

Settlement Methods and Risk-hedging for Domestic Sales in China (Part 2)

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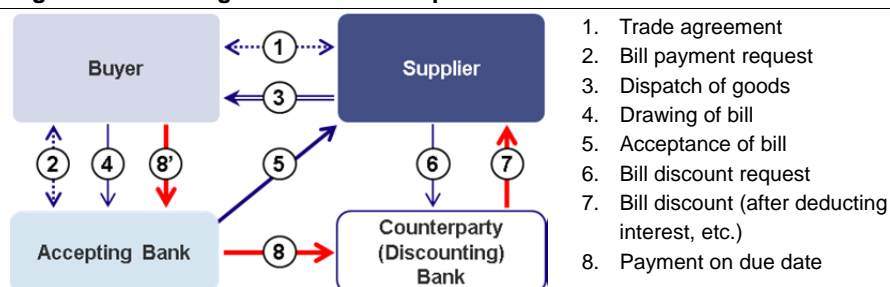
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In the first part of this report, the writer outlined various settlement methods which can be used in domestic sales activities in China. For this part, let's examine several bank-related transactional solutions that can be applied to mitigate related risks and secure payment collections for settlements. Please be aware that these transactional solutions are essentially based on the creditworthiness of the obligor instead of the party dealing with the bank, so the fees charged by the banks providing these transactions shall correspond to the creditworthiness of the obligors.

1. Discounting of Banker's Acceptance Bills

The discounting of banker's acceptance bills is namely a transaction where the holder of a banker's acceptance bill asks their counterparty bank to discount the bill for earlier encashment (see Fig. 1). The discount is provided based on the creditworthiness of the obligor (in this case, the bank accepting the bill). Therefore, even if payment is not made on the due date for reasons such as the bankruptcy or illiquidity of the accepting bank, the counterparty bank will not ask for the repayment of paid funds. As a result, the discounting of banker's acceptance bill can be used not only for early encashment but also to hedge the non-payment risk. As the huge transaction volume for this type of solution suggests, this method is perhaps the easiest and most popular way for cashing and risk-hedging in China today.

Fig. 1: Discounting of Banker's Acceptance Bills

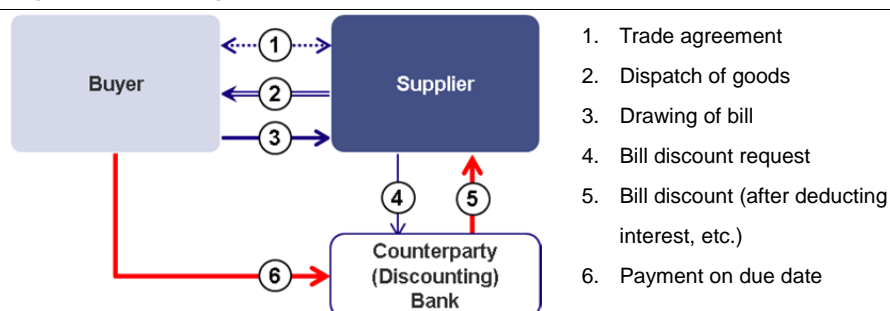


However, it is necessary to note that if the non-payment of the accepting bank occurs due to inadequacy in bill requirements, this is treated as an exception, and the funds will be subject to repayment. As previously mentioned in part 1, Electronic Bills of Exchange is an effective way to prevent inadequate bills. Electronic discounting of such bills has also been widely accepted by many banks.

2. Discounting of Trade Acceptance Bills

In a similar manner to Banker's Acceptance Bills, Trade Acceptance Bills (as well as Electronic Bills) can also be discounted. As mentioned above, for banker's acceptance bills, the non-payment risk lies with the accepting bank. However, in the case of Trade Acceptance Bills, such risk lies with the company accepting the bill (see Fig. 2), and for this reason, cases where a company's counterparty bank can evaluate the accepting company's creditworthiness and further take such risk are inevitably fewer compared to banker's acceptance bills. This is probably one of the main reasons why fewer Trade Acceptance Bills are issued compared to banker's acceptance bills.

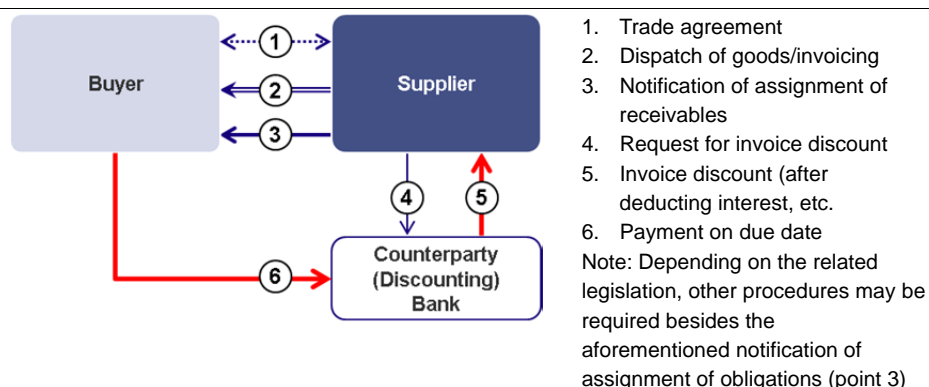
Fig. 2: Discounting of Trade Acceptance Bills



3. Invoice Discount Financing (IDF)

When it comes to transactions based on cash remittance, there is a method known as Invoice Discount Financing (IDF), whereby a company assigns its accounts receivable to a counterparty bank for discount (see Fig. 3). Apart from domestic sales, this transaction can also be used for cross-border settlements involving sales from a third country to China.¹

¹ Some countries have legal restrictions on the assignment of receivables or may prohibit such assignment.

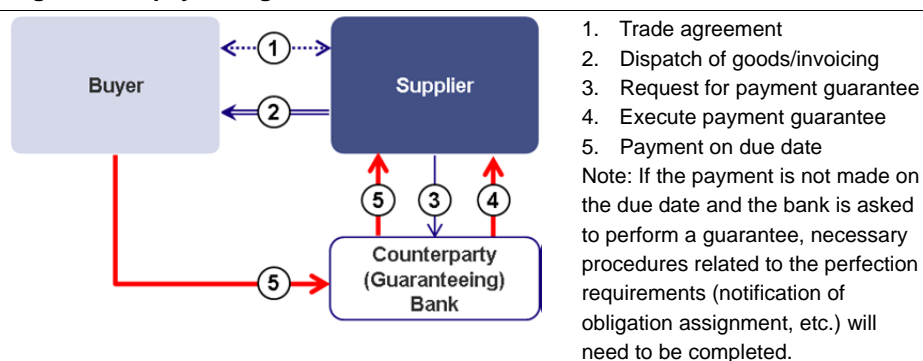
Fig. 3: Invoice Discount Financing(IDF)

However, for the assignment of accounts receivable, there are additional legal requirements (generally known as perfection) to ensure the assignment is recognized by third parties or obligors besides the parties directly involved in the obligation assignment (the assignor, i.e. the original creditor, and the assignee, i.e. the bank). Also, especially with regard to cross-border accounts receivable, the situation tends to get more complicated as a number of laws (different legislation in the countries of location of the related parties, the governing law of the trade agreement, etc.) needs to be taken account of, and related paperwork is generally more complex compared to bill discounting. We will not go into details of related procedures, but it is definitely recommended to consult with the counterparty bank before execution of such transaction.

Note also that as with the aforementioned trade bill discounting, the bank's decision whether to handle such IDF transaction will depend on the creditworthiness of the buyer who bears the final obligation to pay.

4. Bank Payment Guarantee

The IDF is used by the holder of accounts receivable for early encashment by assigning the obligation to a bank at a discount. When the holder is not in need of early encashment, there is a method specially used in the hedging of the non-payment risk, whereby the counterparty bank provides a guarantee – on a silent basis – to pay the Supplier in case the buyer defaults. (see Fig. 4).

Fig. 4: Bank payment guarantees

As mentioned above, the buyer is not informed of this kind of transaction if settlements are completed under normal circumstances. However, when non-payment occurs and the bank needs to perform a guarantee, please be aware that the precondition is the completion of the assignment of obligations (including the perfection requirements, as discussed in the previous section about the IDF). Furthermore, non-payments as a result of trade disputes over, such as, defective goods, are usually not covered by the guarantee.

5. Trade Credit Insurance

So far we have outlined and discussed related bank products. We will now touch briefly on Trade Credit Insurance.

Evidently, this product is provided by insurance companies, and many insurance companies deal with such products. There are also companies that specialize in Trade Credit Insurance, so it might be a good idea to check through an insurance broker.

The transaction itself is very simple. In the case that the insured party (the party holding an insurance policy) suffers a loss due to insolvency or default of a buyer (obligor), insurance will be paid. The insured party (the creditor) pays a fee (insurance premium) to the insurance company beforehand (normally calculated based on declared expected sales for one year from the contract date or the contract renewal date), and the insurance coverage period is usually set at one year.

There are several points to consider when using Trade Credit Insurance. For example, as a general rule, this kind of insurance covers all buyers (or multiple buyers selected under certain criteria). It is not common for the insurance to cover only one buyer. Nevertheless, the insurance criteria often differ according to the insurer, so it is important to carry out sufficient research beforehand.

It is also vital to fully understand each insurer's policy terms, especially exemption clauses. The most common exemptions are those related to trade transactions with buyers in whose operations the company claiming the insurance is deemed to be directly involved, or buyers with a public status (including companies that have capital ties with government sectors). A company may have an insurance claim turned down if the accounts receivable in question are covered by exemptions. In order to avoid such a situation, companies are strongly advised to thoroughly read through and understand the contract stipulations regarding exemptions, and procedures and the timeframe for claiming.

Conclusion

As outlined in part 1, the environment surrounding foreign companies in China has changed dramatically. With labor costs soaring in China, many companies are failing to optimize their production and sales activities if they view China as nothing more than a manufacturing base. At the same time, it

is an undeniable fact that GDP per capita in China continues to grow in leaps and bounds. From here on, China with its over 1.3 billion population will further strengthen its presence as a huge sales market.

However, it is hard to ignore the news flying around recently about China's stalling economy, as shown by the slowing GDP growth rate, and the rise in non-performing bank loans. Under such circumstances, in order to start or expand domestic sales in China, particularly to Chinese companies, it is vital that companies focus not only on increasing sales volumes but also on putting together measures to mitigate the risks of non-payment.

This report has introduced a variety of settlement methods, associated risks, and a number of financial transactions to help deal with risks. We hope this information will help you to grab business opportunities and manage risks in an appropriate manner.

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