



What are trade finance and credit insurance?

# What are trade finance and credit insurance?

As international trade involves buying and selling over extended periods of time across oceans, borders, legal systems and regions with very different business cultures and environments, a range of financial products and services – from bank guarantees to specialised loans providing exporters with working capital – have developed to allow businesses to trade with confidence. This is the area known as trade finance. Credit insurance is the overlapping field of covering exporters against the risk they will not be paid for a range of reasons such as political upheaval or simply default.

Some common elements of trade finance include:

- letters of credit
- forfaiting
- project finance.

## Letters of credit

A letter of credit is an undertaking issued by a bank on behalf of the buyer to pay a stated amount to the exporter within a specified period, provided certain conditions are met. These generally include receipt by the bank of various documents such as a commercial invoice, transport documentation and an insurance certificate.

When the goods have been delivered to the specified location the relevant documents are sent to the buyer's bank, which will then make the payment.

A confirmed letter of credit is one whose settlement is guaranteed by another bank of the exporter's choosing – usually their house bank in the UK – subject to the exporter complying with all the terms of the original deal. The bank issuing this confirmation then collects the payment from the foreign bank issuing the initial letter of credit.

## Forfaiting

Forfaiting is a form of credit whereby a bank or other third party effectively buys an export transaction, presented as bills of exchange. The Forfaiter now has the contract with the buyer. The Forfaiter pays the exporter for the goods – providing security to the exporter – and agrees a payment schedule with the buyer over a period typically of between two to five years. As liability has now passed to the exporter's bank or other Forfaiter, they usually insist the bills are avalised or guaranteed by the buyer's bank, which must promise to honour the bill if the buyer defaults – often using a letter of credit as above.



## Project finance

With some major self-contained overseas projects undertaken by UK firms, such as building a sports stadium or oil installation, exporters may seek to fund the project in a stand-alone manner using project finance. With this, a bank or other funder will issue a loan for the project based on an overall assessment of its viability including projected future income streams (for example oil revenues) and risks of default by the buyer or general project overspend or failure.

If the project does encounter difficulties, the deal will often be structured so the bank will then be able to take over the project, to try to recoup its funds, but the other parts of the exporter's business should not be liable for the loss. Political or other risk insurance might be taken out to protect the parties involved in financing the project. Project finance is often used in developing countries where there is a good business framework and a history of successfully funded commercial projects.

## Credit insurance

The majority of international trade is conducted on 'open account' whereby the exporter accepts payment after the goods or services have been received by the buyer. Exporters face greater risks than sellers within the UK, because they may have no previous experience of dealing with their buyers or because of political or economic uncertainties – or disasters – in the buyer's country. It is therefore usual to cover against non-payment or other unforeseen events outside the exporter's control.

Risks covered might include:

- Pre-delivery losses and work in progress in the event that the buyer becomes insolvent or terminates the contract before goods are despatched;
- Unfair calling of an on-demand contract;
- Cargo risk if not covered by the logistics supplier; and
- Problems with goods getting through customs, or other reasons for non-delivery.

As with all insurance, care must be taken in selecting the right product for each export deal – in other words, always read the small print!

See page 22 for details of brokers and the British Insurance Brokers Association.

# ICAEW services

## Business Advice Service

Being aware of and understanding the necessary aspects of international trade are critical to a successful business looking to export.

ICAEW's Business Advice Service offers a free, straightforward discussion with an ICAEW Chartered Accountant. There's no obligation after your first free session, just practical thinking to help your business succeed. To find your local ICAEW firm, visit [businessadviceservice.com](https://businessadviceservice.com)

For further information:

[businessadviceservice.com](https://businessadviceservice.com)

E [bas@icaew.com](mailto:bas@icaew.com)

T +44 (0)20 7920 3561

## ICAEW Library & Information Service

Our Library & Information Service provides access to a range of information on over 180 countries, including guides to doing business and information on the tax climate in each jurisdiction. The country guides can be found at [icaew.com/countryresources](https://icaew.com/countryresources)

There is also a range of useful information on importing and exporting at [icaew.com/import-export](https://icaew.com/import-export)

E [library@icaew.com](mailto:library@icaew.com)

T +44 (0)20 7920 8620

F +44 (0)20 7920 8621

[icaew.com/library](https://icaew.com/library)