of **fixed short-term maturity, generally of less than one year**, without automatic rollover
- Trade Finance exposures are diverse in nature but share characteristics such as being **small in value** and **short in duration** and **having an identifiable source of repayment**. They are underpinned by movements of goods and services that support the real economy and **in most cases help small companies** in their day-to-day needs, thereby creating economic growth and job opportunities. Inflows and outflows are usually matched and liquidity risk is therefore limited.

Why is Trade attractive to banks?

Why is Trade attractive to banks?

- Efficient use of balance sheet (for contingent products)
- Trade tends to be short tenor
- We know what our balance sheet is being used for
- Transactional or self-liquidating (ie less reliance on company's financials)
- Each transaction is individually assessed
- Trade is generally preferred following a country or counterparty risk event

How did Trade perform during and post the global financial crisis?

The expert's views:

- Given its short term nature, banks have been able to quickly reduce exposure in times of stress
- Global and local Trade Finance markets tend to be resilient unless there are severe adverse shocks that affect credit-worthiness
- Despite crisis conditions, Trade Finance has been relatively safe and assets remained liquid
- Low loss rates and short maturities suggest that Trade Finance is unlikely to pose a financial stability risk
- In our experience, we have only seen one FI-related loss in the last 10 years.

However in respect of LCs:

- Intense scrutiny of Trade documentation by some banks eventually led to higher rates of rejection on the basis of minor discrepancies.

Default rates by product 2008 - 2012

Total customers and default rate by product[19], 2008-12

Product	Customers	Customer Defaults	Customer Default Rate	Moody's rating with same default rate[19]
Export L/C[20]	36,797	12	0.033%	Aaa-Aa
Import L/C	29,098	34	0.117%	Aa
Performance Guarantees	40,167	63	0.157%	Aa-A
Loans for Import/Export	34,851	84	0.241%	A-Baa

FIGURE 8:
Total transactions and default rate by product[21], 2008-12

Product	Transactions	Transaction defaults	Transaction default rate
Export L/C	1,250,903	42	0.003%
Import L/C	828,537	336	0.041%
Performance Guarantees	494,117	131	0.027%
Loans for Import/Export	1,980,642	850	0.043%

- Trade as a product class has an impeccable rating

Source: 2014 ICC Trade Register Report – Global Risks In Trade Finance

Letters of Credit

What is a Letter of Credit?

- Definition:
  - An irrevocable undertaking by a bank (Issuing Bank) on behalf of its customer the buyer (Applicant) under which it undertakes to pay the seller (Beneficiary) for goods or services provided against presentation of documents evidencing compliance with the terms and conditions specified within the LC; or more simply
  - A conditional undertaking to pay by a bank
- A LC substitutes the credit risk of the buyer with that of the Issuing Bank
- To mitigate country/bank risk a LC needs to be confirmed or negotiated by a third party bank.

Who needs them and why?

- Seller requires security of payment without loss of control of documents, which remain within the banking sector, until payment (sight or future) is provided
- Buyer requires documents knowing that funds will only be paid (sight or future) provided required documents are submitted within agreed timeframe
- Issuing Bank requires shipping documents to secure lending facilities it provides to its customer (the Buyer)
- Confirming/Negotiating Bank requires transfer of risk from corporate buyer to an (acceptable) Issuing Bank to secure 'receivables' facility it has provided to its customer (the Seller).

LCs – key features

- Shift risk between the parties
- Autonomy of Letter of Credit
- "Banks deal with documents"
- Import/Export Letters of Credit
- Payment is expected
- Fraud exception
- Discounting of LC proceeds.

LCs – advantages and disadvantages

Beneficiary

Advantages	Disadvantages
Bank undertaking to cover credit risk of Applicant	Document preparation can be technical and tedious (time consuming)
Control of documents (including title to goods – provided not consigned to Applicant) through banking channels	Risk of LC not working (discrepant presentation)
Clear requirements to secure payment	LCs can be costly
Can remove sovereign risk if LC confirmed/negotiated	If not confirmed/negotiated Beneficiary is exposed to country and Issuing Bank risk
Possible financing opportunity for LCs payable at a future date	Some Applicants may be unable to issue LCs due to lack of credit

LCs – advantages and disadvantages

Applicant

Advantages	Disadvantages
Negotiate favourable payment terms due to transfer of risk to Issuing Bank	Payment against documents rather than goods
Individually structured requirements to effect payment	Risk that defective or inferior goods may be shipped - therefore rely on integrity of Beneficiary
Security of funds (or undertaking to pay) will not be released to Beneficiary unless conforming presentation of documents	LCs can be costly
Enables Applicant to obtain financing from its bank using the underlying (shipping) documents as security	Can be time consuming, technical and tedious

Quotes of an LC practitioner (30+ years)

- "The role of a doc credits person has changed so much that it is becoming more one of prevention (KYC, AML and Sanctions screening) than of client delivery"
- "I would say that in the current environment I would prefer to 'miss' a discrepancy under an LC document presentation as opposed to not sanction screening a name or entity from those documents"

Reputational vs Operational requirements

What the last quote broadly means is that the potential financial penalties (and personal liability) for not complying with required process (in this case AML and Sanctions) could far outweigh the consequences (damages / customer impact) arising from missing a discrepancy(ies)

Types of LC

- Silent Confirmation
- Back to Back
- Transferable
- Revolving
- Red or Green Clause
- Sustainable Shipment LC
- Oil / LOI
- SBLC
- IRU
- UPAS
- Inoperative.

Silent Confirmation – Key Points (1)

- Silent Confirmation only covers payment (counterparty and country) risk
- Used where the Issuing Bank does not ask for the LC to be confirmed
- Executed by way of a formal agreement between bank adding its Silent Confirmation and the Beneficiary
- Beneficiary is 'on cover' provided conforming documents are presented and the Issuing Bank accepts
- To be noted:
  - The Silent Confirmation is requested by the Beneficiary, NOT the Issuing Bank
  - It is not disclosed to the Issuing Bank
  - Bank adding its Silent Confirmation not protected by UCP
  - Can be added any time prior to expiry date of LC.

Silent Confirmation – Key Points (2)

- LC wording must not be ambiguous
- Bank is not considered a 'Confirming' Bank under UCP
- Beneficiary must not agree to any amendments without approval otherwise 'confirmation' cancelled
- Beneficiary should have a proven track record in LCs and with Applicant
- Applicant should preferably be end-user not a trader or intermediary (propensity for documents to be rejected)
- Usual documentary/operational risks (delivering documents to counters of Issuing Bank within terms of LC)
- Be careful negotiating documents under a Silent Confirmation
- Silent Confirmation is not the right solution if the LC is negotiable.

Back to Back – (1)

- An Import LC (slave) and Export LC (master) are used 'back to back' to mitigate counterparty risk on middleman
- Proceeds of Export LC used to cover payment under Import LC (surplus is middleman's profit) by way of 'negotiation' backed up by an assignment
- Export LC should be confirmed or restricted for negotiation with the bank
- Used instead of Transferable LCs primarily because the middleman is not constrained by the documentary requirements (under the Transferable LC)
- T+Cs should mirror except for:
  - Value of Import LC and unit price (if any) will be lower
  - Expiry, latest shipment and presentation dates may be earlier
  - Insurance percentage will be higher (to cover insurance requirements in Export LC)
- Commercial invoices to be substituted.

Back to Back - (2)

Risks	Mitigants
Payment of Import LC is independent of the Export LC	• Import LC structured to 'mirror' (subject to limitations) the Export LC • Minimise differences (ie commercial invoice) • Hands on monitoring of transaction throughout
Applicant fails to provide required documentation in order to perform under Export LC	- Power of Attorney to enable completion of missing documents
Operational risks such as: - Missing discrepancies under Import LC - Missing timelines under Export LC	- Import and Export LCs to be managed by same team (ie imperative that the LCs are not separated operationally) - Use most experienced Trade Ops staff
Counterparty risk on Applicant	• Export LC to be confirmed or restricted for negotiation

Transferable - (1)

- Allows for the LC to be transferred (once) in whole or in part to one or more Beneficiaries
- A second Beneficiary cannot transfer the LC
- A Nominated Bank is under no obligation to transfer a LC, except as agreed to
- The first Beneficiary is typically a middleman and the second Beneficiary is usually the ultimate supplier/producer
- Transfer to be effected in accordance with the terms of the original LC subject to:
  - Name and address of Applicant may be substituted by that of Beneficiary
  - Amount of the LC (and unit price) may be reduced (to allow profit for first Beneficiary)
  - Expiry / Latest shipment dates may be shortened
  - Presentation period may be shortened
  - Insurance percentage may be increased.

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Transferable - (2)

Risks	Mitigants
Issuing Bank not knowing identity / location of 2nd Beneficiary(ies)	Issuing Bank to include clause in LC stating that transfer can only take place after advice to them of 2nd Beneficiary details and their agreement to proceed
Origin of goods from sanctioned country	LC to include specific origin requirements within documents required
Monitoring problems of LCs with several 2nd Beneficiaries	• Experienced Trade Ops staff to be used • Constant monitoring of transaction progress through communication with 1st and 2nd Beneficiaries
1st Beneficiary may not be available or knowledgeable in the event of problems (transferable LCs are the easy option for middlemen)	Banks to carry out not only due diligence on 1st Beneficiary (who may not be a client), but also whether they have suitable export knowledge, before agreeing to transfer
2nd Beneficiary documents sent in error to Issuing Bank – possible litigation	• Experienced Trade Ops staff to be used
1st Beneficiary delays in substituting invoice for that of 2nd Beneficiary	• Application for Transfer documentation to include bank liability limitation • Time limit re invoice substitution

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Revolving

- Instead of having one LC for each shipment (from the same Beneficiary) the Applicant has a revolving LC issued which:
  - Makes a fixed sum available
  - For a specified amount of time
  - Covering multiple shipments
  - May revolve in amount or time
  - May be cumulative (carried over) or non-cumulative (Beneficiary loses LC protection for that particular shipment)
- Applicant's (or Issuing Bank where the LC is confirmed) credit limit will be marked for the maximum value of the LC that could be drawn throughout its validity
- Do not confuse with a LC available by installments (goods shipped within given periods whereby if a drawing/shipment is missed the LC is then no longer available for that and any subsequent instalment).

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Red or Green Clause

- Referred to as a Red or Green Clause because banks historically typed this clause in red or green ink (in the days that LCs were issued in hard copy and posted!)
- Used where the Applicant and Beneficiary have a good trading history and the Applicant is willing to take the risk that the Beneficiary will perform under the LC and not disappear with the advance payment which is made through the LC
- Red Clause – advance made in one amount and prior to receipt of any documents
- Green Clause –advance made against certain documents such as warehouse receipts (advances continue until full consignment is ready). Goods are held to the order of the Issuing Bank
- Green Clause provides greater security from the Applicant and Issuing Bank's standpoint
- Advance payment usually related to the underlying goods (eg raw materials, machinery, warehousing, production).

Sustainable Shipment LC

- Developed by commodity buyers, traders, banks, industry bodies and NGOs
- Sustainability standards integrated into LCs relating to specific commodities
- Buyers to demand a 'sustainable shipment'
- Not for banks to enforce or set the standard
- Banks to decide how they distinguish between 'sustainable shipments' and 'conventional shipments'
- How will banks incentivise growth in the trade of sustainably produced commodities
  - Support from the IFC under the Global Trade Finance Program (GTFP)
  - Better capital treatment (full or partial IFC guarantees).

Oil

- Standard LC but with nuances
  - Escalation clause
    - How much exposure do you mark
    - Bank's final liability not known
  - Letter of Indemnity (LOI)
    - Impact on collateral
    - Why LOI if Beneficiary is a producer
- Value - impact on customer credit limits
- Customer expectations
  - Turnaround times
  - Issue/Confirm/check docs
- Very few defaults in oil sector.

Letters of Indemnity (LOI)

- Commonly used for oil traded in a chain/on the high seas
- Provided in lieu of original B/Ls
- Warrants that the seller has title (to the oil) and indemnifies the buyer for any expenses, damages and costs!
- LOI is issued in favour of the buyer (not a bank)
- From a financing bank's point of view:
  - Impacts security (pledge/title documents/constructive possession)
  - Perceived as being low risk (no default/no case law)
  - Capital consumption (performance) v return (flat fee)
  - Mark down to nominal $1 after defined period (3 months)
- Be cognisant of (bank's) liability when counter-signing LOI for customer (limit liability to invoice value - exclude costs/damages etc).

Standby Letters of Credit (SBLC)

- SBLCs originated in the USA as a substitute for bank guarantees and similar to demand bonds, which banks there are not allowed to issue.
- A SBLC operates like a bank guarantee, with the main differentiating factor being that it is governed by the current version of two International Chamber of Commerce (ICC) publications – the Uniform Customs and Practice for Documentary Credits (UCP), or International Standby Practices (ISP). Functionally, a SBLC is a similar instrument to a documentary credit in that it serves as a primary obligation on the part of the issuing bank to pay a beneficiary based on their written demand certifying non-fulfilment of contracted terms. The SBLC may also call for other stipulated documents in support of the claim e.g. a SBLC covering a trade debt may require the Beneficiary to present a demand stating that a specified invoice remains unpaid and in addition require a copy of the invoice to accompany the demand.
- Payment under a SBLC is typically triggered by a negative event, e.g. non performance, whereas payment under a documentary credit is triggered upon a positive event, e.g. shipment of goods. SBLCs may be used, among other things, to guarantee delivery of goods on an open account basis, repayment of trade loans, or securing payment for goods and services delivered by third parties.

Comparison – Documentary LCs and SBLCs

Documentary (commercial) LC	SBLC
Primary payment source – Beneficiary presents documents to receive payment	Secondary payment source – Beneficiary only claims if applicant does not pay
Documentary requirements comprehensive, i.e. bills of lading, inspection documents, etc.	Documentary requirements simple – usually a demand and statement of non-payment
Subject to UCP600	Subject to UCP600 or ISP 98
Reliance on Beneficiary to present conforming documents	Reliance on Applicant to effect payment (outside of SBLC)
Mainly suited to shipment of goods	Diverse range of applications in same way as Bonds, Guarantees or Indemnities (BGIs)
Discountable	Not discountable
Preferable for new buyer/seller relationships as no trust element	Preferable for trading arrangements where some trust exists

Irrevocable Reimbursement Undertaking (IRU)

- Clause incorporated into LC (field 53 of MT700) authorising the bank requested to add its confirmation to claim reimbursement from a third party bank (usually the bank holding an account for the Issuing Bank)
- Reimbursing Bank will be of a better credit standing than the LC Issuing Bank, and usually domiciled in the country of the LC currency
- Used when the bank requested to confirm the LC is initially unable to do so, e.g. no appetite for the Issuing Bank/country risk, no room under facility, but does not want to turn the transaction down, e.g. relationship with Beneficiary
- The IRU transfers the risk from the Issuing Bank to the Reimbursing Bank (effectively a pseudo confirmation), allowing the Advising Bank to add its confirmation due to the switch in settlement risk
- Issuing bank will send authenticated message (MT740) to Reimbursing Bank instructing them to send authenticated message (the IRU) to the Confirming Bank containing specific LC details
- Subject to ICC Rules (publication no. URR725 – specifically article 9).

UPAS (Usance Payable at Sight)

- Contract between Beneficiary and Applicant is for payment at sight against <u>confirmed</u> LC (or at least negotiable at an acceptable bank)
- BUT, Applicant requires post-shipment financing
- If LC not confirmed or negotiable (i.e. payable at Issuing Bank), financing can only take place once Issuing Bank has taken up documents
- LC issued at a tenor, but allows payment <u>in full at sight</u>, and includes clause (in LC or by separate MT799) requesting financing for the tenor period under a pre agreed Bank to Bank facility and rate, and reimbursement instructions for total at maturity
- Applicant will obtain cheaper financing than straight o/d or loan even after margin added, as initial financing is in name of LC Issuing Bank
- Variations of above formula, e.g. <u>deferred payment</u> LC issued, but Issuing Bank unaware of financing arrangement between Confirming Bank and Applicant (client of both banks) where LC payment made in full <u>at sight</u> against Beneficiary's agreement.

Inoperative LC

- **What is it?**
  - Where the LC is stated to be inoperative until such time as the Issuing Bank issues an amendment (making it operative)
  - LC must be complete and workable and state that it will become operative
- **Why?**
  - Licenses still to be issued
  - Destination of goods to be finalised
  - Applicant requires a performance guarantee (or similar instrument) prior to LC being operative (to be a defined condition within LC)
- Inoperative LCs should not be issued if the Issuing Bank believes that there is no intention, on the part of the Applicant, for the LC to 'go live'
- Consider TCF (Treat Customers Fairly).

The Rules – UCP history and the ISBP

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UCP history (1)

Year	Publication No	Comments
1933	82	• Launched in Vienna • 40 countries adopted
1951	151	• Launched in Lisbon • 80 countries, excluding UK and Commonwealth, adopted
1962	222	• French replaced by English • UK and Commonwealth adopted
1974	290	• GHM started in banking
1983	400	• Articles reflect huge increase in containerised shipments and multi modal methods of transport • Includes different ways of payment under the LC (payment, deferred payment, acceptance, negotiation)

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UCP history (2)

Year	Publication No	Comments
1993	500	• 175 countries adopted • Simplified • LC is presumed as irrevocable • 7 banking days limit on time taken to check documents • Liability of Issuing/Confirming Banks • Non documentary conditions • Acceptability elements for each major type of transport documents • Consistency with market practice
2007	600	• Reduction in articles from 49 to 39 • New articles on 'Definitions' and 'Interpretations' • Time for document checking reduced to 5 banking days • Discounting of deferred payment LCs allowed • Nominated Banks given rights over documents lost in transit

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International Standard Banking Practice (ISBP)

- Vague term originally used in UCP 500 (art.13), relating to the standards of document checking
- Formal definition needed, so terms published by ICC in 2002 (pub. 645) and revised as 681 and most recently 745 this year, to align itself more with the requirements of UCP 600 than the previous edition, and following formal Opinions of the ICC from banking committees on various problems
- Current version includes additional documents, and general principles of document checking, inc. date calculations, issuers of documents, non documentary conditions, typing errors, etc
- ICC claim documentary rejections reduced as the guidance on document preparation has reduced discrepancies
- Many practitioners consider it equally as valuable as UCP 600.

Evolution of LCs

Evolution of LCs (1)

- Began as a payment mechanism
  - providing certainty of payment to a Beneficiary against conforming documents
- Became a financing tool
  - Security over underlying goods (self-liquidating LC)
  - LC proceeds (assignment) used as security
- Used for country controls
  - Imports
  - FX
- Tool for regulatory controls
  - Sanctions
  - AML

Evolution of LCs (2)

LC banks used to be compared / chosen by customers based on:

- Expertise
- Global coverage
- Price
- Technical expertise
- Customer service
- Risk appetite (Applicant / Issuing Bank)

Are these attributes still important today?

LCs as security

LCs as security

For the **Issuing Bank** the underlying Bills of Lading can act as good security:

- Has a pledge over the bills of lading (documents of title)
- The LC calls for a full set
- They are negotiable (in fact what we mean is transferable)
- The goods are easily saleable and/or can be hedged
- The Issuing Bank has control/security interest in any on-sale.

For the **Advising/Confirming/Negotiating Bank**:

- Beneficiary assigns proceeds of the LC
- Risk is shifted from corporate (Beneficiary) to bank (Issuing Bank) risk.

Banks deal in documents not goods!

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Banks deal in documents not goods!

- Does this statement continue to hold true?
- Consider:
  - Fraud
  - Sanctions
  - Behaviour of parties where market conditions change:
    - Rejection of documents by Applicant or Issuing bank
    - Propensity to renegotiate contract price
    - Is there a higher risk when the Applicant is a trader not a user?
    - Case studies (Fortis/Stemcor v Indian Overseas Bank).

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What do we think of LCs?

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What do we think of LCs? (1)

Banker:

- Internal systems keeping pace with external demands eg Bolero, BPO, eUCP
- Internal procedures / offshore processing
- Additional checks such as sanctions/KYC/AML
- Customer expectations emanating from electronic delivery (emails/customer front-end) expecting immediate turnaround
- Right product

Customer:

- Banks' systems are slow
- Pedantic internal layers
- Lack of knowledge of clients' business

What do we think of LCs? (2)

Independent practitioner :

- Drafts under LCs are redundant
- B/Ls consigned to the order of the Issuing Bank
- LCs requiring presentation of documents in more than duplicate
- LCs calling for copies, or worse still, originals of courier receipts etc
- Ambiguous wordings

Looking forward:

- ISBP to be delivered and updated electronically ie become a live document
- Make LCs simple and logical
- Change bankers' mindset from trying to find discrepancies
- Better LC training for banks in the newly-emerging countries

Do LCs work?

Do LCs work? (1)

- An LC is a conditional undertaking to pay – nothing more
- It should be unambiguous and workable
- It should not be a recital of the underlying commercial contract
- Create documentary conditions in such a way that no discrepancies can be found
- If one party decides to use the LC as a way to avoid its obligations under the commercial contract (quality/quantity/timeliness of goods and/or contracted purchase price) compounded by an overly complex LC, then the role of the LC bank(s) becomes difficult
- Where irretrievable discrepancies (workability) are found in the LC and a high percentage are know by the Beneficiary in advance of shipment, yet shipment still takes place regardless of risk and negation of certainty of payment
- Intense scrutiny of Trade documentation by some banks eventually leading to higher rates of rejection on the basis of minor discrepancies

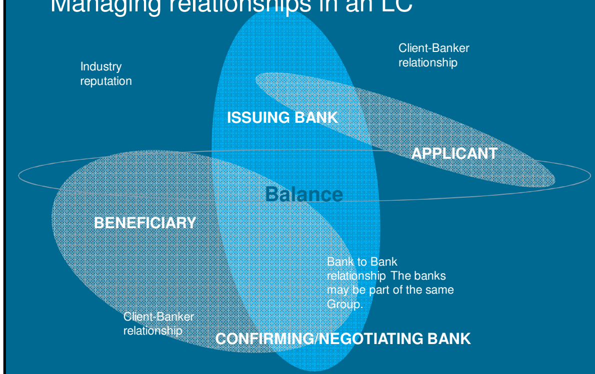
Do LCs work? (2)

- Behaviour of parties in a falling market (Applicant and/or Issuing Bank)
- Untrained and unqualified practitioners (not just banks) are at fault, not the tool itself
- Contractually compliant goods, shipped within the mutually agreed timeframe in the manner required, should be paid

GHM views:

- LCs are overly complex
- They should call for three of four documents (the remainder sent directly by Beneficiary to the Applicant)
- This should minimise the opportunities for discrepancies
- All too often we (all parties) fool ourselves into believing that the more complex the LC is worded, the more protection it provides – 'fool's gold'
- Banks do not want, or need, discrepant presentations – not cost effective and impacts relationships with customers and correspondent banks (see next slide)

Managing relationships in an LC



Recent LC-related issues

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Recent LC-related issues (1)

- **Examining documents where the bank is not an Issuing, Confirming or Nominated Bank:**
  - What is the bank's responsibility
  - Does it assume liability for missed discrepancies
  - Should it charge a risk or service fee
- **What should a bank do with superfluous documents?**
  - Should it examine or disregard the documents
  - What is the bank's responsibility as regards sanctions screening
  - Consequences of a document(s) not called for under the LC generating a sanctions hit and delaying/stopping acceptance/payment.

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Recent LC-related issues (2)

- **Refunds under Oil LCs:**

11.BENEFICIARY MAY DRAW UNDER THIS LETTER OF CREDIT AGAINST PROVISIONAL INVOICE BASED ON PRICE QUOTATION ON NOR DATE. IN THE EVENT THAT THE NOR DATE IS NON QUOTATION DATE, THE PREVIOUS AVAILABLE QUOTE SHALL BE USED. BALANCE PAYMENT TO BE EFFECTED UNDER THIS LC AGAINST PRESENTATION OF FINAL INVOICE WHETHER THE AMOUNT OWED IS IN BENEFICIARYS FAVOUR OR IN THE APPLICANTS FAVOUR.

  - Is it a non-documentary condition and how will it be interpreted?
  - What obligation does it impose on the Confirming/Nominated Bank?
  - Under UCP600 a Confirming/Nominated bank provides no financial covenant on behalf of the Beneficiary
  - Will an Issuing Bank apply set-off (for monies due from the Beneficiary to the Applicant)
  - **ICC opinion (December 2014) 'to be handled outside of the credit as payment obligations of the beneficiary are not covered under the scope of UCP 600'**

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Recent LC-related issues (3)

- **What is the definition of a self-liquidating LC?**
  - Does it matter?
  - Impact on risk appetite?
  - Impact on pricing and regulatory reporting
    - consider the Credit Conversion Factor for a self-liquidating LC (20%) as opposed to a 'standard' LC (50%)
- **A simple definition:**
  - An LC can be considered to be self-liquidating where there is an identifiable source of repayment independent of the Applicant
  - The Issuing Bank is not primarily relying on the balance sheet of the Applicant but is looking to either the goods or the on-sale (receivable) as its means of reimbursement

Challenges from a banker's standpoint

Challenges from a banker's standpoint

- Macro
- Country / Counterparty risk events
- Product Continuum
- Trade - Key risks
- Transactional chain and analysis
- Risk considerations
- LCs as security
- Managing relationships in a LC
- Operational risks.

Macro challenges

- Capital treatment
  - Financial vs. performance (definition of a credit substitute)
  - Advanced vs. Standardised
- AML/fraud
- Sanctions
- Competition
- Quantum/Pricing/Structure
- Economic
  - Sovereign
  - Performance of Developing and Emerging Market banks v OECD
  - Propensity of fraud (e.g. fresh air invoices, inferior or no goods).

Country/Counterparty risk events (1)

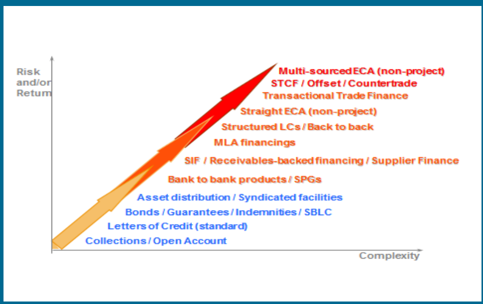
- Recent sovereign defaults include:
  - Argentina (2001)
  - Iran (late '80s)
  - Russia (1998)
  - Kazakhstan / Ukraine (2008)
- Apart from Ukraine, Trade tends to perform reasonably well, though recoveries may be delayed and/or with some form of discount
- Generally speaking Trade tends to be preferred, provided:
  - Genuine underlying transaction linked to that country
  - Under 1 year
  - Strategic imports such as energy, foodstuffs, medicines to support exports (for hard currency/balance of payments).

Country / Counterparty risk events (2)

Export LCs

- Confirming/Negotiating Bank has no rights to documents (and thereby goods) once documents are sent to Issuing bank
- If Issuing Bank fails before documents presented by Beneficiary (or dispatched) the Confirming/Negotiating Bank may have security if:
  - It negotiates documents
  - Bills of Lading are made out to the Confirming/Negotiating Bank (best position) or issued to order and blank endorsed
  - Confirming/Negotiating Bank can avoid paying if discrepant presentation (and not rectified within the terms of the LC)
- Beneficiary may be able to persuade Applicant to pay outside of the LC.

Product Continuum



Source: Barclays Bank PLC

Trade – key risks

Products + Services	Letters of Credit BGIs/ SBLCs Collections
Finance	Debtors/Receivables Stock Payables Bank to Bank
Risk	Buyer (debtor) Bank Country Performance (supplier)

Operations	Operational Process Sanctions Policy Systems Customer service
Counterparty /Structure	Structure Contract Performance Payment Logistics Price Collateral
Counterparty	Counterparty (Corporate or FI) Risk appetite Political Conformance Credit risk Policy

Key learning points

Key learning points

- KYB
  - Track record between Applicant and Beneficiary
  - Role of the Applicant (intermediary or end-user)
  - Market conditions (falling / rising market can influence behaviour)
- Keep LCs simple and avoid ambiguity
- Impact of LOIs on security
- Acting outside of the terms of the LC (e.g. releasing documents 'in trust') may change the bank's obligations

Appendices

- Global Trade export flows
- The transaction chain
- Risk considerations
- Operational risks
- Financing Trade – bank to bank

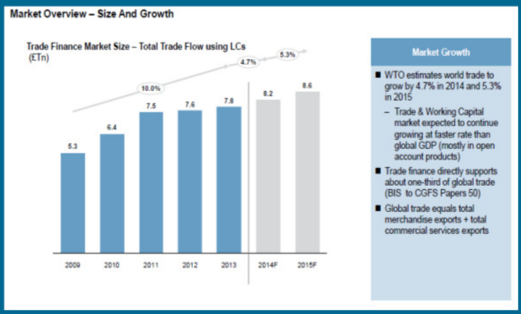
Global Trade Export Flows

Global Trade Flows 2012 - 2014

$ bn	2000		2005		2009		2013		2014	
	Import	Export	Import	Export	Import	Export	Import	Export	Import	Export
UK	348	285	519	391	519	355	656	541	683	507
USA	1,259	782	1,733	901	1,605	1,056	2,329	1,580	2,409	1,623
Brazil	59	55	78	119	134	153	251	242	239	225
France	339	328	504	463	561	485	681	581	679	583
Germany	497	552	777	971	926	1,120	1,192	1,452	1,217	1,517
Italy	239	241	385	373	415	407	479	518	472	529
Spain	156	115	289	193	293	227	341	318	356	323
China	225	249	660	762	1,006	1,202	1,950	2,209	1,960	2,343
Japan	380	479	516	595	552	581	833	715	822	684
South Korea	160	172	261	284	323	364	516	560	526	573
India	52	42	143	100	257	165	465	315	460	317
UAE	35	50	85	117	150	192	251	379	262	359
South Africa	30	30	62	52	74	62	126	96	122	91
World Total	**6,725**	**6,458**	**10,870**	**10,509**	**12,782**	**12,555**	**18,904**	**18,826**	**19,024**	**18,935**

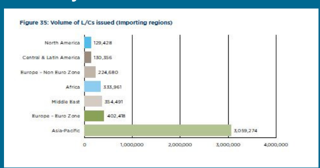
Source: World Trade Organisation (WTO) and UN COMTRADE

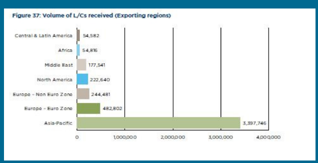
The Trade Finance market is large and growing



Source: BIS – CGFS Papers No 50: developments and issues; WTO

Most LC activity is intra-Asia





Source: ICC: 2013 Rethinking Trade & Finance

The transaction chain

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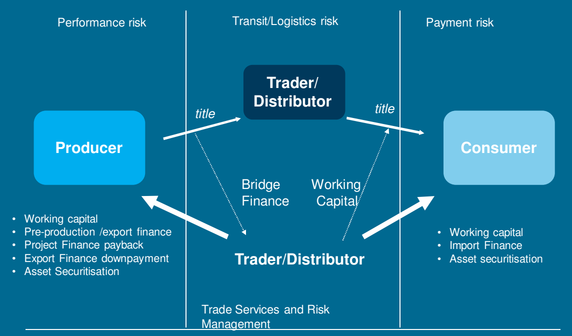
The Transaction Chain



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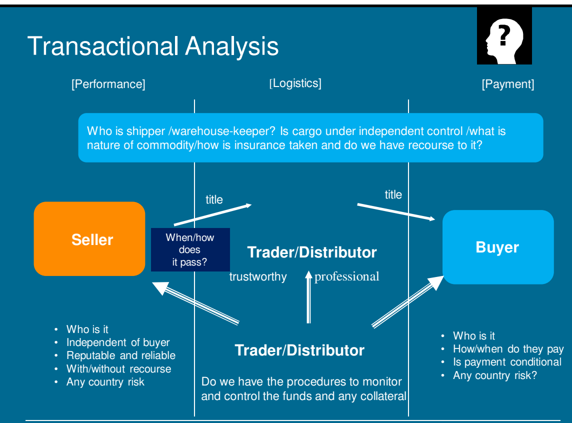
Transactional Analysis



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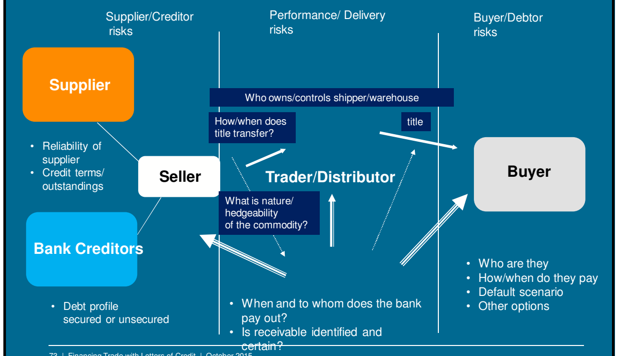
What to look for



Unrestricted

Risk considerations

Unrestricted

Risk considerations (1)

Taken from a dated document – but still relevant today albeit for the same (and additional) reasons:

Applicant

- Track record (management ability / LC experience / repayment record)
- Normal line of business.

Goods

- Insured
- Timing (are the goods affected by seasonal factors or fashion)
- Onward sale.

Value

- Pre-sold
- Taken into stock.

Unrestricted

Risk considerations (2)

Beneficiary

- Good track record for quality and meeting delivery dates
- Normal line of business.

LC

- Is the amount consistent with normal pattern of Trade
- Will the customer be able to meet payment obligation within the timescale imposed by the terms of the LC (under a sight LC payment will be required before goods are sold).

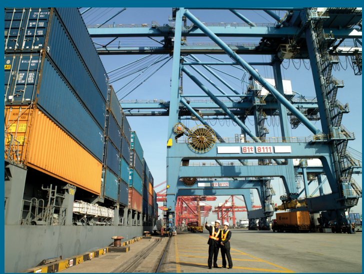
Timing

- Are orders well spaced

Protection

- Goods as security
- Does the LC give the bank effective security
- Security position may be affected by usance/deferred payment LCs.

The vessel has arrived – but we may be looking at the insurer rather than the goods!



Operational risks

Operational risks (1)

Issuance:

- Failure to follow terms of facility documentation e.g. tenor/amount/collateral resulting in breach of credit sanction
- Acting outside customer mandate:
  - Signatures
  - Fax / email instructions (without appropriate indemnity)
- Duplication of LC
- Failure to comply with customer SLA

Result: acting outside of customer's authority

- Missing unusual trading patterns (goods, frequency, seasonal).

Operational risks (2)

Confirmation/negotiation:

- Acting on unauthenticated instructions
- Outside of risk limit (counterparty/amount /tenor)
- Documents lost in transit
- Spurious discrepancies raised by the Issuing Bank
- Non-customer beneficiaries (Wolfsberg).

Operational risks (3)

Generic risks:

- Processing an unworkable/ambiguous LC (impact on checking documents)
- Accept/pay against discrepant documents
- Pay wrong party/late/twice/debit wrong customer
- Potential demurrage costs (caused by delay in processing documents)
- Failure to follow UCP/ISBP and LC terms and conditions
- Sanctions/AML requirements/KYC (missing/incomplete/out of date)
- Fraudulent presentations
- Inexperienced staff/off-shoring/cost pressures (cost to income).

Question: Should documents be checked more than once/twice?

Financing Trade – bank to bank

Bank to Bank (1)

- Risks in cross border Trade are mediated by banks
- Historically banks financed their own customers (Beneficiary or Applicant) directly:
  - Issuing usance/deferred payment LCs
  - Financing Beneficiaries against future LC receivable
- Local banks are now regularly accessing hard currency funding from offshore banks to finance LCs and other Trade-related products (collections, prom notes, open account) increasingly with the approval/support of local central bank/regulator :
  - Liquidity
  - Cost
- A range of B2B (not to be confused with Back to Back) solutions have been developed over the past few years
- Funding (offshore) bank is taking risk directly on local bank (no contingent element in the transaction).

Bank to Bank (2)

Benefits from a financing bank standpoint:

- Extend balance sheet to FIs
- Compensate for limited traditional Trade flows (LCs)
- No transaction-related operational risks (checking documents)
- Resulting in lower operational costs

Potential risks (for a financing bank using B2B):

- Are we financing genuine Trade transactions
- For some B2B structures the financing bank is not a party to the transaction
- The further you move away from the transaction/documentation the risk (of being genuine Trade) increases (rely on the integrity of the borrowing bank)
- Will the transaction be regarded as Trade and therefore be 'preferred'
- Should it be (risk) priced as Trade or simply as debt.

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