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HERMES COVER SPECIAL

Guide to forfaiting for exporters – Best-practice tips for refinancing Hermes-covered export receivables

EXPORT CREDIT GUARANTEES OF THE
FEDERAL REPUBLIC OF GERMANY

► **Hermes Cover**

► Guide to forfaiting for exporters – Best-practice tips for refinancing Hermes-covered export receivables

I. WHAT IS THE PURPOSE OF FORFAITING?

In order to be competitive at an international level, exporters do not only need a good product but frequently also attractive payment terms or the ability to offer finance from a single source. Buyer credits offered by export-financing banks with buyer credit cover provided by the Federal Government are the prime choice here as they do not exert any strain on the exporter's balance sheet and liquidity. In this way, you can concentrate on your core export business while the bank provides the finance. However, buyer credits are not normally available for small-value orders. One alternative is to provide your foreign customer with trade credit. Yet, this raises the question as to whether you have sufficient equity for such a credit arrangement or must fund it. This is where forfaiting can help. For many companies, the purpose of forfaiting is to sell Hermes-covered trade credit without recourse if possible or to refinance it so as to ease the pressure on their own balance sheets. The latter is known as a "true sale". In practice, the classification of a transaction as a true sale for tax and accounting purposes primarily depends on the company's legal status, the accounting standards that it applies and the external auditor's opinion.

The following section describes forfaiting particularly on the basis of supplier credit cover (G) and explains what exporters, forfaiter banks and forfaiting companies should know and pay attention to when forfaiting Hermes-covered export receivables. We have summarised the main results for you again on the last two pages of this guide in the form of a convenient [checklist](#).

Forfaiting

Originally, forfaiting entailed the purchase of bank-secured receivables (bank-guaranteed bills of exchange, deferred-payment letters of credit etc.). When Hermes-covered receivables are forfeited, it is important to note that any receivables disputed by the customer do normally not qualify for indemnification. Nor can the defences that are raised by the debtor with respect to the underlying transaction be overridden by abstract documents (e.g. bill of exchange).

True Sale

With a true sale, under which the receivable is removed from the exporter's balance sheet, economic rights to the receivable pass to the bank. This, in turn, is possible only if the bank accepts the default risk. The prevailing view is that the credit risk must "very predominantly" pass to the forfaiter and that the seller of the receivables may retain only an insignificant residue risk. However, it is not possible to state specific materiality thresholds. On the basis of the uninsured percentage under a credit insurance policy and taking account of other factors relevant for the individual case, it is considered in practice acceptable for the exporter to retain a risk of around 10% of the value of the receivable. However, it is up to the external auditor to determine and assess the merits of the individual case in the light of the applicable accounting standards.

II. WHAT IS FORFAITING?

Forfaiting is the purchase of receivables owed by foreign debtors including the transfer of the default risk. This means that the buyer of the receivable assumes the exporter's original position as creditor and also accepts the default risk with respect to the foreign debtor free of any right of recourse to the exporter in the event of a payment default.¹

As a rule, the grant of supplier credit cover provided by the Federal Government to cover political and economic risks facilitates forfaiting and may result in substantially better finance and forfaiting terms. Banks or forfaiting companies (hereinafter referred to as the "bank") generally buy receivables. In return, the bank will pay you the value of the receivable less a discount as soon as you have submitted the agreed documents. The advantage for you is that you immediately generate liquidity. Ideally, you can sell your entire covered export receivables including the uninsured percentage under the supplier credit guarantee to the forfaiter and simultaneously ease some of the pressure on your balance sheet. However, banks adopt very different and individual approaches. You negotiate the terms and conditions of the sale of your receivables autonomously (i.e. without the Federal Government's involvement).

III. WHO ARE THE PARTIES TO THE FORFAITING TRANSACTION?

When you offer trade credit, you as the exporter grant your foreign customer a payment period without the involvement of any bank at the German end.

Hermes-covered trade credit requires many different activities on your part. Thus, a delivery contract including an offer of finance must be drafted in such a way that it satisfies the conditions for Hermes Cover and also meets any additional requirements stipulated by the forfaiter bank.

For this reason, you should consult with the official representative of the Federal Government and also the forfaiter bank prior to engaging in negotiations on the export contract to avoid any obstacles later on when the receivable is forfeited.

The exporter has contractual obligations under the export (credit) contract, Hermes Cover² and the forfaiting contract entered into with the bank buying the receivable.

IV. BEST PRACTICE TIPS FOR IMPROVING YOUR FORFAITING POSSIBILITIES

In the current regulatory environment, banks' willingness to purchase receivables from small orders in particular in their forfeiting business is tending to decline. This is due to more stringent regulatory due diligence and documentation requirements for banks in tandem with heightened capital adequacy rules. These are both cost factors that are increasingly having an adverse effect on forfaiting business for banks. For this reason, we advise you to observe the points set out below to improve your scope for engaging in forfaiting business and to document the processes and details effectively.

¹ This characteristic explains the origins of the term "forfaiting", namely "à forfait" which means "lock, stock and barrel".

² General Terms and Conditions for Supplier Credit Guarantees (GC (G)) and supplementary conditions for the assignment of receivables (GC (FAB)).

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1. Use customary and unambiguous delivery and performance documents

- ▶ Prior to the transaction, consult with the forfaiter bank on the documentation requirements for export business.
- ▶ Make sure that you use standard documentation for your export transaction as far as possible.
- ▶ Please also observe the Federal Government's requirements (see [checklist on page 9](#)).

2. Observe the import rules applicable in the buyer's country

- ▶ You may only execute your export transaction if you observe the export rules applicable in Germany and particularly also the import rules applicable in the country of destination.³
- ▶ In particular, you must check whether a permit is required or if any other restrictions or rules apply to foreign loans (e.g. foreign currency restrictions) in the buyer's country.

3. Please note that an agreement providing for physical collateral may limit the scope for forfaiting

- ▶ If additional collateral is required for the granting of export credit cover for creditworthiness reasons, this should take the form of readily transferrable third-party payment guarantees or similar collateral.

- ▶ As far as possible, the provision of physical collateral should be avoided if the receivable is to be subsequently forfeited. This is because it is more difficult to transfer physical collateral to the bank and this also involves added expense. Moreover, the assessment of the legal validity of the physical collateral entails an additional risk for the bank.
- ▶ In the case of any doubt, banks will tend to reject any transactions in which physical collateral is involved for cost reasons alone. This particularly applies to smaller-value orders.
- ▶ Contact your bank to clarify the individual circumstances of the planned transaction.

4. As far as possible, abstract payment claims should be agreed upon

- ▶ Bills of exchange, abstract payment obligations or acknowledgements of debt may improve the legal position held by the exporter and the forfaiter bank towards the foreign buyer. Accordingly, this may improve the scope for forfaiting as well as the forfaiting conditions offered by the bank.
- ▶ By contrast, abstract debt instruments do not offer any advantages in dealings with the Federal Government due to the fact that proof that the (non-abstract) underlying receivable (export receivable) is legally valid is always a condition for indemnification.
- ▶ If the foreign debtor raises any objections to the covered receivable, indemnification is generally not paid until or unless the competent court (or arbitration tribunal) has upheld the legal validity of the underlying receivable and ruled that it is due for payment.⁴

³ This is stipulated in Art. 15 (3) GC (G).

⁴ See Art. 5 (2) GC (G).

- ▶ This means that bills of exchange or other abstract debt instruments do not simplify efforts to demonstrate to the Federal Government the legal validity of the receivable. However, they may make it easier for you to assert your rights if an insured event occurs.⁵

5. Request a reduction in the uninsured percentage to 5% for commercial risks in your application for Hermes Cover

- ▶ It is only possible to lower the uninsured percentage to 5% if you are willing to pay a corresponding surcharge on the premium and meet the conditions⁶ for this.
- ▶ In practice, recognition of a true sale is frequently only possible if there is a correspondingly lower uninsured portion.
- ▶ Consult with your auditor on this matter in good time to achieve a positive effect for your balance sheet.

6. Check your guarantee document immediately after receipt for any errors or omission

- ▶ Correct any material differences in the documented particulars immediately and contact the Federal Government.
- ▶ Please particularly note any additional “special conditions” that may be stipulated in the guarantee document.

7. Report any material changes in the execution of the order in writing

- ▶ The export transaction must be executed in accordance with the particulars documented in the guarantee document (e.g. the description of the transaction).
- ▶ Report any (**material**) differences in the execution of the order in writing and request the Federal Government’s approval.⁷
- ▶ The forfaiter bank requires full documentation from you confirming that the documented particulars have been observed in the execution of the export transaction or that the Federal Government has approved any changes that have been reported.

8. Negotiate the forfaiting agreement with your bank carefully

- ▶ The bank’s right of recourse under the forfaiting agreement should be confined solely to defences arising from the underlying transaction. Whether or not this recourse risk has any effect on your credit limit with your bank depends on the wording of the individual forfaiting agreement.
- ▶ You should consult with your **auditor at an early stage** on the effect on your balance sheet and the true sale status of the transaction prior to signing the forfaiting agreement.
- ▶ If forfaiting the receivables is a prerequisite for granting your foreign customer trade credit, you need to check whether a condition precedent should be included in the delivery contract, stipulating that the validity of the delivery contract is contingent upon a forfaiting agreement being signed.

⁵ See also “Hermes Cover Special – Indemnification procedure”.

⁶ The possibility of reducing the uninsured percentage is optional and primarily benefits those exporters who have proved to be experienced and reliable export finance partners and pursue reliable claims and recourse management.

⁷ Under Art. 15 (2) GC (G) you must not depart from the documented particulars without the Federal Government’s written approval unless the changes or additions are of only a minor nature.

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9. Check whether the forfaiting/assignment is subject to approval

- ▶ In most cases, you do not require the Federal Government's express approval. This is particularly the case if
 - the forfaiter bank is domiciled in a country which is a member of the European Economic Area (EEA) or in Australia, Japan, Canada, Switzerland or the United States,
 - or
 - a domestic financial services company (e.g. a forfaiting company) acts as the forfaiter.⁸
- ▶ In other cases or if you are uncertain, ask the Federal Government's representative whether the assignment requires approval. This is because the Federal Government is relieved of any liability for indemnification if a receivable is assigned without the necessary consent of Federal Government unless it determines that it would have consented to the assignment.⁹

10. Report the assignment of the export receivable and the indemnification claims under the supplier credit guarantee to the Federal Government in writing

- ▶ The Federal Government should always be notified of an assignment under forfaiting arrangements even if no approval is required under the supplementary provisions for the assignment of Guaranteed Amounts (GC (FAB)).

- ▶ This is important from the bank's point of view as notification ensures that in the event of a claim the Federal Government pays the indemnification solely to the bank.¹⁰
- ▶ In practice, banks mostly stipulate that the assignment must be reported in writing.

11. As far as possible, the assignment should be disclosed

- ▶ If at all possible, the foreign debtor should agree in writing to the assignment. This avoids any disagreement on the creditor status and responsibility for receivable.¹¹
- ▶ In the case of a disclosed assignment, the netting provisions only apply to the business relationship between the foreign debtor and the forfaiter bank.¹²
- ▶ This is of advantage from the bank's point of view as any incoming payments that you receive towards uncovered receivables under your business relations with the foreign customer do not have any effect on the bank's claim to indemnification.
- ▶ This safeguards the forfaiter bank's right to receive indemnification.
- ▶ To ensure that the receivable is removed from your balance sheet, it is necessary for the auditor to be satisfied that the economic ownership rights in the forfeited receivable have passed to the bank. In this regard, it does not matter whether the assignment of the receivable is disclosed or remains concealed.

⁸ This is stipulated by Articles 19 and 20 GC (G) in connection with Art. 1 of the supplementary provisions for the assignment of Guaranteed Amounts (GC (FAB)).

⁹ See Art. 19 (2) GC (G).

¹⁰ See Art. 4 (4) GC (FAB).

¹¹ See Art. 3 (2) GC (FAB).

¹² More information can be found in Art. 7 GC (G), which sets in details the provisions relating netting.

12. Authorise the bank also to conduct the indemnification procedure

- ▶ Under the terms of cover, you remain the party responsible for conducting the indemnification procedure as you are the party to the contract with the Federal Government despite the assignment. However, you can also declare in writing that the bank is authorised to conduct the indemnification procedure on your behalf.¹³
- ▶ Consequently, the bank may independently initiate and conduct the indemnification procedure in the event of a claim in lieu of the exporter. This, in turn, reinforces the recoverable value of the receivable for the forfaiter bank.
- ▶ Consult with your bank on the basic steps to be taken in this regard.

13. Check that all documents required for reporting a claim are complete

- ▶ In the event of a subsequent claim, the bank must also effectively be able to autonomously conduct the indemnification procedure with the Federal Government.
- ▶ This may mean that all the contract documents must be submitted to the bank prior to the forfeit.

14. Make advance arrangements for collection

- ▶ The forfaiting contract with the bank should stipulate who is responsible for the collection/recourse proceedings.
- ▶ Regardless of what is stated in the forfaiting agreement, you are responsible towards the Federal Government for this.¹⁴ If this matter is not expressly

governed in the forfaiting agreement, legal inconsistencies and uncertainty may arise in a true-sale transaction.

V. TO SUM UP: UNDER WHAT CIRCUMSTANCES DOES FORFAITING OFFER ADVANTAGES FOR YOUR BALANCE SHEET?

When a bank buys a receivable under a forfaiting agreement, it must accept most of the risk of the foreign buyer defaulting under the supplier credit cover provided by the Federal Government. The bank will only be willing to do this if it is satisfied that the export receivable is legally valid, can be assigned and will be settled unconditionally by the foreign buyer. In addition, your auditor must confirm that the assignment is a true sale on the basis of the applicable accounting standards. This is generally only the case if the uninsured percentage under the supplier credit guarantee is reduced to 5% and also depends on the specific wording of the provisions regarding recourse agreed between you and the forfaiter bank. Consequently, it is advisable to consult with the forfaiter bank as well as your auditor at an early stage in the preparation of the export and forfaiting agreements.

Securing the right to indemnification under the supplier credit guarantee also plays a decisive role in terms of the exporter's duty of due and proper conduct in this connection. Clear contractual documentation of the transaction and frank and fair communications between you, the bank and the Federal Government and its representative can avoid uncertainties.

N.B.

If you have any further questions, visit our web site at www.exportkreditgarantien.de/en.

¹³ See Art. 4 (3) GC (FAB).

¹⁴ See Art. 11 (1) GC (G) and Art. 4 (1) GC (FAB)

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Indemnification procedure for assigned claims

The following general points should be noted:

- Report any risk-increasing circumstances, which have become known to you, immediately to the Federal Government in writing. This obligation is governed by Art. 15 (4) GC (G).
- Take all steps necessary and appropriate to avoid a claim or to mitigate the loss in line with the principles of commercial caution.
- The brochure “Hermes Cover Special – Duties” provides greater details of your contract duties.
- Submit your claim within two years of the date reported to the Federal Government on which the receivable falls due for payment. This deadline should be monitored closely as a precaution even though it may be extended under certain conditions.
- More detailed information on the procedure can be found in the brochure “Hermes Cover Special – Indemnification procedure”.
- The documentation of the claim should be complete, in written form and assembled clearly so as to avoid any inquiries and delays as far as possible.
- It is generally sufficient for copies to be submitted with your claim for indemnification, although the Federal Government reserves the right to inspect the originals.
- Depending on the liability period, the archiving periods may extend beyond the general statutory archiving periods; electronic archiving is sufficient.

If the assignment is not reported to the Federal Government in writing,

- only the exporter can claim indemnification/submit a claim as the policyholder,
- the claim is only settled with the exporter,
- indemnification payments are made to the exporter with debt-discharging effect.

If the assignment is reported to the Federal Government in writing,

- the claim for indemnification can still only be asserted by the exporter notwithstanding the existence of the assignment,
- but if the receivable has been assigned to a generally approved bank, the policyholder may alternatively declare in writing that
 - the claim for indemnification is to be asserted by the bank, and
 - the claim is to be settled with the bank
- the claim is settled with the party that submits the request for indemnification.
- the netting provisions¹ contained in the General Terms and Conditions applicable to the relationship between the exporter and the foreign buyer are applied in the case of an undisclosed assignment and the netting provisions agreed upon between the bank and the foreign buyer are applicable in the case of a disclosed assignment.
- indemnification is paid out solely and directly to the bank.

¹ In the case of supplier credit cover, for example, the netting provisions which may be applied to the calculation of the indemnification can be found in Art. 7 of the General Terms and Conditions (G) in connection with the supplementary provisions for the assignment of Guaranteed Amounts (Art. 4 (5) GC (FAB)).

Checklist for the documents to be submitted

- Export contract/order and confirmation of order
- Where applicable, proof that the necessary collateral has been furnished
- Where applicable confirmation by bank of receipt of downpayment
- Proof of delivery and completion

Suitable proof of delivery, which is regularly issued by third parties, particularly includes

- ▶ the consignment note (also multimodal), bill of lading
- ▶ delivery note
- ▶ confirmation of acceptance by forwarder
- ▶ postal receipt
- ▶ confirmation of receipt by courier
- ▶ confirmation of receipt by third-party warehouse

In the case of local costs and foreign deliveries, equivalent documentary evidence may also be accepted provided that it is reliable and in as much detail as possible. A certificate of acceptance by the buyer is generally not sufficient as documentary evidence on its own and is only accepted in exceptional cases, e.g. if no documentary evidence issued by third parties is provided (e.g. if the goods are collected by the buyer). The Federal Government's representative should be consulted in such cases as a precautionary measure.

Suitable documentary evidence particularly includes certificates, declarations of acceptance etc. issued by the exporter/performing party and signed by the buyer or an authorised third party. They must refer to

- ▶ the specific contractual services provided and
- ▶ the underlying export contract.

If the service component in the total value of the order is a maximum of 30% of the delivery component, a unilateral declaration by the exporter may be acceptable as documentary evidence in exceptional cases.

- Invoice
- Collection correspondence/documents
- Documentary evidence that personal collateral has been utilised
- Where applicable, proof that an insured risk has occurred (event of loss)
- Where applicable, any further documents required in individual cases
(e.g. certificate of origin if there are doubts as to the origin of the goods or any necessary documentary evidence on the buy side in the form of invoices issued by suppliers in the case of trading transactions)

Copies are generally acceptable. However, it may also be necessary to submit originals in individual cases. Documents may also be archived electronically.

Export Credit Guarantees and Untied Loan Guarantees: instruments to promote foreign trade and investment provided by the



Federal Ministry
for Economic Affairs
and Climate Action

Commissioned to implement the federal funding instruments Export Credit Guarantees and Untied Loan Guarantees:



EULER HERMES

Cover from the Federal Republic of Germany for foreign business

Export Credit Guarantees and Untied Loan Guarantees have been established and effective foreign trade promotion instruments of the Federal Government for decades. Export Credit Guarantees (so-called Hermes Cover) protect German exporters and banks financing exports against political and commercial risks. Untied Loan Guarantees are to support raw material projects abroad regarded as eligible for promotion by the Federal Government. Both promotion instruments play an important role in fostering economic growth as well as in protecting and creating jobs. Federal Government commissioned Euler Hermes Aktiengesellschaft to manage the federal funding instruments Export Credit Guarantees and Untied Loan Guarantees.

Information on other foreign trade promotion instruments of the Federal Government can be found at www.bmwk.de/en under the heading Promotion of Foreign Trade and Investment.

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