A Guide to Financing Mechanisms in International Business Transactions

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A Guide to Financing Mechanisms in International Business Transactions

By

Sang Man Kim

Cambridge Scholars Publishing

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By Sang Man Kim

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PREFACE

An international business transaction is a transaction between two or more countries that includes international trade in goods, international trade in services, financial transactions, foreign investment, overseas construction, etc.

Companies engage in international business transactions for various purposes. Maximizing corporate value by increasing revenues and profits will be the ultimate goal for most companies. Companies engaging in international business transactions are likely to gain more revenues and profits.

For the successful completion of an international business transaction, depending on the terms of the transaction, both parties need access to funds. Small- and medium-sized enterprises (SMEs), compared to large companies, often face difficulties in raising capital or funds. Financing an international business transaction is often key to successful completion. There are various financing mechanisms available for international business transactions. Besides financing ability, the choice of a proper financing mechanism is also important to the success of an international business transaction.

For successful completion of an international trade in goods or services, depending on the payment terms and other conditions of a particular transaction, both exporters and importers need access to funds. Thus, it is important to understand trade finance mechanisms for a successful outcome of international trade. For credit terms transactions (or for long payment terms transactions), exporters need trade finance, whereas for cash terms transactions (or for a payment in advance transactions), importers need trade finance. The ability to allow longer payment terms has become a competitive factor in an international trade. Long payment terms bring a cash flow shortage to an exporter, thereby making it important for an exporter to have trade finance. Thus, an exporter needs to obtain trade finance in order to make up the cash flow shortage arising out of an international trade transaction with long credit terms (or long payment terms).

Exporters preparing the performance of export transactions are frequently in need of finance for the performance of the transactions (or for delivery of the goods). Such finance is called pre-shipment finance.

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Exporters are also in need of finance after the performance of the transactions (or after delivery of the goods) because they get paid long after transactions are completed. Such finance is called post-shipment finance. Post-shipment finance includes the negotiation of bills of exchange and/or documents, forfaiting, and factoring.

Export credit insurance (or export credit guarantee) is very useful for the facilitation of pre-shipment finance and of post-shipment finance. Therefore, export credit insurance (or export credit guarantee) is considered as one of the financing mechanisms available in international trades.

An overseas construction project helps exporting countries to get access to new emerging markets and to promote economic cooperation with an importing country. Such benefits encourage countries to enhance competitiveness in overseas construction activities. An overseas construction project is normally huge and complex. Also it typically requires long-term financing as the amount of time it takes for an overseas construction project to pay for itself is considerably long.

As an overseas construction project requires considerable amounts of capital investment, an employer (or an owner), particularly if they are in a developing country, cannot afford to finance the undertaking using their own resources. Thus, an employer (or an owner) normally requires a financing mechanism, which is to be provided by a contractor. Therefore, the financing mechanism for an overseas construction project is conclusive in winning it.

There are various financing mechanisms available for an overseas construction project, some of which are combined. Some major financing mechanisms for overseas construction projects include supplier credit/buyer credit, project finance, export credit insurance (or export credit guarantee), syndicated loans, independent guarantees (or demand guarantees, standby letters of credit), official development assistance (ODA), etc. A detailed understanding of financing mechanisms is often a key to success in overseas construction projects.

Many countries have established export credit agencies to promote exports through various supports including export credit insurance (or export credit guarantee). The main aim of export credit insurance (or export credit guarantee) is to promote their exports by protecting exporters from the commercial risks of importers, and from the political risks of an importing country. Export credit insurance (or export credit guarantee) basically provides protection against the non-payment risk, and it covers both political risks, as well as commercial risks.

Export credit insurance (or export credit guarantee) promotes a country's exports by giving a variety of advantages to its exporters. The key functions

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of export credit insurance include reducing non-payment risks, offering competitive payment terms, increasing exports with reduced non-payment risk and competitive payment terms, creating easy and accessible trade financing solutions, etc. When an export credit insurance (or export credit guarantee) backs an exporter's foreign receivables, commercial banks are often willing to lend to an exporter with favorable terms against foreign receivables, otherwise excluded from the borrowing base.

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Sang Man Kim is a professor of International Trade at Duksung Women's University in Seoul, South Korea. He is also an Attorney at Law (New York, USA), and an arbitrator and mediator at the Korean Commercial Arbitration Board.

In his former role as a deputy director at the Korea Trade Insurance Corporation (a Korean Government owned official export credit agency), Prof. Kim worked as an underwriter and legal consultant for Korean international trades for a period of 15 years.

Prof. Kim graduated with a B.A. in law and an M.D. in international business transactions law from Korea University. Prof. Kim further pursued and completed LLM. (M.D.) from the University of Minnesota Law School, and a Ph.D. in commercial law from Korea University.

Over the last 20 years, Prof. Kim has practiced international business transactions law, and has published over 70 articles and 10 books on the topic.

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CHAPTER 1

INTRODUCTION

1. Overview of international business transactions

An "international transaction" is a "transaction between two or more countries"[1] or a "transaction across national borders". An "international business transaction" is a transaction between two or more countries for business purposes or by commercial entities. An "international business transaction" includes an international trade in goods, an international trade in services, an international financial transaction, a foreign investment, an overseas construction, etc.

Companies engage in international business transactions for various purposes. Maximizing corporate value by increasing revenues and profits is the ultimate goal for most companies. As the international market is much larger than the domestic market, international transactions will help to increase revenues and profits.[2] Thus, companies engaging in international business transactions are likely to gain more revenues and profits.

An international transaction will bring various benefits to the countries as well as the parties concerned. Exporting companies can increase sales and profits through exporting goods and/or services to foreign countries, sometimes selling at a higher price. In the US, exporting companies make 17% more profit than those non-exporting companies.[3] Exporting companies will increase their production, which will also bring an employment increase and growth of GDP in an exporting country.

Importing companies can make profits by selling imported goods in the domestic market, which may bring an employment increase. Importing companies may import raw materials which will be used to manufacture

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1 John D. Daniels, et al., *International Business*, 13th ed., Pearson Education (2011), at 49.

2 Charles W.L. Hill, et al., *International Business*, 2nd ed., McGraw-Hill Education (2016), at 530.

3 US Commercial Services, *A Basic Guide to Exporting*, 11th ed. (2015), at 5.

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exporting goods. Such imports will lead to growth of GDP and also contribute to an export increase. Consumers can purchase imported goods at a lower price, or can purchase the goods which are not produced at all in an importing country.

A host country of foreign direct investment can increase employment and GDP. Global companies which conduct foreign direct investment can save costs by producing goods at low cost, and also increase sales/profits by selling the goods either in a host country or in other countries.

As an international business transaction is a transaction between two or more countries, it has characteristics distinctive from a domestic business transaction. These characteristics of an international business transaction bring companies engaging in international business transactions risks as well as benefits. Therefore, it is necessary to find how to maximize the benefits and minimize the risks to achieve business purposes in international business transactions.

To succeed in international business transactions, companies need to know the characteristics of an international business transaction and understand the distinctions between an international business transaction and a domestic business transaction. It is likely that understanding the characteristics of an international business transaction will be the starting point for companies engaging in international business transactions.

For the preparation and performance of an international business transaction, huge funds or financing is normally required. The amount of funds necessary for an international business transaction may vary depending on the type and the terms of a respective international business transaction. Which party will be in need of financing also depends on the terms of a respective international business transaction.

We need to know and understand the financing mechanism for the successful performance of an international business transaction. Financing for an international business transaction is often a key to success in international business transactions. Financial institutions or banks are playing key roles in providing financing for international business transactions. Thus, without the help of financial institutions or banks, international business transactions could be impracticable. By actively participating as a facilitator in an international business transaction, a financial institution or a bank also creates revenues and profits.

2. Characteristics of international business transactions

Regardless of the purposes of international business transactions, companies must be aware of the characteristics of an international business transaction,

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and must understand the distinctions between an international business transaction and a domestic business transaction.

These characteristics of an international business transaction bring companies engaging in international business transactions risks as well as benefits. Therefore, it is necessary to maximize the benefits and minimize the risks to achieve business purposes in international business transactions. An understanding of the characteristics of international business transactions will be the starting point for companies engaging in international business transactions.

2.1 Different languages

As an international business transaction is a transaction between two or more countries, the languages will normally differ between the parties. English is commonly used in international business transactions, and correspondence and documents are normally made in English.

2.2 Different currencies

As an international business transaction is a transaction between two or more countries, the currencies will normally differ between the parties. In an international business transaction, hard currencies (such as the US Dollar, Euro currency, British Sterling, or Japanese Yen) are normally used. A transaction with soft currency can be a problem for the other party.[4]

2.3 Different laws and standards

As an international business transaction is a transaction between two or more countries, laws will differ between the parties. Industry standards will also differ between the parties. Every authority applies particular laws and standards to a specific instance. A court normally uses a "choice of law rules"[5] to determine the laws applicable to a dispute.[6] When a German exporter enters into a contract for the sale of automobiles with an American importer, we need to decide which law governs the contract

4 Charles W.L. Hill, et al., at 530.

5 Choice of law rules are normally enacted in "international private law" of each nation.

6 Ray August, et al., *International Business Law,* 15th ed., Pearson Education (2009), at 149.

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(American law or German law, sometimes a third country's law). The law governing a contract or legal matters is called the "governing law" or the "applicable law".

In reality, American law differs from German law. No matter which country's law governs a contract for the sale of automobiles between a German exporter and an American importer, American laws and standards for automobile safety will apply to the automobiles driven in America. Therefore, the automobiles for American import should be manufactured in compliance with the American laws and standards.

Prior to exporting to a foreign country, an exporting company should be aware of any law of an importing country that might affect the export transaction. Basic information on that law can often be obtained from an importing company or a distributor in an importing country, but further detailed and specific information can be obtained by legal opinions from a local lawyer.

2.4 Different customs

As an international business transaction is a transaction between two or more countries, customs will differ between the parties. Customs may apply to an international business transaction as a gap-filling of the laws. Customs will differ country to country and region to region. An exporting company should be aware of the customs of an importing country for the successful completion of a transaction.

2.5 Different culture

As an international business transaction is a transaction between two or more countries, culture will differ between the parties. An international business transaction involves parties in different countries and in different cultures. Cultural difference might bring misunderstanding and an adverse effect to a transaction. In order to complete an international business transaction successfully, we should understand the culture of a foreign party.

2.6 Long distance

As an international business transaction is a transaction between two or more countries, the parties are located at long distance. It will take time for the parties to meet in one place for the negotiation of a transaction.

In an international trade in goods, the goods will be transported to a

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foreign country across national borders, and thus the transportation distance will be very long. Accordingly, additional time for transportation is also required in the performance of an international business transaction.

2.7 Government control and intervention

As an international business transaction is a transaction between two or more countries, it gives a material effect on national interest as well. Thus, the government has a tendency to intervene in and have control over international business transactions.

As the goods move across national boundaries in an international trade in goods, each country controls and inspects the goods and transportation. Some of the purposes of such control are to protect the local economy, national health (i.e., Ebola virus infection, or MERS infection), etc. An export declaration is required in an exporting country, and an import declaration is required in an importing country.

Transactions with foreign governments, government agencies, or public entities often require specialized procedures and documentations (i.e., public competitive bidding, compliance with invitation to bidding, bank guarantees, numerous certifications, etc.). In many countries, imports by the government exempt import licenses, or customs duties.

2.8 Complex documents

As an international business transaction is a transaction between two or more countries, complex documents are required. In an international trade in goods, various documents (i.e., bill of lading, airway bill, certificate of origin, packing list, inspection certificate, marine insurance policy, etc.) are required. Unlike an international trade in goods, many of these documents are not normally required in a domestic trade.

Furthermore, either an exporter or an importer in an international trade in goods, concludes incidental contracts with a shipping company, an insurance company, an inspecting company, banks, etc. Therefore, an international trade in goods involves various contracts and documents other than a contract for the sale of goods.

3. Financing international business transactions

For the successful completion of an international business transaction, depending on the terms of the transaction, both parties need access to funds. Small- and medium-sized enterprises (SMEs), compared to large

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companies, often face difficulties in raising capital or funds. Financing an international business transaction is often key to successful completion. There are various financing mechanisms available for international business transactions. Besides financing ability, the choice of a proper financing mechanism is also important to the success of an international business transaction.

As a large volume of funds is required in a huge international business transaction such as an overseas construction, a plant construction, a natural resources development project, etc., the financing procedure for such a transaction is normally complex. Governments often intervene in and exercise influence on it.

In an international sale of goods, both an exporter and an importer seek trade finance depending on the terms and conditions of the transaction.[7] In a credit terms transaction (or in a long payment terms transaction), an exporter will need trade finance, while in a cash payment terms transaction (or in an advance payment terms transaction), an importer will need trade finance.[8] The ability for an exporter to allow long payment terms has become a key competitive factor in an international trade. However, long payment terms normally bring a cash flow shortage to an exporter. Thus, an exporter needs to obtain trade finance in order to make up the cash flow shortage arising out of an international trade transaction with credit terms (or long payment terms).

An exporter preparing for the performance of an export transaction is frequently in need of finance for the performance of a transaction (or for delivery of the goods), and such finance is called "pre-shipment finance".[9] An exporter is also in need of finance after the performance of a transaction (or after delivery of the goods) because they get paid long after the performance of a transaction (or delivery of the goods), and such finance is called "post-shipment finance".[10] Post-shipment finance includes the negotiation of bills of exchange and/or documents (or discounting receivables), factoring, forfaiting, etc.

The term of trade finance covers pre-shipment finance and post-shipment finance. Trade finance is generally secured by receivables and/or securities such as bills of exchange, promissory notes, cargo insurances,

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7 Eric Bishop, *Finance of International Trade*, Elsevier (2006), at 132.
8 Belay Seyoum, *Export-Import Theory, Practices, and Procedures*, 2nd ed., Routledge (2009), at 306-307.
9 Anders Grath, *The Handbook of International Trade and Finance*, 3rd ed., Kogan Page (2014), at 143; Eric Bishop, at 138.
10 Michele Donnelly, *Certificate in International Trade and Finance,* ifs School of Finance (2010), at 122; Eric Bishop, at 140.

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export credit insurances, letters of credit, payment guarantees, etc. The payment from the underlying international transaction will first be used for repayment of any outstanding trade finance loan. Thus, trade finance is considered more secured for a financing bank. Many countries operate export credit insurance (or export credit guarantee) programs for their national exports, and export credit insurance (or export credit guarantee) programs are very useful for the facilitation both of pre-shipment finance and of post-shipment finance. Therefore, export credit insurance (or export credit guarantee) is considered as a useful financing mechanism in international trades.

The working capital cycle is very important for cash flow management. The longer the working capital cycle, the longer a business is tying up capital in its working capital without earning a return on it. The working capital cycle mainly depends on the terms of payment in an international trade transaction. The working capital cycle in an international trade is normally longer than that in a domestic transaction. Therefore, exporting companies strive to reduce working capital cycles by collecting receivables quicker. Exporting companies may be able to shorten the working capital cycle with favorable payment terms. If the working capital cycle is shorter, a company can create more sales and revenues. Every company pursues a shorter working capital cycle through favorable payment terms and choosing a proper financing mechanism.

In making a trade financing decision, companies have to consider: the need for finance, the length of time for finance, the cost of different financing mechanisms, the risks associated with the financing, the need for pre-shipment financing, the need for post-shipment financing, etc.[11]

An overseas construction project (or a plant construction project) is normally huge and thus requires considerable amounts of funds. An employer (or an owner), particularly if they are in a developing country, faces difficulty in financing the funds out of their own resources. Thus, an employer (or an owner) normally requires that financing should be provided by a contractor. Therefore, the proper financing mechanism for an overseas construction project is conclusive in winning the project. This is the primary reason we need to study financing mechanisms for an overseas construction project.

There are various financing mechanisms available for an overseas construction project (or a plant construction project), some of which are combined. The major financing mechanisms used for an overseas construction project are a supplier credit, a buyer credit, project finance,

11 US Commercial Services, at 169-170.

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export credit insurance (or export credit guarantee), syndicated loans, independent guarantees (or demand guarantees, standby letters of credit), official development assistance (ODA), a government export loan,[12] etc. The precise understanding of each financing mechanism will be the key to success in an overseas construction project (or a plant construction project).

Many countries operate export credit insurance (or export credit guarantee) programs for their construction companies participating in overseas construction projects (or plant construction projects). An export credit insurance (or export credit guarantee) program can be used as a security for the loan in an overseas construction project (or a plant construction project). Export credit insurance (or export credit guarantee) is often a key to winning an overseas construction project (or a plant construction project).

Many countries have established export credit agencies (ECAs) to promote exports through various supports including export credit insurance (or export credit guarantee).[13] There are various types of export credit insurance (or export credit guarantee) programs available for international business transactions. The terms of a specific export credit insurance (or export credit guarantee) differ from ECA to ECA,[14] although basic concepts are similar. Even in one international business transaction, more than one type of export credit insurance (or export credit guarantee) program can be used either in combination or separately. Understanding various types of export credit insurance (or export credit guarantee) programs will be very useful for financing as well as for non-payment risk protection.

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12 Many countries established some form of an Export-Import Bank to facilitate their exports. (Charles W.L. Hill, et al., at 541.)

13 John E. Ray, *Managing Official Export Credits*, Institute for International Economics, Washington DC (1995), at 1.

14 Richard Willsher, *Export Finance: Risks, Structures and Documentation,* Macmillan Press (1995), at 81.

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CHAPTER 2

RISKS IN INTERNATIONAL BUSINESS TRANSACTIONS

1. Introduction

An exporter is normally concerned about payment, whilst an importer is normally concerned about delivery of goods. However, even a seemingly simple international trade transaction can go wrong, and sometimes it really goes wrong. There are various reasons why a transaction goes wrong. Absence of risk assessment or wrong risk assessment would be one of the most direct reasons for that. What is the best action that a company can take? The right risk assessment can minimize the risks. When the risk factors in a particular transaction are not acceptable, a company has to find another transaction.

While risk is a factor in all business transactions, international business transactions involve additional risks.[15] An international business transaction involves more risk factors than a domestic business transaction. Most of the characteristics of an international business transaction bring some risks. Before commencing an international business transaction, a company must first consider various risks to which it will be exposed, and must assess the various risks.

Many of the risks will be the same regardless of whether we are exporting or importing. The main risk factors in an international business transaction include different languages, different currencies, different laws and standards, different customs, different culture, long distance, government control and intervention, complex documents, and finance concern.

15 Guillermo C. Jimenez, *ICC Guide to Export/Import: Global Standards for International Trade*, ICC Publication No. 686 (2012), at 13.

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2. Risk factors

2.1 Different languages

As an international business transaction is a transaction between two or more countries, the languages will normally differ between the parties. The difference of language brings some risks to the parties.

English is commonly used in international business transactions, and correspondences and documents are normally made in English. Whilst English is considered the standard language of international trade, its use is not universal and the level of understanding will vary from country to country and business to business. Although English is the standard language in international business transactions, disputes may arise out of English communication or documents.

2.2 Different currencies

As an international business transaction is a transaction between two or more countries, the currencies differ between the parties. If payment is going to be made in a currency other than that in which an exporter incurs their costs, currency risk (or foreign exchange risk) will arise. Currency risk (or foreign exchange risk) is present in all international transactions, and the size of that risk will depend on the currency and the outstanding period to full performance and payment.

The exporter's main costs will normally be paid in their own national currency, which automatically creates currency risk if an export contract is concluded in a foreign currency. The choice of currency could be of great importance, particularly in an increasingly competitive market.

Fluctuation of the exchange rate might bring unexpected loss or profit, which will bring significant risk in international business transactions. Foreign exchange and currency risks may give huge damages to a company, and result in actual monetary loss. In some cases, the choice of currency for a contract is more important than the contract price (or unit price). A movement in the foreign exchange rate creates unexpected losses or profits in a transaction. Still worse, some countries may impose a restriction on foreign currency exchange, or on foreign currency transfer, which will cause bigger risks and damages. Indeed, a number of countries have imposed restrictions on foreign currency exchange or transfer.

In an international business transaction, hard currencies (such as the US Dollar, Euro currency, British Sterling, or Japanese Yen) are normally used. However, a transaction with soft currency can be a bigger problem

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for the other party.[16]

2.3 Different laws and standards

As an international business transaction is a transaction between two or more countries, laws will differ between the parties. Industry standards will also differ between the parties. Every authority applies particular laws and standards to a specific instance. The differences between laws and legal systems may cause unexpected troubles or disputes.

Each country has a different level of laws and standards. For example, automobile safety standards vary considerably from country to country. In a developed country, food hygiene policy is likely to be more strict than that in an under-developed country. Each country has its own consumer protection laws which differ from country to country.

In any way, we should be aware of the laws and standards governing the transaction for the successful completion of an international business transaction. Prior to exporting to a foreign country, an exporting company should be aware of any law that might affect the export transaction. Basic information on that law can often be obtained from an importing company or a distributor in an importing country. But further detailed and specific information can be obtained through legal opinions from a local lawyer, without which we may suffer some unexpected loss or damage.

2.4 Different customs

As an international business transaction is a transaction between two or more countries, customs will differ between the parties. Customs may apply to an international business transaction as a gap-filling of the laws. Customs will differ from country to country and region to region. The difference in customs may cause unexpected troubles or disputes. An exporting company should be aware of the customs of an importing country.

2.5 Different culture

As an international business transaction is a transaction between two or more countries, culture will differ between the parties. Cultural difference often brings misunderstanding and an adverse effect to a transaction. As an international business transaction involves parties from different countries

16 Charles W.L. Hill, et al., at 530.

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and different cultures, we should understand the foreign cultures. The culture often has influence on and decides the style and/or the colors of the merchandise. In the case we establish a branch or a foreign subsidiary through foreign direct investment, foreign culture should be first considered.

2.6 Long distance

As an international business transaction is a transaction between two or more countries, the parties are located at long distance. It will take time for the parties to meet at a place for a business corporation or the negotiation of a transaction. Additional time for transportation is also required in the performance of an international business transaction.

In an international trade in goods, the goods will be transported to a foreign country across national borders, and thus the transportation distance will be very long. In many cases, transshipment in a third party country is inevitable. The long period of transportation may cause the goods to be decayed and the price to fluctuate. The transportation cost is expensive. Moreover, vessels transporting the goods are sometimes robbed by sea robbers. Long distance brings a time lag during which funds are tied up while the goods are in transit.

Air transport and ocean transport are more used in international trade transactions. An exporter and an importer should consider both speed and cost to choose a proper transportation method.[17]

2.7 Government control and intervention

As an international business transaction is a transaction between two or more countries, it has a significant effect on national interests as well. Thus, the government intervenes in and has control over international business transactions. An importing country imposes customs duty on the imported goods. In some cases, an importing country imposes anti-dumping duties or countervailing duties on the imported goods.

As the goods move across national boundaries in an international trade in goods, each country controls and inspects the goods and transportation. Some of the purposes of such control are to protect the local economy, national health, etc. An export declaration is required in an exporting country, and an import declaration is required in an importing country.

In the case a dispute is filed at a foreign court, it is likely that the

17 Belay Seyoum, at 201.

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foreign court will make a biased or unfair judgment to protect its nationals. Still worse, it is likely that a foreign court will not recognize and enforce a foreign judgment.

2.8 Complex documents

As an international business transaction is a transaction between two or more countries, complex documents are required or used. In an international trade in goods, various documents (i.e., bill of lading, airway bill, certificate of origin, packing list, inspection certificate, marine insurance policy, etc.) are required or used. Unlike an international trade in goods, many of these documents are not normally required or used in a domestic trade.

In an international sale of goods, an exporter must deliver goods, and hand over the documents required by the contract.[18] Importers often refuse payment on the ground of discrepancies of the documents. In an international trade transaction with a documentary credit, an issuing bank honors (or pays) a complying presentation of documents. Therefore, in the case that any of the documents are not complying with the terms of a documentary credit, an issuing bank shall not honor (or pay) a beneficiary (or an exporter).

2.9 Finance concern

The working capital cycle is very important for cash flow management. In an international business transaction, the working capital cycle is long compared to a domestic business transaction, some of which are caused by the characteristics of an international business transaction. Thus, companies engaging in international business transactions strive to reduce the working capital cycle by collecting receivables quicker or by using the finance mechanism available. However, finance mechanisms incur expense, and some companies face difficulties in obtaining finance. Companies will be able to shorten the working capital cycle with favorable payment terms. If a working capital cycle is short, a company is able to increase sales and revenue.

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18 See Article 30 of the United Nations Convention on Contracts for the International Sale of Goods (the "CISG"); See A1 General Obligations of the seller under Incoterms 2010.

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3. Commercial risk, country risk, and exchange risk

The parties to an international business transaction are exposed to various risks. Such risks are present in any international business transaction. Some of the risks are attributable to the other party, and the others are not attributable to the other party. Although those risks can be mitigated by relevant measures, no international business transaction can be undertaken without those risks. It is essential to understand what ultimate affects each risk will have on the respective parties.

Credit risk can be largely classified into commercial risk and country risk (or political risk). Country risk normally brings more immense and significant impacts on international business transactions than commercial risks. Other than commercial risk and country risk, the parties are exposed to exchange risk.

3.1 Commercial risk

Commercial risk refers to the risk solely attributable to the party itself.[19] Typical commercial risk to an exporter is:

- An importer cannot make payment due to insolvency, or bankruptcy.
- An importer raises a market claim (or a malicious claim) regardless of the quality of the goods.
- An importer delays payment due to a cash flow shortage.

Typical commercial risk to an importer is:

- An exporter delivers non-conforming goods.
- An exporter does not deliver the goods at all.
- An exporter delivers the goods behind schedule.

In order to mitigate commercial risk, we need to conduct a thorough credit investigation and evaluate the creditworthiness of the other party. Some risks can be reduced by obtaining favorable terms of a contract. Unfortunately, we give up other terms in return for obtaining favorable terms, as the terms of a contract are normally a zero-sum game. Export credit insurance (or export credit guarantee) is mainly designed for non-payment risk. Thus, export credit insurance (or export credit guarantee) can be useful for mitigating commercial risks, but we should pay a premium.

19 Anders Grath, at 19.

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3.2 Country risk

Country risk (or political risk) means the risk attributable to the country without the responsibilities of the parties.[20] Country risk includes war, civil disorder, country default, foreign exchange reserve running out, restriction on foreign currency exchange, restriction on foreign currency transfer, etc. Country risk also includes non-payment by public authorities or by private enterprises acting on the state's behalf.[21] Change of political regime, government legislation or monetary policy can be a country risk.[22] Most export credit insurances (or export credit guarantees) also cover the country risk by an exporting country.[23] Thus, export credit insurance (or export credit guarantee) is available to protect from country risk.

The "Arrangement on Officially Supported Export Credits" of the OECD provides "the five elements" of country credit risk in Article 25:

- a general moratorium on repayments decreed by the obligor's/guarantor's government or by that agency of a country through which repayment is effected;
- political events and/or economic difficulties arising outside the country of the notifying Participant or legislative/administrative measures taken outside the country of the notifying Participant which prevent or delay the transfer of funds paid in respect of the credit;
- legal provisions adopted in the obligor's/guarantor's country declaring repayments made in local currency to be a valid discharge of the debt, notwithstanding that, as a result of fluctuations in exchange rates, such repayments, when converted into the currency of the credit, no longer cover the amount of the debt at the date of the transfer of funds;
- any other measure or decision of the government of a foreign country which prevents repayment under a credit; and
- cases of force majeure occurring outside the country of the notifying Participant, i.e., war (including civil war), expropriation, revolution, riot, civil disturbances, cyclones, floods, earthquakes, eruptions, tidal waves and nuclear accidents.

Each export credit agency (ECA) developed its own system for assessing commercial risk and country risk,[24] and provides export credits (export

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20 Malcolm Stephens, *The Changing Role of Export Credit Agencies*, IMF Washington (1999), at 102; Belay Seyoum, at 132; Anders Grath, at 24.

21 John E. Ray, at 18.

22 Richard Willsher, at 128.

23 Malcolm Stephens, at 102.

24 John E. Ray, at 20.

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credit insurance/guarantee, direct loan, etc.) based on their assessment.

The Arrangement on Officially Supported Export Credits of the OECD illustrates country risk mitigation techniques in ANNEX XIII (Criteria and Conditions Governing the Application of Country Risk Mitigation Techniques and Buyer Risk Credit Enhancements).

3.3 Exchange risk

An international business transaction is a transaction between two or more countries, and therefore, the currencies will normally differ between the parties. If the contract price is in a currency other than that in which cost incurs, exchange risk will arise. In the case the contract requires payment in the exporter's currency, the importer bears the exchange risk. In the case the contract calls for payment in the importer's currency, the exporter carries the exchange risk.

Fluctuation of the exchange rate might bring unexpected loss or profit, which is a significant risk in international business transactions. Foreign exchange risk results in actual monetary loss or damage. Foreign exchange risk management has been one of the significant concerns for most exporters, in particular, for small- and medium-sized enterprises ("SMEs").

Depreciation in the contract currency will present an exporter with unexpected loss, while appreciation in the contract currency will present an importer with unexpected loss. The volume of exchange risk depends on a particular currency and the period of payment. Soft currency will normally bring bigger risk as it fluctuates more than hard currency. Transaction with soft currency can be a problem for the other party.[25] In some cases, the choice of currency for a contract is more important than the contract price (or unit price) itself. A movement in a foreign exchange rate creates unexpected losses or profits in a transaction.

There are various methods of hedging foreign exchange risk, but the parties to an international business transaction find many of them unacceptable or impracticable. By using forward exchange or future exchange, the parties to an international business transaction can reduce foreign exchange risk. But such an exchange hedge incurs transaction costs. Some export credit agencies operate "foreign exchange risk insurance (or foreign currency guarantee)", and a foreign exchange risk insurance operated by an export credit agency has been well accepted for foreign exchange risk hedging.

25 Charles W.L. Hill, et al., at 530.

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Restriction on foreign currency exchange or restriction on foreign currency transfer is taken by the government and is attributable to the government. Thus, restriction on foreign currency exchange or restriction on foreign currency transfer is a type of country risk. However, exchange risk is not directly attributable to the government, although it is, in some way, affected by the national economy and politics.

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CHAPTER 3

FINANCING THE INTERNATIONAL SALE OF GOODS

1. Introduction

For the successful completion of an international trade in goods or services, depending on the payment terms and other conditions of a particular transaction, both an exporter and an importer need access to funds. In an international sale of goods, both an exporter and an importer seek trade finance depending on the terms and conditions of a transaction.[26] Thus, it is necessary to understand trade finance mechanisms for a successful outcome of international trade.

For credit terms transactions (or for long payment terms transactions), an exporter needs trade finance, whereas for cash payment transactions (or for a payment in advance transactions), an importer needs trade finance. The ability to allow longer payment terms has become a competitive factor in international trade. Long payment terms bring a cash flow shortage to an exporter, thereby making it important for an exporter to have trade finance. Thus, an exporter needs to obtain trade finance in order to make up the cash flow shortage arising out of an international trade transaction with credit terms (or long payment terms).

Small- and medium-sized enterprises (SMEs), compared to large companies, often face difficulties in raising capital or funds. There are various financing mechanisms available for an international trade transaction, and the availability of a proper financing mechanism is often the key to success in an international trade.

"Trade finance" means financing the fund needed for the performance of an international trade transaction. In traditional trade finance, an exporter and an importer make use of the integrity of the international banking system in order to ensure the safety of a particular international

26 Eric Bishop, at 132.

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trade transaction.[27] Trade finance matters, in particular, in international trade transactions because exporters would not wish to deliver their goods prior to being paid and naturally prefer to get paid as soon as possible, whereas importers would not wish to pay for the goods prior to the delivery of the goods and usually prefer to delay payment.[28]

As international trade is getting more competitive, the ability to arrange trade finance for a particular international trade transaction is increasingly important.[29] Trade finance is generally secured by receivables and/or securities such as bills of exchange, promissory notes, cargo insurances, export credit insurances, letters of credit, payment guarantees, etc. Banks can also finance the goods in transit.

Trade finance is often a key factor for a successful international trade.[30] Although trade finance is needed for both an exporter and an importer, it is more needed for an exporter owing to long credit payment terms. Therefore, this chapter focuses on the exporter's perspective.

The needs of trade finance are much dependent upon the payment terms of a particular transaction. Trade finance is needed to grant credit to an exporter or an importer.[31] Trade finance is self-liquidating as it is financed from the cash flow of the underlying international trade transaction.[32] Receivables, bills of exchange, promissory notes, cargo insurances, export credit insurances, and payment guarantees are used in combination with each other for trade finance.[33] The payment from the underlying transaction will first be used for the repayment of any outstanding trade finance loan. Thus, trade finance is considered more secured for the financing banks. Typical trade finance assures the financing banks that the incoming payment from an importer (or an issuing bank in a documentary credit transaction) will first be used for the repayment of any outstanding loan before being released to an exporter.

The ability to allow longer payment terms has become a major competitive factor for an exporter, because the terms of such credits are mostly to the advantage of an importer. As a consequence, demand for longer payment terms and more advantageous terms for an importer has increased. Exporters need to allow longer credit terms (or long payment

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27 Howard Palmer, *International Trade and Pre-export Finance*, 2nd ed., Euromony (1999), at 21.
28 US Commercial Services, at 168; Howard Palmer, at 21.
29 Anders Grath, at 141.
30 US Commercial Services, at 169.
31 Guillermo C. Jimenez, at 111.
32 Anders Grath, at 142.
33 Guillermo C. Jimenez, at 111.

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terms) to meet competition, which often results in a cash flow shortage to an exporter. Thus, exporters need to obtain trade finance in order to make up the cash flow shortage arising out of the international trade transactions with longer credit terms. In practice, exporters consult their banks for the availability of trade finance before they conclude export contracts with credit terms (or long payment terms).

Trade finance could be classified into:

i) "pre-shipment finance" and "post-shipment finance" by the time of the finance.
ii) "supplier credit" and "buyer credit" by whoever undertakes to provide the fund required for the performance of a contract.
iii) "short-term trade finance" and "mid-long-term trade finance" by the loan period.

Exporters preparing the performance of export transactions are frequently in need of finance for the performance of the transactions (or for delivery of the goods). Such finance is called "pre-shipment finance"[34] or "pre-export finance". Pre-shipment finance includes "export working capital financing for pre-shipment", "issuance of a local letter of credit", etc.

Exporters are also in need of finance after the performance of the transactions (or after delivery of the goods) because they get paid long after transactions are completed, and such finance is called "post-shipment finance".[35] Post-shipment finance includes the negotiation of bills of exchange and/or documents (or discounting receivables), factoring, forfaiting, etc.

"Export working capital financing" means financing the temporary working capital needs for the performance of an export transaction.[36] "Export working capital financing" allows an exporter to procure goods and services for an export transaction.[37] Export working capital financing covers the cash flow related to purchasing raw materials, manufacturing the goods, and/or purchasing the goods from local suppliers.

A supplier credit means a financing scheme in which a supplier (or an exporter) is responsible for providing the fund, while a buyer credit means a financing scheme in which a buyer (or an importer) is responsible for providing the fund.[38] Whilst an exporter would be a borrower under a loan

34 Anders Grath, at 143; Eric Bishop, at 138.
35 Eric Bishop, at 140; Michele Donnelly, at 122.
36 US Department of Commerce/International Trade Administration, at 15.
37 US Department of Commerce/International Trade Administration, at 15.
38 Richard Willsher, at 66.

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agreement, if any, in a supplier credit, an importer would be a borrower under a loan agreement, if any, in a buyer credit.

Most consumer goods exports are on a credit payment terms basis, namely on a supplier credit, while most recent overseas construction projects (or plant construction projects) are on a buyer credit basis. Thus, an understanding on a buyer credit will be more required in overseas construction projects (or plant construction projects). Accordingly, a supplier credit and a buyer credit will be discussed in Chapter 4 (Financing in an Overseas Construction Project).

Short-term trade finance means the trade finance that is provided and repaid within two years, whereas mid-term trade finance is provided and repaid over two to five years, and long-term trade finance is provided and repaid over five years.[39] Short-term trade finance is mostly suited to consumer goods, whilst mid- and long-term trade are mostly suited to capital goods including overseas constructions.

Within the Berne Union, short-term export credit insurance (or a short-term export credit guarantee) is defined as insurance (or guarantee) for exports with repayment terms of less than one year – and most often considerably less than this: 30, 60 or 90 days are standard, and medium- and long-term export credit insurance (or a medium- and long-term export credit guarantee) as insurance (or guarantee) for transactions with tenors longer than one year (often 3, 5, 7 and up to around 10 years), typically in support of capital goods exports and large infrastructure projects.[40]

A documentary credit (or a letter of credit) is very useful for trade finance for both an exporter and an importer. With a documentary credit, an exporter can obtain pre-shipment finance by providing a local supplier with a local letter of credit (a local L/C) issued against a documentary credit (export L/C). A documentary credit (export L/C) also enables an exporter to obtain another pre-shipment finance loan.

A documentary credit (export L/C) also enables an exporter to obtain post-shipment finance such as negotiation, factoring, and forfaiting. A documentary credit (export L/C) can increase the export credit insurance (or the export credit guarantee) limit for an exporter, and therefore an exporter can increase the export volume. By providing a documentary credit (or a letter of credit), an importer can request long credit payment terms to an exporter and pay with the fund from the sale of the imported goods.

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39 Michele Donnelly, at 120, 135.
40 Paul Heaney, "2017 Year end data in review", BU Spring Meeting Newsletter (2018), at 5-6.

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Export credit insurance (or export credit guarantee) covers the risk of non-payment in international trades. Export credit insurance (or export credit guarantee) promotes exports by giving a variety of advantages to exporters. The key functions of export credit insurance include reducing non-payment risks, offering competitive payment terms, increasing exports with reduced non-payment risk and competitive payment terms, creating easy and accessible trade financing solutions, etc.

Banks are willing to finance the goods in transit, once the risk of non-payment is disposed. Export credit insurance (or export credit guarantee) programs are very useful for the facilitation of trade finance in combination with various trade finances. Therefore, export credit insurance (or export credit guarantee) is considered as one of the useful financing mechanisms in international trades.

Export credit insurance (or export credit guarantee) provides protection against the risk of non-payment. When export credit insurance (or export credit guarantee) backs the exporter's foreign receivables, commercial banks are willing to lend otherwise excluded from the borrowing base.[41] Accordingly, an understanding of export credit insurance (or export credit guarantee) to utilize is often very essential to trade finance, in particular for exporters with low credit.

In making a trade financing decision, we have to consider: the need for finance, the length of time for finance, the cost of different financing mechanisms, the risks associated with the financing, the need for pre-shipment financing, the need for post-shipment financing, etc.[42]

2. Export working capital financing (for pre-shipment)

2.1 Overview

"Export working capital financing" means financing the temporary working capital needs for the performance of an export transaction.[43] Export working capital financing allows an exporter to procure goods and services for an export transaction.[44] Export working capital financing covers the cash flow related to purchasing raw materials, manufacturing the goods, and/or purchasing the goods from local suppliers.

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41 See the US EXIM Bank website at https://www.exim.gov/what-we-do/get-financing.

42 US Commercial Services, at 169-170.

43 US Department of Commerce/International Trade Administration, at 15.

44 US Department of Commerce/International Trade Administration, at 15.

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The working capital cycle is very important for cash flow management. The longer the working capital cycle, the longer the company is tying up capital in its working capital without earning a return on it. The working capital cycle mainly depends on the terms of payment in an international trade transaction. The working capital cycle in an international trade is normally longer than that in a domestic trade.

The pre-shipment period (the period between the conclusion of an export contract and the delivery of the goods) is often the most difficult part of an export transaction, particularly when trading on an open account basis. In that stage of a transaction, an exporter does not have bills of exchange or the shipping documents, but has a sales contract only.

In some instances, a contract for the sale itself can be used for creating that additional finance during the pre-shipment period. Documentary credit or a payment guarantee in favor of an exporter could facilitate pre-shipment finance requirements.

2.2 Process flow of working capital finance for pre-shipment

Documentary credit and its future proceeds (payments from an issuing bank or a nominated bank) will be normally pledged for the loan. A payment guarantee in favor of an exporter will also be used for a specific export loan. Most banks will treat documentary credits or payment guarantees as important securities for increasing an exporter's credit limit.

A bank often provides a special "export loan" for pre-shipment finance on the basis of documentary credit up to the documentary credit amount. An advising bank normally provides an export loan as a way of issuing a local L/C in favor of a local supplier at the request of an exporter. Once a local supplier (a beneficiary under a local L/C) presents the documents under a local L/C and an exporter presents the documents under an export L/C with a negotiation request form, a local L/C issuing bank (normally a negotiating bank under an export L/C) pays a local supplier the negotiated amount of an export L/C. Thereafter, in the event that a negotiating bank receives payment (is reimbursed by an issuing bank), it settles the negotiation transaction with an exporter.

■ **Documentary credit (or letter of credit (L/C))**
Documentary credit (or letter of credit) is a definite undertaking of the issuing bank to pay a complying presentation. An issuing bank will pay a beneficiary (normally a seller), if the documents presented comply with the terms and conditions of the credit. (UCP 600 Article 2)

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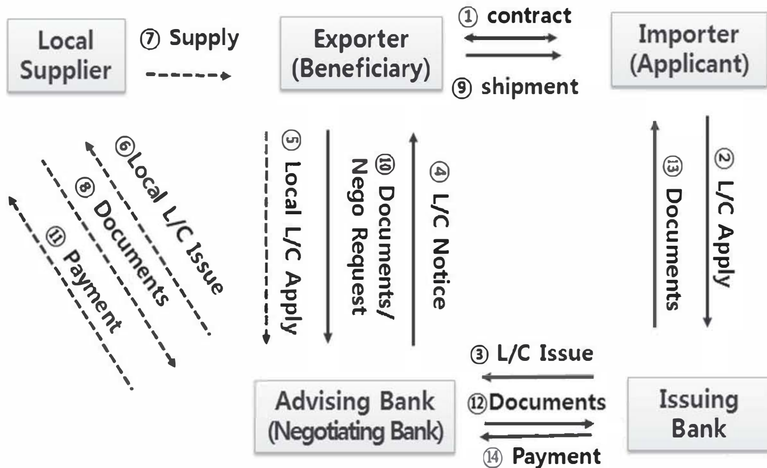
The figure below shows a detailed process concerning pre-shipment finance in a transaction with an export L/C and a local L/C.

Figure 3.1 Process flow of an export L/C and a local L/C for pre-shipment finance



① An exporter and an importer enter into an export contract with payment terms of a letter of credit (L/C).

② An importer (an applicant) applies to an issuing bank to issue an L/C ("export L/C") in favor of an exporter by submitting an L/C issuing application form.

③ An issuing bank processes a formal credit approval of the application and establishes a credit limit for an importer (if the credit limit for a buyer is already established, this process will be omitted).

An issuing bank issues documentary credit in favor of an exporter (a beneficiary) within the remaining credit limit of the importer. Documentary credit is normally sent to an advising bank through the SWIFT system.

④ Once an advising bank receives an export L/C, they check the authenticity of the documentary credit and print it out to give to an exporter. An advising bank is usually located in an exporting country, and its role is to take reasonable care to check the authenticity of an export L/C and to advise it to an exporter

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according to its instructions. An advising bank owes no obligation to pay, unless it is a confirming bank. Once an exporter receives an export L/C, they will check and compare it against the export contract. If all the details conform to the export contract, then an exporter prepares and performs the export contract.

- In the case a bank provides pre-shipment finance in a way of issuing a local L/C, an exporter applies to a bank (normally an advising bank) to issue a local L/C in favor of a local supplier. If a local L/C is issued, an exporter can be supplied by a local supplier without paying in advance.
- A local L/C issuing bank (an advising bank of an export L/C) issues a local L/C against an export L/C. In this case, an export L/C must be negotiated by a local L/C issuing bank (an advising bank) only, as it is used as security for a local L/C payment undertaking.
- A local supplier supplies to an exporter in accordance with a local L/C, and prepares all the documents required under a local L/C.
- A local supplier (a beneficiary under a local L/C) presents a local L/C issuing bank with the documents required under a local L/C.
- An exporter ships the goods in accordance with an export L/C, and prepares all the documents (normally a bill of lading, commercial invoice, packing list, and inspection certificate) required under an export L/C.
- An exporter (a beneficiary under an export L/C) presents the documents (and the drafts if any) to a negotiating bank (a local L/C issuing bank) for negotiation.
- A negotiating bank examines the documents with care. Once the documents comply with the terms of an export L/C, a negotiating bank advances funds to an exporter. However, in the case a negotiating bank issued a local L/C, it will not advance funds to an exporter. Instead, a negotiating bank will pay a local supplier for the payment of a local L/C. A negotiating bank will advance the remaining funds, if any, after payment of a local L/C.
- A negotiating bank dispatches and presents the documents to an issuing bank for payment.
- Upon receiving the documents, an issuing bank examines the documents with care. In many instances, an issuing bank requests an applicant (or an importer) to check the documents to decide whether or not to accept the documents. If the documents are complying with an export L/C, an issuing bank sends "acceptance advice (A/A)" to a negotiating bank and will make payment at

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maturity. An issuing bank releases the documents to an importer (an applicant) against payment at sight (or at any later date) as stipulated in an export L/C. An applicant shall repay (reimburse) an issuing bank.

- An issuing bank pays (or reimburses) a negotiating bank at sight or at maturity.

2.3 Export credit guarantee programs for pre-shipment finance

Many export credit agencies (ECAs) provide programs for export working capital financing in the form of an export credit guarantee.[45] Those programs aim at promoting national exports by facilitating pre-shipment finance for their exporting companies. The UKEF (English ECA) provides the Export Working Capital Scheme, and the US EXIM Bank (American ECA) provides the Working Capital Loan Guarantee for respective exporters. The K-Sure (Korean ECA) provides Pre-shipment Export Credit Guarantee programs.

2.3.1 Export Working Capital Scheme (by the UKEF)[46]

The UK Export Finance (UKEF),[47] an English ECA, operates the Export Working Capital Scheme for pre-shipment export working capital. The Export Working Capital Scheme assists UK exporters in gaining access to working capital finance both pre-shipment and post-shipment in respect of specific export related contracts.

In the Export Working Capital Scheme for pre-shipment finance, the UKEF issues a guarantee to a guaranteed bank at the request of a UK exporter. A guaranteed bank pays the UKEF premium for a guarantee with the interest received from an exporter. An exporter preforms an export

45 Anders Grath, at 145.
46 See the UKEF website available at https://www.gov.uk/guidance/export-working-capital-scheme-overview-and-how-to-apply#how-the-export-working-capital-scheme-works; https://www.gov.uk/guidance/export-working-capital-scheme-overview-and-how-to-apply#overview.
47 "UK Export Finance is the operating name of the Export Credits Guarantee Department, the United Kingdom's export credit agency. ECGD was founded in 1919 and sits within the Department for Business, Innovation and Skills. Its purpose is to complement the private market by providing assistance to UK exporters, principally in the form of insurance and guarantees to banks" (see http://www.eca-watch.org/ecas/uk-export-finance-ukef).

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contract with the fund advanced by a guaranteed bank (i.e., an exporter purchases raw materials to manufacture the goods, an exporter purchases finished goods from a local supplier). An exporter gets the payment from an importer after the performance of an export contract. An exporter repays the loan with the payment received from an importer.

2.3.2 Working Capital Loan Guarantee (by the US EXIM Bank)[48]

The Export-Import Bank of the United States (US EXIM Bank), an American ECA, operates the Working Capital Loan Guarantee for pre-shipment export working capital (or for the performance of export transactions). The Working Capital Loan Guarantee guarantees repayment for a percentage of the working capital loan if the borrower (a US exporter) defaults.

The Working Capital Loan Guarantee can be used for paying for materials, equipment, supplies, labor, and other inputs to perform contracts, for purchasing finished products for export, and for posting standby letters of credit (serving as the Bid-bond, P-bond, AP-bond, R-bond, or W-bond).

The Working Capital Loan Guarantee is a 90% loan-backing guarantee to a lender bank. With a Working Capital Loan Guarantee, financial institutions will be willing to provide loans to exporters by decreasing repayment risk. However, the US EXIM doesn't replace commercial banks; it simply backs their loan and increases US exporters' borrowing power.[49]

With the Working Capital Loan Guarantee, exporters can borrow more working capital, secure performance guarantees (the bid-bond, P-bond, AP-bond) necessary to win and perform export contracts, and increase their global competitiveness.

2.3.3 Pre-shipment Export Credit Guarantee (by the K-Sure)[50]

The Korea Trade Insurance Corporation (K-Sure), a Korean ECA, operates the Pre-shipment Export Credit Guarantee. The Pre-shipment Export Credit Guarantee is designed to help exporters where exporters can produce the Pre-shipment Export Credit Guarantee as security toward

48 See the US EXIM Bank website available at https://www.exim.gov/what-we-do/working-capital.
49 See the US EXIM Bank website available at https://www.exim.gov/what-we-do/get-financing.
50 The K-Sure website is available at https://www.ksure.or.kr/en/product/product_01_05.do.

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securing pre-shipment finance. The Pre-shipment Export Credit Guarantee is very helpful, in particular, to small- and medium-sized enterprises (SMEs) which have difficulty in receiving trade financing from banks.

Pre-shipment Export Credit Guarantee programs are provided for import as well as export, but Pre-shipment Export Credit Guarantee programs for import are limited to the issuance of documentary credit for the import of raw materials for export. Once an export contract is entered into, an exporter normally relies on banks to secure loans to purchase raw materials and manufacture goods to be exported, but these banks normally require some type of security from an exporter. The Pre-shipment Export Credit Guarantee is a loan-backing guarantee up to 90% to a lender bank, and serves as a security for a bank to advance a loan to an exporter. A Pre-shipment Export Credit Guarantee by the K-Sure is well accepted as a security for pre-shipment finance in Korea's exports.

3. Documentary credit (letter of credit)

3.1 Introduction

A documentary credit (or a letter of credit) is very useful for trade finance for both an exporter and an importer. A documentary credit (or a letter of credit) is one of the basic payment methods in international trade.

The four primary methods of payment in international trades are[51] i) payment in advance (cash in advance), ii) open account (cash in arrears, T/T usance), iii) documentary collection (bank collection, bills for collection), and iv) documentary credit (letter of credit).

With a documentary credit, an exporter can obtain pre-shipment finance by providing a local supplier with a local letter of credit (a local L/C) issued against a documentary credit (export L/C). A documentary credit (export L/C) also enables an exporter to obtain another pre-shipment finance loan. A documentary credit (export L/C) also enables an exporter to obtain post-shipment finance such as negotiation, factoring, and forfaiting. A documentary credit (export L/C) can increase the export credit insurance (or the export credit guarantee) limit for an exporter, and therefore an exporter can increase the export volume. By providing a documentary credit (or a letter of credit), an importer can request long credit payment terms to an exporter and pay with the fund from the sale of

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51 Gary Collyer, *The Guide to Documentary Credits,* 3rd ed., ifs School of Finance (2007), at 22-23; Michele Donnelly, at 79; Anders Grath, at 33; Guillermo C. Jimenez, at 109-110.

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the imported goods.

3.2 Concept of a documentary credit

A documentary credit (or letter of credit) is a definite undertaking of the issuing bank to pay a complying presentation. An issuing bank will pay to a beneficiary (normally a seller), if the documents presented comply with the terms and conditions of the credit. A documentary credit can be thus said to be a conditional payment guarantee, not an unconditional payment guarantee.

The Uniform Customs and Practice for Documentary Credits (the 6th revision of 2007, UCP 600) Article 2 defines a documentary credit ("credit"):

> Credit means any arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation.

A documentary credit is basically a transaction between an issuing bank and a beneficiary. A documentary credit is a separate transaction from the sales contract under which it is issued, and is independent from the sales contract. The issuing bank's obligations under the documentary credit are independent of the buyer's obligations under a sales contract. This characteristic of a documentary credit is called the "independence principle".

The issuing bank's payment obligation is decided by the documents presented only, not the goods delivered or the services performed. The issuing bank examines the documents not the goods to determine whether to pay or not. The documentary credit transaction is thus a paper transaction.[52] This characteristic of a documentary credit is called "abstractness".

3.3 Uniform Customs and Practice for Documentary Credits (UCP)

The ICC (International Chamber of Commerce) developed and firstly published the Uniform Customs and Practice for Documentary Credits (UCP) in 1933, and revised the UCP six times. The latest version, the 6th

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52 Carole Murray, et al., *Schmitthoff's Export Trade: The Law and Practice of International Trade*, 11th ed., Thomson Reuters (2010), at 190.

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revision of 2007, is called UCP 600.

The UCP constitutes a rather detailed manual of operations for banks, but they are a restatement of "custom" in the industry, and they do not purport to be law. They are incorporated as an express statement of contract terms and banking trade usage, and the UCP contract terms furnish the rules which usually determine the actions of the parties. Whilst the UCP 600 requires an express indication that a documentary credit is subject to the UCP 600, the UCP 600 may be applied to a documentary credit as a description of custom applicable to documentary credits even if there is no express indication in a documentary credit.[53]

Table 3.1 The revision history of the UCP

No. of Revision	Year	Effective Date	ICC Publication No.
Enactment	1933	1933.6.3	Brochure No. 82
1st Amendment	1951	1952.1.1	Brochure No. 151
2nd Amendment	1962	1963.7.1	Brochure No. 222
3rd Amendment	1974	1975.10.1	Publication No. 290
4th Amendment	1983	1984.10.1	Publication No. 400
5th Amendment	1993	1994.1.1	Publication No. 500
6th Amendment	2007	2007.7.1	Publication No. 600

Although the ICC published the International Standby Practices (ISP98) which may be applicable to standby letters of credit (or independent guarantees, demand guarantees),[54] the UCP 600 may be applicable to standby letters of credit. Thus, during the course of the revision of the UCP 600, the reference to standby letters of credit was suggested to be deleted. However, it could not be deleted since many standby letters of credit are issued to be subject to the UCP.[55]

53 ICC (International Chamber of Commerce), *Commentary on UCP 600*, ICC Publication No. 690 (2007), at 12.
54 James E. Byrne, *ISP98 and UCP 500 Compared*, The Institute of International Banking Law and Practice (2000), at 3.
55 ICC (ICC Publication No. 690), at 12.

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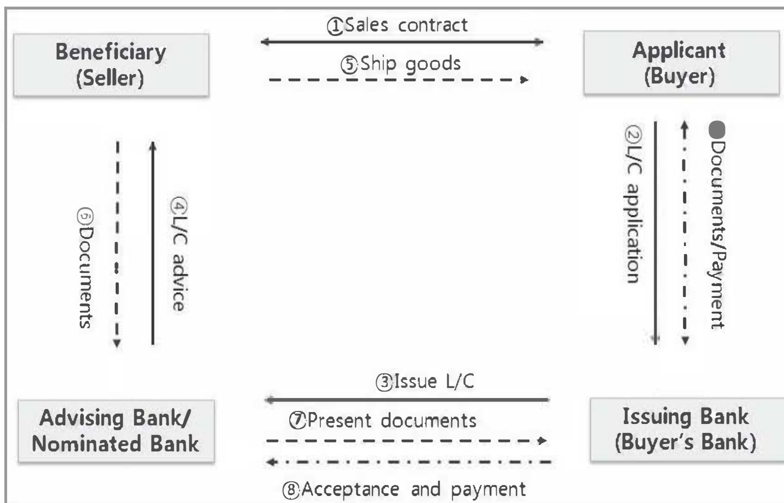
3.4 Operation of a documentary credit

In an international trade with a documentary credit, an exporter and an importer enter into a contract for which the method of payment is a documentary credit. The third party intermediaries for a documentary credit transaction are banks (banks in an importing country and banks in an exporting country). Thus, the parties involved in a documentary credit transaction are i) an exporter (beneficiary under a documentary credit), ii) an importer (applicant under a documentary credit), iii) an importer's bank (issuing bank of a documentary credit), and iv) an exporter's bank (advising bank, nominated bank of a documentary credit). These parties divide the risks into several small and calculable risks, each of which is easily borne by the respective party.

How does a documentary credit transaction for an international sale of goods work? The first step will be agreeing on the terms of payment as a documentary credit in an international trade transaction, and then an exporter and an importer conclude a contract. Once a contract is concluded, an importer shall apply to their bank to issue a documentary credit in favor of an exporter.

The figure below illustrates the flow of a documentary credit transaction.

Figure 3.2 Process flow of a documentary credit transaction



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- an exporter and an importer enter into a contract for sale for which the terms of payment are a documentary credit.
- an importer (an applicant) applies to an issuing bank (the importer's bank) to issue a documentary credit in favor of an exporter by submitting an L/C issuing application form.
- An issuing bank processes a formal credit approval of the application and establishes the credit limit for an importer. (If the credit limit for an importer is already established, this process will be omitted.) An issuing bank issues a documentary credit in favor of an exporter (a beneficiary) within the remaining credit limit of the importer. A documentary credit is normally sent to an advising bank through the SWIFT system.
- Once an advising bank receives a documentary credit, they check the authenticity of the documentary credit and print it out to give to an exporter.
  (The advising bank is usually located in the exporter's country, and its role is to take reasonable care to check the authenticity of the L/C and to advise the L/C to the exporter according to its instructions. This authentication fulfills an important role. However, an advising bank bears no obligation to pay, unless it is a confirming bank.)
- Once an exporter receives a documentary credit, they will check and compare the documentary credit against the contract for sale. If anything is not complying with the contract for sale, an exporter must immediately communicate with an importer for the necessary amendment.
  If all the details conform to the contract for sale, then an exporter prepares and ships the goods, and receives the transport documents from a carrier (or a freight forwarder).
- A beneficiary (exporter) prepares all the documents (normally a bill of lading, a commercial invoice, a packing list, and an inspection certificate) required under the documentary credit, and forwards them to the nominated bank (normally an advising bank).
  In many cases, the nominated bank negotiates (purchases, or discounts) the documents and pays the exporter, then the nominated bank will become a negotiating bank.
- The nominated bank dispatches the documents to the issuing bank.
- Upon receiving the documents, the issuing bank will examine the documents. (In practice, the issuing bank requests an importer to check the documents and to decide whether or not to accept the documents.)
  If the documents are complying with the documentary credit, the

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issuing bank sends "acceptance advice (A/A)" to the nominated bank, and will make payment at maturity.

● The issuing bank releases the documents against payment at sight or at any later date as stipulated in the documentary credit. Once the issuing bank pays on the complying presentation of documents, an importer shall repay (reimburse) the issuing bank.

3.5 Advantages and disadvantages of a documentary credit

A documentary credit (L/C) offers various advantages for an exporter. Payment is guaranteed, and therefore there are fewer concerns about the importer's ability to pay or about other restrictions or difficulties that may exist in the importing country. Only if an exporter can meet all the terms and conditions stipulated in a documentary credit (L/C), will it get paid. However, a documentary credit (L/C) brings some disadvantages to an exporter.

A documentary credit (L/C) also offers various advantages for an importer. While a documentary credit (L/C) is considerably more expensive than other forms of payment, an importer will be assured that an exporter will not be paid unless an exporter performs the contract and the documents presented conform to the terms of the credit (L/C). A documentary credit (L/C) brings some disadvantages to an importer.

■ Advantages for an exporter

i) Payment is more secured: the issuing bank has to accept and pay on complying presentation.

ii) Payment risk is transferred from the buyer's credit rating to the issuing bank's credit rating.

iii) Post-shipment financing may be available such as negotiation, factoring, and forfaiting.

iv) Pre-shipment finance may be available from their banks: trade financing (financing for manufacturing or procuring the goods).

v) The transport documents and the draft may be negotiated more easily.

■ Disadvantages for an exporter

i) An exporter must present complying documents within the L/C expiry date.

ii) An importer requests a price discount in return for an L/C.

iii) An exporter usually pays the cost that occurred in their country.

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■ Advantages for an importer
i) An importer will obtain transport documents prior to payment. An importer need not pay out funds before the documents have arrived.
ii) An importer may be able to obtain a price discount in return for an L/C.
iii) The importer may be able to obtain favorable payment terms such as an usance L/C, a deferred payment L/C.

■ Disadvantages for an importer
i) The amount of an L/C is treated as an importer's contingent liability.
ii) The amount of an L/C will reduce the credit limit of an importer. The L/C will reduce the borrowing line of credit of an importer.
iii) An importer should pay the L/C issuance cost.
iv) An importer's account will be debited on receipt of compliant documents.
v) An importer may receive defective goods even after payment.

3.6 Independence principle and fraud exception

3.6.1 Independence principle

The "Independence principle" means that the bank's obligations under the letter of credit are independent of the buyer's and seller's obligations under the sales contract. (UCP 600 Article 4.) The promise of an issuing bank is not subject to claims or defenses by the applicant (Buyer) that the beneficiary (Seller) has not performed their obligations under the sales contract. (UCP 600 Article 4(a).)

A documentary credit is basically a transaction between an issuing bank and a beneficiary. A documentary credit is a separate transaction from the sales contract under which it is issued, and is independent from the sales contract. The issuing bank's obligations under the documentary credit are independent of the buyer's obligations under a sales contract.

3.6.2 Complying presentation and strict compliance

Banks examine the documents thoroughly to determine that they comply exactly with the terms and conditions of a documentary credit, since banks do not see the goods, but only the documents presented. In the case a seller (an exporter) ships goods conforming to a sales contract and presents documents complying with a documentary credit, it obtains independent promises of payment from both a buyer (importer) and an issuing bank. An issuing bank's promise is enforceable despite assertions of non-

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conformity of the goods, so long as the documents conform to a documentary credit.

An issuing bank is at risk only if a buyer (an applicant) fails or refuses to reimburse the payment to the issuing bank. An issuing bank had an opportunity to evaluate such risk prior to issuing a documentary credit, and for which it could adjust the L/C issuance fee. In the event a buyer's credit rating is low, an issuing bank will charge a high rate of issuance fee.

Since the bank (issuing bank, confirming bank, nominated bank) pays the beneficiary (Seller) against the documents and does not see the goods, banks insist on "strict compliance" with all documentary conditions. Under the doctrine of strict compliance, banks shall not honor the documents that are not in strict conformity with the terms of the credit. The harshness of the doctrine of strict compliance is eased by the UCP.[56]

For instance, UCP 600 Article 14(e) provides:

> In documents other than the commercial invoice, the description of the goods, services or performance, if stated, may be in general terms not conflicting with their description in the credit.

3.6.3 Fraud exception

The "independence principle" promotes the utility of a documentary credit transaction, by providing certainty of payment to the beneficiary. In the event the documents are forged, or there is fraud or forgery in the transaction, however, the "independence principle" is not applied.

Where there is fraud or forgery, rather than a "mere" breach of the sales contract, a counter principle comes into play. The issuing bank does not have to honor a complying presentation when there is fraud in the transaction. This is called the "fraud exception" or the "fraud rule". There is as much public interest in discouraging fraud as in encouraging the use of documentary credits.

The fraud exception (or the fraud rule) was first acknowledged in Sztejn v. J. Henry Schroder Banking Corporation (1941).[57] Thereafter, the US enacted the fraud exception in the UCC 5-114(2) in 1957 by codifying the Sztejn v. J. Henry Schroder Banking Corp. case.[58] The fraud rule has

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56 Indira Carr, *International Trade Law*, 4th ed., Routledge-Cavendish (2010), at 480.

57 Sztejn v. J. Henry Schroder Banking Corp., 31 N.Y.S.2d 631 (N.Y. Sup. 1941).

58 The UCC of 1957 added and provided that the court may enjoin such honor

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been acknowledged in many jurisdictions. The fraud exception has expanded enormously since 1952, but it is still controversial how broad and extensive the fraud exception should be. Although the UCP has no specific provisions on the "fraud exception", the "fraud exception" is generally recognized in many jurisdictions. Since the UCP is silent, the courts have generally held that the governing laws will govern as a "gap-filling provision." Therefore, the fraud exception is subject to the national law of any one country.[59] The courts will not allow a dishonest beneficiary to make use of the "independence principle".

(example of a documentary credit)

Documentary Credit Advice

> Except so far as otherwise expressly stated, this documentary credit is subject to the "Uniform Customs and Practice for Documentary Credits" (2007 Revision) International Chamber of Commerce (Publication No. 600)

ADV700-6695-XXXXXX

------------------ ⟨Message Header⟩ ----------------------

Date of Advice : 2010/11/27
Advice No. : AD1010XXXXXXX
Sender : BKXXCRXXXXXI
PXXXX BANK
Receiver : HVBKKRSEXXX
XXXXBANK SEOUL KOREA

---------------------- ⟨Message Text⟩ ------------------------

40A Form of Documentary Credit : IRREVOCABLE
20 Documentary Credit Number : ILC/2010/XXXXXXXX
31C Date of Issue : 2010/11/25
40E Applicable Rules : UCP LATEST VERSION

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where a required document is forged or fraudulent or there is fraud in the transaction. (Ralph H. Folsom, et al., *International Business Transactions: A Problem-oriented Coursebook*, 11th ed., Thomson Reuters (2012), at 277.)

59 Xiang Gao, *The Fraud Rule in the Law of Letters of Credit*, Kluwer Law International (2002), at 56.

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31D Date and Place of Expiry : (date) 2011/2/25
(place) SOUTH KOREA

50 Applicant : TXXX CO.
XXX, XXX, IRAN
TEL:

59 Beneficiary : SXXXX CORP.
XXX, XXX, SEOUL, KOREA
TEL: 822-2772-XXXX

32B Currency code, Amount : USD 6,000,000

39B Maximum Credit Amount : NOT EXCEEDING

41a Available With ......BY : BY DEF PAYMENT
HVBKKRSEXXX
XXXX BANK, SEOUL

*42P Deferred Payment Details : 180 DAYS FROM B/L DATE

43P Partial Shipments : ALLOWED

43T Transshipment : NOT ALLOWED

44E Port of Loading/Airport of Departure: ANY PORT OF SOUTH KOREA

44F Port of Discharge/Airport of Destination: BANDAR IMAM PERSIAN GULF OF I.R OF IRAN

44C Latest Date of Shipment : 2011/2/25

45A Description of Goods and/or Services:
10,000 MT OF PRIME STEEL BULLETS
SIZE 150 mm x 150 mm (+/- 5 mm)
LENGTH: 12,000 mm (+/- 100 mm)
NO AND KIND OF STANDARD : EN10025
.
FOB VALUE : USD 5,600,000
FREIGHT CHARGES : USD 400,000
TOTAL CFR BANDAR ABBAS PERSIAN GULF OF I.R OF IRAN: USD 6,000,000
.
PACKING: IN BUNDLE IN COMPLIANCE WITH STANDARD EXPORT PACKING
.
OTHER DETAILS AS SPECIFIED IN P/ I NO. SXXXX-XX 2010/11/09
ON CFR BASIS WHICH SHOULD BE INDICATED ON ALL DOCS.

46A Documents Required:
1- FULL SET CLEAN ON BOARD OCEAN B/L ISSUED BY SHIPPING CO. OR ITS AUTHORIZED AGENT IN 3 ORIGINALS AND 3 COPIES TO OUR ORDER (PXXX BANK) MENTIONING APPLICANT AS NOTIFY PARTY, INDICATING NAME AND ADDRESS OF SHIPPING CO'S REPRESENTATIVE IN I.R.I., MARKED FREIGHT PREPAID, NOT LATER THAN 2011/3/26 NOR PRIOR TO DATE OF THIS L/C.

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2- SIGNED COMMERCIAL INVOICE ISSUED BY BENEFICIARY IN 3 ORIGINALS, 1 OF WHICH CERTIFIED BY LOCAL CHAMBER OF COMMERCE DECLARING PRICES STATED ARE CURRENT EXPORT MARKET PRICES FOR MERCHANDISE DESCRIBED THEREIN WITH 3 COPIES.

3- CERTIFICATE OF ORIGIN IN 1 ORIGINAL CONFIRMING GOODS ORIGINATED IN SOUTH KOREA CERTIFIED BY LOCAL CHAMBER OF COMMERCE.

4- DETAILED PACKING LIST IN 3 ORIGINALS (STANDARD EXPORT PACKING).

5- A CERTIFICATE FROM SHIPPING CO. OR ITS AUTHORIZED AGENTS CERTIFYING SHIPMENT EFFECTED ON CLASSIFIED VESSEL PLYING IN REGULAR LINER SERVICE AS PER INSTITUTE CLASSIFICATION CLAUSE IN 3 COPIES.

6- THE ORIGINAL INSPECTION CERTIFICATE IN 1 ORIGINAL ISSUED NOT PRIOR TO B/L DATE BY S.G.S CO. OR ITS AUTHORIZED AGENTS ON S.G.S CO.

LETTERHEAD CERTIFYING GOODS SHIPPED/INSPECTED ARE IN CONFORMITY WITH QUALITY AND QUANTITY AND PACKING OF GOODS LOADED/DELIVERED ARE STRICTLY COMPLYING WITH SPECIFICATIONS OF GOODS INDICATED IN RELATIVE P/I AND TERMS OF L/C AND ALL SUBSEQUENT AMENDMENTS AS ADVISED TO BEN. SUCH INSPECTION CERTIFICATE SHALL VERIFY GOODS ARE IN CONFORMITY WITH "EN10025 STANDARD" AND SHOULD BE ATTESTED BY LOCAL CHAMBER OF COMMERCE WHERE ISSUED. INSPECTION CHARGES TO BE BORNE BY BEN.

7- FREIGHT CHARGES INVOICE ISSUED BY SHIPPING CO. OR ITS AUTHORIZED AGENTS IN 2 ORIGINALS 1 OF WHICH SHALL BE CERTIFIED BY LOCAL CHAMBER OF COMMERCE.

47A Additional Conditions:

+ INSURANCE EFFECTED IN I.R. OF IRAN BY ASIA INSURANCE CO.

UNDER INSURANCE POLICY NO. XXXXX TO BE INDICATED ON ALL DOCS.

SHIPMENT ADVICE TO BE MADE TO SAID INSURANCE CO. VIA FAX NO. (+98) 21 XXXX

INDICATING POLICY NO. AND DETAILS OF SHIPMENT A COPY WHICH MUST BE ACCOMPANIED BY ORIGINAL DOCS.

+ CUSTOMS TARIFF NO. 7206XXXX, CB. NO. 1133XXXX AND OUR DOCUMENTARY CREDIT NO.

ILC/2010/XXXXXXXXXX SHOULD BE INDICATED ON ALL DOCS.

+ THIS CREDIT IS SUBJECT TO UCP 600.

+ THIRD PARTY B/L IS NOT ACCEPTABLE.

+ FREIGHT CHARGES TO BE REFLECTED IN BEN'S COMMERCIAL

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INVOICES SEPARATELY.
+ ALL DOCS SHOULD BE PRESENTED IN ENGLISH.
+ PLEASE FORWARD ALL DOCS IN TWO SEPARATE SETS BY REGISTERED AIRMAIL/COURIER
DIRECTLY TO PXXXX BANK (NXXX BRANCH, XXX AVE.,)
OPPOSITE MEHMANSARAYE OSTANDARI, POSTAL CODE: XXXXX, ISFAHAN, IRAN
+ PLS CONFIRM THAT TERMS OF CREDIT HAVE BEEN COMPLIED WITH AND ADVISE US ANY
DISCREPANCIES FOR OUR OBTAINING APPLICANT'S ACCEPTANCE OR SEND ON APPROVAL BASIS.
+ OUR CHARGES OF ALL SWIFT/TLX MSGS IN RESPECT OF APPROVAL DOCS SHOULD BE BORNE BY BEN.
+ DOCS PREPARED PRIOR TO DATE OF THIS L/C ARE NOT ACCEPTABLE AND NEGOTIABLE.
+ FREIGHT CHARGES ARE PRO RATA TO GOODS SHIPPED.
+ THIS L/C IS FULLY OPERATIVE AT THE STRENGTH OF THIS SWIFT MSG.
+ RELATED GOODS ARE NOT IN LISTED EU-REGULATION NO. 423/2007 AND 428/2009.
SHIPMENT ON DECK IS NOT ACCEPTABLE.
SINCE SHIPMENT SHOULD BE EFFECTED VIA SEA TO SOUTH IRANIAN PORTS IN “PERSIAN GULF”
THE NAME OF “PERSIAN GULF” SHOULD BE MARKED ON ALL SHIPPING DOCS.
71B Charges: ALL FOREIGN BANK CHARGES ARE FOR THE ACCOUNT OF THE BENEFICIARY.
49 Confirmation Instruction: WITHOUT
53a Reimbursement Bank: HVBKKRSEXXX
XXXXI BANK, SEOUL
78 Instructions to the Paying/Accepting/Negotiating Bank:
+ PLS DEBIT OUR AED ACC. WITH YRSELVES ON DUE DATE.

+ REIMBURSEMENT CLAIMS SUBJECT TO ICC URR725
+ NEGOTIATION OF DOCS IS RESTRICTED TO YR GOOD BANK ONLY.
ON EXPIRY WITH MT754 FIVE WORKING DAYS PAYMENT OF L/C AMOUNT.
72 Sender to Receiver: PLS ACKNOWLEDGE RECEIPT
Information

RGDS.,
NXXX BRANCH

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4. Negotiation (or purchase) of bills of exchange (for post-shipment finance)

4.1 Introduction

Negotiation in trade finance means the purchase of bills of exchange and/or shipping documents "with recourse" by a bank from an exporter.[60] Negotiation is also referred to "discounting bills of exchange (documentary drafts) and/or documents". The bank will then collect the proceeds (or payment) in their own name. The finance will be for up to 100 per cent of the bills of draft (or the invoice) amount less interest and fees.[61]

An exporter would send his documents and/or bills of exchange to his bank. Instead of signing a collection instruction form, an exporter would sign a negotiation request form. The decision of negotiation would be made by the bank like any other lending decision.

Negotiation is normally available in an L/C transaction, and also available in a documentary collection transaction such as D/P (documents against acceptance)[62] and D/A (documents against acceptance).[63]

4.2 Operation

In a negotiation, a bank (the exporter's bank) will agree to pay an exporter immediately the value of a bill of exchange (or the value of the receivables) when the exporter signs a foreign exchange transaction arrangement attached to a negotiation request form. Negotiation is normally "with recourse" to an exporter. Thus, if a negotiating bank is not paid from an importer (or an issuing bank in a L/C), then the bank will retrieve the negotiated amount from an exporter (or a drawer of a bill of exchange) immediately.[64]

The amount of negotiation will be calculated after taking into account the foreign exchange rate, if applicable, and credited to an exporter's account. An exporter would also agree to pay interest charged for the period between the negotiation date and the date of payment from an

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60 Michele Donnelly, at 126; Eric Bishop, at 138.

61 Eric Bishop, at 138.

62 In a "D/P (documents against payment)" transaction, a collecting bank releases the documents to an importer against payment of a draft (namely a sight draft).

63 In a "D/A (documents against acceptance)" transaction, a collecting bank releases the documents to an importer against acceptance of a draft (namely a time draft), and an importer will pay a draft on a specified future date.

64 Eric Bishop, at 138.

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importer (or an issuing bank).

Once it has been agreed to negotiate the drafts and/or the documents, the exporter's bank ("negotiating bank") would immediately credit the exporter's account with the face value of the draft less interest and fees. (The exporter will receive a sum less than the face value of the draft drawn or documents presented, taking into account the exchange rate (if the documents are in a different currency) and the delayed period between the negotiating bank's payment and receipt of funds from the importer.)

4.3 Negotiation in a D/P transaction

In documents against payment ("D/P"), a seller (an exporter) entrusts the collection of the payment to a remitting bank by providing the documents (i.e., a transport document, a commercial invoice, a packing list, and bills of exchange) under a sales contract and together with a collection/negotiation instruction, and a remitting bank also forwards the documents to a collecting bank together with a collection instruction to release the documents to a buyer (an importer) against payment of a draft.

When a collecting bank receives the documents and a collection instruction, they will notify a buyer of the arrival of the documents and request a buyer to pay the amount as instructed by a remitting bank. A document against payment collection is also referred to as a "sight draft", as a sight draft is involved.

The documents will be exchanged for payment. The documents will be released only after a buyer pays the draft. The documents will not be released unless payment is made. A seller will not lose the goods without payment. Therefore, documents against payment is normally used when a seller wishes to retain title to the goods until payment has been made.

Documents against payment could be considered as a concurrent payment (or a simultaneous payment) because the documents (including the transport document, title to the goods) are exchanged for payment simultaneously. However, there is still some risk to a documents against payment arrangement. For example, the buyer's ability or willingness to pay might change between the time of shipment and the time of presentation of the documents for payment. In that case, a seller has to ship the goods back to his country at his own cost or dispose of the goods at a lower price. Moreover, the buyer's payment obligation is not backed up by a bank guarantee.

A buyer will take delivery of the goods by using the transport documents which are obtained in exchange for payment. Therefore, a bill of lading must be properly endorsed to a buyer by a seller or consigned to

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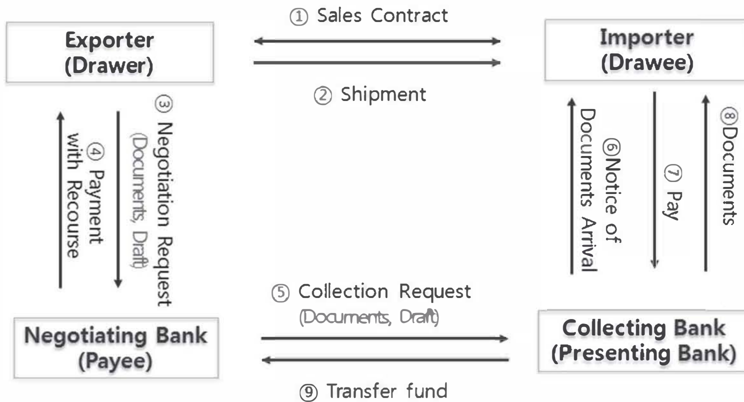
a buyer.

The figure below illustrates the detailed process of negotiation in a D/P transaction.

Figure 3.3 Negotiation process of a sight draft (in a D/P transaction)



① An exporter (a seller) and an importer (a buyer) enter into a contract for sale under which the payment is on a documents against payment basis.

② An exporter prepares the goods by manufacturing, or procuring in the domestic market, or using the goods in stock. An exporter ships the goods according to the shipment terms in the sales contract, and obtains transport documents from a shipping company.

③ An exporter prepares all the documents required under the sales contract including time drafts, and obtains a collection/negotiation instruction form from a remitting bank. An exporter requests a negotiation of the drafts and shipping documents to a remitting bank (a negotiating bank) by providing the documents including term drafts and a collection/negotiation instruction.

④ A negotiating bank checks the shipping documents and the collection/negotiation instruction form to ensure that the documents conform to the instruction. Once the documents conform to the instruction, a negotiating bank pays to an exporter the amount of the draft less the exchange fee.

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- A negotiating bank sends the drafts and the shipping documents together with the collection instruction to a collecting bank to entrust the collection of the payment.
- A collecting bank (this collecting bank making this presentation is called "the presenting bank") notifies an importer of the arrival of the documents and requests the acceptance of drafts. An importer is also advised about the collection.
- An importer (a drawee) checks the documents, and pays the drafts if the documents conform to the sales contract.
- Once an importer pays the drafts, a collecting bank releases the documents to an importer.
- A collecting bank transfers the payment to a negotiating bank as per the instruction, if an importer pays the draft.
- In the case the drafts are not paid on presentation, a negotiating bank shall recourse to an exporter.

4.4 Negotiation in a D/A transaction

In a document against acceptance ("D/A"), a seller (an exporter) entrusts the collection of the payment to a remitting bank by providing the shipping documents (i.e., a transport document, commercial invoice, packing list, bills of exchange) together with a collection/negotiation instruction, and a remitting bank also sends the documents including the drafts together to a collecting bank with a collection instruction to release the documents to a buyer (an importer) against acceptance of a draft and to collect payment at maturity.

When a collecting bank receives the documents and a collection instruction, they will notify a buyer of the arrival of the documents, and request a buyer to accept a term draft and to pay the draft at maturity. A document against acceptance collection is also referred to as a "time draft" (or time bill, term draft, usance bill), as a time draft is involved.

The shipping documents will be released only after a buyer accepts a term draft, not after a buyer pays the draft. The shipping documents may be released to a buyer without payment. Therefore, a documents against acceptance is normally used when a seller extends credit to a buyer and a buyer wishes to take delivery of the goods without making payment at the time of delivery. Therefore, it is probable that a seller will lose the goods without payment if a buyer fails to make payment at maturity.

In the case the remitting bank negotiates the drafts with the shipping documents, it will become a negotiating bank. When the collection is paid, a collecting bank will transfer the payment to a negotiating bank. If the

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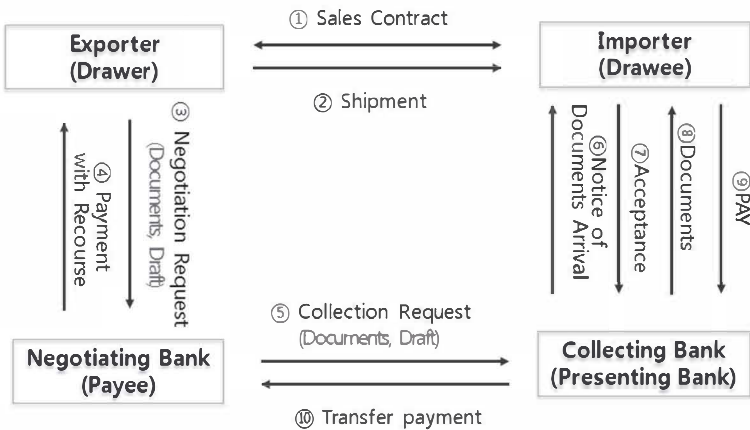
collection is not paid (or the drafts are dishonored), a negotiating bank will recourse the amount of negotiation to an exporter immediately.[65]

Finance can also be provided to an importer by a importer's bank by way of an advance to the importer to pay (to pay an advance payment, to pay a sight bill, or to pay a term bill). The importer's bank may also add "aval" to the bill of exchange accepted by the importer. "Aval" means an unconditional guarantee of the payment of a bill of exchange or promissory note by a third party (usually the drawee's bank or the maker's bank) other than the drawee or the maker. Aval is required when the drawee's (or the maker's) credit is in itself not sufficient.

The figure below illustrates the detailed process of negotiation in a D/A transaction.

Figure 3.4 Negotiation process of a time draft (in a D/A transaction)



① An exporter (a seller) and an importer (a buyer) enter into a contract for sale under which the payment is on a documents against acceptance basis.

② An exporter prepares the goods by manufacturing, or procuring in the domestic market, or using the goods in stock. An exporter ships the goods according to the shipment terms in the sales contract, and obtains transport documents from a shipping company.

65 Eric Bishop, at 138.

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- An exporter prepares all the documents required under the sales contract including time drafts, and obtains a collection/negotiation instruction form from a remitting bank. An exporter requests the negotiation of the drafts and shipping documents to a remitting bank (a negotiating bank) by providing the documents including term drafts and a collection/negotiation instruction.
- A negotiating bank checks the shipping documents and the collection/negotiation instruction form to ensure that the documents conform to the instruction. Once the documents conform to the instruction, a negotiating bank pays to an exporter the amount of the draft less the exchange fee.
- A negotiating bank sends the drafts and the shipping documents together with the collection instruction to a collecting bank to entrust the collection of the payment.
- A collecting bank (this collecting bank which is making this presentation is called "the presenting bank") notifies an importer of the arrival of the documents and requests acceptance of the drafts. An importer is also advised about the collection.
- An importer (a drawee) checks the documents, and accepts the drafts if the documents conform to the sales contract.
- Once an importer accepts the drafts and the documents, a collecting bank releases the documents to an importer.
- A collecting bank keeps the accepted drafts until maturity and presents the drafts for payment at maturity.
- A collecting bank transfers the payment to a negotiating bank as per the instruction, if an importer pays the draft at maturity.
- In the case the drafts are not accepted on presentation, or not paid at maturity, a negotiating bank shall recourse to an exporter.

4.5 Negotiation in a documentary credit transaction

Article 2 of the UCP 600[66] defines that "negotiation means the purchase by the nominated bank of drafts (drawn on a bank other than the nominated bank) and/or documents under a complying presentation, by advancing or agreeing to advance funds to the beneficiary on or before the banking day on which reimbursement is due to the nominated bank."

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66 UCP 600 means the Uniform Customs and Practice for Documentary Credits, 2007 Revision, ICC Publication no. 600. The UCP 600 are rules that apply to a documentary credit.

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The term "negotiation" under the UCP 600 is not exactly the same as the term "negotiation" in international trade. In a documentary credit transaction, a negotiating bank is limited to a nominated bank. Nominated bank means "the bank with which the credit is available or any bank in the case of a credit available with any bank" (Article 2 of the UCP 600). A nominated bank is designated in a documentary credit itself.

In a documentary credit, a nominated bank (a negotiating bank) may negotiate drafts and/or documents when the presentation complies with the terms of a documentary credit. A negotiating bank shall be reimbursed by an issuing bank if the presentation is complying with the documentary credit. Unless a nominated bank is a confirming bank, they have no obligation to negotiate, except when expressly agreed to by that nominated bank and so communicated to a beneficiary (UCP 600 Article 12).

Negotiation by a negotiating bank is usually "with recourse" to an exporter:[67] if an issuing bank does not pay, a negotiating bank will request the negotiated amount back from an exporter. However, a confirming bank should negotiate "without recourse" (UCP 600 Article 8(e)).

In the negotiation process under a documentary credit, once a beneficiary (or a seller) performs an export contract (delivery of goods), they request a negotiating bank to negotiate the drafts and/or the documents. Once a negotiating bank decides to negotiate, they will advance funds to a beneficiary (or credit a beneficiary's account). Then, a negotiating bank presents the drafts and the documents to an issuing bank for acceptance or for payment.

The figure below shows in detail how negotiation works in a documentary credit transaction.

67 Eric Bishop, at 138.

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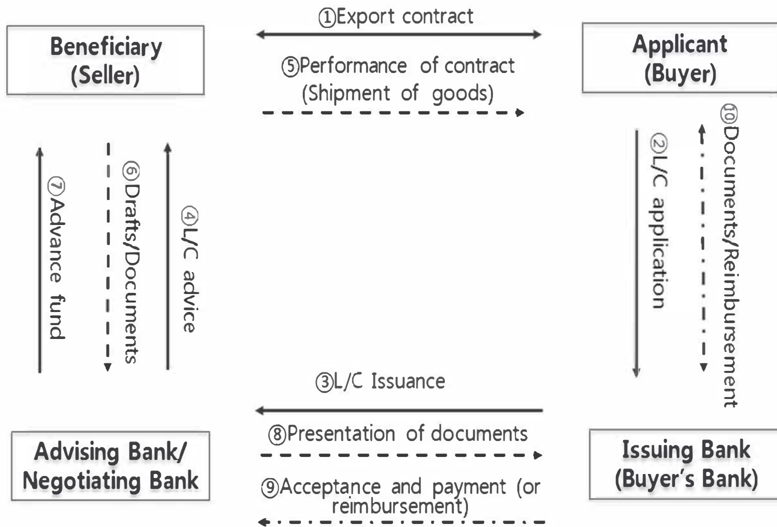
Figure 3.5 Process flow of negotiation in a documentary credit transaction



① A seller (an exporter) and a buyer (an importer) enter into an export contract with the payment terms of a documentary credit. A seller and a buyer agree on the details of a documentary credit to be issued.

② A buyer (an applicant) applies to an issuing bank to issue a documentary credit in favor of a seller by submitting a documentary credit issuing application form.

③ An issuing bank processes a formal credit approval of the application and establishes the credit limit for a buyer. (If the credit limit for a buyer is already established, this process will be omitted.) An issuing bank issues a documentary credit in favor of a seller (a beneficiary) within the remaining credit limit of the buyer. A documentary credit is normally sent to an advising bank through the SWIFT system.

④ Once an advising bank receives a documentary credit, they check the authenticity of the documentary credit and print it out to give to a seller. An advising bank is usually located in a seller's country, and its role is to take reasonable care to check the authenticity of the documentary credit and to advise a documentary credit to a

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seller according to its instructions. An advising bank owes no obligation to pay, unless it is a confirming bank.

- Once a seller receives a documentary credit, they will check and compare the documentary credit against the export contract. If then anything is not complying with the export contract, a seller must immediately communicate with a buyer for the necessary amendment. If all the details conform to the export contract, then a seller prepares and performs the export contract (or ships the goods in an export contract for the sale of goods), and obtains the transport documents from a carrier (or a freight forwarder).
- A beneficiary (seller) prepares all the documents (normally a bill of lading, commercial invoice, packing list, and inspection certificate) required under a documentary credit. A beneficiary presents the documents (and the drafts if any) to the nominated bank (normally an advising bank) for negotiation.
- The nominated bank will examine the documents with care. In many instances, the nominated bank decides to negotiate the documents (and the drafts if any) to advance funds to a beneficiary, then the nominated bank shall be rendered a negotiating bank.
- The negotiating bank dispatches and presents the documents (and the drafts if any) to the issuing bank for payment or acceptance.
- Upon receiving the documents, the issuing bank examines the documents with care. In many instances, the issuing bank requests an applicant (or a buyer) to check the documents and to decide whether or not to accept the documents.
  If the documents are complying with the documentary credit, the issuing bank sends "acceptance advice (A/A)" to the negotiating bank and will make payment at maturity.
- The issuing bank releases the documents to an applicant against payment at sight (or at any later date) as stipulated in the documentary credit. Once the issuing bank pays the complying presentation of documents, an applicant shall repay (reimburse) the issuing bank.

The UKEF (English ECA) operates the Letter of Credit Guarantee Scheme in a letter of credit (L/C) transaction.[68] The Letter of Credit Guarantee Scheme provides a guarantee between 50% and 90% of the

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68 See the UKEF website available at https://www.gov.uk/guidance/letter-of-credit-guarantee-scheme-overview-and-how-to-apply.

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value of an L/C to a UK bank which adds its confirmation to an L/C issued by an overseas issuing bank to finance an export from the UK. The Letter of Credit Guarantee Scheme protects the UK confirming bank against the failure of the issuing bank to reimburse for payments properly made by the confirming bank under the L/C. Under the Letter of Credit Guarantee Scheme, the UKEF shall pay the UK confirming bank if the foreign issuing bank fails to reimburse payments to a UK confirming bank.

5. Export factoring (International factoring)

5.1 Concept

Export factoring means trade finance where a factor purchases the exporter's receivables without recourse (or with recourse) to the exporter, and performs the credit control of the sales or debt collection functions.[69] Export factoring is a package of financial services that meets the requirements of an exporter on short-term credit to a foreign importer. It is a legal agreement between a factor (a division of a bank or a factoring house) and an exporter where the exporter assigns to the factor the account receivables of an export transaction.

Factoring originated in the United States where factors, who distributed goods around the nation, would pay the suppliers prior to the payment from the end customers.[70] Export factoring combines export working capital financing, credit risk protection, the booking of account receivables, and collection services.[71]

The factor's service includes the discounting of receivables, the collection of receivables, the sales ledger administration, and customer protection against bad debt. Thus, export factoring of receivables can be an alternative to an export credit insurance.[72] With factoring, an exporter is able to offer credit terms (or long payment terms) such as an open account without collection problems.[73]

UNIDROIT Convention on International Factoring (1988) Article 2 provides that:

69 Guillermo C. Jimenez, US Department of Commerce/International Trade Administration, at 21.
70 Richard Willsher, at 37.
71 US Department of Commerce/International Trade Administration, at 21.
72 US Department of Commerce/International Trade Administration, at 21.
73 Guillermo C. Jimenez, at 142.

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"factoring contract" means a contract concluded between one party (the supplier) and another party (the factor) pursuant to which:

(a) the supplier may or will assign to the factor receivables arising from contracts of sale of goods made between the supplier and its customers (debtors) other than those for the sale of goods bought primarily for their personal, family or household use;

(b) the factor is to perform at least two of the following functions:
   - finance for the supplier, including loans and advance payments;
   - maintenance of accounts (ledgering) relating to the receivables;
   - collection of receivables;
   - protection against default in payment by debtors;

(c) notice of the assignment of the receivables is to be given to debtors.

In export factoring, an exporter will assign to a factor export account receivables arising from an export transaction, and a factor is to perform at least two of the following functions (UNIDROIT Convention on International Factoring (1988) Article 1):

- finance for the supplier, including loans and advance payments,
- maintenance of accounts relating to the receivables,
- collection of receivables,
- protection against default in payment by debtors.

5.2 Operation of export factoring

Factoring involves not only finance but also additional services, and is generally more complex. Therefore, factoring is often used for larger individual amounts compared with negotiation. A factor (or a factoring house) is a bank or a financial institution that performs export financing through the purchase of account receivables. The exporter enters into a factoring agreement to sell the receivables to the factor. The agreement normally includes the credit control and debt collection functions by the factor against a fee. The factor obtains the title to the invoice and the right to the payment by the importers (or the issuing bank).

There are, in principle, two basic forms of factoring: "two-factor export factoring" and "direct export factoring". In "two-factor export factoring", the seller's domestic factoring company uses a local factoring company (either an independent company or a branch) in an importing country. The use of a local factoring company has the big advantage of a local presence and knowledge of the buyers, but will bring an increase of the overall cost. In "direct export factoring", the seller's domestic factoring company does not use a foreign factoring company, and, therefore, a local factor in an

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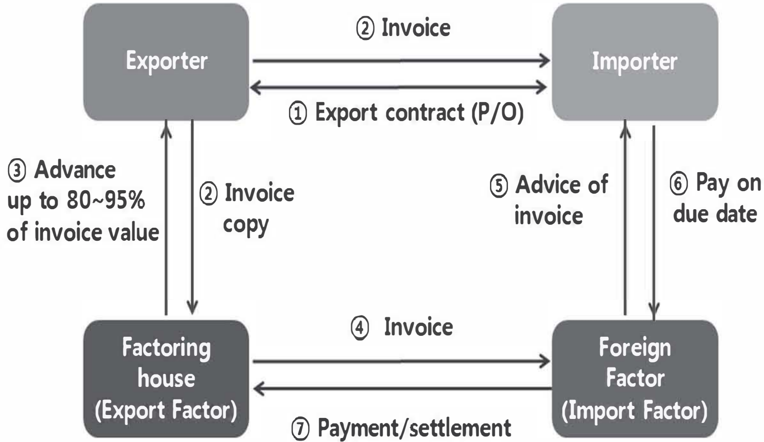
importing country is not involved.

Figure 3.6 Process flow of international factoring



① An exporter (a seller) and an importer (a buyer) enter into a contract (or an importer issues a purchase order (P/O)).

② An exporter raises an invoice on a buyer (or an importer), with a copy of an invoice to an export factor (factoring company).

③ An export factor (a factoring house) advances to an exporter up to 70~90%[74] of the invoice value.

④ An export factor (a factoring house) assigns an invoice to an import factor (a foreign factor).

⑤ An import factor (a foreign factor) requests an importer to pay an invoice.

⑥ An importer pays an invoice on the due date.

⑦ An import factor (a foreign factor) transfers the payment to an export factor (a factoring house).

⑧ A factoring house pays the remaining balance of an invoice, minus the fee.

74 The specific percentage of invoice value varies depending on an individual transaction.

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5.3 Advantages/disadvantages of export factoring

Factoring could have the following advantages for an exporter:[75]

- factors are expert at the collection of unpaid receivables.
- factors have excellent credit control systems which might be expensive for the seller to provide for themselves.
- the borrowing value of the receivables could be higher than the ordinary bank loan.
- without recourse factoring eliminates the non-payment risk by the buyer.
- the factor provides additional administrative systems.
- the seller will be able to maximize cash flows.

However, factoring has some disadvantages for an exporter:[76]

- factoring costs more than export credit insurance.
- factors with poor services can have an adverse impact on the business relationship between the seller and the buyer.
- factors may not be able to deal with queries about the sales contracts without reference back to the seller.
- generally not available in developing countries.

6. International forfaiting

6.1 Concept

Forfaiting means the purchase of future receivables on a "without recourse" basis.[77] "Forfaiting" can be also defined as a purchasing (or discounting) negotiable financial instrument such as a bill of exchange "without recourse". In classic forfaiting, a forfaiter purchases obligations falling due at a future date, arising from the delivery of goods and services in an export transaction.[78] The Uniform Rules for Forfaiting (URF 800) define that the "forfaiting transaction means the sale by the seller and the

75 Michele Donnelly, at 125; US Department of Commerce/International Trade Administration, at 21.
76 Michele Donnelly, at 125.
77 The International Trade and Forfaiting Association (ITFA) website http://itfa.org/trade-forfaiting/what-is-forfaiting/.
78 Howard Palmer, at 99.

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purchase by the buyer[79] of the payment claim on a without recourse basis on the terms of these rules" (Article 2).

Forfaiting allows exporters to obtain cash by selling their medium- and long-term foreign accounts receivable at a discount on a "without recourse" or "non-recourse" basis.[80] "Without recourse" or "non-recourse" means that the forfaiter assumes and accepts the risk of non-payment. A forfaiter offers discount terms based on "tenor of draft (or note)", "forfaiter's cost of funding", and "default risk of obligor (or a drawee, an avaliser)".

Forfaiting eliminates the risk of non-payment, once the goods have been delivered to an importer in accordance with the terms of the sale. Forfaiting is a special type of discounting of trade-related and mostly fixed-term-interest bills of exchange. A forfaiter is a specialized financial institution or a department in a bank that provides non-recourse export financing through the purchase of future account receivables. In practice, forfaiting is normally used in a documentary credit (L/C) transaction or in a transaction with a payment guarantee. A deferred payment L/C which has no bills of exchange (or drafts) is an ideal instrument for international forfaiting.[81]

6.2 Operation of international forfaiting

Unlike export factoring, forfaiting normally requires larger transactions with a minimum of at least USD100,000.[82] Prior to finalizing the transaction's structure, the exporter approaches a forfaiter. Once the forfaiter commits to the deal and sets the discount rate, an exporter can incorporate the discount into the selling price. An exporter then accepts a commitment issued by the forfaiter, signs the contract with an importer, and obtains, if required, a guarantee from the importer's bank that provides the documents required to complete the forfaiting.

An exporter delivers the goods to a foreign importer and delivers the documents to a forfaiter who verifies them and pays for them as agreed in the commitment. Since forfaiting is without recourse, the exporter has no further interest in the financial aspects of the transaction and it is the forfaiter who must collect the future account receivables due from a foreign importer (or an issuing bank).

79 Here, the "buyer" means a forfaiter.
80 US Department of Commerce/International Trade Administration, at 23.
81 Howard Palmer, at 107.
82 US Department of Commerce/International Trade Administration, at 23.

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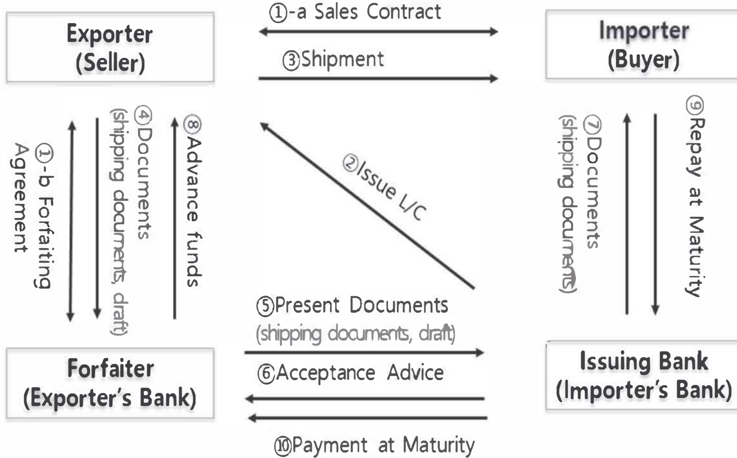
Once the payment risk has been passed to a forfaiter, an exporter obtains fund in return for the receivables (or bills of exchange). A forfaiter has two options: to keep the receivables (or bills of exchange) until the maturity date, or to sell the receivables (or bills of exchange) again on without recourse.[83]

The figure below shows the typical process of international forfaiting.

Figure 3.7 Process flow of International forfaiting



① An exporter (a seller) and an importer (a buyer) enter into a sales contract based on a documentary credit. An exporter concludes a forfaiting agreement with a forfaiter after or prior to a sales contract.
② A documentary credit is issued in favor of an exporter.
③ An exporter ships the goods according to the shipment schedule.
④ An exporter presents the shipping documents under a documentary credit to a forfaiter.
⑤ A forfaiter forwards the shipping documents to an issuing bank.
⑥ An issuing bank examines the shipping documents, and sends acceptance advice (A/A) in the case of complying presentation.
⑦ An issuing bank releases the shipping documents to an importer.
⑧ Upon receiving acceptance advice, a forfaiter advances funds to an exporter.
⑨ An importer reimburses (repays) an issuing bank at maturity.

83 Howard Palmer, at 104.

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● An issuing bank pays a forfaiter at maturity.

※ Very often, step 9 and step 10 are reversed.

6.3 Advantages/disadvantages of international forfaiting[84]

International forfaiting could have the following advantages to an exporter:

- an exporter can eliminate non-payment risk by a foreign importer as a forfaiter purchases receivables "without recourse".
- an exporter can off-load foreign exchange risk.
- if the interest rate rises, the fixed interest rate could prove inexpensive.

International forfaiting could have the following disadvantages to an exporter:

- the cost for international forfaiting is normally very high, and often higher than commercial lender financing.[85]
- the option fee is e-payable even if the forfaiting facility is not taken up.
- the commitment fee is payable at the outset and a penalty would be charged if the receivables are delivered late.
- if the interest rate falls, the fixed interest rate could prove expensive.
- international forfaiting is normally offered to an export transaction with a documentary credit transaction or with a payment guarantee.
- the fund is advanced to an exporter only after acceptance advice by an issuing bank (or a confirming bank) is received.
- international forfaiting is normally limited to medium- and long-term export transactions over USD100,000.

84 Howard Palmer, at 103.

85 US Department of Commerce/International Trade Administration, at 23.

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(Example of a forfaiting agreement)

EXP Co. 11 November 2018

(Address)

Dear Sirs,

Forfaiting Financing-PRC
PRC Bank, China

We are pleased to provide herewith our preliminary offer to purchase from your Company, on a without recourse basis, the valid Bill/debt deriving from the following bona fide transaction, under the following terms and conditions. Such "without recourse" shall mean that we waive for ourselves and any successors/endorsees all rights and claims against your Company or any previous holders/endorsers in the event of delay/default to payment as a result of the Bill/debt obligor's country, credit or transfer risk provided there shall be no fraud or misrepresentation committed.

1) L/C Issuing Bank: PRC Bank, China under L/C No LCXXXXXXXXXXA dated 20 Oct 2018.
2) L/C Amount: USD2,000,000.
3) L/C Tender: 360 days after B/L date.
4) L/C Applicant: IMP Co.
5) L/C Beneficiary: EXP Co. Seoul, Korea.
6) Purpose: Supply of to China.
7) Evidenced By: Bills of Exchange ("Bill") properly drawn on and validly accepted by the L/C Issuing Bank duly negotiated to our order.
8) Interest Rate: At straight discount 0.50% p.a. over the appropriate SIBOR with the rate to be fixed two (2) business prior to our payment. SIBOR shall mean the average of the appropriate period rates quoted by all the reference banks on Reuter Page SIBO (rounded upwards to the nearest whole multiple of one-sixteenth of one per cent).
9) Commitment Fee: Waived.
10) L/C Negotiating Bank: KOR Bank, Korea, Seoul Branch.

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11) Shipment Date: No later than 10 Nov. 2018. We reserve the right to revise our pricing in the event of late shipments.

12) Availability of Documents for Discounting:

Our payment to yourselves shall be conditional upon our receipt of the following valid documents in satisfactory form and substance not later than 30 days from the shipment date.

a) The accepted Bill negotiated to our Risk Booking Unit. Alternatively, in lieu of the accepted Bill, we are prepared to effect payment against receipt of a tested telex from the L/C Issuing Bank to the L/C Negotiating Bank confirming its acceptance of the L/C documents and maturity date of the Bill.

b) A Notice of Transfer of Rights Issued by your company in favor of our Risk Booking Unit per attached format.

c) A certified true copy of the L/C plus all amendments.

13) Other Conditions:

a) All payments at maturity shall be for the full face value of the Bills without deduction for any taxes, duties, levies on imports of whatever nature present or future.

b) Your Company shall be solely responsible for any taxes, duties, or imposts by your local tax authority, if any, in relation to our forfaiting of the above export transaction.

c) All documents, including L/C wording, are subject to our sole satisfaction.

d) The L/C Negotiating Bank's USD35.00 of postage/cable charge shall be waived and the L/C Issuing Bank's charges, including acceptance commission, exchange-in-lien, discrepancy fee, etc., and reimbursement commission of USD100.00 per Bill, shall be for your account and these are to be deducted from our payment.

e) We shall have the right to carry out appropriate due diligence in connection with the underlying transaction and further reserve the final right to discontinue our discounting in the event of a finding that is not to our satisfaction.

f) You hereby express your consent from time to time, if we deem it necessary, that we can release any copy of documents related to this transaction to our Asia Forfaiting Center or relevant departments without requiring your prior approval.

g) We may, at your request and at our sole discretion, agree to effect payment to you prior to our receipt of the acceptance advices from the L/C Issuing Bank; however such payment by us is made

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subject to our full recourse to you notwithstanding the L/C documents may be presented to us via a first presenting bank in the event of non-acceptance by the L/C Issuing Bank within a reasonable time. You will reimburse us, upon our demand, any amount paid to you and indemnify us against any unwinding cost of loss suffered as a result, together with interest from our date of payment to you.

14) Change of Circumstances:
Please note that if there is at any time in our opinion any change in the laws and regulations such as anti-dumping tariffs of the importing country which in any way affects or applies to imports of the underlying goods into the country, we shall have the right to demand any additional documents in order to satisfy ourselves that goods have been properly imported into the country.

15) Expiry of Offer: This offer is valid for your acceptance until our close of business on 15 Dec. 2018.

We reserve the right to amend or cancel our terms of offer in the event of delay in the shipment or presentation of documents for discounting.

Kindly acknowledge your acceptance of the above by signing and returning to us the duplicate of this letter before the expiry date.

Your faithfully

KOR Bank

(Authorized Signature)

EXP Co.

(Authorized Signature)

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CHAPTER 4

FINANCING AN OVERSEAS CONSTRUCTION PROJECT

1. Overview of overseas construction projects

1.1 Introduction

An overseas construction project requires high-tech solutions, and it helps to get access to new emerging markets, brings less trade conflict, helps to transfer technology to an importing country, and promotes economic cooperation with an importing country. Such benefits encourage all the countries to make efforts to promote competitiveness in an overseas construction. As an overseas construction has strong influence on a nation's economy, most countries actively compete in bidding for an overseas construction project.

An overseas construction is normally so huge and complex that a tremendous amount of funds is required. Some overseas construction projects exceed one billion US Dollars. An overseas construction project requires long-term financing as the amount of time it takes for an overseas construction project to pay for itself is considerably long.[86] This amount of time, known as the capital goods cycle, extends into years. It may take considerable time before enough products can be produced for it to pay for itself. Most of the loans are not short-term roll-over credits, but long-term credits. In many cases, syndicated loans rather than single loans are required.[87]

As an overseas construction project requires considerable amounts of capital investment, an employer (or an owner), particularly if they are in a developing country, cannot afford to finance the undertaking using their own resources. Thus, an employer (or an owner) normally requires a

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86 Harry M. Venedikian, Gerald A. Warfield, *Export-Import Financing*, 4th ed., John Wiley & Sons (1996), at 20.
87 In a syndicated loan, two or more financial institutions provide a loan. (Andrew Fight, *Syndicated Lending*, Elsevier (2004), at 1.)

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financing mechanism, which is to be provided by a contractor. Therefore, the financing mechanism for an overseas construction project is conclusive in winning it.

As there are many parties involved in overseas construction financing, which is generally international financing, there arise various disputes and legal issues. Therefore, an understanding on the legal aspects of the financing for an overseas construction project is also required.

There are various financing mechanisms available for an overseas construction project, some of which are combined. The major financing mechanisms for overseas construction projects include supplier credit/buyer credit, project finance, export credit insurance (or export credit guarantee), syndicated loans, independent guarantees (or demand guarantees, standby letters of credit), official development assistance (ODA), etc. A detailed understanding of financing mechanisms is often a key to success in overseas construction projects.

Compared with the export of consumer goods, an overseas construction is a transaction of a large-scale, long-term project, with many parties participating, deferred payment, and of high-technology. The performance often extends over a considerable period of time, during which period the economic conditions may change. An overseas construction plays a major role in promoting a cooperative relationship with importing countries. Moreover, an overseas construction is high value-added, highly productive, has a high industry relation effect, and contributes to foreign currency earning, and also leads a nation's export restructuring work towards one that is high value-added and high-tech industries-led, and enhancing a nation's economy.

1.2 Risks and key factors

There are various risks towards the relevant parties respectively in an overseas construction project. These are key elements in the successful performance of an overseas construction project. The main risks in an overseas construction project are:

i) risk on technology and design,
ii) risk on completion/construction,
iii) risk on operation/management,
iv) risk on market/price,
v) risk on environment/third party,
vi) risk on financing,
vii) risk on payment,

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viii) risk on a performance guarantee,
ix) risk on sub-contractors,
x) risk on foreign currency,
xi) risk on legal matters, and
xii) risk on country.

There are several elements proposed to promote the competitiveness in an overseas construction:

i) developing the ability of process management,
ii) training and education,
iii) emphasis on the project financing competency,
iv) specialization of business, and
v) business innovation.

In a lender's perspective, there are repayment risk, completion risk, political risk in the host country, etc. In order to mitigate the risks, the parties shall take relevant measures or require relevant securities. A contractor needs to evaluate the credibility of an employer against payment risk, and may request a payment guarantee. An employer requests a contractor to provide a performance guarantee against completion risk, and employ a well-known first class bank as a mandated lead arranger to arrange financing. Lenders need to evaluate the credibility of a borrower and accomplish a feasibility study of the project.

Once the parties assess the respective risks and obtain the relevant securities, the project will be successfully completed. The success of the project will be sure to bring the parties involved enormous profits and another opportunity to participate in additional overseas construction projects afterwards.

Due to the features of an overseas construction, its contract type and/or content are different from those of consumer goods. An overseas construction contract can be classified by its type and content as follows;

i) a competition bid contract and a negotiated contract,
ii) a lump-sum fixed price type contract and a cost plus fee type contract,
iii) a single type contract and a consortium type contract.

An overseas construction contract is, in nature, a turnkey contract under which a contractor completes construction and commissioning, puts it into operation, and hands over the installation ready for use. In general, an overseas construction contract includes the following clauses; parties,

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definition, scope of supply or work scope, contract price, payment, project schedule, warranty, governing law, arbitration, force majeure, inspection, testing, indemnity, termination, commissioning, acceptance, and effective date. An overseas construction contract is so immense and complicated that careful caution is required in drafting.

2. Importance of financing an overseas construction project

Overseas constructions are normally so huge and complex that a tremendous amount of funds is required. An overseas construction project requires longer-term financing than traditional commodities. This is because the amount of time it takes for an overseas construction project to pay for itself is considerably longer than for consumer goods.[88] This amount of time, known as the capital goods cycle, extends into years. It may take a considerable time before enough products can be produced for it to pay for itself. Most of the loans are not short-term roll-over credits, but long-term credits. In many cases, syndicated loans rather than single loans are provided.[89]

Moreover, some of the importing countries are developing countries and are politically and economically unstable. Accordingly, the financing mechanism for an overseas construction project is conclusive in winning. This is the primary reason why we need to understand the financing mechanism for an overseas construction project.

As an overseas construction project involves considerable amounts of funds, an owner (employer), particularly if he is in a developing country, cannot or will not finance the undertaking out of his own resources. An owner normally requires that a financing mechanism should be provided by a contractor. Therefore, the financing mechanism for an overseas construction project is conclusive in winning.

As there are many parties involved in overseas construction financing, which is generally international financing, there arise various disputes and legal issues. Therefore, an understanding of the legal aspects of the financing for an overseas construction project is also required.

There are various financing mechanisms available for an overseas construction project, some of which are combined. The major financing

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88 Harry M. Venedikian, Gerald A. Warfield, at 20.

89 In a syndicated loan, two or more financial institutions provide a loan. (Andrew Fight, at 1.)

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mechanisms for overseas construction projects include supplier credit/buyer credit, project finance, export credit insurance (or export credit guarantee), syndicated loans, independent guarantees (or demand guarantees, standby letters of credit), official development assistance (ODA),[90] a government-backed export loan, etc. A detailed understanding of financing mechanisms is often a key to success in overseas construction projects.

An understanding of financing mechanisms in an overseas construction project will help the parties concerned to choose the proper financing mechanisms, and to conclude a contract in an amicable way. In addition, a detailed understanding of the financing mechanisms will hopefully promote overseas construction projects worldwide.

3. Supplier credit and buyer credit

Financing mechanisms are classified into a supplier credit and a buyer credit by whoever is responsible for providing finance.[91] In a supplier credit, a supplier (or an exporter) is responsible for providing finance, while, in a buyer credit, a buyer (or an importer) is responsible for providing finance.[92] In every project (but not limited to an overseas construction), funding will be provided by one of these two financing mechanisms.

A supplier credit is quite the opposite to a buyer credit in the parties to a loan agreement, if any. In a supplier credit, a supplier (or an exporter) will be a borrower in a loan agreement, while a buyer (or an importer) will be a borrower in a buyer credit. A supplier credit and a buyer credit have respectively their own advantages and disadvantages in the respective parties' perspective. These two financing mechanisms are selectively used considering the financing conditions such as funding cost, the buyer's and/or supplier's financial conditions, and the importing country's political risk.

This section will give a more detailed explanation as well as deep analyses of a supplier and a buyer credit, analyzing the advantages and

90 Official development assistance (ODA) is the resource for developing countries by official agencies including the state of government with the purpose of promoting economic development and social welfare of the developing countries. ODA is also very useful financing for an overseas construction project.

91 Malcolm Stephens, at 73, 110; Richard Willsher, at 66-78; Anders Grath, at 146, 160.

92 Malcolm Stephens, at 73, 110; Richard Willsher, at 66-78.

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disadvantages of all the parties (an exporter, a financial institution, and an importer) respectively.

3.1 Supplier credit

3.1.1 Concept

A supplier credit means a financing scheme in which a supplier (or an exporter or a seller) is responsible for providing the fund.[93] In a supplier credit, an exporter (a seller or a supplier) extends a credit to an importer (a buyer) as part of an export contract.[94] Export credit insurance cover for this transaction may be extended to an exporter. In a contract for the sale of goods, a seller shall provide the fund required to manufacture or to procure goods, and in a construction contract, a contractor shall provide the fund required to complete construction. When a supplier credit transaction arises in a mid- and long-term transaction, an importer normally makes a down-payment from 5% to 30% of the contract value.[95]

In a supplier credit, a contractor (or an exporter) shall borrow the fund necessary for the performance of an overseas construction contract with his own credit. After completing the overseas construction, a contractor (or an exporter) will get payment from an employer (or an importer) on a deferred installment payment basis. A contractor (or an exporter) will, in many cases, require, in security of the payment by an employer (or an importer), a payment guarantee from an employer's parent company or a financial institution.

With the payment from an employer (or an importer), a contractor (or an exporter) will repay the loan to a lender (or a financial institution). Even in the case a contractor (or an exporter) does not get the payment from an employer (or an importer), they have to repay the loan with their own fund. Therefore, a contractor will be exposed to non-payment risk by

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93 Malcolm Stephens, at 110; Richard Willsher, at 75; Anders Grath, at 146; Sang Man Kim, "World Shipbuilding Industry and Export Credit Insurances for Ship Exports: Focusing Korea's Export Credit Insurances", *International Journal of Applied Business and Economic Research*, Vol. 15 No. 10 (Serials Publications, 2017), at 268.

94 Malcolm Stephens, at 110; Richard Willsher, at 75; Anders Grath, at 146; Sang Man Kim, "A Comparative Study on a Supplier Credit and a Buyer Credit in International Transactions of Capital Goods", *The International Commerce and Law Review*, Vol. 48 (2010), at 130.

95 Roeland F. Bertrams, *Bank Guarantees in International Trade*, 4th ed., Kluwer Law International (2013), at 39.

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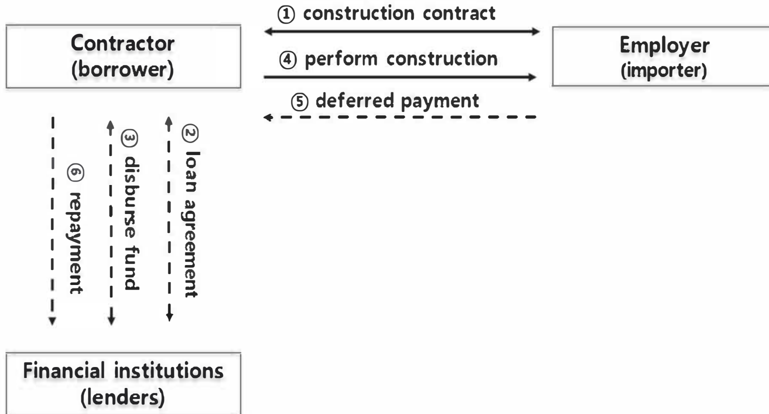
an employer (or an importer) and also will bear the obligation to repay the loan. With export credit insurance (or export credit guarantee), a contractor can mitigate the non-payment risk.

Figure 4.1 Process flow of a supplier credit



The general procedure for a supplier credit is as follows;

① A contractor (or an exporter) enters into an overseas construction contract with an employer (or an importer), in which an employer (or an importer) shall pay a contractor (or an exporter) on a deferred payment basis.

② A contractor (or an exporter) enters into a loan agreement with a financial institution (or a bank). A contractor (or an exporter) borrows the funds necessary to perform the overseas construction contract from a financial institution (or a bank) with its own credit.

③ A financial institution (or a bank) will disburse funds in installments to a contractor (or an exporter) in accordance with the performance of the construction.

④ A contractor (or an exporter), then, performs the overseas construction contract by using the funds.

⑤ After completing the overseas construction in accordance with the overseas contract, a contractor (or an exporter) will receive payment from an employer (or an importer) on a deferred payment basis. An

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employer (or an importer) will pay with the revenues from the operation of the overseas construction project.

- A contractor (or an exporter) will repay to a bank with the payment from an employer (or an importer).

3.1.2 Parties to a loan agreement

As a contractor (or an exporter) borrows funds from a financial institution in a supplier credit, a contractor (or an exporter) will be a borrower and a financial institution will be a lender. In a supplier credit, a contractor (or an exporter) and a financial institution will be the parties to a loan agreement.

In a supplier credit, a contractor (or an exporter) will be required to assign the right to payment (or the account receivables) and/or the promissory notes issued by an employer (or an importer) to a financial institution (or a lender).[96] Although an employer (or an importer) is not a party to a loan agreement, a financial institution (or a lender) shall directly claim the payment to an employer (or an importer) when the right to payment is assigned to a financial institution (or a lender).

3.1.3 Securities

A financial institution (or a lender) requires securities when it decides an exporter's credit is not satisfactory. The main securities required by a financial institution are as follows.

A. Corporate guarantee

A financial institution (or a lender) requires a corporate guarantee by a parent company, which is the simplest security. A financial institution (or a lender) will require an independent guarantee (or a demand guarantee) rather than a traditional guarantee (or a suretyship, an accessory guarantee). In an independent guarantee (or a demand guarantee), a guarantor undertakes to pay as a primary obligor not a secondary obligor upon demand by a beneficiary,[97] while a guarantor, in a traditional guarantee, is a secondary obligor and requires breach

96 Richard Willsher, at 76.

97 Roeland Bertrams, at 11.

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or failure under the underlying transaction.[98] However, these days a parent company is reluctant to provide such a guarantee.

B. Assignment of the right to payment

A contractor (or an exporter) is required to assign the right to payment to a financial institution (or a lender) as security for the loan. Then, a contractor (or an exporter) assigns the right to payment (or the account receivables) and/or the promissory notes issued by an employer (or an importer) to a financial institution (or a lender).[99] In this case, an employer (or an importer) will make payment directly to a financial institution.

C. Export credit insurance policy

A contractor (or an exporter) is required to assign an export credit insurance policy to a financial institution. In this case, export credit insurance cover will be a condition precedent to loan disbursement or to the effectiveness of a loan agreement. An export credit insurance policy will help a contractor (or an exporter) to easily obtain the fund from a bank.[100] Many countries have established export credit agencies to promote exports through various supports including export credit insurance or guarantee.[101] The main aim of export credit agencies is to promote their exports by protecting exporters against commercial risks of an importer and political risks in an importing country.[102] When commercial risks of an importer and political risks in an importing country are not acceptable, a financial institution will require a contractor (or an exporter) to purchase export credit insurance and to assign the insurance policy.

3.1.4 Relevant export credit insurance

Export credit insurance (or export credit guarantee) covers risks which are peculiar to export transactions but are not normally covered by

98 Matti S. Kurkela, *Letters of Credit and Bank Guarantee under International Trade Law*, 2nd ed., Oxford University Press (2008), at 12.
99 Richard Willsher, at 76.
100 Harry M. Venedikian, Gerald A. Warfield, at 2.
101 John E. Ray, at 1.
102 Eric Bishop, at 100.

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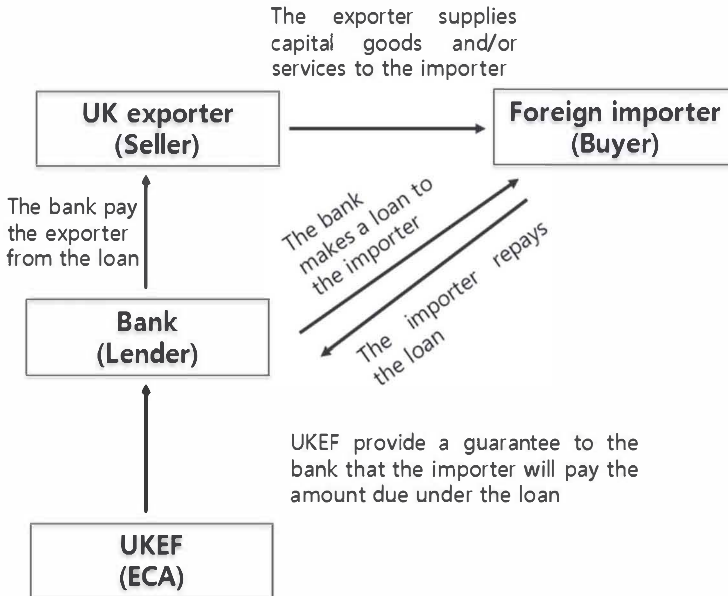
commercial insurance.[103] The UK Export Finance (UKEF), an English ECA, provides the Supplier Credit Bills and Notes Facility for an export transaction based on a supplier credit.[104] The Supplier Credit Bills and Notes Facility provides a guarantee to a financial institution (or a lender) to cover payments due under bills of exchange, or promissory notes, purchased by a financial institution from a UK exporter.[105] The exporter will have received them in payment for capital goods and/or services supplied to an overseas importer.[106]

Figure 4.2 Process flow of the Supplier Credit Bills and Notes Facility[107]



103 Carole Murray, et al., at 442.
104 See the UKEF website at https://www.gov.uk/guidance/supplier-credit-financing-facility.
105 See the UKEF website at https://www.gov.uk/guidance/supplier-credit-financing-facility.
106 See the UKEF website at https://www.gov.uk/guidance/supplier-credit-financing-facility.
107 The UKEF website is available at https://www.gov.uk/guidance/supplier-credit-financing-facility.

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The Korea Trade Insurance Corporation (K-Sure), a Korean ECA, operates a short-term export insurance, and a mid- and long-term export insurance.[108] A short-term export insurance covers risks of non-payment of export proceeds in an export transaction due to political or commercial risks in transactions with less than a two-year payment period. A medium- and long-term export insurance covers risks of non-payment in an export transaction due to political or commercial risks in transactions with a more than two-year payment period.

There are two types of medium- and long-term export insurance; a medium- and long-term export insurance (supplier credit), and a medium- and long-term export insurance (buyer credit). A medium- and long-term export insurance (supplier credit) is for an export transaction based on a supplier credit. "Medium- and long-term export insurance (supplier credit)" is selectively used as a security in an export transaction of capital goods (i.e., industrial plant construction, overseas construction, shipbuilding), while "short-term export insurance" is used in an export transaction of consumer goods.

Medium- and long-term export insurance (supplier credit) covers risks of non-payment by an importer in an export transaction due to political or commercial risks, the payment term of which exceeds one year. Short-term export insurance is the most frequently used insurance product among various export insurances. However, a medium- and long-term export insurance (supplier credit) is typically considered more important than a short-term export insurance for the payment term is longer and therefore the risks are higher. Medium- and long-term export insurance (supplier credit) enables a financial institution to provide a loan to an exporter for it is treated as a safe security.

3.1.5 Advantages and disadvantages of supplier credit[109]

A. Exporter's perspective

It is comparatively easy for an exporter to borrow funds on a supplier credit basis for its good credit rating. Generally an exporter which won industrial plant export, overseas construction, or shipbuilding export has a good stable financial condition. Therefore an exporter can borrow the fund

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108 See the K-Sure website at https://www.ksure.or.kr/en/product/product_01_01.do.

109 Preposition: an exporter is a company with a good credit rating, and an importer is a company with a poor credit rating located in a developing country.

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required to perform an export contract easily from a financial institution. An exporter surpasses an importer in negotiating a contract price for it provides finance.

However, an exporter is paid on a long-term deferred payment method. After an exporter completes its contract obligation, an importer may willfully raise a claim to deduct payment or to reject payment. Furthermore, an importer can be insolvent or bankrupt, in which case an exporter cannot receive payment.

During the performance of the contract, the loan is added to an exporter's balance sheet as a liability (debt). After the performance of the contract, the contract value is added to an exporter's balance sheet as an asset (account receivable). Thus debt on the balance sheet increases, and the liability ratio rises, resulting in the aggravation of the financial structure.

The key to success for an exporter is to obtain securities to mitigate the risks. The securities are a mortgage on the object, export credit insurance, guarantee by a bank or a parent company, etc.

B. Importer's perspective

The advantages of a supplier credit in an exporter's respect are disadvantages in an importer's respect, and the disadvantages of a supplier credit in an exporter's respect are advantages in an importer's respect. In a supplier credit an importer is free from non-performance risk by an exporter for an importer makes payment only after an exporter performs the contract.

In a typical overseas construction contract, an importer (or an employer) shall make advance payment of 5 ~ 30% of the contract price to a contractor (or an exporter).[110] An importer can get rid of the risk of downpayment by way of an advance payment guarantee issued by a financial institution. Furthermore an importer requires a performance guarantee. In the event an exporter fails to perform the contract, an importer can make a demand under a performance guarantee as well as under an advance payment guarantee. As an exporter provides finance, an exporter can surpass an importer in negotiating the contract price, which may result in the increase of the contract price.

110 See "FIDIC Conditions of Contract for EPC/Turnkey Projects" Article 14.2: "The Employer shall make an advance payment, as an interest-free loan for mobilization and design, when the Contractor submits a guarantee in accordance with this Sub-Clause including the details stated in the Particular Conditions."

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C. Financial institution's perspective

A financial institution provides a loan to an exporter in a supplier credit, and to an importer in a buyer credit. Which is more beneficial to a financial institution depends on the specific credit conditions of an exporter and an importer, and on the terms and conditions of a loan agreement. Under the preposition aforesaid, as an exporter has a sound credit rating, the loan is considered to be more secured. As an exporter has a principal place of business in the domestic area, establishing securities is easier. Therefore, a financial institution does not require high spread.

When the repayment term of a loan is long term, a financial institution tends to require securities for an event of default such as; assignment of the payment under the export contract, assignment of export insurance policy, etc. In rare cases a financial institution purchases the payment right without recourse and with a high rate of discount, in which case an exporter is free from payment risk entirely.

3.2 Buyer credit

3.2.1 Concept

A buyer credit means a financing scheme in which a buyer (or an importer) is responsible for providing the fund.[111] A buyer credit is an arrangement in which a supplier (or an exporter, a seller) enters into a contract with a buyer (or an importer) which is financed by a buyer (or an importer).[112] Such arrangements are frequently used to finance capital goods or projects on a medium- or long-term basis.[113] A buyer credit is a loan or credit extended by a financial institution directly to a buyer (or an importer).

An exporter enters into a contract with an importer, which is financed by means of a loan agreement between a lending bank and an importer. In a contract for the sale of goods, an importer shall provide the fund required

111 Richard Willsher, at 66; Malcolm Stephens, at 73; Sang Man Kim, "A Comparative Study on a Supplier Credit and a Buyer Credit in International Transactions of Capital Goods", *The International Commerce and Law Review*, Vol. 48 (2010), at 129; Sang Man Kim, "World Shipbuilding Industry and Export Credit Insurances for Ship Exports: Focusing Korea's Export Credit Insurances", *International Journal of Applied Business and Economic Research*, Vol. 15, No. 10 (Serials Publications, 2017), at 268.

112 Malcolm Stephens, at 73; Richard Willsher, at 66.

113 Malcolm Stephens, at 73; Richard Willsher, at 67.

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to procure the goods by an exporter. In an overseas construction contract, an employer shall provide the fund required to complete a construction. The loan on a buyer credit is a tied loan which should be used for a particular export contract. In practice, the fund shall be disbursed directly to an exporter in accordance with the performance of the export contract.

A buyer credit has two mechanisms: a direct loan and a relending facility. A direct loan is given directly to an importer, and a relending facility is given to a bank in an importing country, and that bank gives the loan to an importer. A buyer credit is common in project finance, a method of raising long-term debt financing for major projects through "financial engineering", based on lending against the cash flow generated by the project alone.[114]

An export credit agency in an exporting country provides export credit insurance cover to a lender (or a financial institution), and an exporter will be paid by the loan by the performance of the contract.[115] In an overseas construction contract, a contractor will be paid by the loan on a progressive payment basis. A buyer credit benefits a seller as the seller gets paid in full on the delivery of goods or on completion of construction, and also benefits a buyer as the buyer is able to obtain medium- and long-term finance.[116]

Interest on the loan accrues during the drawdown period (or construction period in an overseas construction contract) and is typically payable during the drawdown period. However, these days especially in project finance, the interest during the drawdown period (or construction period in an overseas construction contract) is capitalized for a borrower for an importer does not make any profit during construction.

Even though a contractor (an exporter) fails to accomplish the construction (contract), a borrower (an employer) has to repay the loan disbursed. Once the construction is completed, an importer makes revenue by operating the project. And a borrower (an employer) repays the loan (principal and interest together) with the revenue. The interest can be paid either at a floating rate such as Libor plus spread, or at a fixed rate such as CIRR (Commercial Interest Reference Rate).[117]

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114 E.R. Yescombe, *Principles of Project Finance*, Academic Press (2002), at 1.
115 Malcolm Stephens, at 73; Richard Willsher, at 67.
116 Michele Donnelly, at 136.
117 The CIRR (Commercial Interest Reference Rate) is a fixed interest rate published monthly by the OECD. The CIRR represents the lowest interest rates for each of the major currencies at which official export credit agencies may official support credits of over two years' maturity.

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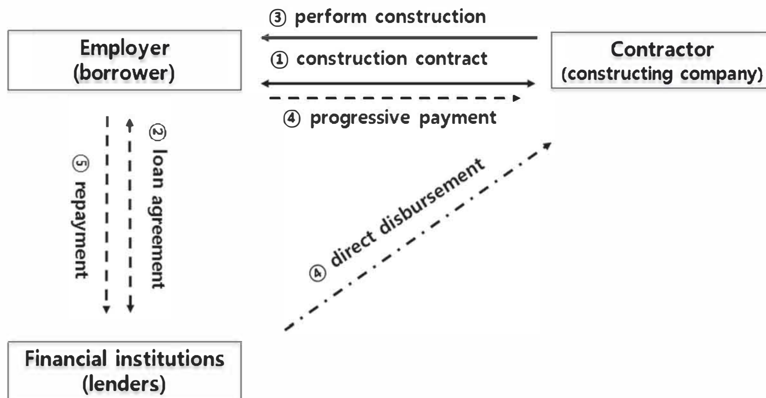
Figure 4.3 Process flow of a buyer credit



The general procedure for a buyer credit in an overseas construction project is as follows;

① A contractor (an exporter) enters into a construction contract with an employer (an importer), in which an employer shall pay a contractor on a progressive payment basis.

※ In progressive payment terms, a contractor shall be paid in proportion to the performance of construction. In an overseas construction contract, a contractor is normally paid monthly. Every month an employer checks the performance and issues a certificate. And a contractor shall be paid with the submission of a certificate and invoice. Finally, at completion of the construction, a contractor shall be paid in full.

② An employer enters into a loan agreement with a bank.

③ A contractor (an exporter) performs the construction.

④ An employer (an importer) pays an exporter on a progressive payment basis with the loan. A bank shall disburse the loan to an importer. In fact, a bank disburses the funds directly to a contractor (an exporter).

⑤ Once a contractor (an exporter) completes the construction, an employer (an importer) shall repay to the bank with the revenues from the operation of the project on a long-term installment basis.

3.2.2 Parties to a Loan Agreement

As an employer (an importer) borrows money from a financial institution in a buyer credit, an employer (an importer) becomes a borrower and a

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financial institution becomes a lender. An employer (an importer) and a financial institution become the parties to a loan agreement. In the case an employer (an importer) lacks creditworthiness, a financial institution purchases export credit insurance and charges an insurance premium to an employer (an importer). Typically, an export credit agency in an exporter's country covers the loan agreement. In some cases, a parent company of an employer (an importer) borrows money from a financial institution.

3.2.3 Securities

A financial institution requires securities when it decides a borrower's (employer's or an importer's) credit rating is not satisfactory. The main securities required by a financial institution in a buyer credit are as follows.

A. Corporate guarantee

A financial institution requires a corporate guarantee by a parent company of a borrower (an employer or an importer). This is the simplest security. However, these days parent companies are reluctant to provide corporate guarantees. Especially in project finance, a sponsor, which is a parent company of a project company, does not provide a direct payment guarantee to a financial institution.

B. Export credit insurance (Export credit guarantee)

A financial institution purchases export credit insurance (export credit guarantee) which is provided by an export credit agency in an exporter's country. Generally, an importer pays all the costs related to export credit insurance (export credit guarantee).

C. Performance bond

A financial institution requires a performance bond (or guarantee) for the completion of construction, and they require an employer (or an importer) to assign the guarantees or request an importer to nominate it as a beneficiary under the guarantees. A financial institution also requires a concession from a host country, a long-term off-take contract, etc.

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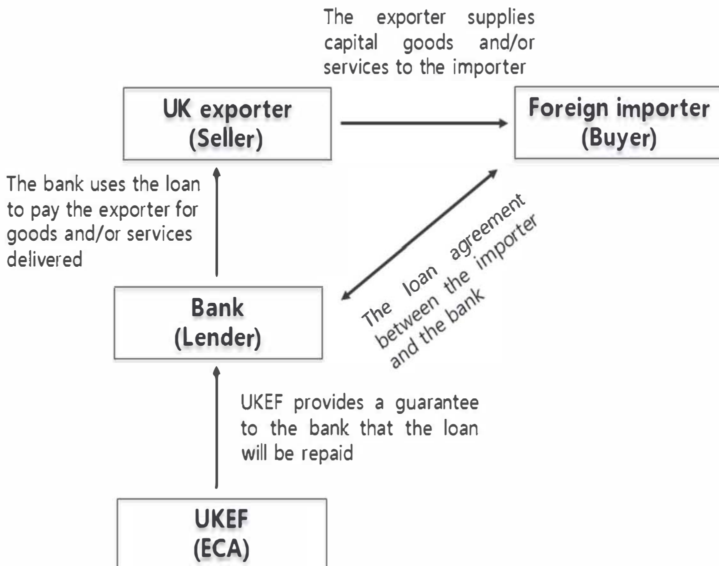
3.2.4 Relevant Export Credit Insurance (Export credit guarantee)

The UK Export Finance (UKEF) provides a Buyer Credit Facility for an export transaction based on a buyer credit.[118] Under a Buyer Credit Facility, the UKEF provides a guarantee to a financial institution (or a bank) which provides the fund to an overseas importer (an employer), so that capital goods and/or services can be purchased from the UK.[119] The loan agreement is concluded between the overseas importer (an employer) and the financial institution. UKEF provides an export credit guarantee to the financial institution that the loan will be repaid by the overseas importer (an employer). The UK exporter (contractor) sells the capital goods and/or services to the overseas importer (an employer), and the financial institution then uses the loan to pay the exporter (a contractor) for goods and/or services delivered.[120]

Figure 4.4 Process flow of a Buyer Credit Facility (by the UKEF)[121]



118 See the UKEF website at https://www.gov.uk/guidance/buyer-credit-facility.
119 See the UKEF website at https://www.gov.uk/guidance/buyer-credit-facility.
120 See the UKEF website at https://www.gov.uk/guidance/buyer-credit-facility.
121 The UKEF website is available at https://www.gov.uk/guidance/buyer-credit-facility.

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The Korea Trade Insurance Corporation (the K-Sure), a Korean ECA, provides a "medium- and long-term export insurance (buyer credit)" which covers the non-recovery risk of financial proceeds by a financial institution in a medium- and long-term loan agreement, the repayment period of which exceeds two years. Separate from the export contract (or the supply contract), a financial institution provides export financing to an importer (an employer) and a financial institution becomes a policyholder of a medium- and long-term export insurance (buyer credit). A medium- and long-term export insurance (buyer credit) enables a financial institution to provide a loan to an importer (an employer) for it is regarded as a safe security.

The basic function of a medium- and long-term export insurance (buyer credit) is to cover non-payment risks, and it plays a more important role as a security for buyer credit finance. This is why financial institutions come to visit an export credit agency to request insurance cover before they issue a letter of intent for a loan. The detailed terms of an export credit insurance (an export credit guarantee) will differ.

3.2.5 Advantages and disadvantages of a buyer credit[122]

A. Exporter's perspective

An exporter (a contractor) is normally paid on a progressive payment method in a buyer credit, in which it receives full payment before they complete the construction (before they perform the export contract). Therefore, an exporter is not exposed to non-payment risk. As an exporter receives payment on a progressive payment basis or 100% downpayment, it enjoys the same satisfaction as cash payment. An exporter does not need to borrow funds to perform an export contract. After an exporter performs an export contract, not the total transaction but the margin (operational profit) only is added to the balance sheet as an asset, which results in the reduction of the liability ratio and the improvement of financial status. As an exporter's finance structure improves, the borrowing cost afterwards will go down.

As an importer provides finance, it surpasses an exporter in negotiating the contract price, which may result in the reduction of the contract amount. Furthermore, an exporter is obliged to provide a bank guarantee such as an advance payment guarantee (Ap-bond), and a performance

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122 Preposition: an exporter is a company with a good credit rating, and an importer is a company with a poor credit rating located in a developing country.

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guarantee (P-bond). An importer (an employer) requires that an export credit agency in an exporter's country provides export credit insurance (export credit guarantee) cover for a financial institution (or a lender).

B. Importer's perspective

In a buyer credit, an importer (an employer) can surpass an exporter in the negotiating contract amount to reduce the contract price. In the event an export credit agency provides export credit insurance (or export credit guarantee) cover, an importer can borrow funds with long-term credit and low spread.

However, an importer is exposed to the non-performance risk by an exporter. An importer should repay the loan to a financial institution (or a lender) even though an exporter fails to perform the contract. To mitigate non-performance risk by an exporter, an importer, normally, advances a payment guarantee (Ap-bond), and a performance guarantee (P-bond) is issued by financial institutions.

In the event that an exporter fails to perform the export contract, an importer shall make a demand call under an advance payment guarantee (Ap-bond), and performance guarantee (P-bond). With the payment from these guarantees an importer recovers what it paid and damages caused by the exporter's failure. A loan agreement stipulates the "Isabella Clause"[123] in order to obligate an importer to repay regardless of the performance of the contract by an exporter. An importer's financial structure gets worse for its liability ratio rises.

C. Financial institution's perspective

As an importer has a poor financial condition in general in a buyer credit, high spread is applied to a loan. Especially, in project finance, a financial institution requires extremely high spread. To mitigate risk, financial institutions cooperate to provide loans on a syndicated loan basis. In many instances, the term and risk go beyond the willingness of one bank to carry so that several banks act as a syndicate in financing large projects with a long term.[124]

Furthermore, a financial institution requires securities for an importer's default as well as for political risk in an importing country. One of the

123 They put the "Isabella Clause" in a loan agreement, which means that the borrower's obligation under a loan agreement is independent from, and is not affected by a supply contract.

124 Harry M. Venedikian, Gerald A. Warfield, at 21.

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most preferred securities is export credit insurance (export credit guarantee) by an ECA of an exporter's country, for export credit insurance (export credit guarantee) covers not only commercial risks but also political risks.

In project finance, a more detailed feasibility study is required. One of the main elements is DSCR which means "debt service coverage ratio". In a power plant project with a long-term off-take contract, DSCR at a minimum 1.3 is required, and without a long-term off-take contract, 2.0 is required.[125]

4. Project finance

4.1 Concept

Project finance may be used for a financing mechanism in an overseas construction project. Recently, the project finance mechanism has been popular in a huge overseas construction project. As a sponsor is not willing to bear the project risk, they establish a project company which is designed to bear the project risk.

Project finance can be defined as a financing mechanism under which a lender makes a loan based on future cash flow generated by the project alone.[126] Project finance differs from "financing projects" as a project may be financed in various ways.[127]

In project finance, it is not a pre-existing company but a newly established company commonly called "a project company or a special purpose company ("SPC")" which borrows funds from lending banks. A sponsor does not provide a guarantee for the repayment by a borrower, and the recourse to a sponsor is limited.[128] Moreover, there is little mortgage on the real property. In this respect, there is a widespread belief that project finance is too risky to fund. Project finance requires a complete understanding of the legal, commercial and political background to the project. The lending banks look at the cash flow and viability of a project as the security for repayment rather than the general creditworthiness or financial strength of the borrower (SPC).[129]

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125 E.R. Yescombe, at 273.

126 E.R. Yescome, at 1; Stefano Gatti, *Project Finance in Theory and Practice*, Academic Press (2008), at 2; Graham Vinter, *Project Finance*, 2nd ed., London Sweet & Maxwell (1998).

127 E.R. Yescome, at 1.

128 Scott L. Hoffman, *The Law and Business of International Project Finance*, 3rd ed., Cambridge University Press (2009), at 4.

129 Malcolm Stephens, at 104.

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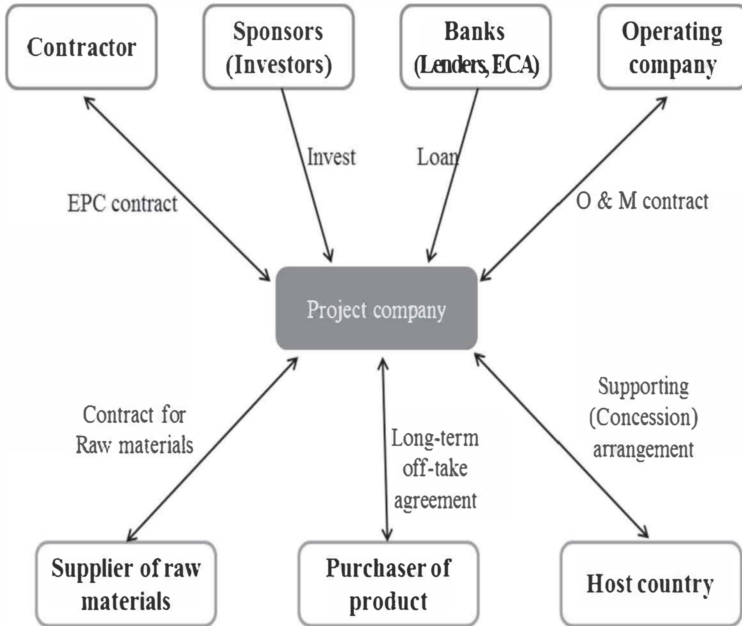
Project finance for natural resources was first developed in the Texas oil fields in the 1930s boosted by oil price rise.[130] Project finance for public infrastructure was developed through the Private Finance Initiative ("PFI") of the UK from the early 1990s, and thereafter increased worldwide in mobile phone networks in the late 1990s.[131] Project finance dramatically increased from the early 2000s in energy/power, infrastructure, and oil & gas. For instance, the global sector share in 2009 was:[132] energy/power (35%), infrastructure (28%), and oil & gas (22%), telecom (6%), petrochemical (3%), mining (3%), and industrial (3%).

Figure 4.5 Flow of project finance



Lending banks evaluate and analyze completion risk, resource risk, operating risk, market risk, currency risk, and political risk. After analyzing the overseas construction project, lending banks enter into a loan agreement with a borrower. Generally financial advisors play a

130 E.R. Yescome, at 6.
131 E.R. Yescome, at 6.
132 Project Finance February 2011, at 84.

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substantial role in concluding project finance by analyzing the project and preparing "preliminary memorandum information (PIM)" to solicit lending banks and export credit agencies. Where a project can be proved self-financing, export credit agencies may cover the risks of the project itself rather than take only the political risk of the sovereign government in whose country the project is being carried out.[133]

4.2 Features of project finance

Project finance differs from conventional corporate finance. Project finance is based on future cash flow from the operation of a new project, while conventional corporate finance is based on a company's assets and credit rating. Project finance is financed for a new project not an established business.

A borrower is not a pre-existing company, but a newly established company which is commonly called "a project company or a special purpose company ("SPC")". A project company has no business record or credit rating. Thus, a borrower (or a project company) does not have assets enough to repay the loan. The primary source of repayment of the loan is the cash-flow from the operation of the new project, not the asset of a borrower. The lenders rely mainly on the future cash flow of a project.

A sponsor (a parent company of a project company) does not offer a guarantee to the lenders for the repayment by a borrower. Recourse to a sponsor is very limited (or in many cases no recourse at all), and thus project finance is called "limited-recourse finance". Therefore, project finance requires a complete understanding of the legal, commercial and political background to the project. The lending banks look at the cash flow and viability of a project as the security for repayment rather than the general creditworthiness or financial strength of a borrower (SPC).[134]

Although the sponsor does not offer a guarantee, there are various securities such as guarantees for the completion of construction, licenses for project development, concession agreements by the host country's government, ownership rights to natural resources, a project company's assets, a long-term off-take agreement, escrow account, etc. The risks must be allocated equitably between all the parties involved, and well organized project finance allows for a high level of risk allocation.[135]

The volume of a project is normally huge, and a syndicated loan is

133 Richard Willsher, at 85.
134 Malcolm Stephens, at 104.
135 Stefano Gatti, at 3.

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normally required. Many parties are involved, and it takes a long time for a project's finance to be completed. Project finance involves various agreements or contracts other than a loan agreement such as engineering, a procurement and construction contract (EPC contract), an input supply contract, an off-take agreement, a concession agreement, an operating and management contract (O&M contract), a government support agreement, etc.

The "Arrangement on Officially Supported Export Credits" of the OECD provides that project finance is characterized by:[136]

a) The financing of a particular economic unit in which a lender is satisfied to consider the cash flows and earnings of that economic unit as the source of funds from which a loan will be repaid and to the assets of the economic unit as collateral for the loan.
b) Financing of export transactions with an independent (legally and economically) project company, e.g., a special purpose company, in respect of investment projects generating their own revenues.
c) Appropriate risk-sharing among the partners of the project, e.g., private or creditworthy public shareholders, exporters, creditors, and off-takers, including adequate equity.
d) Project cash flow sufficient during the entire repayment period to cover operating costs and debt service for outside funds.
e) Priority deduction from the project revenues of operating costs and debt service.
f) A non-sovereign buyer/borrower with no sovereign repayment guarantee (not including performance guarantees, e.g., off-take arrangements).
g) Asset-based securities for proceeds/assets of the project, e.g., assignments, pledges, proceed accounts.
h) Limited or no recourse to the sponsors of the private sector shareholders/sponsors of the project after completion.

5. Syndicated loans

5.1 Concept

Generally an overseas construction project is so huge and complex that no single bank would have the capacity to lend the entire loan on its own.

136 See APPENDIX 1: ELIGIBILITY CRITERIA FOR PROJECT FINANCE TRANSACTIONS, I. BASIC CRITERIA.

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Some banks are reluctant to solely bear the risk arising from lending huge loans, and others have difficulty in supplying a huge amount of money. The desire to spread the risk has given rise to the syndicated loan agreement under which a group of banks each commit to contribute a proportion of the loan under the syndicated loan agreement between lending banks and a borrower. Therefore, syndicated loans are more common than single loans (or a bilateral loan) in large overseas construction projects.

A bilateral loan is a loan between a borrower and a single bank.[137] A syndicated loan (or "syndicated bank facility") is a loan which is provided to a borrower by multiple banks.[138] An "International syndicated loan" is "a facility for which there is at least one lender present in the syndicated loan whose nationality is different from that of the borrower."[139]

In a syndicated loan, two or more banks make a loan to a borrower on the common terms. There is usually one bank that takes a leading position in making part of the credit, and syndicates the rest to other interested banks. A syndicated loan is a much larger and more complicated version of a participation loan. There are typically more than two banks involved in a syndication. The parties to a syndicated loan are normally a borrower, an arranger bank, lending banks, and an agent bank.[140] A syndicated loan is arranged and structured by an arranger bank(s), and is managed by an agent bank(s).[141] An arranging bank(s) will normally be an agent bank(s) in a syndicated loan.[142]

Under a syndicated loan, each lender should receive pro rata payment and should be treated equally. In order to preserve the principle of equality between members of a syndicate, some syndicated loan agreements attempt to cover these possibilities by providing that if a participant receives any payment, by set-off, benefit of security or otherwise, in a greater than pro rata proportion it will purchase proportions of the other participants' quotas or otherwise make such payments to the other participants as are necessary to establish pro rata receipts.

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137 Phillip Wood, *Law and Practice of International Finance*, Thomson & Reuters (2008), at 93.

138 Andrew Fight, at 1.

139 Blaise Gadanecz, "The syndicated loan market: structure, development and implications", *BIS Quarterly Review*, December 2004, at 77-78 (available at http://www.bis.org/publ/qtrpdf/r_qt0412g.pdf).

140 Phillip Wood, at 94.

141 Andrew Fight, at 1.

142 Andrew Fight, at 1.

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There are the "pari passu clause" and the "negative pledge clause" in a syndicated loan agreement to prohibit the borrower from discriminating among syndicate lenders. In normal syndication, all the lenders sign the loan agreement directly or through agents expressly on their behalf, and the obligations of lenders under a syndicate loan agreement are several. Each lender is responsible for its own commitment only, and is not responsible for the commitment of other lenders.

In another method of syndication, a leading bank is the only lending bank under the loan agreement but then arranges for other lenders to participate in the loan, usually without knowing the borrower. In this case, the participants are not the parties to a loan agreement. Therefore, the participants are not responsible for the commitment under a loan agreement.

5.2 Types of syndicated loans

There are largely three types of syndicated loans by the participant to the loan: the direct loan syndicate, participation syndicate, and mixed syndicate.

5.2.1 Direct loan syndicate

In a direct loan syndicate, a group of lenders will be a separate finance party (or a separate lender) to a loan agreement, and one loan agreement is concluded between respective finance parties (or separate lenders) and a borrower. Each finance party (or each separate lender) is obliged to provide its portion of the loan. Even though only one loan agreement is concluded, there are in reality as many separate loan agreements as there are finance parties.

The obligations of the finance parties under the loan agreement are several. Failure by a finance party to perform its obligations under the loan agreement does not affect the obligations of any other party under the loan agreement. No finance party is responsible for the obligations of any other finance party under the finance documents.

The rights of the finance parties under or in connection with the loan agreement are separate and independent rights and any debt arising under the loan agreement to a finance party from an obligor shall be a separate and independent debt. A finance party may, except as otherwise stated in the loan agreement, separately enforce its rights under the loan agreement.

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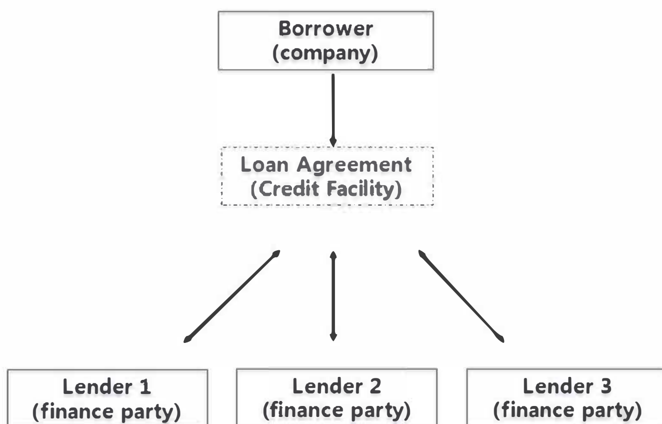
Figure 4.6 Direct loan syndicate



5.2.2 Participation syndicate

In a participation syndicate, a lead arranger only will be a finance party (or a lender) to a loan agreement, and no other participant (or other financial institution) will be a finance party (or a lender) to a loan agreement. A lead arranger only negotiates the terms of a loan agreement and signs a loan agreement. Other participants (or other financial institutions) conclude a participation agreement with a lead arranger, and therewith is formed a syndication.

Each participant disburses a loan of its portion, but they do not have the right to directly claim repayment to a borrower. However, in the case a lead arranger assigns a portion of its loan to a participant, that participant shall have the right to directly claim repayment to a borrower.

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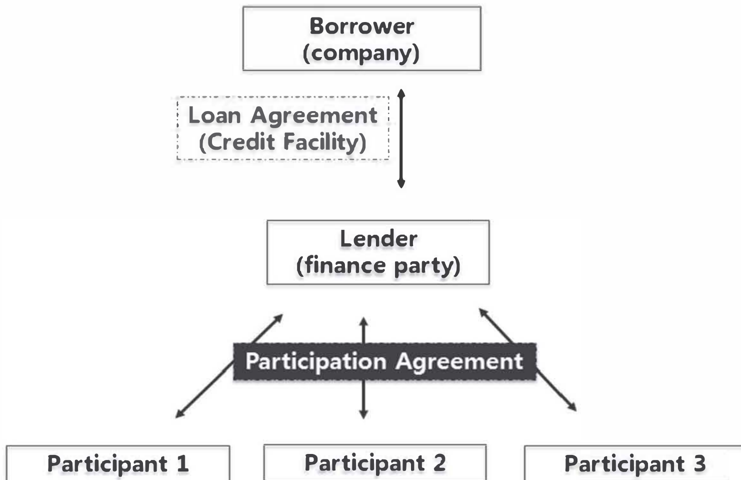
Figure 4.7 Participation syndicate



5.2.3 Mixed syndicate

A mixed syndicate is a combination of a direct loan syndicate and a participation syndicate. In a mixed syndicate, multiple lenders will be a separate finance party (or a separate lender) to a loan agreement, and one loan agreement is concluded between respective finance parties (or separate lenders) and a borrower just like a direct loan syndicate.

Each finance party will conclude a separate participation agreement with participants, and thus each finance party has its own participants. The participants will not be a finance party (or a lender) to a loan agreement, but a party to each participation agreement.

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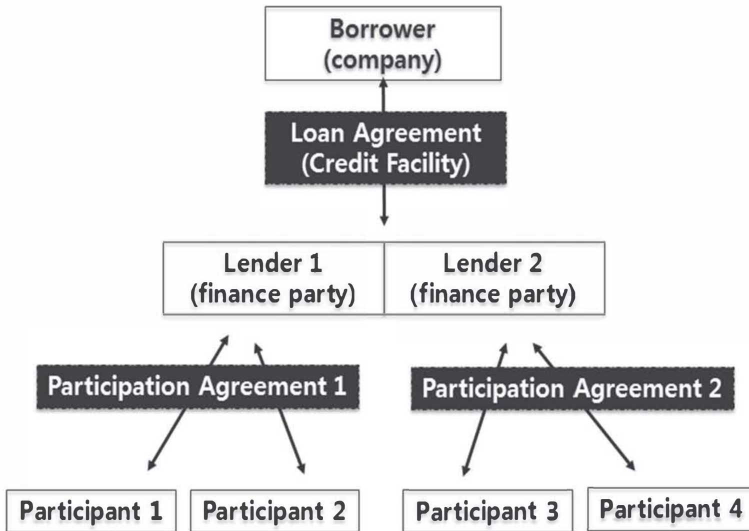
Figure 4.8 Mixed syndicate



5.3 Parties to a syndicated loan

The parties to a syndicated loan are normally: a borrower, a lead arranger (or an arranger bank), lending banks (or lenders), and an agent bank.

Syndication begins by a borrower's grant of a "mandate" to negotiate and syndicate to an arranger (or a group of arranging banks). An arranger arranges the loan on the financial terms set out in a term sheet. The term sheet states the basic terms of the loan such as facility purpose, loan amount, term, repayment schedule, interest margin, fees, any special conditions, etc. Sometimes there is a provision that an arranger may revise the terms or structure of the loan, and this provision is called "market flex".[143]

A lead arranger assists a borrower in preparing a preliminary information memorandum ("PIM") or prepares a PIM by itself. A lead arranger solicits interest from banks and negotiates the finance documents. An arranger is often a party to the loan agreement just like other participants. A lead arranger's role is often completed once the finance

143 Phillip Wood, at 94.

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documents are executed, but a lead arranger usually continues their involvement in a syndicated loan by acting as an agent bank.[144]

A lead arranger is normally not responsible for the legality, validity, effectiveness, adequacy or enforceability of any Finance Document or the Project Security or any other agreement, arrangement or document entered into, made or executed in anticipation of or in connection with any Finance Document or the Project Security. A lead arranger is normally not responsible for the adequacy, accuracy and/or completeness of any information (whether oral or written) supplied by any other mandated lead arranger, Agent, borrower, sponsor or any other person given in or in connection with any Transaction Document or the Information Memorandum or the transactions contemplated in the Transaction Documents, or any other agreement, arrangement or document entered into, made or executed in anticipation of, pursuant to or in connection with the Transaction Documents. A lead arranger shall not be liable for any action taken by it under or in connection with any Finance Document, unless directly caused by its gross negligence or willful misconduct.

A bank is appointed as an agent of the syndicate for the convenience of the management and administration of the credit facility. An agent bank is appointed under a loan agreement once the loan agreement is signed. An agent bank is an agent of the banks in a syndicated loan, not an agent of the borrower.[145] An agent bank is a channel for payment and communication. An agent bank arranges for loan disbursement, and keeps records of all payments made and received on behalf of the participants. An agent, acting with the authorization of the majority lenders, shall be entitled to refuse to make the disbursement of the loan if the request for the first disbursement is submitted to it after the Termination Date.

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144 Andrew Fight, at 19-20.
145 Phillip Wood, at 97.

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(Example 1: Mandate Proposal)

March 10, 2015

To the attention of:

Re.: K-ECA Covered Financing for XXX Oil Field Acquisition

Dear Sir,

Further to our previous conversations and your request for a proposal on Feb. 10, 2015, we are pleased to provide you herein with an indicative proposal related to the financing up to 50% of its 20% share of acquisition of offshore oil & gas fields in Louisiana from BBB Energy Company LLC incorporated in the United States.

On the basis of the information provided to us to date, we understand that SXXX Corp. is looking for K-ECA covered financing for 50% of its 20% share of the aforementioned oil & gas fields acquisition project i.e., US$ under the K-ECA overseas investment insurance program. In response to this requirement, we intend to provide a financing proposal as attached.

In view of our long experience in North America and our reputable relationship with K-ECA, we believe that ABC Bank is very well positioned to assist you in arranging the financing of the Project.

We hope that the attached offer will meet your requirements and remain at your disposal should you need further clarification.

This offer has been defined in accordance and subject to, inter alia, the following conditions:

1. Execution of an arranging mandate;

2. Receipt of all Project information and satisfactory due diligence of the Project and its contractual structure (the Contract to incorporate provisions in compliance with K-ECA requirements);

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3. Issuance of the K-ECA Insurance Cover in a form and substance acceptable to ABC Bank;

4. All necessary approvals from the United States and Korean authorities have been obtained;

5. Approval of ABC Bank's credit committee;

6. Satisfactory legal opinions and execution of documentation in a form and substance satisfactory to the Lenders;

7. No material adverse changes in our opinion on/in (i) the financial position of the Borrower, or (ii) the national or international money market, or (iii) the political, economic, financial, commercial, legal and fiscal environment of the transaction and/or of the United States and/or of South Korea which may then result in a reconsideration of our indicative offer.

The terms and conditions contained in this offer will be valid until Mar. 31, 2015.

Once again we reiterate our strong interest in working with your Company and assure you of our total commitment to provide you with the best possible execution with the complete support of our experienced team.

Yours faithfully,

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(Example 2: Mandate Letter)

March 30, 2015

Mr. XXX
Senior Country Officer
ABC Bank Seoul Branch
5F, XXX Bldg, XXXX
Seoul, 03187, Korea

RE: USD XXX million Loan Facility for AAA Oil & Gas Corp.

Thank you for the proposal dated March 10, 2015. Based on the proposal and subsequent meetings, we are pleased to mandate you to act as a Co-Lead Arranger for the ECA covered financing. The major terms and conditions for the financing are shown below.

1. Project: Oil Field Acquisition in the Gulf of Mexico
2. Borrower: AAA Oil & Gas Corp.
3. Co-Lead Arranger: XXX Bank and ABC Bank
4. Export Credit Agency: XXXX
5. Amount: USD XXX million
6. Tenor: 10 years
7. Interest Rate: Libor (6 m) +
8. Management Fee: USD XXX
9. Repayment: semi-annual installments
10. Availability Period: 1 month.

We are delighted to have the opportunity to work with your fine institution for the financing and look forward to continuing the relationship on a long-term basis.

Sincerely yours,

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(Example 3: Mandate Letter)

Dear Sirs,

It is our pleasure to award (Name of Lead Arranger) a mandate to arrange and lead manage our planned US$ (   ) syndicated loan as per your letter dated (   ).

- Amount:
- Tenor:
- Issue Date:

We look forward to your support and corporation for the successful completion of this issue.

Sincerely yours,

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(Example 4: Term Sheet)

Indicative Terms and Conditions

Financing Structure – ECA covered Export Finance
For the purchase of three Chemical Tankers

<u>Summary of Indicative Terms and Conditions</u>

Buyer/Borrower:	Three single purpose companies, on a joint and several basis, each registered in the Netherlands and directly or indirectly owned by ABC Co. ("ABC").
Lender:	XXX Bank (the "Bank").
ECA:	K-ECA and H-ECA.
Facility:	Export Finance loan.
Guarantor:	ABC Group ("ABC Group") will provide an unconditional and irrevocable guarantee for the obligations of the Borrower.
Purpose:	Financing of the export of three Chemical Tankers (the "Vessels").
Contract Amount:	Approximately USD 90,000,000 of which USD 61,500,000 is from Hankook Shipyards (60,000,000 contract amount and 1,500,000 interest during construction).
Facility Amount:	Approximately USD 67,000,000 – plus 100% of the credit insurance premium of which USD 45,000,000 is covered by K-ECA plus 100% of the Credit insurance premium.

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Final Maturity Date:	The date falling not later than 12 years after the earlier of i) 20 months after the signing of the building contract per vessel, and ii) May 31, 2017.
Availability Period:	From the signing of the Loan Documentation until the earlier of i) the date of the final drawdown of the Facility, and ii) May 31, 2017, with a maximum drawdown period of 20 months, unless extended by the Bank in writing.
Drawdown:	Drawdown under this Facility shall take place according to a schedule to be agreed upon between the Borrowers and the Bank following the independent verification of achieved milestones in the building process of the Vessels.
Repayment:	Subject to the prior approval by ECA's repayment conditions it shall constitute of 24 equal, consecutive semi-annual installments. The first repayment date is falling due six months after the earlier of i) the date of the final drawdown of the Facility, and ii) May 31, 2017.
Indicative Interest Rate:	Based on 6 months Libor, the Bank indicates the following interest rate for the export finance facility:
Interest Margin:	Floating interest rate: Pre-delivery: LIBOR plus a margin of % per annum; Post-delivery: LIBOR plus a margin of % per annum. If required by the Borrower, the Bank can provide a Fixed Interest Rate from the date of the final drawdown of the loan until the maturity of the loan, based upon 6 months Libor plus the margin as mentioned above.

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Default Interest:	1.00% per annum over the aforementioned Indicative Interest Rate. The Default Interest Rate will apply to all principal and interest amounts outstanding upon the occurrence of any Event of Default.
Management Fee:	0.65% flat over the Facility Amount, payable by the Borrower, at the signing of the Loan Documentation.
Costs:	Out of pocket expenses incurred in the implementation of the Facility embodied herein, including but not limited to legal expenses to be borne by the Borrower.
Credit insurance premium:	The credit insurance premium as indicated to the Bank will be paid as a one-time upfront fee, and can be included in the financing. When the Facility is repaid earlier than the estimated period a refund of the insurance premium will take place. The final premium will be calculated on the actual period that the loan has been in place. K-ECA and H-ECA informed us that the part of the premium for the unused period will be refunded in full and they will invoice administration costs only.
Commitment Fee:	0.75% per annum payable quarterly in arrears and to be calculated on a daily basis over the undrawn amount under the Facility Amount, commencing from the date of signing of the loan agreement.
Calculation Method:	All interest payable will be calculated on the basis of a 360-day year and the actual number of days elapsed.
Governing Law:	German Law will govern the financing documentation.

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Jurisdiction: The competent courts in Germany.

Loan Documentation: In addition to the specific terms mentioned herein, the Facility will be evidenced by mutually satisfactory documentation in the English language.

Conditions Precedent: Certain conditions (to be agreed upon) will have to be met before drawdown under this facility is permitted, including (but not limited to):

- The receipt of a comprehensive policy of the ECA for their respective tranches satisfactory to the Bank;
- Signed Documentation;

Evidence of payment of all fees, costs and expenses then due from the Borrowers under the agreement;

Security: Security will be shared pro rate parte between K-ECA and H-ECA;

- First right of pledge of the shipbuilding contracts in relation to the Vessels;
- First right of pledge of the refund guarantees provided by the refund guarantor in relation to the Vessels;
- Refund guarantor to be a first class international bank acceptable to the Bank;
- A first priority mortgage over the Vessels, in a jurisdiction acceptable to the Bank;
- Assignments of insurances over the Vessels (including but not limited to H&M, P&I, War Risk, MII/MAPI) to be taken out for the minimum of 120% of the outstanding under the Facility;
- A first priority Dutch law pledge on bank accounts of the Borrowers with the Bank;
- A first priority pledge of the shares of the Borrowers;
- A first priority assignment of all earnings of the Vessels; and
- An unconditional and irrevocable guarantee from the Guarantor.

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Security Maintenance:	The indebtedness outstanding under the Facility shall not exceed 80% of the Vessel's fair market value as determined by the Bank's broker/valuer. The loan to value shall be determined annually with the first time one year after delivery of the Vessels. If the loan to value is not maintained the Borrowers shall, at its option, make appropriate prepayments (without compensation) or grant additional security reasonably acceptable to the Bank.
Financial Covenants:	During the full term of the Facility, ABC will comply with the following financial covenants: - Interest Coverage Ratio minimum 1.5; - Consolidated Solvency Ratio >25% and minimum USD 20,000,000; - Available Cash (including available undrawn credit lines) minimum 0.5% of total interest bearing debt. The financial covenants and underlying terms, such as but not limitative to, consolidated net debt, consolidated EBITDA and consolidated net worth will be specifically defined in the Loan Documentation. Financial covenants are to be calculated and reported semi-annually via a Compliance Certificate submitted by ABC to the Bank and to be approved by the Bank.
Confidentiality:	The indicative terms and conditions are strictly confidential and cannot be disclosed to any third party without prior written consent from the Bank.
Validity:	The terms and conditions as stated here above are valid till April 19, 2015.

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6. Independent guarantees (or standby letters of credit)

6.1 Concept

An independent guarantee (or a demand guarantee) may be used for the purpose of financing an overseas construction project. Independent guarantees are widely used in international business transactions to support performance obligations or payment obligations.[146] An independent guarantee (or a demand guarantee) is an irrevocable undertaking to pay a sum of money to a beneficiary (or a creditor) upon a complying demand.[147]

An independent guarantee (or a demand guarantee) is legally independent, irrevocable, and payable on demand. An independent guarantee (or a bond) is normally issued by a bank (or an insurance company) in favor of a creditor at the request of a principal (or an obligor).[148] In a conventional independent guarantee (or a demand guarantee), a guarantor (or a guarantor bank) irrevocably, absolutely, and unconditionally guarantees to pay a beneficiary (or a creditor) as primary obligor.

A guarantor in an independent guarantee (or a demand guarantee) undertakes to pay to a beneficiary (or a creditor) a sum of money if the principal (or an obligor) fails to complete his contractual duties. An independent guarantee is also referred to as a "demand guarantee", an "independent bank guarantee", a "bank guarantee", a "performance guarantee", or a "performance bond".[149] See "Schmitthoff's Export Trade: The Law and Practice of International Trade".[150]

> In practice, demand guarantees, performance bonds, performance guarantees and standby letters of credit have a similar legal character and resemble documentary credits in that they are primary in form, and generally conditional only upon presentation of a written demand for

146 Eric Bishop, at 78.

147 George Affaki, Roy Goode, *Guide to ICC Uniform Rules for Demand Guarantees URDG 758*, ICC Services Publications (2011), at 1; Carole Murray, et al., at 245; Roeland Bertrams, at 1, 13; the Uniform Rules for Demand Guarantee, 2007 Revision (URDG 758), Article 2; Sang Man Kim, "The Supreme Court of Korea's Decisions on the Fraud Exception in a Demand Guarantee", *Journal of Korea Trade*, Vol. 19, No. 3 (2015), at 42.

148 Roeland Bertrams, at 13.

149 George Affaki, Roy Goode, at 1; Carole Murray, et al., at 245; Roeland Bertrams, at 4, 13; the Uniform Rules for Demand Guarantee, 2007 Revision (URDG 758), Article 2; Indira Carr, at 503.

150 Carole Murray, et al., at 245.

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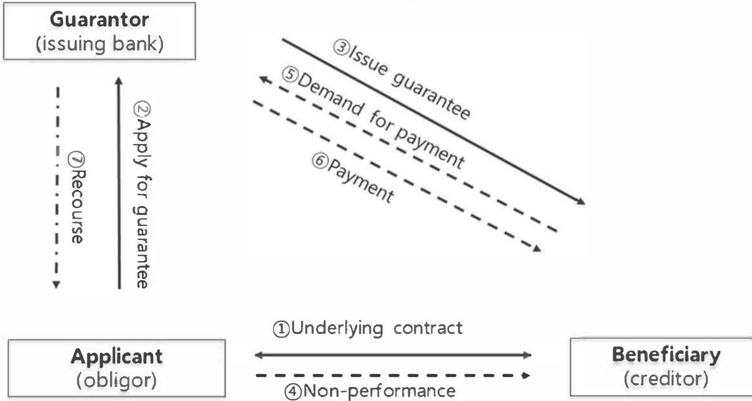
payment together with any other stipulated documents. The issuing bank is not concerned as to whether there has been any actual default by the principal.

Figure 4.9 Process flow of an independent guarantee



In an independent guarantee, a guarantor undertakes to pay a sum of money, but does not undertake fulfilment of a debtor's obligation under the underlying contract.[151] Most independent guarantees state that the guarantor undertakes to pay as a primary obligor or a principal obligor, not as a surety.[152] See relevant expressions below issued in independent guarantees in international transactions.

Example 1)

We, [Name of Guarantor Bank] the ["Guarantor"], as primary obligor and not merely as surety hereby irrevocably and unconditionally guarantee the payment to you of the following sums payable by the Borrower under the Agreement,

(A) The principal of the loan (the "Loan") up to [ ] US Dollars (US$ [ ]) which shall be repaid in sixteen (16) consecutive semi-annual installments;

(B) The interest on the Loan at the rate of five per cent (5.0%) per annum computed on the basis of the actual number of days elapsed and a year of 360 days; and

151 Sang Man Kim, "Reduction Clause in an Advance Payment Guarantee (AP-Bond) under an Overseas Construction Contract", *Journal of Korea Trade*, Vol. 23, No. 1 (2019); Anders Grath, at 78.

152 Suk, Kwang Hyun, "Various Issues on International Guarantees", *The International Commerce and Law Review*, Vol. 117 (2002), at 10.

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(C) The default interest on the unpaid Loan and interest at the rate of seven per cent (7.0%) per annum from the due date to the date of full payment thereof; and

(D) Any other amounts payable by the Borrower under the Agreement.

Example 2)

The undersigned, as primary obligor and not merely as surety, hereby irrevocably, absolutely and unconditionally guarantees the full, prompt and punctual payment when due.

Example 3)

The Guarantor hereby irrevocably and unconditionally guarantees to pay to the Lender any sum up to a maximum amount of USD 24,103,518.61 to be increased by all interests, interests on late payments, and treasury costs upon receipt by the Guarantor of a first demand in writing from the Lender and the written statement of the Lender stating the amount to be paid by the Guarantor.

Example 4)

This being stated, we, (Name of issuing bank and address), irrespective of the validity and the legal effects of the Contract and waiving all rights of objection and defense arising from the principal debt, hereby irrevocably undertake to pay immediately to you, upon your first demand, any amount up to (currency/maximum amount) (in full letters: ....).

In Edward Owen Engineering v. Barclays Bank International Ltd.,[153] the UK leading case of an independent guarantee, Lord Denning viewed that an independent guarantee is virtually a promissory note payable on demand. Unlike a documentary credit, a guarantee (or a demand guarantee) or a standby letter of credit serves as security for default, and is payable in the event of non-performance of an underlying contract or in the event of default by a principal (or an obligor).[154]

In some countries, standby letters of credit are often issued by banks instead of independent guarantees. A standby letter of credit has the same function as an independent guarantee, and is just another name for an independent guarantee.[155] A standby letter of credit and an independent guarantee are conceptually and legally the same device,[156] and are in practice the same as guarantees.[157]

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153 〔1978〕 QB 159.

154 Indira Carr, at 503.

155 Roy Goode, *Guide to the ICC Uniform Rules for Demand Guarantees*, ICC Publication No. 510 (1995), at 16.

156 Roeland Bertrams, at 13.

157 Carole Murray, et al., at 245; Roeland F. Bertrams, at 7.

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In some countries, banks may be restricted by law or common practice from issuing guarantees to third parties, so they issue standby letters of credit as the alternative. Standby letters of credit originated in the US because federal law was construed to prohibit banks from issuing guarantees, performance bonds, or insurance policies.[158] However, the power of American banks to issue guarantees was finally recognized in the final revised Interpretive Ruling 7.1016 of the Comptroller of the Currency of 9 February 1996.[159] Standby letters of credit have been widely used in the US instead of such guarantee. But they are also used in other parts of the world.

An independent guarantee (or a demand guarantee, a standby letter of credit) is normally unconditional and payable on demand without proof. This characteristic of an independent guarantee has triggered the fraudulent demand or the abusive demand. If a principal (or an obligor) wishes to protect himself from the fraudulent demand or the abusive demand, he can do so by imposing conditions for the demand such as a certificate issued by an independent third party.[160] However, in many cases, both creditors and guarantor banks are reluctant in such conditions. Banks in documentary credit or in independent guarantees are reluctant to be involved in the disputes between applicants and beneficiaries, instead they wish to recourse to applicants when paying the demand.

6.2 The independence principle and the fraud exception

6.2.1. The independence principle

An independent guarantee (or a demand guarantee, a standby letter of credit) is basically independent of the underlying transaction. This characteristic is called the “independence principle”. Most independent guarantees expressly state the “independence principle” .

Sang Man Kim, “The Supreme Court of Korea’s Decisions on the Fraud Exception in a Demand Guarantee”
(*Journal of Korea Trade*, Vol. 19, No. 3. (2015))

158 Ralph H. Folsom, et al., *International Business Transactions in a nutshell*, 10th ed., West Academic (2016), at 240.
159 Roeland Bertrams, at 6.
160 Indira Carr, at 503.
(In Gur Corp. v. Trust Bank of Africa Ltd. (1986), the P-bond was payable on production of a certificate signed by a certified surveyor.)

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In practice, a demand guarantee has similar legal characteristics and functions as a documentary credit in that it is primary in form, and normally payable only upon presentation of a written demand for payment together with any other documents stipulated therein. Under a demand guarantee the undertaking of the guarantor is not secondary, but primary in that there need not be any proven evidence of breach or failure under the underlying transaction. Most guarantees state that the guarantor undertakes to pay as a primary obligor or a principal obligor, not as a surety. A demand guarantee is independent from the underlying transaction (or the principal contract) under which it is issued. A demand guarantee is payable upon first demand by the beneficiary against the presentation of specified documents, and is unconditional. The independence principle promotes the utility of a demand guarantee by providing certainty of payment to the beneficiary who complies with the requirements of a demand guarantee.

The guarantor cannot avoid paying on the grounds of the defenses based on the underlying transaction.[1] For this reason, the undertaking of a demand guarantee is called an "abstract payment undertaking". A beneficiary's right to payment under a demand guarantee is defined solely by the terms and conditions specified in the guarantee in contrast to a traditional suretyship. A suretyship, an "accessory guarantee" or a "conditional guarantee" is an undertaking by the surety to pay the sum due from the applicant by way of debt or damages, as opposed to the guarantor's own primary obligation under a demand guarantee. The surety is entitled to assert all defenses that are available to the applicant. Unless a demand guarantee requires the beneficiary to present documents or proof sustaining the breach of the underlying transaction, the beneficiary is entitled to demand a payment without asserting, let alone proving, that the applicant is in breach of its obligations. When the specified documents are presented, the guarantor should pay regardless of the performance of the underlying contract and without question. The guarantor must make payment regardless of any dispute arising from the underlying contract. The independence principle enhances an assurance of payment, and has led to the equivalent of cash in hand.

The independence principle of a demand guarantee is similar to that of a documentary credit. A demand guarantee, however, would be more independent and primary in that it generally requires a written demand only, and is normally absolute and unconditional, and in that the beneficiary is entitled to payment without any proof of breach of the underlying transaction. In international transactions, a demand guarantee normally states a primary and independent undertaking to pay if the

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conditions of the guarantee are met. These features would be more advantageous in favor of a beneficiary. This explains why the use of a demand guarantee has been growing for assurance of payment in international transactions. On the other hand, the independence principle exposes the guarantor and the account party to the risk of fraudulent demand or abusive demand.

* * *

Sang Man Kim, "Reduction Clause in an Advance Payment Guarantee (AP-Bond) under an Overseas Construction Contract"
(*Journal of Korea Trade*, Vol. 23, No.1 (2019))

An independent guarantee is by its nature independent of the underlying contract, and "independence" from the underlying contract is essential in an independent guarantee. The Supreme Court of Korea has admitted the "independence nature" of an independent guarantee since 1994, and most Korean scholars have also recognized it. A beneficiary is not required to prove that a debtor (an applicant) has actually defaulted on the obligations under the underlying contract. The independence nature constitutes the unique value of an independent guarantee in that a beneficiary can be paid regardless of any dispute arising between him and the applicant.

The UN Convention[161] provides for the "independence nature" of a guarantee (or a standby letter of credit) in Article 2(1)[162] and Article 3.[163]

161 The UN Convention means the "United Nations Convention on Independent Guarantees and Stand-by Letters of Credit of 1995" by the UNCITRAL.
162 Article 2. Undertaking
(1) For the purposes of this Convention, an undertaking is an independent commitment, known in international practice as an independent guarantee or as a stand-by letter of credit, given by a bank or other institution or person ("guarantor/issuer") to pay to the beneficiary a certain or determinable amount upon simple demand or upon demand accompanied by other documents, in conformity with the terms and any documentary conditions of the undertaking, indicating, or from which it is to be inferred, that payment is due because of a default in the performance of an obligation, or because of another contingency, or for money borrowed or advanced, or on account of any mature indebtedness undertaken by the principal/applicant or another person.
163 Article 3. Independence of undertaking
For the purposes of this Convention, an undertaking is independent where the guarantor/issuer's obligation to the beneficiary is not:
(a) Dependent upon the existence or validity of any underlying transaction, or

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Even if the UN Convention is ratified by only 8 states (Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama, and Tunisia) as of August 2018 and the trade volume of those states is marginal, it could be used to supplement an operation of the rules and laws on a specific independent guarantee. The URDG 758 also provides for the "independence nature" of a demand guarantee as follows in Article 3:

Article 3. Independence of guarantee and counter-guarantee

a. A guarantee is by its nature independent of the underlying relationship and the application, and the guarantor is in no way concerned with or bound by such relationship. A reference in the guarantee to the underlying relationship for the purpose of identifying it does not change the independent nature of the guarantee. The undertaking of a guarantor to pay under the guarantee is not subject to claims or defenses arising from any relationship other than a relationship between the guarantor and the beneficiary.

b. A counter-guarantee is by its nature independent of the guarantee, the underlying relationship, the application and any other counter-guarantee to which it relates, and the counter-guarantor is in no way concerned with or bound by such relationship. A reference in the counter-guarantee to the underlying relationship for the purpose of identifying it does not change the independent nature of the counter-guarantee. The undertaking of a counter-guarantor to pay under the counter-guarantee is not subject to claims or defenses arising from any relationship other than a relationship between the counter-guarantor and the guarantor or other counter-guarantor to whom the counter-guarantee is issued.

The International Standby Practice (the "ISP98") has also provisions stipulating the "independence principle" of a guarantee (or a standby letter of credit) in Article 1.06.[164] Those provisions stipulating the "independence

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upon any other undertaking (including stand-by letters of credit or independent guarantees to which confirmations or counter-guarantees relate); or

(b) Subject to any term or condition not appearing in the undertaking, or to any future, uncertain act or event except presentation of documents or another such act or event within a guarantor/issuer's sphere of operations.

164 Article 1.06 Nature of Standbys

a. A standby is an irrevocable, independent, documentary, and binding undertaking when issued and need not so state.

b. Because a standby is irrevocable, an issuer's obligations under a standby cannot be amended or cancelled by the issuer except as provided in the standby or as consented to by the person against whom the amendment or cancellation is asserted.

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nature" of an independent guarantee show that independence guarantees including advance payment guarantees in international trades are to be by nature "independent" of the underlying transaction. An independent guarantee is also independent of the application for issuance between an applicant and a guarantor, and, therefore, the instructions by an applicant do not give an effect on payment obligation by a guarantor.

As an advance payment guarantee falls in an independent guarantee, it shares the independence nature of an independent guarantee, and, therefore, a beneficiary is entitled to repayment under an advance payment guarantee regardless of any dispute as to whether repayment is due under the underlying overseas construction contract. The overseas construction contract is of course the context and cause for the advance payment guarantee but is nevertheless a separate contract between different parties. An advance payment guarantee is subject only to its terms and conditions, not to the clauses of the overseas construction contract unless they are incorporated in an advance payment guarantee and accordingly form an integral part of an advance payment guarantee. A beneficiary's right to make a demand for payment under an advance payment guarantee is to be determined solely by the terms and conditions specified in an advance payment guarantee. A guarantor should pay a demand for payment if the demand is complying solely with the terms and conditions of an advance payment guarantee. A guarantor cannot assert any defense arising out of the underlying overseas construction contract.

Therefore, it is, in theory, possible that the demand to be paid notwithstanding repayment by a contractor is not due under the overseas construction contract, in which case the contractor will be forced to recover the amount paid from an employer by taking legal action against

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c. Because a standby is independent, the enforceability of an issuer's obligations under a standby does not depend on:

i. the issuer's right or ability to obtain reimbursement from the applicant;

ii. the beneficiary's right to obtain payment from the applicant;

iii. a reference in the standby to any reimbursement agreement or underlying transaction; or

iv. the issuer's knowledge of performance or breach of any reimbursement agreement or underlying transaction.

d. Because a standby is documentary, an issuer's obligations depend on the presentation of documents and an examination of required documents on their face.

e. Because a standby or amendment is binding when issued, it is enforceable against an issuer whether or not the applicant authorised its issuance, the issuer received a fee, or the beneficiary received or relied on the standby or the amendment.

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him. In most cases, a contractor will be forced to file a suit in a foreign country, which will be very disadvantageous and expensive.

* * *

6.2.2. The fraud exception

Sang Man Kim, "The Supreme Court of Korea's Decisions on the Fraud Exception in a Demand Guarantee"
(*Journal of Korea Trade*, Vol. 19, No. 3 (2015))

The independence principle has contributed to securing the applicant's obligation, enhancing assurance of payment, and promoting international transactions. On the other hand, the independence principle brought the problems of fraudulent demand or abusive demand. Where there is fraud, forgery, or abuse, rather than a mere breach of the underlying contract, the independence principle should not be applied. Many courts have recognized a number of exceptions to the independence principle in order to provide a better balance between the need to maintain the international commercial value of a demand guarantee and the need to protect the interests of the applicant. An applicant may apply for an order restraining a guarantor from making payment on the grounds that a demand for payment is fraudulent, unfair, or abusive. Although fraudulent demand for payment is common in a demand guarantee and a documentary credit, abusive or unfair demand under a demand guarantee is more probable than under a documentary credit because an issuing bank, not an applicant, is to be the first port of demand for payment.

The 1978 Uniform Rules for Contract Guarantees (the "URCG 325") has a provision requiring the production of a judgment or an arbitral award, or the principal's written approval of the claim and its amount in order to deal with the problem of unfair demand (Article 9), but the requirements proved too removed from dominant banking and commercial practice to obtain general acceptance, finally resulting in that the URCG 325 has not been successful. Although the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit of 1995 (the "UN Convention") has a provision specifying the fraud exception for fraudulent demand (see Article 19), it is not widely used in international transactions for the small number of ratifying countries. On the other hand, the Uniform Rules for Demand Guarantee, 2007 Revision, ICC Publication no. 758 (the "URDG 758"), the International Standby Practice of 1998 (the "ISP 98") and the

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Uniform Customs and Practice for Documentary Credits, 2007 Revision, ICC Publication no. 600 (the "UCP 600") do not have provisions specifying the fraud exception for fraudulent or abusive demand because the fraud exception was excluded from the scope of these rules for the reason that the fraud exception has been addressed in different ways in different countries. The ISP 98 has rather a provision expressly excluding the matters related to defenses to honor based on fraud or abuse (Rule 1.05).

Although most jurisdictions admit certain exceptions to the independence principle, the ambit of the fraud exception has been debated and is controversial. The ambit of the exception varies from jurisdiction to jurisdiction, and from country to country in reality, and also there is a divergence of views not only between different legal systems, but also within the same legal system. Therefore, the fraud exception under a demand guarantee is more dependent upon each nation's local laws and local court's decisions, and the world wide uniform application and interpretation on the fraud exception are not performed. Therefore, it is of practical use to understand each jurisdiction's view of the fraud exception. It is necessary to understand whether or not a guarantor should pay a fraudulent or abusive demand, or whether the fraud exception should be admitted.

* * *

6.3 Types of independent guarantees

In an overseas construction contract, various types of independent guarantees (or demand guarantees) are required at each stage of the progress on the construction. At the time of bidding, a tender guarantee (or a bid bond) is required. Then at the time of conclusion of an overseas construction contract, a performance guarantee (P-bond) and an advance payment guarantee (Ap-bond) are required. At the time of completion of construction, a warranty bond (or maintenance bond) is required.

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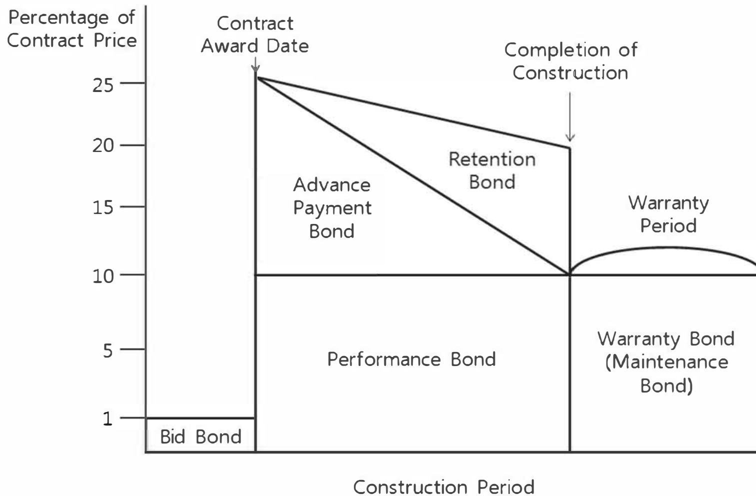
Figure 4.10 Types of guarantees at each stage in an overseas construction



A. Performance guarantee (P-bond)

A performance guarantee (or a performance bond) is a guarantee issued by a guarantor (usually banks) in favor of a buyer (or an importer, an employer) on behalf of a seller (or an exporter, a contractor), which guarantees that if a seller (or an exporter, a contractor) fails to perform his contractual obligations, a guarantor will pay to a buyer (or an importer, an employer) a sum of money in accordance with the performance guarantee.

A performance guarantee (or P-bond) is to secure the performance of any contract or contractual obligation (see Article 2 of the Uniform Rules for Contract Bonds (1993, "URCB")). A performance guarantee secures the performance of contractual obligation by a seller (or an exporter, a contractor) in favor of a buyer (or an importer, an employer).

The Uniform Rules for Contract Guarantees (1978, Publication No. 325, "URCG 325") provides that:

> 'performance guarantee' means an undertaking given by a bank, insurance company or other party ('the guarantor') at the request of a supplier of goods or services or other contractor ('the principal') or given on the instructions of a bank, insurance company, or other party so requested by the principal ('the instructing party') to a buyer or to an employer ('the beneficiary') whereby the guarantor undertakes – in the event of default by

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> the principal in due performance of the terms of a contract between the principal and the beneficiary ('the contract') to make payment to the beneficiary within the limits of a stated sum of money or, if the guarantee so provides, at the guarantor's option, to arrange for performance of the contract.

B. Advance payment guarantee (AP-bond)

In overseas construction transactions, it is the practice that an owner pays some downpayment to a contractor. An employer is entitled to repayment of advance payment paid in the event that a contractor is in default under an overseas construction contract. Thus, an overseas construction contract requires, as a security for such repayment, an advance payment guarantee (AP-bond) or a repayment guarantee[165] issued by a financial institution in favor of an employer.[166]

A guarantor, in an advance payment guarantee, irrevocably and unconditionally undertakes to pay on a simple demand for payment by a beneficiary (or an employer). When an employer is entitled to repayment of advance payment under an underlying overseas construction contract, but is not repaid, a beneficiary (or an employer) under an advance payment guarantee will demand for payment against a guarantor.

> An advance payment guarantee (AP-bond) is issued by the guarantor in favour of the beneficiary to secure the repayment of any sum or sums advanced by the beneficiary to the principal under or for the purposes of the underlying contract, where such sum or sums is or are advanced before the carrying out of works, the performance of services or the supply or provision of any goods pursuant to such contract. (see Article 2 of the URCB)

An advance payment guarantee under an overseas construction contract normally contains a "reduction clause" that the guaranteed amount will be automatically reduced as per the performance of construction.[167] In a shipbuilding contract, a refund guarantee (or a repayment guarantee) is

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165 Uniform Rules for Contract Guarantees (1978) by the ICC calls for a "repayment guarantee" instead of an advance payment guarantee (Article 2).

166 Carole Murray, et al., at 247; Roeland F. Bertrams, at 39; Simon Curtis, *The Law of Shipbuilding Contracts*, 3rd ed., Lloyd's Shipbuilding Law Library (2002), at 251.

167 Sang Man Kim, "Reduction Clause in an Advance Payment Guarantee (AP-Bond) under an Overseas Construction Contract", *Journal of Korea Trade*, Vol. 23, No. 1 (2019), at 36.

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issued as a security for repayment of the pre-delivery installment.[168] A refund guarantee under a shipbuilding contract normally contains an "increase clause" in contrast with a "reduction clause" in an advance payment guarantee under an overseas construction contract.[169]

The URCG 325 provides that:

> 'repayment guarantee' means an undertaking given by a bank, insurance company or other party ('the guarantor') at the request of a supplier of goods or services or other contractor ('the principal') or given on the instructions of a bank, insurance company or other party so requested by the principal ('the instructing party') to a buyer or to an employer ('the beneficiary') whereby the guarantor undertakes in the event of default by the principal to repay in accordance with the terms and conditions of a contract between the principal and the beneficiary ('the contract') any sum or sums advanced or paid by the beneficiary to the principal and not otherwise repaid to make payment to the beneficiary within the limits of a stated sum of money.

In a shipbuilding contract, a refund guarantee (RG) is required to secure the refund of the pre-delivery installments paid to a shipbuilder. A refund guarantee is to indemnify a buyer for losses resulting from a shipbuilder's default under the shipbuilding contract. A refund guarantee is one type of advance payment guarantee.

Sang Man Kim, "Why is a Refund Guarantee independent from a Shipbuilding Contract?"
(*International Journal of Economic Research*, Vol. 14, No. 15 (2017))

In a typical shipbuilding contract, a shipbuilder is paid in five instalments: the first to fourth instalments are paid before delivery ("pre-delivery instalments"), and the fifth instalment is paid at the time of delivery ("delivery instalment"). A buyer (or owner) is entitled to repayment of those instalments paid where a shipbuilder is in default under a shipbuilding contract. A shipbuilding contract requires, as a

168 Sang Man Kim, "Why is a Refund Guarantee independent from a Shipbuilding Contract?", *International Journal of Economic Research*, Vol. 14, No. 15 (Serials Publications, 2017), at 31.
169 Stephenson Harwood, at 47; Sang Man Kim, "Reduction Clause in an Advance Payment Guarantee (AP-Bond) under an Overseas Construction Contract", *Journal of Korea Trade*, Vol. 23, No. 1 (2019).

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security for such repayment, a refund guarantee (also referred to as "refundment guarantee", "advance payment bond", or "advance payment guarantee") issued by a financial institution in favour of a buyer for the account of a shipbuilder. An issuance of a refund guarantee is usually required as a condition precedent to the payment of the first instalment in a shipbuilding contract or to the effectiveness of a shipbuilding contract. Therefore, a shipbuilding contract may not be effective or go utile unless a refund guarantee is issued.

A financial institution, a guarantor in a typical refund guarantee, irrevocably and unconditionally undertakes to pay on a simple demand for repayment by a beneficiary, normally a buyer in a shipbuilding contract. When a buyer is entitled to repayment of the pre-delivery instalments under a shipbuilding contract and is not repaid, a beneficiary under a refund guarantee demands for repayment against a guarantor. A guarantor's obligation of payment in a refund guarantee shall be solely subject to the terms and conditions of a refund guarantee, not to the terms and conditions of an underlying shipbuilding contract. Once a guarantor receives such a demand for payment by a beneficiary, they will be entitled to immediate recourse against a shipbuilder under an arrangement for an issuance of a refund guarantee between a guarantor and a shipbuilder. Thus a refund guarantee is treated as a shipbuilder's contingent liability. Therefore, a financial institution, in practice, issues a refund guarantee within the credit limit of a shipbuilder. When the amount of a refund guarantee applied for exceeds the credit limit, a financial institution will require security such as mortgage, a personal guarantee by a parent company, an export bond insurance, etc. An export bond insurance, a kind of export credit insurance, by an export credit agency is well accepted as a security for an independent guarantee or a refund guarantee with a shipbuilder without credit limit available. A refund guarantee is considered as a significant financial risk in the shipbuilding industry.

Such a refund guarantee (or an advance payment guarantee) is, in reality, of no difference to an independent guarantee (also referred to as "independent bank guarantee", "bank guarantee", "demand guarantee", "first demand guarantee", or "on-demand guarantee") in international trade. And a standby letter of credit is used for the same purpose as an independent guarantee, and represents conceptually and legally the same device as an independent guarantee. As a typical refund guarantee falls in an independent guarantee, it shares the characteristics of an independent guarantee, in particular, independence nature.

* * *

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C. Tender guarantee (or bid bond)

When a company or government invites bidders to submit offers to complete a contract, it will be concerned to receive bids only from those genuinely capable and willing to sign a contract if their bid is selected. To protect themselves, potential buyers may ask bidders to submit a bond that can be called in the event that the bidder does not contract and/or fails to meet the other bonding requirements. The value of such bonds is typically a small percentage of the contract value. A business tendering or bidding for a contract may be requested to provide a bond guaranteeing that, if successful, a contract will be established and the successful bidder may have to provide bonds covering their performance and their warranties.

A tender guarantee is to secure the payment of any loss or damage suffered or incurred by the beneficiary arising out of the failure by the Principal to enter into a contract or provide a performance bond or other bond pursuant to such tender (see Article 2 of the URCB).

The URCG 325 provides that:

> 'tender guarantee' means an undertaking given by a bank, insurance company or other party ('the guarantor') at the request of a tenderer ('the principal') or given on the instructions of a bank, insurance company, or other party so requested by the principal ('the instructing party') to a party inviting tenders ('the beneficiary') whereby the guarantor undertakes in the event of default by the principal in the obligations resulting from the submission of the tender to make payment to the beneficiary within the limits of a stated sum of money.

D. Retention Bond (R-bond)

A retention bond (R-bond) is to secure the payment of any sum or sums paid or released to the principal by the beneficiary before the date for payment or release thereof contained in the underlying contract (see Article 2 of the URCB).

An overseas construction contract provides that an employer shall pay interim installments as the construction progresses, in which case an employer shall sometimes be entitled to retain a percentage of such interim installments, normally between 5% and 10% as security for defects.[170] When a retention bond (R-bond) is offered to an employer, an employer shall release the retention money to a contractor. As retention money

170 Roeland F. Bertrams, at 40.

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increases as the construction progresses, the maximum amount payable under a retention guarantee will increase accordingly. This is very similar to the increase clause in a refund guarantee under a shipbuilding contract.

E. Warranty guarantee (warranty bond, maintenance bond)

A warranty guarantee (or maintenance bond) is to secure contractual obligations relating to the maintenance of works or goods following the physical completion pursuant to a Contract (see Article 2 of the URCB). A warranty guarantee (or maintenance bond) is required to cover the defect during the warranty period once construction is completed. Nowadays, a performance guarantee is extended to cover the defect during the warranty period, and replaces a warranty bond. This is to reduce the inconvenience of issuing an additional guarantee in a single overseas construction project.

F. Payment guarantee

A payment guarantee is a guarantee issued by a guarantor (usually banks) in favor of a creditor (or an exporter, a constructor) on behalf of a principal (or an importer, an employer), which guarantees that if the principal (or an importer, an employer) fails to make payment, the guarantor will pay to a creditor (or an exporter, a constructor) a sum of money in accordance with the guarantee.[171] In international transactions, payment guarantees are issued on the instruction of an importer (or an employer) in favor of an exporter (or a constructor), to cover an importer's payment obligations.

A payment guarantee is similar to a documentary credit with regard to the function and the structure. However, a payment guarantee does not require shipping documents, but merely a written demand for payment. A payment guarantee is payable in the event of default under an underlying contract, while a documentary credit is payable in the case of the performance of an underlying contract. Recently, there has been a growing demand for payment guarantees (or standby letters of credit) assuring payment in sales transactions.

171 Roeland F. Bertrams, at 41.

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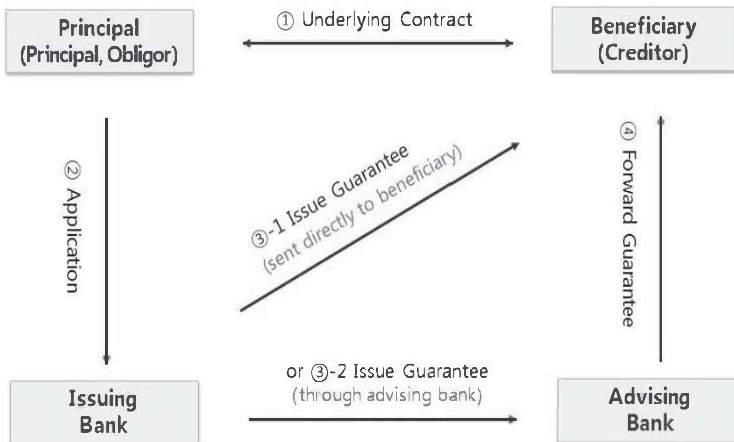
6.4 Direct or indirect guarantee

The question of who should issue a guarantee (or a standby letter of credit) is usually determined by a beneficiary, but could also depend on rules or local conditions in a beneficiary's country. There are also situations when a local bank in the country of the beneficiary must issue a guarantee (which is the standard procedure in many Islamic and/or developing countries) particularly if a beneficiary is a local authority or similar body.

In a direct guarantee, a guarantee (or a standby letter of credit) will be sent directly to a beneficiary in a foreign country. A guarantee can also be forwarded to a beneficiary through an advising bank at the beneficiary's location, but without any responsibility for that advising bank under a guarantee. The role of an advising bank is then only to forward a guarantee to a beneficiary, verifying the authenticity of a guarantor bank (an issuing bank).

Figure 4.11 Process flow of a direct guarantee



In an indirect guarantee, the principal's bank (1st instructing bank) issues a guarantee (a counter guarantee) to a local bank (2nd issuing bank), and the local bank (2nd issuing bank) will issue a guarantee in favor of a beneficiary against a counter guarantee. An indirect guarantee is also called a "4 parties guarantee".

In some countries it may even be stipulated by law that guarantees should be issued by a local bank. In these cases the principal's bank (the instructing bank) will issue a counter-guarantee as an indemnity to the

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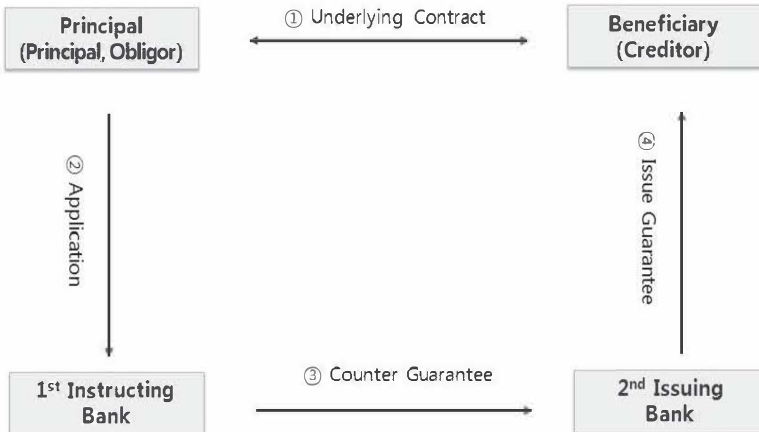
local bank, which will then become the issuing bank. In these situations, an "indirect guarantee (4 parties guarantee)" is issued.

The counter-guarantee would be accompanied by instructions about the wording of the guarantee to be issued – either in a specified form (if that is at all possible) or it will be issued according to local law and practice.

Figure 4.12 Process flow of an indirect guarantee



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(Example 1) Performance Guarantee (P-bond)

PERFORMANCE GUARANTEE

(*Date of Issue*)

To: (*Employer's (Beneficiary's) name and address*)

Re; Our Irrevocable Letter of Guarantee No.__________ as Performance Bond

By an agreement dated (   ) ("the Agreement") made between yourselves and (*Contractor's name*) (a company incorporated under the laws of the Republic of Korea and having its registered office at (*Contractor's address*)) ("the Contractor") the Contractor agreed, and became bound to inter alia, design, manufacture, supply, erect, assemble, deliver, commission, and warrant three units of quayside cranes and associated works.

The terms of the Agreement oblige the Contractor to provide you with a bond as security for the due performance of the Contractor's obligations under the Agreement.
In consideration of your accepting our obligations hereunder in discharge of the Contractor's obligations to provide such a bond, we, (*Guarantor Bank's name*) hereby and irrevocably and unconditionally undertake to pay you the sum of (*USD 10,000,000*) and accordingly, covenant and agree with you as follows:

1. Forthwith upon receipt of a written demand by you upon us at any time within the validity of this bond (as defined in item 7 in this bond) stating (i) that the Contractor has failed to perform its obligations under the Agreement specifying the Contractor's default, and (ii) the amount of the damage suffered by you as a result of the Contractor failing to perform such obligations, and notwithstanding any objection by the Contractor or any other person to set off or counterclaim, we shall forthwith pay to you the amount specified in such demand not exceeding in aggregate the stipulated sum.

2. For the avoidance of doubt, it is confirmed that you may make as many separate demands hereunder as you think fit, provided that the total amount paid by us hereunder or demanded from us hereunder, at any time, shall not exceed the stipulated sum.

3. All payments hereunder shall be made free and clear of and without deduction for or an account of any present or future taxes, duties, charges,

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fees, deductions or withholding of any nature whatsoever and by whomsoever imposed.

4. Our obligations hereunder shall not be affected by any act, omission, matter or thing which but for this provision might operate to release or otherwise exonerate us from our obligations hereunder, in whole or in part, including, but not limited to and whether or not known to us or you;
   (a) any time or waiver granted to the Contractor or any other person; or
   (b) any taking, variation, compromise, renewal or release of or any refusal or neglect to perfect; or
   (c) any limitation, disability or incapacity relating to the Contractor or any other person; or
   (d) any variation of or amendment or supplement to the Agreement or the works to be performed thereunder or any other document or security so that references in this bond to the Agreement shall include each such variation, or supplement; or
   (e) any unenforceability, invalidity or frustration of any obligations of the Contractor or any other person under the Agreement or any other document or security.

5. The benefit of this bond may be assigned by you at any time and references in the bond to "you": "yourselves" and the like shall include your successors and assignees.

6. This bond shall be governed by and construed in accordance with (*governing law*) and we hereby submit to the non-exclusive jurisdiction of the courts of (*jurisdiction*) over any claim arising out of this bond.

7. The validity of this bond is up to the date on which you notify us in writing that the Contractor has complied in all respects with the provisions of Clause (*Article XX*) of the Agreement.

8. This bond shall automatically become null and void, if no written demand as defined in item 1 in this bond from you is received by us within the validity of this bond, and then this bond shall be returned to us in the earliest manner.

In witness whereof this Bond has been executed on (*date of issue*).

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(Example 2) Payment Guarantee

LETTER OF GUARANTEE

Gentlemen;

In consideration of your delivering (*object of contract*) to (*Importer's name*) having its principal place at (*Importer's address*) ("Purchaser"), on a deferred payment basis under the purchase and sale agreement dated (*date of contract*) ("Agreement") entered into by and between you and the Purchaser, the undersigned, as primary obligor and not merely as surety, hereby irrevocably, absolutely and unconditionally guarantees the full, prompt and punctual payment when due (whether at stated maturity, by acceleration or otherwise) by the Purchaser of a series of (10) promissory notes ("Note") to be issued by the Purchaser to your order pursuant to the Agreement, respectively numbered "XXX 1" to "XXX 10", inclusive, the aggregate principal amount of which is US Dollars Thirty-Four Million (US$ 34,000,000) plus pre-delivery interest capitalized in accordance with the Agreement, the first of the said Notes to be due and payable six (6) months after the Last Shipment Date of the Commodities and the remaining Notes to be due and payable at intervals of six (6) months thereafter, and also guarantees the due and punctual payment by the Purchaser of interest on the principal amount of the Notes, the first such payment of interest to be due and payable six (6) months after the Last Shipment Date of the Commodities and subsequent payments to be made at intervals of six (6) months thereafter at the rate of zero point seven five per cent (0.75%) plus a six (6) month London Inter-Bank Offered Rate (LIBOR) per annum until maturity (by acceleration or otherwise) and thereafter at the rate of fifteen per cent (15%) per annum until full payment.

Interest on the principal amount of the Notes shall be calculated on the basis of a year of 360 days and the actual number of days elapsed.

The undersigned here waives the right to interpose any set-off or counterclaim of any nature or description in any action or proceedings arising out of or in any way connected with the Notes, this Letter of Guarantee or the Agreement.

In the event that the Purchaser fails to pay any amount of the principal or interest on any Note on the maturity date or upon acceleration on the Notes in accordance with their terms, the undersigned will pay to you or any assignees hereof the outstanding principal amount of the Notes which are then payable and interest (including default interest for the period from the due date to and including the date of actual payment of the full amount demanded by you or any such assignee) accrued thereon as aforesaid within five (5) days after receipt by us of a written demand from you or any such assignee including a

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statement that the Purchaser is in default of payment of the amount claimed in respect of the said Notes and/or interest thereon, without requesting you to take any or further procedure or step against the Purchaser or with respect to the Notes and/or interest in default; provided, however, that no demand hereunder may be made after the date which is sixty (60) days after the maturity date of the last maturing Note.

The undersigned hereby consents to any renewal, changes, extensions and partial payments of the Notes or the indebtedness for which they are given without notice to it, and consents that no such renewals, changes, extensions or partial payments shall discharge any party to the Notes or the undersigned from any liability thereon or hereon in whole or in part; provided that no amendment or extension of any of the Notes, the effect of which would be to increase the principal amount of the Notes and the interest payable thereon or to vary the dates or payment under the Notes shall be entered into by you with the Purchaser without the written consent of the undersigned.

The undersigned hereby agrees that this Letter of Guarantee and the undertakings hereunder shall be assignable in whole or in part to and shall ensure to the benefit of any holder of the Notes as if each of them were originally named herein; provided that upon each such assignment by you or by any other assignee, the assignor thereof shall give written notice to the undersigned of the name and address of any such assignee and the extent of the interest assigned to such assignee within ten (10) days of its taking place. The undersigned shall be entitled to treat any such assignee as the person entitled to the benefit of this Letter of Guarantee to the extent of his interest (as so notified to the undersigned) until the undersigned is notified of a further assignment.

Payments by the undersigned under this Letter of Guarantee shall be made in United States Dollars by telegraphic transfer to the account nominated by you in favor of you or your assignee without deduction, withholding or set-off of any kind.

In the event that any withholding or deduction is imposed on any payment to be made hereunder by law or by any taxing authority, except taxes on the income of the holder of the Notes, we agree to pay such additional amount as may be necessary in order that the actual amount received after deduction or withholding shall be equal to the amount that would have been received if such deduction or withholding were not required after allowance for any increase in taxes or charges payable by virtue of the receipt of such additional amount.

This letter of Guarantee shall come into full force and effect upon its issue and

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shall continue in force and effect until sixty (60) days after the maturity date of the last Note in the said series or until the full payment of the said (10) Notes and interest thereon whichever occurs first.

Notwithstanding the other provisions of this Letter of Guarantee, the undersigned shall be fully discharged of any further liability under this Letter of Guarantee if on any due date of the Notes, upon the giving of thirty (30) days prior written notice to you (or any assignee hereof), the undersigned pays by telegraphic transfer to the account nominated by you in favor of you or any such assignee an amount in United States Dollars equal to the full outstanding unpaid principal amount of such Notes together with accrued interest thereon up to the date of payment. Any such notice by the undersigned shall identify the Note(s) in question by number, shall specify the date of payment, shall be irrevocable and shall oblige you or any assignee thereof to cancel and surrender such Note(s) against such payment by the undersigned being made in full.

The obligations of the undersigned are joint and several with any other guarantee or security and are absolute and unconditional irrespective of any legal limitation, disability, incapacity or other circumstance relation to the Purchaser or any other persons, or any amendments or supplements to the Agreements, the Notes or any other documents, instruments or agreements contemplated therein or of the genuineness, legality, validity, regularity or enforceability of the Agreement, the Notes or any other documents, instruments or agreements contemplated therein.

This shall be a continuing guarantee and shall cover and secure any balance owing under the Notes, but you shall not be obliged to exhaust your recourse against the Purchaser or the securities which you may hold before being entitled to payment from the undersigned of the obligation hereby guaranteed.

The undersigned hereby represents and warrants that (a) it is duly organized, validly existing and in full compliance with the laws of (*importing country*) and in full legal right, power and authority to execute this Letter of Guarantee and to perform its obligations hereunder, (b) it has taken all appropriate and necessary corporate action to authorize the issuance of this Letter of Guarantee and the performance by it of its obligations hereunder, (c) the execution, delivery and performance of this Letter of Guarantee and the covenants herein contained will not violate or contravene any provisions of any existing treaty, law or regulation or any judgment, order or degree of any court, or governmental agency, or violate or result in a default under any mortgage, indenture, contract or agreement to which the undersigned is a party, or by which we or our assets are bound, (d) this Letter of Guarantee constitutes the legal, valid and binding obligation of the undersigned enforceable in

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accordance with its terms, and (e) the undersigned has obtained all necessary consents, licenses, approvals, and authorizations and registrations or declarations, with any governmental authority required in connection with the validity and enforceability of this Letter of Guarantee and the same are in full force and effect.

This Letter of Guarantee shall be governed by and construed under and in accordance with the laws of the State of New York, USA. The undersigned hereby irrevocably submits to the non-exclusive jurisdiction of the courts of the State of New York, USA.

The undersigned hereby consents to the service of process out of said courts by registered airmail, postage prepaid to the undersigned or in any other manner provided by law.

The undersigned represents and warrants that this Letter of Guarantee is a commercial and not a public or governmental act and the undersigned is not entitled to claim immunity from legal proceeding with respect to itself or any of its properties or assets on the grounds of sovereignty or otherwise under any law. To the extent that the undersigned or any of its property or assets has or hereafter may acquire any right to immunity from set-off, legal proceedings, attachment prior to judgment, other attachment or execution of judgment on the grounds of sovereignty or otherwise, the undersigned for itself and its properties and other assets hereby irrevocably waives such right to immunity in respect of its obligations under this Letter of Guarantee.

IN WITNESS WHEREOF, the undersigned has caused this Letter of Guarantee to be executed and delivered by its duly authorized representative as of the day and year first written above.

Yours very truly

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(Example 3) Standby Letter of Credit (for an AP-bond)

STANDBY LETTER OF CREDIT

Date: [ ]

Messrs.

[Name and Address of the Issuer]

Since our client, [AAA] Engineering & Construction Co., Ltd. ("[AAA]") acknowledges that [Name and Address of the Issuer] ("Issuer"), has issued an Advance Payment Bond in favor of [Name and Address of the Beneficiary] ("Beneficiary") for the amount of US$ [ ] ([ ] US Dollars) for the [Name of Project], and that [AAA] has a share in this indemnity of US$ [ ] ([ ] US Dollars) representing [ ]% of the Advance Payment Bond, we, the BBB Bank, issue in your favor this Standby Letter of Credit.

According to Article XIV, Section [ ] of the Agreement between the Issuer and [AAA], we herewith irrevocably undertake to pay you on first demand, without any reservation and notwithstanding any objection by [AAA], any amount you demand up to US$ [ ] ([ ] US Dollars) upon receipt of your written request for payment duly signed confirming that the amount claimed under this Standby Letter of Credit is due because of a failure of [AAA] in the delivery of equipment and/or materials to the Construction Site in [Name of the Country].

Any payment made hereunder shall be made free and clear of, and without deduction for or on account of, any present or future taxes, levies, imposts, duties, charges, fees, deductions or withholdings of any nature whatsoever and by whomsoever imposed.

This Standby Letter of Credit shall remain valid and in full force and effect until [ ] or, if earlier, the date on which you notice to us that [AAA] has delivered the equipment and/or materials to the Construction Site in [Name of the Country]. If the notice date is later than [ ], this Letter of Credit shall automatically be extended for successive periods of [ ] months each, thereafter until the certification Date.

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This Standby Letter of Credit is issued subject to the International Standby Practices, approved on April 6, 1998, International Chamber of Commerce Publication No. 590.

For and on behalf of
[BBB Bank]

By: _
Name: [ ]
Title: [ ]

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(Example 4) Refund Guarantee in a shipbuilding contract

REFUND GUARANTEE NO. [M○○○○○○○○○○○○○○○○]

We hereby issue our irrevocable Letter of Guarantee number M○○○○○○○○○○○○○○○○ in favor of ○○○○○ Limited, of (address) Libera (hereinafter called the "Buyer") for the account of ○○○○○ SHIPBUILDING CO., LTD., a corporation dully organized and registered under the laws of the Republic of Korea, having its principal office at (address), Korea (hereinafter called the "Builder") as follows in connection with the shipbuilding contract dated 16 September, 20XX (as amended by an Addendum No. 1 dated 16 September, 20XX, and as otherwise may be amended from time to time, together "the Contract") made by and between the Buyer and the Builder for the construction of one (1) 50,300 DWT Product Oil/Chemical Tanker having Builder's Hull No. ○○○○○ (hereinafter called the "Vessel"). Other terms and expressions employed herein shall bear the same meaning as in the Contract, a copy of which has been provided to us.

In consideration of the Buyer entering into the Contract with our customer, the Builder, upon, in connection with the terms of the Contract, rescission in the circumstance of Article 10(f), the Buyer becoming entitled to a refund of the advance payments made to the Builder prior to the delivery of the Vessel, we hereby irrevocably guarantee (as primary obligor and not merely as surety only) the repayment of the same to the Buyer within seven (7) days after demand by the Buyer being initially US$ 3,287,500 (say US Dollars Three Million Two Hundred Eighty-Seven Thousand Five Hundred only) together with interest thereon at the rate of five per cent (5%) per annum computed from the respective dates on which such sums were paid by the Buyer to the Builder to the date of remittance by telegraphic transfer of such refund to the Buyer by the Builder.

The amount of this guarantee will be automatically increased upon the Builder's receipt of the respective installment, not more than three times, each time by the amount of the installment plus interest thereon as provided in the Contract, but in any eventuality the amount of this guarantee shall not exceed the total sum of US$ 13,150,000 (Say US Dollars Thirteen Million One Hundred Fifty Thousand only) plus interest thereon at the rate of five per cent (5%) per annum computed from the respective dates on which such sums were paid by the Buyer to the Builder to the date of remittance by telegraphic transfer of the refund to the Buyer by the Builder.

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This Letter of Guarantee is available against the Buyer's first written demand and the Buyer's signed statement (or that of the Buyer's assignee/transferee) certifying that the Buyer's demand for refund has been made in conformity with Article 10(f) of the Contract and the Builder has failed to make the refund within twenty-one (21) days of the Buyer's demand to the Builder. Such written statement shall identify (i) the number and amount of Installments in respect of which repayment has not been received, and (ii) the total interest payable in respect of the same on the assumption that payment of the principal sum outstanding is made by us five (5) Banking Days from the date of receipt of such statement. Refund shall be made to the Buyer within seven (7) days from the Buyer's demand by telegraphic transfer in United States Dollars to an account designated by the Buyer.

Our liability hereunder shall not be released, discharged or otherwise impaired by reason of any amendment or variation to the Contract or by any time, forbearance, waiver or other indulgence granted to or agreed with the Builder, any legal limitation, disability or incapacity of the Builder or the Buyer, any invalidity, irregularity, unenforceability, or otherwise of the Contract or the liquidation, bankruptcy, insolvency or similar of the Builder or the Buyer or any act, omission, defense or counterclaim or other event or occurrence which but for this provision might otherwise impair, release, discharge or reduce our liability hereunder.

Notwithstanding the provisions hereinabove, in the event that within thirty (30) days of the date of your demand to the Builder referred to above we receive notification from you or the Builder accompanied by written confirmation to the effect that an arbitration has been initiated and that your claim to cancel the Contract or your claim for refund thereunder has been disputed and referred to arbitration in accordance with the provisions of the Contract, we shall under this Letter of Guarantee refund to you the sum (not exceeding US$ 13,150,000 plus interest by the same manner hereinabove) due to you from the Builder pursuant to the award made under such arbitration immediately upon receipt from you of a demand for payment of the sum and copy of the award.

This Letter of Guarantee is a continuing guarantee and shall become null and void upon the irrevocable receipt by the Buyer of the sum guaranteed hereby or upon the unconditional acceptance by the Buyer of the delivery of the Vessel in accordance with the terms of the Contract and, in either case, this Letter of Guarantee shall be returned to us.

Any payment under this Guarantee shall be made without any set-off or counterclaim and without deduction or withholding for or on account of any

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taxes, duties, or charges whatsoever unless we are compelled by law to deduct or withhold the same. In the latter event we shall make the minimum deduction or withholding permitted and shall pay such additional amounts as may be necessary in order that the net amount received by you after such deductions or withholdings can be equal to the amount which would have been received had no such deduction or withholding been required to be made.

This Letter of Guarantee is assignable and we hereby confirm that we shall consent to any such transfer upon receipt of a written request by you so to do. This Letter of Guarantee is valid from the date of this Letter of Guarantee until such time as the Vessel is delivered by the Builder and accepted by the Buyer in accordance with the provisions of the Contract. In any such case, this Refund Guarantee shall be returned to us.

All demands or notices in connection with this Letter of Guarantee shall be validly given if sent by post, facsimile or e-mail to our office as follows;

This Letter of Guarantee shall be governed by and construed in accordance with the laws of England and the undersigned hereby submits to the non-exclusive jurisdiction of the courts of England and irrevocably appoints [XXXX BANK] as its agent to receive and accept service on our behalf of any legal proceedings in England.

Your faithfully

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CHAPTER 5

EXPORT CREDIT INSURANCE (OR EXPORT CREDIT GUARANTEE)

1. Introduction

1.1 Concept

Many Countries have established export credit agencies (ECAs) to promote exports through various supports including export credit insurance (or export credit guarantee).[172] The main aim of export credit agencies is to promote their exports by protecting exporters from commercial risks of importers, and from political risks of an importing country.[173]

Most countries provide export credits such as export credit guarantee, export credit insurance, direct credit/financing, refinancing, and interest rate support to support their exports.[174] Export credit insurance (or export credit guarantee) basically covers non-payment under an export contract.[175] Export credit insurance (or export credit guarantee) covers

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172 John E. Ray, at 1.

173 Eric Bishop, at 100.

174 OECD Arrangement on Officially Supported Export Credits (Jan. 2019). (TAD/PG(2019)1)

CHAPTER I GENERAL PROVISIONS

5. SCOPE OF APPLICATION

The Arrangement shall apply to all official support provided by or on behalf of a government for export of goods and/or services, including financial leases, which have a repayment term of two years or more.

a) Official support may be provided in different forms:

1) Export credit guarantee or insurance (pure cover).

2) Official financing support:

- direct credit/financing and refinancing, or

- interest rate support.

3) Any combination of the above.

175 See the UKEF website https://www.gov.uk/guidance/export-insurance-policy;

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export risks which are not normally covered by cargo insurance or marine insurance.[176]

Export credit insurance and export credit guarantee are included in the term “pure cover”.[177] An export credit insurance generally means cover provided directly to an exporter, while an export credit guarantee means cover provided directly to banks.[178] An export credit insurance is also called “export insurance”, “export credit guarantee”, or “trade credit insurance”.

An institution operating export credits such as export loan, export credit insurance, or export credit guarantee is called an export credit agency (“ECA”). Export credit agencies were in the early days either government departments or public corporations, but in recent years many have been privatized or are commercial companies. Export credit operated by an ECA on a government account is called “officially supported export credit”,[179] and that ECA is called an “official export credit agency”.[180] Official export credits could be granted to the exporters who cannot provide collaterals (securities) for export financing to commercial banks.[181]

Official export credit agencies do not aim at making a profit,[182] but do aim at supporting exports. Normally, export credit insurance programs (or export credit guarantee programs) by official export credit agencies charge less premium than commercial programs because they are operated for non-commercial purposes or they are supported by the government. Moreover, exporters can obtain financing at a lower interest rate with

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See the US EXIM Bank website https://www.exim.gov/what-we-do/export-credit-insurance; the US Department of Commerce/International Trade Administration, at 19.

176 See the UKEF website https://www.gov.uk/guidance/export-insurance-policy; See the US EXIM Bank website https://www.exim.gov/what-we-do/export-credit-insurance; the US Department of Commerce/International Trade Administration, at 19.

177 John E. Ray, at 21; OECD Arrangement on Officially Supported Export Credits (July 2018) (TAD/PG(2018)8) Article 5 a).

178 John E. Ray, at 21.

179 Malcolm Stephens, at 98-99; It is also called “public export credit” (see Peter Egger and Thomas Uri, “Public Export Credit Guarantees and Foreign Trade Structure: Evidence from Austria”, *The World Economy*, Vol. 29, Issue 4 (2006), at 400).

180 Malcolm Stephens, at 1; Carole Murray, et al., at 441.

181 Yehuda Kahane, “Insurance and Risk Management of Foreign Trade Risks”, Geneva papers on Risk and Insurance Issues and Practice (1986), at 275.

182 Carole Murray, et al., at 443.

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export credit insurances (or export credit guarantees).[183]

Whilst officially supported export credits promote national exports,[184] they have brought the concern that they may distort fair competition in international trades.[185] In 1978, the OECD prepared the "Arrangement on Guidelines for Officially Supported Export Credits" to provide a framework for the orderly use of officially supported export credits and to provide for a level playing field (whereby competition is based on the price and quality of the exported goods and not the financial terms provided) and working to eliminate subsidies and trade distortions related to officially supported export credits.[186] In January 2004, the "Arrangement on Guidelines for Officially Supported Export Credits" was renamed "the Arrangement on Officially Supported Export Credits". The Arrangement is a soft law and a gentlemen's agreement.[187]

1.2 Functions

Export credit insurance (or export credit guarantee) principally protects exporters from the risk of non-payment.[188] Export credit insurance (or export credit guarantee) significantly reduces the non-payment risk associated with an export transaction by providing an exporter conditional assurance that payment will be made even if a foreign buyer is unable to pay.[189] With export credit insurance cover (or export credit guarantee cover), exporters can protect their foreign receivables from various risks that could result in non-payment. Export credit insurance (or export credit

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183 Carole Murray, et al., at 443.

184 David Camino, Clara Cardone "The EU Proposal for a Council Directive on Export Credit Insurance: A Critical Evaluation", Geneva papers on Risk and Insurance Issues and Practice (1997), at 414.

185 Roberto Soprano, "Doha Reform of WTO Export Credit Provisions in the SCM Agreement: The Perspective of Developing Countries," *Journal of World Trade* Vol. 44 No. 3 (June 2010), at 611-632; Filip Abraham, Gerda Dewit, "Export Promotion Via Official Export Insurance", *Open Economies Review* (2000), at 6.

186 John E. Ray, at 2; OECD, the Arrangement on Guidelines for Officially Supported Export Credits Chapter See Chapter I.1 Purpose.

187 OECD, *Smart Rules for Fair Trade: 50 Years of Export Credits*, OECD Publishing (2011), at 7, 20.

188 See the UKEF website https://www.gov.uk/guidance/export-insurance-policy; See the US EXIM Bank website https://www.exim.gov/what-we-do/export-credit-insurance; the US Department of Commerce/International Trade Administration, at 19.

189 US Department of Commerce/International Trade Administration, at 19.

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guarantee) is one of the key security devices employed by an exporter.

As export credit insurance (or export credit guarantee) covers the risk of non-payment in international trades, banks are willing to finance the goods in transit. Export credit insurance (or export credit guarantee) programs are very useful for the facilitation of trade finance in combination with various types of trade finance. When export credit insurance (or export credit guarantee) backs an exporter's foreign receivables, commercial banks are willing to lend against assets otherwise excluded from the borrowing base.[190] Accordingly, utilizing an understanding of export credit insurance (or export credit guarantee) is often very essential to trade finance, in particular, for exporters with low credit.

Export credit insurance (or export credit guarantee) is issued in favor of exporters or their banks.[191] When an exporter can obtain export credit insurance (or export credit guarantee) for exports, the exporter can offer credit payment terms (or longer payment terms) to a foreign buyer.[192]

Export credit insurance (or export credit guarantee) basically provides protection against the non-payment risk, and it covers both political risks, as well as commercial risks. Export credit insurance (or export credit guarantee) normally covers both commercial risks (such as insolvency of the buyer, bankruptcy, or protracted defaults/payment delay) and certain political risks (such as war, terrorism, riots, revolution, currency inconvertibility, foreign currency transfer restriction, expropriation, and changes in import or export regulations) that could result in non-payment. Furthermore, when export credit insurance (or export credit guarantee) backs an exporter's foreign receivables, commercial banks are often willing to lend to an exporter with favorable terms against foreign receivables otherwise excluded from the borrowing base.[193]

Export credit insurance (or export credit guarantee) promotes exports by giving a variety of advantages to exporters. The key functions of export credit insurance include reducing non-payment risks, offering competitive payment terms, increasing exports with reduced non-payment risk and competitive payment terms, creating easy and accessible trade financing solutions, etc.[194] When an export credit insurance (or export credit guarantee) backs an exporter's foreign receivables, commercial banks are

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190 See the US EXIM Bank website at https://www.exim.gov/what-we-do/get-financing.

191 Richard Willsher, at 80.

192 Guillermo C. Jimenez, at 110.

193 See the US EXIM Bank website at https://www.exim.gov/what-we-do/get-financing.

194 US Department of Commerce/International Trade Administration, at 28.

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often willing to lend to an exporter with favorable terms against foreign receivables, otherwise excluded from the borrowing base.

However, export credit insurance (or export credit guarantee) does not cover physical losses or damages to the goods which are covered by commercial insurances such as cargo insurance, marine insurance, fire insurance, casualty insurance, etc.[195] The insured will not be indemnified when the non-payment is attributable to the non-performance of the underlying contract by the exporter such as delivery of defective goods, discrepancies of the documents in a documentary credit transaction.

The International Union of Credit and Investment Insurers ("Berne Union")[196] set the [Berne Union General Understanding][197] which regulates the starting point of credit, length of credit, minimum downpayment, and installment. One of the main purposes of the Berne Union is to work for the international acceptance of sound principles of export credit insurance and the establishment and maintenance of discipline in the terms of credit for international trade. As the Berne Union General Understanding restricts the length of credit of consumer goods within one year, medium- and long-term export credit insurance is applicable to exports of capital goods such as industrial plants, overseas constructions, and shipbuilding exports.

The Berne Union, in the Berne Union General Understanding, defines "short-term credit" as "up to and including one year", "medium-term credit" as over one year, and "long-term credit" as "over 5 years".[198]

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195 Carole Murray, et al., at 443; US Department of Commerce/International Trade Administration, at 19.

196 The Berne Union is an international not-for-profit trade association, representing the global export credit and investment insurance industry. The Berne Union was founded in 1934, and now has 85 members of government-backed official export credit agencies, multilateral financial institutions, and private credit insurers from 73 countries. (See the Berne Union website available at http://www.berneunion.org/.)

197 The Berne Union, The Berne Union General Understanding, 99654-RL, January 2001.

198 III. DEFINITION OF CREDIT PERIODS FOR GOODS AND SERVICES

The Berne Union defines Credit Periods as follows:-

(a) Short Term Credit

Up to and including one year's credit.

(b) Medium Term Credit

Over one year's credit. A formal division between Medium and Long Term Credit does not seem necessary, however, if this was required by any Member, then:

(c) Long Term Credit

should be regarded as over 5 years (i.e. Medium Term being up to and

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2. Main types of export credit insurance (or export credit guarantee)

2.1 Overview

There are various types of export credit insurance (or export credit guarantee) operated by export credit agencies (ECAs). The main basic types of export credit insurance (or export credit guarantee) would be a supplier credit insurance, a buyer credit insurance, a short-term export credit insurance, a medium- and long-term export credit insurance, an export bond insurance, and an investment insurance.[199] The terms of a specific export credit insurance (or export credit guarantee) differ from ECA to ECA,[200] although basic concepts are similar.

A supplier credit insurance protects an exporter from non-payment by an importer. An exporter purchases supplier credit insurance cover against the non-payment of their export. A buyer credit insurance protects a lender (a bank) from non-repayment by a borrower (an importer). A buyer credit insurance is usually used in medium- and long-term credit transactions.[201]

Within the Berne Union, a short-term export credit insurance (or short-term export credit guarantee) is defined as insurance (or guarantee) for exports with repayment terms of less than one year – and most often considerably less than this: 30, 60 or 90 days are standard, and a medium- and long-term export credit insurance (or medium- and long-term export credit guarantee) as insurance (or guarantee) for transactions with tenors longer than one year (often 3, 5, 7 and up to around 10 years), typically in support of capital goods exports and large infrastructure projects.[202] An investment insurance covers risks associated with direct foreign investment.

A short-term export credit insurance is used in a transaction of consumer goods, whilst a medium- and long-term export credit insurance is used in a transaction of capital goods such as overseas construction, ships, industrial plants, etc. A short-term export credit insurance is usually used in a type of supplier credit insurance. An export credit guarantee for pre-shipment finance (or a working capital loan guarantee) and an export bond insurance also would fall in export credit insurance (or export credit guarantee).

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including 5 years).

199 Malcolm Stephens, at 8-11.

200 Richard Willsher, at 81.

201 Malcolm Stephens, at 10.

202 Paul Heaney, "2017 Year end data in review", BU Spring Meeting Newsletter (2018), at 5-6.

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For instance, the Korea Trade Insurance Corporation (K-Sure), a Korean ECA, operates a short-term export insurance, and a medium- and long-term export insurance.[203] A short-term export insurance covers risks of non-payment of export proceeds in an export transaction due to political or commercial risks in transactions with a less than two-year payment period. Short-term export insurance is the most frequently used insurance product among various export insurances.

A medium- and long-term export insurance by the K-Sure covers risks of non-payment in an export transaction due to political or commercial risks in transactions with more than a two-year payment period. The K-Sure operates two types of medium- and long-term export insurance; a medium- and long-term export insurance (supplier credit), and a medium- and long-term export insurance (buyer credit). A medium- and long-term export insurance (supplier credit) is for an export transaction based on a supplier credit. "Medium- and long-term export insurance (supplier credit)" is selectively used as a security in an export transaction of capital goods (i.e., industrial plant, overseas construction, shipbuilding), while "short-term export insurance" is used in an export transaction of consumer goods. Medium- and long-term export insurance (supplier credit) covers risks of non-payment by an importer in an export transaction due to political or commercial risks, the payment term of which exceeds two years. A medium- and long-term export insurance (supplier credit) is typically considered more important than short-term export insurance for the payment term is longer and the risks are thus higher. A medium- and long-term export insurance (supplier credit) enables a financial institution to provide a loan to an exporter against long-term receivables for it is accepted as a security for the loan.

The volume of the total insured amount of a short-term export credit insurance (or short-term export credit guarantee) by all "Berne Union"[204] members was USD 2,237 billion, the volume of the total insured amount of a mid/long-term export credit insurance (or mid/long-term export credit guarantee) was USD 193 billion, and the volume of the total insured amount of an investment insurance was USD 46 billion in 2018.[205]

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203 See the K-Sure website at https://www.ksure.or.kr/en/product/product_01_01.do.

204 The Berne Union means "International Union of Credit and Investment Insurers".

205 Berne Union, *Berne Union Statistics 2018 YE.*

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2.2 Short-term export credit insurance (or short-term export credit guarantee)

A short-term export insurance covers risks of non-payment of export proceeds in an export transaction due to political or commercial risks in transactions with less than one year payment period. A short-term export credit insurance (or short-term export credit guarantee) is the most popular among export credit insurances (or short-term export credit guarantees). The volume of the total insured amount of short-term export credit insurance (or short-term export credit guarantee) by all Berne Union members was USD 2,237 billion in 2018.[206]

A short-term export credit insurance (or short-term export credit guarantee) provides cover against non-payment by a foreign buyer, and covers political risks in an importing country. Although the specific procedures or flows of a short-term export credit insurance (or short-term export credit guarantee) vary on a respective export credit agency, the very basic flows could be as follow:

- An exporter enters into an export contract with an importer.
- An exporter (insured) submits an application for an export credit insurance limit.
- An export credit agency conducts a credit investigation on an importer to establish an insurance limit, and issues an export credit insurance policy to an exporter.
- An exporter performs an export contract (i.e., ships the goods).
- An importer fails to make payment on the due date, or another event of default occurs.
- An exporter submits insurance claims.
- An export credit agency conducts an investigation and pays the insurance claims in the case the non-payment is not attributable to an exporter.

206 Berne Union, *Berne Union Statistics 2018 YE.*

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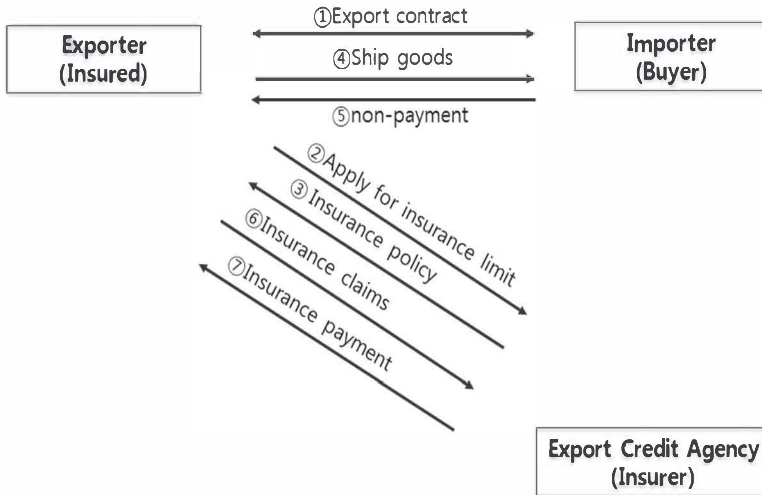
Figure 5.1 Process flow of short-term credit insurance



2.3 Medium- and long-term export credit insurance

2.3.1 Overview

Basically, a medium- and long-term export credit insurance (or mid- and long-term export credit guarantee) covers risks of non-payment in an export transaction due to political or commercial risks in transactions with more than one year payment period. Medium- and long-term export insurance (or mid- and long-term export credit guarantee) is provided in an export transaction of capital goods (i.e., industrial plant, overseas construction, shipbuilding).

There could be two types of medium- and long-term export credit insurance programs: a medium- and long-term export credit insurance (supplier credit), and a medium- and long-term export credit insurance (buyer credit). There could be medium- and long-term export credit insurance (pre-shipment) other than those two insurance programs. A medium- and long-term export credit insurance (pre-shipment) covers the risks associated with the impossibility of the export after concluding an export contract, but it is very rarely used.

Whilst a medium- and long-term export credit insurance (supplier credit) covers the risks of non-payment to an exporter by an importer, a medium- and long-term export credit insurance (buyer credit) covers the

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risks of non-repayment to a lender bank by an borrower (normally an importer). An exporter will be an insured under a medium- and long-term export credit insurance (supplier credit), whilst a lender bank will be an insured under a medium- and long-term export credit insurance (buyer credit). A medium- and long-term export credit insurance (buyer credit) is also called a "buyer credit insurance".

2.3.2 Medium- and long-term export credit insurance (supplier credit)

A medium- and long-term export credit insurance (supplier credit) covers the risks of non-payment to an exporter by an importer. In a supplier credit, an exporter can borrow funds with favorable terms and conditions by assigning a medium- and long-term export credit insurance (supplier credit) policy to a lender bank.

An exporter's credit rating in a supplier credit, is also replaced by that of the ECA providing a medium- and long-term export credit insurance (supplier credit) in the case the insurance policy is assigned to a lender bank, and a lender bank will thus charge a lower interest than otherwise.[207] A medium- and long-term export credit insurance (supplier credit) enables an exporter to reduce the funding cost. Thus, an exporter will be able to offer an importer very favorable payment terms such as longer payment terms, a lower interest rate for deferred payments, etc., which will bring them more chance of winning an export contract.

2.3.3 Medium- and long-term export credit insurance (buyer credit)

A medium- and long-term export credit insurance (buyer credit) covers the risks of non-repayment to a lender bank by a borrower (normally an importer). A medium- and long-term export credit insurance (buyer credit) policy or a buyer credit insurance policy by an official export credit agency is, in the international financial market, treated as equal to the payment guarantee by the government. Therefore, in a buyer credit, an importer's credit rating is replaced by that of the ECA providing export credit insurance. If a medium- and long-term export credit insurance (buyer credit) policy is provided, a lender bank will charge a lower interest than otherwise.[208]

Therefore, a medium- and long-term export credit insurance policy contributes to reducing the funding cost. In a buyer credit, an exporter's

207 Carole Murray, et al., at 443.
208 Carole Murray, et al., at 443.

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ability to arrange a medium- and long-term export credit insurance (buyer credit) policy is very essential. When an official export credit agency in an exporting country agrees to issue a medium- and long-term export credit insurance (buyer credit) policy, the company in that exporting country will obtain priority in a bidding.

As the figure below illustrates, a medium- and long-term export credit insurance (buyer credit) for an export contract (or an overseas construction contract) normally proceeds as follows:

- An exporter enters into an export contract (or an overseas construction contract) with an importer. In many cases, an exporter applies for a letter of intent to an export credit agency prior to submitting a bid or concluding a contract.
- A bank(s) and an importer conclude a provisional loan agreement.
- A bank(s) applies for a medium- and long-term export credit insurance (buyer credit) to an export credit agency.
- An export credit agency evaluates the application including an importer's creditworthiness, shipping market conditions, the importing country's political risk, etc., and then, issues a medium- and long-term export credit insurance (buyer credit) policy.
- A bank(s) and an importer conclude a final loan agreement.
- A bank(s) disburses funds to an importer according to a loan agreement, and an importer pays an exporter according to a contact with the funds disbursed. In practice, a bank(s) will disburse funds directly to an exporter.
- In the event an importer fails to repay the loan to a bank(s),
- A bank(s) makes insurance claims to an export credit agency.
- An ECA pays insurance claims.

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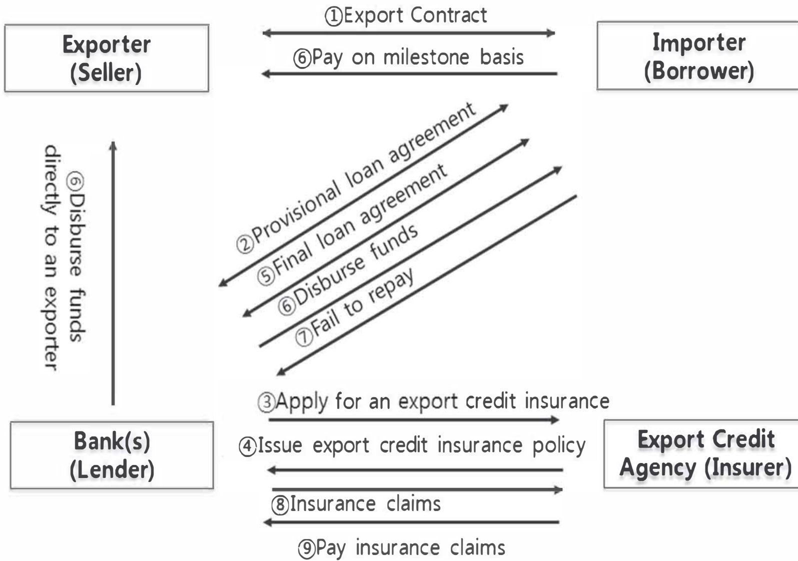
Figure 5.2 Process flow of medium- and long-term export credit insurance (buyer credit)



2.3.4 Medium- and Long-term Guarantee (by the US EXIM Bank)[209]

A Medium- and Long-Term Guarantee helps US exporters secure competitive financing for foreign buyers. A Medium- and Long-Term Guarantee guarantees long-term financing (generally up to 10 years) to creditworthy foreign importers. A Medium- and Long-Term Guarantee is generally used for financing purchases of US capital equipment and services.

A Medium- and Long-Term Guarantee to the lender is unconditional and transferable. A Medium- and Long-Term Guarantee covers local costs up to 30% and ancillary services (i.e., financial, legal or bank fees) may be included. A Medium- and Long-Term Guarantee helps foreign importers get competitive long-term financing which might previously have been

209 See the US EXIM Bank website at https://www.exim.gov/what-we-do/loan-guarantee.

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unavailable otherwise.

As a Medium- and Long-Term Guarantee is an officially supported export credit program, it requires that:

i) A Medium- and Long-Term Guarantee covers only the US content.
ii) Products must be shipped from the US to a foreign importer.
iii) Like other programs by the US EXIM Bank, a Medium- and Long-Term Guarantee may be offered in certain countries and under certain terms. The US EXIM Bank periodically published the "Country Limitation Schedule".[210]
iv) Exports of military or defense products and services (with some exceptions) are excluded.
v) EXIM Bank cannot support exports of military or defense products and services (with some exceptions), nor can we support purchases made by military buyers.

The functions of a Medium- and Long-Term Guarantee will be:
i) Risk mitigation for an export transaction with a particular foreign buyer.
ii) Financing for foreign buyers of US capital goods and related services.
iii) Secure entry to emerging markets.
iv) Longer repayment terms.
v) Flexible lender financing options, backed by a Medium- and Long-Term Guarantee, for foreign buyers of US capital goods and related services for long-term projects as well as medium-term.
vi) Coverage for 100% of commercial and political risks.
vii) No limits on transaction size.

2.4 Export bond insurance (Bond insurance)

2.4.1 Overview

In the export of capital goods such as overseas construction, industrial plants, or ships, a bond or a guarantee (i.e., performance guarantee, advance payment guarantee, warranty bond, etc.) is normally required as a security for an exporter's performance of a contract. There is a range of bonds or guarantees such as tender guarantee (or bid bond), performance guarantee (P-bond), advance payment guarantee (AP-bond), retention guarantee (R-bond), warranty guarantee (maintenance guarantee), etc.

210 The Country Limitation Schedule as of 28 March 2019 is available at https://www.exim.gov/tools-for-exporters/country-limitation-schedule.

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These bonds or guarantees are issued in favor of an importer by a financial institution at the request of an exporter.

A financial institution which issues such a bond or a guarantee shall pay to a beneficiary (normally an importer) on demand in the event an exporter fails to perform a contract or other event of calling occurs. A financial institution will recourse to an exporter once they receive a demand for payment from a beneficiary. Therefore, a bond or a guarantee is, in practice, considered as an exporter's contingent liability. For this reason, a financial institution will issue a bond or a guarantee within the credit limit of an exporter, if not, they will request a security in return for issuance of a bond.

An export bond insurance protects a guarantor (a bank) against unfair calling and/or fair calling by an importer (a beneficiary), or an exporter against loss caused by unfair calling by an importer. The details of an export bond insurance vary from ECA to ECA. Some ECAs issue a bond or a guarantee instead of providing an export bond insurance. Some ECAs provide export bond insurances to guarantor banks, while others provide export bond insurances to exporters. Some ECAs cover only unfair calling, while others cover both unfair calling and fair calling.

An export bond insurance policy is well accepted as a security for a bond, and facilitates issuance of a bond or a guarantee. When an exporter uses up its credit limits and is unable to provide a security, which occurs very often, an export bond insurance is essential for concluding an export contract (or an overseas construction contract). In many instances, an exporter applies to an ECA to provide an export bond insurance support prior to concluding a contract.

2.4.2 Operation of export bond insurance

As the figure below illustrates, an export bond insurance provided for a bank normally proceeds as follows:

- An exporter (or a contractor) enters into an export contract (or an overseas construction contract) with a foreign importer (or an employer).
- An exporter requests a financial institution (or a bank) to issue a bond or guarantee.
- A financial institution applies for an export bond insurance to an export credit agency. In practice, an exporter submits the application form on behalf of a financial institution.
- An export credit agency evaluates the performance competence of

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an exporter including financial standing, and issues an export bond insurance policy.

⑤ A financial institution (or a guarantor) issues a bond (or a guarantee) in favor of an importer.

⑥ An importer pays the downpayment, and progressive payments according to the performance of a contract.

⑦ In the event an exporter fails to perform a contract or another event of calling occurs,

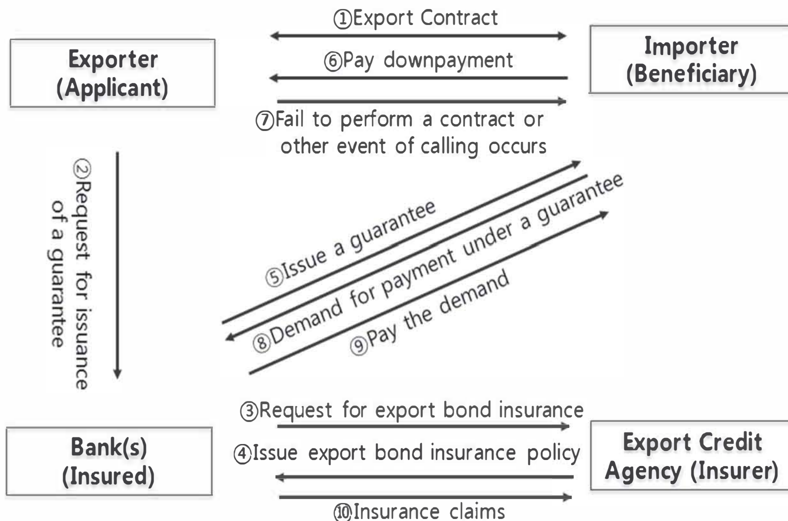
⑧ An importer demands payment under a bond (or a guarantee) to a financial institution (a guarantor).

⑨ A financial institution (a guarantor) pays an importer immediately upon receiving the demand for payment.

⑩ A financial institution (a guarantor) makes insurance claims to an export credit agency.

⑪ An export credit agency pays insurance claims to a financial institution (a guarantor).

Figure 5.3 Process flow of export bond insurance



The UK Export Finance (UKEF), an English ECA, provides Bond Insurance for UK exporters, where a bank issues a guarantee (Bid-bond, P-bond, AP-bond, R-bond, or W-bond) to a foreign buyer (an importer) or a

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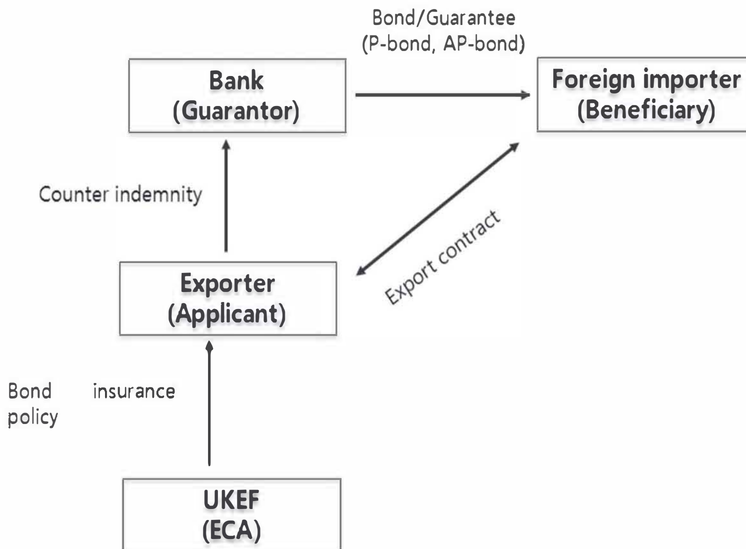
counter-guarantee to a foreign bank. Bond Insurance by the UKEF is an another name for an export bond insurance.

Bond Insurance protects an exporter against loss caused by the "unfair calling" of a guarantee issued to an importer. Bond Insurance also protects an exporter against loss caused by the "fair calling" of a guarantee due to certain "political events".[211] Bond Insurance by the UKEF is another name for an export bond insurance.

Figure 5.4 Process flow of Bond Insurance (by UKEF)[212]



2.5 Export credit guarantee (or working capital loan guarantee) for pre-shipment finance

2.5.1 Overview

Most export credit agencies (ECAs) provide export credit guarantees for pre-shipment finance (or for export working capital financing). An export

211 The UKEF website available at https://www.gov.uk/guidance/bond-insurance-policy.
212 The UKEF website available at https://www.gov.uk/guidance/bond-insurance-policy.

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credit guarantee for pre-shipment (or a working capital loan guarantee) is offered to a lending bank as security for pre-shipment finance (or a working capital finance pre-shipment) necessary for purchasing raw materials, manufacturing the goods, and/or purchasing the goods from local suppliers. With an export credit guarantee for pre-shipment (or a working capital loan guarantee for pre-shipment finance), the exporter is able to increase their borrowing capacity considerably.

2.5.2 Working Capital Loan Guarantee for pre-shipment (by the US EXIM Bank)[213]

The Export-Import Bank of the United States (US EXIM Bank), an American ECA, operates a Working Capital Loan Guarantee for pre-shipment export working capital (or for the performance of export transactions). A Working Capital Loan Guarantee guarantees repayment for a percentage of the working capital loan if the borrower (US exporter) defaults.

A Working Capital Loan Guarantee empowers exporters to unlock cash flow to perform export contracts and enables exporters to borrow more funds from financial institutions. A Working Capital Loan Guarantee is a 90% loan-backing guarantee to a lender bank. With a Working Capital Loan Guarantee, financial institutions will be willing to provide loans to exporters by decreasing repayment risk. However, the US EXIM doesn't replace commercial banks; it simply backs their loan and increases US exporters' borrowing power.[214]

A Working Capital Loan Guarantee can be used for paying for materials, equipment, supplies, labor, and other inputs to perform contracts, for purchasing finished products for export, and for posting standby letters of credit (serving as Bid-bond, P-bond, AP-bond, R-bond, or W-bond). With an expanded borrowing capacity by a Working Capital Loan Guarantee, exporters, in particular SMEs, are able to borrow more working capital. A Working Capital Loan Guarantee can cover both multiple export contracts and individual contracts, and can guarantee both revolving and transaction-specific facilities. A Working Capital Loan Guarantee requires no minimum or maximum transaction amount.

213 See the US EXIM Bank website available at https://www.exim.gov/what-we-do/working-capital.; https://www.exim.gov/what-we-do/get-financing.
214 See the US EXIM Bank website available at https://www.exim.gov/what-we-do/get-financing.

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With a Working Capital Loan Guarantee, exporters can borrow more working capital, secure the performance guarantees (bid-bond, P-bond, AP-bond) necessary to win and perform export contracts, and increase their global competitiveness. Functions of a Working Capital Loan Guarantee are:

- Flexible financing for large contracts.
- More attractive advance rates than conventional financing.
- Obtain the line of credit quickly from a qualified lender without an EXIM review.
- Inclusion of otherwise excluded collateral in the borrowing base.
- Lower collateral requirements for bid bonds, performance bonds, or advance payment guarantees.

2.5.3 Export Working Capital Scheme for pre-shipment (by UKEF)[215]

The UK Export Finance (UKEF), an English ECA, operates the Export Working Capital Scheme for pre-shipment export working capital. In the Export Working Capital Scheme for pre-shipment finance, the UKEF issues a guarantee to a guaranteed bank at the request of a UK exporter.

A guaranteed bank pays the UKEF premium for a guarantee with the interest received from an exporter. An exporter performs an export contract with the fund advanced by a guaranteed bank (i.e., an exporter purchases raw materials to manufacture the goods, an exporter purchases finished goods from a local supplier). An exporter gets payment from an importer after the performance of an export contract, and repays the loan with the payment received from an importer.

The Export Working Capital Scheme for pre-shipment finance assists UK exporters in gaining access to working capital finance both pre-shipment and post-shipment in respect of specific export related contracts. The Export Working Capital Scheme enables UK exporters to borrow export loans in circumstances where their banks are reluctant to provide the full facility amount.

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215 See the UKEF website available at:
https://www.gov.uk/guidance/export-working-capital-scheme-overview-and-how-to-apply#how-the-export-working-capital-scheme-works;
https://www.gov.uk/guidance/export-working-capital-scheme-overview-and-how-to-apply#overview.

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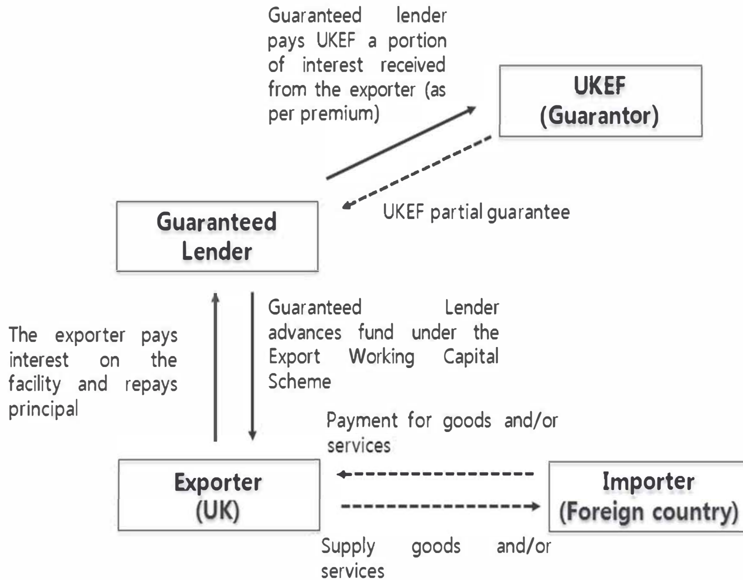
Figure 5.6 Process flow of the Export Working Capital Scheme for pre-shipment (by UKEF)



2.5.4 Pre-shipment Export Credit Guarantee (by K-Sure)[216]

The Korea Trade Insurance Corporation (K-Sure), a Korean ECA, operates a Pre-shipment Export Credit Guarantee. A Pre-shipment Export Credit Guarantee is designed to help exporters where exporters can produce a Pre-shipment Export Credit Guarantee as security toward securing pre-shipment finance. A Pre-shipment Export Credit Guarantee is very helpful, in particular, to small- and medium-sized enterprises (SMEs) which have difficulty in receiving trade financing from banks.

Once an export contract is entered into, an exporter normally relies on banks to secure loans to purchase raw materials and manufacture goods to be exported, but these banks normally require some type of security from an exporter. A Pre-shipment Export Credit Guarantee serves as a security for a bank to advance a loan to an exporter. A Pre-shipment Export Credit Guarantee is well accepted as a security for such pre-shipment finance.

216 The K-Sure website available at https://www.ksure.or.kr/en/product/product_01_05.do.

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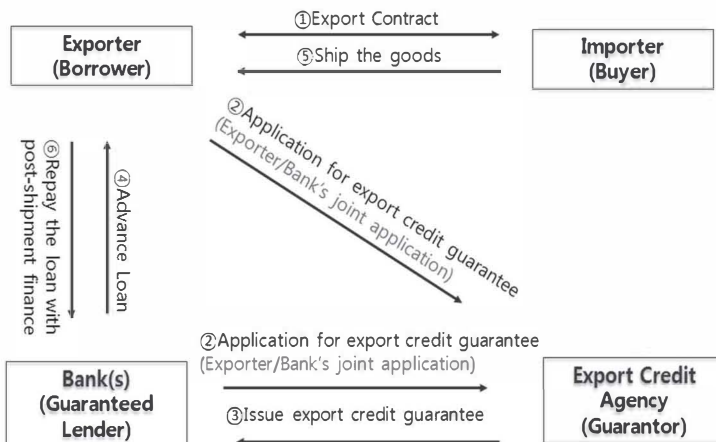
Figure 5.7 Process flow of a pre-shipment export credit guarantee (by K-Sure)



The process for a Pre-shipment Export Credit Guarantee is as follows:

① An exporter enters into an export contract under which an exporter shall be paid after the performance of an export contract.

② An exporter and a bank jointly apply for a Pre-shipment Export Credit Guarantee to the K-Sure.

③ The K-Sure issues a Pre-shipment Export Credit Guarantee to a bank after evaluation of an exporter and/or an export contract.

④ A bank advances funds under a Pre-shipment Export Credit Guarantee.

⑤ An exporter purchases raw materials and manufactures goods, or purchases the finished goods from a local supplier, and ships the goods.

⑥ An exporter repays the pre-shipment finance loan with the fund from the negotiation or from the payment by an importer. In the case of negotiation, a lender bank will be a negotiating bank, and a negotiating bank will set off the loan with the fund from the negotiation.

In the event an exporter fails to ship the goods, an exporter shall repay the pre-shipment finance loan with his own funds. In the event an exporter fails to ship the goods, or fails to repay the

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pre-shipment finance loan, the K-Sure shall pay to a bank and recourse to an exporter.

2.6 Foreign exchange risk insurance

2.6.1 Overview

An international business transaction is a transaction between two or more countries, and therefore, the currencies will normally differ between the parties. In the case the contract price is in a currency other than that in which the cost incurs, foreign exchange risk (or currency risk) will arise. Fluctuation of the foreign exchange rate might bring unexpected loss or profit, which is a significant risk in international business transactions. Foreign exchange risk results in actual monetary loss or damage. Foreign exchange risk management has been one of the significant concerns for most exporters, in particular, for small- and medium-sized enterprises ("SMEs"). The primary objective of foreign exchange management is not to make profit, but to minimize potential currency losses.

Depreciation in the contract currency will present an exporter with unexpected loss, while appreciation in the contract currency will present an importer with unexpected loss. The volume of foreign exchange risk depends on a particular currency and the period of payment. Soft currency will normally bring bigger risk as it is likely to fluctuate more. A transaction with soft currency can be a problem for the other party.[217] A movement in the foreign exchange rate creates unexpected losses or profits in a transaction. The choice of the contract currency is often more important than the contract price (or unit price) itself.

There are various techniques of hedging foreign exchange risk, and the techniques are a fixed forward contract, an option forward contract, and a foreign currency option.[218] However, the parties to an international business transaction find many of them unacceptable or impracticable. By using forward exchange or future exchange, the parties to an international business transaction can reduce foreign exchange risk. But such an exchange hedge incurs transaction costs. Some export credit agencies operate foreign exchange risk insurance (or foreign currency guarantee) for export, and a foreign exchange risk insurance (or foreign currency guarantee) operated by an export credit agency has been well accepted for foreign exchange risk hedging.

217 Charles W.L. Hill, et al., at 530.
218 Eric Bishop, at 107.

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2.6.2 Foreign Currency Guarantee (by the US EXIM Bank)[219]

Some strong foreign importers demand to pay in their local currencies to US exporters. In this case, US exporters are exposed to foreign exchange risks. These risks can be avoided by insisting on US Dollars, but insisting on US Dollars may lose out to competitors who are willing to accept local currencies. Moreover, insisting on US Dollars could result in the non-payment by a foreign buyer.

The US EXIM Bank operates the Foreign Currency Guarantee. The Foreign Currency Guarantee policy helps exporters to control foreign exchange fluctuation risks associated with export credit insurance (or export credit guarantee) by allowing an obligor to repay funds in the same currency as its revenue stream. The Foreign Currency Guarantee is offered in association with export credit insurance (or export credit guarantee) in buyer credit. The Foreign Currency Guarantee policy covers a number of hard and soft currencies, and the US EXIM Bank is willing to consider any currency to cover under Foreign Currency Guarantee.

2.6.3 Foreign Exchange Risk Insurance (by K-Sure)

The K-sure basically operates two types of foreign exchange risk insurance: a bidding arrangement and a forward arrangement. In practice, when an exporting company submits a bid proposal in foreign currency, it is difficult to determine the percentage likelihood that they will eventually be awarded and receive the revenue. Therefore, it is not easy to accurately measure the foreign exchange exposure at the time of bidding, and the exporting company will have difficulty in hedging the foreign exchange risk. If an exporting company takes out foreign exchange hedging and is not awarded the contract they will suffer heavy loss. Under a bidding arrangement scheme of a foreign exchange risk insurance, foreign exchange rates are fixed in advance when exporters bid for large exports to insure against currency depreciation after signing the export contracts.

Under a forward arrangement scheme of a foreign exchange risk insurance, exporters may freely subscribe to a forward rate contract within limits based on their export performance. In an export contract, an exporter will be normally paid in foreign currency, mostly in US Dollars or Euros.

219 See the US EXIM Bank website available at https://www.exim.gov/what-we-do/loan-guarantee/foreign-currency-guarantee.

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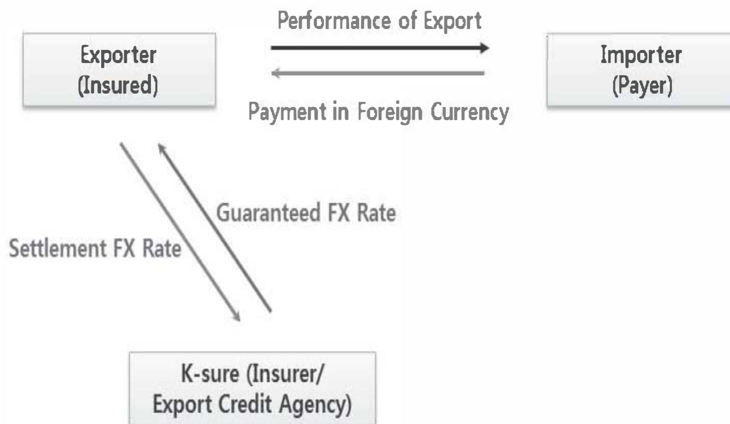
An exporter applies for an insurance limit for a foreign exchange risk insurance, and the K-sure sets an insurance limit valid for one year within the total amount of annual export of the exporter. The insurance limit is very similar to an open policy or a floating policy in marine insurance in that an exporter can be insured within the insurance limit only. However, an exporter is not obliged to have their exports insured. Therefore, an insurance limit itself cannot be considered an insurance contract, but a commitment for insurance.

An exporter will make an application for a foreign exchange risk insurance within the insurance limit, and the application shall include relevant information including but not limited to the insured amount and the settlement date. The K-sure will issue a foreign exchange risk insurance policy stipulating the guaranteed foreign exchange rate ("guaranteed rate"). On the settlement date, the K-sure will indemnify the losses or recover the gains calculated by the difference between the guaranteed rate and the market foreign exchange rate on the settlement date.

A foreign exchange risk insurance allows a pre-settlement application in which the exporter will notify the settlement date at least two days prior to the settlement date specified in the foreign exchange risk insurance policy, if not, the settlement date in the policy shall be deemed to be the actual settlement date. In the case of a pre-settlement application, the losses or the gains shall be discounted at the rate of the treasury bond.

Figure 5.8 Process flow of Foreign Exchange Risk Insurance (by K-Sure)



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2.7 Overseas investment insurance

Overseas investment insurance protects an investor against potential losses on overseas investments due to political risks in a host country. Most ECAs operate overseas investment insurance to promote their foreign investment.

In the US, the Overseas Private Investment Corporation (OPIC) operates political risk insurance to cover a variety of political risks[220] concerning American companies' foreign investment.[221] The UKEF operates Overseas Investment Insurance to protect a UK investor against potential losses on overseas investments due to defined political events that may arise in a non-OECD country.[222]

The Nippon Export and Investment Insurance (NEXI), a Japanese ECA, Overseas Investment Insurance is to cover losses suffered by a Japanese company with a subsidiary or a joint venture in a foreign country.[223] NEXI Overseas Investment Insurance covers the losses incurred when the relevant subsidiary or the joint venture is forced to discontinue business due to war, terrorism, or force majeure, such as a natural disaster and then covers the losses incurred when a Japanese company is unable to remit dividends to Japan due to the prohibition of foreign currency exchange or the suspension of remittance.

The K-Sure operates two types of overseas investment insurance: Overseas Investment Insurance (Investment Financing) and Overseas Investment Insurance. Overseas Investment Insurance covers overseas investment in stocks, properties, and other rights, or loans, surety obligations, etc., to promote Korea's overseas investments, and also covers the principal, dividends, and interests of overseas investments and ensures the amount to be paid in the event of non-payment due to the following reasons.[224] Overseas Investment Insurance (Investment Financing) covers

220 Political risks covered are:

- War, civil strife, coups and other acts of politically-motivated violence, including terrorism
- Expropriation, including abrogation, repudiation, and/or impairment of contract and other improper host government interference
- Restrictions on the conversion and transfer of local-currency earnings

221 See the OPIC website available at https://www.opic.gov/what-we-offer/political-risk-insurance.

222 See the UKEF website available at https://www.gov.uk/guidance/overseas-investment-insurance.

223 See the NEXI website available at https://www.nexi.go.jp/en/products/types/investment.html.

224 See the K-Sure website available at

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financial institutions that extend financing for Korean developers of overseas projects in the areas of natural resources, property, M&A, etc., that normally require large-scale long-term financing.[225]

The Multilateral Investment Guarantee Agency (MIGA) under the Word Bank Group guarantees to protect investments against non-commercial risks and can help investors obtain access to funding sources with improved financial terms and conditions.[226]

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https://www.ksure.or.kr/en/product/product_02_08.do.

225 See the K-Sure website available at https://www.ksure.or.kr/en/product/product_02_07.do.

226 See the MIGA website available at https://www.miga.org/.

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