Foreign Bill Purchase / Discounted: An Interrelationship between International trade and Treasury Business

By:
Sohail Chagani
(Treasury Settlement, SBL)

INTRODUCTION:

FBP(Foreign Bill Purchased)

- A post shipment facility secured by the future proceeds of a specific export bill.
- Working capital finance facility
- The Export Bills may be classified in two categories for their tenors .*Sight* and *Usance*. Normally Sight bills are paid within 12 days and Usance Bills may normally take three to six months to get mature.
- Bill can be purchased both under LCs and under Collection method.

Foreign Bill Discounting (FBD)

- The only difference between FBP and FBD is that it is extended under usance bills which have been accepted by the LC issuing bank or the importer for payment at determinable future date.

Negotiation of Bills under LC

- Credit lines should be available for the Purchase of Bills from respective Customer.
- Clearance of the status of the LC issuing Bank (Since under LC , the ultimate liability of paying the bill is taken by the issuing bank)
- Export documents submitted and cleared by the Export Department.
- Get the unconditional indemnification for purchasing discrepant bills.
- After purchasing the bill, the bank acquires the title to the export bill and its proceeds.

Negotiating Bills on Collection

- This scenario is riskier than earlier one because the importer is liable for paying the bills in this case.
- The bank therefore obtains collateral and gets unconditional indemnification to pay the bank in case of non-realization of proceeds.
- Get a credit opinion of the buyer, if possible, to secure the bank's position in any adverse case.

A Treasury Perspective to FBPs/FBDs

Concept:
We, at treasury, buy the customer export dollar bill of some future date (any date excluding today) and pay him today. That is, we are paying our Local Currency (say, PKR) funds today for the dollars which we will receive in future. Therefore, for paying them the funds instantly, we charge him the Interest of using the Local currency funds and deduct the interest upfront on the forward exchange rate of the Local currency in terms of the currency of the bill of exchange. The Forward

exchange rate is a term used for the spot rate added Inter-bank forward points of the duration till the bill is realized.

Working (Rupee Based Discounting/ Negotiation):
While branch communicates Treasury Dealing Room for getting a rate for negotiation of FBP for its customer, the Front Office Personnel / Dealer gets an inter-bank forward premium/discount points for purchasing Foreign Currency against Local Currency, having an specific tenor.

For Example A branch comes with $100,000/= bill having 60 days tenor. The Front Office dealer will get the inter-bank forward discount/premium points for purchasing the dollar (Suppose Local Currency in this case is PKR and PKR is in discount to dollar with 1.50 points in 60days.The Following Formula will be used to get the negotiation rate

Negotiation Rate = [Spot rate – {((Spot rate + Forward points) * Kibor rate *tenor) /(100*365)}]

Here If,
Kibor Rate = Market Offer Rate of the PKR funds for the 60 days = 11.5%
Tenor = 60 days
Spot Rate for buying USD = 80 (Normally this rate is some points less than the current inter bank rates)

Then,
Negotiation Rate = [80-{((80+1.50) *11.5*60) / 36500}]

Negotiation Rate = 78.46

Normally this is the maximum rate you can offer to a customer in negotiation. The range of negotiation goes downward i.e. any points less than the above rate.

Hedging:
With this transaction, treasury has now been exposed to major risks

1. Exchange risk
2. Counter-party Risk

Counter party risk is some what a more concern to the branch level / Region level /Country Level credit approval team of the banks, the treasury here is more concerned to the Exchange risk.

Although the bank has given the price of for the future dollars with a discount , however this discount is based on some future inter-bank market pereception of the exchange rate and therefore that rate should be locked in such a way that any adverse moment should not affect the return on the transaction alongwith the standing of the bank should be steady in any case.

Therefore the treasury hedge the future price i.e. what ever they will receive from the customer as a result of proceeds of the bill after the respective tenor, treasury sells out the same today in interbank market.

Since the tenors may range to a month to six months or so, the inter-bank market does not take the risk of buying at the exchange rate prescribed by the inter-bank market forward premiums/discounts. Therefore, in most of the cases the inter-bank market prefer a swap while buying a currency in a month or so forward with simultaneous sell of the same in ready with the same bank .

After entering into a swap, the bank with the FBP has settled its forward exchange risk, but now having ready dollars bought as a result of swap from the inter-bank market. The bank will now sell these dollars in the ready market to complete the transaction cycle and locking the return on the transaction.

The above transaction cycle can be summarized into two steps

1. Selling forward of the FBP's dollars in inter-bank market with simultaneous purchase of the same
2. selling the ready dollars , purchased as a result of above swap transaction , in the inter-bank market

<u>The return to the treasury on the transaction of FBP:</u>

1. As a result of FBP, bank has purchased cheaper dollars which now been sold to a bank with forward higher rate, thus earning the spread.
2. As a result of swap, the bank may have purchased the ready leg with a reasonable ready price which if sold with some points, gives a fair return in the ready market.
3. While FBPs are booked in the books of accounts of the treasury with the Negotiation rate, they are daily revalued according to their tenors with Mark-to-Market rates provided by the Central Bank. These rates are the fair reflection of the premium / discounted but actual forward inter-bank rate which are always higher than the FBPs booked rate (because FBPs are discounted by the forward rates).With this revaluation , the treasury book unrealized profit on FBPs through out the tenor of the FBP.

Note:

1. The treasury shares this return with a certain approved rate to the respective branches through which the customers have booked the respective FBPS.
2. When the proceeds of the respective FBP is realized in treasury books of accounts, no profit on that day is accumulated for the realization of the cheaper proceeds because the bill has already been booked in forward books of treasury and while the treasury reverses its forward realizable assets head , it accrues a loss (with the same amount as it actually gets in the realization of the asset in the ready book) due to Mark to Market revaluation rate higher than the booked rate (Loss is accrued because the reversal of an asset is actually selling of the asset and we sell the asset on the lower rate as booked from the higher rate of Mark to Market Revaluation). Therefore, gain or loss cancel each other on the day and there is no gain or loss on the day as a result.

Settlement Risks of the Transaction:

1. If the bill goes in OVERDUE, the transaction booked in the forward accounts will be shown by the system as the ready mature deal on the day bill gets matured for its tenor. Although we did not receive any dollars in ready accounts of our books, we loose the unrealizable profit of the respective day because system do not runs the Mark to Market Revaluation on the Maturities (or Matured Transactions).
   Therefore, the transactions should be extended for a few days before they gets matured (normally a day before they get mature), if the proceeds are not realized (Although its not a reasonable way out , as it is not so sue that for how many days it should be extended to avoid loss and whether the proceeds will be realized within the period or not and further if the proceeds are realize within next 3 days and you have extended the FBP on maturity for further 7 days, there is always a wrong picture of the profit accumulated for the actual period of the Bill.
2. GAP risk is quite important. While you have booked a fixed swap in your NOP which gets matured normally on the same day while your receive the proceeds of the FBP in your Nostro and at maturity , you come to know that FBP is in Overdue, you can not turn down the inter-bank maturity with this excuse. The treasury has to arrange the Cheaper / Costlier funds on the day and absorb the adverse price risk
3. Short-realization is another case while you realize less amount than booked in treasury books. In this case , the branches should be so vigilant to charge the customer for the amount realized short with ready selling quote and transfer the difference to treasury(difference between Booked rate and ready Selling rate)

Reference:

1. Finance of International Trade by Institute of Bankers Pakistan
2.