Export Finance Tutorial

1. Introduction

It can be exciting to close your first international sale. Most of the world's purchasing power is outside the UK, and the benefits that flow from tapping that potential are obvious. But these new markets bring new risks, so you must be able to finance an overseas contract and protect yourself against not being paid.

All businesses face payment challenges. Those who trade domestically face commercial risk, when buyers delay payment unreasonably, and production and logistics issues. They are buffeted by financial uncertainty and adverse business risks.

These problems are magnified in international trade, and are joined by challenges that are unique to export markets. Currency fluctuations may wreak havoc on the terms of trade, or political turmoil might close off whole markets.

We will look at these issues but, more importantly, we will look at the range of tools available to help insure against them. These tools are known collectively as export finance.

Understanding export finance is key to successful exporting. You need to be aware of the many financing options, so that you can choose the one that best suits your customer and your company.

Intense competition in export markets means that being able to offer attractive payment terms is necessary to make a sale. But a customer is not a customer until they have paid your invoice. Credit has become a major competitive force in negotiations, but this can lead to sales staff agreeing generous terms of trade that turn out to be damaging to their company.

Thinking about export finance can help us to create a sales culture that factors in these payment risks. Thankfully, there are ways to make sure that your sales staff keep these risks in mind.

- Review the way you incentivise your salespeople to ensure that you're not accidentally encouraging risky deals.
- Train your salespeople in payment terms and negotiation skills.
- Ensure your salespeople understand what your business considers acceptable and unacceptable risks.
- Having set out these parameters, check that your sales staff aren't being unnecessarily risk averse. They may compromise potential orders if you don't calibrate their risk sensitivity.

Keep in mind that the result of the EU Referendum will present challenges and opportunities for exporters. Those who prepare now will have the best chance of continued success. While it is too early to know what the future trading relationship between the UK and the EU will look like, it's important to consider the implications to your company's export finance.

2. Risks in international trade

There are six broad risks for businesses entering export markets. These are:

- Product, production, and transportation risk
- Commercial risk
- Political risk
- Adverse business risk
- Currency risk
- Financial risk

Product, production, and transportation risk

Let's look at product, production, and transport risks. These risks can include:

- shortcomings or defects in the product itself
- manufacturing risks
- transport risks
- problems with delivery schedules
- poor product performance due to different conditions in the buyer's country, such as higher heat and humidity
- negligence in operating procedures, careless treatment, lack of maintenance, damage caused by the climate or environment
- problems with commercial documentation

Unless you have procedures to manage all these risks, you increase the likelihood of errors. Such errors give buyers opportunities to dispute invoices and delay payment or, worse still, not pay you at all.

Commercial risk

Commercial risk is the chance that the buyer will somehow default on paying you. These may be legitimate—they may go into bankruptcy, or be otherwise incapable of fulfilling their contractual obligations.

How can you evaluate a buyer's ability to fulfil their obligations?

- Obtain up-to-date information about commercial risk elements and keep information current.
- Look at credit reports. These will show the same types of information as a personal credit report, but specific to a business' debt repayment and public records, such as bankruptcies or tax liens.
- Get close to the buyer.

The most successful exporters know the people they're doing business with. A buyer is less likely to fail someone that they know well.

Political risk

Political risk is the possibility that a deal will fall through because of laws or regulations imposed by the government of the buyer's country. Such risk might also arise from any other foreign country that you must deal with during the export process.

There are three underlying causes of political risk:

- Political instability
- Social instability
- Economic instability

A combination of any or all three may result in sudden and immediate changes in taxes, import duties, currency restrictions, import quotas. There may be non-tariff barriers thrown up in the way of your export business.

Non-tariff barriers

Non-tariff barriers are restrictions other than taxes or duties that can make exporting more difficult or costly, such as:

- demands for new product standards
- new or changed environmental standards
- transit countries
- labour strikes
- force majeure – unforeseeable circumstances that prevent someone from fulfilling a contract

Adverse business risk

Another pitfall related to political risk is adverse business risk. This risk includes all negative business practices common in some overseas markets such as bribery, money laundering, and other corrupt practices.

Corruption

Developing countries are particularly vulnerable to corruption because they often have poorly-regulated financial systems. Exporters have a duty to watch out for bribery under the Bribery Act 2010. The Act enables courts and prosecutors in the UK to respond to bribery at home and abroad. All organisations, including businesses, are criminally responsible for all bribes paid on their behalf, whether they know about them or not.

We recommend that you make sure all staff are familiar with the Bribery Act. You can find useful information at https://www.gov.uk/government/publications/bribery-act-2010-guidance

Make sure that your business has a strong anti-corruption policy, which is understood by all employees, and that management regularly audits its implementation.

Protect yourself against corruption by keeping an eye out for suspicious behaviours and transactions such as:

- unusual payment settlements
- unusual transfer instructions
- secretiveness
- rapid movements of money in and out of accounts
- numerous transfers
- complicated accounting structures

Currency risk

One of the most persistent risks in international trade is currency risk. This occurs when payment is received in a currency other than the one in which you incur costs. Currency risk is relative to the currencies involved and the outstanding period until payment. The longer the payment terms, the greater the risk of changes in currency values wiping out your margin.

Managing this risk can be difficult. It may seem straightforward to insist on being paid in sterling, but many buyers will want to settle their accounts in their own currency or US dollars.

Many currencies are not tradeable on the open market due to government restrictions. Still others experience too much volatility to be good stores of value.

A list of the ten most regularly traded currencies is a good proxy for the most stable and convertible ones. In 2017 they were:

1. US dollar
2. Euro
3. Japanese Yen
4. British Pound Sterling
5. Australian Dollar
6. Swiss Franc
7. Canadian Dollar
8. Hong Kong Dollar
9. Swedish Krona
10. New Zealand Dollar

No overview of currency risk management would be complete without a mention of exchange rate hedging mechanisms, such as forward exchange contracts.

Forward contracts

A forward contract, in the context of exporting, is an agreement with your bank to exchange a specified amount of the importer's currency for your currency. This takes place on the payment date, but using the exchange rate on the date that the contract was signed. Forward exchange contracts have been used for decades by successful exporters as a hedge against currency fluctuations.

Every international trade transaction contains an element of financial risk. Making the sale may be easy —the problem is getting paid.

Balancing interests

It's important to make allowances for unforeseen costs, particularly in sales of services or expertise. You must always keep in mind the balance between your interests and your buyer's demands. Train your sales staff in what risks are acceptable and which are not for your business.

Ask yourself:

– How easily will we get paid?
– How will we finance costs until the buyer pays their invoice?
– Can we afford to offer extended credit limit?

Remember, a consignment that takes five hours to deliver in the UK may take 50 days to reach an overseas buyer.

3. Methods and terms of payment

Choosing the right method and terms of payment can protect your business from some of the risks of international trade. There are a range of payment methods, each one riskier than the last:

- Cash in advance
- Letter of credit
- Documentary collection
- Open account

Cash in advance

If you are selling to a new customer for the first time, and that buyer is based in a country affected by political and adverse business risks, then cash in advance might be your best option.

Alternatively, you could agree to a staged part-payment. Make sure that you receive full payment before the goods leave your control.

Letter of credit

Short of cash in advance or staged part-payments, your best option is to obtain a letter of credit. A letter of credit is a written commitment by a buyer's bank to pay your bank for your goods, provided that you meet precisely-defined conditions and present prescribed documents within a fixed timeframe. Letters of credit transfer the risk of non-payment from you to the buyer's bank.

You should opt for a letter of credit when:

- you enter a new business relationship with a buyer, where sufficient trust has not yet been established for more generous payment options.
- your research has shown that your buyer lacks a strong credit rating.
- you are selling to parts of the world where country risks are higher.
- you have a unique product that cannot be sourced elsewhere.

Documentary collection

Documentary collection is similar to a letter of credit, but does not carry the bank's guarantee. In this case, a bank in the buyer's country acts on your behalf to collect and remit payment for a shipment. You must present the shipping and collection documents to your bank, which sends them to your buyer's bank.

The buyer's bank, called the presenting bank, hands over the shipping and title documents to the buyer. These are required for taking delivery of the shipment. The presenting bank does this in exchange for cash payments or a firm commitment to pay on a fixed date.

The banks involved act only in a fiduciary capacity to transfer title and collect payments. They are only liable for correctly carrying out your collection instructions. You can also authorise them to sue non-paying buyers.

Open account

An open account transaction is the riskiest option. This is a sale where goods are shipped and delivered before payment is due. This option should only be used if you have an established relationship with a customer.

Exporters from Northern Ireland can access a number of sources of export financing:

- Invest Northern Ireland
- UK Export Finance
- Export Finance Managers

Invest NI has created a suite of six funds totalling more than £170 million to help SMEs with high growth potential to forge ahead.

The funds are part of Invest NI Access to Finance initiative and offer a continuum of support, via loans and equity, to businesses of different sizes or at different stages of growth or development.

UK Export Finance

UK Export Finance (UKEF, also known as the Export Credits Guarantee Department) is the UK's official export credit agency. If you are planning to export goods or services from the UK, then it is likely you'll need some form of guarantee or insurance to protect you against payment risks. If you can't get what you need from the private market, UK Export Finance may be able to help.

UKEF provides guarantees, insurance and advice to UK-based exporters large and small. UKEF works across all sectors from engineering to IT to infrastructure projects, consulting and service industries.

Further information on UK Export Finance can be found on their website: https://www.gov.uk/government/organisations/uk-export-finance

Export Finance Managers

Export Finance Managers are regional representatives of UK Export Finance (UKEF). They are local points of contact for exporters and businesses with export potential and can provide information on:

- payment methods and risks
- the types of finance available
- trade finance (before and after export)
- export insurance
- foreign exchange risks

Speaking to an export finance manager will help you get a better understanding of your export finance requirements. They will identify an appropriate solution to support your export transactions where possible. They will talk you through relevant UK Export Finance products and services and can assist in the preparation of an application.