BARCLAYS COMMERCIAL

# IMPORTING & EXPORTING.

## INTERNATIONAL TRADE IN THE NEW ECONOMY.

TURNING THE CORNER

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*AS A RESULT OF THE ECONOMIC DOWNTURN THE PAST YEAR HAS SEEN THE SHARPEST DEVALUATION IN STERLING FOR DECADES. AGAINST THE CURRENCIES OF OUR MAJOR TRADING PARTNERS, STERLING IS NOW WORTH ALMOST 25% LESS THAN AT THE BEGINNING OF 2007.*

*THIS ISN'T GREAT FOR HOLIDAYMAKERS, BUT FOR BRITISH BUSINESSES EXPORTING OVERSEAS, THE WEAKNESS OF THE POUND AGAINST THE DOLLAR AND THE EURO IS ONE REASON FOR OPTIMISM.*

In recent years British exporters have struggled to compete from a price perspective in Europe and the Far East. Now British goods and services are looking far more attractive to overseas markets, many of which are coming out of recession and ready to spend again.

Coupled with low interest rates, the weak pound can help UK manufacturers increase profit margins, repair damaged balance sheets and make inroads into new markets.

However, this optimism is tempered with a note of caution. Counterparty risk – that is the risk of either party defaulting on the terms of a contract – is at a ten-year high. As a result, companies trading internationally need to consider risk mitigation techniques to minimise their trading risks.

This document offers practical guidance to business owners and leaders on how to make the most of the export opportunities that have been created by the current economic climate, without putting their businesses at risk.

# UNDERSTANDING THE RISKS.

At the EuroFinance International Cash and Treasury Management Conference in Copenhagen, Denmark in October 2009, it emerged that the risk of counterparty default topped the list of major concerns for organisations in the global financial market. It ranked more highly than availability/cost of credit and cash forecasting.

An example of a market where the counterparty risk is particularly elevated is the volatile commodity trade sector. It is not unheard of for an exporter to agree a price with an overseas buyer; the price of the commodity then falls, and, although the order has already been shipped, the buyer decides they would rather obtain the goods from a cheaper source, leaving the seller high and dry.

This is an extreme example, but it does demonstrate what can happen to exporters who aren't rigorous enough when agreeing the terms of a transaction. More typically though, counterparty defaults will occur because the buyer does not have the cash to pay for the goods they have ordered – either because their business is in trouble or they are having cash flow problems.

# MITIGATING THE RISKS.

There are plenty of steps businesses can take to make sure they don't fall victim to counterparty risk.

## KNOW WHO YOU'RE DEALING WITH.

- Be selective: don't just take any work that comes your way. A lot of overseas companies want to do business with UK exporters but that doesn't mean you will necessarily want to do business with them.
- Check out your customers: apply due diligence to any companies you are considering trading with. This includes carrying out background credit checks on potential customers, reviewing their company accounts and asking for references from other companies they do business with and following up on those references.
- Research your market: it's not just about making sure the customer is stable; it's also about making sure the country they are domiciled in is stable. Look at the economic and political situation in the country you're considering dealing with. How high is inflation? What is the transport infrastructure like? Is the country prone to natural disasters? How stable is the government?

## BE RIGOROUS IN YOUR CREDIT ANALYSIS.

You need to have closer control than ever before over how much credit you grant to your customers:

- Make sure that the policies in place within your own credit analysis department are reviewed regularly. For example, the limits that are granted to buyers should be reviewed regularly, based on up-to-date information on a buyer's financial performance.
- Get out and visit buyers: regular monitoring of customers' financial performance is essential, but there's no substitute for visiting buyers to find out, first hand, what is happening on the ground.
- Don't deviate from your agreed credit policy, even if an attractive opportunity presents itself. For example, if you have a policy not to trade on over 60-day payment terms, and a buyer comes along with a large order based on 120-day terms, don't be pressured into accepting this. Unfavourable credit terms will put you at risk of non-payment and have working capital implications for your business.

# TOOLS OF THE TRADE.

There are also a number of tools that have been developed by the Government and the financial services community, which can mitigate the risks of exporting.

## LETTERS OF CREDIT.

Letters of credit have been used for centuries to facilitate payment in international trade. In recent years though, the trend has been towards open account trade, in which the buyer releases the goods without having received any payment, then invoices the buyer, who pays on receipt of the goods.

In this climate of heightened risk however, the balance is shifting again – this time in favour of letters of credit.

Under this arrangement the importer's bank guarantees payment to the exporter, provided documents stipulated in the letter of credit issued by them are presented to them in compliance with the terms and conditions of the letter of credit. In this way, the UK exporter is able to eliminate the risk of non-payment by its buyer. If the exporter is unhappy with the credit standing of the importer's bank they can request a UK bank to add its confirmation to the letter of credit transferring the payment risk to that UK bank.

Letters of credit can be for any amount, in any freely traded currency, and may be payable at sight, which means as soon as a compliant set of documents are presented to the paying bank, or after a specified term, for example at 30, 60, 90 or 180 days after sight or bill of lading date.

If the documents are not presented exactly as specified in the letter of credit, payment will not be made unless the importer gives their authority to waive or amend the specified condition.

In fact, it is estimated that over half of the documents presented by exporters to banks for payment under letters of credit are rejected on first presentation. This can cause expensive delays for both the exporter and the importer and may even result in a lesser payment or no payment at all.

A great many of those rejections could be avoided if export businesses involved their banks from the outset in agreeing the terms of the letter of credit and ensuring that the documents called for in the letter of credit can be presented in order.

# GOVERNMENT CREDIT GUARANTEE SCHEME.

With letters of credit, the burden of risk has historically been borne by the bank, so a company's ability to obtain a letter of credit has been dependent on the bank's willingness and ability to provide one, and in the last year or so, the banks have had less capacity to offer this type of facility.

In October 2009 this changed. The Export Credits Guarantee Department (ECGD), the UK export credit agency, has launched a letter of credit guarantee scheme to assist UK exporters by boosting the availability of short-term export finance.

By sharing with banks the credit risks associated with confirming a letter of credit, ECGD aims to increase the amount of short-term export finance which the banking sector can make available to UK exporters. This is particularly important at a time when the overall risk appetite of the trade market has been reduced due to the recent difficulties in the financial sector.

To start with, a number of banks, including Barclays, are supporting the scheme. It will cover 282 local issuing banks in 36 export markets.

ECGD will share up to 90% of the risk on individual letters of credit.

# WORKING CAPITAL FINANCE.

Goods generally take longer to deliver overseas, adding an extra delay in the cash conversion cycle from when exporters incur costs such as raw materials to when the importer receives the goods and pays for them.

Working capital finance is one option that is open to exporters who need to accelerate the influx of cash into the business.

In essence, working capital finance involves your bank advancing money owed to you. Typically, the following trade receivable documents are used to generate cash – invoices, promissory notes or bills of exchange – enabling you to improve cash flow.

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## CREDIT INSURANCE.

The credit insurance industry has suffered during the recession and consequently, the availability of cover has been reduced. However, credit insurance should still be available and shouldn't be discounted, even if you are trading on an open account basis, particularly if you are trading with customers in more distant markets such as Asia, South America and parts of Africa.

Export credit insurance can be divided into two types – short- and medium/long-term.

Consumer goods, raw materials and other similar items are normally sold on cash or short payment terms of less than two years. Your insurance broker or banker should be able to advise you on suitable insurers who will cover short-term risks.

If you plan to export capital or semi-capital goods or services with payment terms exceeding two years, you may require more specialist help. Some is provided by the ECGD, through a range of products and services. However, specialist private sector insurance companies increasingly provide this kind of credit insurance.

Make sure that the credit insurer understands the market in which you are selling, and that they can cover all of the potential risks that you are likely to face. If you are new to exporting, get recommendations from other businesses, your bank or your financial adviser.

You can find brokers specialising in financial export credit insurance on the British Insurance Brokers Association (BIBA) website.

# *IMPORTING CHALLENGES.*

It might be prime time for UK exporters, but for importers, the weaker pound means importing goods becomes more expensive.

**That said, there are still some steps UK importers can take to alleviate the pain:**

- Trade on an open account basis: whilst as an exporter, it's safer to trade on letters of credit, for an importer, open account trading is more favourable as it allows you to pay for goods only once you've received them.
- Review and analyse your supplier base: it is vital importers keep a close eye on any changes in the macro-economic environment so they are aware of how markets are changing in terms of their competitiveness. For example, it may be that suppliers in the Far East are no longer as competitive as suppliers in Eastern or even Western Europe, because they have not been as affected by the economic crisis so have not felt the need to reduce their prices.
- Consider supply chain finance: banks now offer supply chain finance solutions which balance the supplier's desire to be paid quickly with the buyer's desire to extend credit terms. The supplier sells its invoices to the bank at a rate discounted against the credit rating of the buyer. The bank then pays the supplier when the supplier wants payment, and the buyer pays the bank in line with normal payment terms. This helps buyers improve working capital without alienating their suppliers.

# END TO END SOLUTIONS.

Where companies are involved in both importing and exporting, they should work closely with their bank so that a holistic solution which capitalises on any synergies can be identified.

There are some more complex trade finance options whereby businesses provide finance to their customers for importing based on the knowledge that the money will be coming back through exports.

# DEALING WITH CURRENCY FLUCTUATIONS.

Whether you're importing or exporting, if your business deals in foreign currencies you are exposed to certain risks. For example, you might find that after agreeing a price for exported or imported goods the exchange rate changes before delivery. Clearly, this can work both for and against you.

**Here are some suggestions for minimising the risks associated with currency fluctuations:**

- Fix your foreign exchange rate using a forward exchange contract. This is a contract between you and Barclays for the sale or purchase of a specific amount of foreign currency at a certain rate, on or before a certain date. The downside is that you have to go ahead with the contract once you've arranged it, regardless of whether your circumstances change, and you can't benefit from any favourable movement in the exchange rate.
- Use a flexible solution. A currency option which may involve paying a premium to 'insure' a rate of exchange for a given period, is a more flexible form of hedging than setting up a forward foreign exchange contract.
- An alternative way of hedging your currency risk is to open a foreign currency account – a bank account operated in the UK in a foreign currency of your choice. If you open an account in the currency in which you make the bulk of your transactions, you can hedge against exchange rate changes by keeping money in the account until the rate is beneficial to you.
- Negotiate fixed prices for guaranteed volumes and build triggers into pricing agreements, stipulating which party will absorb currency fluctuations.

# IN A NUTSHELL.

- *THE WEAK POUND AND THE FACT THAT MANY ECONOMIES ARE NOW ENTERING RECOVERY MEANS NOW IS A GOOD TIME FOR BUSINESSES TO START EXPORTING OR EXPAND THEIR EXPORT ACTIVITY.*
- *HOWEVER, IT IS MORE IMPORTANT THAN EVER TO BE PRUDENT ABOUT COUNTERPARTY RISK, IN PARTICULAR, ABOUT BUYERS DEFAULTING ON PAYMENTS.*
- *EXPORTERS SHOULD EXPLORE ALL THE RISK MITIGATION TOOLS AVAILABLE TO THEM, INCLUDING MARKET RESEARCH, CREDIT INSURANCE, LETTERS OF CREDIT, WORKING CAPITAL FINANCE, RIGOROUS CREDIT ANALYSIS AND THE GOVERNMENT CREDIT GUARANTEE SCHEME.*
- *CONVERSELY, THE WEAK POUND MEANS TIMES ARE TOUGH FOR BRITISH IMPORTERS. IF POSSIBLE, THEY SHOULD TRY TO EXTEND CREDIT TERMS WITH SUPPLIERS, OR ALTERNATIVELY, LOOK INTO SUPPLY CHAIN FINANCE IF THEIR SUPPLIERS NEED TO ACCELERATE CASH FLOW.*

## WHERE TO GO FOR MORE INFORMATION.

If you would like to discuss this further, please contact your local Barclays Commercial Bank Relationship Team, visit www.barclayscommercial.com or call 0800 015 1921.*

*To maintain a high quality of service, your call may be monitored or recorded for training and security purposes. Calls to 0800 numbers are free of charge, when calling from a UK landline. Charges may apply when using a mobile phone or when calling from abroad. Lines are open 9am to 5pm Monday to Friday.

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