Methods of Risk Protection

Method of Risk Protection	Description	Applicability	Breadth	Coverage	Residual Exposure
Unconfirmed L/C	Undertaking, usually on the part of a bank and at the request of one of the bank's customers, to pay a named beneficiary a specified amount of money (or to deliver an item of value) if the beneficiary presents documents in accordance with the terms and conditions specified in the letter of credit.	Letter of Credit	Transactional although a program can be developed to cover multiple transactions	100%	Country risks and commercial risk of the issuing bank; discrepancies between the L/C requirements and the shipping documents
Confirmed L/C	Letter of credit to which the advising bank has added their own, independent undertaking to honor presentation of the required documents, i.e. pay the beneficiary at sight or at maturity, as specified by the L/C. See also "silent confirmation."	Letter of Credit	Transactional	100%	Commercial risk of the confirming bank and country risks of the confirming bank's home country if the bank is foreign; discrepancies between the L/C requirements and the shipping documents
Silent L/C Confirmation	Term used for a bank's commitment to negotiate (i.e. purchase) documents under a letter of credit without recourse at a future date. A silent confirmation is not a confirmation in the true sense, and will not use the word "confirm," but is rather an equivalent form of protection for the beneficiary. The bank will require that the letter of credit be negotiable or payable by themselves in order to be able to establish holder-in-due-course rights equivalent to those of a confirming bank.	Letter of Credit	Transactional	100%	Discrepancies between the L/C requirements and the shipping documents

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Standby L/C	Letter of credit which does not cover the direct purchase of merchandise, so called because it is generally intended to be drawn on only when the applicant for whom it is issued fails to perform an obligation. Standby letters of credit are based on the underlying principle of letters of credit that payment is made against presentation of documents— whatever documents the applicant, beneficiary, and issuing bank may agree to, not necessarily docu-ments evidencing shipment of goods. This often amounts to just a draft and a beneficiary's statement of why payment is due.	Open account with standby L/C. The standby L/C may cover the full credit limit or only the amount above the seller's normal limit for the buyer.	Although standby L/Cs can cover individual sales, they are only cost-effective when used for multiple, repetitive sales to the same buyer	100%	Country risks and commercial risk of the issuing or confirming bank; discrepancies between the L/C requirements and the documents, notably failure to present prior to expiration
Independent/ Demand Guarantee	Essentially the same thing as a standby letter of credit—demand guarantees are payable against presentation of documents. The major differences are (1) there is no specified time limit for the guarantor to refuse documents and (2) the "principal" (applicant) must be notified of all drawings prior to payment. This gives the issuer latitude to delay payment until any disputes are resolved.	Same as standby L/C	Same as standby L/C	100%	Country risks and commercial risk of the guarantor; discrepancies between the guarantee requirements and the documents, notably failure to present prior to expiration; court injunction blocking payment
Ancillary/ Contract Guarantee, Surety Bond	Arrangement where the guarantor (surety) joins with one of the parties to a contract and agrees to fulfill that party's obligations if necessary, effectively co-signing the contract. As opposed to an independent or demand guarantee, under an ancillary guarantee the guarantor also acquires rights under the contract and may resort to terms in the contract to dispute claims against the guarantee. Note: A surety bond is normally issued by an insurance company and may have a specified maximum dollar value, an expiration date, and cancellation clauses.	Open account with guarantees (bond)	Transactional (by contract). In the U.S., banks are generally prohibited from issuing ancillary guarantees, banks in other countries and other U.S. companies are not.	100%	Country risks and commercial risk of the guarantor, including repudiation by the guarantor; contract dispute

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Forfaiting	Sale of negotiable instruments, most often avalized drafts, without recourse. The forfaiter assumes the credit risk of being able to collect payment when due.	Time Draft Collection	Transactional	100%	Contract repudiation; refusal of buyer to accept drafts or of buyer's bank to avalize drafts once accepted
Factoring	Service of assuming the credit risk of another party's sales, generally including collecting payment when due, effectively "outsourcing" the credit & collections function. Although factors often provide or arrange limited-recourse financing against the accounts receivable they are guaranteeing, this is not "part & parcel" to the service as is commonly believed.	Open Account Sales to companies in Western Europe, U.S.A./Canada, Japan, Hong Kong	Repetitive sales to the same buyers; usually "whole turnover" on a country-by-country basis	100%	Contract repudiation; contract dispute
Non-Recourse Sale of Receivables	Sale of individual receivables based on the receivable purchaser's comfort with the underlying obligor and the documentation—similar to factoring but transactional rather than "whole turnover"; obligors need not be pre-approved but an understanding of proper documentation should be arrived at—documentation may include accepted drafts, similar to forfaiting.	Open Account, Time Draft Collection	Transactional	100%	Contract repudiation; contract dispute
Credit Insurance	Insurance against losses due to inability or failure of the insured's customers to pay for goods sold by the insured. The insurance normally covers a specified percentage of each loss beyond a deductible indicated in the policy. Insurance is available covering a variety of risks, e.g. political and transfer risks ("country risks") and financial risks (called "commercial risks"). Although "comprehensive" credit insurance does not cover contract repudiation, separate insurance is available. Even "comprehensive" insurance, however, will not cover non-payment for contract disputes.	Open Account, Time Draft Collection, Sight Draft Collection	Repetitive sales to the same buyers. Traditionally "whole turnover" of all export sales not covered by L/Cs or avalized drafts, but coverage can be highly tailored.	Up to 90%	Contract dispute; improper documentation for filing insurance claim

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Credit Derivative	Essentially a bet placed with a derivative writer that a defined credit event (usually negative) will take place by an agreed date. Examples of events are the default on a particular bond, a specified ratio in a company's annual report, and a designated company filing for bankruptcy. Occurrence of the event should be determinable from public information. The derivative seller agrees to pay off if the event occurs and charges a fee up front based on his assessment of the probability of the event occurring, much like giving odds.	The derivative buyer stands to lose money if the event occurs, usually because they are holding on to receivables, bonds, or other obligations of the underlying party	Very narrow—derivative writers only follow very large companies and certain government bonds	If the specified event occurs, the difference between the covered amount and the market value of the underlying obligation will be paid, whether the derivative buyer has actually suffered a loss related to the event or not	The derivative buyer may suffer a loss and yet not be able to collect on the derivative because the event did not occur
FX Forward Contract	Contract with a bank to exchange an agreed amount of one currency for an agreed amount of another on an agreed future date, thus locking in the exchange rate ahead of time. FX *futures* contracts, available through futures dealers, are similar but are for standardized amounts and maturities which only approximate actual FX needs. Furthermore, futures contracts are normally "unwound" prior to maturity rather than having either party deliver currency to the other.	Sale denominated in foreign currency	May be transactional or part of an overall FX hedging strategy	100% of exchange rate fluctuation	In the event the sale is canceled, the exporter is still liable to deliver the agreed amount of foreign currency to the bank and may have to purchase the currency at a higher rate than it is being sold for
FX Option	Option purchased from a bank (or a futures dealer) to buy an agreed amount of foreign currency at a set exchange rate during a defined period. Options purchased from futures dealers are for standardized amounts and maturities whereas those purchased from banks may be for any amount and maturity the parties may agree to. "In the money" options with banks are usually exercised, whereas those with dealers are usually "unwound" or "cashed out."	Sale (or potential sale) denominated in foreign currency	May be transactional or part of an overall FX hedging strategy	100% of exchange rate decreases with potential to profit from upward movement in the value of the foreign currency	The exporter must always pay the amount required to purchase the option, even if the option is never exercised (*i.e.* if the goods are never shipped or if the value of the foreign currency goes up)