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MEDIUM AND LONG-TERM TRADE FINANCE: AVAILABLE SCHEMES AND PROBLEMS

1. Mr. Kenneth Owen, Head of Trade Finance Department, Hansabanka (Latvia**)**

This presentation focuses on the following issues:

(a) Forfeiting operations,
(b) Creation of trade finance consortia
(c) Development of a private insurance market
(d) Cross-border leasing operations.

(a) Forfeiting operations

Forfeiting can be defined as an instrument in medium- and long-term trade finance where a bill of exchange or a promissory note is issued by a buyer. Such a bill of exchange or promissory note is a clear obligation to pay, and can be used in court as an evidence of debt. This debt instrument can be avalized or guaranteed by a bank or other financial institution. "Aval" is a commitment by a bank to pay under the debt; although under the UK law this term is not specifically mentioned, it is a commonly accepted security in banking practice. Most importantly, such notes or bills are sold or purchased on the forfeit market on a "without recourse" basis, i.e. the payment obligation lies fully on the primary party or the avalizer and not on any of the subsequent holders of the security.

The first forfeiting transactions were undertaken by Swiss trading companies supplying grain to Russia over 50 years ago. At the moment forfeiting is used for transactions spanning periods of between 6 months and 5-7 years for a variety of products, such as machinery, equipment, etc. The primary restriction on the time period is the availability of a long-term forward market for the currency of the transaction. Long-term deals are carried out predominantly in such currencies as the US dollar, Euro or pound sterling, for which the indicated forward market is available.

Forfeiting can often be used in conjunction with other types of trade finance. For example, a recent financing package for Latvian Railways was 85 per cent financed under the United States Eximbank scheme and 15 per cent part financed through bills of exchange drawn on Latvian Railways and payable over a period of two years.

In Latvia, bills of exchange legislation has been adopted enabling refinancing operations between the Central Bank and commercial banks. According to this legislation, banks are prohibited from discounting bills of exchange that have more than 180 days to maturity. Obviously this stipulation does not reflect properly the interests of the trade finance market, where imports of machinery and equipment are usually financed over longer time periods. In this context, let me suggest that the dialogue between the private sector and Governments regarding the regulation of financial services should continue. Legislation should be very clear and should correctly cover the types of instruments and transactions that commercial banks are trying to finance. Should this fail to happen, local banks may find themselves at risk of losing their business to international banks, which do not operate under the same regulatory restrictions.

In many cases the purchaser of a forfeiting instrument is not a bank but an investor from the country of origin. Most large banks produce rate sheets on a monthly or quarterly basis, which give a good indication of a maximum time horizon and rate for a transaction in a particular country. This information is particularly valuable to exporters seeking to enter a new market with a product that needs long-term financing.

As opposed to banks having forfeiting operations, forfeiting companies are usually not bound by the same regulatory rules, and, hence, have different capital adequacy and provisioning requirements. This allows these companies to achieve higher yields due to lower transaction costs. Also, the specialist companies do not necessarily hold the security to maturity and often try to benefit from the movements of market interest rates applicable to the securities before maturity. In this respect, the forfeiting product can be seen not just as a mechanism for creating finance for long-term project financing, but also as a tool for capitalising on movements in the financial markets.

(b) Trade finance consortia

A trade finance consortium is defined as a partnership of two or three banks (or a "Club"), or of three or more banks (or a "Syndication") which finances the business of a common client or a specific product type. The reasons for which banks choose to share business are threefold. First, is prudential risk management: when sharing banks are unlikely to use up their country "limits" for one deal or one client. Secondly, there exist sectoral, entity and country constraints imposed by regulatory authorities of the home jurisdiction. Finally, the third reason is the so-called "additional comfort" factor. This can be obtained through participation of a local bank, which brings local knowledge and expertise regarding the issues of rules, regulations, competition, etc. Therefore, creating partnerships with local financial institutions becomes a very important part of complex trade finance transactions.

In the near future we are likely to witness a consolidation of the banking market in transition economies, which will take place mainly through strategic alliances. International financial institutions should be attracted to local markets as partners to share the business and bring their expertise, financial muscle and cheap funding. In this respect, the role of the Central Bank is paramount, because it can and should initiate a legislative system that is uncomplicated, efficient and well suited for foreign banks.

(c) Private insurance market

The term “private insurance market” does not cover government-supported schemes or ECAs, but relates to the operations of large insurance companies, underwriters and syndicates. For example, “Lloyds of London” is not an exchange, or an enterprise, or a corporation, but a market, where groups of companies or syndicates or individuals gather and agree upon risks they are prepared to take.

Insurance should not be regarded as competing with banking activities but rather as part of the financial “package”. An insurance company can share a percentage of risk with a bank, thus leading to more attractive rates for customers and enhancing the credit facilities available. The insurance market covers insolvency, bankruptcy and liquidation as well as confiscation, expropriation and currency default. Very often, the bank or the exporter may be satisfied with the exposure on a country but may not trust the counterpart, or vice-versa. In these cases, insurance is an effective and often low-cost way to mitigate part of the risk. The regulatory authorities should find ways of recognising and rewarding prudent risk management (risk sharing) and risk insurance by banks and their clients.

(d) Cross-border leasing operations

In the final part of this presentation, we shall discuss current developments in cross-border leasing, a type of leasing whereby the ownership of the leased product remains outside the country of operation.

In general, companies prefer to lease ‘externally’ for two basic reasons. The first reason is tax related – within certain countries there exist ‘tax holidays’ or tax allowances for the purchase of fixed assets, so an entity in such a country may wish to remain the owner of the asset. The second reason is related to foreign exchange risks, i.e. the purchase of the underlying asset may be in United States dollars requiring repayment in that currency. Therefore, the risk of restrictions on foreign currency transactions or of non-availability of foreign currency over the deferred payment period often makes it more suitable to retain ownership of the asset outside the country of use.

At the same time, leasing is a very appropriate instrument for transition economies for two reasons. First, local entities often have little balance sheet value, and, therefore, struggle to obtain long-term bank financing to purchase equipment and machinery. Second, legislation in countries such as Estonia and Lithuania prevents banks from lending without collateral, making leasing (whereby the ownership remains with the lessor) a very attractive product.

This situation is not uniform in all transition economies, though. For example, Poland does not have very good leasing regulations, so the market has developed slowly. However, the Baltics could become a major centre for leasing activities in the region, and could serve countries within the CIS with their leasing needs, i.e. the ownership of assets for use in other countries could be held in the Baltic States.

To make progress in facilitating trade financing in transition economies, the latter should harmonize their legislation. In particular, the tax treatment of various business operators should be the same in all countries. Ending my presentation, let me express my belief that the dialogue between governments and the business community should continue and that legislation influencing the business environment should be developed in cooperation with the private sector.

2. Tomas Dvořak, Deputy Financial Director, SKODA Export Co. Ltd (Czech Republic)

Skoda Export Ltd is a company that has been active worldwide for nearly 35 years. The reference list of Skoda Export includes approximately 100 power stations that Skoda either constructed or to which it supplied the equipment, as well as other products such as locomotives, trolley-buses, etc. Throughout its existence, Skoda Export has used various mechanisms to finance its operations.

In the beginning, Skoda offered its customers long-term supplier credits, with the debtor being granted repayment terms of up to 10 years. The economic changes that took place in the region of central and eastern Europe made it impossible to continue this type of financing.

As a result, Skoda Export has pursued closer cooperation with local banks and the Czech Export Credit Agency - EGAP. The company has also developed further its cooperation with foreign institutions, creating supplier consortia. Export sales of machinery and equipment often require complex financing schemes, which involve the participation of foreign banks.

I would also like to say a few words about alternative mechanisms for financing long-term projects. Such instruments include BOO (build-own-operate) and BOT (build-operate-transfer) projects. Under BOO, the supplier, instead of delivering the equipment to a third party, is constructing his own plant, thus owning and operating it. Under BOT the plant is built and operated by the supplier who is paid out of the project revenues and after a certain, agreed period of time transfers the plant to the owner.

Regarding the various risks relating to export transactions, I should underline the importance of political risk. For example, Skoda Export has concluded an agreement with the Government of Pakistan, which was cancelled after just two months due to the change of government in the country. Another example also relating to Pakistan illustrates the relevance of transfer risk. In that instance, Skoda Export supplied a large power station on the basis of a long-term supplier credit. All the instalments were paid up until the moment when Pakistan was denied credits due to nuclear testing. This has considerably worsened the possibility of receiving due payments in convertible currency.

When alleviating country risk, Skoda Export has to take into consideration the exposure limits of various export credit agencies. Bank risk is also an important issue: for long-term projects lasting 5-10 years it is important to be confident in the financial standing of the client’s bank. For this reason, Skoda Export largely prefers to deal with leading and highly-rated financial institutions.

Unfortunately, in many transition countries financial institutions are not strong enough to cover large transaction amounting to tens or hundreds of millions of USD. For this reason, from time to time Skoda Export insists on governmental guarantees of the buyer’s solvency. When this type of security is not available, as is the case in some countries, this can be a serious obstacle on the path of mutual cooperation.

Finally, I would like to emphasize the importance of adequate regulations in export transactions. In transition economies, it is often very difficult to accept and apply the local law for long-term transactions due to its inadequacy and/or the lack of stability. For this reason, trading partners often have to agree on the application of appropriate western legislation.