

Trade Finance Guide

A Quick Reference
for U.S. Exporters



Trade Finance Guide: A Quick Reference for U.S. Exporters is designed to help U.S. companies, especially small and medium-sized enterprises, learn the basic fundamentals of trade finance so that they can turn their export opportunities into actual sales and to achieve the ultimate goal of getting paid—especially on time—for those sales. Concise, two-page chapters offer the basics of numerous financing techniques, from open accounts, to forfaiting to government assisted foreign buyer financing.

Table of Contents

Introduction	1
Chapter 1: Methods of Payment in International Trade.....	3
Chapter 2: Cash-in-Advance.....	5
Chapter 3: Letters of Credit	7
Chapter 4: Documentary Collections	9
Chapter 5: Open Account.....	11
Chapter 6: Consignment	13
Chapter 7: Export Working Capital Financing	15
Chapter 8: Government-Guaranteed Export Working Capital Loan Programs.....	17
Chapter 9: Export Credit Insurance.....	19
Chapter 10: Export Factoring	21
Chapter 11: Forfaiting	23
Chapter 12: Government-Assisted Foreign Buyer Financing.....	25
Chapter 13: Government-Backed Agricultural Export Financing	27
Chapter 14: Foreign Exchange Risk Management	29

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The International Trade Administration's mission is to create prosperity by strengthening the competitiveness of U.S. industry, promoting trade and investment, and ensuring fair trade and compliance with trade laws and agreements. To learn more about the ITA write to: International Trade Administration, Office of Public Affairs, U.S. Department of Commerce, Washington, DC 20230 or visit the ITA's Web site at www.trade.gov.

Introduction

Opportunities, Risks, and Trade Finance

Welcome to the third edition of the *Trade Finance Guide: A Quick Reference for U.S. Exporters*. This guide is designed to help U.S. companies, especially small and medium-sized enterprises (SMEs), learn the basic fundamentals of trade finance so that they can turn their export opportunities into actual sales and to achieve the ultimate goal of getting paid—especially on time—for those sales. This guide provides general information about common techniques of export financing. Accordingly, you are advised to assess each technique in light of your specific situation or needs. This edition includes two new chapters on “Consignment” and “Government-Backed Agricultural Export Financing” with minor updates on other chapters. The *Trade Finance Guide* will be revised and updated as needed. Future editions may include new chapters discussing other trade finance techniques and related topics.

Benefits of Exporting

The United States is the world's second largest exporter, with \$2.06 trillion in goods and services exports in 2011, according to the World Trade Organization's *World Trade Report 2012*. In 2011, the United States was the top exporter of services and second largest exporter of goods, behind only China. However, 95 percent of the world's consumers live outside of the United States. So if you are selling only domestically, you are reaching just a small share of potential customers. Exporting enables SMEs to diversify their portfolios and insulates them against periods of slower growth in the domestic economy. Free trade agreements (FTAs) have helped to open markets such as Australia, Canada, Central America, Chile, Israel, Jordan, Korea, Mexico, and Singapore. FTAs create more export opportunities for U.S. businesses. The *Trade Finance Guide* is designed to provide U.S. SMEs with the knowledge necessary to grow and become competitive in overseas markets.

Key Players in the Creation of the Trade Finance Guide

The International Trade Administration (ITA) is an agency within the U.S. Department of Commerce whose mission is to foster economic growth and prosperity through global trade. ITA provides practical information to help you select your markets and products, ensures that you have access to international markets as required by our trade agreements, and safeguards you from unfair competition such as dumped and subsidized imports. ITA is made up of the following four units: (a) **Manufacturing and Services**, the industry analysis unit that supports U.S. industry's domestic and global competitiveness; (b) **Commercial Service**, the trade promotion unit that helps U.S. businesses at every stage of the exporting process; (c) **Market Access and Compliance**, the country-specific policy unit that keeps world markets open to U.S. products and helps U.S. businesses benefit from our trade agreements with other countries; and (d) **Import Administration**, the trade law enforcement unit that ensures that U.S. businesses face a level playing field in the domestic marketplace. For more information, visit www.trade.gov or contact the

A QUICK GLANCE

Trade Finance Guide

A concise, simple, and easy-to-understand guide designed to help U.S. small and medium-sized exporters learn quickly how to get paid from their foreign customers in the most effective manner.

Trade Finance

A means to turn export opportunities into actual sales and to get paid for export sales—especially on time—by effectively managing the risks associated with doing business internationally.

Opportunities

- Reaching the 95 percent of potential customers worldwide who live outside the United States
- Diversifying customer portfolios

Risks

- Non-payment or delayed payment by foreign buyers
- Political and commercial risks as well as cultural influences

Trade Information Center, 1-800-USA-TRADE or the Commercial Service's global network of domestic Export Assistance Centers and overseas posts. To find the nearest Export Assistance Center or overseas Commercial Service office, visit www.export.gov.

Partnership and Cooperation

The *Trade Finance Guide* was created in partnership with FCIB—The Finance, Credit, and International Business Association—a prominent business educator of credit and risk management professionals in exporting companies ranging in size from multinational to SMEs. FCIB's parent, the National Association of Credit Management, is a non-profit organization that represents nearly 16,000 businesses in the United States and is one of the world's largest credit organizations. This *Trade Finance Guide* was also created in cooperation with the U.S. Small Business Administration, the U.S. Export-Import Bank (Ex-Im Bank), the International Factoring Association, the Association of Trade & Forfaiting in the Americas, and BAFT-IFSA, the association for organizations actively engaged in international transaction banking. (BAFT-IFSA was formed by the merger of the Bankers Association for Finance and Trade (BAFT) and the International Financial Services Association (IFSA).) Their contact information is listed below and provided in other sections of the *Trade Finance Guide*.

Trade Finance Guide in Spanish

ITA has published a Spanish version of the *Trade Finance Guide* in partnership with the California Centers for International Trade Development (CITD) to help facilitate U.S. exports to Spanish-speaking countries. The CITD is a state-funded non-profit organization that promotes California's international trade and global competitiveness. With offices across California, the CITD assists local SMEs with expanding their global presence, especially in Mexico and Latin America, where Spanish is the primary language. Through this collaboration with CITD, the Spanish language *Trade Finance Guide* will enable ITA to reach thousands of potential new exporters. Visit www.citd.org for more information.

For More Information about the Guide

The *Trade Finance Guide* was created by ITA's Office of Financial Services Industries (OFSI). A part of ITA's *Manufacturing and Services* unit, OFSI is dedicated to enhancing the domestic and international competitiveness of U.S. financial services industries and providing internal policy recommendations on U.S. exports and overseas investment supported by official finance. For more information, contact the project manager and author of the Guide, Yuki Fujiyama, tel. (202) 482-3277; e-mail yuki.fujiyama@trade.gov.

How to Obtain the Trade Finance Guide

The *Trade Finance Guide* (both English and Spanish versions) is available online for free download at Export.gov, the U.S. government's export portal. Print copies of the Guide may be available upon request at FCIB.

Where to Learn More about Trade Finance

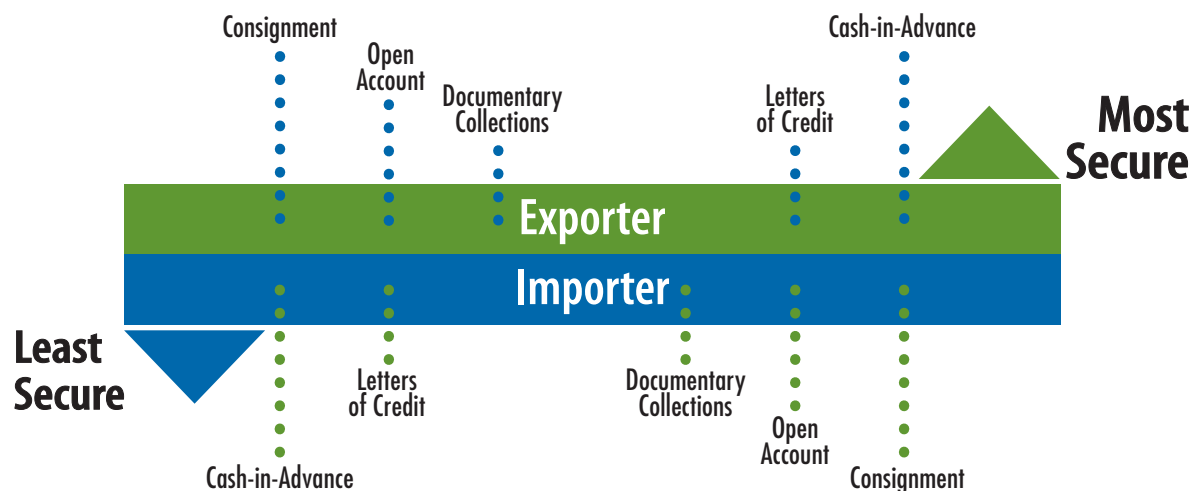
As the official export credit agency of the United States, Ex-Im Bank regularly offers trade finance seminars for exporters and lenders. These seminars are held in Washington, DC and in many major U.S. cities. For more information about the seminars, visit www.exim.gov or call 1-800-565-EXIM (3946). For more advanced trade finance training, FCIB offers the 13-week International Credit and Risk Management online course, which was developed with a grant awarded by the U.S. Department of Commerce in 2001. For more information about the course, visit www.fcibglobal.com or call 1-888-256-3242. BAFT-IFSA also offers trade finance events and educational programs. For more information about the events and programs, visit www.baft-ifsa.com or call (202) 663-7575.

Chapter 1

Methods of Payment in International Trade

To succeed in today's global marketplace and win sales against foreign competitors, exporters must offer their customers attractive sales terms supported by the appropriate payment methods. Because getting paid in full and on time is the ultimate goal for each export sale, an appropriate payment method must be chosen carefully to minimize the payment risk while also accommodating the needs of the buyer. As shown in figure 1, there are five primary methods of payment for international transactions. During or before contract negotiations, you should consider which method in the figure is mutually desirable for you and your customer.

Figure 1: Payment Risk Diagram



Key Points

- International trade presents a spectrum of risk, which causes uncertainty over the timing of payments between the exporter (seller) and importer (foreign buyer).
- For exporters, any sale is a gift until payment is received.
- Therefore, exporters want to receive payment as soon as possible, preferably as soon as an order is placed or before the goods are sent to the importer.
- For importers, any payment is a donation until the goods are received.
- Therefore, importers want to receive the goods as soon as possible but to delay payment as long as possible, preferably until after the goods are resold to generate enough income to pay the exporter.

Cash-in-Advance

With cash-in-advance payment terms, an exporter can avoid credit risk because payment is received before the ownership of the goods is transferred. For international sales, wire transfers and credit cards are the most commonly used cash-in-advance options available to exporters. With the advancement of the Internet, escrow services are becoming another cash-in-advance option for small export transactions. However, requiring payment in advance is the least attractive option for the buyer, because it creates unfavorable cash flow. Foreign buyers are also concerned that the goods may not be sent if payment is made in advance. Thus, exporters who insist on this payment method as their sole manner of doing business may lose to competitors who offer more attractive payment terms.

Letters of Credit

Letters of credit (LCs) are one of the most secure instruments available to international traders. An LC is a commitment by a bank on behalf of the buyer that payment will be made to the exporter, provided that the terms and conditions stated in the LC have been met, as verified through the presentation of all required documents. The buyer establishes credit and pays his or her bank to render this service. An LC is useful when reliable credit information about a foreign buyer is difficult to obtain, but the exporter is satisfied with the creditworthiness of the buyer's foreign bank. An LC also protects the buyer since no payment obligation arises until the goods have been shipped as promised.

Documentary Collections

A documentary collection (D/C) is a transaction whereby the exporter entrusts the collection of the payment for a sale to its bank (remitting bank), which sends the documents that its buyer needs to the importer's bank (collecting bank), with instructions to release the documents to the buyer for payment. Funds are received from the importer and remitted to the exporter through the banks involved in the collection in exchange for those documents. D/Cs involve using a draft that requires the importer to pay the face amount either at sight (document against payment) or on a specified date (document against acceptance). The collection letter gives instructions that specify the documents required for the transfer of title to the goods. Although banks do act as facilitators for their clients, D/Cs offer no verification process and limited recourse in the event of non-payment. D/Cs are generally less expensive than LCs.

Open Account

An open account transaction is a sale where the goods are shipped and delivered before payment is due, which in international sales is typically in 30, 60 or 90 days. Obviously, this is one of the most advantageous options to the importer in terms of cash flow and cost, but it is consequently one of the highest risk options for an exporter. Because of intense competition in export markets, foreign buyers often press exporters for open account terms since the extension of credit by the seller to the buyer is more common abroad. Therefore, exporters who are reluctant to extend credit may lose a sale to their competitors. Exporters can offer competitive open account terms while substantially mitigating the risk of non-payment by using one or more of the appropriate trade finance techniques covered later in this Guide. When offering open account terms, the exporter can seek extra protection using export credit insurance.

Consignment

Consignment in international trade is a variation of open account in which payment is sent to the exporter only after the goods have been sold by the foreign distributor to the end customer. An international consignment transaction is based on a contractual arrangement in which the foreign distributor receives, manages, and sells the goods for the exporter who retains title to the goods until they are sold. Clearly, exporting on consignment is very risky as the exporter is not guaranteed any payment and its goods are in a foreign country in the hands of an independent distributor or agent. Consignment helps exporters become more competitive on the basis of better availability and faster delivery of goods. Selling on consignment can also help exporters reduce the direct costs of storing and managing inventory. The key to success in exporting on consignment is to partner with a reputable and trustworthy foreign distributor or a third-party logistics provider. Appropriate insurance should be in place to cover consigned goods in transit or in possession of a foreign distributor as well as to mitigate the risk of non-payment.

Chapter 2

Cash-in-Advance

With the cash-in-advance payment method, the exporter can eliminate credit risk or the risk of non-payment since payment is received prior to the transfer of ownership of the goods. Wire transfers and credit cards are the most commonly used cash-in-advance options available to exporters. With the advancement of the Internet, escrow services are becoming another cash-in-advance option for small export transactions. However, requiring payment in advance is the least attractive option for the buyer, because it tends to create cash-flow problems, and it often is not a competitive option for the exporter especially when the buyer has other vendors to choose from. In addition, foreign buyers are often concerned that the goods may not be sent if payment is made in advance. Exporters who insist on cash-in-advance as their sole payment method for doing business may lose out to competitors who are willing to offer more attractive payment terms.

Key Points

- Full or significant partial payment is required, usually via credit card or bank or wire transfer or escrow service, before the ownership of the goods is transferred.
- Cash-in-advance, especially a wire transfer, is the most secure and least risky method of international trading for exporters and, consequently, the least secure and an unattractive method for importers. However, both the credit risk and the competitive landscape must be considered.
- Exporters may select credit cards as a viable cash-in-advance option, especially for small consumer goods transactions.
- Exporters may also select escrow services as a mutually beneficial cash-in-advance option for small transactions with importers who demand assurance that the goods will be sent in exchange for advance payment.
- Insisting on cash-in-advance could, ultimately, cause exporters to lose customers to competitors who are willing offer more favorable payment terms to foreign buyers.
- Creditworthy foreign buyers, who prefer greater security and better cash utilization, may find cash-in-advance unacceptable and simply walk away from the deal.

CHARACTERISTICS OF CASH-IN-ADVANCE

Applicability

Recommended for use in high-risk trade relationships or export markets, and appropriate for small export transactions

Risk

Exporter is exposed to virtually no risk as the burden of risk is placed almost completely on the importer.

Pros

- Payment before shipment
- Eliminates risk of non-payment

Cons

- May lose customers to competitors over payment terms
- No additional earnings through financing operations

Wire Transfer: Most Secure and Preferred Cash-in-Advance Method

An international wire transfer is commonly used and is almost immediate. Exporters should provide clear routing instructions to the importer when using this method, including the receiving bank's name and address, SWIFT (Society for Worldwide Interbank Financial Telecommunication) address, and ABA (American Bankers Association) number, as well as the seller's name and address, bank account title, and account number. The fee for an international wire transfer can be paid by the sender (importer) or it can be deducted from the receiver's (exporter's) account.

Credit Card: A Viable Cash-in-Advance Method

Exporters who sell directly to foreign buyers may select credit cards as a viable cash-in-advance option, especially for small consumer goods transactions. Exporters should check with their credit card companies for specific rules on international use of credit cards. The rules governing international credit card transactions differ from those for domestic use. Because international credit card transactions are typically placed using the Web, telephone, or fax, which facilitate fraudulent transactions, proper precautions should be taken to determine the validity of transactions before the goods are shipped. Although exporters must tolerate the fees charged by credit card companies and assume the risk of unfounded disputes, credit cards may help the business grow because of their convenience and wide acceptance.

Escrow Service: A Mutually Beneficial Cash-in-Advance Method

Exporters may select escrow services as a mutually beneficial cash-in-advance option for small transactions with importers who demand assurance that the goods will be sent in exchange for advance payment. Escrow in international trade is a service that allows both exporter and importer to protect a transaction by placing the funds in the hands of a trusted third party until a specified set of conditions are met. Here's how it works: the importer sends the agreed amount to the escrow service. After payment is verified, the exporter is instructed to ship the goods. Upon delivery, the importer has a pre-determined amount of time to inspect and accept the goods. Once accepted, the funds are released by the escrow service to the exporter. The escrow fee can either be paid in full by one party or split evenly between the exporter and the importer. Cross-border escrow services are offered by international banks and firms that specialize in escrow and other deposit and custody services.

Payment by Check: A Less-Attractive Cash-in-Advance Method

Advance payment using a check drawn on the importer's account and mailed to the exporter will result in a lengthy collection delay of several weeks to months. Therefore, this method may defeat the original intention of receiving payment before shipment. If the check is in U.S. dollars and drawn on a U.S. bank, the collection process is the same as it would be for any U.S. check. However, funds deposited by non-local checks, especially those totaling more than \$5,000 on any one day, may not become available for withdrawal for up to 10 business days due to Regulation CC of the Federal Reserve (§ 229.13 (ii)). In addition, if the check is in a foreign currency or drawn on a foreign bank, the collection process can become more complicated and can significantly delay the availability of funds. Moreover, if shipment is made before the check is collected, there is a risk that the check may be returned due to insufficient funds in the buyer's account or even because of a stop-payment order.

When to Use Cash-in-Advance Terms

- The importer is a new customer and/or has a less-established operating history.
- The importer's creditworthiness is doubtful, unsatisfactory, or unverifiable.
- The political and commercial risks of the importer's home country are very high.
- The exporter's product is unique, not available elsewhere, or in heavy demand.
- The exporter operates an Internet-based business where the acceptance of credit card payments is a must to remain competitive.

Chapter 3

Letters of Credit

Letters of credit (LCs) are one of the most versatile and secure instruments available to international traders. An LC is a commitment by a bank on behalf of the importer (foreign buyer) that payment will be made to the beneficiary (exporter) provided that the terms and conditions stated in the LC have been met, as evidenced by the presentation of specified documents. Since LCs are credit instruments, the importer's credit with his bank is used to obtain an LC. The importer pays his bank a fee to render this service. An LC is useful when reliable credit information about a foreign buyer is difficult to obtain or if the foreign buyer's credit is unacceptable, but the exporter is satisfied with the creditworthiness of the importer's bank. This method also protects the importer since the documents required to trigger payment provide evidence that goods have been shipped as agreed. However, because LCs have opportunities for discrepancies, which may negate payment to the exporter, documents should be prepared by trained professionals or outsourced. Discrepant documents, literally not having an “*i* dotted and *t* crossed,” may negate the bank's payment obligation.

Key Points

- An LC, also referred to as a documentary credit, is a contractual agreement whereby the issuing bank (importer's bank), acting on behalf of its customer (the importer or buyer), promises to make payment to the beneficiary or exporter against the receipt of “complying” stipulated documents. The issuing bank will typically use intermediary banks to facilitate the transaction and make payment to the exporter.
- The LC is a separate contract from the sales contract on which it is based; therefore, the banks are not concerned with the quality of the underlying goods or whether each party fulfills the terms of the sales contract.
- The bank's obligation to pay is solely conditioned upon the seller's compliance with the terms and conditions of the LC. In LC transactions, banks deal in documents only, not goods.
- LCs can be arranged easily for one-time transactions between the exporter and importer or used for an ongoing series of transactions.
- Unless the conditions of the LC state otherwise, it is always irrevocable, which means the document may not be changed or cancelled unless the importer, banks, and exporter agree.

CHARACTERISTICS OF A LETTER OF CREDIT

Applicability

Recommended for use in higher-risk situations or new or less-established trade relationships when the exporter is satisfied with the creditworthiness of the buyer's bank

Risk

Risk is spread between exporter and importer, provided that all terms and conditions as specified in the LC are adhered to.

Pros

- Payment made after shipment
- A variety of payment, financing and risk mitigation options available

Cons

- Labor intensive process
- Relatively expensive method in terms of transaction costs

Confirmed Letter of Credit

A greater degree of protection is afforded to the exporter when an LC issued by a foreign bank (the importer's issuing bank) is confirmed by a U.S. bank. The exporter asks its customer to have the issuing bank authorize a bank in the exporter's country to confirm (this bank is typically the advising bank, which then becomes the confirming bank). Confirmation means that the U.S. bank adds its engagement to pay the exporter to that of the foreign bank. If an LC is not confirmed, the exporter is subject to the payment risk of the foreign bank and the political risk of the importing country. Exporters should consider getting confirmed LCs if they are concerned about the credit standing of the foreign bank or when they are operating in a high-risk market, where political upheaval, economic collapse, devaluation or exchange controls could put the payment at risk. Exporters should also consider getting confirmed LCs when importers are asking for extended payment terms.

Illustrative Letter of Credit Transaction

1. The importer arranges for the issuing bank to open an LC in favor of the exporter.
2. The issuing bank transmits the LC to the nominated bank, which forwards it to the exporter.
3. The exporter forwards the goods and documents to a freight forwarder.
4. The freight forwarder dispatches the goods and either the dispatcher or the exporter submits documents to the nominated bank.
5. The nominated bank checks documents for compliance with the LC and collects payment from the issuing bank for the exporter.
6. The importer's account at the issuing bank is debited.
7. The issuing bank releases documents to the importer to claim the goods from the carrier and to clear them at customs.

Special Letters of Credit

LCs can take many forms. When an LC is made transferable, the payment obligation under the original LC can be transferred to one or more "second beneficiaries." With a revolving LC, the issuing bank restores the credit to its original amount each time it is drawn down. A standby LC is not intended to serve as the means of payment for goods but can be drawn in the event of a contractual default, including the failure of an importer to pay invoices when due. Similarly, standby LCs are often posted by exporters in favor of an importer to pay invoices when due. Standby LCs are often posted by exporters in favor of importers because they can serve as bid bonds, performance bonds, and advance payment guarantees. In addition, standby LCs are often used as counter guarantees against the provision of down payments and progress payments on the part of foreign buyers.

Tips for Exporters

- Consult with your bank before the importer applies for an LC.
- Consider whether a confirmed LC is needed.
- Negotiate with the importer and agree upon detailed terms to be incorporated into the LC.
- Determine if all LC terms can be met within the prescribed time limits.
- Ensure that all the documents are consistent with the terms and conditions of the LC.
- Be cautious of discrepancy opportunities that may delay or cause non-payment.

Chapter 4

Documentary Collections

A documentary collection (D/C) is a transaction whereby the exporter entrusts the collection of payment to the exporter's bank (remitting bank), which sends documents to the importer's bank (collecting bank), along with instructions for payment. Funds are received from the importer and remitted to the exporter through the banks in exchange for those documents. D/Cs involve using a bill of exchange (commonly known as a draft) that requires the importer to pay the face amount either at sight (document against payment [D/P] or cash against documents) or on a specified future date (document against acceptance [D/A] or cash against acceptance). The collection cover letter gives instructions that specify the documents required for the delivery of the goods to the importer. Although banks do act as facilitators (agents) for their clients under collections, D/Cs offer no verification process and limited recourse in the event of non-payment. D/Cs are generally less expensive than letters of credit (LCs).

Key Points

- D/Cs are less complicated and less expensive than LCs.
- Under a D/C transaction, the importer is not obligated to pay for goods before shipment.
- If structured properly, the exporter retains control over the goods until the importer either pays the draft amount at sight or accepts the draft to incur a legal obligation to pay at a specified later date.
- Although the goods can be controlled under ocean shipments, they are more difficult to control under air and overland shipments, which allow the foreign buyer to receive the goods with or without payment unless the exporter employs agents in the importing country to take delivery until goods are paid for.
- The exporter's bank (remitting bank) and the importer's bank (collecting bank) play an essential role in D/Cs.
- Although the banks control the flow of documents, they neither verify the documents nor take any risks. They can, however, influence the mutually satisfactory settlement of a D/C transaction.

CHARACTERISTICS OF A DOCUMENTARY COLLECTION

Applicability

Recommended for use in established trade relationships, in stable export markets and for transactions involving ocean shipments

Risk

Riskier for the exporter, though D/C terms are more convenient and cheaper than an LC to the importer

Pros

- Bank assistance in obtaining payment
- The process is simple, fast, and less costly than LCs

Cons

- Banks' role is limited and they do not guarantee payment
- Banks do not verify the accuracy of the documents

When to Use Documentary Collections

With D/Cs, the exporter has little recourse against the importer in case of non-payment. Thus, D/Cs should be used only under the following conditions:

- The exporter and importer have a well-established relationship.
- The exporter is confident that the importing country is politically and economically stable.
- An open account sale is considered too risky, and an LC is unacceptable to the importer.

Typical Simplified D/C Transaction Flow

1. The exporter ships the goods to the importer and receives the documents in exchange.
2. The exporter presents the documents with instructions for obtaining payment to his bank.
3. The exporter's remitting bank sends the documents to the importer's collecting bank.
4. The collecting bank releases the documents to the importer on receipt of payment or acceptance of the draft.
5. The importer uses the documents to obtain the goods and to clear them at customs.
6. Once the collecting bank receives payment, it forwards the proceeds to the remitting bank.
7. The remitting bank then credits the exporter's account.

Documents against Payment Collection

With a D/P collection, the exporter ships the goods and then gives the documents to his bank, which will forward the documents to the importer's collecting bank, along with instructions on how to collect the money from the importer. In this arrangement, the collecting bank releases the documents to the importer only on payment for the goods. Once payment is received, the collecting bank transmits the funds to the remitting bank for payment to the exporter. Table 1 shows an overview of a D/P collection:

Table 1: Overview of a D/P collection

Time of Payment	After shipment, but before documents are released
Transfer of Goods	After payment is made at sight
Exporter Risk	If draft is unpaid, goods may need to be disposed of or may be delivered without payment if documents do not control possession

Documents against Acceptance Collection

With a D/A collection, the exporter extends credit to the importer by using a time draft. The documents are released to the importer to claim the goods upon his signed acceptance of the time draft. By accepting the draft, the importer becomes legally obligated to pay at a specific date. At maturity, the collecting bank contacts the importer for payment. Upon receipt of payment, the collecting bank transmits the funds to the remitting bank for payment to the exporter. Table 2 shows an overview of a D/A collection:

Table 2: Overview of a D/A collection

Time of Payment	On maturity of draft at a specified future date
Transfer of Goods	Before payment, but upon acceptance of draft
Exporter Risk	Has no control over goods after acceptance and may not get paid at due date

Chapter 5

Open Account

An open account transaction in international trade is a sale where the goods are shipped and delivered before payment is due, which is typically in 30, 60 or 90 days. Obviously, this option is advantageous to the importer in terms of cash flow and cost, but it is consequently a risky option for an exporter. Because of intense competition in export markets, foreign buyers often press exporters for open account terms. In addition, the extension of credit by the seller to the buyer is more common abroad. Therefore, exporters who are reluctant to extend credit may lose a sale to their competitors. However, though open account terms will definitely enhance export competitiveness, exporters should thoroughly examine the political, economic, and commercial risks as well as cultural influences to ensure that payment will be received in full and on time. It is possible to substantially mitigate the risk of non-payment associated with open account trade by using trade finance techniques such as export credit insurance and factoring. Exporters may also seek export working capital financing to ensure that they have access to financing for production and for credit while waiting for payment.

Key Points

- The goods, along with all the necessary documents, are shipped directly to the importer who has agreed to pay the exporter's invoice at a specified date, which is usually in 30, 60 or 90 days.
- The exporter should be absolutely confident that the importer will accept shipment and pay at the agreed time and that the importing country is commercially and politically secure.
- Open account terms may help win customers in competitive markets and may be used with one or more of the appropriate trade finance techniques that mitigate the risk of non-payment.

CHARACTERISTICS OF AN OPEN ACCOUNT TRANSACTION

Applicability

Recommended for use (a) in low-risk trading relationships or markets and (b) in competitive markets to win customers with the use of one or more appropriate trade finance techniques

Risk

Substantial risk to the exporter because the buyer could default on payment obligation after shipment of the goods

Pros

- Boost competitiveness in the global market
- Help establish and maintain a successful trade relationship

Cons

- Significant exposure to the risk of non-payment
- Additional costs associated with risk mitigation measures

How to Offer Open Account Terms in Competitive Markets

Open account terms may be offered in competitive markets with the use of one or more of the following trade finance techniques: (a) export working capital financing, (b) government-guaranteed export working capital programs, (c) export credit insurance, and (d) export factoring. More detailed information on each trade finance technique is provided in Chapters 7 through 10 of this Guide.

Export Working Capital Financing

Exporters who lack sufficient funds to extend open accounts in the global market need export working capital financing that covers the entire cash cycle, from the purchase of raw materials through the ultimate collection of the sales proceeds. Export working capital facilities, which are generally secured by personal guarantees, assets, or receivables, can be structured to support export sales in the form of a loan or revolving line of credit.

Government-Guaranteed Export Working Capital Programs

The U.S. Small Business Administration and the U.S. Export-Import Bank offer programs that guarantee export working capital facilities granted by participating lenders to U.S. exporters. With those programs, U.S. exporters can obtain needed facilities from commercial lenders when financing is otherwise not available or when their borrowing capacity needs to be increased.

Export Credit Insurance

Export credit insurance provides protection against commercial losses (such as default, insolvency, bankruptcy) and political losses (such as war, nationalization, and currency inconvertibility). It allows exporters to increase sales by offering more liberal open account terms to new and existing customers. Insurance also provides security for banks that are providing working capital and are financing exports.

Export Factoring

Factoring in international trade is the discounting of short-term receivables (up to 180 days). The exporter transfers title to his short-term foreign accounts receivable to a factoring house, or a factor, for cash at a discount from the face value. It allows an exporter to ship on open account as the factor assumes the financial liability of the importer to pay and handles collections on the receivables. Factoring houses most commonly work with exports of consumer goods.

Trade Finance Technique Unavailable for Open Account Terms: Forfaiting

Forfaiting is a method of trade financing that allows the exporter to sell his medium and long-term receivables (180 days to 7 years or more) to a forfaiter at a discount, in exchange for cash. The forfaiter assumes all the risks, thereby enabling the exporter to offer extended credit terms and to incorporate the discount into the selling price. Forfaiters usually work with exports of capital goods, commodities, and large projects. Forfaiting was developed in Switzerland in the 1950s to fill the gap between the exporter of capital goods, who would not or could not deal on open account, and the importer, who desired to defer payment until the capital equipment could begin to pay for itself. More detailed information about forfaiting is provided in Chapter 11 of the Guide.

Chapter 6

Consignment

Consignment in international trade is a variation of the open account method of payment in which payment is sent to the exporter only after the goods have been sold by the foreign distributor to the end customer. An international consignment transaction is based on a contractual arrangement in which the foreign distributor receives, manages, and sells the goods for the exporter who retains title to the goods until they are sold. Payment to the exporter is required only for those items sold. One of the common uses of consignment in exporting is the sale of heavy machinery and equipment because the foreign distributor generally needs floor models and inventory for sale. Goods not sold after an agreed upon time period may be returned to the exporter at cost. Exporting on consignment is very risky as the exporter is not guaranteed any payment and someone outside the exporter's control has actual possession of its inventory. However, selling on consignment can provide the exporter some great advantages which may not be obvious at first glance. For example, consignment can help exporters compete on the basis of better availability and faster delivery of goods when they are stored near the end customer. It can also help exporters reduce the direct costs of storing and managing inventory, thereby making it possible to keep selling prices in the local market competitive. However, though consignment can definitely enhance export competitiveness, exporters should keep in mind that the key to success in exporting on consignment and in getting paid is to partner with a reputable and trustworthy foreign distributor or a third-party logistics provider.

Key Points

- Payment is sent to the exporter only after the goods have been sold by the foreign distributor.
- Exporting on consignment can help exporters enter new markets and increase sales in competitive environments on the basis of better availability and faster delivery of goods.
- Consignment can also help exporters reduce the direct costs of storing and managing inventory, thereby making it possible to keep selling prices in the local market competitive.
- Partnership with a reputable and trustworthy foreign distributor or a third-party logistics provider is a must for success.
- The importing country should be commercially and politically secure.
- Appropriate insurance should be in place to mitigate the risk of non-payment as well as to cover consigned goods in transit or in possession of a foreign distributor.
- Export working capital financing can help exporters of consigned goods have access to financing and credit while waiting for payment from the foreign distributor.

CHARACTERISTICS OF CONSIGNMENT

Applicability

Recommended for use in competitive environments to enter new markets and increase sales in partnership with a reliable and trustworthy foreign distributor

Risk

Significant risk to the exporter because payment is required only after the goods have been sold to the end customer

Pros

- Help enhance export competitiveness on the basis of greater availability and faster delivery of goods
- Help reduce the direct costs of storing and managing inventory

Cons

- Exporter is not guaranteed payment
- Additional costs associated with risk mitigation measures

How to Export on Consignment

If you believe you are ready to export on consignment, the first step is to select a reputable and trustworthy foreign distributor or a third-party logistics provider who is based in a market of interest. The next step is to ensure that you have access to financing and credit and that appropriate insurance is in place to cover consigned goods against loss or damage as well to mitigate the risk of non-payment. As such, exporting on consignment may require the use of one or more of the following trade finance techniques: (a) export working capital financing, (b) government-guaranteed export working capital programs, and (c) export credit insurance. More detailed information on each trade finance technique is provided in Chapters 7 through 9 of this Guide.

Partnership in Exporting on Consignment

To succeed in exporting on consignment, the exporter must partner with a reputable and trustworthy foreign distributor or a third-party logistics provider (3PL) that is based in its selected overseas market. A 3PL is a firm that provides logistics services with expertise in pick-up and delivery of shipments for exporters. 3PLs can help exporters reduce costs, mitigate risks, and manage expenses and time factors as well as to ensure that the consignment is shipped on the most economical and optimal route.

Here is a real life example of how a partnership in exporting on consignment helped a U.S. company. A Midwest-based manufacturer of packaging equipment faced challenges in meeting market demand for quick delivery of its products to Asia as well as in reducing the costs of storing and managing overseas inventory to keep prices competitive. The U.S. manufacturer entered a consigned inventory arrangement with a Japanese 3PL who receives and stocks the goods in Japan and sells them to the end customers in Asia. The Japanese 3PL receives a commission for sales made, and then sends the net proceeds to the U.S. manufacturer as their goods are sold. The U.S. manufacturer's sales increased substantially because exporting on consignment helped deliver their products faster to the local market and kept prices competitive due to reduced direct costs of storing and managing overseas inventory.

Export Working Capital Financing

Exporters who sell on consignment in the global market need financing to ensure that they have access to working capital and credit while waiting for payment from the foreign distributor. Export working capital facilities, which are generally secured by personal guarantees, assets, or receivables, can be structured to support export sales in the form of a loan or revolving line of credit.

Government-Guaranteed Export Working Capital Programs

The U.S. Small Business Administration and the U.S. Export-Import Bank offer programs that guarantee export working capital facilities granted by participating lenders to U.S. exporters. With those programs, U.S. exporters can obtain needed facilities from commercial lenders when financing is otherwise not available or when their borrowing capacity needs to be increased.

Export Credit Insurance

Export credit insurance provides protection against commercial losses (such as default, insolvency, bankruptcy) and political losses (such as war, nationalization, and currency inconvertibility). It gives the exporter conditional assurance that payment will be made if the foreign distributor is unable to pay. Appropriate insurance should be obtained to cover consigned goods in transit or in possession of a foreign distributor.

Chapter 7

Export Working Capital Financing

Export working capital (EWC) financing allows exporters to purchase the goods and services they need to support their export sales. More specifically, EWC facilities extended by commercial lenders provide a means for small and medium-sized enterprises (SMEs) that lack sufficient internal liquidity to process and acquire goods and services to fulfill export orders and extend open account terms to their foreign buyers. EWC financing also helps exporters of consigned goods have access to financing and credit while waiting for payment from the foreign distributor. EWC funds are commonly used to finance three different areas: (a) materials, (b) labor, and (c) inventory, but they can also be used to finance receivables generated from export sales and/or standby letters of credit used as performance bonds or payment guarantees to foreign buyers. An unexpected large export order or many incremental export orders can place challenging demands on working capital. EWC financing, which is generally secured by personal guarantees, assets, or high-value accounts receivable, helps to ease and stabilize the cash flow problems of exporters while they fulfill export sales and grow competitively in the global market.

Key Points

- Funds may be used to acquire materials, labor, inventory, goods and services for export.
- A facility can support a single export transaction (transaction-specific short-term loan) or multiple export transactions (revolving line of credit) on open account terms.
- A transaction-specific loan is generally up to one year, and a revolving line of credit may extend up to three years.
- Availability is generally limited to financially-stable corporations or established SMEs with access to strong personal guarantees, assets, or high-value accounts receivable.
- A government guarantee may be needed to obtain a facility that can meet your export needs.
- Exporters may need to employ risk mitigation measures to offer open account or consignment terms confidently in the global market.

CHARACTERISTICS OF AN EXPORT WORKING CAPITAL FACILITY

Applicability

Used to purchase raw materials, supplies, and equipment to fulfill a large export sales order or many small export sales orders

Risk

Significant risk of non-payment for exporter unless proper risk mitigation measures are used

Pros

- Allows fulfillment of export sales orders
- Allows exporter to offer open account terms or sell on consignment to remain competitive

Cons

- Generally available only to SMEs with access to strong personal guarantees, assets, or high-value receivables
- Additional costs associated with risk mitigation measures

Where and How to Obtain an Export Working Capital Facility

Many commercial banks and lenders offer facilities for export activities. To qualify, exporters generally need: (a) to be in business profitably for at least 12 months (not necessarily exporting), (b) to demonstrate a need for transaction-based financing, and (c) to provide documents to demonstrate that a viable transaction exists. Note that personal guarantees, collateral assets, or high-value accounts receivable are generally required for SMEs to obtain commercial EWC facilities. The lender may place a lien on the exporter's assets, such as inventory and accounts receivable, to ensure repayment of the loan. In addition, all export sale proceeds will usually be collected and applied to the principal and interest by the lender before the balance is passed on to the exporter. Fees and interest rates are usually negotiable between the lender and the exporter.

Short-term Loans or Revolving Lines of Credit

Basically, there are two types of EWC facilities: transaction-specific short-term loans and revolving lines of credit. Short-term loans, which are appropriate for large and periodic export orders, are typically used if the outflows and inflows of funds are predictable over time. Short-term loans can be arranged for 3, 6, 9, or 12 months, and the interest rates are usually fixed over the requested tenors. Revolving lines of credit, however, are appropriate for a series of small export orders because they are designed to cover temporary funding needs that cannot always be anticipated. Revolving lines of credit have a very flexible structure so that exporters can draw funds against their current account at any time and up to a specified limit.

Why a Government Guarantee May Be Needed

The U.S. Small Business Administration and the U.S. Export-Import Bank offer programs that guarantee EWC facilities on behalf of U.S. exporters to commercial lenders which make the actual loans. These programs allow U.S. exporters to obtain needed credit facilities from participating lenders when commercial financing is otherwise not available or when their borrowing capacity needs to be increased. Advance rates offered by commercial banks on export inventory and foreign accounts receivables are not always sufficient to meet the needs of exporters. In addition, some lenders do not lend to exporters without a government guarantee due to repayment risks associated with export sales. More detailed information is provided in Chapter 8.

Why Risk Mitigation May Be Needed

While EWC financing certainly makes it possible for exporters to offer open account terms or sell on consignment in today's highly competitive global markets, the use of such financing itself does not necessarily eliminate the risk of non-payment by foreign customers. Some forms of risk mitigation may be needed in order to offer open account or consignment terms more confidently and to obtain EWC financing. For example, a lender may require an exporter to obtain export credit insurance on its foreign receivables as a condition of providing working capital and financing for exports.

Chapter 8

Government-Guaranteed Export Working Capital Loan Programs

Financing offered by commercial lenders on export inventory and foreign accounts receivables is not always sufficient to meet the needs of U.S. exporters. Early-stage small and medium-sized exporters are usually not eligible for commercial financing without a government guarantee. In addition, commercial lenders are generally reluctant to extend credit due to the repayment risk associated with export sales. In such cases, government-guaranteed export working capital (EWC) loans can provide the exporter with the liquidity to accept new business, help grow U.S. export sales, and let U.S. firms compete more effectively in the global marketplace. Two U.S. Government agencies—the U.S. Small Business Administration (SBA) and the U.S. Export-Import Bank (Ex-Im Bank)—offer loan guarantees to participating lenders for making export loans to U.S. businesses. Both agencies focus on export trade financing, with SBA typically handling facilities up to \$5 million and Ex-Im Bank processing facilities of all sizes. Through these government-guaranteed EWC loans, U.S. exporters can obtain financing from participating lenders when commercial financing is otherwise not available or when their borrowing needs are greater than the lenders' credit standards would allow.

Key Points

- The loan expands access to EWC for supplier financing and production costs.
- The loan maximizes the borrowing base by turning export inventory and accounts receivable into cash.
- Risk mitigation may be needed to offer open account terms confidently in the global market.
- SBA's EWC loan is appropriate for U.S. small-sized businesses and has credit lines up to \$5 million.
- Ex-Im Bank's EWC loan is available for all U.S. businesses, including small and medium-sized exporters, and has credit lines of all sizes.
- Both SBA and Ex-Im Bank generally guarantee 90 percent of the bank's EWC loan.

CHARACTERISTICS OF A GOVERNMENT-GUARANTEED EXPORT WORKING CAPITAL LOAN

Applicability

Recommended when commercial financing is otherwise not available or when pre-approved borrowing capacity is not sufficient

Risk

Exposure of exporter to the risk of non-payment without the use of proper risk mitigation measures

Pros

- Encourages lenders to offer financing to exporters
- Enables lenders to offer generous advance rates

Cons

- Cost of obtaining and maintaining a guaranteed facility
- Additional costs associated with risk mitigation measures

Comparison: Commercial Facility vs. Government-Guaranteed Facility

Table 3 is an example of how a government-guaranteed export loan from a lender participating with SBA or Ex-Im Bank can increase your borrowing base against your total collateral value. Advance rates may vary depending on the quality of the collateral offered.

Table 3: Government-guaranteed loans increase your borrowing power

Borrow up to \$1.65 million against your collateral value of \$2 million		Commercial Facility Without a Government Guarantee		Commercial Facility With a Government Guarantee	
COLLATERAL	VALUE	Advance Rate	Borrowing Base	Advance Rate	Borrowing Base
Export Inventory					
Raw Materials	\$200,000	20%	\$40,000	75%	\$150,000
Work-in-Process	\$200,000	0%	\$0	75%	\$150,000
Finished Goods	\$600,000	50%	\$300,000	75%	\$450,000
Export Accounts Receivable					
On Open Account	\$400,000	0%	\$0	90%	\$360,000
By Letter of Credit	\$600,000	70%	\$420,000	90%	\$540,000
Total Collateral Value	\$2,000,000				
Total Borrowing Base			\$760,000		\$1,650,000

Key Features of SBA's Export Working Capital Program

- Exporters and indirect exporters must meet SBA eligibility and size standards.
- There is no application fee and there are no restrictions regarding foreign content or military sales.¹
- A 0.25 percent upfront facility fee is based on the guaranteed portion of a loan of 12 months or fewer.
- Fees and interest rate charged by the commercial lender are negotiable.
- The "Export Express" program can provide exporters and lenders a streamlined method to obtain SBA-backed financing for EWC loans up to \$500,000. With an expedited eligibility review, a response may be obtained in fewer than 36 hours.
- Exporters and indirect exporters are also eligible for the International Trade Loan Program that offers permanent working capital and fixed asset financing for export and related business purposes.

For more information, visit the SBA Web site at www.sba.gov/international and click on the dropdown menu for SBA Export Programs or call 1-800-U-ASK-SBA (8-275-722).

Key Features of Ex-Im Bank's Export Working Capital Program

- Exporters and indirect exporters must adhere to the Bank's requirements for content, non-military uses, environmental and economic impact and to the Country Limitation Schedule.
- There is a non-refundable \$100 application fee.
- A 1.75 percent upfront facility fee based on the total loan amount and a one-year loan but may be reduced to 1 percent with export credit insurance and if designated requirements are met.
- Fees and interest rate charged by the commercial lender are usually negotiable.
- Enhancements are available for minority- or woman-owned, rural and environmental firms.
- Participating commercial lender partners can expeditiously process EWC loans under established criteria without pre-approval from Ex-Im Bank.

For more information, visit the Ex-Im Bank Web site at www.exim.gov or call 1-800-565-EXIM (3946).

Why Risk Mitigation May Be Needed

Government guarantees on export loans do not make exporters immune to the risk of non-payment by foreign customers. Rather, the government guarantee provides lenders with an incentive to offer financing by reducing the lender's risk exposure. Exporters may need some form of risk mitigation, such as export credit insurance, to offer open account terms more confidently.

1. SBA encourages the use of American made products, if feasible. Borrowers must comply with all export control requirements.

Chapter 9

Export Credit Insurance

Export credit insurance (ECI) protects an exporter of products and services against the risk of non-payment by a foreign buyer. In other words, ECI significantly reduces the payment risks associated with doing business internationally by giving the exporter conditional assurance that payment will be made if the foreign buyer is unable to pay. Simply put, exporters can protect their foreign receivables against a variety of risks that could result in non-payment by foreign buyers. ECI generally covers commercial risks (such as insolvency of the buyer, bankruptcy, or protracted defaults/slow payment) and certain political risks (such as war, terrorism, riots, and revolution) that could result in non-payment. ECI also covers currency inconvertibility, expropriation, and changes in import or export regulations. ECI is offered either on a single-buyer basis or on a portfolio multi-buyer basis for short-term (up to one year) and medium-term (one to five years) repayment periods.

Key Points

- ECI allows exporters to offer competitive open account terms to foreign buyers while minimizing the risk of non-payment.
- Even creditworthy buyers could default on payment due to circumstances beyond their control.
- With reduced non-payment risk, exporters can increase export sales, establish market share in emerging and developing countries, and compete more vigorously in the global market.
- When foreign accounts receivable are insured, lenders are more willing to increase the exporter's borrowing capacity and offer more attractive financing terms.
- ECI does not cover physical loss or damage to the goods shipped to the buyer, or any of the risks for which coverage is available through marine, fire, casualty or other forms of insurance.

CHARACTERISTICS OF EXPORT CREDIT INSURANCE

Applicability

Recommended for use in conjunction with open account terms and pre-export working capital financing

Risk

Exporters assume the risk of the uncovered portion of the loss and their claims may be denied in case of non-compliance with requirements specified in the policy

Pros

- Reduces the risk of non-payment by foreign buyers
- Offers open account terms safely in the global market

Cons

- Cost of obtaining and maintaining an insurance policy
- Risk sharing in the form of a deductible (coverage is usually below 100 percent)

Coverage

Short-term ECI, which provides 90 to 95 percent coverage against commercial and political risks that result in buyer payment defaults, typically covers (a) consumer goods, materials, and services up to 180 days, and (b) small capital goods, consumer durables, and bulk commodities up to 360 days. Medium-term ECI, which provides 85 percent coverage of the net contract value, usually covers large capital equipment up to five years. ECI, the cost of which is often incorporated into the selling price by exporters, should be a proactive purchase, in that exporters should obtain coverage before a customer becomes a problem.

Where Can I Get Export Credit Insurance?

ECI policies are offered by many private commercial risk insurance companies as well as the Export-Import Bank of the United States (Ex-Im Bank), the government agency that assists in financing the export of U.S. goods and services to international markets. U.S. exporters are strongly encouraged to shop for a specialty insurance broker who can help them select the most cost-effective solution for their needs. Reputable, well-established companies that sell commercial ECI policies can be easily found on the Internet. You may also buy ECI policies directly from Ex-Im Bank. In addition, a list of active insurance brokers registered with Ex-Im Bank is available at www.exim.gov or you can call 1-800-565-EXIM (3946) for more information.

Private-Sector Export Credit Insurance

- Premiums are individually determined on the basis of risk factors and may be reduced for established and experienced exporters.
- Most multi-buyer policies cost less than 1 percent of insured sales, whereas the prices of single-buyer policies vary widely due to presumed higher risk.
- The cost in most cases is significantly less than the fees charged for letters of credit.
- There are no restrictions regarding foreign content or military sales.
- Commercial insurance companies can usually offer flexible and discretionary credit limits.

Ex-Im Bank's Export Credit Insurance

- Ex-Im Bank customers are advised to refer to the Exposure Fee Information & Fee Calculators section (which are posted on the Bank's Web site www.exim.gov under the "Apply" section) to determine exposure fees (premiums).
- Coverage is available in riskier emerging foreign markets where private insurers may not operate.
- Exporters electing an Ex-Im Bank working capital guarantee may receive a 25 percent premium discount on multi-buyer insurance policies.
- Enhanced support is offered for environmentally beneficial exports.
- The products must be shipped from the United States and have at least 50 percent U.S. content.
- Ex-Im Bank is unable to support military products or purchases made by foreign military entities.
- Support for exports may be closed or restricted in certain countries for U.S. government policy reasons (for more information, see the Country Limitation Schedule posted on the Bank's Web site under the "Apply" section).

Chapter 10

Export Factoring

Export factoring is a complete financial package that combines export working capital financing, credit protection, foreign accounts receivable bookkeeping, and collection services. A factoring house, or factor, is a bank or a specialized financial firm that performs financing through the purchase of invoices or accounts receivable. Export factoring is offered under an agreement between the factor and exporter, in which the factor purchases the exporter's short-term foreign accounts receivable for cash at a discount from the face value, normally without recourse. The factor also assumes the risk on the ability of the foreign buyer to pay, and handles collections on the receivables. Thus, by virtually eliminating the risk of non-payment by foreign buyers, factoring allows the exporter to offer open account terms, improves liquidity position, and boosts competitiveness in the global marketplace. Factoring foreign accounts receivables can be a viable alternative to export credit insurance, long-term bank financing, expensive short-term bridge loans or other types of borrowing that create debt on the balance sheet.

Key Points

- Factoring is suited for continuous short-term export sales of consumer goods on open account terms.
- It offers 100 percent protection against the foreign buyer's inability to pay—no deductible or risk sharing.
- It is an option for small and medium-sized exporters, particularly during periods of rapid growth, because cash flow is preserved and the risk of non-payment is virtually eliminated.
- It is unsuitable for the new-to-export company as factors generally (a) do not take on a client for a one-time deal and (b) require access to a certain volume of the exporter's yearly sales.
- It is generally a more expensive option that may erode a significant amount of an exporter's margin.
- The advance rate is generally limited to 80 percent of invoices that are factored.

CHARACTERISTICS OF EXPORT FACTORING

Applicability

Best suited for an established exporter who wants (a) to have the flexibility to sell on open account terms, (b) to avoid incurring any credit losses, or (c) to outsource credit and collection functions

Risk

Risk of non-payment inherent in an export sale is virtually eliminated

Pros

- Eliminates the risk of non-payment by foreign buyers
- Maximizes cash flows

Cons

- More costly than export credit insurance
- Generally not available in developing countries

How Does Export Factoring Work?

The exporter signs an agreement with the export factor who selects an import factor through an international correspondent factor network. The import factor then investigates the foreign buyer's credit standing. Once credit is approved locally, the foreign buyer places orders for goods on open account. The exporter then ships the goods and submits the invoice to the export factor, who transfers it to the import factor. The import factor then handles the local collection and payment of the accounts receivable. During all stages of the transaction, records are kept for the exporter's bookkeeping.

Two Common Export Factoring Financing Arrangements and Their Costs

In **discount factoring**, the factor issues an advance of funds against the exporter's receivables until money is collected from the importer. The cost is variable, depending on the time frame and the dollar amount advanced. In **collection factoring**, the factor pays the exporter (less a commission charge) when receivables are at maturity, regardless of the importer's financial ability to pay. The cost is fixed, and usually ranges between 1 and 4 percent, depending on the country of destination, sales volume, and amount of paperwork. However, as a rule of thumb, export factoring usually costs about twice as much as export credit insurance.

Limitations of Export Factoring

- It exists only in countries with laws that support the buying and selling of receivables.
- It generally does not work with foreign account receivables that have more than 180-day terms.
- It may be cost prohibitive for exporters with tight profit margins.

Where to Find a Factor?

The international factoring business involves networks, which are similar to correspondents in the banking industry. There are two sources for global networks—Factors Chain International (FCI) and International Factors Group (IFG). FCI is located in the Netherlands, and their Web site is www.factors-chain.com. IFG is located in Belgium, and their Web site is www.ifg-group.com. Another useful source is the International Factoring Association (IFA), which is the world's largest association of financial firms that offer factoring services. The IFA is located in Pismo Beach, California, and their Web site is www.factoring.org.

Export Factoring Industry Profile

According to FCI, the total worldwide volume for factoring in 2011 was \$2.6 trillion, up more than 22 percent from 2010. The 2011 data indicates that exporters and importers around the world are becoming more familiar with the many advantages in a factoring arrangement. Although U.S. export factors have traditionally focused on specific market sectors such as textiles and apparel, footwear, and carpeting, they are now working with more diversified products. Today, U.S. exporters who use export factoring are manufacturers, distributors, wholesalers, and service firms with sales ranging from \$5 million to \$200 million. Factoring is also a valuable financial tool for larger U.S. corporations to manage their balance sheets. Total international factoring volume in the United States is now worth around \$19 billion annually, greatly contributing to the growth in U.S. exports.

Chapter 11

Forfaiting

Forfaiting is a method of trade finance that allows exporters to obtain cash by selling their medium and long-term foreign accounts receivable at a discount on a “without recourse” basis. A forfaiter is a specialized finance firm or a department in a bank that performs non-recourse export financing through the purchase of medium and long-term trade receivables. “Without recourse” or “non-recourse” means that the forfaiter assumes and accepts the risk of non-payment. Similar to factoring, forfaiting virtually eliminates the risk of non-payment, once the goods have been delivered to the foreign buyer in accordance with the terms of sale. However, unlike factors, forfaiters typically work with exporters who sell capital goods and commodities, or engage in large projects and therefore need to offer extended credit periods from 180 days to seven years or more. In forfaiting, receivables are normally guaranteed by the importer’s bank, which allows the exporter to take the transaction off the balance sheet to enhance key financial ratios. The current minimum transaction size for forfaiting is \$100,000. In the United States, most users of forfaiting are large established corporations, but small and medium-size companies are slowly embracing forfaiting as they become more aggressive in seeking financing solutions for exports to countries considered high risk.

Key Points

- Forfaiting eliminates virtually all risk to the exporter, with 100 percent financing of contract value.
- Exporters can offer medium and long-term financing in markets where the credit risk would otherwise be too high.
- Forfaiting generally works with bills of exchange, promissory notes, or a letter of credit.
- In most cases, the foreign buyers must provide a bank guarantee in the form of an aval, letter of guarantee or letter of credit.
- Financing can be arranged on a one-shot basis in any of the major currencies, usually at a fixed interest rate, but a floating rate option is also available.
- Forfaiting can be used in conjunction with officially supported credits backed by export credit agencies such as the U.S. Export-Import Bank.

CHARACTERISTICS OF FORFAITING

Applicability

Suited for exports of capital goods, commodities, and large projects on medium and long-term credit (180 days to seven years or more)

Risk

Risk of non-payment inherent in an export sale is virtually eliminated

Pros

- Eliminates the risk of non-payment by foreign buyers
- Offers strong capabilities in emerging and developing markets

Cons

- Cost is often higher than commercial lender financing
- Limited to medium and long-term transactions and those exceeding \$100,000

How Forfaiting Works

The exporter approaches a forfaiter before finalizing the transaction's structure. Once the forfaiter commits to the deal and sets the discount rate, the exporter can incorporate the discount into the selling price. The exporter then accepts a commitment issued by the forfaiter, signs the contract with the importer, and obtains, if required, a guarantee from the importer's bank that provides the documents required to complete the forfaiting. The exporter delivers the goods to the importer and delivers the documents to the forfaiter who verifies them and pays for them as agreed in the commitment. Since this payment is without recourse, the exporter has no further interest in the financial aspects of the transaction and it is the forfaiter who must collect the future payments due from the importer.

When to Contact a Forfaiter

Forfaiting is widely used by exporters and financial institutions throughout Europe because their sales and financing professionals work very closely together to develop a contract price proposal that makes the cost of financing competitive and attractive to foreign buyers, an approach not widely embraced and practiced in the United States. Thus, exporters should contact a forfaiter at the earliest possible point in formulating their sales and financing proposals so that they might better understand the subtleties and complexities of dealing in certain markets, including how to create a medium-term financing proposal at interest rates that are competitive, without reducing the margin on the sale.

Cost of Forfaiting

The cost of forfaiting to the exporter is determined by the rate of discount based on the aggregate of the LIBOR (London inter bank offered rate) rates for the tenor of the receivables and a margin reflecting the risk being sold. In addition, there are certain costs that are borne by the importer that the exporter should also take into consideration. The degree of risk varies based on the importing country, the length of the loan, the currency of the transaction, and the repayment structure—the higher the risk, the higher the margin and therefore the discount rate. However, forfaiting can be more cost-effective than traditional trade finance tools because of the many attractive benefits it offers to the exporter.

Three Additional Major Advantages of Forfaiting

Volume: Forfaiting can work on a one-off transaction basis, without requiring an ongoing volume of business.

Speed: Commitments can be issued within hours or days depending on details and country.

Simplicity: Documentation is usually simple, concise, and straightforward.

Forfaiting Industry Profile

Forfaiting was developed in Switzerland in the 1950s to fill the gap between the exporter of capital goods, who would not or could not deal on open account, and the importer, who desired to defer payment until the capital equipment could begin to pay for itself. Although the number of forfaiting transactions is growing worldwide, there are currently no official statistics available on the size of the global forfaiting market. However, industry sources estimate that the total annual volume of new forfaiting transactions is around \$30 billion and that forfaiting transactions worth \$60 to \$75 billion are outstanding at any given time. Industry sources also estimate that only 2 percent of world trade is financed through forfaiting. U.S. forfaiting transactions account for only 3 percent of that volume. Forfaiting firms have opened around the world, but the Europeans maintain a hold on the market, including in North America. Although these firms remain few in number in the United States, the innovative financing they provide should not be overlooked as a viable means of export finance for U.S. exporters.

Where to Find a Forfaiter

The Association of Trade & Forfaiting in the Americas, Inc. (ATFA) and the International Forfaiting Association (IFA) are useful sources for locating forfaiters willing to finance exports. ATFA and IFA are associations of financial institutions dedicated to promoting international trade finance through forfaiting. ATFA is located in New York, and its Web site is www.tradeandforfaiting.com. IFA is located in Switzerland and its Web site is www.forfaiters.org.

Chapter 12

Government-Assisted Foreign Buyer Financing

International sales of high-value capital goods or services and exports to large-scale projects, which require medium- or long-term financing, often pose special challenges to exporters as commercial lenders may be reluctant to lend large sums to foreign buyers, especially those in developing countries, for extended periods. One viable solution to these challenges is foreign buyer financing offered by the U.S. Export-Import Bank (Ex-Im Bank). As the official U.S. export credit agency, Ex-Im Bank supports the purchases of U.S. goods and services by creditworthy foreign buyers who are unable to obtain the financing they need through traditional commercial sources. Ex-Im Bank does not compete with commercial lenders but provides products that fill gaps in trade financing by assuming country and credit risks that the private sector is unable or unwilling to accept. With Ex-Im Bank's foreign buyer financing, U.S. exporters can turn their business opportunities into real transactions and get paid cash on delivery and acceptance of the goods or services.

Key Points

- Government-assisted foreign buyer financing helps turn export opportunities, especially in high-risk emerging markets, into real transactions for large U.S. corporations and established medium-sized companies, as well as their small business suppliers.
- Creditworthy foreign buyers can obtain loans needed for purchases of U.S. goods and services, especially high-value capital goods or services and exports to large-scale projects.
- This type of financing provides direct loans to foreign buyers at a fixed interest rate or provides guarantees for term financing offered by commercial lenders.
- Financing is available for medium-term (up to 5 years) and long-term (generally up to 10 years) transactions.

CHARACTERISTICS OF GOVERNMENT-ASSISTED FOREIGN BUYER FINANCING

Applicability

Suitable for the export of high-value capital goods or services or large-scale projects that require extended-term financing

Risk

Risk is transferred to Ex-Im Bank and to the foreign buyer who is required to make a 15 percent cash down payment to the exporter

Pros

- Buyer financing as part of an attractive sales package
- Cash payment upon shipment of the goods or services

Cons

- Subject to certain restrictions for U.S. government policy reasons
- Possible lengthy process of approving financing

Key Common Features of Ex-Im Bank's Loan Guarantees and Direct Loans

Ex-Im Bank assists U.S. exporters by: (a) providing direct loans; or (b) guaranteeing repayment of commercial loans to creditworthy foreign buyers for purchases of U.S. goods and services. These loans are generally used to finance the purchase of high-value capital equipment or services or exports to large-scale projects that require medium- or long-term financing. Ex-Im Bank's foreign buyer financing is also used to finance the purchase of refurbished equipment, software, and certain banking and legal fees, as well as some local costs and expenses. There is no minimum or maximum limit to the size of the export sale that may be supported by the Bank's foreign buyer financing. Ex-Im Bank requires the foreign buyer to make a cash payment to the exporter equal to at least 15 percent of the U.S. supply contract. Repayment terms up to five years are available for exports of capital goods and services. Transportation equipment and exports to large-scale projects may be eligible for repayment terms up to 10 years (12 to 18 years for certain sectors). Military items are generally not eligible for Ex-Im Bank financing nor are sales to foreign military entities. In addition, goods must meet the Bank's foreign content requirements. Finally, Ex-Im Bank financing may not be available in certain countries and certain terms for U.S. government policy reasons (for more information, see the Country Limitation Schedule posted on the Bank's Web site, www.exim.gov, under the "Apply" section).

Key Features of Ex-Im Bank Loan Guarantees

- Loans are made by commercial banks and repayment of these loans is guaranteed by Ex-Im Bank.
- Guaranteed loans cover 100 percent of the principal and interest for 85 percent of the U.S. contract price.
- Interest rates are negotiable, and are usually floating and lower than fixed rates.
- Guaranteed loans are fully transferable, can be securitized and are available in certain foreign currencies.
- Guaranteed loans have a faster documentation process with the assistance of commercial banks.
- There are no U.S. vessel shipping requirements for amounts less than \$20 million.

Key Features of Ex-Im Bank Direct Loans

- Fixed-rate loans are provided directly to creditworthy foreign buyers.
- Direct loans support 85 percent of the U.S. contract price.
- Exporters will be paid in full upon disbursement of a loan to the foreign buyers.
- Generally, goods shipped by sea must be carried exclusively on U.S. vessels.
- Direct loans are best used when the buyer insists on a fixed rate.

Fees and Ex-Im Bank Contact Information

- **Letter of interest:** \$50 for online application; \$100 for paper application via mail and fax.
- **Preliminary commitment:** 0.1 of 1 percent of the financed amount up to \$25,000.
- **Guarantee commitment:** 0.125 percent per year on the undisbursed balance of the loan.
- **Direct loan commitment:** 0.5 percent per year on the undisbursed balance of the loan.
- **Exposure fee:** varies, depending upon tenor, country risk, and buyer credit risk.

For more information about loans from Ex-Im Bank, visit its Web site at www.exim.gov or call 1-800-565-EXIM (3946).

Chapter 13

Government-Backed Agricultural Export Financing

The United States is the world's largest exporter of agricultural products. U.S. agricultural exports play a vital role in building and strengthening the nation's economy. As is the case with any cross-border transaction, international sales of agricultural products often pose financing challenges to exporters as commercial lenders may be reluctant to extend credit to foreign buyers, especially those in risky emerging market countries. One viable solution to these challenges is government-backed agricultural export financing offered by the U.S. Department of Agriculture (USDA). USDA's Foreign Agricultural Service (FAS) is responsible for the operation of two credit guarantee programs for commercial financing of U.S. agricultural exports and related facilities—the Export Credit Guarantee (GSM-102) Program and the Facilities Guarantee Program (FGP). These programs, with guarantees issued by USDA's Commodity Credit Corporation, encourage commercial lenders to extend otherwise unavailable financing to buyers in countries where credit is necessary to purchase U.S. agricultural products and build or expand agricultural-related facilities. With USDA's agricultural export financing, U.S. exporters of agricultural commodities and products can turn their business opportunities into real transactions and get paid upon submission of the proper documents.

Key Points

- Government-backed agricultural export financing helps turn sales opportunities, especially in emerging markets, into real transactions for U.S. exporters of agricultural products and related facilities.
- Letters of credit are required in all USDA-supported export financing transactions.
- USDA takes the lead on U.S. agricultural export financing, while the U.S. Export-Import Bank (Ex-Im Bank) is the lead federal agency for providing financing and insurance for non-agricultural U.S. exports.
- However, should USDA-backed export financing be unavailable due to its program restrictions or the terms of the sales contract proposed by the foreign buyer, government-backed agricultural export financing may be available at Ex-Im Bank.

Export Credit Guarantee (GSM-102) Program

GSM stands for General Sales Manager, which refers to the FAS official with the responsibility of administering the GSM-102 program. Under the GSM-102 program, USDA's Commodity Credit Corporation (CCC) provides credit guarantees to encourage commercial financing of U.S. agricultural exports, thereby assisting U.S. exporters in making sales that might not otherwise occur. USDA does not provide loans to foreign

CHARACTERISTICS OF GOVERNMENT-BACKED AGRICULTURAL EXPORT FINANCING

Applicability

Suitable for the export of agricultural commodities and products, and manufactured goods to improve or establish agricultural-related facilities, to emerging markets where credit may be difficult to obtain

Risk

USDA assumes almost all the risk of payment default

Pros

- Making otherwise unavailable financing available to buyers of U.S. agricultural products
- Prompt payment upon submission of proper documents

Cons

- Cost of obtaining a guarantee from USDA
- Subject to certain restrictions for U.S. government policy reasons

buyers, but guarantees payments due from foreign banks under letters of credit (LCs) to U.S. exporters or U.S. commercial lenders. Because payment is guaranteed, U.S. commercial lenders can offer competitive credit terms to the foreign banks that issue letters of credit for the importers of U.S. food and agricultural products. It is the U.S. exporter who must apply for the CCC guarantee and pay a fee. As such, the exporter may factor this cost into the selling price prior to the contract negotiation process. The CCC guarantee covers up to 98 percent of the loan principal and a portion of the interest for terms up to 3 years. The U.S. exporter can avoid assuming a loss by assigning the CCC guarantee to a U.S. bank. In other words, the holder of a CCC guarantee takes the 2 percent loss if there is a default.

Step-by-Step GSM-102 Program Process

1. U.S. exporter qualifies to participate in the GSM-102 program (Online application)
2. U.S. exporter negotiates a firm sales contract with the importer
3. Importer requests the opening of a LC in favor of the U.S. exporter at a USDA-approved foreign bank
4. U.S. exporter applies for a CCC guarantee and pays a guarantee fee
5. CCC issues a guarantee to the U.S. exporter
6. U.S. exporter typically assigns the CCC guarantee to a USDA-approved U.S. bank
7. U.S. exporter ships the commodity and presents documents to the U.S. bank
8. U.S. bank pays the U.S. exporter at sight and extends financing terms to the foreign bank
9. Foreign bank pays the U.S. bank per terms of CCC-guaranteed financing
10. Importer pays the foreign bank per terms established between these two parties
11. If the foreign bank defaults, the holder of the CCC guarantee files claim with USDA

Examples of GSM-102 Eligible U.S. Food and Agricultural Products

- **Bulk commodities:** wheat, feed grains, cotton, soybeans, rice
- **Intermediate products:** animal feed, cattle hides, soybean meal, flour, sweeteners
- **High-value products:** meat, fruits, vegetables, wine, grocery products

Facilities Guarantee Program (FGP)

Another USDA export financing program is called the Facilities Guarantee Program (FGP), which provides payment guarantees to finance commercial exports of U.S. manufactured goods and services that will be used to establish or improve agriculture-related facilities in emerging countries. The FGP program is designed to expand sales of U.S. food and agricultural products to emerging markets where inadequate storage, processing or handling capacity limit trade potential. USDA makes a determination annually as to whether or not to make this program available. The FGP guarantee covers 95 percent of the value of goods and services to be exported less any discounts or allowances to the importer.

Examples of FGP Eligible U.S. Products or Services

- Construction of a soybean crushing facility for the purpose of crushing U.S. soybeans
- Construction of a corn silo to hold imported U.S. corn
- Implementation of an agricultural commodity data system

More Information about FAS and USDA Export Financing Programs

On behalf of USDA, FAS operates both the GSM-102 Program and the FGP. FAS links U.S. agriculture to the world to enhance export opportunities and global food security. In addition to its Washington, D.C., staff, FAS has a global network of 98 offices covering 162 countries. These offices are staffed by agricultural attachés and locally hired professionals who are the eyes, ears, and voice of U.S. agriculture around the world. FAS staff identify problems, provide practical solutions, work to advance opportunities for U.S. agriculture, and support U.S. foreign policy around the globe. For more information about FAS, visit their Web site at www.fas.usda.gov. For more information about the GSM-102 Program and the FGP, contact: Credit Programs Division, Office of Trade Programs, FAS/USDA, 1400 Independence Ave. SW, Washington, DC 20250-1025; tel.: (202) 720-6211; fax: (202) 720-2495.

Chapter 14

Foreign Exchange Risk Management

How to Export in Foreign Currencies

Foreign exchange (FX) is a risk factor that is often overlooked by small and medium-sized enterprises (SMEs) that wish to enter, grow, and succeed in the global marketplace. Although most U.S. SME exporters prefer to sell in U.S. dollars, creditworthy foreign buyers today are increasingly demanding to pay in their local currencies. From the viewpoint of a U.S. exporter who chooses to sell in foreign currencies, FX risk is the exposure to potential financial losses due to devaluation of the foreign currency against the U.S. dollar. Obviously, this exposure can be avoided by insisting on selling only in U.S. dollars. However, such an approach may result in losing export opportunities to competitors who are willing to accommodate their foreign buyers by selling in their local currencies. This approach could also result in the non-payment by a foreign buyer who may find it impossible to meet U.S. dollar-denominated payment obligations due to a significant devaluation of the local currency against the U.S. dollar. While losses due to non-payment could be covered by export credit insurance, such “what-if” protection is meaningless if export opportunities are lost in the first place because of a “payment in U.S. dollars only” policy. Selling in foreign currencies, if FX risk is successfully managed or hedged, can be a viable option for U.S. exporters who wish to enter and remain competitive in the global marketplace.

Key Points

- Most foreign buyers generally prefer to trade in their local currencies to avoid FX risk exposure.
- U.S. SME exporters who choose to trade in foreign currencies can minimize FX exposure by using one of the widely-used FX risk management techniques available.
- The sometimes volatile nature of the FX market poses a risk of unfavorable FX rate movements, which may cause significantly damaging financial losses from otherwise profitable export sales.
- The primary objective of FX risk management is to minimize potential currency losses, not to profit from FX rate movements, which are unpredictable.

CHARACTERISTICS OF A FOREIGN CURRENCY- DENOMINATED EXPORT SALE

Applicability

Recommended for use (a) in competitive markets and (b) when foreign buyers insist on purchasing in their local currencies

Risk

Exporter is exposed to the risk of currency exchange loss unless FX risk management techniques are used

Pros

- Enhances export sales terms to help exporters remain competitive
- Reduces non-payment risk because of local currency devaluation

Cons

- Cost of using some FX risk management techniques
- Burden of FX risk management

FX Risk Management Options

A variety of options are available for reducing short-term FX exposure. The following sections list FX risk management techniques considered suitable for new-to-export U.S. SME companies. The FX instruments mentioned below are available in all major currencies and are offered by numerous commercial banks. However, not all of these techniques may be available in the buyer's country or they may be too expensive to be useful.

Non-Hedging FX Risk Management Techniques

The exporter can avoid FX exposure by using the simplest non-hedging technique: price the sale in a foreign currency in exchange for cash in advance. The current spot market rate will then determine the U.S. dollar value of the foreign proceeds. A spot transaction is when the exporter and the importer agree to pay using today's exchange rate and settle within two business days. Another non-hedging technique to minimize FX exposure is to net foreign currency receipts with foreign currency expenditures. For example, the U.S. exporter who receives payment in pesos from a buyer in Mexico may have other uses for pesos, such as paying agent's commissions or purchasing supplies in pesos from a different Mexican trading partner. If the company's export and import transactions with Mexico are comparable in value, pesos are rarely converted into dollars, and FX risk is minimized. The risk is further reduced if those peso-denominated export and import transactions are conducted on a regular basis.

FX Forward Hedges

The most direct method of hedging FX risk is a forward contract, which enables the exporter to sell a set amount of foreign currency at a pre-agreed exchange rate with a delivery date from three days to one year into the future. For example, U.S. goods are sold to a German company for €1 million on 60-day terms and the forward rate for "60-day euro" is 0.80 euro to the dollar. The U.S. exporter can eliminate FX exposure by contracting to deliver €1 million to its bank in 60 days in exchange for payment of \$1.25 million. Such a forward contract will ensure that the U.S. exporter can convert the €1 million into \$1.25 million, regardless of what may happen to the dollar-euro exchange rates over the next 60 days. However, if the German buyer fails to pay on time, the U.S. exporter will still be obligated to deliver €1 million in 60 days. Accordingly, when using forward contracts to hedge FX risk, U.S. exporters are advised to pick forward delivery dates conservatively or to ask the trader for a "window forward" which allows for delivery between two dates versus a specific settlement date. If the foreign currency is collected sooner, the exporter can hold on to it until the delivery date or can "swap" the old FX contract for a new one with a new delivery date at a minimal cost. Note that there are no fees or charges for forward contracts since the FX trader makes a "spread" by buying at one price and selling to someone else at a higher price.

FX Options Hedges

If an SME has an exceptionally large transaction that has been quoted in foreign currency and/or there exists a significant time period between quote and acceptance of the offer, an FX option may be worth considering. Under an FX option, the exporter or the option holder acquires the right, but not the obligation, to deliver an agreed amount of foreign currency to the FX trader in exchange for dollars at a specified rate on or before the expiration date of the option. As opposed to a forward contract, an FX option has an explicit fee, a premium, which is similar in nature to the premium paid for insurance. If the value of the foreign currency goes down, the exporter is protected from loss. On the other hand, if the value of the foreign currency goes up significantly, the exporter simply lets it expire and sells the foreign currency on the spot market for more dollars than originally expected; although the premium would be forfeited. While FX options hedges provide a high degree of flexibility, they can be significantly more costly than FX forward contracts.

The International Trade Administration's mission is to create prosperity by strengthening the competitiveness of U.S. industry, promoting trade and investment, and ensuring fair trade and compliance with trade laws and agreements.



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