

Letter of Credit Confirmation Insurance, The Implementation in Turkey and Possible Effects

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Extensive Summary

Last figures show that international trade is improving constantly even though some fluctuations happen sometimes and the acceleration of export and import volumes show that new economic operators/actors join to the sector. The countries claiming themselves as the most closed economies start to realize that they should enter the globalization circle in order to move in their development way, and they give importance to the exportation.

There are four payments methods (payment terms) in international trade: cash, cash against documents, cash against goods and letter of credit (L/C). Banks have important duties in L/C transaction which can be defined as a contract which has a definite payment commitment between exporter and importer if both parties comply with the conditions of L/C. In practice, it seems that almost each L/C conform to the UCP 600 rules published by ICC. L/Cs are the combinations of "bank guarantees" and "payments" which provide sight or deferred payment options by presenting related documents to the advising bank.

In this study; definition of L/C Confirmation Insurance, parties, work flow, the differences with alternative products, usage in Turkey / world and sample practices are examined. Also, it is assessed how this product would work in Turkish economical system and which risks/ which advantages will occur after using this product in the system.

Within this study, we examined Export Credit Agencies who provide this product and 15 institutions who are using this product are analyzed with a comparative method.

It is not a new practice to insure the shipments made through L/Cs, on the contrary Turk Eximbank gives cover for such shipments against commercial/political risks since 1989. But, beneficiary is the confirming bank of L/C; not exporter regarding the product has been mentioned in this document. There is no any comprehensive academic study in the world about this subject.

The most comprehensive study about this subject is “Insurance of Confirmed Letter of Credit and Implementation of This Programme to Turk Eximbank” as one of the dissertations which are needed to become a specialist in Turk Eximbank. In that study, it is said that “L/C confirmation insurance will be useful to serve Turk Eximbank’s purposes in the context of facilitating exporters’ presence in the new and risky markets and to strengthen their competitiveness in the current markets”.

Implementing authorities like Turk Eximbank are named as “Export Credit Agencies – ECA”. Main “L/C confirmation insurance providers” are Federal Republic of Germany, DHAMAN (multinational), EXIMBANK SR (Slovakia), EXIAR (Russia), EFIC (Australia), EKN (Sweden), EKF (Denmark), FINNVERA (Finland), GIEK (Norway), ICIEC (multinational), OEKB (Austria), SACE (Italy), SERV (Switzerland), UKEF (United Kingdom) and US EXIM (USA) around the world.

Recent politic and economic turmoils force exporters to find safe areas even though issuing banks guarantee to pay L/C amount to the exporter on condition that all terms in L/C wording are met. Some cases could come into question such like issuing banks will not be able to fulfill their obligations due to the aforementioned risks (turmoils) or can have difficulties to transfer money because of the currency crisis. In these cases, L/C confirmation insurance will help exporters to mitigate their risks.

In L/C confirmation insurance; banks operating in Turkey would be able to confirm letter of credits by means of this insurance type; maybe they wouldn’t be able to confirm these letter of credits if there is no insurance for their confirmed letter of credits. Given the fact that private sector doesn’t have an aim to incent exportation, but public sector has this aim; L/C confirmation insurance is in public sector’s responsibilities mainly.

Results of the study could be summarized as follows:

	Profile of Beneficiary	Covered Risks	Indemnity Percentage	Max Tenor	Duration of Claims Applications and Payment	Pricing
FEDERAL REPUBLIC OF GERMANY	- German banks - Branch offices of foreign banks in Germany - Foreign banks (under special conditions)	- Foreign bank’s failure to make payment within 1month after the due date (protracted default), - Other commercial risks (e.g. insolvency), - Political risks (e.g. warlike events)	95%	- 360 days from L/C confirmation, - Plus, 360 days as lending period	- Claims period: 1 month - Payment period: 5 banking days	- 2 kinds of cost: (processing fee and premium) - Processing fee: Calculated according to transaction amount - Premium: A certain percentage of the documentary credit amount covered (criteria: rating of issuing bank, country risk and duration of risk)
DHAMAN - MULTINATIONAL	- Arab banks - Arab-Foreign bank partnerships	- Commercial risks - Non-commercial risks	90%	Depends on L/C	-	- Only cost is insurance premium.
EFIC - AUSTRALIA	-Confirming banks in	- Commercial and Political	Up to %85	-	-	- According to OECD

	Australia	Risks				Regulations
EKF – DENMARK	- Danish or - Foreign confirming banks	- Commercial and Political Risks	Up to 50% - 95%	24 months	-	-
EKN – SWEDEN	- Swedish or -Foreign confirming banks	- Commercial and Political Risks	50%	Normally 12 months - but can be extended exceptionally -	- Notification: In 30 days from due date - Claims submission: 1 year from due date in written.	- Criteria for Premium: Application amount, risk level of transaction. Min premium: <u>1500 Swedish Kronor</u> or its equivalent
	Profile of Beneficiary	Covered Risks	Indemnity Percentage	Max Tenor	Duration of Claims Applications and Payment	Pricing
EXIAR – RUSSIA	-Russian banks or financial institutions	- Commercial Risks (protracted default, bankruptcy etc.) -Political Risks (Currency Problems, War, Force Majeure etc.)	-Political risks (up to 95%) -Commercial risks (up to 85%)	Depends on L/C	-	- Only cost is insurance premium.
EXIMBANKA SR – SLOVAKIA	-L/C confirming banks of Slovak exporters	- Commercial and Political Risks	up to 85%	24 months	-	Min premium: 50% of cost of issuing bank's for confirmation
FINNVERA – FINLAND	- Finnish or - Banks on abroad (on condition that L/C's beneficiary will be Finnish exporter)	- Commercial and Political Risks	- In normal coverage; up to 95% for commercial risks, up to 100% for political risks, - In risk sharing model 50%	-	Claims submission: In 60 days after due date Claims Process: FINNVERA will conclude claims process in 30 days after submission.	- Criteria (in normal coverage): Creditworthiness of issuing bank and its country, validity pf L/C and payment conditions. (In risk sharing model) Based on the confirmation cost of issuing bank - For both model, there is a processing fee to be paid extra.
GIEK - NORWAY	- Confirming banks for the goods which have been exported from Norway	- Commercial and Political Risks	up to 50%	-	-	- Criteria for premium: Country of the buyer and the financial situation of the buyer
ICIEC - MULTINATIONAL	- Banks&Financial Institutions in the Member States - Banks&Financial Institutions in non-Members countries; but	- Commercial and Political Risks	up to 90%	up to 7 years	-	-

	owned as 50% share or more by the Islamic Development Bank or Member countries - Banks&Financial Institutions which have products complying with Shariah					
	Profile of Beneficiary	Covered Risks	Indemnity Percentage	Max Tenor	Duration of Claims Applications and Payment	Pricing
OEKB – AUSTRIA	-Banks in Austria	- Commercial and Political Risks	up to 100%	up to 2 years	-	- Processing fee: between 10 €- 720 € -Premium (Depends on L/C conditions)
SACE – ITALY	- Confirming banks for the L/Cs issued on behalf of Italian exporters	- Commercial and Political Risks (up to 5m €)	-	up to 5 years	-	-
SERV – SWITZERLAND	- Confirming Banks&Financial Institutions	- Commercial and Political Risks - Credit Risk - Force Majeure	up to 95%	-	-Claims payment: In 30 days after submission.	- Only cost is insurance premium
UKEF – UNITED KINGDOM	-Banks in United Kingdom	- Commercial and Political Risks	up to 90%	up to 1 year	-	- Premium: A proportion of the fee which UKEF receives from exporter for confirming L/C
US EXIM - USA	- Confirming banks for the American products shipped from USA or rendering of services by American personnel in any part of the world (goods or services which have less than 50% U.S. content cannot be covered – defense products are not subject to this limitation).	- Commercial and Political Risks	- Up to 100% for sovereign financial institution, - Up to 95% for non-sovereign financial institution, - Up to 98% for approved agricultural commodities	up to 12 months	- Claims submission: Not before than 60 days, not later than 120 days. - A written warning should be sent to issuing bank in 30 days after due date. - Claims payment will be realized in 60 days after receiving a satisfactorily completed proof of loss.	-Premiums are calculated according to the specifications of each application. - Advance deposit of \$ 2.000 is paid to set-up the policy.

Even though competitive atmosphere in international trade forces exporters to sell their products with cash against goods payment term, L/C keeps its strong position as it is described as the *life-blood of international trade*. Hence, it is shown in the studies of WTO, IMF and BAFT (Bankers' Association for Finance and Trade) that one third of international trade is realized by the mediation of banks. It is forecasted that 12% – 15% of international trade volume is realized by L/Cs.

Exporters who want to secure their receivables from importers against the default risk choose L/C payment terms. But, as it is mentioned before in this study, even L/C is not a totally risk-free payment term and it can be far from guarantee if economic and politic risks are growing in issuing bank's country. When such risk occur, there is a high possibility to see default risks due to deterioration of issuing bank's financial situation or political risks in the country which issuing banks is located. For such risks, L/C confirmation insurance is demanded from exporters or advising/confirming banks.

L/C usage in Turkey is nearly 11 billion USD in 2017. It makes 7% of total export of Turkey. But we don't have statistical data regarding the (unrealized) potential export volume due to not having L/C confirmation insurance. It is expected that L/C confirmation insurance will come into prominence by providing guarantee to the confirming banks and exporters. However, discussions made with private sector representatives showed signs that there will be a reasonable demand for the product.

It is highly anticipated that L/C confirmation insurance will increase the amount of export L/C transactions in Turkey. Its effect on confirmation costs will be subject to banks' perspective on the product. Banks could not create any extra costs for exporters given the fact that they would not be able earn confirmation fees from them if there was no coverage for their L/Cs. In practice, it is also possible to create an additional cost for exporters by hiding it in confirmation fee.

Most likely, main demand will come from risky regions such as Africa, Middle East and Central Asian Turkic Republics. It will contribute the economic connection between Turkey and those countries and could act as a bridge between their financial institutions and ours.

L/C credit confirmation insurance which is not offered from any company/institution in Turkey; but a very well-known product by other Export Credit Agencies around the world is expected to increase the volume of Turkey's exportation by starting to provide by Turkey's official export credit agency, Turk Eximbank.