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Instruments securing receivables and liabilities in international trade

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ABSTRACT

Securing trade receivables resulting from concluded trade agreements on the economic market is a vital element from the point of view of both entrepreneurs as well as frequently external entities offering their finances to enterprises. Current economic situation characterized by long delays of debtors in timely payment of receivables makes entrepreneurs use other, more secure solutions than merchant credits. Payment backlogs are a very dangerous element that influences the financial liquidity of enterprises, which can lead to untimely supplies caused by delays in paying liabilities to suppliers.

Keywords: international trade, documentary letter of credit, standby letter of credit, bill of exchange, prepayment, bank guarantee, insurance guarantee, factoring, forfaiting, receivables insurance

1. INTRODUCTION

International trade is dominated by transactions in which making the payment is connected with granting the buyer a merchant credit by the exporter. In such transactions risk is of particular importance both for the importers and exporters, and securing the risk is a concern of both parties of the contract. The importance of securing export contracts has grown together with appearing medium- and long-term financing. The importer is primarily interested in securing the contract in the scope of quality and timeliness of supplied goods, or possibly in return of the paid advance payment in case if the concluded contract failed to

come into existence, and would like its payment liability to be associated with least possible risk.

2. MOST POPULAR FORMS OF SECURING CONTRACTUAL LIABILITIES

There are numerous forms of securing the contractual liabilities in international trade, one of them being a bill of exchange. It is used with payments made by means of documentary collection and documentary letter of credit as an instrument securing receivables in forfaiting and also as a guarantee bill of exchange can secure payment of credit, leasing instalments or possible payment under the bank guarantee. The bill of exchange, as a financial document that fulfils various functions, finds its application while making settlements between the exporter and importer, and is also used as an instrument of foreign trade financing. The bill of exchange is a security of a precisely defined by law on bills of exchange form. There are no uniform standards of the law on bills of exchange, which would be commonly valid. However, a significant unification of regulations on bills of exchange can be observed in the international scale. Two main systems are present here: conventional one, also called the Geneva System based on three passed on 7 June 1930 in Geneva international conventions on bills of exchange and the Anglo-Saxon System, based on the British *Bills of Exchange Act* of 1882, although the American law *Uniform Commercial Code* of 1952 indicates certain differences.

Majority of European countries and a part of non-European ones ratified the Geneva Conventions or accepted their provisions in their national legislation. They include: Belgium, Austria, Bulgaria, Czech Republic, the Netherlands, Denmark, France, Finland, Greece, Jordan, Indonesia, South Korea, Italy, Hungary, Japan, Luxembourg, Norway, Portugal, Poland, Slovakia, Germany, Sweden, Switzerland, Brazil, Liechtenstein, Spain, Russia, Turkey, Ukraine. In Poland, the law of 28 April 1936 with future amendments – the Law on Bills of Exchange is in force. In all these countries, the principles of the law on bills of exchange are similar, although there are certain differences in bill of exchange trade practice. They result from 23 so called national reserves included in the attachment to the convention, foreseeing possibilities of applying amendments to the uniform law on bills of exchange by each of the countries ratifying the convention. Some countries made use of these possibilities and therefore laws on bills of exchange of the countries being parties of the convention are different. These laws are applicable both to bills of exchange used in national and international trade.

The Anglo-Saxon System is characterized by a large formal freedom and is in force, among others, in Great Britain, the USA, Canada, New Zealand, Ireland, Cyprus, India, Philippines and Singapore. In case of different regulations on the same issue the legislations of particular countries use the convention on collision of laws in respect of bills of exchange, which decides the law of which country should be applied in the given situation.

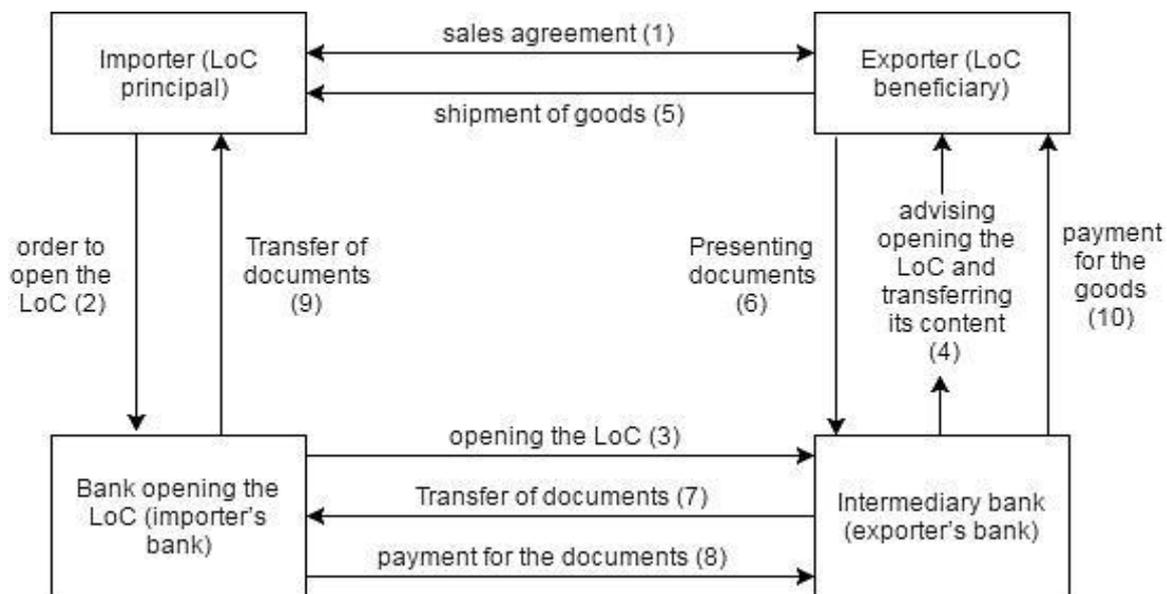
The law on bills of exchange regulates functioning of so called drafts and won bills. The draft is a highly-formalized type of transfer of funds, which in order to be valid needs to contain the following data:

- the name „bill of exchange” in the wording of the document, in the language the document was issued,
- unconditional order to pay the defined amount,

- surname of the physical or legal person who has to make the payment,
- indication of date of payment,
- indication of place of payment,
- surname of the person, for whom or for whose order the payment has to be made,
- place and date of issuing,
- signature of the bill issuer.

Document which does not contain the abovementioned details is not considered to be a draft, but a bill without a date of payment is considered as payable upon presenting. A stamp duty has to be paid on bill liability to the budget. The amount of payment depends on the amount of liability. Bills are usually issued on an official blank, the purchase of which implies unequivocally paying a stamp duty. It can be also issued on another paper in writing or by machine. In such a case the payment is made with tax stamps at tax offices or in a non-cash form.

Own bill is different from the draft in this respect that its issuer is a main debtor. The bill of exchange is a security. However, it is not a capital investment. It plays numerous functions in economic turnover, primarily the credit one, guarantee, payment and circulation function.



Picture 1. Course of payment with the use of documentary letter of credit

The law on bills of exchange allows for functioning in the trade *blank bills*, which usually remain in the possession of the first creditor. A blank bill is a document which contains at least the signature of the issuer or the merchant, made with an intention of making the liability on the bill. Lack of required by law on exchange bills elements or even only one of them can result from the oversight, but the mutual agreement of the parties. The parties of the liability on the bill most frequently conclude a proper agreement, defining the way of its fulfilment; this is usually a separate document, so called bill declaration. In the declaration, the debtor agrees to fill in the bill according to defined conditions.

Another form of securing contractual liabilities is documentary letter of credit. This is a written obligation of the bank, called an opening bank, to pay the specified beneficiary the defined in the letter of credit amount of money in return for provided by him documents compliant with the stated in the letter of credit conditions. This liability is similar to liability on the bill: the very fact of issuing the letter of credit by the bank is enough for the beneficiary who fulfils the conditions concerning documents to demand the opening bank to make the payment, and in case of refusal to do so, ascertain his claims in court. Possible pleas and objections of the bank may concern only the documents. The letter of credit is an instrument for the supplier to influence a negligent recipient. This form of settlement is an instrument which guarantees that the supplier receives immediate payment, after fulfilling all the conditions defined in the letter of credit. Picture 1 presents the course of payment with the use of documentary letter of credit.

The presented chart shows that two stages can be distinguished in the procedure of the documentary letter of credit: the opening stage of the letter of credit (numbers 1-4 in picture 1) and the stage of its implementation (numbers 6-10). Shipment of goods takes place between the first and the second stage. The exporter cannot ship the goods until a letter of credit for his benefit is not opened, the conditions of which he recognizes as compliant with the provisions of the contract and possible to be fulfilled in the specified term of letter of credit validity. The documentary letter of credit belongs to the conditional payment forms in foreign trade and simultaneously is the most complex form, which requires from the exporter a lot of attention. However, it ensures the exporter high security of receiving payment for the supplied goods.

The standby letter of credit in turn is a commitment of the opening bank to pay the amount of the letter of credit on the first request of the beneficiary, in case if the payer of the letter of credit has not fulfil their liabilities, i.e. does not make the payment in the agreed period of time for the goods or services. The standby letter of credit is also called a securing letter of credit and has the nature of a bank guarantee. Similarly to a guarantee, the standby letter of credit serves only to secure fulfilment of contractual liabilities, and is not supposed to be used for payment purposes.

The difference in nature of the documentary letter of credit and the standby letter of credit is emphasised in the role of the opening bank. In case of the documentary letter of credit the opening bank participates actively in the settlement of the trade transaction, but after issuing the standby letter of credit the opening bank waits passively for possible claims of the beneficiary, as in case of the standby letter of credit the settlement of the trade transaction should be made directly between the importer and exporter. Only if the importer does not fulfil the liabilities specified in the contract, the exporter who possesses the security in the form of the standby letter can request the opening bank to make the payment, demonstrating the documents required in the wording of the standby letter of credit, which include, among others, a statement of the exporter (beneficiary of the standby letter of credit) that the importer refuses the payment (payer of the standby letter of credit). Standby letters of credit can be opened on the basis of the Uniform Customs and Practices for Documentary Credits (UCP 600) or International Standby Practices (ISP 98).

“A letter of credit of this traditional type (now commonly called a “trade” or “commercial” letter of credit) thus serves to facilitate payment; it also serves a function akin to an escrow, as neither buyer nor seller has both the money and the goods at the same time. When the parties enter into the transaction they expect that the credit will be drawn upon. The

issuing bank's credit exposure typically is only that of a secured creditor, as the issuing bank typically will obtain a security interest in the goods covered by the documents to secure its customer's reimbursement obligation. Banks have long issued letters of credit in this transactional setting, and it has long been established that banks in this country are authorized to issue them."

Another form to secure the performance of contractual liabilities are bank and insurance guarantees. Guarantees are a tool which is quite commonly used in the economic trade abroad, they allow to limit the risk of exporter and importer cooperating within a signed contract. Although the origin of bank guarantees dates back to antiquity they have been used on a larger scale only for several dozens of years. After the Second World War, for a long time, guarantees only existed in foreign trade. Over time they have also appeared in the domestic trade.

The bank guarantee is a written obligation of the bank undertaken on the customer's order to satisfy the party accepting the guarantee according to its provisions, in case if the customer does not fulfil contractual liabilities stipulated in the guarantee for the benefit of this party.

A wider definition of the guarantee is included in art. 81 of the Banking Law Act. According to this article the bank guarantee is a unilateral commitment of the bank-guarantor stating that if the authorised entity fulfils the agreed payment conditions, which can be confirmed by the defined in this commitment documents, which the beneficiary will attach to the prepared in the indicated form payment request, the bank will make the payment for the guarantee beneficiary – directly or through another bank. Granting and confirming the bank guarantee has a written form under pain of nullity.

As it results from the definition included in the Banking Law Act the bank guarantee is, among others:

- an agreement between the bank-guarantor and the guarantee beneficiary, while the unilaterally liable party is the bank which issues the guarantee;
- a cash liability, which consists in payment of a specified amount of money in case the beneficiary performs the rights guarantee from the guarantee. The guarantee can be issued in PLN or foreign currency;
- own liability of the guarantor, the bank is responsible only for its debt and does not commit in any case to perform the liability being the subject of the guarantee.

Bank guarantees in the foreign trade are a means of assurance not regulated in the regulations commonly valid in all countries. This situation has caused that in practice there have developed numerous types of guarantees. However, certain guidelines of international chambers of commerce have also developed in this scope. The International Chamber of Commerce in Paris has issued the following two documents which regulate the issues connected, among others, with the wordings of the guarantee liability:

- Uniform Rules for Contract Guarantees,
- Uniform rules for Demand Guarantees.

There are two types of guarantees: direct and indirect ones. In case of the direct guarantee the bank being the guarantor – that is the bank which issued the guarantee grants the guarantee directly to the foreign contractor. In case of indirect guarantee in turn, the customer's bank asks the beneficiary's bank to issue a guarantee. The reasons for including a second bank can be different, which can result from laws in force and regulations of particular

countries or the arrangements between the parties of the contract. Majority of guarantees applied in practice include a specification of the period in which the guarantee can be used. Thus, they can be called term guarantees. It is also possible to grant a guarantee without any time limit – indefinite guarantees.

Insurance guarantee is a written commitment undertaken by the insurance institution or a bank on the customer's initiative, which includes an abstract, irrevocable commitment of the guarantor to pay the specified amount of money. The possible payment depends on fulfilling the conditions specified in the guarantee – it is an abstract commitment as it is inherent, i.e. fully independent of the existence of main debt. The possibility to use the guarantee is foreseen only in case if the parties liable to make the payment or perform particular actions have not performed them in the agreed time period or performed them without preserving the determined quality.

Another form of securing contractual liabilities in foreign trade is advance payment or prepayment. Generally, these are forms of crediting an export transaction by the importer, which also fulfils other functions, beneficial from the point of view of the exporter. However, while negotiating an advance payment or prepayment higher than standard ones applied in the given industry, even for justified reasons, the exporter has to also consider the fact that it diminishes the attractiveness of his offer, which can lead to the loss of export possibility.

When choosing the form of payment preferences of the exporter and importer are different. For the selling party the most favourable situation is to receive the payment before the goods are shipped. The exporter then does not have any problems with financial liquidity and does not have to fear that he will not receive the due payment. From the point of view of the importer in turn the most favourable situation is a payment to the open account, connected with receiving by him a merchant credit.

3. ALTERNATIVE METHODS OF SECURING TRADE RECEIVABLES

A creditor who decides on any of the forms of securing should first of all consider the reality of satisfying his claims from the accepted security. It should be always considered that the debtor fails to comply with the liabilities and the creditor will not receive the due payment in the specified time period. Therefore, a strictly formal approach to the issue of security is a mistake and can lead to unpleasant financial consequences. Another aspect of market realities is a situation in which the receiver may not possess a possibility to establish classic security. Then, it is possible to withdraw from concluding a transaction with such a contractor without much trouble in the situation when the demand is higher than the supply. However, in the free market realities such a situation is rare and short-lasting. Therefore, if the contractor seems reliable new solutions are searched for, which allow to decrease the financial risk connected with deferred payment term.

The solutions which indirectly influence limiting the risk include factoring and forfaiting, which fulfil primarily the role of instruments that maintain financial liquidity of enterprises. They also include methods based on economic information flow and access to it, e.g. rating.

Factoring is an economic instrument which is used mainly for short-term financing of enterprises. In particular companies which possess limited ability of self-financing should use this source of financial resources acquisition. Factoring is taking over against payment – on

the basis of the agreement concluded between the seller and the factor – risk connected with carrying out timely liabilities by the factor who a simultaneously transfers to the seller the financial resources resulting from taken over receivables not yet due, connected with rendering additional services by the factor to the benefit of the seller.

Forfaiting is a form of long-term financing of sales (usually from 6 months to 7-10 years). One can notice numerous similarities between forfaiting and factoring. Sometimes, forfaiting is even called a form of the non-recourse factoring, which however is an oversimplification. Both factoring and forfaiting are used to accelerate the reception of payment by the supplier, who possesses liabilities with the deferred payment term. In both cases three parties of the agreement are present (trilateral legal relationship), although the agreement is bilateral. The situation of the debtor in both agreements is identical. Both agreements are unnamed agreements, shaped by the economic practice – no statutory provisions. They are based on the principle of freedom to conclude agreements or transfer of receivables. As a result of frequent connection with bill of exchange trade, forfaiting has been sometimes treated as a special form of using a bill of exchange in foreign transactions (discounting bills of exchange without the recourse right towards the payee). Presently, a wider definition of forfaiting, which comprises also other types of receivables than bills of exchange receivables are not being questioned.

Another type of securing risky transactions is insuring the receivable. In case the payment is not made by the contractor, the insurer compensates for the loss. However, it is worth remembering that the indemnity agreement includes a number of conditions. Thus, in order to make sure that the compensation is paid, it is necessary to make acquainted with the requirements and comply with them.

One of the policies that secure the company against not receiving the payment for the invoice, both at home as well as abroad is the insurance policy – Europolisa offered by the insurance company KUKI. Europolisa is a trade receivables security addressed to companies which begin their trade activity or conduct it on a small scale. Lack of payment for the supplied goods or rendered services can result in problems with maintaining financial liquidity at the beginning of the business activity, and what follows, lack of ability to carry out further contracts. In order to comply with the conditions of cooperation with the insurance company an enterprise has to fulfil one of the following conditions:

- conducting export sales, the value of which has not exceeded EUR 1 000 000 within the last 12 months, regardless of the domestic sales,
- conducting sales only on the domestic market, on condition that the amount of sales for the past 12 months did not exceed PLN 5 000 000,
- conducting sales on the domestic market and foreign markets, with the provision, that the amount of sales for the last 12 months did not exceed PLN 5 000 000 and EUR 1 000 000 in export.

The policy insures receivables in 34 countries, among others: Romania, Bulgaria, Croatia, Monaco, the Netherlands, Czech Republic or Ireland. The advantages of receivables insurance Europolisa include: securing the company against not receiving the payment for the supplied goods or rendered services and enabling insurance of a single receiver or a single transaction.

4. CONCLUSIONS

Securing properly the fulfilment of contractual liabilities is a particularly important element from the point of view of entrepreneurs as it constitutes a tool aimed at ensuring financial liquidity in the situations of untimely payment threat. There are many tools that secure fulfilment of contractual liabilities in international trade, however, not all of them can be used in every contract. Other forms of security are present in case of contracts with regular contractors, and others are used in case of new contractors. Applying a given security form is to a large extent conditioned by the cost of a given security establishment and formalities that are associated with this security, and also the time necessary to obtain a particular security. Payment terms offered by the exporter are also closely related to the market situation, competitive offer, regulations valid in the country of one of the parties to the contract, or even expiry date of goods being the subject of the transaction. However, an effective measure to limit the trade risk is undoubtedly reliable information on the future contractor.

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