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International trade finance: commercial letters of credit and independent payment undertakings

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Commercial letters of credit, the most frequent method of payment for goods in international trade transactions, have frequently been described as the lifeblood of international commerce. However, it can be argued that another, related method of payment is of equal importance, namely the independent or "on-demand" payment undertaking. This form of payment encompasses standby letters of credit, independent or on-demand bank guarantees and performance bonds.

This chapter considers:

- The basic features of letters of credit (also known as documentary credits). In particular it considers:
  - the principles underpinning the two types of letters of credit, that is, commercial and standby letters of credit;
  - how letters of credit can be categorised;
  - the impact of the Uniform Customs and Practice for Documentary Credits (UCP) on letters of credit.
- How commercial letters of credit work and how they are used in international trade.
- How standby letters of credit work and considers international standby practice.
- The basic principles of performance bonds and bank/ on-demand guarantees, and outlines their use in international trade, their effectiveness and the establishment of uniform rules in this area.
- From an English law perspective, other negotiable instruments that are used in trade finance to effect payment, in particular, bills of exchange, promissory notes, forfaiting and advance payment bonds and guarantees. It also considers the use of these instruments in international trade.

BASIC FEATURES OF LETTERS OF CREDIT

The two types of letter of credit are, the most common type, the commercial letter of credit, and the standby letter of credit, which is a form of independent payment undertaking.

Principles underpinning letters of credit

Both types of letters of credit are founded on two principles: the independence of credit and the doctrine of strict compliance.

The independence principle dictates that the credit is a "transaction in documents". The credit is an autonomous contract, the performance of which is separate, and unaffected by, the underlying contract between the account party and the beneficiary that gave rise to it.

The independence principle works in tandem with the principle that a commercial credit is a transaction in documents only, known as the doctrine of strict compliance. According to this doctrine, a paying bank is entitled to reject documents that do not strictly conform to the terms of the credit.

Categories of letters of credit

Documentary credits can be categorised as:

- **Transferable or non-transferable.** A beneficiary under a letter of credit often insists on an express term in the contract specifying that the credit is "transferable". The effect of a transferable credit is that the beneficiary can request the nominated bank to transfer the credit to the beneficiary's supplier, although the nominated bank is not legally obliged to do so.

  As a result, a transferable credit may provide an efficient means by which the seller can pay its supplier. The UCP states that a letter of credit is only transferable if the contract specifically states it to be so. In the absence of such an express term, all a beneficiary can do is request that the nominated bank transfer the credit; it cannot insist that this happen.
- **Revocable or irrevocable.** A revocable credit is one that may be amended or revoked by the issuing bank at any time without prior notice to the beneficiary. The UCP (*see below, UCP*) states that in order for a letter of credit to be revocable, the contract must specifically state it to be so. Otherwise, the credit will be deemed irrevocable. A beneficiary seller in an international trade transaction requires payment security and as a result is rarely prepared to accept a revocable letter of credit. To do so would result in there being a risk that the credit may be amended or revoked after the seller has delivered the goods, but before he has presented the documentation or obtained payment for the goods.
- **Negotiable or non-negotiable.** Under a typical letter of credit the undertaking of the issuing or confirming bank is usually directed to the named seller alone and only that seller can rely on the credit. This is known as a "non-negotiable credit". However, the seller can request a negotiable credit. If this is the case, the undertaking of the issuing bank can be addressed to anyone who becomes a bona fide holder of the documents called for by the credit. This may be helpful to the seller where the credit does not provide for immediate payment because it can sell the documents to a bank for cash, getting immediate payment, although usually at a discount.

Analysis

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There is no general consensus on what the default position is if a letter of credit is silent on the point as to whether or not it is negotiable. As a result, parties should always ensure that this point is clearly addressed under the terms of the letter of credit.

UCP

Given the extensive use of documentary credits (and their fundamental importance to international trade), the importance of having a uniform international code governing their operation cannot be overstated. International standardisation has been achieved through the efforts of the International Chamber of Commerce (ICC), which produced the UCP. The UCP is now in its sixth edition, in the form of the UCP 600, ICC Publication No. 600. UCP 600 was approved by the ICC Banking Commission on 25 October 2006 and came into effect on 1 July 2007.

The UCP is not intended to be a code having the force of law, and in this respect it is quite different in nature to the many international conventions, such as those on carriage, which have the force of law in the countries that are a party to them. The UCP is only binding in a letter of credit if the parties to the contract expressly state it to be so.

The UCP does not purport to be a universal code setting out the law relating to credits in the way that, for example, the Sales of Goods Act 1893 intended to codify the sale of goods under English law. As a result, there are substantial areas on which the UCP is silent (such as the effect of fraud and forgery, which is the main basis for refusing payment under a documentary credit), and in respect of which national courts of the relevant countries are left to adjudicate.

The ICC has also published ICC Banking Commission Opinions 2005-2008, ICC Publication No. 697. The opinions give guidance on how ICC rules are interpreted in practice by answering queries on various ICC publications, including the UCP.

COMMERCIAL LETTERS OF CREDIT

Commercial letters of credit are commonly used in international trade transactions as an alternative to secured lending. The rationale behind this form of credit is similar to that of secured lending.

For example, in commercial trade deals where the buyer and seller are in different countries and the goods are to be delivered by sea, air or road by a third party carrier, the seller may be unwilling to dispatch such goods unless he has some security of payment. Similarly, the buyer may be unwilling to pay for the goods unless he has some security that they will be delivered.

A letter of credit, by its nature, bridges that gap. It is a means of effecting payment in a way that addresses both the buyer's and the seller's concerns as to certainty of payment (in the case of the seller) and certainty of delivery (in the case of the buyer). It is a promise by a bank of payment against specified documents, on terms that the bank will be reimbursed by the party requesting the issuance of the credit.

At its simplest, a commercial letter of credit gives rise to the following separate contractual relationships:

- The underlying contract between the "account party" (or the "applicant") and the "beneficiary" of the credit, requiring the account party to arrange the issuance of a letter of credit in favour of the beneficiary.
- A contract between the "issuing bank" (or the "opening bank", derived from "opening" a credit) and the account party, in which the issuer agrees to issue the letter of credit in favour of the beneficiary and the account party agrees to reimburse the issuer for amounts paid under it.
- A contract between the issuer and the beneficiary under which the issuer agrees to make payment to the beneficiary under the letter of credit on presentation of stipulated documents.
- As most letter of credit transactions are international in character, the issuer normally instructs a "correspondent bank" or "advising bank", located in the beneficiary's jurisdiction, to advise the credit. Where the correspondent bank in addition confirms the credit, the "confirming bank" adds its own undertaking to pay to that of the issuer. This gives rise to a fourth contract, between the issuer and the confirming bank under which the issuing bank agrees to reimburse the confirming bank.
- As a result, a fifth contract comes into being, between the confirming correspondent bank and the beneficiary, to pay under the letter of credit on presentation of documents stipulated in the credit.

For an illustration of the basic structure of a commercial letter of credit, see box, *Commercial letter of credit: basic structure*.

It is also worth bearing in mind that the UCP uses the term "nominated bank" to mean a bank with which the credit is available, and at which the documents entitling payment may be presented.

The main exceptions to effecting payment under the above arrangements are fraud or illegality, whether relating to the letter of credit or the underlying contract. In and of itself, that proposition is a simple one. However, the area of law surrounding the basis and circumstances when payment under a documentary credit may be stopped, not effected or enjoined has historically been one of substantial discussion and case law. (This area is outside the scope of this chapter.)

Use in international trade

The uses of commercial letters of credit in international trade, and the various roles played by banks in this context, are best illustrated by way of example, as set out below.

A Ghanaian oil refinery company, B, contracts to buy 5,000 barrels of crude oil from an English oil trading company, S:

- B and S enter into a contract for the sale of the crude, which provides for payment by letter of credit.
- B (as the account party) requests its bank (likely to be in Ghana) to issue, or open, a letter of credit. On accepting the request, the bank asks B to sign the bank's standard application form, the effect of which is to create a binding obligation on:
  - the bank to issue the credit as per B's instructions;
  - B to reimburse the bank for any sums it pays out and any related costs and expenses.

  Once this form has been completed, B's bank becomes the issuing bank and issues (or opens) the letter of credit.

- Given the international nature of the deal, B's bank instructs a local bank in England to communicate the terms of the credit to S, accept presentation of the documents and, ultimately, effect payment to S. This is the correspondent bank (or, the "advising bank", as it advises on the terms of the credit).

The operation of the credit by S is straightforward. When S has shipped the crude, S presents documents evidencing the shipment to the correspondent bank. If the documents comply with the terms of the credit (including specified crude oil quantity and so on) the correspondent bank effects payment.

If the documents are not strictly in order, the correspondent bank is under a prima facie obligation to refuse them. However, the bank can seek instructions from the issuing bank, or, in the case of the issuing bank, from the account party (B) directly, as to whether B is prepared to accept documents even though the terms of the credit have not been strictly complied with.

If the correspondent bank has accepted the documents from S, it remits them to the issuing bank. It is then the duty of the issuing bank to check whether the documents conform to the credit. If they do, the issuing bank reimburses the correspondent bank. However, if it considers that the documents do not conform, it returns the documents to the correspondent bank, unless B instructs the bank to waive the discovered discrepancies.

Importantly, unless the advising correspondent bank expressly agrees to confirm the credit, it is not under an obligation to S in respect of the payment. The sole undertaking in that regard remains with the issuing bank. However, Article 9 of the UCP (*see above, UCP*) does provide that the advising bank should satisfy itself as to the apparent authenticity of the credit on which it advises, and its advice should accurately reflect the terms and conditions of the credit. If it cannot establish such apparent authenticity it must inform the issuing bank, and if it in any case elects to advise the credit it must inform S that it has not been able to satisfy itself as to the apparent authenticity of the credit.

Finally, the issuing bank needs to present the documents to B. This is done against payment by B to the bank. If the bank has accepted documents that do not comply with the credit, B may reject them. If the documents are accepted by B, they are then used by B to obtain possession of the shipped crude under the underlying contract.

In this way, the commercial credit safeguards the interests of B and S. B is assured that payment is made against documents that confer title to the crude to B. S, when parting with possession of the crude, is assured of payment by a financially reliable third party and is therefore protected against the risk of B's inability or unwillingness to pay.

STANDBY LETTERS OF CREDIT

Although evolved from commercial letters of credit, standby letters of credit serve a fundamentally different function. While the function of the former is to provide payment for goods or services, the typical function of the standby credit is to enable one party to a contract to obtain payment when the other party has failed, or is alleged to have failed, to perform the underlying contract. Essentially, the standby credit is designed to provide security or an indemnity to the beneficiary as a contingency for the other contracting party's default under the underlying contract.

The standby letter of credit, like the commercial credit, is a documentary credit. Its cornerstone is the issuing bank's undertaking to the beneficiary to pay as the credit provides if documents are presented in accordance with the terms of the credit. Subject to such minor distinctions as may follow from the difference in function, such as differences in the type of documents to be presented, the principles relating to commercial letters of credit also apply to standby credits, *mutatis mutandis* (that is, with the necessary changes). This means that a standby credit is also a transaction in documents, and is an autonomous contract the performance of which is independent of the underlying contract.

While a standby letter of credit effectively performs the function of a traditional guarantee in that it enables the beneficiary to obtain money from the issuer in relation to the (non)performance of an underlying contract, its distinguishing feature is that the issuer gives an undertaking to pay against documents. Unlike a traditional guarantee, this creates a primary obligation on the issuer that is independent of the underlying transaction.

While the formal requirements of a claim as stipulated in a standby letter of credit may include the provision of documents by an independent third party dealing with the issue of default, it is far more common for there to be a requirement of only a written statement of the beneficiary to the effect that the account party has defaulted under the underlying contract. As a result, payment might be effected even though the contingency did not in fact occur (or is being disputed).

The ensuing risk rests ultimately with the account party who, in addition to having performed the contracted obligation under the underlying transaction, must reimburse the issuing bank where payment has been made in accordance with the terms of the credit.

International standby practice

Following a steady increase in the use of standby letters of credit it became apparent that these documentary credits would benefit from having their own code. On 1 January 1999, the International Standby Practices (ISP 98) came into effect. Although the UCP states that standby credits may be made subject to its rules, there were a number of provisions that had proven to be problematic for standby credits. The ISP 98 is therefore tailored specifically for use with standby credits.

The ISP 98 looks at areas specific to standby credits that were deemed to be inappropriately addressed under the UCP, including presentation of documents, examination of documents and rejection.

The rules created by the ISP 98 are in many ways similar to those under the UCP, and the parties to a standby credit must state specifically their intention for the ISP 98 to be binding on them/the credit. As with the UCP, there is no obligation on the contracting parties to be bound by its terms and in many instances such parties may prefer the incorporation of the UCP, owing to familiarity with its operation.

The UN Convention on Independent Guarantees and Standby Letters of Credit is also applicable to standby letters of credit, but is of lesser importance at present (*see below, Bank guarantees and performance bonds: Establishment of uniform rules*).

BANK GUARANTEES AND PERFORMANCE BONDS

The distinguishing feature of the obligation assumed by a guarantor under a traditional guarantee is the secondary nature of the obligation. That is, it is contingent on the principal debtor's continuing liability and, ultimately, default.

In the context of international trade finance, a guarantee typically has a different meaning. It usually means a primary and independent undertaking by the guarantor to pay if the conditions of the guarantee are satisfied. Such a guarantee is often prefaced by the words "bank", "demand" or "first demand". These terms appear to be used interchangeably. In other words, the word "guarantee" in the context simply means an undertaking (rather than its true legal meaning). In this context, a bank guarantee is normally an absolute undertaking by the bank to pay if the conditions for payment are satisfied.

As such, it is effectively identical to a standby letter of credit and most considerations that apply to letters of credit also apply to bank guarantees, *mutatis mutandis*. For instance, the obligation of the bank to honour its undertaking under an independent guarantee is subject to the fraud exception in the same circumstances as in relation to letters of credit. In fact, some of the fraud exception rules were developed in cases in which bank guarantees were involved.

It is essential to the commercial efficacy of bank guarantees and performance bonds as international financing tools that they are distinct from a traditional guarantee. A bank guarantee or performance bond is only distinct from a traditional guarantee to the extent that it remains independent of the underlying contractual relations between the account party and the beneficiary. As soon as it is made conditional on default in the underlying contract, it loses this distinguishing characteristic.

The terms "bond" and "guarantee" have often been used interchangeably, sometimes prefaced by the words "performance", "demand" or "first demand". Legal relationships arising under a bank guarantee, performance bond or standby letter of credit (generally, "on-demand payment undertakings") are the same as those arising under a commercial letter of credit. The following contractual relationships arise:

- The underlying contract between the account party and the beneficiary.
- The payment obligation owed by the issuer to the beneficiary under the undertaking.
- An indemnity given by the account party to the issuer for any amounts paid under the undertaking.
- Where a beneficiary requires that the payment undertaking be issued by a bank in its own country rather than that of the account party, the account party's bank instructs a correspondent bank to confirm the undertaking. In these circumstances, the legal relationships are the same as above, except that the primary payment obligation is owed by the correspondent bank to the beneficiary, and the account party's instructing bank owes an indemnity obligation to the correspondent bank.

Use in international trade

Bank guarantees and performance bonds are mainly used in relation to export financing. An exporter may instruct a bank to issue the payment undertaking on its behalf, and if the exporter fails to perform its obligations under the export contract, the importer has a right to seek recompense for its losses against the issuing bank.

The "performance" element of a bank guarantee or performance bond is in relation to the obligation of the exporter to perform certain contractual obligations as agreed between the parties. The payment undertaking is generally issued by a reputable bank (however, it can also be issued by an insurance company or a surety company). In turn, the exporter undertakes to place the issuing bank in funds should the bank have to make any payments under the payment undertaking. This counter-indemnity ensures that the exporter does all that is possible to perform his side of the contract.

There are many uses of bank guarantees and performance bonds. In addition to being of potential use in connection with the (non) delivery of goods or (non)performance of services, they are also often used (issued) in relation to the performance of warranty obligations in connection with the underlying contract, or for payment of liquidated damages for late delivery of goods or non-compliance with contractual specifications.

On a more practical level, the issuing of a bank guarantee or performance bond by the issuing bank depends on a variety of matters, not least the credit worthiness of the exporter. In addition, the location of the issuing (or confirming) bank is likely to be paramount; for instance, the importer will be concerned about whether the bank is located in a country that is subject to foreign currency constraints. Thought must also be given to the credit worthiness of the issuing (or confirming) bank as the parties will be keen to ensure the issuing (or confirming) bank's ability to honour the on-demand payment undertaking.

Given the potential ease with which bank guarantees and performance bonds may be called on (whether in fact justifiably and correctly, or not), it is not surprising that the main area of contention and discussion in relation to these types of undertaking relates to their payment obligations. A particular concern is when the beneficiary of the payment instrument (likely, the importer) is entitled to payment, and whether such entitlement is payable on demand. It is this element of the bank guarantee or performance bond that is likely to be most heavily negotiated between the account party (exporter) and beneficiary (importer).

Effectiveness

Bank guarantees and performance bonds can be extremely effective instruments for ensuring the performance of contractual obligations. However, their attractiveness to an importer also depends on circumstances.

For instance, there is an issue as to how the importer is to pay for such goods. If they are paid for on due receipt by the importer, then a bank guarantee or performance bond is not overly helpful, as the risk that the payment undertaking is designed to mitigate is essentially zero. Alternatively, an importer may have an advance buyer for the goods in question and will not want to risk a break down in its business relationship with that buyer as a consequence of non-performance by the exporter. In these circumstances, an importer may push strongly for the exporter to provide an on-demand payment undertaking like a bank guarantee or performance bond.

An importer may also insist on the issuance of a bank guarantee or performance bond where the importer has concerns as to the solvency of the exporter. A payment undertaking would transfer the risk from an insolvency of the exporter to a risk on the issuing bank. The issuing bank would be liable to pay the importer if the exporter fails to perform its part of the contract (subject to the terms of the guarantee or bond). However, although a bank guarantee or performance bond offers some insolvency protection, it is also unlikely that an issuing bank would issue a payment undertaking at the request of an exporter that exhibits signs of being in financial difficulty.

Establishment of uniform rules

Bank guarantees and performance bonds are not subject to the UCP and are instead subject to the Uniform Rules for Demand Guarantees (URDG), published by the ICC. The current version of such rules is the 2010 revision, ICC Publication No 758 (URDG 758). The URDG is a voluntary code and must be incorporated directly by the contracting parties and, like the UCP, is not intended to have the force of law. Although initially slow to catch on, incorporation of the URDG 758 into demand guarantees is increasingly common.

The UN Convention on Independent Guarantees and Standby Letters of Credit entered into force on 1 January 2000. However, it has only been ratified or acceded to by eight countries. As with the UCP and the URDG, the convention is intended to create a uniform set of rules for independent guarantees and standby letters of credit, however, it is intended to operate in tandem with existing established principles. The convention is of minor importance at present given the small number of countries to have ratified or acceded to it.

BILLS OF EXCHANGE

Bills of exchange can be payable either at a future date or immediately (that is, on sight). The ability to make payment by a bill that is payable at a later date is beneficial to both the importer and the exporter. The importer is granted credit on the goods that it is buying and the exporter can obtain immediate payment by selling the bill to a bank (or other financial institution).

One of the key elements of a bill of exchange is that it allows for the facilitation of international trade without the intervention of any bank.

Bills of exchange are creatures of historical evolution; in England and Wales, the law relating to their operation was historically governed by common law before the enactment of the Bills of Exchange Act 1882, which sought to codify the existing law. This act defines a bill of exchange as (*section 3(1)*):

"…an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money to or to the order of a specified person, or to bearer."

Under this definition, a bill of exchange must have the following key defining characters:

- It must be an unconditional order.
- It must be in writing.
- It must be signed by the person "proving" the bill.
- It must provide for the payment of such unconditional order on demand.
- The sum must be for a predetermined amount and payable at a fixed or determinable future time.
- It must be payable to a specified person or the bearer of it.

A bill of exchange is essentially a negotiable instrument that provides an exporter with a right to receive payment at a fixed future date from the importer's bank or nominated financial institution. In addition, and crucially, the bill of exchange may be sold to another party to allow for the immediate realisation of cash by the exporter.

Note that, similar to a letter of credit, a bill is non-negotiable if it expressly states that any transfer of the bill is prohibited or if there is any other wording proving an intention that the bill be non-transferrable. While a negotiable bill may be payable either to "order" (that is, to the order of a specified party or person) or to the bearer, a non-negotiable bill is payable only to the party named as "drawee" (being the named beneficiary).

Use in international trade

The bill of exchange has a number of important roles to play in international trade. A bill of exchange facilitates the granting of trade credit in a legal format by documenting payments to be made at future dates. A bill of exchange also provides formal written evidence of the demand for payment from an exporter to an importer.

A key element of a negotiable bill of exchange is that it allows the exporter access to finance by permitting it to transfer the bill of exchange (and therefore its debts owing on the bill of exchange) to a bank or financial institution. The bank or financial institution, on acquiring the rights under the bill of exchange, has a legal claim against both the importer and exporter in the event of non-payment.

A bill of exchange can either be payable immediately or at a pre-determined future date (*see above, Bills of exchange*). Bills payable at a future date are often sold/transferred at a discount to the face value of that bill to allow the transferee quick access to funds. The transferor then holds the bill until its payment date and receives the face value of the bill.

See box, *The basic structure of a bill of exchange*.

PROMISSORY NOTES

A promissory note is essentially an unconditional promise to pay a sum of money, on demand or at a fixed future date. Although a promissory note can be distinguished from a bill of exchange, it does share most of its characteristics with the latter and is governed in England and Wales by parallel provisions of the Bills of Exchange Act 1882.

A promissory note is defined as (*section 83(1), Bills of Exchange Act 1882*):

"an unconditional promise in writing made by one person to another, signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money, to, or to the order of, a specified person or to bearer."

A mere acknowledgement of indebtedness, even if such an acknowledgement contained an implied promise to pay, is not enough; there must be a specific intention between the contracting parties to create a promissory note.

A promise to pay does not, of itself, create a promissory note. The terms of the promissory note must include such details as the principal amount, the parties, the applicable interest rate, the date payment is due and the terms of repayment. In addition (and as set out in the definition above), the promise must be signed by the maker and there must also be an intention between the parties to create a promissory note.

A promissory note is another form of negotiable instrument and therefore can be payable to a specified person or the bearer.

Use in international trade

Promissory notes can offer an alternative method for financing international trade transactions outside the traditional sphere of bank financing or corporate bonds and have long been established as an effective credit instrument. Owing to the nature of the instrument and the fact that a promissory note can be issued for any sum, they are used in a wide variety of transactions.

Promissory notes are also commonly used in forfaiting transactions (additionally, bills of exchange may also be traded in the forfaiting market (*see below, Forfaiting*)).

FORFAITING

Forfaiting involves the surrender by the exporter of its rights under a negotiable debt instrument (typically a bill of exchange or a promissory note) in return for an immediate (and most likely) reduced payment of the face value of such instrument by the forfaiter (most likely a bank or financial institution).

The "cost" to the exporter (that is, the amount of cash it receives against its accounts receivable) is calculated based on the risks connected to payment of the instrument (including credit, economic and political risks). These risks are borne by the forfaiter until he can either:

- Gain payment on the instrument.
- Sell the promissory note in the secondary market.

Risk can be transferred from a primary forfaiter to a secondary forfaiter (*see box, Forfaiting: an example*). Any transfer of the instrument is on a non-recourse basis, meaning that if there is non-payment, the bank or financing institution that purchases such promissory note waives (or forfeits) its rights of recourse against the exporter and must pursue the importer for payment if the importer fails to pay any amount when due.

For an example of how a forfaiting transaction operates, see box, *Forfaiting: an example*.

Forfaiting is an area of international trade that has no governing, standardised rules of operation, unlike for example, the UCP, which governs the operation of letters of credit.

There have, however, been recent efforts to implement a global set of rules to cover forfaiting transactions. In June 2009, the International Chamber of Commerce and the International Forfaiting Association announced the creation of a drafting group for the purposes of taking the first steps to prepare and implement a codified governing set of rules. It may take several years before a final document is eventually approved.

ADVANCE PAYMENT BONDS AND GUARANTEES

An advance payment bond or guarantee, also known as a progress bond, is a guarantee or bond provided by a party receiving an advanced payment to the party providing such advanced payment. At the exporter's request, the issuing bank or institution issues the advance payment bond or guarantee in favour of the importer. This ensures that if the exporter fails to comply with its obligations under the relevant contract the importer can call on the advance payment bond or guarantee to be reimbursed the sums that it has paid in advance.

The terms of the advance payment bond or guarantee determine whether the importer is entitled to a refund of payments made on demand, or on the occurrence of certain contractually agreed events. Such terms are up to the negotiation of the individual parties, based on the individual circumstances of each transaction.

Use in international trade

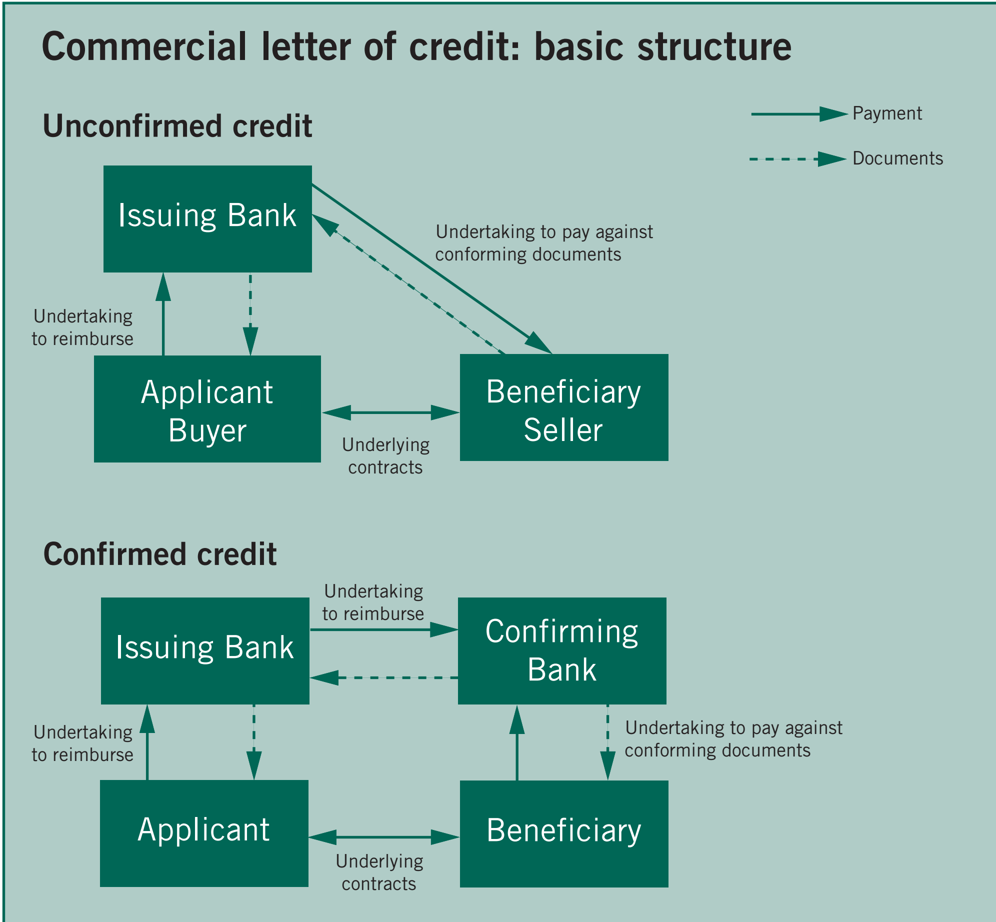
An advance payment bond or guarantee is used as a "statement of intent" between contracting parties and, as such, is likely to be used where parties do not have an existing business relationship. The advance payment bond illustrates to the exporter that the importer is serious in its intention to purchase the proposed goods and/or services. It is a useful facilitating tool as it provides a "middle-man" service to both the importer and exporter to ease concerns regarding payment obligations between unfamiliar parties.

Such advance payment bonds and guarantees are used in a variety of trade finance transactions, however, they are used particularly in the construction and engineering industries.

CHOOSING THE RIGHT INSTRUMENT

The options available to finance international trade transactions are as varied and distinct as the transactions themselves. A number of considerations should be borne in mind when deciding which product is most suitable for any given transaction. Such considerations include:

- Trade usage (commercial acceptance).
- The speed at which payment needs to be made.
- The existence (or non-existence) of a commercial relationship between the contracting parties.


Commercial letter of credit: basic structure
Unconfirmed credit
Payment
Documents
Issuing Bank
Undertaking to pay against
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Undertaking
to reimburse
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Buyer
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Seller
Underlying
contracts
Confirmed credit
Undertaking
to reimburse
Issuing Bank
Confirming
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Undertaking
to reimburse
Undertaking to pay against
conforming documents
Applicant
Beneficiary
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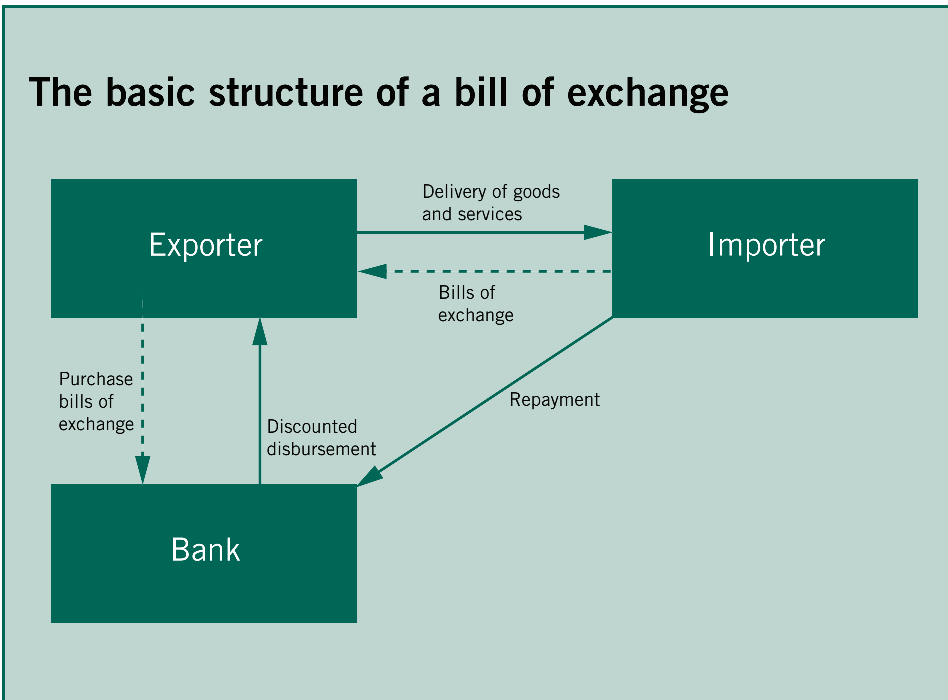
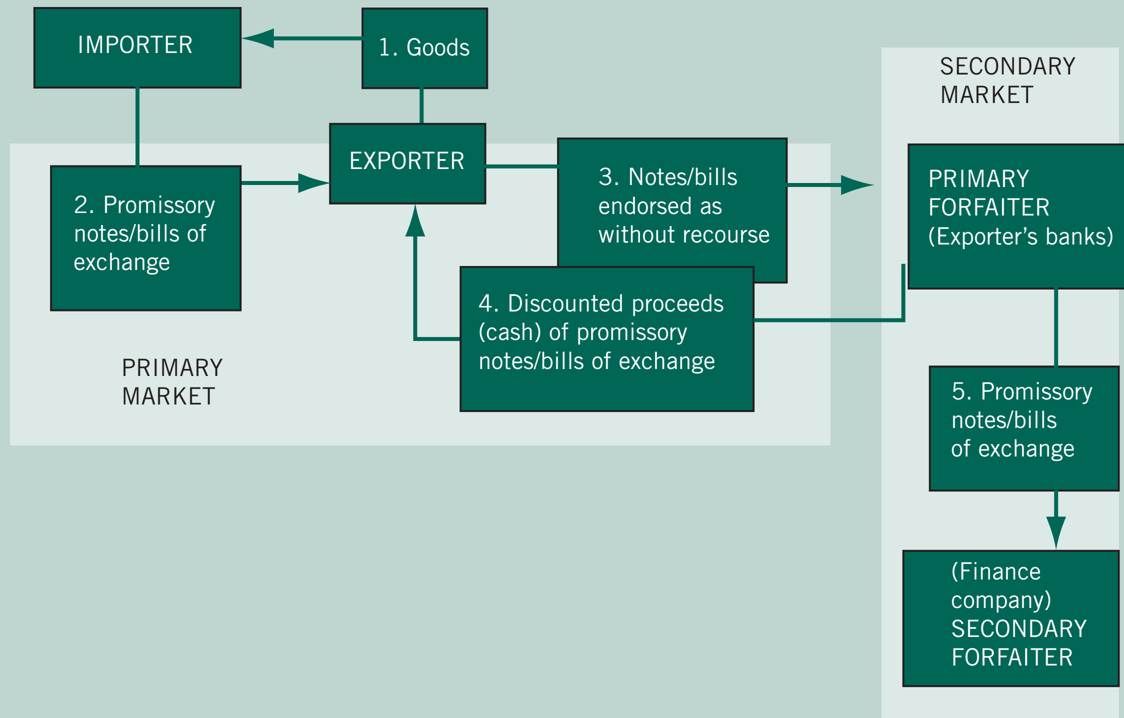

The basic structure of a bill of exchange
Exporter
Delivery of goods
and services
Importer
Bills of
exchange
Purchase
bills of
exchange
Discounted
disbursement
Repayment
Bank

Forfaiting: an example



The above example demonstrates a typical forfaiting transaction, which operates as follows:

- First, the importer receives the goods; the importer then transfers the promissory notes and/or bills of exchange to the exporter for payment for such goods (the promissory notes are guaranteed by the importer's bank).
- The exporter endorses these promissory notes and/or bills of exchange as being "without recourse", and then further transfers them to the primary forfaiter.
- The exporter receives discounted proceeds on the promissory notes and/or bills of exchange from the primary forfaiter. These activities take place in what is known as the "primary market", that is, the market containing all of the original parties to the transaction (importer, exporter and primary forfaiter).

The primary forfaiter may do one of two things following completion of the initial forfaiting transaction:

- Keep hold of the promissory notes and claim repayment from the importer on the repayment date.
- On-sell the promissory notes to a "secondary forfaiter". Accordingly, the secondary forfaiter can recover the face value of the promissory note (together with any interest payable) on the repayment date.

The advantage for the exporter is that he receives his cash much sooner than if he had to wait for payment on the original promissory notes. However, he receives an amount that is less than if he waited for payment under the document's terms. The exporter, by entering into a forfaiting transaction, has effectively transferred a number of potential risks, including non-payment, country/political and currency risks.

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