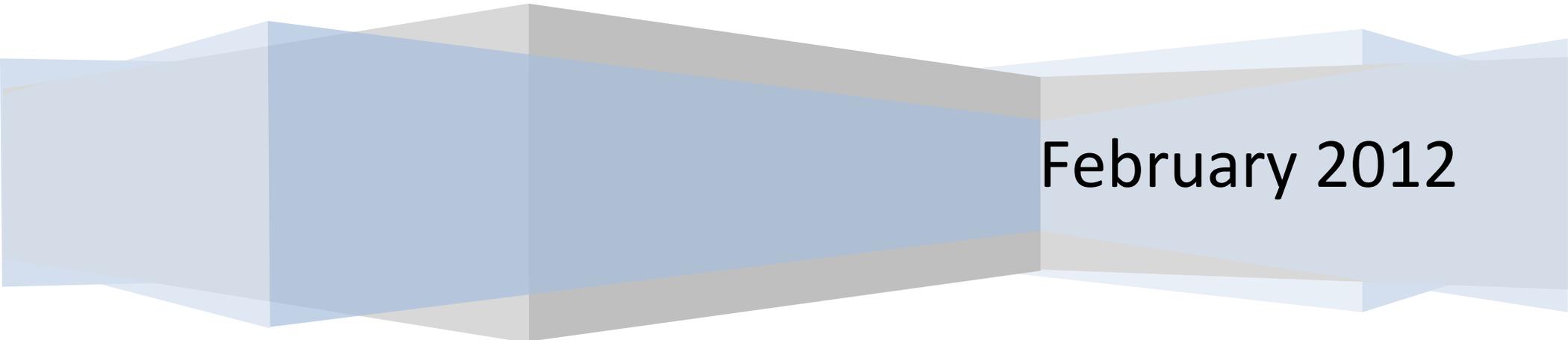


Traditional Trade Finance Definitions

Product Definitions for Trade Finance

BAFT-IFSA Global Trade Industry Council



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Product Definitions for Traditional Trade Finance

Section 1: Introduction

Banks have long provided trade finance services - processing information, managing documents, providing financing, and facilitating payments related to trade transactions through various products. With the advent of technology, new variations of trade finance products (specifically new open account products) have evolved but the fundamentals of traditional trade products have remained constant. Given the renewed interest in trade finance products in general, it is an appropriate time to review trade finance products and provide definitions that can serve as a common reference point for banks, their customers, regulators, service providers, and other stakeholders, in order to provide a base clarity as the trade finance marketplace continues to grow and evolve.

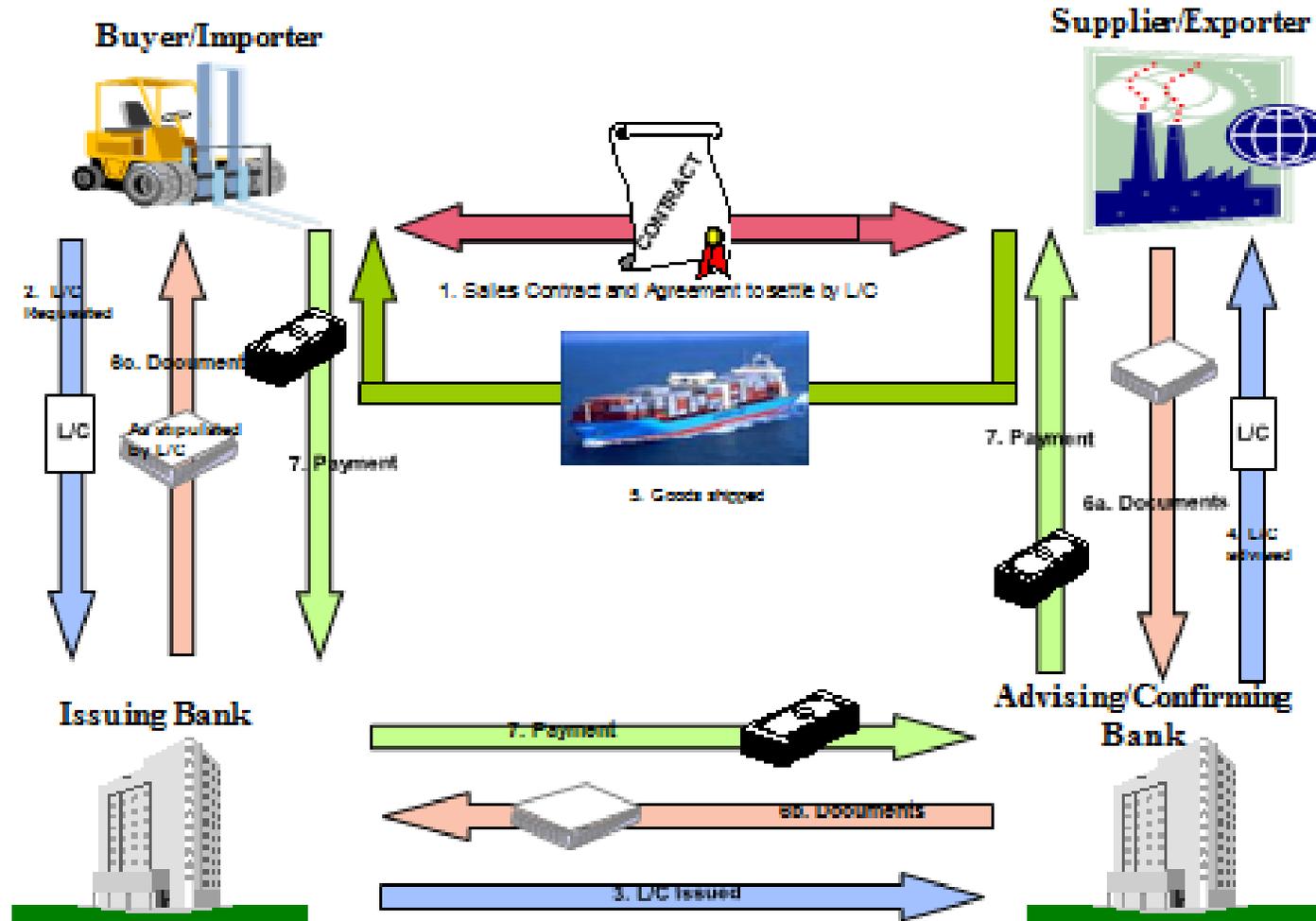
Traditional trade products are typically short-term (less than one year in tenor), self-liquidating transactions. The most basic of these are documentary in nature, and in most cases these transactions are contingencies that remain off balance sheet. As there is a commercial transaction underlying the trade financing, they tend to be low risk transactions with an easily identifiable use of funds. Rules for traditional trade products are widely accepted and are documented in publications from the International Chamber of Commerce (ICC) including:

- Uniform Customs & Practice (UCP 600)
- International Standby Practices (ISP 98)
- Uniform Rules for Collections (URC 522)
- Uniform Rules for Bank-to-Bank Reimbursements (URR 725)
- Uniform Rules for Demand Guarantees (URDG 758)

Additionally, there are forms of Trade Finance that are widely accepted, but not necessarily governed by ICC publications as mentioned above. In some instances, a transaction results in an advance of funds or commitment to pay that becomes a balance sheet item for the bank. These transactions will be described as well, with the understanding that the consistent element of these transactions is an underlying commercial trade transaction between buyer and seller.

Based on market feedback, BAFT-IFSA will build upon these definitions and will further international standards and documentation to govern Trade Finance transactions among financial institutions and their counterparties.

Documentary Letter of Credit Flow



Section 2: Trade Finance Definitions - Traditional Documentary Products

Traditional Trade Finance products have existed in some form for hundreds of years. Generally speaking, banks have served as intermediaries to facilitate the flow of documents (information) and payments related to the flow of goods in international trade or to provide assurance relating to the performance or financial obligations of a person or company to another. Different products provide importers and exporters with varying levels of risk mitigation and/or financing.

1. Collections

Collection refers to the handling by banks of documents, in accordance with instructions received, in order to obtain payment and/or acceptance or deliver documents against payment and/or against acceptance or deliver documents on other terms and conditions (Source URC 522). Specifically, (i) A Collection that is payable at Sight is known as **Documents against Payment (D/P)**. The documents are sent to the presenting/drawee bank and delivered to the drawee against payment. (ii) A Usance Collection is known as **Documents against Acceptance (D/A)**. The documents are sent by the principal/drawer to the presenting bank and delivered to the drawee against the buyer's commitment to pay at a future date. Such commitment is usually evidenced by a bill of exchange, issuance of a promissory note, or an undertaking to pay at a future date, which, when accepted by the drawee/buyer for payment at a future date, is known as a trade acceptance.

Unlike a letter of credit there is no explicit undertaking by a bank to make finance available, however, the Remitting bank may choose to finance the exporter at the bank's own risk with or without recourse, by purchasing the bill or by discounting the unaccepted bill before despatch to the presenting or collecting bank. The remitting bank may also discount the advice of the drawees acceptance without cognisance of the presenting or collecting banks co-acceptance. If the presenting/collecting bank is requested to co-accept or avalize the accepted bill it may do so. In some circumstances the presenting/collecting bank may also offer finance to the remitting bank by discounting its own acceptance, or in response to the request of the drawer through the presenting bank, provide a discounted advance payment.

2. Letters of Credit (LCs)

A letter of credit is an arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honor a complying presentation. There are two main types --- a Commercial (or Documentary) Letter of Credit and a Standby Letter of Credit. Commercial Letters of Credit typically are used to assure payment for a transaction involving the movement of goods and involve the presentation of commercial documents that usually transfer title of the underlying goods, while Standby Letters of Credit are typically used as performance or financial assurances and are payable against a simple demand or a demand and a statement. These are defined in greater detail below.

A. Commercial (Documentary) Letters of Credit

A Commercial (Documentary) Letter of Credit is a written undertaking given by a bank (Issuing Bank), at the request of a buyer (Applicant), to pay the seller (Beneficiary) of goods or services provided that the seller strictly fulfills a defined set of documentary terms and conditions specified in

the letter of credit. Any amendment of the LC requires the consent of all participants. Such credits are normally governed by the International Chamber of Commerce (ICC)'s Uniform Customs and Practice (UCP). UCP 600 came into effect in July 2007.

(i) **Commercial (Documentary) Letters of Credit --- Availability**

The Commercial LC will specify how and when the payment/proceeds will be made available:

- a. **Sight** indicates the Letter of Credit is payable upon presentation of documents in compliance with the terms and conditions of the LC and may or may not include a Draft/Bill of Exchange.
- b. **Usance** indicates the Letter of Credit is payable on some future date after presentation of documents in compliance with terms and conditions of the LC.
 - i. **Deferred Payment** is a promise of the Issuing Bank to pay a certain sum of money on a future fixed date. No Draft/Bill of Exchange or other negotiable instrument is required.
 - ii. **Acceptance** of Draft(s) drawn on the Issuing Bank (or Nominated Bank) represents a promise of the accepting bank to pay a certain sum of money on a fixed date. Such future date may be a pre-determined fixed date or based on a period of time after shipment date or presentation date
- c. **Negotiation** indicates that the LC may be negotiated either by any bank of the beneficiary's choosing (freely negotiable), or, by a specifically nominated bank.

(ii) **Commercial (Documentary) Letters of Credit --- Risk Mitigation**

1. **Unconfirmed Letter of Credit** - The Issuing Bank is obligated to pay upon presentation of conforming documents and at the designated time specified within the letter of credit. There is no obligation on the part of the Advising Bank should the Issuing Bank not pay. The Advising Bank is solely responsible for the authenticity of the letter of credit.
2. **Confirmed Letter of Credit** - A Commercial Letter of Credit in which the Issuing Bank requests and nominates a second bank (often the Advising Bank) to add its payment undertaking to the letter of credit in addition to that of the Issuing Bank. The confirming bank becomes a participant of the LC and their consent to any amendment or cancellation is also required. Such commitment from this second bank provides additional comfort to the seller who wishes to mitigate the country and bank risk of an Issuing Bank.
3. **“Silently” Confirmed Letter of Credit** - A Silent Confirmation is typically undertaken at the request of the Beneficiary instead of the Issuing Bank, and without the knowledge of the Issuing Bank. A bank that adds this type of confirmation undertakes to honor or negotiate compliant documents by direct arrangement with the beneficiary. The 'Silent' Confirming Bank's obligation is evidenced by a separate undertaking document which is outside the terms of the letter of credit and this distinct bilateral arrangement is not covered by the ICC rules. By contrast to an "open" confirmation, the silently confirming bank is not a participant in the LC according to UCP.
4. **Reimbursement Undertaking** - Irrevocable guarantee by the reimbursing bank to a nominated bank/claiming bank (to whom documents under a letter of credit would be presented for payment) to honor their reimbursement claim. An IRU can be based upon the request of an issuing bank or can be silent to the issuing bank.

(iii) **Commercial (Documentary) Letters of Credit - Special characteristics**

- a. **Revolving Credit** – A commitment on the part of the issuing bank to automatically restore the credit value to the original (or other) amount after it has been drawn upon. This is typically used for instalment or multiple delivery contracts and may revolve around time or value.
- b. **Transferable Credit** – The original letter of credit allows the beneficiary to transfer all or part of the originally issued letter of credit (Master LC) to another party (one or more second beneficiary) and specifically states that the LC is transferrable.
- c. **Back-to-Back Credit** – A separate letter of credit is issued at the request of the beneficiary of an original letter of credit using the original letter of credit as a model and/or collateral for the bank issuing the second letter of credit.
- d. **Front-to-Back or “To Arrive” Credit** - The second letter of credit is issued without the benefit of the original Master credit being available. In some markets this is also known as an “Export will Buy” credit where the master credit leg is replaced with a commitment to discount or purchase an export collection to pay out the import credit.
- e. **Red Clause** – A clause authorizing the nominated bank to make advances to the beneficiary (usually by simple receipt) prior to the shipment of goods or presentation of documents.
- f. **Green Clause** – A green clause credit is the same as a “Red Clause” credit except that pre-shipment advance is made against beneficiary’s presentation of title document to the goods made to the order of the bank or its nominated agent, evidencing storage of the goods in a warehouse in the exporter’s country..
- g. **Assignment of Proceeds** – A beneficiary may assign all or part of the proceeds of a letter of credit to another party (assignee). The original beneficiary maintains sole rights to the letter of credit and the payment to the assignee is contingent upon payment under the original letter of credit.

B. Standby Letters of Credit

A Standby Letter of Credit is a written undertaking given by a bank (Issuing Bank), at the request of an Applicant, which can be a bank, to provide assurance to a Beneficiary regarding the Applicant's (or a third party's) performance or financial obligations, that promises to pay the Beneficiary against presentation of a documentary demand conforming with the terms and conditions specified in the letter of credit. Unlike a commercial letter of credit, which is expected to be the means of payment in the underlying transaction, a standby letter of credit is typically not drawn unless there is some manner of default in the underlying transaction. Such credits are normally governed by the ICC rules (UCP or ISP 98).

(i) Standby Letters of Credit --- Risk Mitigation

- a. **Confirmed Standby Letter of Credit** --- A Standby Letter of Credit in which the Issuing Bank requests and nominates a second bank (often the Advising Bank) to add its undertaking to the Standby Letter of Credit, in addition to that of the Issuing Bank, to honor a compliant claim without recourse to the Beneficiary. Generally governed by ICC rules, such confirmation provides additional comfort to the Beneficiary who wishes to mitigate the bank risk of the Issuing Bank, or to credit enhance the undertaking of the Issuing Bank.
- b. **“Silently” Confirmed Standby Letter of Credit** --- A Silent Confirmation is typically undertaken at the request of the Beneficiary instead of the Issuing Bank. A silently confirming bank undertakes to honor a compliant claim made under a Standby Letter of Credit. The Silent Confirming Bank's obligation is evidenced by a separate undertaking document which is outside the terms of the Standby Letter of Credit and this distinct bilateral arrangement is not covered by the ICC rules.

(ii) Standby Letters of Credit --- Categories

- a. **Performance Standby Letters of Credit (or Performance Bond)** --- is issued to guarantee performance of the Applicant (or a third party) under a contract. It is considered a show of “good faith” and is not normally expected to be drawn upon. Advance Payment and Bid Bonds are also generally considered to be similar in nature to Performance Bonds. Performance standby LCs are related to underlying commercial trade transactions.
- b. **Financial Standby Letter of Credit** --- is issued to guarantee future payment obligation(s). The Financial Standby LC will only be drawn upon should the Applicant (or a third party) not make the payment(s) as expected. This instrument may also be used in lieu of cash collateral. Financial standby LCs are NOT related to underlying commercial trade transactions.
** Financial standby LCs may NOT be considered Trade products where there is no underlying trade transaction.*

(iii) Standby Letters of Credit – Special Characteristics

- a. **Evergreen Clause** – Allows the letter of credit to be automatically extended until the issuing bank informs the beneficiary of its final expiration date.

3) Letters of Guarantee

A bank guarantee is an irrevocable promise of a bank to compensate the beneficiary under clearly prescribed conditions fully, immediately, and without failure for damages suffered. To be utilized in the event of default by the applicant of the letter of guarantee. Guarantees are usually governed by local law and different ICC rules (URDG 758 and others).

- a. Letter of Guarantee issued on behalf of another bank - Issuing Bank issues a Letter of Guarantee at the request of another bank, which issues a counter guarantee in favour of the Issuing Bank.
- b. "Silently" confirmed Letter of Guarantee issued by another bank - Issuing Bank adds at the request of its customer a silent guarantee to a L/G issued by another bank in favour of said customer

Section 3: Trade Finance Definitions - Traditional Financing Products

Trade Finance lending also uses traditional products that have existed in practice for a long period of time, but are not necessarily governed by the same structured ICC rules that traditional documentary products use. Nevertheless, industry practice and standards have demonstrated these instruments to be fairly widely used, fairly consistent in structure and application, and consistently low-risk. These are funded assets that in some cases originated as contingents. The key differentiating component of these financing methods are that they all support identifiable trade transactions.

1. Trade Loans

Trade loans occur when a lender grants a loan to a corporate or bank client to finance clearly defined trade transactions. The proof of the underlying trade transaction comes either from local regulatory practice (e.g. currency control), documentary evidence, or from the way the transaction is structured. Such evidence may include shipping documents or other documents that demonstrate the financing to be consistent with the goods or services imported/exported (e.g. tenor of loan is consistent with goods being financed).

Loans typically come from a flexible short-term borrowing facility and may facilitate a pool of trade transactions (e.g. bank loans) or be linked to single transactions. Loans may be made against either corporate risk or bank risk.

- A. **Import Loans** – provide financing for the importation of goods or services. These loans are often a bridge to enable importers to pay suppliers on a timely basis, while providing additional time to convert imported goods into cash receipts. Import loans are often made against evidence of shipment and/or supplier invoices.
- B. **Export Loans** – provide financing for the exportation of goods or services. Export loans are typically needed to fund activities required prior to shipment. Loans may be made to banks to enable them to fund pre-export activity on behalf of their customers. Some banks may consider LC discounting a form of export loans, while others measure LC discounting separately.

2. LC Financing

Letters of credit are contingent instruments, that are payable only at such time as the terms of the letter of credit have been complied with. Nevertheless, there are instances when banks choose to advance funds during the course of the life cycle of the letter of credit, and certain events trigger the contingent liability to become on-balance sheet.

- A. **Negotiation** - the purchase by the nominated bank of drafts (drawn on a bank other than the nominated bank) and/or documents under a complying presentation, by advancing or agreeing to advance funds to the beneficiary on or before the banking day on which reimbursement

is due to the nominated bank. Banks often deduct the cost of advancing funds from the proceeds based on the expected time between the negotiation and reimbursement from the Issuing Bank.

- B. Acceptance** – the accepted draft under the LC becomes a negotiable instrument. The holder in due course can hold until maturity, or receive discounted funds in advance.
- C. Bills of Exchange / Promissory Notes** – a bill of exchange is a written order from the drawer to the drawee to pay the payee on demand or at a fixed date. A promissory note is a written unconditional promise to pay the payee (or bearer) on demand or at a date in the future. In negotiable form, these instruments also function similar to acceptances in that the holder in due course can hold until maturity or receive discounted funds. The difference being when the maker of a note pays the payee directly, rather than ordering a 3rd party to do so.
- D. LC Refinancing / Post-Shipment Financing** – through the wording of the LC, the issuing bank requests the presenting bank to pay the exporter through a loan granted to the issuing bank. At final maturity, the issuing bank repays the presenting bank the principal plus interest.
- E. LC Financing by Reimbursement Bank** - The Issuing Bank opens a Commercial LC and nominates a Reimbursement Bank which agrees to pay the reimbursement claim of an entitled claiming bank and grant a pre-agreed loan to the Issuing Bank. The Issuing Bank repays principal plus interest to the reimbursing bank at maturity.

3. Trust Receipts

When issuing a Trust Receipt, the bank enables the importer to obtain goods and/or shipping documents while retaining title/ownership. The importer that obtains the goods (or proceeds from sale of the goods) is obligated to identify and maintain them separate from other assets. Payment is made by the importer by the Trust Receipt due date. Trust receipts may be set up as specific facilities, or may be treated as import loans.

4. Shipping Guarantees

A Shipping Guarantee is an indemnity that the bank executes jointly and severally with its customer in favour of a shipping company, enabling the importer to obtain goods without the actual title documents (e.g. bills of lading). This is used when the goods arrive prior to the actual title documents, and the buyer wish to obtain the goods so as to avoid demurrage charges or losses due to deterioration of goods (esp. Perishables). Settlement occurs upon receipt and processing of the documents. Release of the Guarantee occurs after the surrender of the original bills of lading to the Steamship Company.

5. Forfaiting

Forfaiting is the sale of an export receivables transaction to a 3rd party for immediate payment at a discount. It includes a number of different underlying instruments including:

- Bills of exchange / promissory notes – negotiable instruments which provide for payment of a fixed sum on a fixed future date and which can be transferred to third parties through endorsement, assignment or novation. These instruments can also be used in other Traditional Trade Finance solutions.
- Deferred payment letters of credit
- Loans and payment undertakings / receivables including open account receivables
- Any other trade finance instrument that has a fixed value and maturity date

Forfaiting differs from factoring in that it is transaction-based as opposed to pool-based, and typically has relatively large transaction sizes. Forfaiting instruments may also carry the guarantee of a bank or foreign government. Transactions normally have a tenor of 6 months to medium-term (3-5 years), but may range from less than 6 months to upwards of 10 years. Forfaiters may hold the assets to maturity or trade them in a well established secondary market.