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Indo-German Cooperation on **Agricultural Market Development**

Building sustainable partnerships



INTERNATIONAL TRADE & FINANCE

Compiled by

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Indo-German Cooperation on
Agricultural Market Development

Preface

The Indo-German Cooperation on Agricultural Market Development (AMD) Project is intended to contribute to the sustainable economic growth of India's agricultural sector and improve livelihoods in rural regions. The project's goal is to support India's strategy for modernizing agricultural markets and enhance knowledge and skills on the various key aspects of international Agribusiness management, specifically targeting the European Union (EU) markets. The project further focuses enhancing the knowledge on international market management; outlook to identify markets and buyers; Indian and EU trade policies; import regulations and associated incentives; agri trade logistics & management; emerging foreign trade policies; and tools for enhancing price competitiveness in the global markets.

It is with great pleasure that we present an e-book, "International trade and finance". The e-book comprises information on export food trade policies and showcasing the need and scope of export opportunities in Rajasthan, Odisha, and Uttar Pradesh states. The e-book will give information and knowledge to upcoming entrepreneurs and learn the details to start a foreign trade operation. The e-book has been prepared to provide basic knowledge about the export-import management of agri. commodities in seven parts. This e-book is a part of the series of seven e-books as

1. India's agri-food trade policies and export incentives
2. European union agri-food trade policies and import regulations
3. Product and market identification for exports
4. International marketing management
5. Trade operations and documentation
6. Agri-trade logistics and customs regulation
7. International trade and finance

We wish all the officials from the agriculture and marketing division/APMCs, state representatives from the Directorate of Marketing and Inspection (DMI), and leading exporters/ agri-startups/ FPO CEOs/ FPOs resource institutions that will benefit from the e-book and get knowledge about export-import operations.

**Dr. Ramesh Mittal, Director,
CCS National Institute of Agricultural Marketing**

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International Trade and Finance



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Indo-German Cooperation on Agricultural Market Development

Chapter No 1

Payment Terms and UCP 600

Payment Terms and UCP 600

Dr. Asheesh Pandey

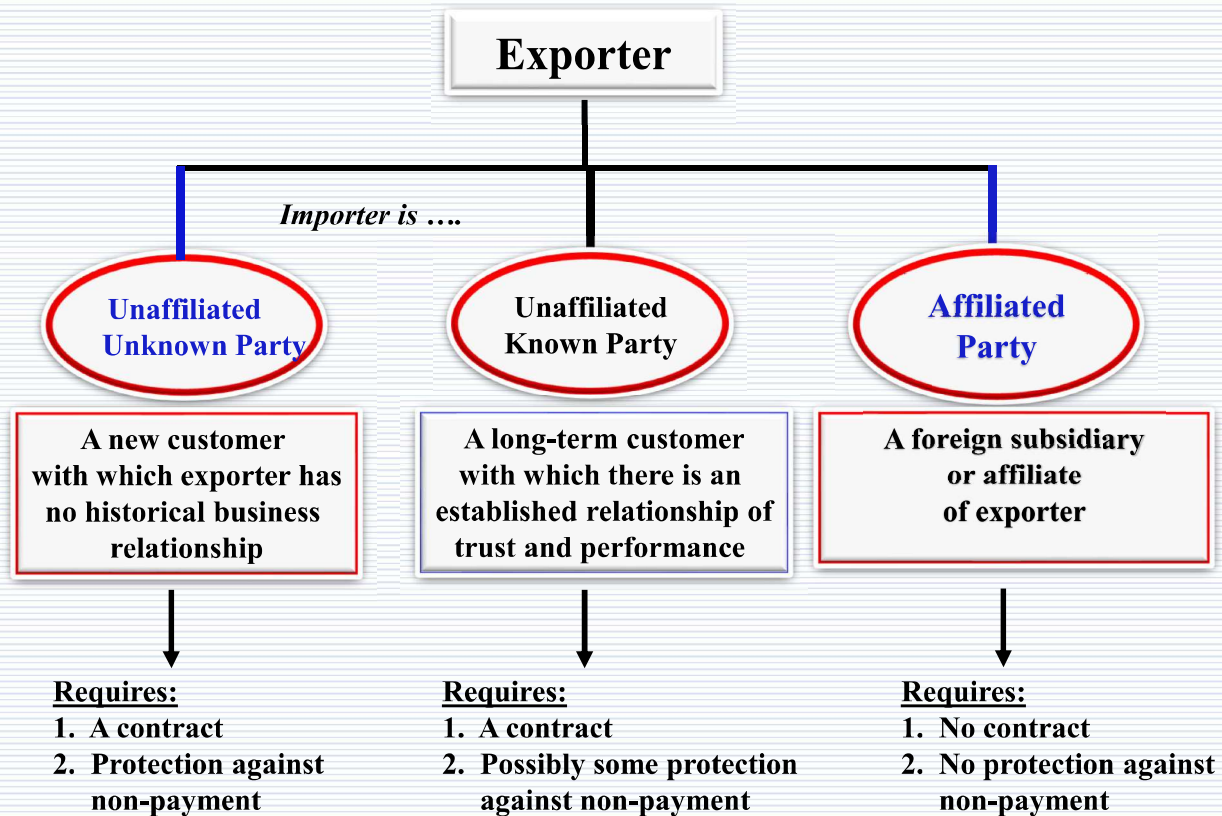
Indian Institute of Foreign Trade
New Delhi

The Trade Relationship



- The nature of the relationship between the exporter and the importer is critical to understand the methods for import-export financing utilized in industry.
- There are three categories of relationships (see next exhibit):
 - Unaffiliated unknown
 - Unaffiliated known
 - Affiliated (sometimes referred to as *intra-firm trade*)
- The composition of global trade has changed dramatically over the past few decades, moving from transactions between unaffiliated parties to affiliated transactions.

Alternative International Trade Relationships

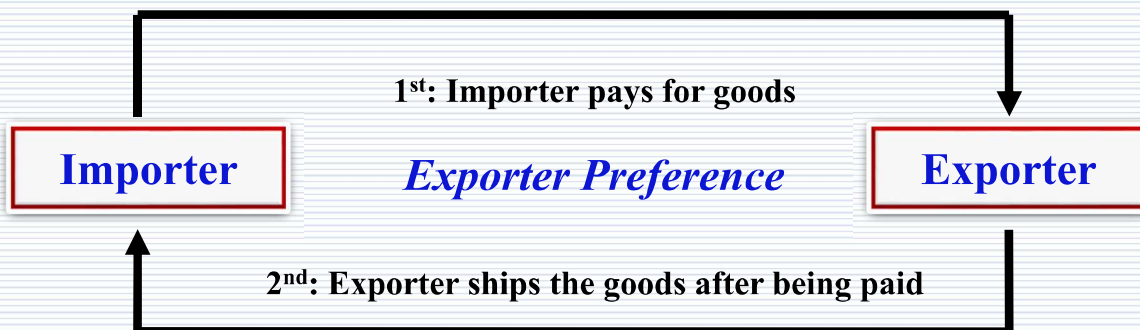


The Trade Dilemma



- International trade (i.e. between an importer and exporter) must work around a fundamental dilemma:
 - They live far apart
 - They speak different languages
 - They operate in different political environments
 - They have different religions
 - They have different standards for honoring obligations
- In essence, there could be distrust, and clearly the importer and exporter would prefer two different arrangements for payment/goods transfer

The Mechanics of Import and Export

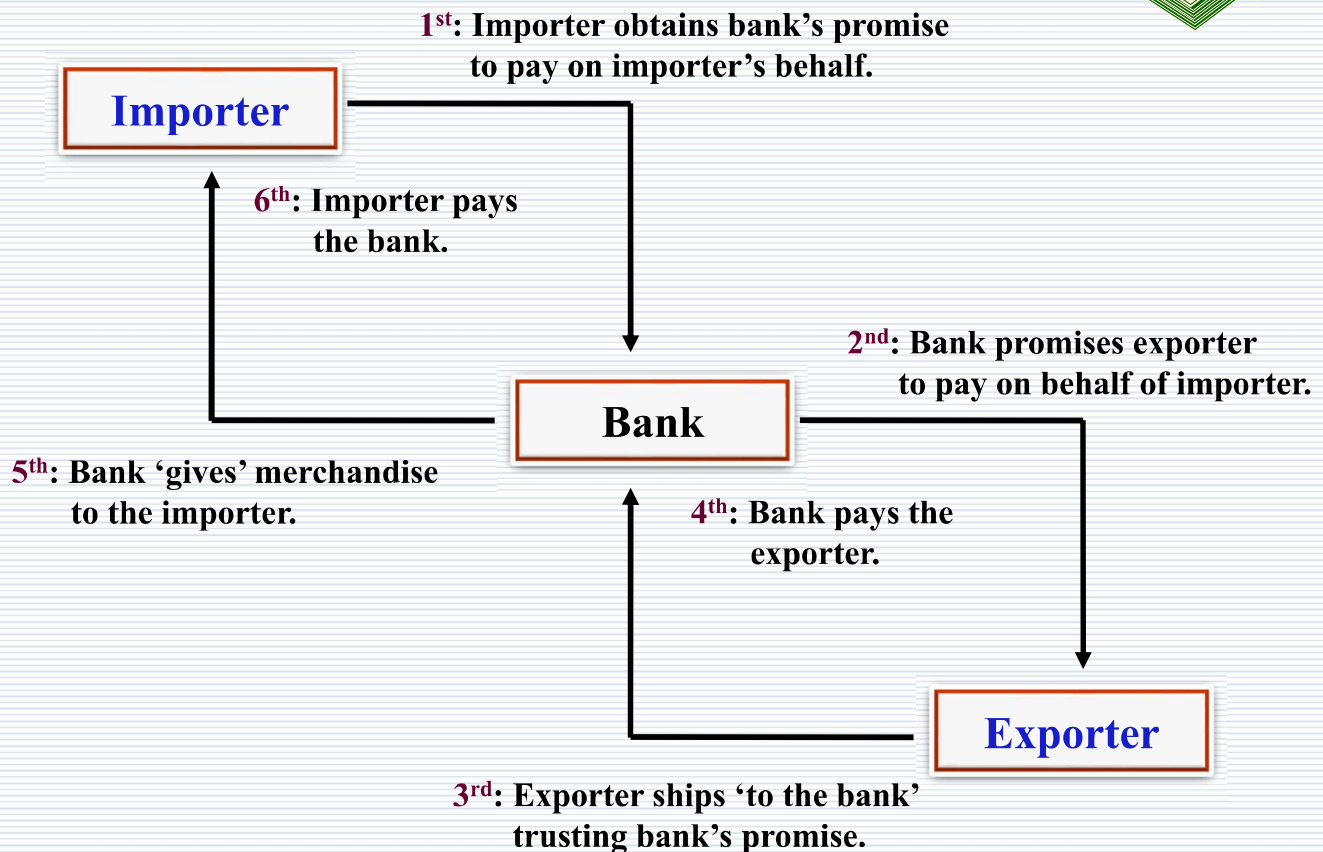


The Trade Dilemma



- The fundamental dilemma of being unwilling to trust a stranger in a foreign land is solved by using a highly respected bank as an intermediary.
- The following exhibit is a simplified view involving a *letter of credit* (a bank's promise to pay) on behalf of the importer.
- Two other significant documents are an *order bill of lading* and a *sight draft*.

The Bank as the Import/Export Intermediary



Benefits of the System



- The system (including the three documents discussed) has been developed and modified over centuries to protect both importer and exporter from:
 - The risk of non-completion
 - Foreign exchange risk
 - To provide a means of financing

Elements of an Import/Export Transaction



- Each individual trade transaction must cover three basic elements: contract, prices, and documents regarding shipping and delivery instructions.

Contracts:

- An import or export transaction is by definition a contractual exchange between parties in two countries that may have different legal systems, currencies, languages, religions or units of measure
- All contracts should include definitions and specifications for the quality, grade, quantity, and price of the goods in question

Elements of an Import/Export Transaction



Prices:

- Price quotations can be a major source of confusion
- Price terms in the contract should conform to published catalogs, specify whether quantity discounts or early payment discounts are in effect, and state whether finance charges are relevant in the case of deferred payment, and should address other relevant fees or charges

Elements of an Import/Export Transaction



- **Documents:**

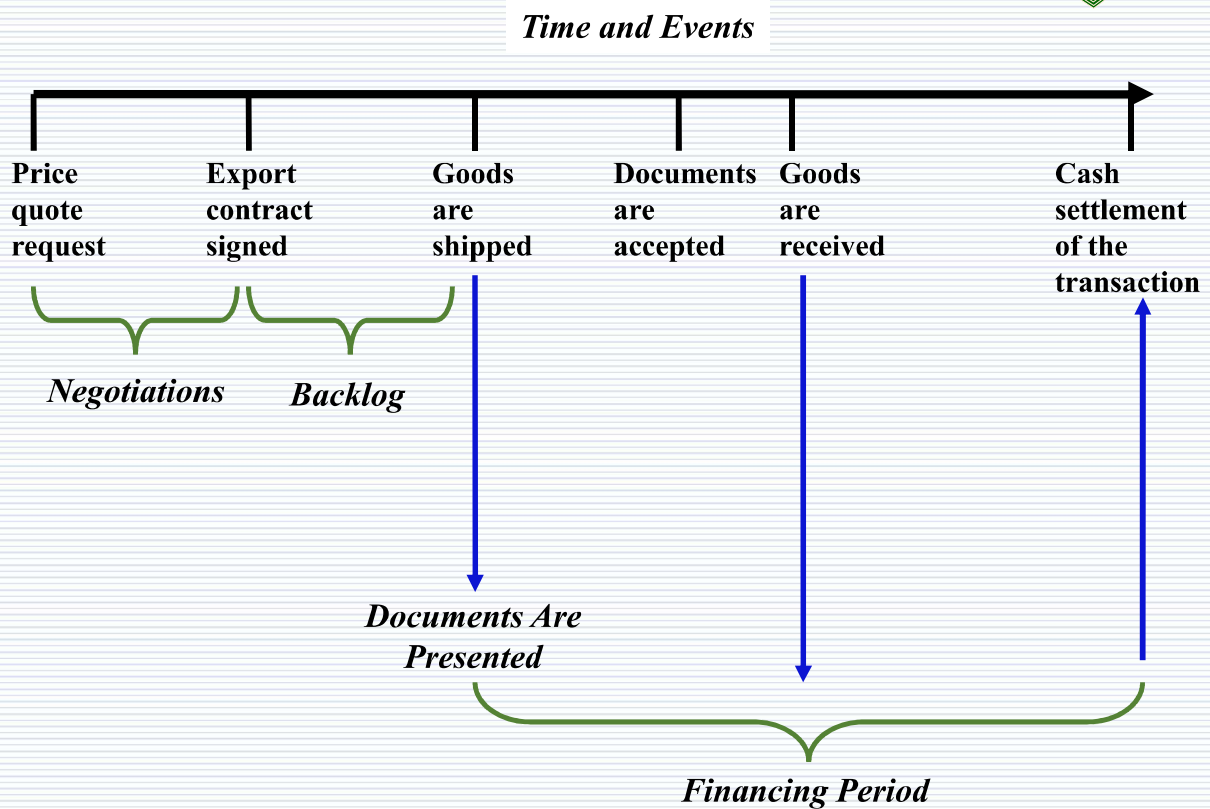
- *Bill of lading* – issued to the exporter by a common carrier transporting the merchandise. It serves three purposes: a receipt, a contract, and a document of title
- *Commercial invoice* – issued by the exporter and contains a precise description of the merchandise (also indicates unit prices, financial terms of the sale etc.)
- *Insurance documents* – specified in the contract of sale and issued by insurance companies (or their agents)
- *Consular invoices* – issued in the exporting country by the consulate of the importing country
- *Packing lists*

International Trade Risks

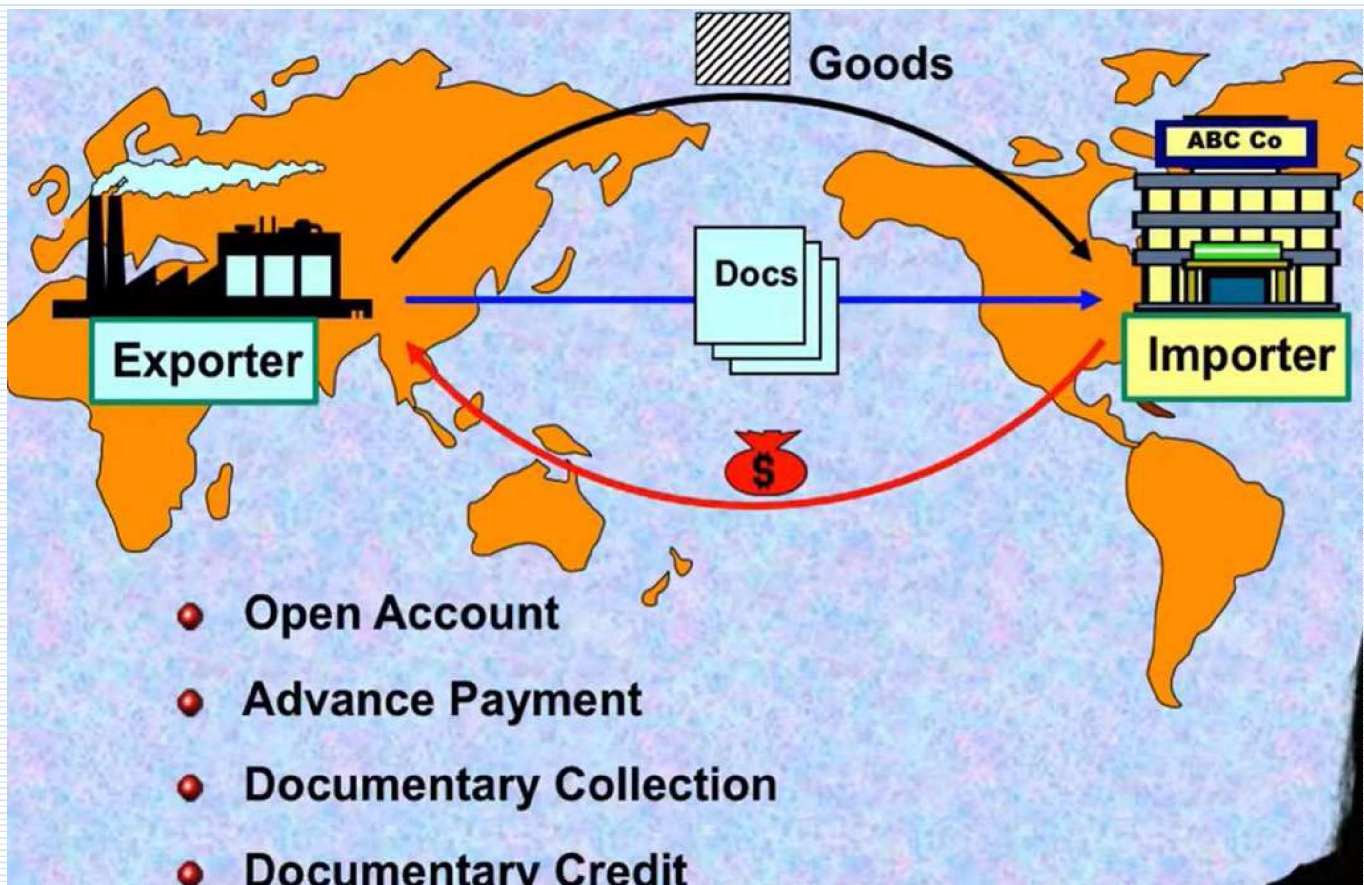


- The following exhibit illustrates the sequence of events in a single export transaction.
- From a financial management perspective, the two primary risks associated with an international trade transaction are *currency risk* (currency denomination of payment) and *risk of non-completion* (timely and complete payment).
- The risk of default on the part of the importer is present as soon as the financing period begins.

The Trade Transaction Time-Line and Structure



Methods of Payment



Bills



- Documents are necessary and integral to most trade transactions, serving wide ranging requirements
- They are generated for transfer of possession or ownership, statutory obligations, regulatory requirements and so on.
- A set of documents relating to a particular shipment are called as *shipping documents*
- A complete set of documents (bills) relating to a particular shipment may be loosely termed as bills for collection, export bills, usance bills, import bill or LC bill etc.
- A set of these 'bills' may include bills of exchange, commercial invoice, transport documents, quality certificate, packing list, weight list, certificate of origin, phytosanitary certificates and so on

Documents Direct to Importer



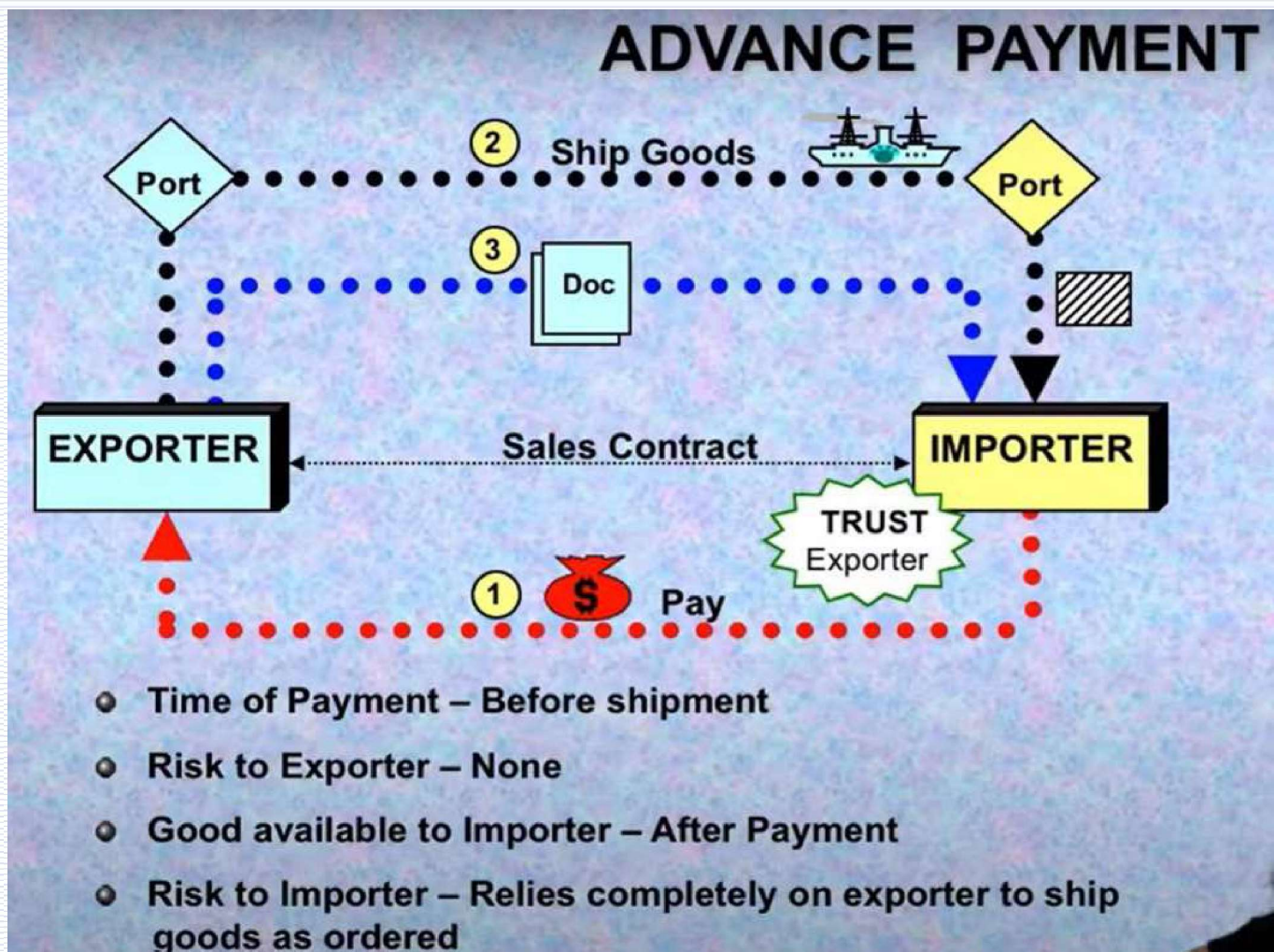
- When the goods are consigned directly to the buyer to enable it to take delivery of consignment, commercial banking system need not be used
- Shipping documents can be directly dispatched by seller to buyer
- Commercial banking system may be used but only for remittance of the proceeds
- Transactions of this type are mainly used where settlement is:
 - a. Against advance payment/Prepayment
 - b. On open account
 - c. Through escrow
 - d. Against bank guarantee/payment guarantee

Payment Methods for International Trade



Method : Prepayments/ Advance payment

- The goods will not be shipped until the buyer has paid the seller.
- *Time of payment* : Before shipment
- *Goods available to buyers* : After payment
- *Risk to exporter* : None
- *Risk to importer* : Relies completely on exporter to ship goods as ordered



Advance Payment or Pre-Payment Steps



1. Agreement of Sales Contract
2. Advance remittance
3. Shipment of Goods
4. Dispatch of documents
5. Payment of Balance if any

Payment Methods for International Trade



Method ☐ : Prepayments: Risk for seller

If full invoice value is received in advance, there is no risk. Most buyers, however, are not willing to bear all the risk by prepaying an order. Many a times the advance is paid partly, then seller's risk exposure may only be to the extent of amount not yet received.

Payment Methods for International Trade



Method □ : Prepayments: Risk for Buyer

- Risk is for the amount unreceived
- Buyer is dependent on seller for performance as per agreement which depends solely on integrity and commitment of buyer to pay seller
- Other risks like war or war like situation, damage or loss of goods in transit, inability of seller to fulfil his commitment inspite of being committed may wholly or partially frustrate main objective of buyer in receiving consignment
- Probable costs and delay in his efforts to recover funds paid in advance
- Seller may vary terms without consulting buyer
- The worst case is that buyer may never get goods and remain out of pocket of having parted away with funds

Payment Methods for International Trade



Method ① : Prepayments: Why Pay in Advance?

- a. To avoid procedural formalities, costs and delays
- b. Considerations of risk perceptions, relationship, track record
- c. If the quantity of value is small or if buyer can't negotiate or search for best buy; or is in extreme need of item
- d. Seller has necessary bargaining power "monopoly"
- e. Intention of buyer is to demonstrate his commitment to the transaction or seller wants to bind buyer to deal.
- f. Such arrangements are made for custom made goods, high value capital goods or speciality products that may not find alternate buyers if original purchaser defaults to pay

Payment Methods for International Trade



Method 2 : Open Accounts

- The exporter ships the merchandise and expects the buyer to remit payment according to the agreed-upon terms.
- Not supported by any traditional banking or documentary instrument
- *Time of payment* : As agreed upon
- *Goods available to buyers* : Before payment
- *Risk to exporter* : Relies completely on buyer to pay account as agreed upon
- *Risk to importer* : None

Payment Methods for International Trade



Method 2 : Open Accounts

- Sale on open account basis also called sale on ‘consignment’ or ‘account sale’ takes place when there is certain amount of mutual trust between two parties
- Seller sends goods and relevant documents directly to buyer
- If goods are dispatched unsecured, entire risk is on consignor-exporter
- Seller may reduce his risk if he can procure payment guarantee from buyer or a bank guarantee (BG)

Payment Methods for International Trade



Method 3 : ESCROW

- The importer deposits the purchase price with the Escrow, which is a third party before the shipment
- Third party: known as Escrow which collects, holds and disburses the purchase price according to a pre arranged procedure
- No universal rules to govern escrow
- Escrow acts only as an independent third party, as a custodian of buyer's funds till goods are accepted by buyer

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Payment Methods for International Trade



Method 3 : ESCROW

- *Time of payment* : The buyer inspects the goods and once he is satisfied, the payment is made
- *Goods available to buyers* : After payment
- *Risk to exporter* : Allows importer to check the inventory before paying exporter
- *Risk to importer* : Money is blocked before the shipment
- **USP (Unique Selling Proposition) of Escrow**: Buyer pays only after inspection of goods, if rejected funds may get locked up till dispute is resolved

Payment Methods for International Trade



Documents Through Bank:

- Most frequently shipping documents and drafts are routed through banks acting as intermediary

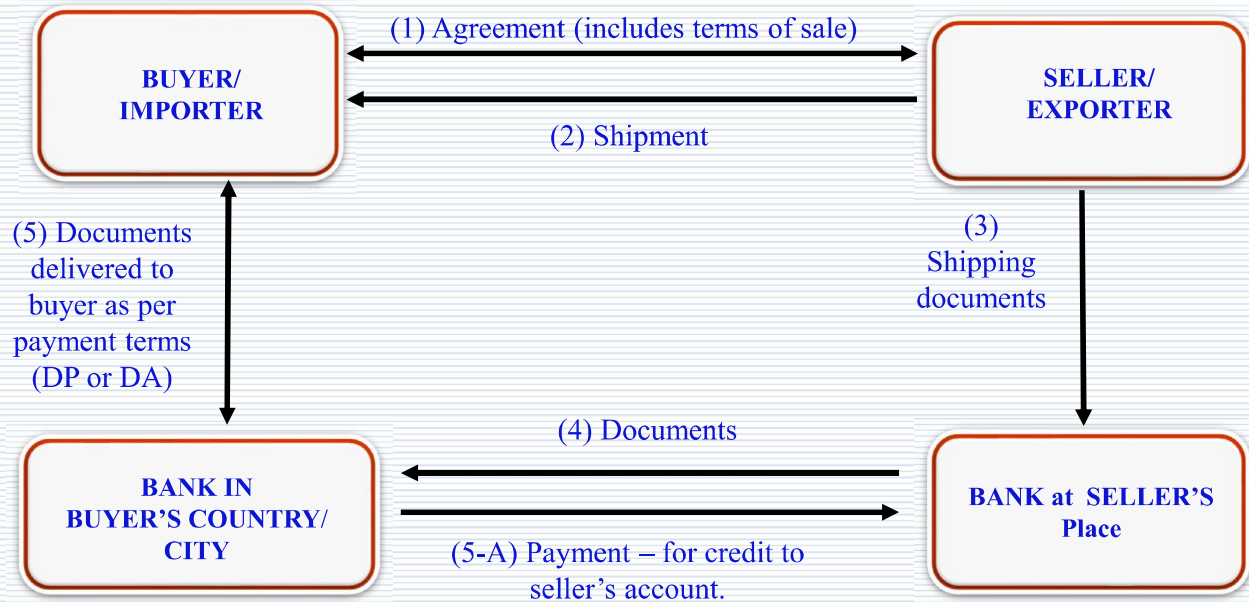
Payment Methods for International Trade



Documents Through Bank:

- This route offers greater safety than when goods are directly sent to buyer
- Following are commonly used methods of settlement under this method:
 1. Bills for collection (payable at sight or demand)
 2. Bills for collection (acceptance or usance)
 3. Banker's Acceptance
 4. Deferred Payment
 5. Letter of Credit (LC)
 6. Bank guarantee (BG) or payment guarantee
 7. Standby letter of credit (SBLC)

Documents through bank



Payment Methods for International Trade via bank



Method 4: Bills for Collection (Non-LC Bills/Documentary Collection)

- Documentary collections constitute a significant volume of domestic and international trade
- As against LC they are cheaper, more flexible and easier to manage
- However, risks are much higher than in LC

Payment Methods for International Trade via bank



Classification and rules of Bills

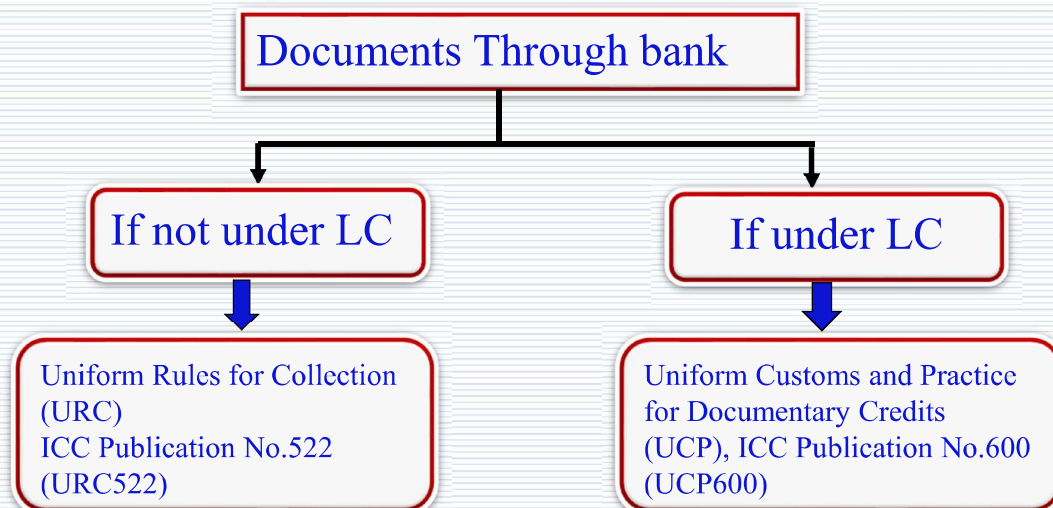
- **All trade bills** – irrespective of their nature, purpose or content, whether covering domestic or export trade- are classified as:
 - a. Non-LC bills** : These shipping documents are processed without involvement of LC
 - b. LC bills:** They are processed under LC

Payment Methods for International Trade via bank



Classification and rules of Bills

- Because the applicable rules differ, every set of documents presented to a bank must be clearly identified under one of these two grouping:



Payment Methods for International Trade via bank



Rules applicable to two groups of Collection Bills

- **Non-LC bills:** Also referred to as ‘bills for collection’; are governed by Uniform Rules for Collection (URC) of International Chambers of Commerce (ICC), Paris. At present, ICC Publication No. 522 (1995 Revisions), also known as URC 522 or ICC 522 is in operations
- **LC Bills:** are governed by UCP. Presently 2007 Revision of UCP commonly referred to as UCP 600 is in operations

Note:

- *The UCP rules apply to all documents presented under LC*
- *Instead if the documents are presented to the bank for ‘collection’ the ICC URC522 rules are applied*

Payment Methods for International Trade via bank



Types of Collection Bills or non-LC Bills:

1. **Clean Bills for collection:** include only financial documents like bills of exchange, cheques etc. without commercial documents
2. **Documentary bills for collection (Sight or Demand bills/DP):** sets of shipping documents accompanied by sight bills of exchange (also known as drafts) or bills of exchange payable on demand/on presentation
3. **Documentary bills for collection (usance, accepted or DA bills):** set of shipping documents accompanied by usance or acceptance bills of exchange or usance/time drafts

Payment Methods for International Trade via bank



Types of Collection Bills or non-LC Bills

- **Bill of Exchange (Draft or B/E)**: is the principal financial document used in international trade

Note: Banks in countries like US and Europe avoid using B/E as it may attribute high stamp duties.

- In India B/E are governed by Negotiable Instrument Act (1881).
- Section 5 of N.I. Act defines B/E as ‘an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person to pay a certain sum of money only to, or to the order of, a certain person or the bearer of the instrument’

Payment Methods for International Trade via bank



Types of Draft

- **Bill of Exchange (Draft or B/E)**: defined in article 2 of URC 522 as a ‘financial document’ are of 2 types:
 - a. **Sight draft/ DP** : The drawee, the one on whom draft, is drawn, is supposed to pay immediately after demand is made for payment. Also known as drafts being payable ‘on demand’ or ‘at sight’
 - b. **Acceptance or usance draft/DA**: Maturity date is determined from the face of the draft

(Drafts can be seen through following examples)

Date: _____

Place: _____

Currency & Amount: _____

At Sight of this bill of exchange

PAY TO _____ (2)

the sum of _____

Against _____ (4) for value received.

To: _____ for A B C Limited

M/s XYZ Ltd., _____ (3)

(Buyer's name and address)

(1)
(Seller signs here)

Figure: Sight draft

Date: _____

Place: _____

Currency & Amount: _____

_____ days after sight of this bill of exchange

PAY TO _____ (5) or order

the sum of _____

against _____ for value received.

To: _____ for A B C Limited

M/s XYZ Ltd., _____

(Buyer's name and address)

(6)

Accepted for payment on _____ For XZ Ltd. Authorized signatory Dated: _____

(Seller signs here)

(Authorised signature)

Figure: Acceptance or usance draft

Date: _____

Place: _____

Currency & Amount: _____

_____ days from the date of (invoice, BL etc.) # PAY this bill of exchange

TO _____ or order

the sum of _____

against _____ for value received.

To: _____ for A B C Limited

M/s XYZ Ltd., _____

(Buyer's name and address)

Accepted for payment on

For XZ Ltd.
Authorized signatory

Dated: _____

(Seller signs here)

(Authorised signature)

Payment Methods for International Trade via bank



Features of B/E (Draft)

1. Seal and Signature of Seller or drawer
2. Name of remitting or negotiating bank: first bank that handles documents on behalf of seller
3. A reference to underlying invoice, contract or principal document
4. Name and address of drawee, i.e. buyer, importer or applicant
5. The number of days after presentation to drawee-being the date of maturity of draft, which is due date of payment by drawee
6. On acceptance by drawee, maturity date of B/E is inserted in DA along with drawee's authorized signature and date of acceptance

Note: In acceptance bills (like in bill 3) maturity date is calculated not from date of presentation but with reference to another date or event (like invoice date, date of shipment etc.) as agreed between parties

Payment Methods for International Trade via bank



Uses of B/E (Draft)

1. Documents accompanying a 'collection' are commercial documents and not financial documents, hence do not authorize or confer legal rights on banks to demand payment. However, if accompanied with B/E provides legal right to bank for demand by buyer
2. Acceptable in court of law to prove liability and establish claim
3. Otherwise courts will have to rely on circumstantial evidence in event of default
4. Drafts accepted or co-accepted (avalised) by commercial banks offer better security to their holder for value

Parties in Documentary Collection as per ICC guidelines URC-522



- **The Principal (the drawer):** the exporter who arranges the collection documents and delivers them to his bank with collection instruction.
- **The remitting bank:** the exporter's bank which forwards the documents together with the exporter's instructions to the collection bank.
- **The collecting bank:** any bank (other than the remitting bank) involved in the processing of the collection and would normally be the remitting bank's correspondent in the importer's country

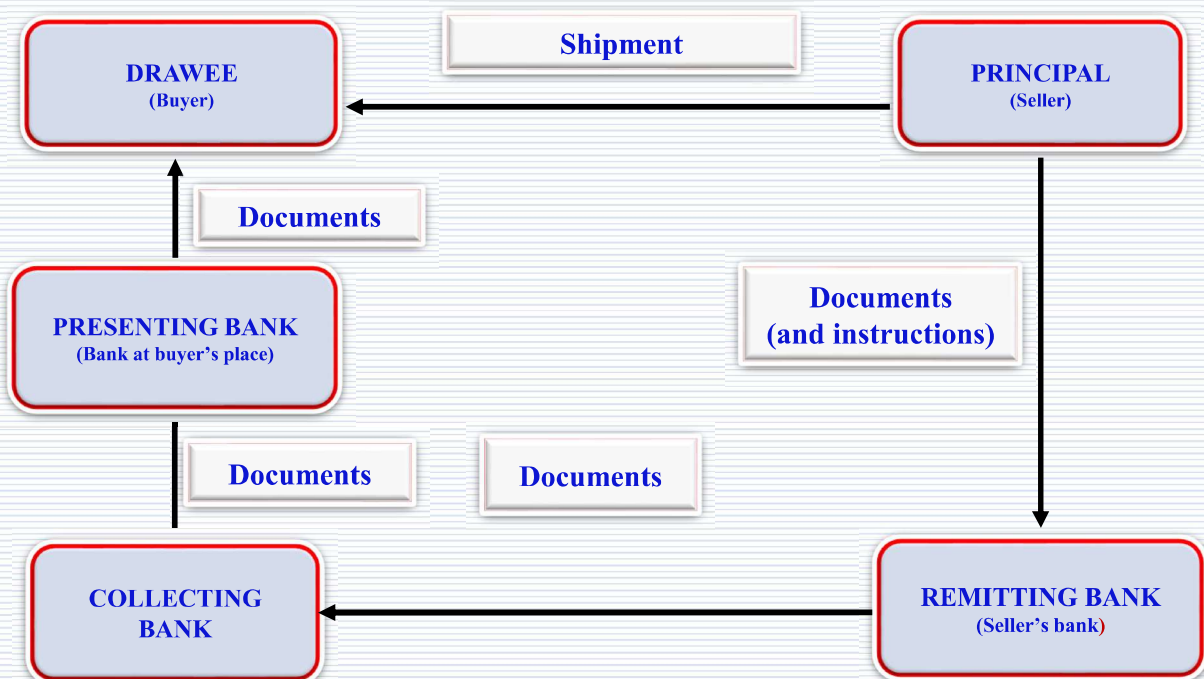
Parties in Documentary Collection as per ICC guidelines URC-522



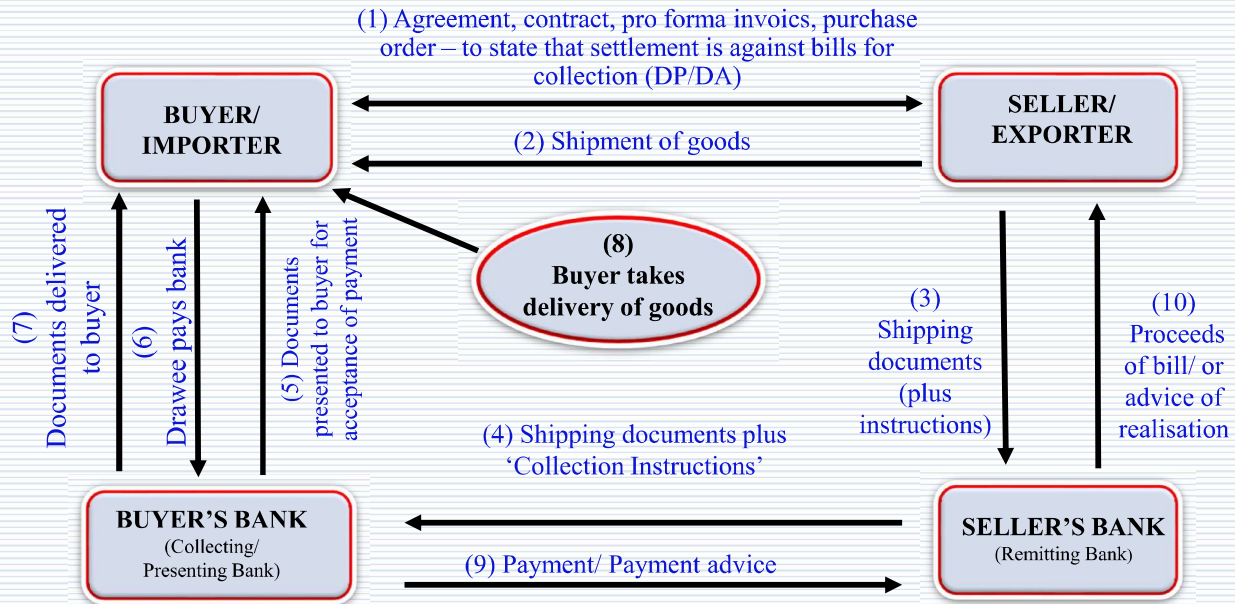
- **The presenting bank:** the importer's bank which presents the collection documents to the drawee (importer) and collects the payment or obtain the acceptance from the drawee. The collecting and presenting bank are often the same.
- **The drawee:** the importer to whom the documents are presented for payment or acceptance.

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PARTIES TO A COLLECTION



Documentary collection - Flow chart



Case-I



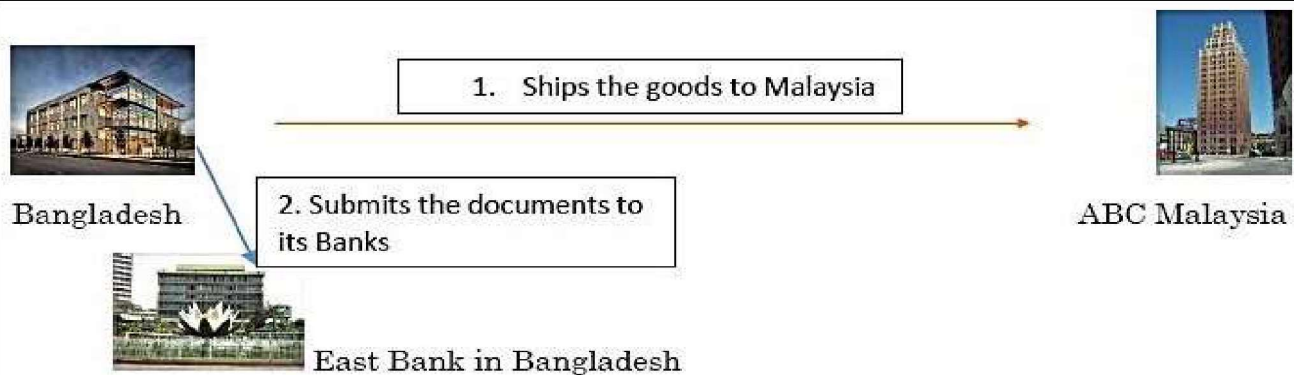
- ABC, Malaysia, a retail trader has signed a purchase agreement on 1st November with a Cloth company in Bangladesh. The order value of the contract is USD 100,000.
- Shipment to be made on 25th November. Cloth Company ships the goods and submits the documents to its bank, say East Bank.

Collection under Documents against Payment or D/P (Sight Draft)



- If shipment is made under a sight draft, the collecting bank is instructed to deliver documents only against the payment
- It is a practice that provides the exporter with some protection, since the banks will release the shipping documents only according to the exporter's instructions

Collection under Documents against Payment or D/P (Sight Draft)



1. Cloth Company Bangladesh ships the goods as a Consigner of the shipment
2. Cloth Company then submits the documents on 27th November to its bank East Bank (Remitting Bank).
3. Collecting bank or presenting bank collects the payment on sight or usance basis

Documents Involve for this transaction

1. Collection Order
2. Commercial Invoice
3. Packing List
4. Bill of Exchange drawn on ABC Malaysia payable at sight for USD 10,000
5. Marine Bill of Lading (Transport Document)

Collection under Documents against Payment or D/P (Sight Draft)



- The buyer needs the shipping documents to pick up merchandise. Sometimes goods reach the dock much earlier than document reaches the bank
- If the goods are not as per the ordered quality importer would lose as payment is already made
- If for any reason, the collecting bank overlooks the instructions on sight payment and delivers documents before getting paid it faces the risk of having to recompense the seller for loss

Collection under Documents against Acceptance or D/A (Time Draft)



- If a shipment is made under a time draft the exporter provides instructions to the buyer's bank to release shipping documents against acceptance
- This method of payment is referred to as documents against acceptance.
- By accepting the draft, the buyer promises to pay the exporter at the specified future date. Consequently, the buyer is able to obtain the merchandise and check the quality of the goods prior to the payment. It might create the risk of non-payment to the exporter

Collection under Documents against acceptance or D/A (Time Draft)



- It is the buyer's responsibility to honour the draft at maturity. In this case, the exporter provides the financing in terms of time and is dependent upon the buyer's financial integrity to pay the draft at maturity
- The added risk is that if the buyer fails to pay the draft at maturity; the bank is not obligated to honour payment. The exporter assumes all the risk and must analyse the buyer accordingly.
- Sometimes after checking goods importer refuses to pay, so seller may have to arrange some other customer in the same country or in different country

Risk in Documentary Collections



- Documentary collection shifts the risk from the exporter to the importer compared to the open account transaction
- Under documentary collection the importer takes control over the goods on presentation of an appropriate document of title (typically the same documents which would be presented under open account terms) together with some form of commitment to pay (typically a bill of exchange).

Risk in Documentary Collections



- Under the terms of a documentary collection, the banks are only concerned with the exchange of documents
- They offer no guarantee of payment, unless the buyer's bank AVALS an accepted bill of exchange
- AVALIZING a collection document means bank undertakes unconditional payment obligation on behalf of the importer, which may be extremely dangerous from a bank's point of view

Sight Bill: Risk Analysis



Advantages to Seller

- Goods in seller's possession till byer pays
- Seller comes to know quickly about byer's intent to pay
- Clear set on internationally accepted rules under URC522 to guide collection process

Risk to Seller

- No immediate recourse if buyer delays/cancel delivery/order
- No guarantee that buyer will take delivery
- If buyer delays delivery demurrages and other incidental costs to seller
- Legal remedy could be costly and time consuming
- Cost of storage, insurance etc. while legal process is on
- If buyer defaults, finding another buyer may be at heavy discount

Risk to Buyer

- If seller does not ship on time may adversely impact buyer's production schedule or business plan
- No control over quality, quantity or any aspect covering shipped goods
- Buyer has to first pay to verify quality, packaging etc. of goods
- Once paid, buyer can not recall funds if quality is not upto mark

Usance/Acceptance Bill (DA Bill): Risk Analysis



Advantages to Buyer

- Buyer pays after taking possession of goods
- Buyer can examine goods received, store, process and sell them before making payment
- No pressure on buyer's cash flows and gets time to pay

Risk to Seller

- After receiving goods buyer may not pay
- Period of usance offered is a cost to the seller
- Payment terms are more advantageous to buyer

Banker's Acceptance (Rescue to Seller)

- Accepted DA bill can be co-accepted by buyer's bank which provides better security for eventual payment
- After buyer's acceptance the document is said to carry a Banker's Acceptance (avalization) which provides additional security to seller

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Payment Methods for International Trade



Method 5. : Deferred Payment Arrangement

A. Deferred Payment Undertaking

- *B/E is not necessarily needed*
- *Payment spread over longer period 5-7 years*
- *Suitable for transactions involving project exports, capital goods, infrastructure financing etc.*
- *Payment made in installment with interest*
- *Banker's co-acceptance may be added apart from buyer's acceptance*

Payment Methods for International Trade



Method 5 : Deferred Payment Arrangement

B. Deferred Payment Guarantee (DPG)

- *At buyer's request bank may issue DPG to seller guaranteeing payment over a pre arranged contract period*
- *Mostly used for purchase of capital goods, large plant and machinery etc. where large money is involved*
- *Guarantee is invoked only if buyer fails to pay*

Payment Methods for International Trade



Method 5 : Deferred Payment Arrangement

C. Deferred Payment Credit (DPC)

- *It's LC issued by a bank covering payment due to be made not on presentation but later or in installments over a deferred period say 5-7 years or more*
- *The issuing bank's undertaking to meet payment obligation on respective due dates is main distinguishing feature*

Payment Methods for International Trade



Method 5 : Deferred Payment Arrangement

Comparison of 3 methods:

- *In DPU risk of seller is huge owing to longer time period and also as payment depends on the integrity and ability of buyer to honor his commitment*
- *DPG is relatively safer for seller as it is backed by bank's undertaking*
- *DPC is best among 3 as it is documentary credit*

Payment Methods for International Trade



Method 6 : Guarantees

- A guarantee may be defined as an independent, documentary undertaking issued by a bank (or other legally qualified entity) at request of its customer (instructing party) by which guarantor irrevocably promises to pay a sum of money to third party (beneficiary), provided a complying demand is presented
- While there are standard Guarantee formats, Guarantees can be tailored to meet your specific contractual needs.
- The Uniform Rules for Demand Guarantee, ICC publication No.758 (URDG758) defines a demand guarantee or simply a guarantee as 'any signed undertaking, however named or described providing for payment on presentation of a complying demand'.
- *It's a passive instrument unlike LC and is expected to remain dormant until its expiry serving as security under commercial transactions*

Payment Methods for International Trade



Method 6 : Categories of Guarantee:

1. Accessory and Independent Guarantee

A. Accessory guarantee

- *Guarantor binds itself for fixed amount to cover a debt or default for its applicant who is already bound to beneficiary via underlying contract*
- *There is linkage between guarantee and underlying contract*
- *It implies demand must prove the contractual default supported by an judicial or mediation 'award' consisting of amount resulting in default*
- *Dependent on local legislation, it may differ from country to country*
- *It cannot be issued subject to URDG758, UCP 600 or ISBP (International Standard Banking Practice)*

Payment Methods for International Trade



Method 6 : Categories of Guarantee:

1. Accessory and Independent Guarantee

B. Independent guarantee

- *Depends solely on guarantee and complying demand*
- *A reference in guarantee to underlying contract may be made*
- *Guarantor is not liable for effectiveness of documents i.e. he will not go beyond documents to check if information contained therein is correct or commercially justifiable*
- *Often referred to as 'Demand Guarantee'*
- *It may be issued subject to UCP 600 or ISBP but more preferably under ICC URDG 758*

Payment Methods for International Trade

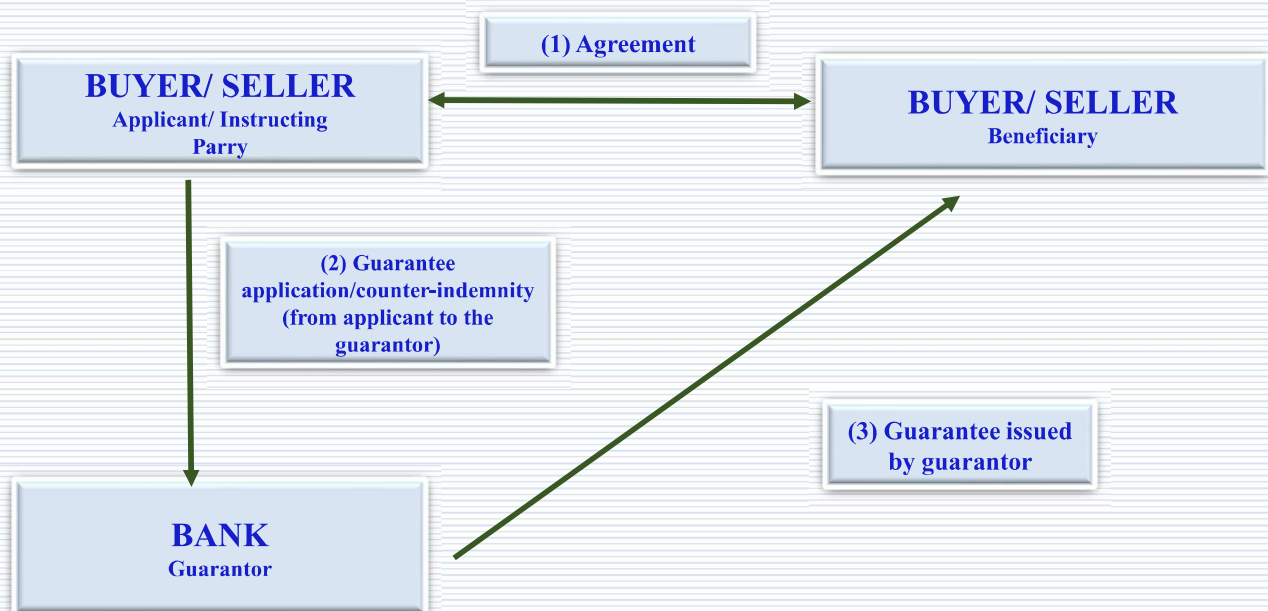


Method 6 : Categories of Guarantee

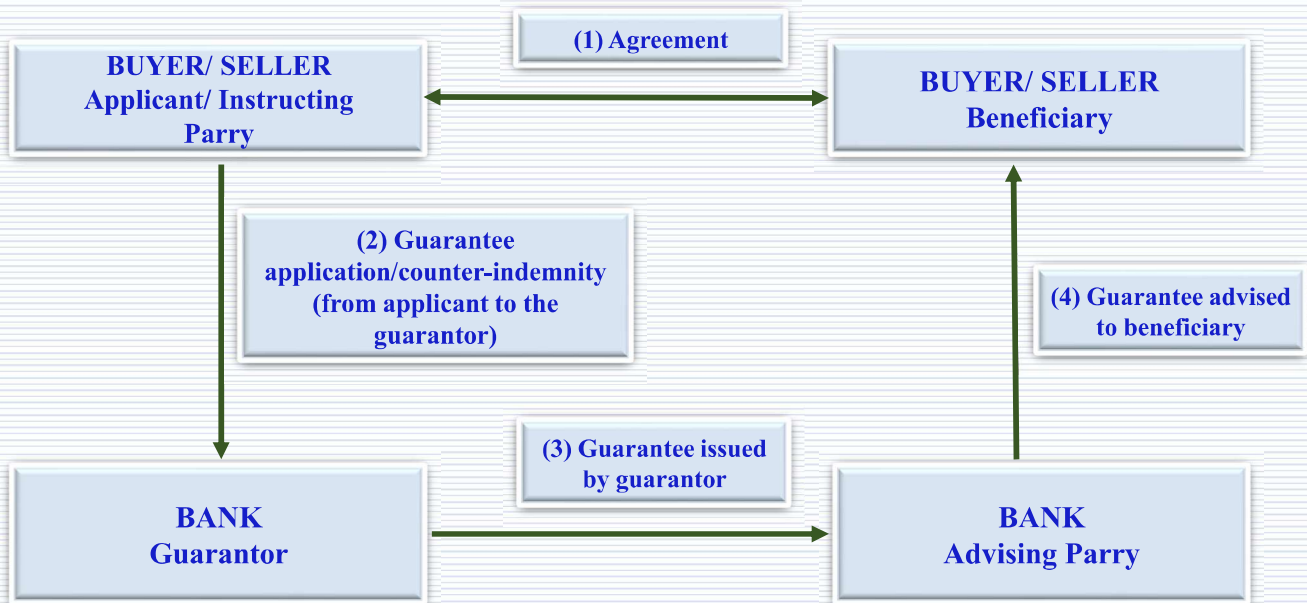
2. Direct and Indirect guarantee

- *Direct Guarantee: can be issued directly in favor of beneficiary by the principal bank or through an advising bank or through a bank in beneficiary's country*
- *Indirect guarantee: the principal bank instructs a local bank (issuing bank) at beneficiary's place of business to issue the guarantee in favor of the beneficiary*
- *As security the instructing bank issues a counter guarantee in favor of local bank entitling it to the right to submit a claim to instructing bank in event of payment of a claim*

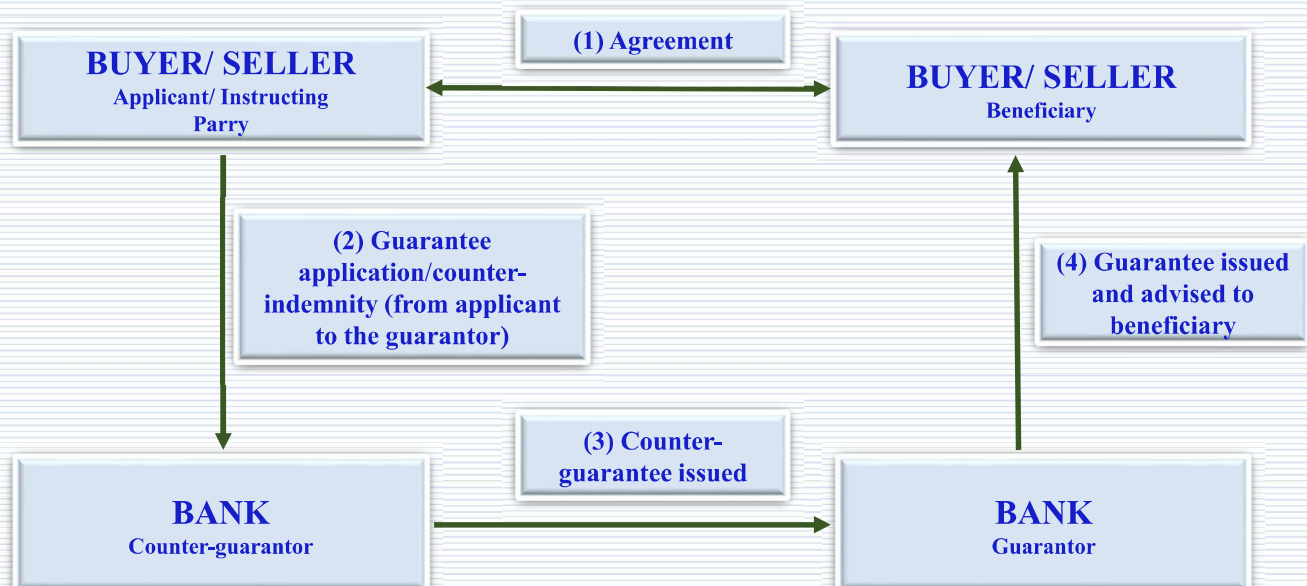
Direct Guarantee (no advising bank)



Direct Guarantee (issued through advising bank)



Indirect Guarantee



Payment Methods for International Trade



Method 6 : Categories of Guarantee

3. Performance and Finance (Bank) guarantee

A. Performance Guarantee

- *It offers security of 'performance'*
- *Issuer of guarantee, the guarantor (say manufacturer or service provider) undertakes to repair or replace the offending item, thus ensuring uninterrupted service*
- *Performance guarantee is different from financial guarantee in that purpose of former is not to compensate breach in performance with money*
- *It is meant to ensure continuity in performance*

Payment Methods for International Trade



Method 6 : Categories of Guarantee

4. Financial guarantee (BG) Rules - URDG

- *Formats and contents of BG differ across issuers, transactions and countries depending upon its purpose*
- *Applicable laws also differ depending upon jurisdiction*
- *ICC, after a gap of 18 years, came out with revised set of guidelines for BG named as Uniform Rules for Demand Guarantees (URDG) in 2010 in its publication 758 and hence called as URDG758*
- *It comprises of 35 articles in all which apply to both domestic and international guarantees*

Payment Methods for International Trade



Method 7 : Letters of credit (LC)

- LC is a written, irrevocable undertaking issued by a bank on behalf of the importer promising to pay the exporter upon ‘complying presentation’ (Article 2, UCP600)
- *Time of payment* : When shipment is made
- *Goods available to buyers* : After payment
- *Risk to exporter* : Presenting complying documents
- *Risk to importer* : Relies on exporter to ship goods as described in documents
- Also called Documentary Credit or simply ‘Credit’

Payment Methods for International Trade



Method 7 : Letters of credit (LC)

- LC relies on two fundamental principles for their success:
 - Doctrine of strict compliance: (somewhat diluted now)
 - The independence principle

Features of Documentary Credit or Letter of Credit



- The exporter is assured of receiving payment from the issuing bank as long as it presents documents in accordance with the LC.
- It is important to point out that the issuing bank is obligated to honour drawings under the LC regardless of the buyer's ability or willingness to pay
- On the other hand, the importer does not have to pay for the goods until shipment is made and documents are presented in good order. However, the importer must still rely upon the exporter to ship the goods as described in the documents, since the LC does not guarantee that the goods purchased will be those invoiced and shipped.

Features of Documentary Credit or Letter of Credit



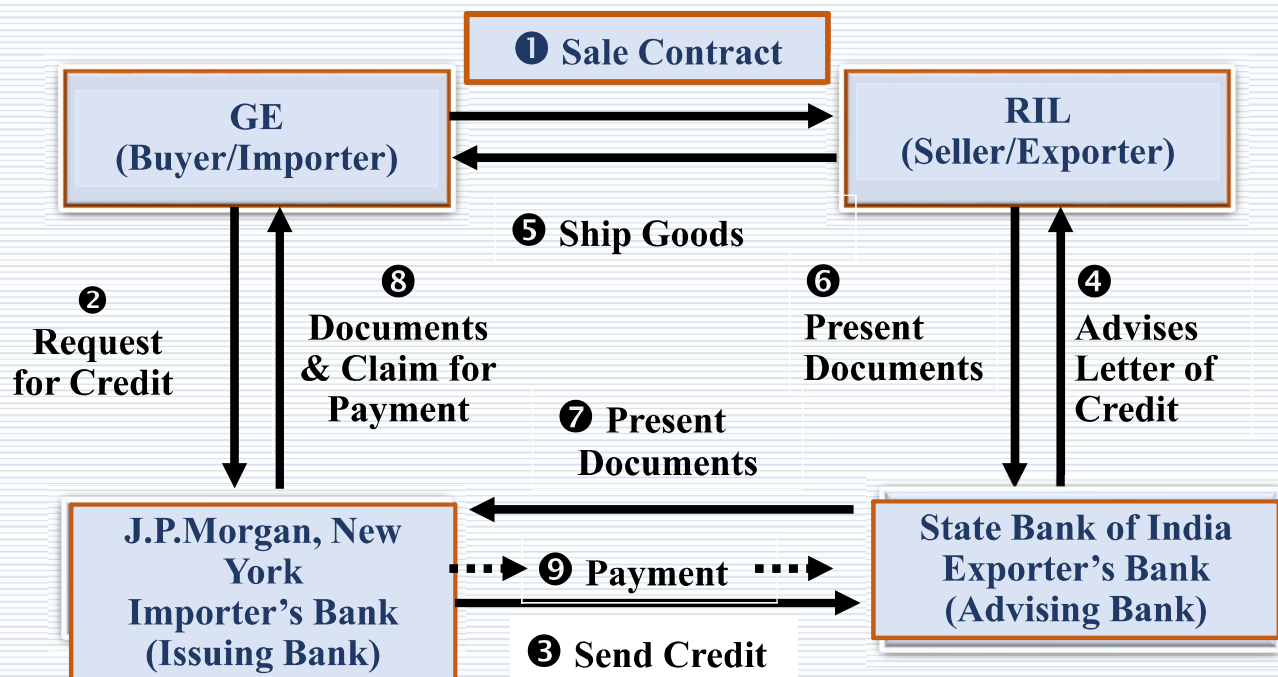
- All the LCs are subject to The Uniform Customs and Practices of Documentary Credit, 2007 Revision, ICC Publication No. 600 (UCP), which has 39 articles
- Under UCP 600, all the LCs are treated to be irrevocable, even if there is no indication to that effect
- An irrevocable letter of credit cannot be amended or cancelled without the consent of the issuing bank, confirming bank (if any) and the exporter

Features of Documentary Credit or Letter of Credit



- This allows the exporter to procure the goods or prepare them for shipment with the assurance that payment will be received if the stipulated documents are presented and complied with the terms and condition of the credit
- At present there is no existence of revocable letter of credit which allows importer to amend or even cancel the LC and it provides no security to the exporter

Documentary Credit (L/C) Procedure



Documentary Credit (L/C) Procedure



1. General Electric (importer), USA and Reliance Industries Limited (exporter), India establish a sales contract between them
2. The importer then initiates the LC mechanism by giving an application to its bank, J.P.Morgan New York, USA (known as issuing bank) for issuing a letter of credit
3. The issuing bank (J.P. Morgan) issues LC through Society for Worldwide Interbank Financial Telecommunication (SWIFT) in favour of the beneficiary or exporter. By opening an LC, J.P. Morgan undertakes the payment obligation irrespective of the ability of the importer to pay. Then issuing bank sends the LC to advising bank or the exporter bank, SBI, India.

Documentary Credit (L/C) Procedure



4. SBI advises or notifies RIL about the LC without undertaking the payment obligation unless and until it plays a role of a confirming bank
5. Exporter ships the goods as per the terms and conditions of the credit.
6. Exporter submits all the documents asked by the credit along with bill of lading - a shipping document and a bill of exchange or draft representing issuing bank's payment obligation to his bank within 21 days from the date of shipment and within the validity of the credit

Documentary Credit (L/C) Procedure



7. All the documents are sent to the issuing bank.
8. The issuing bank checks the document. If the documents comply the payment terms then the importer either initiates the payment under a sight draft or accepts the future payment obligation under Time draft
9. The issuing Bank (J.P. Morgan) makes payment to the Advising Bank (SBI)

Documentary Credit (L/C) Procedure



10. If the documents do not comply then J.P. Morgan cites a documentary discrepancy, notifies RIL through the advising bank within 5 banking days from the date of sighting the documents
11. If exporter is able to correct the documents as per the LC terms and resubmits within a stipulated time period then he gets the payment or else payment gets rejected

UCP and its Evolution



- LC's operations are guided by well defined, internationally recognized, widely accepted set of rules, practices and procedures
- The first attempt to codify LC goes back to 1929 when International Chamber of Commerce (ICC) introduced its 'Uniform Regulations for Commercial Documentary Credits', which initially were only limited to French and Belgian banking practices
- In 1933, ICC issued 'Uniform Customs and Practice for Commercial Documentary Credits' and these set of rules received formal acceptance in 40 countries
- In 1951 Revision, the acceptance of these rules doubled but after the issuance of UCP in 1962 the global acceptance of these rules took place
- Since then rules have been regularly updated at approximately after every 10 years, to arrive at the current 6th revision in 2007, commonly referred to as UCP 600

Interpreting Rules of UCP



- The essence of UCP has been embodied in article 1 of UCP 600 as:
- *"The Uniform Customs and Practice for Documentary Credits, 2007 Revision, ICC Publication No.600 (UCP) are rules that apply to any documentary credit (credit) (including, to the extent to which they may be applicable, any standby letter of credit) when the text of the credit expressly indicates it is subject to these rules. They are binding on all parties thereto unless expressly modified or excluded by the credit."*
- As the very name suggests this ICC publication represents uniform customs and practice for (documentary credits).
- In order to minimise adverse effect of confusion and ambiguity in International Trade, ICC introduced degree of uniformity in terms and expressions often used in trade.
- UCP may be termed as standardized set of best practices to promote smooth operation of international trade through LC

Interpreting Rules of UCP



- UCP articles are rules and not laws or statutes propounded by a statutory body anywhere in world
- However, over the years (as a result of judicial pronouncements, case studies and doctoral researches) rules of UCP have gained acceptance worldwide for documentary credit
- Since UCP articles are not laws by statute, so if the parties agree to subject themselves to rules of UCP, they do so purely on their will and declare it in the credit.
- Upon declaration only coverage of UCP extend to operations under credit
- The last sentence of article is important which means that once parties through declaration in credit document subject themselves to UCP, the rules are binding on them
- However, last sentence of UCP (1), also says that any provision of UCP could be **modified or excluded** by the credit with the consent of concerned parties. But it should be done with utmost care

Related, Useful ICC Publication (ISBP)



- Documentary rules under LC governed by UCP 600 are more complicated than for 'collections' governed by URC 522.
- Hence, trading communities even if they start with LC, tend to migrate to 'collection' as they gain confidence
- ISBP (International Standard Banking Practices) for the Examination of Documents under documentary credit, an ICC Publication, complements UCP
- The current version of ISBP i.e. ISBP 745 came in effect from July 2010
- It is an essential guide to everyone involved with preparation, presentation and examination of documents under LC.

Parties in Documentary Credit or Letter of Credit



As per sub-article 10(a) of UCP, a credit can not be amended nor cancelled without the agreement of issuing bank, confirming bank, if any, and beneficiary and hence main parties to credit are:

1. Issuing Bank (Article 7)
2. Beneficiary
3. The conforming Bank (Article 8)

Note:

- *In spite of being initiator of the credit applicant (importer) is not considered to be the party to credit*
- *Advising bank or second advising bank, reimbursing bank are also not party unless they are also confirming bank*

Parties in Documentary Credit or Letter of Credit

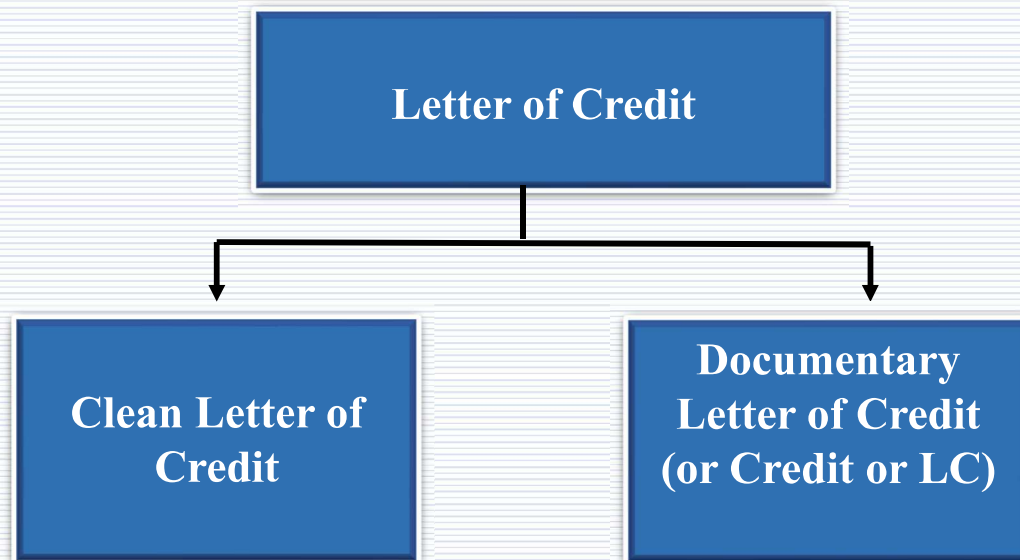


The definition, 'parties to a credit' therefore includes only those who have express obligation under the credit, none other.

Applicant is not a party to the credit because:

- LC is direct undertaking of issuing bank to beneficiary
- Conforming bank enters scene only if it confirms
- As LC is direct commitment of issuing bank, UCP and ISBP ruled that LC should not be made 'available by draft on applicant' because in such case very *availability* of it would become subject to applicant's acceptance or refusal of draft. However, LC may call draft as part of 'documents required'.
- Issuing bank must decide based on documents available to approve to reject credit. It's sole discretion of issuing bank to give waiver to beneficiary in certain cases. And that's why it is based on **doctrine of independence and called as an independent instrument**

LC Terms and Expressions



LC Terms and Expressions



Clean LC: does not call for financial or commercial documents

- Governed by URC 522 which defines a 'clean' document as a one that is ' a financial document that is not accompanied by a commercial document'
- In ancient times business men used this instrument as a convenient and safe mode for making cash available when away from home
- Overtime with development of technology clean LCs have virtually disappeared

Documentary Letter of Credit: LC in conjunction with financial or commercial or both it is termed as 'documentary LC'.

Expressions Relating to LC



- **Applicant:** Party at whose request credit is issued
- **Issuing Bank:** Bank that advises the issue of credit at request of applicant
- **Advising Bank:** Bank that advises the issue of credit at request of issuing bank
- **Second Advising Bank:** Bank through which the first advising bank advises the issue of credit to beneficiary
- **Confirming Bank:** Bank that at request of credit issuing bank, adds its confirmation to a credit. The confirming bank is almost always (but not necessarily) the first advising bank

Advising bank



- **Beneficiary:** party in whose favour credit is issued
- **Nominated Bank:** The bank with which the credit is available for negotiation, acceptance, honour or deferred payment. If no bank is specifically nominated by credit, any bank is nominated bank
- **Negotiating Bank:** The bank which examines the documents presented by the exporter, then negotiates the credit (i.e., in the case time draft, either advances or agrees to advance funds to the beneficiary on or before the maturity date of the draft). This negotiation is usually done ‘with recourse’, which means that if the issuing bank fails to reimburse the negotiating bank, the negotiating bank will recover the funds advanced to the exporter

Doctrine of Strict Compliance



- It states that if seller wishes to be paid under LC, it must submit documents that strictly comply with terms of credit.
- If they don't; nominated bank (including confirming bank) or issuing bank may refuse to honour or negotiate
- However, ISBP 745, has made a significant impact in lessening exactitude of doctrine of strict compliance as banks are not robots and also don't know details of each contract signed between parties.
- It has been acknowledged that purpose of LC is to facilitate international trade, not to find excuses for refusing payment

LC: Advantage to Applicant



1. **Stipulates LC terms:** buyer specifies type of LC to be issued, its terms and conditions and documents to be presented as a pre-condition to payment being effected
2. **Specifies nature of documents:** buyer stipulates the documents required and define the data content of such documents
3. By stipulating LC terms and documents and their contents, buyer exercises control over shipment especially when buyer can not physically ensure compliance with various aspects of shipment
4. Payment only by compliance
5. **Improves bargaining position:** Through LC buyer signals that he has ability to obtain credit line from bank and can therefore, negotiate better terms with seller and improve his market competitiveness

LC: Advantage to Beneficiary



1. **Certainty of payment**
2. **LC reduces risk:** integrity and creditworthiness of buyer are replaced by that of issuing bank and hence reduces counterparty risk and country risk
3. **Transparent Terms:** LC offers safety and transparency to beneficiary/seller as credit is received well before date of shipment.
4. **Option to accept or reject LC terms:** If certain terms appear difficult to be performed beneficiary may request for amendment of LC or not to effect shipment
5. **The right to accept or reject amendments:** Consent of beneficiary is necessary to amend LC by issuing bank
6. **The irrevocable nature of LC:** Issuing bank or conforming bank are irrevocably bound to honour or negotiate without recourse a complying presentation
7. **Export Finance on more convenient terms:** Banks are more willing to finance exporters who have LC since risk parameters can be easily assessed, terms of payments are clearly defined and possibility of non-payment gets significantly reduced. Export credit insurance is also available for lower premium

LC: Other Advantage to Beneficiary from risk management perspective



1. LC reduces credit investigation on buyer
2. LC reduces transit risk: In DP or DA transactions, seller may not get paid if consignment does not reach buyer. These risk are significantly reduced under LC.
3. LC reduces country risk
4. Confirmed credits localise performance: If credit is confirmed by another bank in country of beneficiary, performance under credit is said to be localised.

LC Risks: For Buyer



1. Beneficiary may never ship the goods
2. Seller may present perfect documentation as required by LC, but not goods, as described therein.

LC Risks: For Seller



1. LC is as good as the bank that issues it. LCs offered by unknown banks may not offer protection to seller
2. Issuing bank may refuse to pay citing discrepancy
3. After shipment is effected and complying presentation being made, issuing bank may suspend operations or close down altogether
4. Nominated bank, including confirming bank, may not negotiate or honour documents, leaving it to issuing bank to determine final approval. Resolution of discrepancies, sometimes silly could be a time consuming process
5. Buyer may obtain a court order to stop payment by issuing bank or fraud may be discovered after acceptance but before maturity date.

LC Risks: For Issuing Bank



1. Applicant may not be in a position to pay on maturity
2. Payment under fraudulent documents may precipitate a credit risk
3. A common misconception about LC is that it eliminates all kinds of risk, however, LC can not eliminate exchange risk

LCs vs Guarantees



1. LC is a type of BG, basically it is conditional payment guarantee. It is a single instrument which has features of both, guarantee and method of settlement
2. LC is structured to ensure performance upon complying presentation while BG has no such performance safeguard. It is invoked only after breach has occurred
3. A guarantee is payable on demand i.e. if demand is complying guarantor has to pay and has no room for delay, objection or defence while in case of LC payment is effected only if conditions as set by applicant through issuing bank are strictly complied with by beneficiary
4. Restitution under a guarantee is somewhat longer than payment under documentary credit
5. LC is undertaken to be used with complying presentation while guarantee is undertaken with intention of not to be invoked

Costs and Charges



1. Issuing Bank's Charges
2. Advising Bank's Charges
3. Conforming Bank's Charges
4. Commitment charges
5. LC amendment charges
6. Negotiating Bank's charges
7. Discrepancy charges (if any)
8. Reimbursing bank's charges

Note: Credit must explicitly explain who (seller or buyer) has to pay which charges

Standard Terms in LC Operations



1. **Presentation:** of documents under a credit, for sight payment, deferred payment, acceptance or negotiation
2. **Availability:** of a letter of credit to beneficiary
3. **Nominated Bank:** for purpose of availability and utilization of LC
4. **Restriction:** with regards to availability of credit
5. **Engagement, obligation:** of a bank while advising a credit
6. **Recourse and without recourse:** payment modes under credits that are confirmed, unconfirmed, advised with or without obligation
7. **Under reserve:** payment to an exporter/seller upon purchase, discount or negotiation of outward bill

Standard Terms in LC Operations: Presentation



Key Issues:

- Article 2 of UCP state that presentation has to be complying presentation meaning , “presentation or submission of documents within validity of credit to the issuing, confirming or to any other nominated bank, that, on their face, comply or **conform strictly with the terms and conditions of credit**”.
- The bank to which LC permits ‘presentation’ of documents is called ‘**nominated**’ bank which is nominated by issuing bank
 - Issuing bank can never be termed as nominated bank
 - A nominated bank is not obliged to negotiate or pay against presentation except when it becomes confirming bank or it has agreed to become negotiating bank
 - Similarly a confirming is not necessarily a nominated bank just by confirming credit.
 - Presentation of documents to a bank that is not nominated bank (or issuing bank, as presentation to issuing bank can always be directly made) would not be complying presentation

Standard Terms in LC Operations: Presentation



• Key Issues:

- **Last Date of Presentation: Credit contains following dates**
 - Date of issue of credit
 - Date of its expiry
 - Last Date of shipment (Article 14.c.)
 - Counting from actual date of shipment, last date of presentation
- As per UCP 600, expiry date stated in credit is not last date of honor or negotiation, but only for presentation.
- Hence, last date for presentation would be date of expiry as stated in credit or last date for presentation counting from date of shipment, but within validity of credit
- eg: if last date of shipment is 20 March and expiry date is 30 march and documents are to be presented within 15 days from date of shipment. What would be last date of presentation if goods are shipped on :
 - A. 10 March and B. 19 March
- *Note: Beneficiary should be careful about the date of expiry in credit because if he makes presentation well in advance, he will have time left to make corrections, if any, in credit suggested by issuing/nominated bank to comply with LC terms*

Standard Terms in LC Operations: Availability



- **Availability:** LCs are issued so that beneficiary can obtain funds on presentation at the earliest.
- UCP gives issuing bank right to stipulate in credit, which bank or banks are available for beneficiary for presentation known as ‘**availability**’ of credit
- **With regards to availability two terms are used:**
 - **Available with:** when this is completed it identifies the bank(s) authorized for presentation to, therefore the utilization(article 6.a.) of credit
 - **Available by:** This indicates the manner of a credit utilization i.e. how a credit is to be utilized (article 6.b.) i.e. by sight payment, deferred payment, acceptance or negotiation
- **LC Available by sight payment:** similar to that of demand bill (DP) or sight bill. Payment is made by nominated or issuing bank on complying presentation
- **LC Available by acceptance:** similar to that of usance bill (DA) which must accompany shipping documents. Payment is made by nominated or issuing bank on complying presentation

Standard Terms in LC Operations: Availability



- **LC Available by negotiation:** in such cases documents need not include a draft. *Negotiation means payment of proceeds under an LC, against complying presentation, by a nominated bank that is not drawee or issuing bank.*
 - *If draft is drawn on nominating or issuing bank, it being the ‘drawee’ the concerned bank can only ‘honour’ or ‘pay’ but can never negotiate.*
- **LC Available by Deferred Payment:** in such cases beneficiary is paid over an extended period of time as per agreement between the parties concerned.
- **Availability of credit at Beneficiary's place:** *As far as possible credit should be available for negotiation, honour or payment at or near beneficiary’s place of business*

Standard Terms in LC Operations: Restricted Credit and Presentation to other Bank than nominated bank



- It conveys the issuing bank's stipulation that utilization of credit should only be through the bank(s) to which the availability of credit is so 'restricted'.
- **Presentation to other than nominated bank:**
 - For a valid presentation, the beneficiary or his bank should present complying documents within validity of credit to a bank with which credit is available (a nominated bank) or to issuing bank
 - Presentation for negotiation can be made only to nominated bank
 - A non nominated bank can still extend finance to beneficiary but it would be called as purchase or discounting (not negotiation) under financing arrangement and credit risk would be of discounting bank but such bank should immediately send documents to nominated or issuing bank

Standard Terms in LC Operations: Restricted Credit and Presentation to other Bank than nominated bank



- The concerned non-nominated bank is not entitled to claim reimbursement from reimbursing bank under terms of credit but can claim reimbursement from issuing bank against complying presentation
- Another demerit of making presentation to a bank other than nominated bank is that Article 35 gives protection to beneficiary if he makes the complying presentation if documents are lost in transit between the nominated and the issuing bank. But no such protection is given if the complying presentation is made to a bank other than nominated or issuing bank

Standard Terms in LC Operations



- **Recourse, Without Recourse:** Negotiation or payment without recourse means that bank that has effected payment cannot resort to the receiver from recovery of payment
 - In LC negotiation by a non-confirming bank is always with recourse to beneficiary
 - Negotiation by a confirming bank is always without recourse to beneficiary
- **Under Reserve:** When payment is made under reserve the paying bank is said to have expressed 'its reservation' about the transaction and is reserving the right to re-claim funds if cause of such 'reservation' comes to pass.

Standard Terms in LC Operations



- **Purchase:** means paying consideration against demand instruments. It is used for advances only against non-LC bills (clean or documentary bills) payable on demand or sight
- **Discount:** is used when usance (DA drafts) bills are involved for transactions

Note: Purchase and discount are always with recourse, but acceptance by drawee bank of a usance draft (both LC and non LC) is without recourse

- **Negotiation:** by banks takes place invariably under a third party mandate. Purchase is a financing decision by financing bank itself, but negotiation is the advancing of funds under the terms of a third party 'mandate'. Negotiation is dependent on the conditions set out in a document created by a third party.

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Comparison of Payment Methods



Method	Usual Time of Payment	Goods Available to Buyers	Risk to Exporter	Risk to Importer
Prepayment	Before shipment	After payment	None	Relies completely on exporter to ship goods as ordered
Letter of credit	When shipment is made	After payment	Very little or none, depending on credit terms	Assured shipment made, but relies on exporter to ship goods described in documents
Sight draft; documents against payment	On presentation of draft to buyer	After payment	If draft unpaid, must dispose of goods	Same as above unless importer can inspect goods before payment
Time draft; documents against acceptance	On maturity of drafts	Before payment	Relies on buyer to pay drafts	Same as above
Consignment	At time of sale by buyer	Before payment	Allows importer to sell inventory before paying exporter	None; improves cash flow of buyer
ESCROW	Before shipment	After payment	Allows importer to check the goods before payment	Money blocked from preshipment to delivery
Open Account	As agreed	Before payment	Relies completely on buyer to pay account as agreed	None

Essence of a Letter of Credit (L/C)

Bank of the East, Ltd.

[Name of Issuing Bank]

Date: September 18, 2022
L/C Number 123456

Bank of the East, Ltd. hereby issues this irrevocable documentary Letter of Credit to Jones Company *[name of exporter]* for US\$500,000, payable 90 days after sight by a draft drawn against Bank of the East, Ltd., in accordance with Letter of Credit number 123456.

The draft is to be accompanied by the following documents:

1. Commercial invoice in triplicate
2. Packing list
3. Clean on board order bill of lading
4. Insurance documents, paid for by buyer

At maturity Bank of the East, Ltd. will pay the face amount of the draft to the bearer of that draft.

Authorized Signature

Name of Exporter

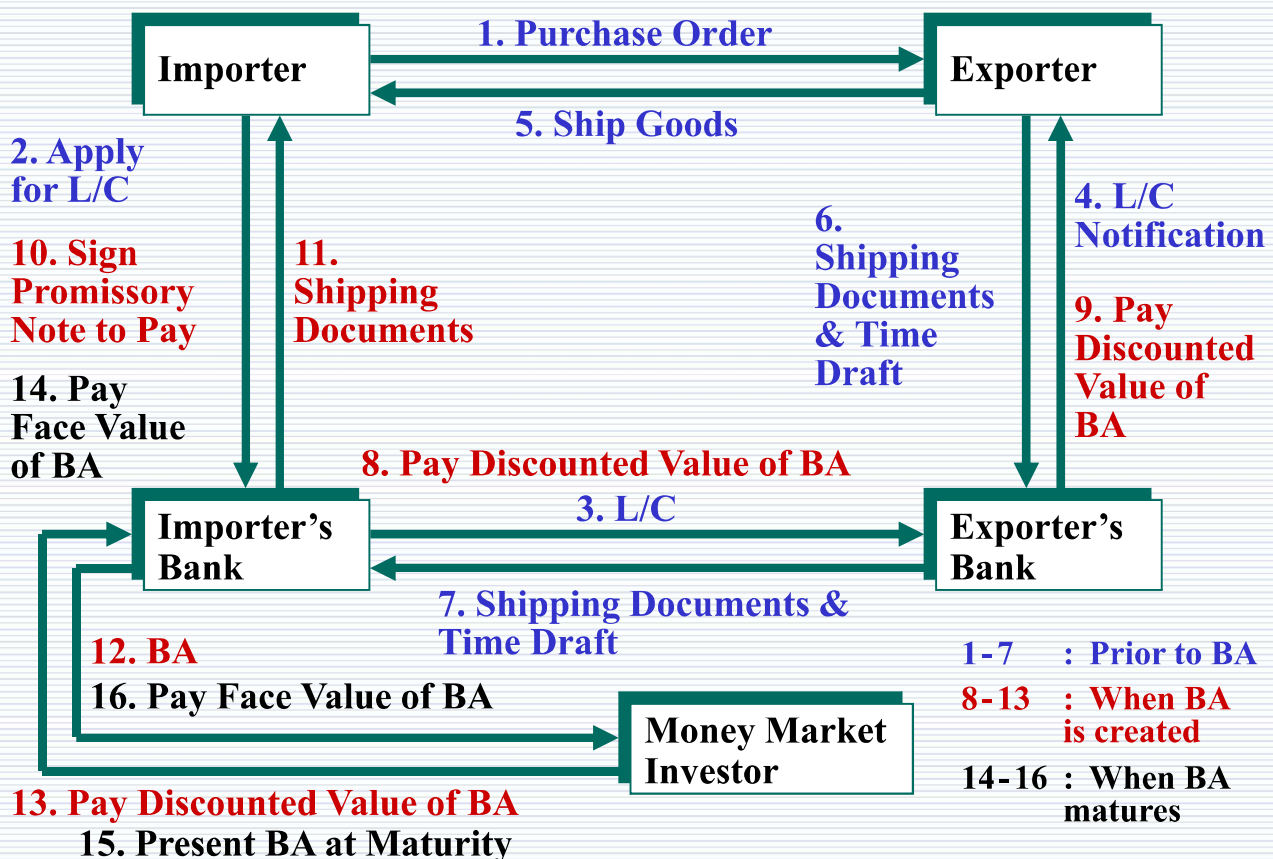
Date: October 10, 2022

Draft number 7890

Ninety (90) days after sight of this First of Exchange, pay to the order of Bank of the West [*name of exporter's bank*] the sum of Five-hundred thousand U.S. dollars for value received under Bank of the East, Ltd. letter of credit number 123456.

Signature of Exporter

Life Cycle of a Typical Time Draft (Banker's Acceptance)



Different Types of Letter of Credit



- **Revocable and Irrevocable Letter of Credit:**

Revocable letter of Credit is one which could be amended or cancelled by the Issuing bank without prior notice to the beneficiary. Under UCP 600 all Letter of Credits are irrevocable and Revocable LC does not exist.

- **Confirmed and Unconfirmed Letter of Credit:** An Unconfirmed LC is one which bears no confirmation from another bank and direct commitment from the issuing bank to the beneficiary. On the other hand a Confirmed LC is one where the credit is confirmed by another bank at the request of the issuing bank

Different Types of Letter of Credit



- **Red Clause Letter of Credit:**

- A Red Clause LC authorises the advising bank to pay a part of the face value of the credit as “pre-shipment credit advance” to the beneficiary.
- The arrangement provides for amount of advance to be deducted from amount to be paid to seller upon presentation of documents
- Issuing bank incorporates a clause in LC authorizing nominated bank to pay a percentage of value of LC to beneficiary.
- Historically this clause appeared in “Bold Red Colour” in order to draw attention, hence, termed as Red Clause LC

- **Green Clause Letter of Credit:** In addition to pay an advance, a Green Clause LC envisages grant of further facilities for storage and insurance at the port.

Different Types of Letter of Credit



• Back-to-Back Letter of Credit:

- It is an irrevocable LC which serves as a collateral for another. The advising bank of the first LC becomes the issuing bank of the second LC.
- Suppose the exporter further wants to buy some raw-material for which he needs money
- If he has got LC from importer, he can use it as collateral to get LC issued from domestic bank in favour of his vendor
- Such an LC which is issued on back of an existing LC can be termed as Back-to Back LC
- However, it should be noted that the two LCs are completely separate and each issuing bank is liable for its own obligation
- The exporter who has issued this back to back LC has to pay for it irrespective of whether he gets paid against original LC or not
- The first LC is merely an evidences as a means of payment that will be forthcoming to meet payment obligation on second LC. It only provides comfort to bank that issues second LC rather than security

Different Types of Letter of Credit



• Transferable Letter of Credit:

- It means a credit that specifically states that it is transferable (Article 38, UCP600)
- It may be available in whole or in part to another beneficiary (second beneficiary) at the request of beneficiary (first beneficiary)
- It means a credit that has been made available by a transferring bank to a second beneficiary
- Transferring bank means a nominated bank that transfers the credit or any other bank authorized by issuing bank or the issuing bank itself
- Unless and otherwise stated all charges like commissions, fees or any other expense incurred in respect of a transfer must be paid by first beneficiary
- In Transferable LC the first beneficiary may transfer the full or part of LC to second beneficiary or to multiple beneficiaries
- Example: If Mr. X has an order to send 10000 pieces, he can transfer it to 10 beneficiaries of 1000 piece each
- Second beneficiary cannot further transfer the credit

Different Types of Letter of Credit



• Difference between Bank to Back and Transferable Credits:

- Transferable credit enables beneficiary to transfer to the second beneficiary the obligation and rights conferred upon the first beneficiary by terms of credit.
- Issuing bank remains committed to beneficiary of the transferred credit, i.e. to the second beneficiary, under credit issued by it
- In contrast every back to back LC is a standalone credit i.e. original issuer's obligation do not extend to back to back credit or its beneficiary
- Original beneficiary's credit line gets blocked with issuance of every back to back credit, whereas in transferable credit it is not the case
- Risk of original beneficiary in a transferable credit are lower as compared to back to back credit

Different Types of Letter of Credit



• Revolving L/C:

- If the buyer requests partial deliveries of the ordered goods at specific intervals (contract for delivery by instalments), payment can be made under the terms of a revolving letter of credit that covers the value of each consecutive installment.
- The bank is normally liable for the total value of all agreed partial deliveries.
- However, the second partial payment is not effective until the first installment has been paid, and so forth.
- From buyer's and sellers perspective this arrangement saves not only bank charges, but also overhead costs incurred in keeping records for each LC and amendment separately

Different Types of Letter of Credit



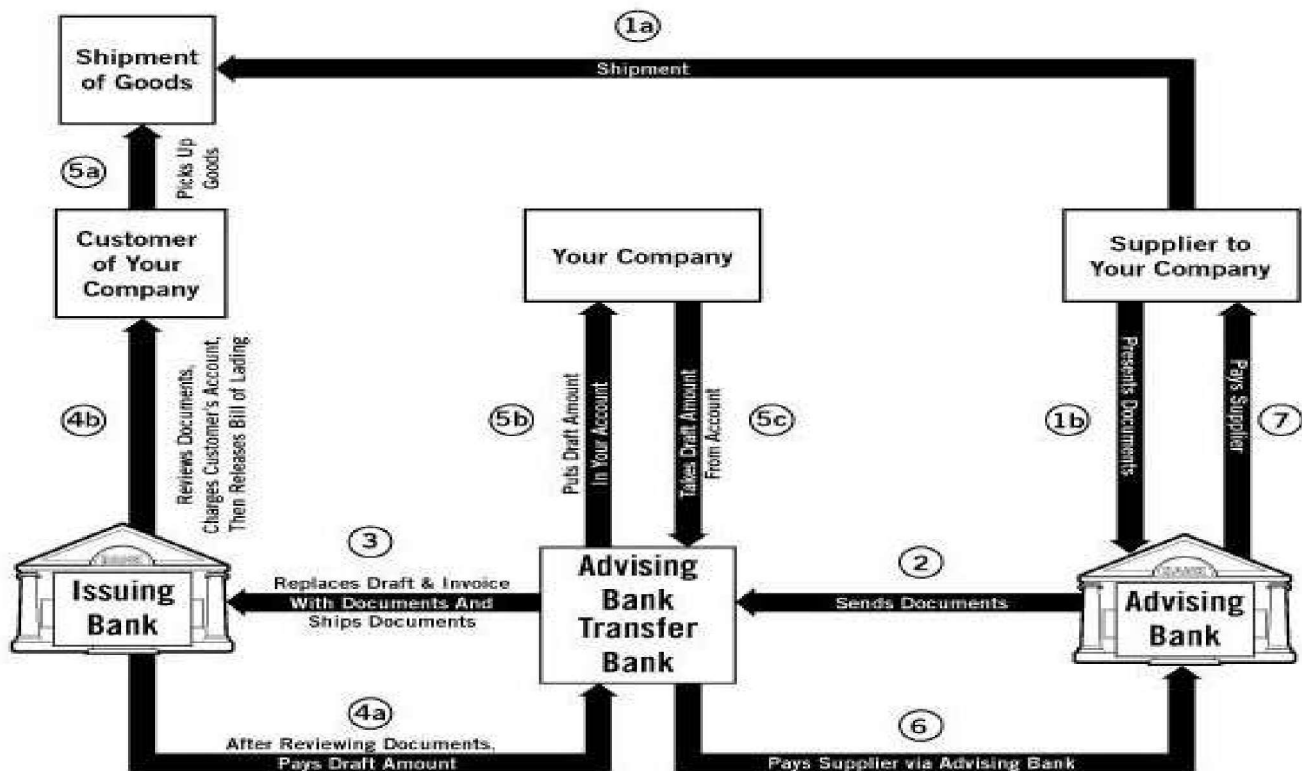
- **Standby Letter of Credit:** Standby LCs are similar to guarantees. Due to their documentary nature, they fall under the UCP (Uniform Customs and Practice for Documentary Credits). Standby letters of credit can also be issued under ISP98 (International Standby Practices).
- If the guaranteed service/payment is not provided, the seller can invoke the bank's obligation to pay by submitting, together with any other documents that the letter of credit might require, a declaration stating that the letter of credit customer has failed to meet his obligations/payment.

Common Mistakes under LC



- Late shipment or Presentation
- Stipulated documents are not prepared as specified by LC
- Certificate of origin or certificate of inspection are not signed
- The goods description on commercial invoice does not correspond to description on LC
- Documents are not properly endorsed like signed by exporter/bank/agency
- B/E (drafts) are not presented as required or are prepared improperly
- Insurance document is dated after shipment date or does not cover the risk as requested by credit the types of risks, extent of risk coverage or currency differs from what is stated in LC
- Transport document is not prepared as per LC or is not properly signed
- Right number of documents not submitted as mentioned in documents

Back-to-Back Letter of Credit



Buyer's Credit

• Need for Credit Facility:

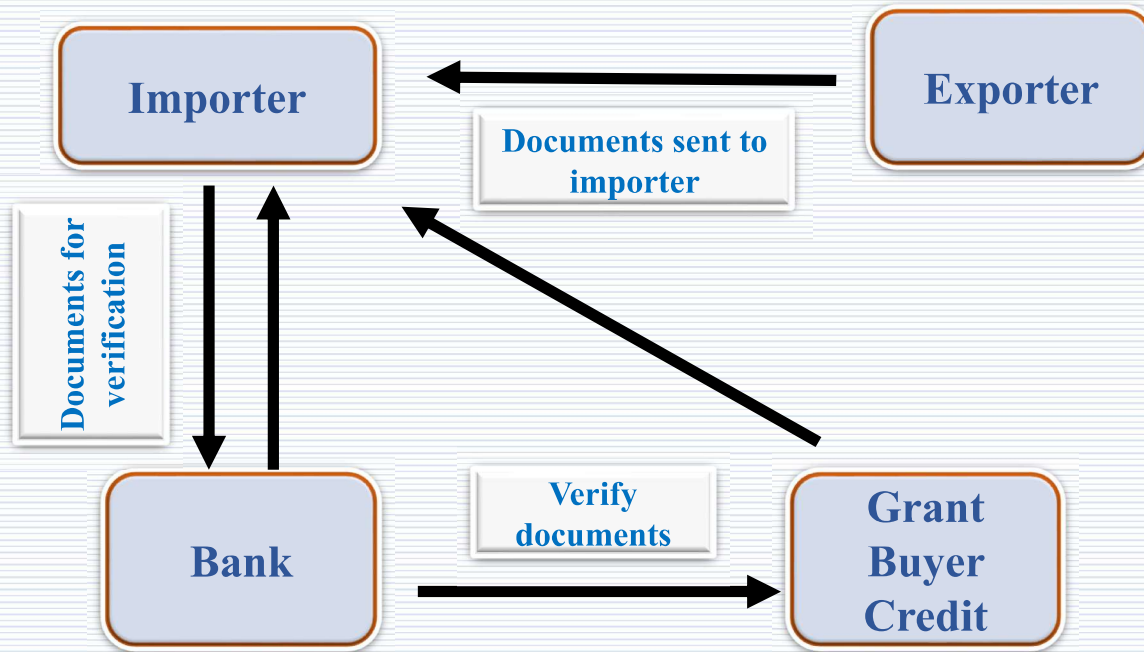
- If exporter does not discount LC, he would ask for payment on due date from importer
- Many times importer does not have ready cash available

• Option to importer: Buyer's Credit i.e. Bank Loan

- Buyer's credit facility can not be used to make advance payment
- Payment can be done only when bank has proof of shipment of goods i.e. export documents including bill of lading.

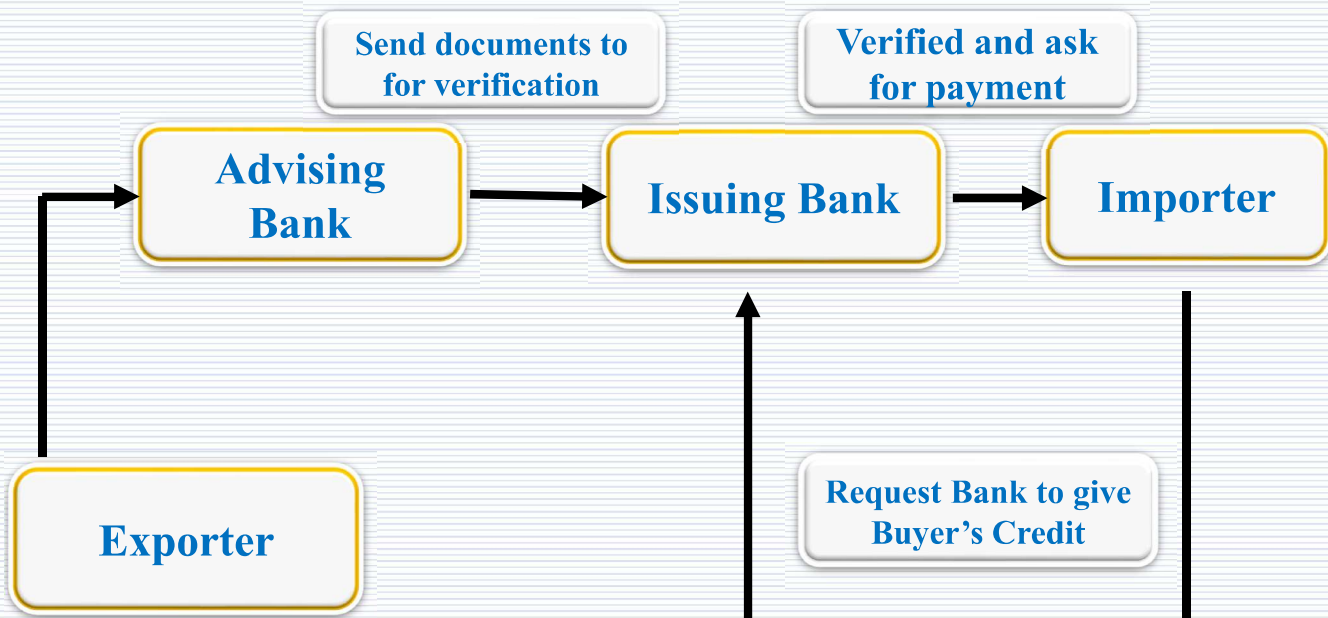
Buyer's Credit

• Documents sent Directly



Buyer's Credit

• Documents sent indirectly



Buyer's Credit

Q. Why importer does not pay through cash credit?

- Ans. Because it is maintained in INR
- **Buyer's Credit:** It is a funding done by overseas bank in foreign currency and its borrowing cost is LIBOR + spread
- Hence it is a cheaper source of foreign currency loan to Indian importer

Q. Who can avail buyer's credit?

- Creditworthy clients having:
 - High Net worth
 - Financial Statements
 - Banks would also ask for property mortgages to recover in case of default

Buyer's Credit: Prior to Nirav Modi

- Importer approaches overseas bank i.e. bank at exporter's destination and after due diligence bank can provide 'Buyer's Credit'
- But practically it is difficult by small importers to directly approach overseas bank (Big companies like Tata can do it)

Buyer's Credit: Prior to Nirav Modi

- **Alternative Approach:**

1. Importer goes to domestic bank and presents his case along with documents
2. Importer requests domestic bank to approach overseas bank. ***It is to be noted that buyer's credit can be issued only by overseas bank***
3. Domestic bank makes due diligence and take quotations from overseas bank
4. Overseas bank send quotations to domestic bank which is being shared with importer
5. Once terms are agreed by importer, domestic bank sanctions buyer's credit facility after taking security from importer asks overseas bank to grant loan
6. Overseas bank would ask for security from domestic bank in lieu of which domestic bank gives Letter of Undertaking (LoU) or Letter of Comfort (LoC). LoU/LoC is an undertaking given by domestic bank that in case of default by importer, domestic bank would make payment
7. After getting LoU/LoC, overseas bank would transfer buyer's credit amount in Nostro account of domestic bank which would make payment in importers account to be paid to exporter
8. On due date overseas bank would ask importer to make payment and in case of default overseas bank take payment from domestic bank who will sell mortgage of importer and recover his amount

Buyer's Credit: Prior to Nirav Modi

Difference between LC and LoU: LC is documentary credit regulated by ICC while LoU is a small 1-2 page document which is an undertaking by domestic bank to overseas bank for issuance of buyer's credit to importer

Buyer's Credit: Nirav Modi Scam

- Issuance of LoU/LoC without collateral by PNB
- No entry of issue of LoC/LoU in Bank's Core Banking System (CBS) by PNB staff which is mandatory
- Buyer's Credit facility, as per RBI, has to be given for :
 - Non Capital Goods : 1 year or operating cycle whichever is less
 - Capital Goods: Upto 3 years
- PNB issued buyer's credit for 1 year irrespective of capital or non-capital goods
- SWIFT (Society for Worldwide Interbank Financial Telecom) details not entered into CBS
- As per norms SWIFT details (communication among banks in international trade) have to be entered in CBS which was not done
- Non-Audit of Nostro Account: Because of no entry of LoU/LoC, if Nostro A/C had been audited they could have caught the scam

Buyer's Credit: Nirav Modi Scam

- On due date, more LoU/LoC's were issued to other banks to generate funds to settle previous dues
- Whole scam continued from 2011-2018 and more than INR12000 crores were involved
- Employee transfer policy of 3 years not followed
 - 2 PNB officials who helped in scam were not transferred

Buyer's Credit: Discovery of Scam

- One of the two employees retired and a new honest person joined
- Nirav Modi company asked for issuing LoU/LoC and when the new employee asked for security the company said as a practice they were not giving any security
- The new employee checked previous transactions and scam was unleashed

Buyer's Credit: Impact of Scam

- Scam was revealed in January 2018 when a corrupt employee retired and was replaced by honest employee
- PNB wrote letters to all banks in February 2018 asking if they are in possession of any such fraudulent LoUs/LoCs
- In March 2018, RBI discontinued process of LoU/LoCs and instead asked to use LC/BGs to replace them.
- It meant that domestic banks issue either LC/BG to overseas bank for getting credit to the importer
- SWIFT code of such transactions to be booked under MT760 instead of MT799

Buyer's Credit: Post Scam

- Instead of LoU/LoC banks started using SBLC which is as per UCP600
- SBLC: has a format of 1-2 pages which is less detailed than LC but it is regulated and governed by UCP600 and more authentic
- Change in SWIFT code from MT799 (general communication among banks) to MT760 (communication in regards to LC)
- GIFT (Gujarat International Finance Tec-city) city is another solution to it
- Branch of bank set up in GIFT city would be treated as 'Foreign Branch of Indian Bank' and hence can issue SBLC to its Indian Branch
- In buyer's credit maximum pricing is restricted by RBI to Libor +250 basis points

Foreign Currency Demand Loan

- In Buyer's credit SBLC has to be issued by domestic bank to foreign bank
- In FCDL, SBLC is not issued rather loan is given by domestic bank to importer and domestic bank on its own arranges for currency
- It's a dealing between buyer and domestic bank
- It is not done for import of capital goods
- It's tenure is 6 months or operating cycle whichever is less
- Benefits of FCDL to Bank: In buyer's credit maximum pricing is restricted by RBI to Libor +250 basis points whereas in FCDL there is no RBI guideline for maximum price

NOSTRO, VOSTRO AND LORO ACCOUNTS

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NOSTRO, VOSTRO AND LORO ACCOUNTS

In interbank transactions, foreign exchange is transferred from one account to another account and from one center to another center.

Therefore, the banks maintain three types of current accounts in order to facilitate quick transfer of funds in different currencies

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NOSTRO, VOSTRO AND LORO ACCOUNTS

- Therefore, the banks maintain three types of current accounts in order to facilitate quick transfer of funds in different currencies.

Nostro
Account

Vostro
Account

Loro
Account

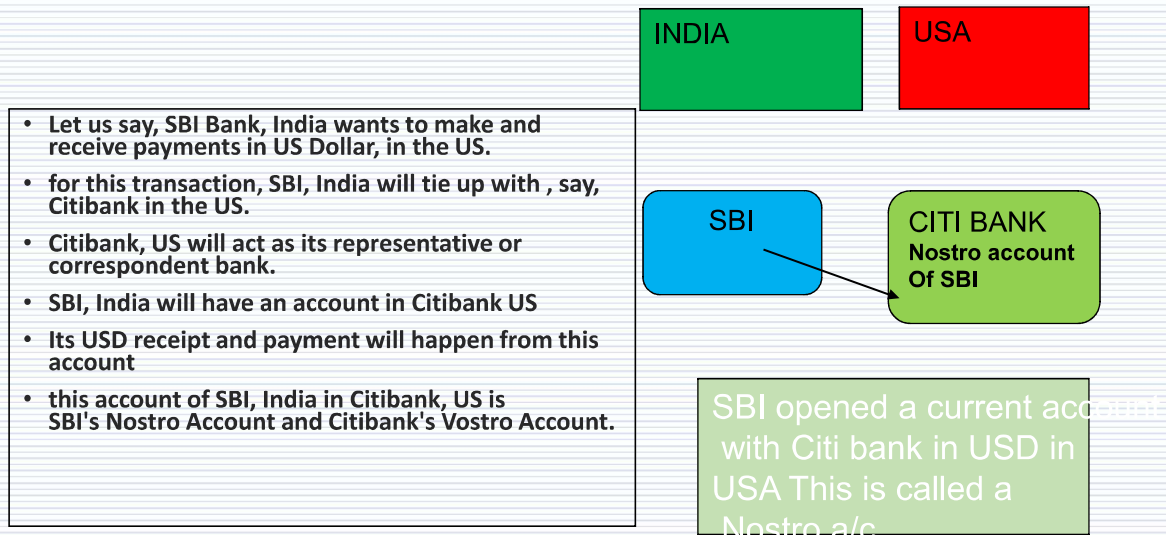
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Nostro Account

A bank's foreign currency account maintained by the bank in a foreign country and in the home currency of that country is known as Nostro Account

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Example-NOSTRO AND VOSTRO ACCOUNT



NOSTRO ACCOOUNT

A Nostro account is a reference used by Bank X to refer to "our" account held by Bank Y.

Nostro is a shorthand way of talking about "our money that is on deposit at your bank"

The Nostro account is the record of the bank that has money on deposit at another bank.

These accounts are often used to simplify settlements of trade and foreign exchange transactions.

VOSTRO ACCOOUNT

Vostro is the term used by Bank Y, where bank X's money is on deposit.

Vostro is a reference to "yours" and refers to "your money that is on deposit at our bank."

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NOSTRO and VOSTRO Accounts

"Nostro" and "vostro" are two different terms used to describe the same bank account.

The terms are used when one bank has another bank's money on deposit, typically in relation to international trading or other financial transactions

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NOSTRO and VOSTRO Accounts

Nostro comes from the Latin word for "ours," as in "our money that is on deposit at your bank."

Vostro comes from the Latin word for "yours," as in "your money that is on deposit at our bank."

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Loro account

When domestic banks use the account of third party banks

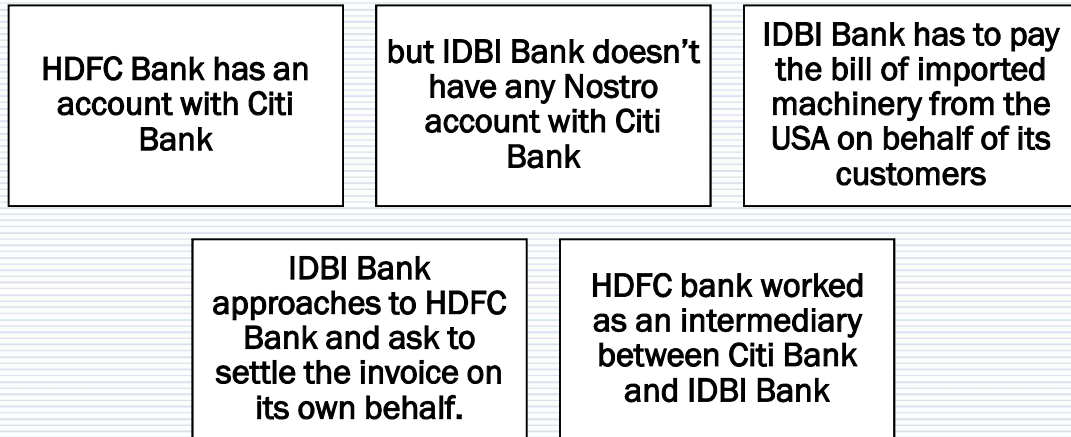
which holds a Nostro account to settle foreign exchange transactions

these type of transactions are included under the Loro Account.

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Loro account - Example



Thank You

Chapter No 2

Pre and Post Shipment Financing



Pre and Post Shipment Financing

Dr. Asheesh Pandey

Indian Institute of Foreign Trade
New Delhi

Government Programs to Help Finance Exports

- Governments of most export-oriented industrialized countries have special financial institutions that provide some form of subsidized credit to their own national exporters.
- These export finance institutions offer terms that are better than those generally available from the competitive private sector.
- Thus domestic taxpayers are subsidizing lower financial costs for foreign buyers in order to create employment and maintain a technological edge.
- The most important institutions usually offer export credit insurance and a government-supported bank for export financing.

INSTITUTIONAL FRAMEWORK FOR EXPORT FINANCE

- Several financial benefits were made available to Indian exporters
- To accelerate the flow of credit financial institutions have been established in India.
- **Regulatory Institutions:**
 1. Reserve Bank of India (RBI)
 2. Directorate General of Foreign Trade (DGFT)
 3. International chamber of Commerce (ICC)
 4. Foreign Exchange Dealer's Association of India
- **Other important Institutions:**
 1. Commercial Banks
 2. Export-Import Bank of India (EXIM)
 3. Export Credit guarantee Corporation Of India ltd.(ECGC)

RESERVE BANK OF INDIA

- Central bank and apex body of all financial institutions in India.
- It's major role in trade is concerned with:
 - Exchange Control: It oversees the payments and receipts by residents to non-residents and vice versa
 - Credit Norms of RBI: Any credit being extended to another party is controlled by RBI credit norms
- So, both international trade and currency transactions come within the scope of various RBI regulations
- RBI also closely monitors international transactions in order to ensure compliance with various forex regulations
- FEMA (Foreign Exchange Management Act) is an important act that lays down the underlying regulations governing all foreign currency transactions in India

Director General of Foreign Trade (DGFT)

- DGFT operates under Ministry of Commerce and it lays down policies and regulations relating to physical movements of goods into India
- Any company undertaking imports or exports of goods/services requires to get itself registered with DGFT
- DGFT issues an Importer Exporter Code (IEC) to the company which is a unique code that the company needs to provide to bank and to customs/other regulatory agencies while making International transactions
- IEC code also helps DGFT and other regulatory agencies in keeping track of various International Transactions done by the company

International Chamber of Commerce (ICC)

- ICC is an apex international body, which forms the guidelines for smooth functioning of trade and forex transactions across countries
- It has created a set of rules called UCP600 (Uniform Customs and Practices for Documentary Credit) to be used by banks throughout the world for LC transactions
- The interests of India, with regards to ICC regulations is looked after by Indian National Chapter (INC) which is based in New Delhi

Foreign Exchange Dealers' Association of India (FEDAI)

- FEDAI is the apex forum of all banks authorized to deal in forex issues and guidelines.
- It is self regulated organization (SRO)
- It's major activities include:
 - framing of rules governing the conduct of inter-bank foreign exchange business
 - liaison with RBI for reforms and development of forex market
 - Training of bank personnel in the areas of forex business
 - Accreditation of Forex brokers

Commercial Banks

- Commercial banks provide major part of export finance.
- They extend financial assistance both at pre-shipment and post-shipment.
- The directives of RBI under Exchange Control Regulation Act make it obligatory for payments of exports to be settled through the medium of a bank in India authorized to deal in foreign exchange.

COMMERCIAL BANKS SERVICES ARE DIVIDED INTO TWO

- Fund based assistance also known as Financial Services.
- Non-fund based assistance also known as non-financial assistance.
- Fund based assistance These are in the form of advances, credits and loans offered at various stages.
 - 1.Pre-shipment finance
 - 2.Post-shipment finance

NON-FUND BASED ASSISTANCE

1. Bank guarantees
 - ❖ Performance guarantee
 - ❖ Advance payments guarantee
 - ❖ Guarantee for payment of retention money
 - ❖ Guarantee for loans in foreign currency
2. credit ratings of importers.
3. Information about foreign exchange.
4. Dollar account
5. Confirmation of letters of credit
6. Forward exchange contracts

Export Import (EXIM) Bank of India

- EXIM bank, a premier export finance institution of the country was set up in 1982
- Objective was not just to enhance exports from India but also to integrate country's foreign trade and investments with the overall economic growth.
- Role of EXIM Bank:
 - i. Coordinator: between financial institutions to help exporters get finance from financial institutions
 - ii. Source of Finance: Pre shipment, Post shipment, Buyer's Credit, BG especially for capital projects; Line of credit to overseas financial institutions or governments of other nations
 - iii. Consultant: research and analysis; export advisory; marketing advisory
 - iv. Financing international joint ventures both in debt and equity
- Agri export Advantage: multi-lingual, quarterly publication

Export Credit Guarantee Corporation (ECGC) of India

- ECGC was established in 1957 by Government of India to strengthen export promotion drive by covering risk of exporting on credit
- Role of ECGC in export promotion:
 - Offers insurance protection to exporters against commercial and political risk
 - Provides guidance in export related activities
 - Credit ratings for different countries
 - Makes it easy to obtain export finance from banks/financial institutions
 - Assist exporters in recovering bad debt
 - Provides information about credit worthiness of foreign buyers
 - Different types of credit insurance covers to bank and other financial institutions to enable them to extend credit facility to exporters
 - Factoring service to MSME sector

Pre-Shipment Finance

- Packing Credit (PC)

Requirements for getting Packing Credit

- Exporter should have 10 digit importer-exporter code (IEC) number allotted by DGFT
- Exporter should not be in cautious list of RBI
- Exporter should not be in Specific Approval List of ECGC
- For restrictive category goods (as per current FTP), exporter should have requisite authorization/quota permit from DGFT to export Goods

Quantum of Pre-Shipment Finance

- Quantum of finance is granted to exporter on the basis of “Need based” principle
- It is granted against either LC or an expected order
- Banks decide financing based on:
 - Nature of order
 - Nature of commodity
 - Capability of exporter to bring in the requisite contribution in terms of forex

Pre-Shipment Credit Facility: Why?

- Suppose Mr. John places, an order of Basmati Rice in 6 months to be shipped in 5 months
- John has to:
 - Buy raw-material
 - Incur Manufacturing expenses like machine, labor etc.
 - Work in Progress (Storage Cost)
 - Finished Stock (say in 4 months)
 - Packing
 - Transportation to Port
 - Custom Clearance
 - Shipping
- In order to meet working capital needs, an exporter requires credit known as pre-shipment credit or packing credit

Pre-Shipment Credit Facility: Why?

- Suppose his operating cycle is as follows:

Process	Time Period
Manufacturing	4 months
Shipping	15 days
Goods Reaching Destination	15 days
If DA Bill	2 months
Total working Capital	7 months

- Now, suppose he gets another order to export, he won't be able to execute it as his money is blocked
- Solution: Pre-shipment Credit

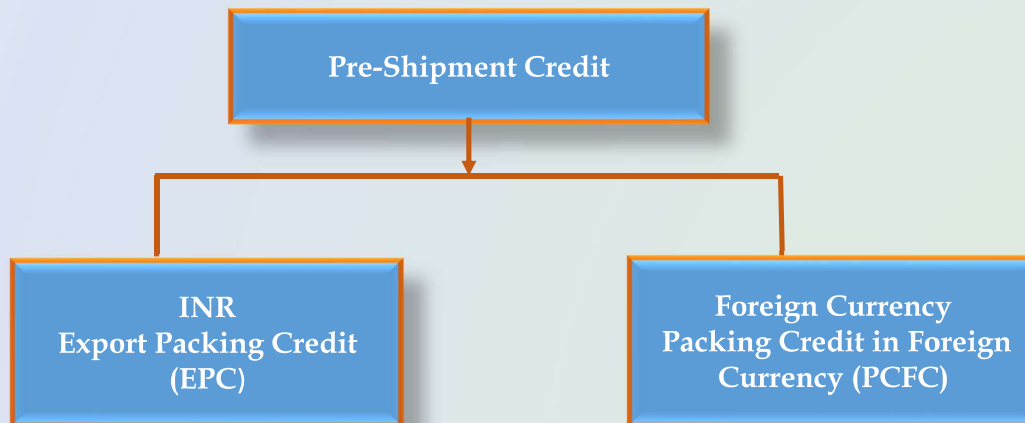
Pre-Shipment Credit Facility: Process

- Exporter would approach a bank and request for pre-shipment credit based on order received to meet working capital requirement
- Banks after making due diligence provide exporter packing credit. Due diligence includes:
 - Export order
 - Financial statements of exporter
 - Part Funding
 - CIBIL Score (Credit Information Bureau (India) Ltd.)
 - Property Mortgage
- Exporter has to repay bank on the day bill of lading is generated i.e. shipment is done
- Otherwise loan would stand in 'overdue'
- Bank would do pre-shipment financing based on :
 - Stock
 - Manufacturing Expenses
 - Packing
 - Less: any credit received from vendor

Note: Pre-shipment Finance is 'Stock financing' while post shipment financing is 'Debtor Financing'

Pre-Shipment Credit Facility: Process

Pre-shipment Facility Time: Normally it is given for 180 days in maximum cases which may be extended by two times of 90 days each (i.e. 180 extension days making total period of 360 days) by special approval of bank



EPC Vs PCFC

- Bank will open Pre-shipment credit A/C like a running account and make disbursement in that account
- PCFC: Bank can open separate PCFC account for each currency
- Benefits of PCFC:
 - Low rate of interest and is linked with LIBOR (London Interbank Offered Rate)
 - Generally, EPC is given for 8-9% (MCLR or Repo) while PCFC rate is around 3-4%
 - Hedges Exchange Risk: As you avail credit in foreign currency, it is repaid with export proceeds while in EPC currency is risk is high
- So, why should exporter take EPC?
- **Interest Equalization Scheme:** If packing credit is taken by MSME client in INR, then government gives 5% interest subsidy
- So, if bank charges 8% interest and subsidy is 5%, net credit rate is 3% which is almost equal to PCFC.
- However, this scheme is available in few sectors which are mostly labor intensive sectors like processed agriculture' food item sectors, handicrafts, coir, readymade garments etc.

EPC and PCFC Account

- **Both credit facilities can be taken in two forms:**

- Order Based
- Running Limit

- **Order Based Packing Credit Facility:**

- Importer places export order
- Exporter goes to bank for credit facility
- In order based facility, for every order there would be 'unique reference number'
- Payment against this credit has to be made by payment received against same client
- Banks track and monitor this order through unique reference number
- Exporter can not settle this payment through any other export's payment received
- However, if the first client against whom credit was taken sends payment against some other order it can settle

EPC and PCFC Account

- **Merit and Demerit of Order Based Financing:**

- Merit is that it leads to better control through tracking of order
- If repayment is not done on time it will be traded as 'overdue' and bank can charge hefty penalty against it and it also leads to poor CIBIL score and decrease in creditworthiness of exporter
- *Order based system is generally bad for both client and bank; for bank it may lead to high NPAs and for client high risk*

EPC and PCFC Account: Running Order

- In this system, payment can be settled from any client
- It is less risky system and is like a cash credit limit
- Exporter opens an account and banks provide a credit limit
- Example: Suppose exporter takes 3 month packing credit with sanctioned limit as INR 15 Lakhs

Date	Particular	Dr.	Cr.	Limit Utilized
1 st July	PC disburses (David)	7500		(7,500)
20 th July	PC Disburses (Richard)	10,000		(17,500)
31 st August	PC disburses (John)	20,000		(37,500)
30 th September	Payment Received (John)		18,000	(19,500)

Note: Payment under this method is adjusted on FIFO (First in First Out) method and hence, risk of overdue is very less in this method

Advances Against Cheques/Drafts received as Advance Payment

- If exporter receives advance payment in form of cheque/draft etc., bank may grant export credit at concessional rate to exporters of good track record, till the realization of such cheques/drafts etc.
- Bankers must satisfy themselves that proceeds are against export order

Liquidation of Packing Credit

- By discounting/negotiating LC and converting packing credit to Post shipment credit
- Through Export remittances if no post shipment credit is availed
- Payment receivable through government in terms of duty drawbacks etc.
- If export does not takes place or exporter does not pay packing credit on time, bank would term it as 'overdue' and may recover its entire amount along with market rate of interest

Rupee Packing credit to specific sectors

- **Rupee Packing Credit to manufacturers or suppliers for exports routed through STC/MMTC/Other Export Houses/Agencies etc.**
 - Banks may grant PC to manufacturers or suppliers who do not have export orders/letters in their own name and goods are exported through STC/MMTC etc.
- **Rupee Export Packing Credit to sub-suppliers: Packing credit can be shared between an Export Order Holder (EOH) and sub-supplier of raw materials, components etc. of the exported goods as in the case of EOH and manufacturer suppliers, subject to the following:**
 - ❖ Running Account facility is not contemplated under the scheme. The scheme will cover the LC or export order received in favor of Export Houses/Trading Houses/Star Trading Houses etc. or manufacturer exporters only. The scheme should be made available to the exporters with good track record.

Contd.....

- ❖ Bankers to an EOH will open an inland LC specifying the goods to be supplied by the sub-supplier to the EOH against the export order or LC received by him as a part of the export transaction. On the basis of such a LC, the sub-supplier's banker will grant EPC as working capital to enable the sub-supplier to manufacture the components required for the goods to be exported.
- ❖ It is upto the EOH to open any number of LCs for the various components required with the approval of his banker/leader of consortium of banks within the overall value limit of the order or LC received by him.
- ❖ The EOH will be responsible for exporting the goods as per export order or overseas LC and any delay in the process will subject him to the penal provisions issued from time to time.
- ❖ The scheme is an additional window besides the existing system of sharing of packing credit between EOH and manufacturer in respect of exported goods in addition to available against Export houses/ Agencies as above

Contd.....

- ❖ **EOUs/EPZ/SEZ units supplying goods to another EOU/EPZ/SEZ unit for export purposes are also eligible for rupee pre-shipment export credit under this scheme.** However, the supplier EOU/EPZ/SEZ unit will not be eligible for any post-shipment facility as the scheme does not cover sale of goods on credit terms.
- ❖ The scheme does not envisage any change in the total quantum of advance or period. Accordingly, the credit extended under the system will be treated as export credit from the date of advance to the sub-supplier to the date of liquidation by EOH under the inland export LC system and upto the date of liquidation of packing credit by shipment of goods by EOH.. It has to be ensured that no double financing of the same leg of the transaction is involved.
- ❖ Banks may approach the ECGC for availing suitable cover in respect of such advances.
- ❖ The scheme does not envisage extending credit by a sub-supplier to the EOH/manufacturer and thus, the payment to sub-suppliers has to be made against submission of documents by LC opening bank treating the payment as EPC of the EOH.

Rupee Packing credit to specific sectors

• Rupee Pre-shipment Credit to Construction Contractors

- a) The packing credit advances to the construction contractors to meet their initial working capital requirements for execution of contracts abroad may be made on the basis of a firm contract secured from abroad, in a separate account, on an undertaking obtained from them that the finance is required by them for incurring preliminary expenses in connection with the execution of the contract e.g., for transporting the necessary technical staff and purchase of consumable articles for the purpose of executing the contract abroad, etc.
- b) The advances should be adjusted within 365 days from the date of advance by negotiation of bills relating to the contract or by remittances received from abroad in respect of the contract executed abroad.
- c) To the extent the outstandings in the account are not adjusted in the stipulated manner, banks may charge normal rate of interest applicable for working capital finance.

Rupee Packing credit to specific sectors

Export of Services

- Pre-shipment and post-shipment finance may be provided to exporters of all the 161 tradable services covered under the General Agreement on Trade in Services (GATS) where payment for such services is received in free foreign exchange as stated at Chapter 3 of the Foreign Trade Policy 2009-14. All provisions of this circular shall apply mutatis mutandis to export of services as they apply to export of goods unless otherwise specified. A list of services is given in Appendix 10 of HBPv1. The financing bank should ensure that there is no double financing and the export credit is liquidated with remittances from abroad. Banks may take into account the track record of the exporter/overseas counter party while sanctioning the export credit. The statement of export receivables from such service providers may be tallied with the statement of payables received from the overseas party.
- In view of the large number of categories of service exports with varied nature of business as well as in the environment of progressive deregulation where the matters with regard to micro management are left to be decided by the individual financing banks, the banks may formulate their own parameters to finance the service exporters.

Rupee Packing credit to specific sectors

Pre-shipment Credit to Floriculture, Grapes and Other Agro-based

- i. In the case of floriculture, pre-shipment credit is allowed to be extended by banks for purchase of cut-flowers etc. and all post-harvest expenses incurred for making shipment.
- ii. However, with a view to promoting export of floriculture, grapes and other agro-based products, banks are allowed to extend credit for working capital purposes in respect of export-related activities of all agro-based products including purchase of fertilizers, pesticides and other inputs for growing of flowers, grapes etc., provided banks are in a position to clearly identify such activities as export-related and satisfy themselves of the export potential thereof, and that the activities are not covered by direct/indirect finance schemes of NABARD or any other agency, subject to the normal terms & conditions relating to packing credit such as period, quantum, liquidation etc.
- iii. Export credit should not be extended for investments, such as, import of foreign technology, equipment, land development etc. or any other item which cannot be regarded as working capital

Rupee Packing credit to specific sectors

Export Credit to Processors/Exporters - Agri-Export Zones

- Government of India has set up Agri-Export Zones in the country to promote Agri Exports. Agri-Export Oriented Units (processing) are set up in Agri- Export zones as well as outside the zones and to promote such units, production and processing are to be integrated. The producer has to enter into contract farming with farmers and has to ensure supply of quality seeds, pesticides, micro-nutrients and other material to the group of farmers from whom the exporter would be purchasing the products as raw material for production of the final products for export.
- The Government, therefore, suggested that such export processing units may be provided packing credit under the extant guidelines for the purpose of procuring and supplying inputs to the farmers so that quality inputs are available to them which in turn will ensure that only good quality crops are raised.
- Banks may treat the inputs supplied to farmers by exporters as raw material for export and consider sanctioning the lines of credit/export credit to processors/exporters to cover the cost of such inputs required by farmers to cultivate such crops to promote export of agri products.
- Banks have to ensure that the exporters have made the required arrangements with the farmers and overseas buyers in respect of crops to be purchased and products to be exported respectively.

Post Shipment Finance: Types

- Majorly Post-shipment Financing happens in 3 ways:
 - Foreign Bill Discounting (FBD): Financing of DA bill without LC
 - Foreign Bill Negotiated (FBN): Financing of DA bills with LC
 - Foreign Bill Purchase (FBP)
- Note: Only DA bills are fundable in post shipment since credit period is involved for only DA bills as DP bills are settled on sight
- Documents need to be sent to issuing bank through nominated/negotiating bank

Post Shipment Finance: Types

- Foreign Bill Negotiated (FBN) and LC Bill Discounting (LCBD)
- Example:
 - Manufacturing Period: 2-3 months
 - Custom Clearance: 10-15 days
 - Complying Documents sent by exporter: 15 days
 - Total Period = Approx. 4 months
- In case of sight LC: Payment received once LC reaches along with documents to issuing bank
- In case of Usance LC: There is suppose acceptance period of 90 days from bill of lading
- In the above example if BL is generated after 3.5 months, LC payment would be received after 6.5 months (3.5+3)
- Hence, compared to sight LC, exporter will have to wait for another 2.5 months.
- Next option is monetization of assets i.e. FBN where exporter will ask his bank to negotiate LC against documents submitted

Post Shipment Finance: Types

Foreign Bill Negotiated (FBN): Steps for Indian Exporter

1. Advising bank (SBI) sends LC with documents to Negotiating Bank (Axis Bank)
2. Negotiating bank (Axis Bank) confirms that documents are in confirmation with terms of LC and sends it to issuing bank (Citi Bank) who after getting satisfied in turn intimates the same to applicant as well
3. Once advising bank (SBI) gets confirmation from negotiating and issuing bank, it is sure that now issuing bank is liable to make payment
4. Exporter requests negotiating bank (Axis Bank) to negotiate LC and make immediate release of payment
5. Negotiating bank takes interest of 90 days (in case of 90 days usance LC) and give remaining amount to exporter.
6. On maturity negotiating bank (Axis bank) gets its claims from issuing bank (Citibank) who gets claim from applicant.
7. This is called as Foreign bill negotiated and one major benefit of it is that exporter does not have to mortgage any property/security for taking money as LC by issuing bank serves as a security to the discounting bank.

Note:

- Any bill that gets discounted against LC domestically is called LCBD and in case of international trade it is called as FBN
- FBN is done only for usance LC

Post Shipment Finance

- Post-Shipment Finance is also called as 'Debtor Financing' as it is required from the shipment date till the debtor pays
- Exporter would receive period till debtor pays, but he has to manage working capital for that period as well as to process new orders and run business
- This is met by Post Shipment Finance facility

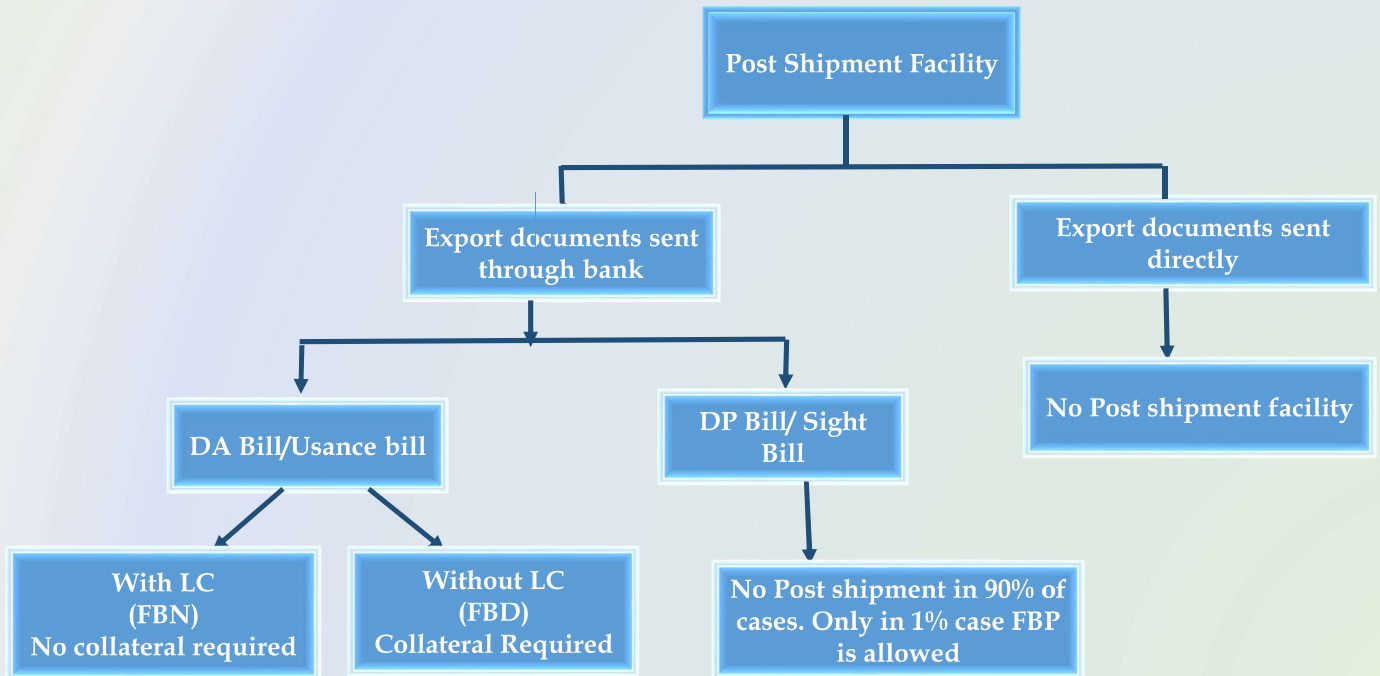
Post Shipment Finance: Example

Particular	Date	Remarks
Export Order Received	1 st May	
Shipment Date (Bill of lading generated)	31 st July	3 month period for shipping goods (met by Pre-shipment credit)
Payment Terms	60 days from sight	
Documents submitted to Advising bank	5 th August	It takes around 1 week from shipment to preparation of documents and submitting them to bank
Ship Reaches destination	31 st August	1 month time from shipment
Advising Bank takes 1 day (submitted on 5 th as above) to check documents and sends it to issuing bank	7 th August	Documents reach issuing bank on 7 th August
Issuing bank checks documents and take acceptance from importer	12 th August	5 Working Days

Post Shipment Finance: Example

- So in above example, from bank's perspective, Post-shipment credit period is from 12th August to 11th October
- However, shipment was done on 31st July. So what happens to 12 days interim period?
- Generally, client will have to manage funds for this period, but if exporter has good relationship with bank and track record; bank would consider interim period also as post shipment period for granting credit. Such financing is called FBP (Foreign Bill Purchase)
- If payment term were 60 days from shipment, then payment would become due on 30th September, but bank would finance only when acceptance and confirmation is done by issuing bank

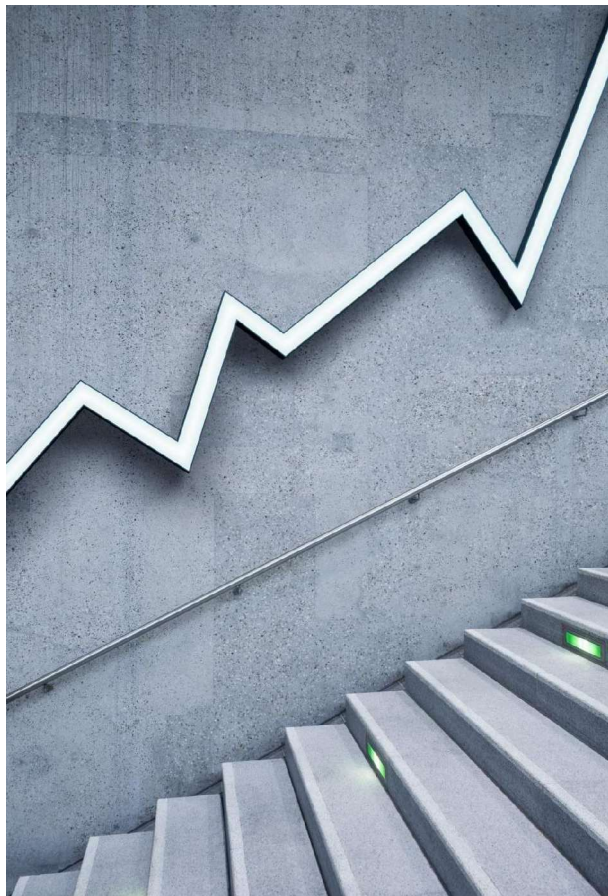
Post Shipment Finance: Types



THANKS

Chapter No 3

Foreign Exchange Exposure and Risk Management



FOREIGN EXCHANGE EXPOSURE AND RISK MANAGEMENT

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Introduction

The forex market is the market in which participants can buy, sell, exchange, and speculate on currencies.

Currency	Bank Buys Notes	Bank Sells Notes
US Dollar (USA)	31.51	32.8
Singapore Dollar (Singapore)	23.46	24.5
日本円 (100) (Japan)	25.83	28.0
人民币 (China)	4.7	

FX Market Participants

The forex market is made up of Banks, Commercial Companies, Central Banks, Investment management firms, Hedge funds, and Retail Forex Brokers and Investors.



The Forex Market

The forex market is made up of two levels; the interbank market and the over-the-counter (OTC) market.

The interbank market is where large banks trade currencies for purposes such as hedging, balance sheet adjustments, and on behalf of clients.

The OTC market is where individuals trade through online platforms and brokers.

What are Foreign Exchange Rates?

Two kinds of exchange rate transactions make up the foreign exchange market:

Spot transaction is an agreement between two parties to buy one currency against selling another currency at an agreed price for settlement on the spot date. Most spot market transactions have a T+2 settlement date.

Forward transaction is an agreement between you and the bank to purchase one currency against selling another currency at a fixed price for delivery on an agreed date in the future

5

Bid, Ask and Spread

Bid, Ask and Spread

A foreign exchange quotes are two-way quotes, expressed as a 'bid' and ask' rates.

Bid is the price at which the dealer/bank is willing to buy another currency.

The ask or offer is the rate at which the dealer/ bank is willing to sell another currency.

7

BID / ASK

BID, BUY –
dealers/bank's
buy price

ASK, SELL ,
OFFER –
dealers/banks
sell price

8

Bid, Offer and Spread

For example, a dealer may quote Indian rupees as Rs 79.80 - 79.90 vis-a-vis dollar.

That means that he is willing to buy dollars at Rs 79.80/\$ (sell rupees and buy dollars), while he will sell dollar at Rs 79.90/\$ (buy rupees and sell dollars).

The difference between the bid and the offer is called the spread.

The offer/ask is always higher than the bid as inter-bank dealers make money by buying at the bid and selling at the offer/ask

9

Bid / Ask & Spread

If you want to buy currency, you have to pay the higher ask price, but if you want to sell currency, you have to sell it at the lower bid price.

So if you were to buy currency, then immediately sell it back to the same dealer, the dealer would make money, and you would lose money.

Thus, the spread is the **transaction cost** of trading currency.

10

Quiz 1

John is an American traveller visiting Europe. The cost of purchasing euros at the airport is EUR 1 = USD 1.20 / USD 1.30 , John wants to buy EUR 15,000 , how many dollars he has to pay to the dealer .

- A. USD 13000
- B. USD 19,500
- C. USD 18,000
- D. USD 15,000

1

John is an American traveller visiting Europe. The cost of purchasing euros at the airport is EUR 1 = USD 1.20 / USD 1.30 , George wants to buy EUR 15,000 , how many dollars he has to pay to the dealer .

- A. USD 13000
- B. **USD 19,500**
- C. USD 18,000
- D. USD 15,000

Quiz 2

George is an American traveller returning from Europe. The cost of euros at the airport is EUR 1 = USD 1.20 / USD 1.30 , George wants to sell EUR 3,000 , how many dollars he will get from the dealer

- A. USD 5,000
- B. USD 3,600
- C. USD 3,900
- D. USD 3,000

2

George is an American traveller returning from Europe. The cost of euros at the airport is EUR 1 = USD 1.20 / USD 1.30 , George wants to sell EUR 3,000 , how many dollars he will get from the dealer

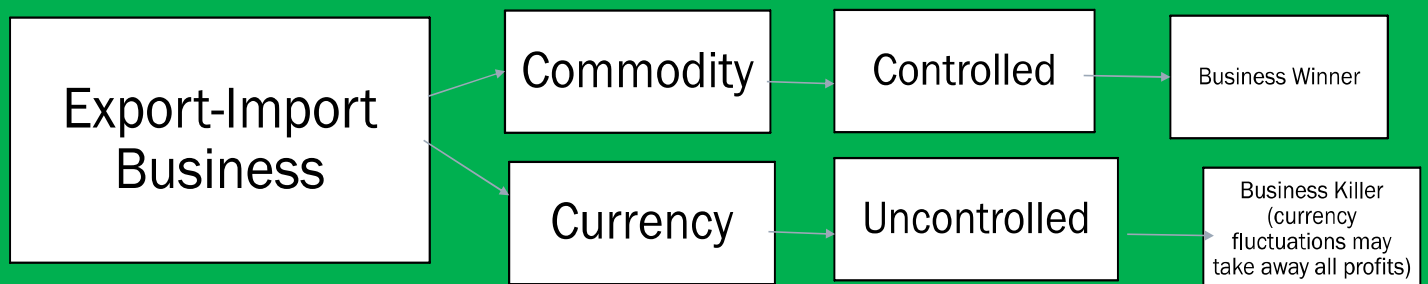
- A. USD 5,000
- B. **USD 3,600**
- C. USD 3,900
- D. USD 3,000

FOREIGN EXCHANGE EXPOSURE AND RISK MANAGEMENT

Foreign exchange (FX) risk is an intrinsic part of doing international business.

The values of major currencies constantly fluctuate against each other, creating income uncertainty for your business.

FOREIGN EXCHANGE EXPOSURE AND RISK MANAGEMENT



FOREIGN EXCHANGE EXPOSURE: UNHEDGED



Currency Price Effect

US \$ Price	Importer	Exporter
75	Booking	Booking
78	Loss	Profit
72	Profit	Loss

Global Currency Markets

- ✓ One of the largest and most liquid in the world
- ✓ Daily turnover of \$ 6.5 Trillion
- ✓ Main trading centers are
 - ✓ London (38%)
 - ✓ New York (18%)
 - ✓ Tokyo (06%)
 - ✓ Singapore (05%)
- ✓ Over 85% of all FX transactions involve 7 major currencies
- ✓ Market never sleeps and has its own rhythm (24/7)
- ✓ Starts in Sydney and ends in St. Francisco
- ✓ Markets: Spot, Forward, Futures and Options
- ✓ Currency Derivatives started in 1972 at CME



Source: BIS 2017 Report

2



Chicago Mercantile Exchange (CME)

USD to INR Chart

Dollar has appreciated 10% in last one year • 1 USD = 82.2281 INR Oct 18, 2022, 03:21 UTC

US Dollar to Indian Rupee



for hemsync.clickagq.com...

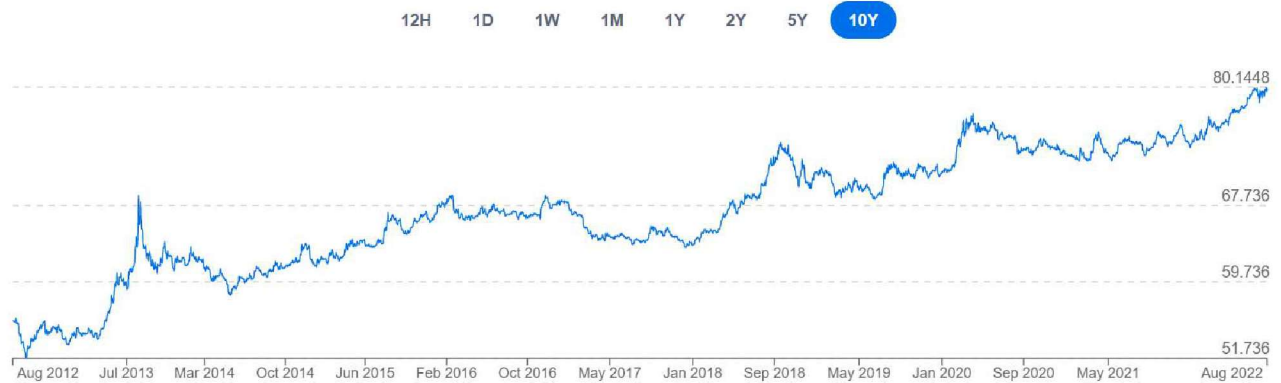
75—82.50

<https://www.xe.com/currencycharts/?from=USD&to=INR>

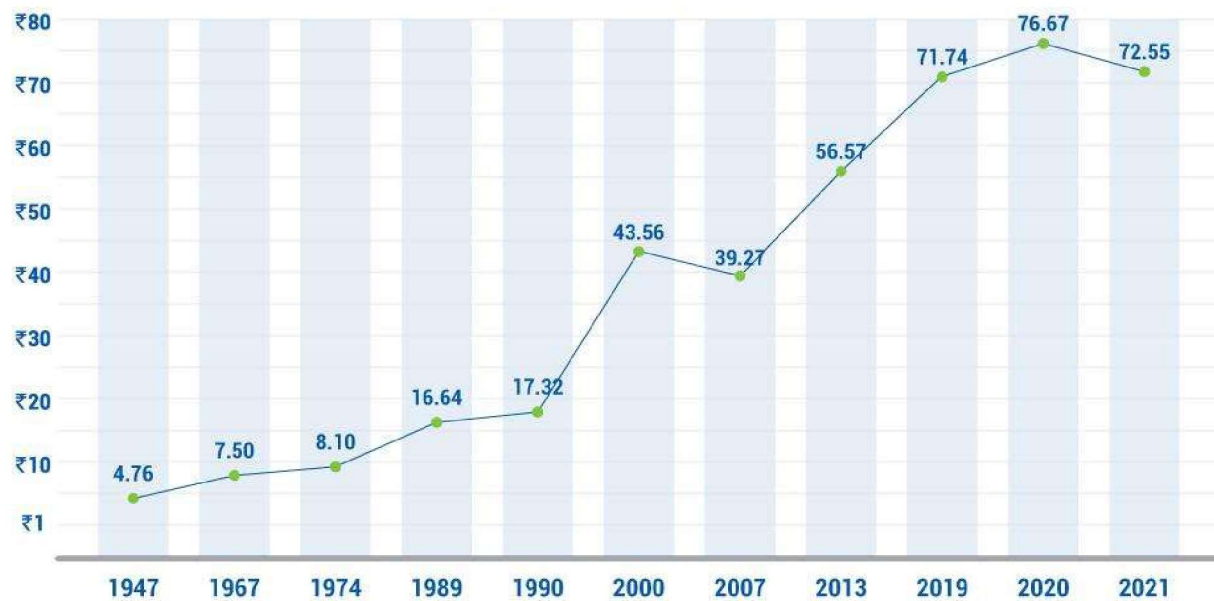
USD to INR Chart

1 USD = 79.7802 INR Aug 25, 2022, 02:58 UTC

US Dollar to Indian Rupee



1 USD to INR Rates from 1947-2021

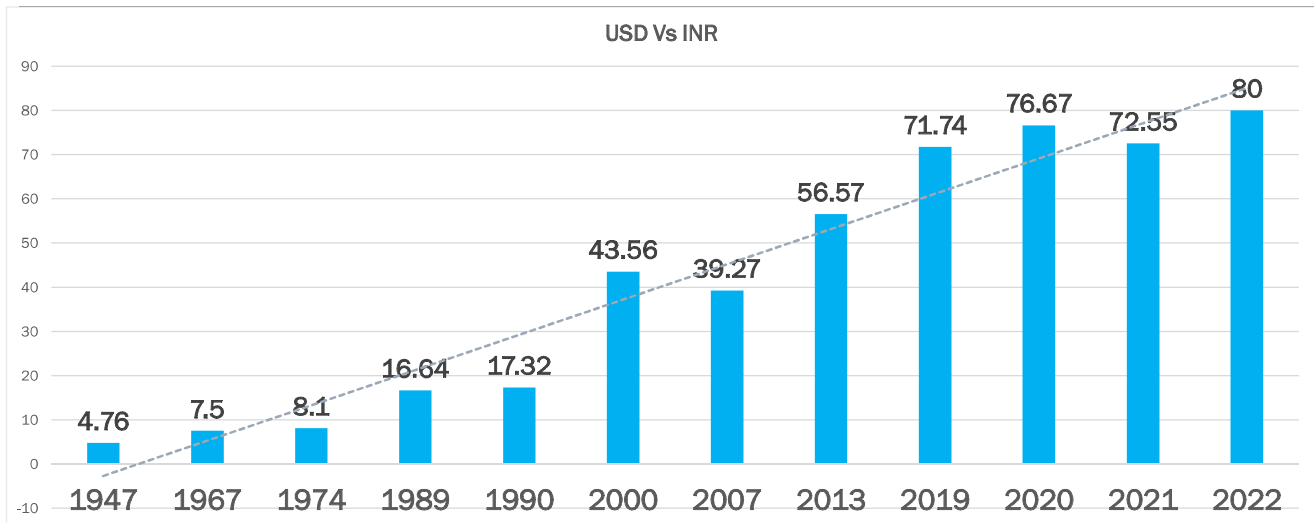


Data Source: Reserve Bank of India (RBI)

CAGR = 4%

www.CompareRemit.com

USD / INR Chart



FOREIGN EXCHANGE EXPOSURE AND RISK MANAGEMENT

Many businesses like to eliminate this uncertainty by locking in future exchange rates.

But some businesses regard exchange rate movements as a profit opportunity.

FOREIGN EXCHANGE EXPOSURE AND RISK MANAGEMENT

The simplest risk management strategy for reducing foreign exchange risk is to make and receive payments only in your own currency.

FOREIGN EXCHANGE EXPOSURE AND RISK MANAGEMENT

You might lose customers to competitors who offer more currency flexibility and your suppliers may be unwilling to accept payments in what is to them a foreign currency

So you may therefore find that competitive pressures force you to explore a risk management strategy that helps manage your foreign exchange risk more efficiently.

HEDGING CURRENCY RISK

HEDGING CURRENCY RISK : is a way for a company to minimize or eliminate **foreign exchange risk**.

***Internal
Techniques-within
the business
itself***

***External
Techniques-
involve dealing
with a third party***

Hedging Foreign Exchange Risk

Internal Techniques:

Leading and lagging
Invoicing in domestic currency
Netting

External Techniques:

Forwards
Futures
Options

Internal Techniques

Leading and Lagging-Leading means advancing a payment i. e. making a payment before it is due. Lagging involves postponing a payment i. e. delaying payment beyond its due date.

Example: X Ltd imports \$1,00,000 goods from abroad
(current rate 1\$ =Rs 75)
Payable after 6 months

X :Ltd expects \$ to appreciate significantly in next 6 months . So X plans to pay the amount upfront

Internal Techniques

Leading and Lagging-Leading means advancing a payment i. e. making a payment before it is due. Lagging involves postponing a payment i. e. delaying payment beyond its due date.

For example an Indian Firm which is due to receive payments from its customer in the UK, may press for prompt payment from the customer if it expects the INR to appreciate in future

when this happens we say that the Indian firm is leading its receivables.

One pound = 102.5 → Rs 100

Internal Techniques

Invoicing in Domestic Currency- invoicing in domestic currency, an exporter can shift transaction risk to his customer abroad

X Ltd invoices Rs75,000 for their exports (at the time of export 1\$ =Rs 75)
Payment receivable after 6 months

1\$ = Rs 70 after 6 months
X receives Rs 75,000
Importer has to pay \$ 1071.42 as against \$1000

$\text{Rs } 75,000 / 70 = \1071.42

Internal Techniques

Netting-Exposure **netting** is a method of hedging **currency risk** by offsetting exposure in one currency with exposure in the same or another currency.

Example : X India Ltd owes \$1,00,000 to its group company X USA Ltd for the goods supplied and X USA Ltd also owes \$ 80,000 for the services provided to X India Ltd

Internal Techniques

Netting-Exposure **netting** is a method of hedging **currency risk** by offsetting exposure in one currency with exposure in the same or another currency.

Example : X India Ltd owes \$1,00,000 to its group company X UK Ltd for the goods supplied and X UK Ltd also owes £ 78000 for the services provided to X India Ltd (1\$ = £.78)

External Techniques- Derivative Instruments

FORWARD
CONTRACTS

FUTURES
CONTRACTS

OPTION
CONTRACTS

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Currency Forward Contract

Forward Contract

A forward contract is a **customized contract** between two parties to buy or sell an asset at a specified price on a future date.

A forward contract can be used for hedging or speculation, although its non-standardized nature makes it particularly apt for hedging.

Forward Contract

A currency forward is a customized, written contract between parties that sets a fixed foreign currency exchange rate for a transaction that will occur on a specified future date.

The future date for which the currency exchange rate is fixed is usually the date on which the two parties plan to conclude a buy/sell transaction of goods.

FORWARD CONTRACT

Thus, Salient features of Forward contract are:

1. Private deals b/w two parties to exchange cash in future
2. No cash flow at initiation of contract
3. Non-standardized contracts in self regulated forward market
4. Contract size and maturity period can be customized so it provides perfect hedge
5. Mostly interbank transactions traded over the counter

6. There is normally no insistence on margin as the bank and client know each other
7. High counter party risk which may lead to default

Understanding Currency Forward Contracts

Currency forward contracts are primarily utilized to hedge against currency exchange rate risk.

It protects the buyer or seller against unfavorable currency exchange rate occurrences that may arise between when a sale is contracted and when the sale is actually made.

However, parties that enter into a currency forward contract forego the potential benefit of exchange rate changes that may occur in their favor between contracting and closing a transaction.

Example of Forward Contract

A Ltd. of India has imported some chemical worth of USD 3,64,897 from one of the U.S. suppliers.	The amount is payable in six months time. The relevant spot and forward rates are:	Spot Rate BID \$1 = 74.2150 ASK \$1 = 74.2250
Six Months forward rate BID \$1 = Rs74.324 ASK \$1 = Rs 74.327	Forecasted Spot rates after six months BID \$1 = Rs74.720 ASK \$1 = Rs 74.860	Should he hedge his forex exposure or leave it unhedged ?

Solution

Amount payable in USD 3,64,897 after six months	Six Months forward rate BID \$1 = Rs74.324 ASK \$1 = Rs 74.327	$\$3,64,897 \times 74.327$ =Rs 2,71,21,699
---	--	---

Solution

Forecasted Spot
rates after six
months

BID \$1 = Rs74.720
ASK\$1= Rs 74.860

Amount payable if
not hedged
 $\$3,64,897 \times 74.860$
Rs 2,73,16,189

Solution

OPTION 1 :
HEDGED
Rs 2,71,21,699

OPTION 2 :
UNHEDGED
Rs 2,73,16,189

OPTION 1 is
better so take a
forward cover

Exercise

XYZ Ltd. of India has imported some equipment worth of £ 5,00,000 from one of the UK. suppliers.	The amount is payable in six months time. The relevant spot and forward rates are:	Spot Rate BID £1 = 100.2150 ASK £1= 100.2250
Six Months forward rate BID £1 = Rs100.324 ASK£1= Rs 100.327	Spot rates after six months BID £1 = Rs100.720 ASK£1= Rs 100.860	Should he hedge his forex exposure or leave it unhedged ?

Solution

Amount payable in £ 5,00,000 after six months	Six Months forward rate BID £1 = Rs100.324 ASK £1= Rs 100.327	£ 5,00,000 X 100.327 = Rs 5,01,63,500
---	---	---

Solution

Spot rates after six months

BID \$1 = Rs100.720

ASK\$1= Rs 100.860

Amount payable if not
hedged $\text{£}5,00,000 \times$
100.860
Rs 5,04,30,000

Outflow in rupee under both the options

OPTION 1 :
HEDGED

Rs 5,01,63,500

OPTION 2 :
UHEDGED

Rs 5,04,30,000

OPTION 1 is
better so take a
forward cover

Exercise

An Indian importer has to settle an import bill for \$ 1,30,000. The exporter has given the Indian exporter two options:

(i) Pay immediately without any interest charges

(ii) Pay after three months with interest at 5 percent per annum.

The importer's bank charges 15 percent per annum on overdrafts.

The exchange rates in the market are as follows:

Spot rate (Rs / \$) :
74.35 / 74.36

3-Months forward rate
(Rs / \$) : 74.81 / 74.83

The importer seeks your advice. Give your advice.

Solution

If importer pays now, he will have to buy US\$ in Spot Market by availing overdraft facility. Accordingly, the outflow under this option will be

Amount required to purchase
 $\$1,30,000 \times \text{Rs } 74.36 =$
96,66,800,

Add: Overdraft Interest
for 3 months @15% p.a.
=Rs 3,62,505

Total outflow = Rs
1,00,29,305

Spot rate (Rs / \$) : 74.35 / **74.36**

Solution

If importer makes payment after 3 months then, he will have to pay interest for 3 months @ 5% p.a. for 3 month along with the sum of import bill.

Accordingly, he will have to buy \$ in forward market. The outflow under this option will be as follows:

Amount of Bill = \$1,30,000
Add: Interest for 3 months @5% p.a.= \$1625= Total \$ 1,31,625

Amount to be paid in Indian Rupee after 3 month under the forward purchase contract
Rs 98,49,498
US\$ 1,31,625 X Rs 74.83

Outflow
option1 = Rs 1,00,29,305
Option 2 =Rs 98,49,498

Since outflow of cash is least in (ii) option, it should be opted for.

3-Months forward rate (Rs/\$) : 74.81 / **74.83**

Exercise

XYZ Ltd. of India has exported some equipment worth of \$ 3,00,000 from one of the supplier.

The amount is receivable in six months time. The relevant spot and forward rates are:

Spot Rate
BID \$1 = 76.2150
ASK \$1= 76.2250

Six Months forward rate
BID \$1 = Rs77.324
ASK\$1= Rs 77.327

Expected Spot rates after six months
BID \$1 = Rs76.124
ASK\$1= Rs 76.128

Should he hedge his forex exposure or leave it unhedged ?

Solution

Amount receivable
\$ 3,00,000 after
six months

Six Months forward
rate

BID \$1 = Rs77.324

ASK \$1= Rs 77.327

\$ 3,00,000 X
77.324 =
Rs2,31,97,200

Solution

Expected Spot rates
after six months

BID \$1 = Rs76.124

ASK\$1= Rs 76.128

Amount receivable
if not hedged
\$3,00,000X 76.124
Rs 2,28,37,200

Inflow in rupee under both the options

OPTION 1 :
HEDGED

Rs 2,31,97,200

OPTION 2 :
UHEDGED

Rs 2,28,37,200

OPTION 1 is
better so take a
forward cover

Currency Futures Contract

CURRENCY FUTURES

These are financial contracts that obligate the contracts' buyers to purchase an asset at a pre-agreed price on a specified future date.

Of the two parties, one agrees to buy (who takes long position) while other agrees to sell taking short position.

CURRENCY FUTURES

Future contracts are

- (i) standardized contracts
- (ii.) between two parties who do not necessarily know each other
- (iii) guaranteed for performance by an intermediary known as Stock Exchange

The exchange determines the size of the contract, price to be quoted, delivery location and limits on the amount by which the future price can move in any one day.

CURRENCY FUTURES

Future contracts are Settled on Mark to Market basis (MTM) and are cash settled. Buyers and seller are required to deposit an initial margin which is around 5% of the value of the contract.

In the futures market, margin refers to the initial deposit of "good faith" made into an account in order to enter into a futures contract.

Currency Futures in India

In India the stock exchange provides foreign exchange risk management. The contracts available are:

Futures Contracts in USD-INR,

EUR-INR,

GBP-INR

and JPY-INR.

(maximum of 12 monthly contracts)

To make the markets for USDINR futures deeper and more liquid, NSE has now launched weekly currency futures on the USDINR.

Contract Size (Lot size)

1000USD
USDINR

1000 EURO
EURINR

1000Pounds
GBRINR

1,00,000
Yens
JPYINR

Example on Hedging Using Currency Futures for Importer

XYZ is an Importer. On 15th Nov 2021, XYZ Limited wish to book its outwards remittance for 31st Dec 2021 worth \$100,000.

On 15th Nov
\$ Futures is trading at
74.60 (LTP)
Expiry on 31st Dec

No of Contracts
(100,000/\$1000): 100

Buy Currency Futures 100
contracts at
\$1= 74.60

Margin 3% = INR 2,23,800
(74,60,000 *3%)

What would be the cost to
importer if on maturity RBI
Reference rate is:
a. 75.90
b. 73.60

LTP : Last trading price

Spot rate on 15th Nov 1\$ =Rs 74.27

Month End 31st Dec : Case 1

Assume USD/INR
75.90 (RBI Ref
Rate)

Cash Profit =
 $(75.90 - 74.60) * 1,00,000$
= INR 1,30,000

Margin will get
released

Importer has to
pay Rs 75,90,000
on 31st Dec at spot
rate

Net outflow = Rs
75,90,000 -
1,30,000 = Rs
74,60,000

He is hedged and
fixed his payment
@74.60/\$

Month End 31st Dec : Case 2

Assume USD/INR
73.60 (RBI Ref
Rate)

Loss: = $(73.60 - 74.60) * 1,00,000$
= INR 1,00,000

Margin will get
released

Importer will pay
Rs 73,60,000
on 31st Dec at
spot rate

Net outflow = Rs
73,60,000
+ 1,00,000 = Rs
74,60,000

He is hedged and
fixed his payment
@74.60/\$

Example on Hedging Using Currency Futures for Exporter

XYZ is an exporter. On 15th Nov 2021, XYZ Limited wish to book its inward remittance for 31st Dec. 2021 worth \$100,000.

\$ Futures is currently trading at 74.60
Expiry on 31st Dec

No of Contracts
(100,000/\$1000): 100

Sell Currency Futures 100 contracts at
\$1= 74.60

Margin 3% = INR
2,23,800 (74,60,000 *3%)

What would be the cost to exporter if on maturity
RBI Reference rate is:
a. 73.10
b. 75.60

Spot rate on 15th Dec , 1\$ =Rs 74.27

Month End 31st Dec : Case 1

Assume USD/INR
73.10 (RBI Ref Rate)

Cash Profit =
(73.10-
74.60)*1,00,000
= INR 1,50,000

Margin will get released

Exporter will get
Rs 73,10,000
on 31st Dec at
spot rate

Net Receipts = Rs
73,10,000 +
1,50,000 = Rs
74,60,000

He is hedged and
fixed his receipts
@74.60/\$

Month End 31st Dec: Case 2

Assume USD/INR
75.60 (RBI Ref
Rate)

Loss: = $(74.60 - 75.60) \times 1,00,000$
= INR 1,00,000

Margin will get
released

Exporter will get
Rs 75,60,000
on 31st Dec at
spot rate

Net Receipts = Rs
75,60,000 -
1,00,000 = Rs
74,60,000

He is hedged and
fixed his receipts
@74.60/\$

Difference between Forward and Futures Contract

Difference between Forward and Futures

S.No.		Forward	Future
1.	Trading Location	Over the Counter	Exchange Traded
2.	Regulation	Self-Regulating	RBI, SEBI
3.	Frequency of delivery	Mostly by actual delivery	Cash Settled
4.	Size of Contract	Tailormade	Standardized
5.	Delivery Date	Tailormade	Standardized
6.	Transaction Cost	Bid-Ask Spread	Negotiated brokerage Fees
7.	Margins	Not required normally	Initial and Maintenance margins required
8.	Settlement	On the Maturity Date by actual deliver	Daily on MTM basis, cash settled

Cash flows under forward and Futures:

Value of forward contract changes from the time the contract is entered to the time when it matures because the spot rate the time of contract and its maturity changes

Forward contracts are settled on maturity while futures contract are settled daily on MTM basis

Thus cash flows on forward contract are different from cash flows on futures contract

For example a forward and a futures contract on USD was entered by importer on date 1 (D1) to buy USD at exchange rate of USD/INR 74 for settlement on date 4.

Cash flows to forward and future transactions are shown as:

Cash flows under forward and Futures:

Cash flows of Forward Contract

Date	Forward Rate (USD/INR)	Settlement price (USD/INR)	Cash Flows from Forward (INR)
D1	74.00	72.00	0
D2	74.00	73.00	0
D3	74.00	75.00	0
D4	74.00	76.00	76-74=2

Cash flows of Futures Contract

Date	Forward Rate (USD/INR)	Settlement price (USD/INR)	Cash Flows from Forward (INR)
D1	74.00	72.00	(2)
D2	72.00	73.00	1
D3	73.00	75.00	2
D4	75.00	76.00	1

Options Contract

Options Contract

Buyer has the right to buy while
seller has the obligation to sell

Value derived by the underlying
security

Option Price: Premium

Types of options

Call Option

Option to
buy security
(Long)

Put Option

Option to
sell security
(short)

Types of options

European Option

Settled on Expiry
of contract

(In India European
options are
traded)

American Option

Settled on before
or end of expiry of
contract

Call Option

Call options provide the holder the right (but not the obligation) to purchase an underlying asset at a specified price (the **strike price or exercise price**), for a certain period of time.

If the stock fails to meet the strike price before the expiration date, the option expires and becomes worthless.

Investors buy calls when they think the share price of the underlying security will rise or sell a call if they think it will fall.

Selling an option is also referred to as "writing" an option.

Call Option: Example

Reliance Industries is trading at 2361. (Feb. 15, 2022)

The call option is as follows: Strike price = 2300, Expiry Date = Feb. 24, 2022, Premium on the call = Rs. 81.50

In this case, the buyer of the Reliance call today has to pay the seller of the Reliance call Rs. 81.50 for the right to purchase IBM at Rs.2300 on or before Feb.14,2022. If the buyer decides to exercise the option on or before expiry date, the seller will have to deliver Reliance shares at a price of Rs.2300 to the buyer.

Put Option

Put options give the holder the right to sell an underlying asset at a specified price (the strike price).

The seller (or writer) of the put option is obligated to buy the stock at the strike price.

Investors buy puts if they think the share price of the underlying stock will fall, or sell one if they think it will rise.

Example on Hedging Using Currency Options for Importer

XYZ is an Importer.

On 15th Nov 2021, XYZ Limited wish to book its outwards remittance for 29th Dec 2021 worth \$100,000.

Option Strike price 74.25 is available at premium of Rs 0.25
Expiry on 29th Dec

No of Contracts
(100,000/\$1000): 100

Buy Call option 100 contracts at \$1= 74.25

Option Premium = INR 25,000 (1,00,000 * 0.25)

Spot rate on 15th Nov 1\$ =Rs 74.27

Month End 29th Dec : Case 1

Assume USD/INR
75.75 (RBI Ref Rate)

Cash Profit = $(75.75 - 74.25) * 1,00,000 =$
INR 1,50,000 -
25000 = 1,25,000

Importer has to pay
Rs 75,75,000 on
29th Dec at spot
rate

Net outflow = Rs
75,75,000 -
1,25,000 = Rs
74,50,000

He is hedged and
fixed his payment
@74.50-./\$

Month End 29th Dec : Case 2

Assume
USD/INR **73.00**
(RBI Ref Rate)

He will not
exercise his right

Loss = Rs 25,000

Importer will pay
Rs 73,00,000
on 29th Dec at
spot rate

Net outflow = Rs
73,00,000
+25,000 = Rs
73,25,000

He gets the gain
on Rs
appreciation

Example on Hedging Using Currency Options for Exporter

XYZ is an exporter.

On 15th Nov 2021, XYZ
Limited wish to book its
inward remittance for
29th Dec 2021 worth
\$100,000.

Option Strike price 74.25
is available at premium of
Rs 0.25
Expiry on 29th Dec

No of Contracts
(100,000/\$1000): 100

Buy Put option 100
contracts at \$1= 74.25

Option Premium = INR
25,000 (1,00,000 *0.25)

Spot rate on 15th Nov 1\$ =Rs 74.27

Month End 29th Dec : Case 1

Assume USD/INR
73.00 (RBI Ref Rate)

He will exercise his
right

Gain $74.25 - 73.00 =$
 $1.25 = 1,25,000 -$
 $25,000 = \text{Rs } 1,00,000$

Exporter will receive
Rs 73,00,000 on
29th Dec at spot
rate

Net inflow = Rs
73,00,000
 $+ 1,00,000 = \text{Rs}$
74,00,000

He is hedged at Rs
74.00

Month End 29th Dec : Case 2

Assume USD/INR
75.75 (RBI Ref
Rate)

He will not exercise
his right and losses
Rs 25,000
premium

Exporter will receive
Rs 75,75,000
on 29th Dec at spot
rate

Net inflow = Rs
75,75,000 -
25,000 = Rs
75,50,000

He gains on \$
appreciation

Review of Techniques for Hedging Transaction Exposure

HEDGING TECHNIQUE	TO HEDGE PAYABLES	TO HEDGE RECEIVABLES
Futures hedge	Purchase a currency futures contract (or contracts) representing the currency and amount related to the payables.	Sell a currency futures contract (or contracts) representing the currency and amount related to the receivables.
Forward hedge	Negotiate a forward contract to purchase the amount of foreign currency needed to cover the payables.	Negotiate a forward contract to sell the amount of foreign currency that will be received as a result of the receivables.
Money market hedge	Borrow local currency and convert to currency denominating payables. Invest these funds until they are needed to cover the payables.	Borrow the currency denominating the receivables, convert it to the local currency, and invest it. Then pay off the loan with cash inflows from the receivables.
Currency option hedge	Purchase a currency call option (or options) representing the currency and amount related to the payables.	Purchase a currency put option (or options) representing the currency and amount related to the receivables.

THANKS



Indo-German Cooperation on **Agricultural Market Development**

Building sustainable partnerships

Indo-German Cooperation on **Agricultural Market Development**

C/o CCS National Institute of Agricultural Marketing (CCS NIAM)
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