BANKING MODUL

Trade product
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TRADE PRODUCTS

1.1 Types of Off-Balance Sheet Products
1.2 Trade Payment System Flows
1.3 Letter of Credit
1.4 Bank Guarantee
1.5 Trade Financing
Lesson 1.1
UNDERSTANDING THE PAYMENT SYSTEM

GOALS

Acquaint the students the definition of payment system, who are involve in the system and type of payment system commonly available in the banking industry.
COMMITMENTS and CONTINGENCIES

- **A commitment** is an undertaking or contract in the form of a promise which is irrevocable by one party and must be performed if the agreed conditions are met.

Examples of commitments include loan commitments, commitments to sell or buy bank assets under repurchase agreements (Repo), and commitments to provide other banking facilities.

- **Contingencies** are bank receivables or liabilities which may arise depending on whether or not one or more future event takes place.
TYPE OF COMMITMENTS

- Loan Facility Given are credit facilities approved by a bank for loans to customers and are currently effective for use by the customers.
- Commitments to repurchase bank assets sold under Repo terms are bank commitments to repurchase bank assets at a specific agreed upon time.
- **Outstanding irrevocable L/Cs** are guarantees in the form of the issuance of irrevocable L/Cs for imports and exports or trading.
- **Acceptance of import drafts on the basis of issuance of L/Cs** is the provision of guarantees in the form of the accepting import drafts that are tied to L/Cs.
- Unsettled foreign exchange spot transactions are total foreign exchange spot transactions which have not been settled at the report date.
- Forward/future forward exchange transactions
TYPE OF CONTINGENCIES

- **Bank guarantees** are all forms of guarantee accepted or issued by a bank which result in payment to the party receiving the guarantee in case of default of the guarantor.

- **Outstanding revocable L/Cs** are guarantees in the form of the issuance of revocable L/Cs for imports and exports or trading.

- Foreign exchange options outstanding at the report date must be reported in the Statement of Commitments and Contingencies and translated into Rupiah using the middle rate at the report date.

- **Past due interest** is the accrued interest on non-performing assets which may not be recognized as interest income in the current period.
Lesson 1.2

TRADE PAYMENT SYSTEM FLOWS

GOALS

Explore how each type trade payment system flow and understand how it works.
BUYER’S GOAL

- Minimize the total cost of the goods which, in addition to the agreed-upon price, may include:
  - Cost of financing the goods between the time they are purchased and the time they are converted into cash upon subsequent resale
  - Lost opportunity cost of not being able to invest funds in the event available cash is used to pay for the goods
  - Foreign exchange costs if the deal is denominated in a currency other than the buyer’s

- Maintain good relationships with sellers
  Poor payment practices may offend suppliers of materials that are critical to the production of the buyer’s goods. Conversely, the relationship with a seller who offers lenient payment terms is a valuable resource that the buyer will want to protect.

- Assure receipt of specified goods previously contracted with the seller
SELLER’S GOAL

- Increase the attractiveness of the product. By offering lenient trade terms to the buyer, it increases the likelihood that the buyer can afford the product.

- Maximize the price of the goods without losing the sale
  - Either through borrowing or through available cash, the seller must cover the cost between the time the sale is contracted and the final payment is received. The seller may try to build this cost into the price of the product, but runs the risk of making the goods less attractive.

- Assure payment from the buyer. The seller will examine all the risks associated with the trade transaction to ensure that —
  - The buyer is able to pay
  - Funds can be converted to the currency of the seller’s country
  - Funds can be transferred to the seller’s country
TRADE PAYMENT OPTIONS

- The buyer and seller arrange one of five major payment options to settle the transaction:
  1. Cash in advance
  2. Open account
  3. On consignment
  4. Documentary collections
  5. Letters of credit
**#1 CASH ADVANCE**

- Cash in advance is the most basic payment method for goods. The seller receives cash from the buyer before goods are shipped.

- **Buyer’s advantages and risks** - There are no advantages to the buyer in this transaction and there are several risks to consider.

- **Seller’s advantages and risks** - The seller has all of the advantages in the cash-in-advance transaction and almost none of the risks. The seller can ship the goods whenever convenient and, in the meantime, enjoy the use of the buyer’s funds.

- **Bank’s role** - Bank has minimal involvement in a cash-in-advance transaction. However, it can derive fee income from transactions associated with funds transfer, foreign exchange (if required), and cash management.
#2 OPEN ACCOUNT

- The seller ships the goods, accompanied by the title documents (legal documents, e.g. insurance and transport documents, indicating proof of an individual’s ownership of the goods), before receiving payment or a written promise to pay (i.e. promissory note or draft). The shipper does not retain control of the goods.

- **Buyer’s advantages and risks** - The buyer has all of the advantages and minimal risk in an open account transaction. The buyer:
  - Retains control of the goods
  - Has time to generate cash from the sale of the goods before paying the seller to cover the period between the purchase and resale of the goods.
  - May not have to borrow and can use available cash on receipt of the goods
  - May incur foreign exchange risk if the imported goods are priced in the seller’s currency.
#2 OPEN ACCOUNT

- **Seller’s advantages and risks** - The seller has none of the advantages and all of the risks in an open account transaction. The seller:
  - Has no control over the goods and the buyer’s willingness to pay for them.
  - Incurs cross-border risk which may prevent an otherwise reputable buyer from sending payment.
  - May incur FX risk if the exported goods are priced in the buyer’s currency.
  - May need to borrow to cover the period between shipment of the goods and receipt of funds. If the seller borrows at a floating rate, the seller may incur interest rate risk.

- **Bank’s role** - Bank has minimal involvement in an open account transaction. However, it can derive fee income from transactions associated with funds transfer, foreign exchange (if required), and cash management.
#2 OPEN ACCOUNT

(1) Shipment of goods
   Title documents

(2) Payment
   On the agreed upon date, amount, currency

The buyer may also be the end-user of the imported goods.
#3 ON CONSIGNMENT

- In an “on consignment” sale, the seller ships the goods to the importer while retaining ownership of the goods. The importer is referred to as the consignee who is actually an agent responsible for paying for the goods if and when the goods are sold.

- **Consignee’s advantages and risks** - The prime advantage for the consignee is that the consignee pays only as the imported goods are sold. The consignee receives a fee for brokering the sale. There are no risks for the consignee.
On Consignment

- **Seller’s advantages and risks** - The key advantages for the seller are that the seller retains ownership of the goods until sold and uses the services of the consignee to intermediate the sale of the goods to the buyer. In terms of risks, the seller:
  - Has limited control over the goods
  - Has no control over the consignee’s willingness to pay for goods
  - Receives payment only upon sale of goods
  - May incur cross-border risk of the consignee’s country, foreign exchange risk, commercial or credit risk

- **Bank’s role** - Bank has minimal involvement in an “on consignment” transaction. However, it can derive fee income from transactions associated with funds transfer, foreign exchange (if required), and cash management.
#4 DOCUMENTARY COLLECTIONS

- Documentary collections, is a method by which a seller is able to collect payment from an overseas buyer through an intermediary bank. Banks act as intermediaries in facilitating the flow of the title documents and in the payment of the transaction.

- Parties and process - There are four major parties involved: the seller, remitting bank (seller’s bank), buyer, and collecting / presenting bank (buyer’s bank).
There are four major steps in a documentary collection:

1. The seller, after effecting shipment, forwards to the remitting bank (seller’s bank) the following documents covering the shipment
   - Written collection instructions
   - Draft (financial document which is a demand for payment), and/or
   - Commercial documents (e.g. commercial invoice, transport document, and any other document applicable to the collection transaction)

2. The remitting bank, acting as an intermediary, transcribes the sellers’ collection instructions and forwards it to the collecting / presenting bank along with the draft and/or commercial documents.

3. The collecting / presenting bank, acting as an intermediary, makes the draft and/or commercial docs available to the buyer for inspection and only delivers the original commercial documents in accordance with the remitting bank’s collection instruction.

4. The buyer, after inspecting the commercial documents, has three options: (i) to pay, (ii) to obligate itself to pay at a future date, or (iii) to refuse either to pay or to obligate itself to pay the accompanying draft.
DOCUMENTARY COLLECTIONS

DOCUMENT AGAINST PAYMENT
DOCUMENT AGAINST ACCEPTANCE
Advantages and Risks to the Buyer, Seller, and Bank

- **Buyer’s advantages and risks** - In a documentary collection transaction, the buyer’s advantage is that the buyer may refuse to:
  - Pay for drafts and/or documents
  - Accept a time draft
  - In terms of risks, the goods may not meet the buyer’s specifications after payment and/or acceptance.

- **Seller’s advantages and risks** - For the seller, the advantage is that the seller knows that the commercial and/or financial documents are controlled by the banks, acting as intermediaries, and are not delivered to the buyer until payment is made or a time draft is accepted by the buyer.
#4 DOCUMENTARY COLLECTIONS

- A bank’s control of the documents reduces the seller’s risk in relation to the documents only; however, the seller may be exposed to:
  - Cross-border risk
  - Foreign exchange risk
  - Interest rate risk
  - Commercial or credit risk
  - Costs resulting from the buyer’s refusal to pay.
  - Loss of goods resulting from a time limit for holding goods in public storage.

- **Bank’s advantages and risks** - In a documentary collection transaction, the bank facilitates the flow of the title documents and of the payment of the transaction. The bank does not deal with goods and does not assume any credit risk — it acts only as an intermediary in the collection process.
“Letter of Credit,” is an instrument issued by a bank to a named party which substitutes the bank’s creditworthiness for that of its customer. The letter of credit states the bank’s willingness to guarantee its customer’s credit and the bank’s conditional obligation to pay the party named in the letter of credit.
Lesson 1.3

LETTER OF CREDIT

GOALS

Explain the type of LC and parties involve in the LC transactions and understand how the transaction flows.
PARTIES INVOLVED IN LC TRANSACTIONS

- The **applicant** is the party that arranges for the letter of credit to be issued.
- The **beneficiary** is the party named in the letter of credit in whose favor the letter of credit is issued.
- The **issuing or opening bank** is the applicant’s bank that issues or opens the letter of credit in favor of the beneficiary and substitutes its creditworthiness for that of the applicant.
- An **advising bank** may be named in the letter of credit to advise the beneficiary that the letter of credit was issued.
- The **paying bank** is the bank nominated in the letter of credit that makes payment to the beneficiary without recourse, after determining that documents conform, and upon receipt of funds from the issuing bank or another intermediary bank nominated by the issuing bank.
- The **confirming bank** is the bank which, under instruction from the issuing bank, substitutes its creditworthiness for that of the issuing bank. It ultimately assumes the issuing bank’s commitment to pay.
A **revocable LC** is one that can be amended or canceled by the issuing bank at any time without prior notice to, or agreement of, the beneficiary. However, the issuing bank must reimburse a nominated bank that has honored / taken up documents in compliance with the terms and conditions of the L/C prior to receipt by the nominated bank of notice of amendment or cancellation. It is seldom used.

An **irrevocable LC** is one that is a definite commitment by the issuing bank to pay, provided the beneficiary complies with the terms and conditions of the letter of credit. An irrevocable L/C cannot be amended or canceled without the consent of the issuing bank, confirming bank (if the L/C is confirmed), and the beneficiary.

Unless clearly designated revocable, a L/C is considered irrevocable.
#1 COMMERCIAL L/C

- A commercial letter of credit is an instrument that states the bank’s obligation to pay the beneficiary upon presentation of conforming documents evidencing that goods have been shipped.

- Bank only pays the beneficiary if the required documents presented are in accordance with the terms and conditions of the letter of credit.
#1 COMMERCIAL L/C

1. Application for L/C
2. L/C
3. Advice of L/C
4. Transportation of Goods
5. Documents
6. Money
7. Documents
8. Money
9. Documents

APPLICANT / BUYER / IMPORTER

ADVISING BANK / PAYING (CONFIRMING) BANK

ISSUING / OPENING BANK
COMMERCIAL L/C FLOW

1. The applicant (buyer or importer) initiates the request for a letter of credit.
2. The issuing bank (opening) issues the L/C and forwards it to the beneficiary directly or transmits it to the advising bank.
3. The advising bank authenticates presents the L/C to the beneficiary. If the issuing bank nominates the advising bank to be its paying agent, the advising bank may also become the paying bank. The issuing bank may also request the advising bank add its confirmation to the L/C.
4. The beneficiary ships the goods.
5. The beneficiary forwards the documents required under the terms and conditions of the letter of credit to the paying (confirming) bank.
6. The paying (confirming) bank examines the documents to ensure compliance with the terms and conditions of the L/C. If the documents comply, the paying bank receives funds from the issuing bank before releasing payment to the beneficiary.
7. The paying (confirming) bank forwards the documents to the issuing bank. Upon receipt, the issuing bank reexamines the docs to ensure compliance with the terms & conditions of the L/C.
8. The issuing bank debits the applicant’s account.
9. The issuing bank releases the documents to the applicant.
**IMPORT AND EXPORT L/C**

- **Import Letter of Credit** - From the importer’s or applicant’s perspective, the issuing bank (local bank) issues an import letter of credit for the account of the applicant (local importer or buyer), in favor of the beneficiary (foreign seller), to secure payment for foreign goods purchased.

- **Export Letter of Credit** - From the exporter’s perspective, it is the same (import) letter of credit opened by the issuing bank on behalf of the beneficiary. This letter of credit is viewed by the advising / confirming / paying / negotiating bank as an export letter of credit for the account of an overseas buyer of the exporter’s goods, in favor of the exporter, as payment for goods purchased.
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<th>EXPORT Letter of Credit</th>
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<td></td>
<td>Beneficiary (Exporter)</td>
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<tr>
<td>L/C Opened by</td>
<td>Applicant's bank</td>
<td></td>
</tr>
<tr>
<td>For the Account of</td>
<td>Applicant</td>
<td></td>
</tr>
<tr>
<td>In Favor of</td>
<td>Beneficiary</td>
<td></td>
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<tr>
<td>As Payment for</td>
<td>Foreign goods purchased</td>
<td>Local goods sold</td>
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Lesson 1.4

BANK GUARANTEE

GOALS

Explain several type of bank guarantee and explore parties involved as well as the usage of the bank guarantee.
Standby Letter of Credit, is an instrument that secures the beneficiary against loss resulting from the failure of the bank’s customer to perform a contractual obligation, financial or nonfinancial, that the customer has with the beneficiary. This means that the bank promises to make a monetary payment under certain conditions specified in the letter of credit.
SBLC - GUARANTEE

- Form of protection to cover performance under a contract - The guarantee type standby letter of credit, issued only as irrevocable, may be used as a form of protection to cover performance, financial or nonfinancial obligation, under a contract.

- It is referred to as a “standby” letter of credit because it provides financial protection to the beneficiary if the applicant defaults on the terms of the contract or agreement.

- The guarantee type can be used in just about any business transaction that requires a financial indemnification such as:
  - In lieu of bid, performance, and surety bonds
  - In lieu of bank guarantees
  - To support another bank’s guarantee or undertaking
  - To provide security for advance payments
SBLC - GUARANTEE

- **Applicant’s advantages and risks:**
  - The applicant may not have to commit funds to collateralize the transaction.
  - The instrument is widely accepted in the marketplace as a financial indemnity.
  - The instrument is less costly than other indemnification instruments such as surety bonds.
  - The applicant will always run the risk that the beneficiary may not perform honestly, ethically and legally.
  - The applicant has to accept the risk of the beneficiary’s integrity.

- **Beneficiary’s advantages:**
  1. The beneficiary may enjoy the advantage of mitigating the issuing bank’s country risk by requiring that the letter of credit be confirmed by a bank in its own country. That bank then takes on the country and commercial risk of the issuing bank.
  2. The beneficiary’s foreign exchange risk is eliminated with a letter of credit issued in the currency of the beneficiary’s country.
  3. The beneficiary is assured of payment as long as it complies with the terms and conditions of the L/C. The L/C identifies which documents must be presented and the data content of those documents. The credit risk is transferred from the applicant to the issuing bank.
SBLC - GUARANTEE

A bank can incur other risks depending on the role(s) played, the roles and corresponding risks are as follows:

- **Issuing Bank** — faces a credit risk, as the bank that substitutes its creditworthiness for that of its customer. The issuing bank takes the full risk of the transaction until its customer, the applicant, is able to repay the full amount of the payment under the LC.

- **Advising Bank** — faces operational risks such as delaying or failing to advise the beneficiary that a LC has been issued. As a result, LC may expire or there may be insufficient time for the beneficiary to present the documentation under the terms and conditions of the LC. In addition, the advising bank can be liable for failure to properly authenticate the LC.

- **Paying Bank** — faces operational risks such as paying the beneficiary against nonconforming documents.

- **Confirming Bank** — faces a credit risk since the confirming bank takes the full risk of the transaction until its customer, the issuing bank, reimburses the full amount of the payment under the LC. It also incurs operational risks and country risks of the issuing bank’s country.
**OTHER TYPE OF BANK GUARANTEE**

- **Bid bond** – an instrument designed to ensure that the tenderer (e.g., supplier) will honor its commitment to a buyer when bidding for a construction or supply contract. The tenderer submitting a bid requests its bank to issue a bid bond in favor of the buyer as beneficiary. In the event the tenderer’s bid is accepted and the tenderer fails to sign the contract, the bid bond is normally payable against the buyer’s statement that the bank’s customer, the tenderer, failed to sign the contract.

- **Performance bond** – issued when the contract has been awarded. It is an instrument designed to ensure that the contractor (e.g. supplier) will perform and execute the contract in accordance with all its terms and conditions. A performance bond gives the buyer an indication of the contractor’s creditworthiness and, in the case of default, is payable on demand.

- **Surety bond** – designed to ensure financial compensation to the buyer if the supplier does not perform contractually as agreed. It is an instrument issued by insurance and surety companies for one of the parties involved in a contract, arbitration, and judgment who is required to post bond.
Lesson 1.5

TYPE OF BANK’S TRADE FINANCING

GOALS

Explore several type of bank’s financing in relation to the trade products.
Pre-Export Financing Acquisition and preparation of goods for export. In pre-export financing, the exporter (seller) has a firm contract of sale but needs financing to acquire and prepare the goods for shipment. Manufactured or processed goods, as well as readily marketable staples (e.g. wheat, sugar, corn, coffee, copper, silver), may be financed.

Pre-payment of exports allows an exporter to obtain financing from foreign banks or directly from the importer. Depending on the exporter’s track record or current export sales contract, the exporter may obtain pre-payment of exports from the Bank.
**Export Financing** - In export financing, the exporter (seller) needs financing for the period between shipment of the goods and receipt of payment from the importer (buyer). The exporter can ship under an open account, documents against acceptance or documents against payment basis, or letter of credit. In this instance, the exporter (seller) is providing supplier credit to the importer (buyer).

**Import Financing** - In import financing, the importer (buyer) who is purchasing goods under a sight letter of credit or under other payment terms (open account, term letter of credit) may need financing to meet the required payment.
INVENTORY (WAREHOUSE) FINANCING

- Inventory (Warehouse) - In inventory or warehouse financing, an exporter (seller) needs financing to hold readily marketable staples in storage and complete the sale of these staples to a buyer within the seller’s country or overseas. In reality, inventory or warehouse financing is a type of secured lending because the goods serve as collateral for the loan.

- The exporter (seller) must pledge to the bank a warehouse receipt covering the goods, issued by an independent third party. The warehouse receipt is a title document which states that a warehouse company is holding a certain quantity of a specific commodity and that the company will continue to hold these goods until the warehouse receipt is presented. At such time, the merchandise is returned in exchange for the warehouse receipt.
Transatlantic Imports is a Bank ABC customer and wants to pay for imported goods 120 days from the shipment date. However, the exporter demands payment at sight. What type of financing should the Bank provide?
Suppose a government agency advances $1 million to a construction company for materials to build a hospital. The government agency requires the contractor to have its bank issue a bank guarantee to cover the advance in case the contractor goes out of business or disappears with the money.

- What type of bank guarantee will the contractor need?
- What happened if the contractor defaults?
- What happened if the contractor perform as expected?