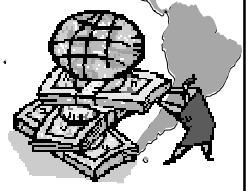
Financial Risk, Payment Methods, Trade Finance

World Trade Practices
Chapter 16

International Financial Risk

- Incomplete International Data
- Procedural Errors
- External risks
  - Currency valuation
- Foreign receivables
  - Bank fears



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Three Risk Categories

Credit Risk

Political Risk

FX Risk

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Foreign Exchange Exposure

Economic — The objective is to anticipate and influence the effect of unexpected changes in exchange rates on a firm's future cash flows

Transaction — Arises when payments must be made or received in a foreign currency

Translation — Arises from consolidating assets and liabilities measured in foreign currencies with those in the reporting currency

9-4

4

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Figure 16.1

- Sources of Risk
- Data sources for risk assessment
- Techniques to reduce risk

5

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Minimizing Credit Risk

- Most straightforward risk
- Easy to identify
  - Exact amount of transaction
- Letters of credit L/C
- Advance Payments
  - May restrict sales

6

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Open Accounts

- Company Profiles (ICP)
- Private credit reporting
  - Dun & Bradstreet www.dnb.com
- Foreign receivables insurance

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Ex-Im Bank

www.exim.gov

15-11

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The Role of Government in the Export/Import Environment

- **Political**
  - Protecting jobs and industries.
  - National security.
  - Retaliation.
- **Economic**
  - Develop/protect infant industry.
  - Strategic trade policy.
    - First mover advantage.
    - The 'catch-up' argument.
- Government may restrict payment even if buyer able to pay.
- May internally tax outside transaction.
  - FAW tuition at UNI

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15-12

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Minimizing Political Risk

- Government documentation
  - *Note: may not be up-to-date*
- Two methods
  - Prepayment
  - Export Credit Insurance
- Consult financial advisors

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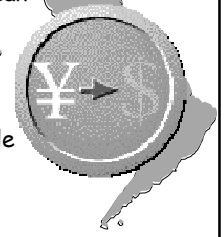
How much FX risk?

- Determine how much you can handle
- Involve bank
  - Could restrict credit availability
- Consider Vadnais Life Cycle Model
  1. Adverse
  2. Tolerant
  3. Strategist



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Model Implications

- FX management - competitive tool
- Strategic tool for ALL companies
  - Size immaterial
- Must be linked to all aspects of the Value Chain

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Currency Risk Strategy

- Receipts or dividends may be made in a foreign currency.
- Purchases may have to be paid in the supplier's currency.
- Company may want to invest in a country.
- Company may wish to merge or make an acquisition in other country.
- Currency Speculation

9-2

13

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Foreign Exchange (Fx)

A commodity that consists of currencies issued by countries other than one's own.

9-3

14

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Exchange Market/Exchange Rate

- The ***Foreign Exchange Market***: a market for converting the currency of one country into the currency of another country.
- An ***Exchange Rate***: is the rate at which one currency is converted into another.

9-5

15

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Functions of the Foreign Exchange Market

- *Converting currencies*
- *Reducing risk*

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Currency Risk

- In every international transaction there is a currency risk that runs from the date of contract to date of payment.
- Currency exchange rates are continuously changing.

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Reducing Risk

- ***Netting:*** intracompany hedge in its own network against currency fluctuation
- ***Forward Exchange Rates:*** when two parties agree to exchange currency and execute the deal at some specific future date.
- ***Futures Contract:*** the simultaneous purchase and sale of a given amount of foreign exchange a specific date in the future.
- ***Currency Options:*** a tradable forward contract with the option to either buy or NOT buy the currency at the agreed price

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Exchange Rate Forecasting

- Efficient market: where prices reflect all available public information.
  - *Forward exchange rates* reflect market participant's collective predictions of likely spot exchange rates at specified future dates.
- Inefficient market: where prices do not reflect all available information. Forward exchange rates *are not* the best predicators of future spot exchange rates.
  - Use fundamental or technical analysis to predict the exchange rates.

9-21

19

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Factors Influencing Currency Value

Economic Factors

1. Balance of Payment
2. Interest Rates
3. Inflation
4. Monetary and Fiscal Policy
5. International Competitiveness
6. Monetary Reserves
7. Government Controls and Incentives
8. Importance of Currency in World

Political Factors

9. Political Party and Leader Philosophies
10. Proximity of Elections or Change in Leadership

Expectation Factors

11. Expectations
12. Forward Exchange Market Prices

9-22

20

Currency Convertibility

- Freely convertible.
- Externally convertible.
- Not convertible.
  - Preserve foreign exchange reserves.
    - Service international debt.
    - Purchase imports.
- Political decision.
- Many countries have some kind of restrictions.
- Countertrade.

9-23

21

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Export/Import Financing

- Letters of Credit (LOC)
  - Bank guarantee on behalf of importer to exporter assuring payment when exporter presents specified documents
- Drafts (Bill of Exchange)
  - Written order exporter, telling an importer to pay a specified amount of money at a specified time.
- Bill of Lading
  - Issued to exporter, by carrier. Serves as receipt, contract and document of title.

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15-6

22

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Int'l Payment Methods

- Cash in Advance
- Letters of Credit
- Collections
- Open Account

23

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Cash in Advance

- Risk to seller:
  - none
- Risk to buyer:
  - very high
  - Relies on seller to ship quality good
  - Capital tied up until goods received
- Buyer receives goods:
  - after payment
- Cost:
  - low
  - Cost of wire transfer or Western Union money transfer

International wire transfers are not as "speedy" as U.S. bank transactions.
Make sure to verify account credit prior to shipment

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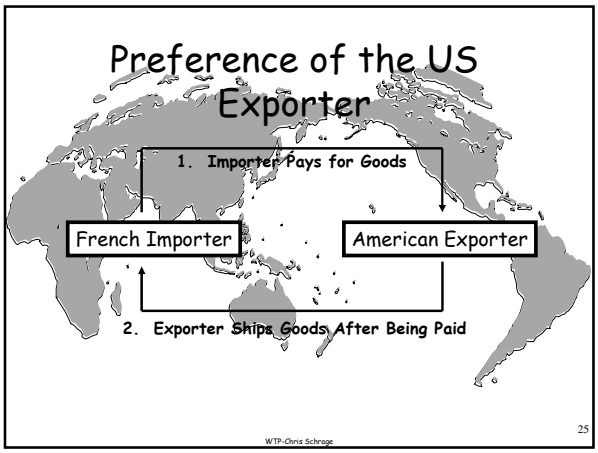
Preference of the US Exporter
1. Importer Pays for Goods
French Importer
American Exporter
2. Exporter Ships Goods After Being Paid
25
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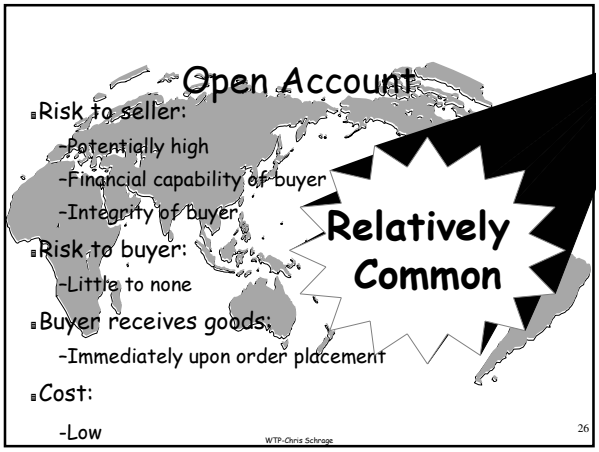
Open Account
Risk to seller:
-Potentially high
-Financial capability of buyer
-Integrity of buyer
Risk to buyer:
-Little to none
Buyer receives goods:
-Immediately upon order placement
Cost:
-Low
Relatively Common
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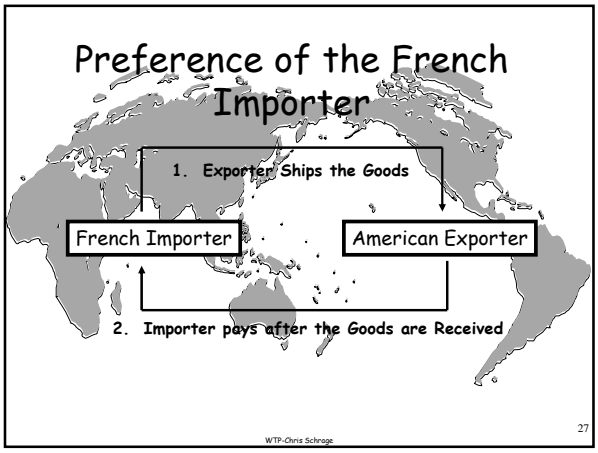
Preference of the French Importer
1. Exporter Ships the Goods
French Importer
American Exporter
2. Importer pays after the Goods are Received
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Collections

Other names
- Documentary collections
- Cash against documents
- Payment against documents

- Risk to seller:
  - Potentially high
    - If bank or forwarder unreliable
- Risk to buyer:
  - Similar to L/C
  - Lower if inspection of goods allowed prior to payment
- Buyer receives goods:
  - after fulfilling payment terms
- Cost:
  - low

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L/C (Irrevocable)

- Risk to seller:
  - little to none if properly executed
- Risk to buyer:
  - little
  - No shipment, no payment
  - Reliant on seller to ship as specified
- Buyer receives goods:
  - After payment of a L/C sight draft
  - Before payment for L/C time draft
- Cost:
  - Related to value of transaction
  - Can be high

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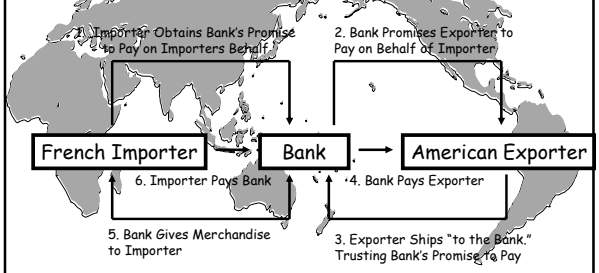
The Use of a Third Party



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L/Cs

- **Types**
  - Irrevocable
    - Both parties MUST agree to any amendments
  - Revocable
    - Can be amended without sellers consent
- **Drafts**
  - Sight
    - As soon as documents verifying shipment presented to the bank
  - Time
    - Time period negotiated between seller and buyer
    - Can be called Usance L/C
    - Provide delayed payment option to buyer without adding risk to seller
    - Use a stated time period for payment after documentation presented

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L/C Challenges

- **Using foreign banks as intermediaries**
  - May not be experienced
  - May not be financially strong
- **Issued by U.S. Bank**
  - Know it is genuine
  - However may take considerable time to receive
  - Still necessary to verify accuracy of document

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L/C Problems

- **Discrepancies**
  - Mis-spelling
  - Make sure all documents include same number for L/C
  - High fees can be charged to correct discrepancies!!!!!
- **Date of shipment**
  - Missed shipment dates could result in non-payment
  - Be cautious, avoid being over optimistic
- **Partial Shipments**
  - L/C must indicate whether or not allowed
- **Costs-**
  - If seller responsible for carriage, make sure to have accurate costs prior to signing
  - May end up eating freight cost overages

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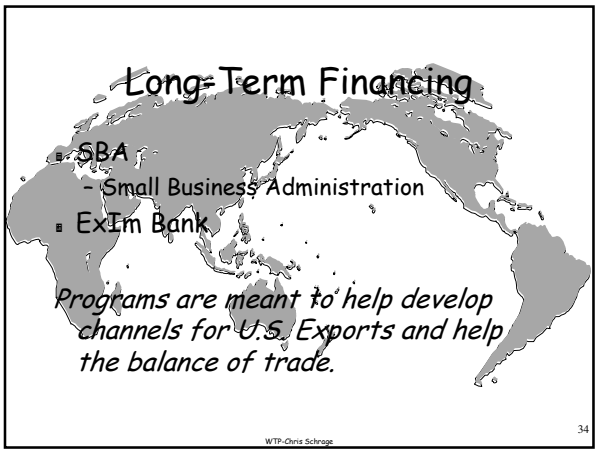
Long-Term Financing
SBA
Small Business Administration
ExIm Bank
Programs are meant to help develop channels for U.S. Exports and help the balance of trade.
34
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