

DP06

# International Trade Finance

10 MAY 1999

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|---|--|
| 1. Time allowed   | : Three (3) hours  |
| 2. Total number of questions  | : Seven (7) questions on 3 pages                                   |
| 3. Number of questions to be answered   | : Five (5) questions of which at least two (2) must be from Part A |
| 4. Candidates must obtain a minimum of 16 marks in Part A as well as pass the paper as a whole. |  |
| 5. Begin each answer to a new question on a fresh page.   |  |
| 6. Answer <b>all</b> questions in <b>English</b> .  |  |

**PART A****ANSWER AT LEAST TWO (2) QUESTIONS**

1. (a) Mr Richard Tan of Duckie Feedmill Sdn Bhd, whose factory is located in Johor Bahru, received a confirmed order through a letter of credit (LC) issued by Bank of Europe to export some fertiliser to an importer in Amsterdam. Unfortunately he was not able to source sufficient supply of raw material from the local supplier and has to import them from a supplier in Australia. Since his import LC facility with your bank is fully utilised, he came to seek your advice on how he could still fulfill the order without having to temporarily increase his facility.
- (i) Give **two** suggestions on how Mr Richard Tan can still honour the order. [4]
- (ii) What are the main differences between a “back-to-back” letter of credit and a “transferable” letter of credit? [2]
- (iii) State **two** advantages and **two** disadvantages to a middleman for each of the following: [4]
- a back-to-back letter of credit [4]
  - a transferable letter of credit [4]
- (b) (i) Name **five** of the commonly issued guarantees by commercial banks and give an example for each type of guarantees. [5]
- (ii) Give **three** examples of guarantees that can be issued for a period exceeding **one** year. [3]  
(Total:20 marks)
2. (a) (i) Name the **two** types of documents that can be handled under the Uniform Rules for Collection, ICC 522 and provide **three** examples under each type of documents. [6]
- (ii) Name the **five** main parties associated with the collections provided under the Uniform Rules for Collection, ICC 522 and briefly explain their respective responsibilities. [5]
- (b) (i) What is the main difference between a “standby” letter of credit and the “traditional” letter of credit? [5]
- (ii) Name **two** advantages and **two** disadvantages of a standby letter of credit to an importer. [4]  
(Total:20 marks)
3. (a) At the request of Miss Lim of Premal Sdn Bhd, you have issued a shipping guarantee for her to clear a cargo that has arrived at Port Klang **five** days ago. **Five** days later, the set of documents drawn under your letter of credit arrived with several discrepancies noted. Miss Lim noted that some of the goods she has cleared earlier were missing and has advised you that she will not accept the discrepancies and has requested you to dishonour the claim and reject the documents.
- Required:**
- Can Premal Sdn Bhd refuse to accept the discrepant import documents drawn under the letter of credit for which they have obtained a shipping guarantee from you to clear the goods? Explain your answer. [5]
- (b) Briefly describe the following types of payment provisions:
- (i) by sight payment [2]
- (ii) by deferred payment [2]
- (iii) by acceptance [2]
- (iv) by negotiation [2]

- (c) Briefly describe **three** main functions of a bill of lading in an international trade transaction. [3]
- (d) Briefly define the following types of bills of lading:
- (i) Through (combined) bill of lading [2]
- (ii) Short form bill of lading [2]
- (Total:20 marks)

## PART B

4. (a) On 3 January 1999, you negotiated an export bill drawn under First Bank of Korea's letter of credit for USD100,000. Documents were dispatched on the same day by DHL Worldwide Express and were acknowledged receipt by the issuing bank on 5 January 1999. Meanwhile, you have claimed TT reimbursement on Citibank, New York and payment was received on 10 January 1999. On 14 January 1999, you received a telex from the issuing bank claiming that they have noted a discrepancy in the documents i.e. port of loading was indicated as Port Kelang instead of Port Klang as per the terms in the letter of credit. The issuing bank is now claiming for refund of proceeds.
- (i) What would your initial response to the issuing bank be and why? [6]
- (ii) What would be your next course of action? [4]
- (b) What is the main distinction between a "clean collection" and a "documentary collection"? [2]
- (c) Name **two** advantages and **two** disadvantages of a collection to an [4]
- (i) exporter; and [4]
- (ii) importer. [4]
- (Total:20 marks)

5. (a) On 1 March 1999, Skylight Ventures Sdn Bhd (Skylight), who has export bills discounting facilities with you, submitted a complete set of a 90 days D/A export documents for discounting for a value USD500,000. Skylight's limit for discounting facilities would exceed if you were to discount this bill. However, you have agreed to forward the documents on a collection basis first and purchase them once Skylight's limit was regularised.

You are also given the following information:

- Assume that Skylight's limit was regularised on 15 March 1999 and, as agreed, you are discounting the bill for the remaining period.
- The arrangement with Skylight is to use the day's best forex rate and interest to be collected upfront.
- USD SIBOR Rate : 4.5% per annum
- Collection charges : 0.1% flat

Forex Rate	Selling/TT	Buying/TT
USD/MYR	3.8300	3.7700

### Required:

Using the above information, what will the net proceed credited to Skylight's account be? Show your workings. [6]

- (b) (i) What is a “silent confirmation”? [4]
- (ii) Explain why an approved credit facility must be in place before a bank issues a letter of credit. [4]
- (c) (i) What is a bankers’ acceptance (BA)? [3]
- (ii) What are the underlying trade transactions which form the basis for the creation of a BA? [3]  
(Total:20 marks)
6. (a) (i) Export Credit Refinancing (ECR) Scheme has **two** methods of pre-shipment financing. Name these **two** methods. [1]
- (ii) Under what circumstances, would each of these **two** methods be available to the exporter? [3]
- (iii) Under what circumstances, would an exporter be required to liquidate the outstanding certificate of performance loan, irrespective of the date of drawdown? [4]
- (b) Name **five** ways to mitigate credit risk in a pre-shipment financing. [5]
- (c) What are the **three** inherent risks in pre-shipment financing under a letter of credit? Explain your answer. [3]
- (d) What is an “assignment of proceed”? [4]  
(Total:20 marks)
7. Temenggong Sdn Bhd submitted a “complete” set of export documents for discounting. When perusing through the document, you note the following:
- Only 2/3 Original bills of lading were submitted;
  - Incoterm used is FOB; and
  - Buyer is not an approved drawee as per limit terms.
- The Limit Term reads as follows:
- RM5,000,000: Bills Purchase Limit drawn at sight on the following approved drawees, where the bank will have a clear title to the goods until such time the bills are paid. Evidence of appropriate insurance to be sighted in respect of each bill purchased.
- Required:**
- (a) Explain what is meant by “where the bank will have a clear title to the goods until such time the bills are paid.” [4]
- (b) What is the risk to the bank when Temenggong Sdn Bhd submits 2/3 bills of lading? [4]
- (c) Why does bills discounting facility require a pre-approved list of drawees? [4]
- (d) Explain the measures you would take to ensure the performance of the drawee. [4]
- (e) Since the incoterm is FOB, how you would mitigate the risk for the bank and the exporter for non-sighting of the insurance policy? [4]  
(Total: 20marks)

## OUTLINE ANSWERS

### PART A

#### Question 1

**Most of the candidates failed to see the risk of a back-to-back letter of credit. It is a standard approach by all banks in Malaysia to ensure that customers do have a credit limit for a back-to-back letter of credit before its issuance. Candidates' understanding on bank guarantees was of average level.**

1. (a) (i) **Suggestion 1**  
 To transfer the Master LC to the beneficiary in Australia. Before doing so, I would advise Mr Richard to instruct the applicant of the Master LC to do the following amendments:
- To allow LC to be transferable to a third country;
  - To allow third party documents; and
  - To ensure the presentation period is sufficient for him to substitute his invoices (and other documents, if required).

**Suggestion No. 2**

To do an assignment of proceeds to the Australian supplier.

- (ii) A back-to-back letter of credit is issued against a master letter of credit whereby the master letter of credit stands as the collateral for the issuance. The master letter of credit stands on its own and the issuing bank is obliged to pay the beneficiary when all terms and conditions are complied with, without having to rely on the payment from the master letter of credit.

A transferable letter of credit is transferred to the second beneficiary on the strength of the master allowing it to be transferred. There is no obligation for the transferring bank to pay the second beneficiary upon receipt of the documents. But the transferring bank may choose to claim from the issuing bank upon presenting the substituted documents for payment.

- (iii) **Back-to-Back Letter of Credit**

**Advantages**

- The applicant of the LC is able to conceal the identity of the final buyer from the supplier thus avoiding the possibility of being cut-off from the continuous business from all parties.
- The applicant is not constrained by the original terms of the credit and may impose some of his conditions to the final supplier without compromising on the conditions of the master LC.
- If the master letter of credit is acceptable to the bank as the collateral and source of repayment, the middleman is relieved from having to provide his own asset as collateral.

**Disadvantages**

- The middlemen have to request the bank to issue a separate letter of credit. Hence, he will be subject to credit assessment and, if the bank should desire it, he will have to provide appropriate security in addition to lodging the master letter of credit. The cost of giving such a security will have to be paid by him.
- Once his account has been debited to settle the claim on the second letter of credit, his resource of payment is from the first letter of credit. The payment is subjected to him providing the specified documents before the credit expires.
- If his supplier is located in a different country, it will be more problematic for him to conceal the identity of the first supplier for he has to provide the same set of documents for his negotiation of the first letter of credit. He may also be constrained by the shorter time period in receiving the documents drawn under the first letter of credit in order not to present the documents under the first letter of credit within the expiry date.

- If the master letter of credit does not allow a third party's documents, it will be a problem for him to produce substitute documents, especially if the goods are produced by a supplier in another country.

### **Transferable Letter of Credit**

#### **Advantages**

- It is administratively efficient from the middlemen's point of view. He does not have to make a separate application for a separate letter of credit to be issued by his bank.
- Since the middlemen is not applying for a separate letter of credit, he will not be required to provide additional security or use his credit line.
- It is cost effective as he does not have to incur additional cost in getting a separate letter of credit to be issued.

#### **Disadvantages**

- The final buyer will know that he is not the actual supplier of the goods.
- The final buyer may know the identity of the final supplier and thus the middlemen may be cut-off from a future business.
- If he does not provide his substituted documents, such as the invoices, on or before the expiry date, he will not be able to draw down any balance to which he is entitled.

(b) (i) The types of guarantees are

- |                             |   |  |
|-----------------------------|---|--|
| • Utility guarantee         | - | issued to Tenaga Nasional Berhad                               |
| • Performance Guarantee     | - | issued to Immigration Department                               |
| • Bid/Tender Bond           | - | issued to company inviting an open tender                      |
| • Advance payment guarantee | - | issued to the principal company for a completion of a contract |
| • Customs guarantee         | - | issued to Customs Department                                   |
| • Goods and services        | - | issued for supply of goods and services                        |

(ii) Any three examples of guarantees that can be issued for more than one year:

- Guarantee in favour of government contract.
- Guarantee in respect of contract for a specified period.
- Guarantee in respect of import and export of capital goods.
- Guarantee in lieu of earnest money / security deposit for licences issued by government for a specified period.

## **Question 2**

**This was one of the most popular questions among candidates. Unfortunately, many did not understand the concept and application of a standby letter of credit.**

(a) (i) The types of documents and three examples of the documents are:

- Financial documents – bills of exchange, promissory notes, and cheques.
- Commercial documents – invoices, transport documents, insurance certificate, certificate of origin, certificate of quality.

(ii) The five main parties and their responsibilities are:

- Principal or Drawer or Exporter or Seller – entrusting the handling of the collection to a bank.

- Drawee or Importer or Buyer – the party to whom the presentation is being made in accordance with collection instructions.
  - Remitting Bank – the bank which the principal had entrusted the handling of the documents.
  - Presenting Bank – the collecting bank making presentation to the drawee.
  - Collecting Bank – The bank, other than the collecting bank, which is involved in the collection process.
- (b) (i) Standby letter of credit acts as a guarantee to the beneficiary to demand payment from the issuing bank before its expiry date for a non-performance of the applicant. In contrast, the traditional letter of credit requires to the beneficiary to fully comply to the terms of the credit by presenting the full set of the documents stipulated therein before the expiry date before payment is made.
- (ii) **Advantages to Importer**
- As compared to the traditional letter of credit, the importer and his bank are less exposed to credit risk.
  - It enables a creditworthy importer to continue to trade on terms that are effectively either “open account” or on the basis of “D/A collection”. By always paying on time, the importer knows that the exporter will not call on the standby letter of credit.
- Disadvantages to Importer**
- The importer must apply for his bank to issue the standby letter of credit and he will be subjected to a credit assessment. The bank may require collateral before issuing the standby letter of credit and this will provide additional cost to the importer.
  - In view that the exporter or beneficiary can make claim on demand against the standby letter of credit, the exporter may be exposed to paying for the goods twice. Trying to recover the second payment may be expensive and time consuming.

### Question 3

**Many candidates were confused with the types of payments which relate to UCP 500 guidelines and to the collection rules (URC522). The question on Bill of Lading was well-answered.**

- (a) If YES, it is because shipping guarantee is a contractual agreement between the issuing bank and the importer. He is entitled to refuse to accept the discrepant documents, as the undertaking he signed with the bank is not transferred to the exporter or the negotiating bank.
- If NO, it is because in a shipping guarantee the importer has undertaken to accept the discrepant documents in lieu of the bank releasing the shipment to him under the guarantee. Therefore, he cannot refuse the discrepant documents.
- (b) (i) Sight payment is where the beneficiary will draw a sight draft on the nominated bank and the nominated bank will be responsible to pay the exporter upon his sighting of the draft.
- (ii) Deferred payment is where a draft will not be drawn. Thus after the goods has been exported, the required documents will be sent to the nominated bank for inspection. The applicant will pay at the time specified in the letter of credit.
- (iii) By acceptance of a usance payment is where the beneficiary draws the draft payable at some future date after the bill has been sighted by the drawee, who in this case will be the nominated bank. The nominated bank will accept the bill and determine the maturity date of the draft when payment will be made.

- (iv) Payment under negotiation is when the bank buys the documents that relate to a letter of credit. Thus, the bank gives full immediate value to the beneficiary under the credit. Having purchased the documents, the bank will present them to the drawee or issuing bank for payment at sight or usance, as indicated in the LC terms.
- (c) The 3 main functions of a bill of lading are:
- (i) Upon issuance, the bill of lading acts as receipt for the underlying goods.
  - (ii) It contains the terms and conditions of the contract of carriage.
  - (iii) It acts as a document of title for the underlying goods.
- (d) (i) Through bill of lading is used when the goods are to be transported using different modes of transport by two or more carriers. The shipping company that issues this bill of lading assumes liability for the goods while it is in transit, even when they are not under its control. The bill of lading will indicate where the goods are to be taken in charge, the name of the port of loading and discharge and the place where the goods are to be delivered to.
- (ii) Short-form bill of lading is briefer in size and contents as compared to the standard bill of lading. The brevity arises because the contract terms and conditions do not appear on the bill of lading itself. Instead, the exporter is referred to a master document which is “located” somewhere else.

## PART B

### Question 4

**Though the approach in responding to a set of discrepant documents is very subjective, the points looked for are more on the application or the use of UCP as argument for rejection. Many candidates failed to do this.**

- (a) (i) The issuing bank is correct to state that the difference between Port Kelang and Port Klang is a discrepancy. It does not comply to Article 13A of UCP 500, which states that “documents, which appear on their face to be inconsistent with one another, will not be considered as not appearing on the face to be in compliance with the terms and conditions of the credit”.

However, the issuing bank also failed to comply to Article 13B whereby they did not act within the reasonable time, i.e. not to exceed seven banking days following the day of receipt of documents, to refuse the documents due to the discrepancy. In this situation, the issuing bank is precluded from claiming that the documents are not in accordance to the terms and conditions of the credit. Thus, the issuing bank is not entitled to claim for refuse.

- (ii) I will telex the issuing bank denying their calling by stating the requirement of Article 13B which they did not comply with. As for the discrepancy, I will advise them that the ports referred to be of the same.
- (b) A clean collection refers to a collection of financial documents alone, i.e. there are no commercial documents attached to the financial documents. This type of collection is seen where, for example, a cheque drawn by the buyer is handled by the bank in order to obtain payment.

A documentary collection may take one of two forms. It may consist financial documents accompanied by commercial documents or commercial documents alone.

- (c) (i) **To exporter**

#### Advantages

- If the collection is on DP, the documents will not be released to the importer until payment is made. In the event that buyer could not take up the goods, he can still sell it to another buyer as he retains control of the goods.

- If it is on DA terms, the documents will not be released until acceptance is made. Control still remains until acceptance and promise to pay is made.
- Even if the importer refuses to pay, on a DP or DA terms, the exporter still has an option for noting or protesting a dishonoured bill of exchange.
- The exporter does not have to comply to the stricter criteria that would be imposed upon him under a letter of credit.
- Inexpensive settlement technique.
- Can obtain financing from bank.

#### **Disadvantages**

- Fees have to be paid if he cannot pass this over to the importer.
- There could be a time lag in obtaining payment from importer.
- If the importer, on a D/A term, does not pay on maturity date, he will have to consider noting or protesting which will be an additional cost to him.
- If upon arrival of documents at the presenting/collecting bank, the importer decides not to pick the goods, it will be an expensive exercise for the exporter to find an alternate buyer or re-ship the goods back to Malaysia.

#### (ii) **To importer**

#### **Advantages**

- For a D/A term, he could possibly get the goods and sell them before he pays for the collection.
- The importer may be able to delay the acceptance or payment until the goods arrive in his country.
- He would not incur cost which is incidental to setting up a documentary letter of credit.

#### **Disadvantages**

- Even if the deal is a D/A/ tenor, he will still be responsible for interest charge during the tenor of the bill, thereby increasing his cost.
- If he did not pay for the import, the bill may be protested and thus his image will be tarnished in the local business.
- He does not have the opportunity to see the goods before he is obliged to accept or pay for it.

### Question 5

**None of the candidates who attempted this question gave the correct answer to the calculation. The main reason is their failure to apply the ABM rules on the maximum of RM100 as the collection fees.**

#### (a) Terms of payment:

- 90 days sight
- Assuming that on 15 March 1999, the maturity date has yet to be confirmed by presenting bank, thus the tentative maturity date for calculation of bill discounting will start from 1 March 1999. Therefore, the maturity date for bill discounting is 30 May 1999.
- The balance for discounting from 15 March 1999 to 30 May 1999 is 77 days.

Net proceeds to be credited:

$$\text{USD}500,000 \times 3.7700 = \underline{\text{RM}1,885,000}$$

*Less: Interest for 77 days @ 4.5%*

$$\text{USD}500,000 \times \frac{77}{360} \times 4.5\% = \text{USD}4,812.50 \times 3.77 = \underline{\text{RM}18,143.12}$$

$$\text{Net proceeds} = \text{RM}1,885,000 - \text{RM}18,143.12 = \underline{\text{RM}1,866,856.88}$$

- (b) (i) An agreement between the bank and the beneficiary of the LC for that bank is to “add its confirmation” to the LC despite not being authorised by the issuing bank. The beneficiary is seeking security of a confirming bank and is willing to pay the confirmation due, but does not want to ask the applicant to instruct the issuing bank to give its authorisation to have another bank confirm its LC. Article 9 of the UCP 500 states that an LC may only be confirmed if it is so authorised or requested by the issuing bank. Therefore, silent confirmation does not allow the bank to acquire the full benefits of UCP 500 afforded to a confirming bank, as the agreement involves solely the confirming bank and the beneficiary.
- (ii) A letter of credit represents an extension of credit by the bank to its customers, i.e. the applicant. A credit decision will need to be made and the credit approval process of the issuing bank must be followed in which an approved credit facility (which may be either secured or unsecured) be in place. The customers’ requests could be denied if the decision maker(s) find the creditworthiness of the customer to be unsatisfactory.
- (c) (i) A Bankers Acceptance is a bill of exchange drawn and accepted by a commercial bank or a merchant bank in Malaysia. It is payable on a specific future date not earlier than 21 days but not later than 365 days. It is payable to the drawer and only traded in MYR.
- (ii) It is the most flexible form of financing as it can be used to finance import, export, local sales and local purchases whereas other financing facility is only for a specific purpose (e.g. Trust Receipt is only for imports)

## Question 6

**This question was poorly answered especially the one on risk mitigation and Export Credit Refinancing (ECR).**

- (a) (i) The two methods of financing available under ECR scheme are:
- Order Based Method
  - Certificate of Performance Method
- (ii) The circumstances under which the above methods would be eligible are:
- Order Based Method**
- Indirect Exporters; or
  - Direct Exporters who are:
    - New exporters
    - Seasonal exporters
    - Maximum export for last financial year and the preceding 12 months is less than RM1 million

**Certificate of Performance (CP)**

All those exporters of eligible products but not eligible for Order Based Method.

- (iii)
- For CP user with brought forward loan, an exporter is required to use at least 70% of his export proceeds received during a CP validity period to liquidate all loans outstanding.
  - Proceeds from Post shipment financing (ECR, BA, LC Negotiation etc).
  - Abuse and misuse of facility.
- (b) To mitigate credit risk, it is essential that:
- It must be with full recourse to the beneficiary.
  - LC must be irrevocable and, where possible, confirmed.
  - LC proceeds must be used to settle the outstanding loan.
  - There must be cap to financing amount. Do not finance profit margin.
  - There should not be an occasion where double financing can happen.
- (c) The main risks inherent in preshipment financing are:
- **Credit Risk**  
The customer may become insolvent, or may use the specific pre-shipment finance for other purposes or may fail to manufacture at all.
  - **Operational Risk**  
The exporter may present discrepant documents under the export LC. This is a fairly common occurrence, but in the majority of cases the buyer wants the underlying goods and is prepared to authorise payment notwithstanding documentary discrepancies. The bank should have ultimate recourse to the beneficiary in the event of non-payment due to discrepant documents.
  - **Bank and Country Risk**  
This risk is controlled by ensuring that preshipment financing is provided in instances only where the LC is confirmed.
- (d) It is used in LC transactions where the beneficiary (exporter) may not actually be supplying the goods, and in bond guarantees whereby the beneficiary (importer/buyer) may assign any proceed to which he may be, or may become, entitled under the bonds/guarantee. Under an LC, the beneficiary may assign to the ultimate supplier a part or all of the proceeds. The assignment does not constitute the transfer, and it does not give the assignee any interest in or rights under the LC except that they will receive the assigned amount from the proceeds, if any. There is normally a written agreement between the parties, i.e. the assignor (beneficiary) and the assignee (supplier) and written notice provided to the advising/negotiating bank. The negotiating bank shall normally retain the original LC for future negotiation.

**Question 7**

**Most of the candidates failed to understand the credit risks involved.**

- (a) It means that the bank has full control or custody over the goods by having all the three original bills of lading either in the bank's possession or endorsed to the order of the bank.

- (b) The risk to the bank is that it will not have full control over the goods. Only one original bill of lading is required to obtain ownership of the goods. When that is done, the remainder will be void, thereafter. Thus, if the bank chooses to purchase Temenggong document while not having full control over the goods, it will run the risk of non-payment from the importer. Since the facility limit does not allow such to happen, the bank may also run the risk of not being able to seek refund from Temenggong due to their own oversight.
- (c) Prudent banking will always have a pre-approved list of drawee before extending a bill discounting facility to the customer. Before a drawee is on a pre-approved list of the bank, the bank needs to do a background credit checking on the drawee. Drawees that have acceptable financial reports from the bankers or any creditable credit agency will provide comfort to the bank that their good track records will continue. In addition, it also gives comfort to the bank that their customer is dealing with an acceptable creditworthy drawee.
- (d) The measures are:
- To obtain and ensure that the credit report on the drawee is current.
  - To review the past record of the drawee in relation to their payment pattern and meeting financial obligations.
  - To ensure that there are no adverse reports made on the drawee.
  - To cover via MECIB or other forms of export insurance.
- (e) By requesting the exporter to obtain a duplicate copy or the copy of the master policy of the insurance purchased by the importer to be forwarded to them.