

# Security versus trust in international trade

In international trade you need to be able to trust your business partner implicitly or protect yourself accordingly. Risks can only be mitigated, if you are aware of them.

Rudolf M. Pauli



Swiss companies have been active in the export trade for centuries. As a small country in the middle of Europe, the narrow limits of Switzerland's home market and the proximity of its neighbours have always favoured foreign trade and promoted a strong external orientation in the economy. Today the liberalization of trade has opened up the world's markets, while global communications and transport links, as well as close cross-border economic ties, have made even the remotest markets accessible to an increasing number of Swiss companies. With the progressive saturation of Western markets, more and more firms today are trying to generate additional growth in more exotic locations. Exporting goods to far-flung destinations, often thousands of miles away, can also be a risky business, however. Will goods arrive on time or at all and, more importantly, will you be paid? Trading partners, especially in new

markets, are often unfamiliar with the business practices employed by Swiss companies. The trust relationship between buyers and sellers can also be tested by difficulties relating to a country's legal, political and economic regime. Firms can only make full use of the opportunities offered by foreign trade if they are aware of the negatives as well as the positives and hedge the risks involved. An optimal trade finance solution and a transaction structure tailored to the needs of the individual firm is thus a key element in any export deal.

## Important exports

Switzerland has become more closely meshed with the international economy through its trade in goods and services in recent decades. Whereas in 1948 exports and imports made up just 21% and 27% of Swiss GDP respectively, exports now account for 42% and imports 36%. Last year Swiss firms exported some CHF 130 billion worth of goods and services, against CHF 120 billion in imports. About 16% of exported goods were destined for transition or emerging economies. Over the past twelve years these countries have increased their share of Swiss exports by more than a fifth in value terms – up from just under 13% in 1990. In particular, the Asian states (including China) and the countries of Central and Eastern Europe (Poland, Slovakia, Czech Republic, Hungary, Estonia, Latvia

and Lithuania) doubled their share of total Swiss exports over the same period. Particularly when trading with emerging economies and establishing new business relationships, it is extremely important to consider the various risks carefully and think over the terms of delivery and payment thoroughly before signing contracts. The services of partners who specialize in mitigating risk – via documentary credits, documentary collections, guarantees or complex export financing – are geared to both trade transactions with transition and emerging economies as well as with companies in industrialized countries.

Think of everything early on!

## Consider the risks

In foreign trade as with any other type of transaction, buyers are mainly concerned with ensuring that suppliers fulfil their obligations as agreed, while sellers are most interested in being paid on time. The sale of goods and services to foreign buyers entails additional and greater risks than domestic trade. The risks involved in export orders have to do with different ways of procuring raw materials, the manufacture and storage of goods, with prompt delivery and payment. Similar, albeit less pronounced, sources of risk are present in the provision of services. Buying and selling goods across borders thus entails greater risks because buyers are less able to judge the trustworthiness of foreign suppliers compared with domestic ones.



In addition, the remedies available for breach of contract by a business partner are more limited. The same is true for sellers or exporters, who not only run additional transportation risks but also a greater credit risk. The difficulty of evaluating specific country risks is an additional problem. Swiss exporters should therefore always ask themselves whether they have analysed every individual component of a transaction thoroughly enough and understood the risks involved. Delivering goods to Russia, for instance, is one thing; taking the client to court in Russia for non-payment is another. Likewise, exporters should structure their transactions in such a way that all risks are minimized or limit the structure of the transaction so that it can be executed profitably and without excessive risk to their firms.

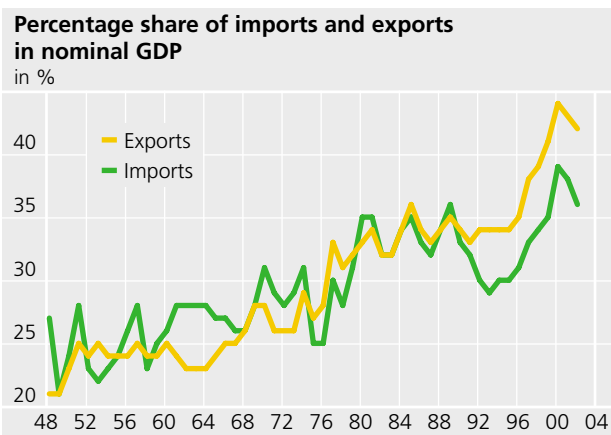
### What are the main sources of risk?

Country risk covers both political uncertainty and transfer risk. Either could prevent the performance of contracts. The outbreak of war, attempted coups, revolutions, embargoes, boycotts, protectionism or unexpected non-tariff barriers to trade in the contracting party's country can make it difficult, if not impossible, to comply with the contractual terms and conditions. Transfer risks arise if regulations prohibiting payments and transfers, exchange controls or moratoria make it impossible to convert or transfer the money paid by the importer in local currency. Business transactions with medium-to-long-term time horizons are particularly exposed to the risk of a change in regime. If your company has agreed to export machine parts to a buyer abroad over a two-to-eight-year period, for instance, you can hardly expect all

the contingent factors in the business environment to remain stable from the moment the contract is signed. It is essential therefore to plan for all eventualities early on, weigh up the consequences and take corresponding action to insure your risks.

Furthermore, there is always a currency risk in foreign trade. Although

transact a lot of business in foreign currencies – whether in euros, dollars or British pounds – systematic and comprehensive treasury and cash management is even more important. Bringing in experienced professionals from outside the firm can prove highly beneficial in such cases as it allows companies to focus on their core competencies.



As demonstrated by the long-term growth in exports as a percentage of nominal GDP, foreign markets are becoming increasingly important to Swiss companies.

many transactions are denominated in US dollars, euros or Swiss francs, currency risks do not disappear altogether. If the buyer's currency depreciates against the contractually agreed currency for the export transaction, the goods can suddenly become very expensive when the time comes to pay the bill. While, in principle, buyers have the option of purchasing the contract currency forward in the forex market, thereby fixing the price they will pay in foreign currency on the payment date, some of these forward markets are – depending on the currency – more liquid than others. If the value of their currency falls sharply, buyers who have not made hedging arrangements could have real trouble meeting their payment obligations. Take for example the losses suffered last year by the Brazilian real or the Turkish lira, which fell 44% and 26%, respectively, against the Swiss franc. If Swiss companies

### Know your business partner

From a financial perspective exporters run the risk of buyers refusing or being unable to pay for the goods. Conversely, foreign importers may find themselves in a situation where, in the event of non-performance of the contract, the seller of the ordered goods is unwilling or unable to reimburse any advance payments made by the buyer. Production problems (e.g. if intermediary inputs required for manufacturing are not available) or transport problems (if the container ship chartered for the carriage of goods is damaged at sea) can also represent a significant performance risk, leading – just like construction faults, defective components or incorrectly assembled goods – to delays and a subsequent impact on sales. As it is not always possible to resolve problems on the basis of mutual trust and as the parties involved do not know enough about each

other and each other's business practices, an extremely wide range of instruments has been developed around the world to reduce these risks, all of which are essentially used in very similar ways.

#### You can't be too careful

Today shipments of goods are accompanied by up to 200 individual documents, including those related to payment procedures. The measures available to ensure that the buyer fulfils his part of the contract range from advance payments to documentary credits and collections. If there is a relationship of trust between the seller (exporter) and the buyer (importer) and if there is no doubt as to the buyer's willingness and ability to pay, then a documentary collection will enable a bank to collect payment for the goods, even where the seller has made advance deliveries, upon presentation of certain documents. If the business relationship is less solid, documentary credits give the exporter the security of knowing that the goods delivered will be paid for in full, on time and in the correct currency. With a documentary credit, the bank undertakes to pay the seller a specified amount on condition that he presents, within a prescribed period of time, the documents stipulated in the terms of the credit confirming that the goods have been dispatched or the services provided. The documentary credit is a means of securing and executing payments and, despite its strict formal requirements, global trade would be unimaginable today without it.

#### Will the buyer pay?

When you sign a contract, you naturally expect the other party to honour the obligations contained in it.

With export transactions, however, it can be very difficult to evaluate the creditworthiness, say, of a Malaysian client. Conversely, Swiss importers perhaps know too little about the ability of their Argentinean suppliers to honour their contracts. With a guarantee, a bank undertakes to pay a certain sum to the beneficiary if the contracting party fails to perform his contractual obligations or to make an agreed payment. A stand-by letter of credit is used instead of a guarantee especially in import-export business with the USA or Canada. This guarantee undertaking, an invention of US banks, is based on uniform guidelines issued by the International Chamber of Commerce and lays down specific formal requirements. A surety often suffices in dealings with Swiss partners.

#### State support

When exporting large volumes of capital goods and with periods of performance extending over a number of years, companies often have to grant payment terms of several years. Swiss exporters may find themselves compelled by intense global competition to offer their customers financing for their products. Long-term commercial or export transactions may be particularly risky. Payment for the goods exported can be jeopardized by the political or economic situation in the importing country. The Export Risk Guarantee (ERG) scheme was set up by the Swiss government in 1934 as a means of combating unemployment and over time has taken on the function it has today as an instrument for export promotion and a

#### Risks in international trade

<b>Credit risk</b>	Inability and/or unwillingness to pay on the part of debtors and guarantors
<b>Country risk:</b> – <b>political risk</b> – <b>transfer risk</b>	– Risk that political events or measures may prevent the performance of contractual obligations – Impossibility of converting and transferring the amount paid in local currency into the currency of the contract
<b>Reputational risk</b>	Damage to the reputation of one or more parties participating in the commercial transaction
<b>Currency risk</b>	Appreciation and depreciation of a currency or fluctuations in the exchange rate between the invoice and the buyer's currency
<b>Manufacturing and performance risk</b>	Importer cancels or changes the order unilaterally, or importer is unable to perform his contractual obligations
<b>Delivery risk</b>	Contractual delivery is impossible or cannot be reasonably expected due to an increase in the credit and/or country risk, or lack of transportation after conclusion of the contract
<b>Transport risk</b>	Goods lost or damaged in transit
<b>Technical risk</b>	The product does not conform to contractual specifications; e.g. the machine supplied does not function correctly
<b>Settlement risk</b>	Non-compliance with deadlines, non-observance of national regulations, incomplete delivery, customs problems, missing or incorrect documents
<b>Mailing risk</b>	Late arrival or loss of documents



### Interview with Renato Ranza, Head of Sales and Advisory Trade Finance

*Renato Ranza, 40, was head of the UBS representative office in Tehran for seven years. At the end of 1995 he returned to UBS Lugano, from where he has been heading the Sales and Advisory Trade Finance unit since mid-2000.*

**UBS Outlook:** *What are the common risks involved in export transactions?*

**Renato Ranza:** Companies usually know the rules of their home market better than those of their trading partner. It is not easy doing business in a foreign market with a different culture, mentality and language. Unfamiliar legal and business practices require experience and a great deal of caution. Risks arise when business partners are overconfident at some stage that everything will go fine – whether due to ignorance or uncertainty – and therefore fail to take appropriate precautionary measures.

*In your experience, which types of risk are particularly important?*

**R.R.:** I would place commercial or credit risk top of the list; in other words, the risk of debtors not meeting their payment obligations or doing so very late. However, this risk can be mitigated via an irrevocable documentary credit or a payment guarantee issued by a bank in the buyer's country, transferring the risk from the exporter to the buyer's bank. The country risk can be covered with a confirmed documentary credit, a payment guarantee issued by a Swiss bank or, in the case of long-term business transactions, with the aid of the government's Federal Export Risk Guarantee (ERG) scheme. Particularly in our increasingly globalized world with a steadily growing number of new trading partners from far-flung countries it is important to look at the political and transfer risks.

*Reputation also plays a key role*

**R.R.:** All the parties involved in a business transaction should be aware that careless action not only damages their partners' reputations but also their own. Despite hedging financial risks, it is ultimately the exporter who always signs the contract with the client. Political and regulatory provisions, governing the environmental area for instance, the ship-

ment of goods to crisis areas or goods that can be used for another purpose are becoming increasingly important. Exporters must always ask themselves whether they know what use their goods will be put to and/or who the end-user is.

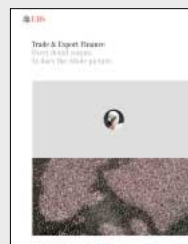
*What else must an exporter be aware of?*

**R.R.:** They must be particularly careful of delivering goods against open account to unknown clients or to high-risk countries. Exporters all too often make false economies here. In particular I would like to draw exporters' attention to the reputational risk in connection with money laundering. Especially if the client transfers money without using a conventional instrument such as a documentary credit, documentary collection or guarantee, exporters should ask themselves "Where does this money come from?"

If one of the above-mentioned instruments is used, the terms of payment must be formulated as clearly as possible. And when examining documentary credits received or when giving guarantees, especially in countries where the texts are prescribed, special care must be taken to scrutinize the wording. Every comma can be crucial in a critical situation.

*What message would you like to give to companies active in exports?*

**R.R.:** You should involve us as early as possible. Asking questions only costs time. Not asking them can cost money!



Detailed information is available in the Trade & Export Finance brochure and on [www.ubs.com/tef](http://www.ubs.com/tef)

means of supporting small and mid-sized businesses. The ERG covers specific risks – in particular risk arising from long-term contracts – for which there is no coverage available in the market: in addition to political risk, transfer risk, manufacturing risk and currency risk, the ERG can, on request, also cover the credit risk. However, the latter is only possible if the business partner is a state, a municipality or other public agency, or a company owned by the state or with public duties. While it makes complete sense from a regulatory point of view, the ERG does not – in contrast to similar institutions in other OECD states – insure the credit risk of private entities unless an ERG-approved bank guarantee can be furnished in the buyer's country. This can be seen as a significant competitive disadvantage in the global marketplace.

The financing and execution of trade transactions requires all those involved to act in partnership. Whatever the type of product that companies wish to import or export and whatever the type of trading partner or the country they hail from – knowing the quality of the parties and banks involved as well as the relevant legislation and guidelines is essential. Whether you are a small business or a major corporation, a thorough analysis of the risks associated with exporting goods and services and the involvement of professional partners enable both the buyer and the seller to reap the justified rewards of cross-border business. ■

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