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TECHNICAL SUMMARY

Agricultural Export Financing Tools

by Nina Holle. Working paper, 2017

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JUNE 2017

Introduction

Banks support international trade through a wide range of financial products that help customers manage international payments and associated risks – providing essential working and investment capital.

This brief provides an overview of existing agricultural export financing tools available for agribusinesses and exporters to expand their businesses. Some tools are especially interesting for SMEs who face additional barriers to their counterparts in developed countries, including heightened perceptions of lack of creditworthiness and a lack of availability to longer term capital.

Challenges and opportunities of agricultural export financing

There are several reasons why access to a wide range of financial tools helps facilitate international trading of agricultural commodities:

- The high value of commodity trades and associated need for funding while goods are in transit
- The nature of the collateral, which is easy to verify, pledge, sell, and hedge on the market
- The potential for significant price fluctuations combined with long transaction chains
- The underlying transactional structure (including the documentary evidence) providing quick and effective recourse should problems arise.

Agricultural production and international trade depends on the availability of finance for all participants along the agricultural value chain. However, there are many challenges in providing funding. But, at the same time, agricultural production and international trade present many opportunities and benefits for financial institutions providing funding.

Global population growth and changing diets are increasing demand for food. Production is struggling to keep pace and the food security challenge will only increase – the world will need to produce about 70% more food by 2050 to feed an estimated 9 billion people.

Agricultural development and exports are powerful tools in this regard. And access to finance is an important prerequisite for sector development. For banks and financial institutions this represents a major opportunity to participate in, and profit from, a valuable and growing market.

Export-oriented agribusinesses financing needs to include collection, processing, storage, and export logistics. Agribusinesses and exporters must also ensure payment and bridge the financing gaps between product dispatch and payment receipt.

There are significant gaps in provision of export finance for agricultural products and many agribusinesses, especially in developing countries, are restricted in their scale of operations due to shortages of capital. In short, lack of access to finance is cited by businesses around the world, especially SMEs, as a major barrier to their capacity to export. The estimated value of unmet demand for overall trade finance in Africa was USD 120 billion in 2014 alone.

Without adequate financing, opportunities for growth and development are limited – both for agribusinesses and local economies. Financial institutions often struggle to provide sufficient financing to agricultural export-oriented enterprises as they lack the specific export financing tools required.

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Financial innovations are necessary to change the landscape of agricultural trade finance and to enable banks and other financial institutions to take a new look at providing finance to exporting businesses, by using value chain contracts as collateral for example.

Agricultural export financing tools

Financial tools relevant to agricultural export financing can be categorized into three areas:

1. Payments, which enable the participants of a trade to get paid securely
2. The provision of working capital and loans to finance working capital requirements
3. The management of risk related to a range of potential challenges – natural hazards, non-payment, price, and FX risk.

1. PAYMENTS

The primary goal for each export sale is getting paid – either on delivery or within a period post-delivery (maybe 30, 60, or 90 days). An appropriate payment method must be chosen to minimize payment risk while accommodating the needs of the buyer. Exporting agricultural SMEs are often obligated to offer customers (buyers/importers) attractive sales terms supported by appropriate payment methods to secure sales.

There are four primary methods of payment for international transactions:

a) Cash in advance
b) Letters of credit
c) Documentary collections
d) Open account.

Cash in advance is the most secure for the seller, open account the least. Banks may assist by providing various forms of support. For example, the importer's bank may issue a letter of credit to the exporter or the exporter's bank, providing payment upon presentation of certain documents, such as a bill of lading. Alternatively, the exporter's bank may advance funds to the exporter on the basis of the export contract.

a) **Cash in advance.** An importer must pay the exporter in cash before shipment is made, eliminating credit risk or risk of non-payment for the exporter – wire transfers for example. With the rise of the Internet, escrow services, which allow 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, are increasingly an option for small export transactions. Cash-in-advance, especially wire transfers, are the most secure and least risky method of international trading for exporters, hence, the least secure and unattractive payment method for importers.

b) **Letter of credit.** Letters of credit (LCs) are one of the most versatile and secure methods available to international traders. An LC is a commitment by a bank on behalf of the importer that payment will be made to the beneficiary (exporter) provided the terms and conditions stated in the LC have been met, evidenced by the presentation of specified documents. 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 provide this service. An LC is useful when reliable credit information about the buyer is unavailable, or if the buyer's credit is unacceptable, but the exporter is satisfied with the creditworthiness of the importer's bank. This instrument also protects the importer since the documents required to trigger payment provide evidence that goods have been shipped as agreed.

c) **Documentary collection.** A transaction whereby the exporter entrusts the collection of the payment for a sale to its bank, which sends the documents that its buyer needs to the importer's bank, with instructions to release the documents to the buyer for payment. Funds are received and remitted through the banks involved in the collection in exchange for those documents. D/Cs involve 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.

d) **Open account.** An open account transaction is a sale where goods are shipped and delivered before payment is due – typically in 30, 60, or 90 days. This option is the most advantageous for the importer in terms of cash flow and cost, but the highest risk option for an exporter. With high competition in export markets, foreign buyers often demand open account terms from exporters. Exporters reluctant to extend credit may lose contracts to competitors. Exporters can offer competitive open account terms while substantially mitigating the risk of non-payment by using other trade finance instruments. For example, when offering open account terms, the exporter can seek extra protection using export credit insurance.

2. CREDIT/WORKING CAPITAL FINANCING

Only a small percentage of international trade is paid cash in advance. Importers generally want to pay upon receipt of goods at the earliest. In order to bridge the gap between when the exporter needs payment and when the importer will pay, a credit or a guarantee is required.

Working capital finance or credit can be provided by financial institutions (bank intermediated trade finance) or extended directly by other value chain participants, e.g. the buyer or seller (inter-company credit, value chain financing).

Value chain finance (VCF) is an innovative way to expand financing for agricultural production and export and improve repayments by reducing information asymmetries, transaction costs, and tailoring financial products to suit the needs of the value chain participants.

RECEIVABLE FINANCING

These products are mainly used as a tool to provide working capital to aggregators, processors, etc. They include trade receivables finance, factoring, and forfeiting (the purchase of receivables from an exporter, for a margin). Although all three revolve around the conversion of receivables, they differ in the way they manage risk and collection payments. Receivables can also be structured as collateral. In a well-established VCF operation, participants should benefit from this form of financing as their contracts with aggregators are recognized as equally enforceable as with receivables further downstream.

a) **Trade receivables finance.** A bank or financier advances working capital to agribusinesses (supplier, processor, trader, or exporter) against accounts receivable or confirmed orders to producers. Receivables financing takes into account the strength of the buyer's purchase and repayment history. Trade receivables finance reduces financing constraints for exporters and eases repayment urgency for importers – a cost-effective alternative to bank loans. It is increasingly used by input suppliers, equipment dealers, and major commodity traders. However, it requires a proven track record and is not suitable for perishable goods. It is most suitable for import and export transactions for durable commodities and large transactions.

b) **Export factoring.** A transaction where a business or exporter sells accounts receivable or contracts of sales of goods at a discount to a specialized agency called a factor. The factor pays the business the face value less a factor discount and collects receivables when due. The factor also assumes the risk on the ability of the foreign buyer to pay and handles collection of receivables. Hence, export factoring offers a complete financial package that combines export working capital financing, credit protection, foreign accounts receivable bookkeeping, and collection services. By virtually eliminating risk of non-payment, factoring enables the exporter to offer open account terms, improves liquidity, and increases 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.

c) **Forfeiting.** A financial institution (forfeiter) purchases the amount importers owe to the exporter using freely negotiable instruments, discounting commissions and fees, and paying cash. The importer is obliged to pay its debt to the forfeiter. Like factoring, forfeiting virtually elimi¬nates risk of non-payment once goods have been delivered to the foreign buyer in accordance with the terms of sale. However, unlike factors, forfeiters typically work with exporters who sell capital goods and commodities, or engage in large projects and there¬fore need to offer extended credit periods from 180 days to seven years or more. In forfeiting, receivables are normally guaranteed by the importer's bank, allowing the exporter to take the transaction off the balance sheet to enhance financial ratios. For the client, the 'all-in' cost may be lower than an actual credit line for working capital. Additionally, given that receivables financing is not a debt, it doesn't impact the client's borrowing capacity, as opposed to working capital credit.

PHYSICAL ASSET COLLATERALIZATION

These products depend on a physical asset as collateral. The two most important, warehouse receipts and repurchase agreements (repos), are used mainly for working capital.

By contrast, financial leasing means the use of an asset over a fixed time period, after which the client may or may not eventually take ownership. For this to happen, the legal system must recognize the rights and obligations inherent in control of the assets as a precondition for the development and use of these products. Additionally, there should be a known market for pricing the assets (mark-to-market), as well as a liquid resale market. For agricultural commodities and foods, the markets should also reflect types and grades used commercially for the assets under control.

All financial instruments in this category use innovative collateralization techniques and inject vital liquidity into international agricultural value chains – one of the most pressing challenges when it comes to agricultural export financing.

a) **Warehouse receipts financing (WRF).** Farmers/value chain businesses receive a receipt from a certified warehouse that can be used as collateral for a loan from third-party financial institutions against the security of goods in an independently controlled warehouse. Such systems ensure quality of inventory and enable sellers to retain outputs to sell for a higher price during the off-season or later. WRF can reduce financial costs and has proved successful for selected commodities with well-functioning commodity exchanges. It is used infrequently by exporters for some commodities.

b) **Repurchase agreements (Repos).** Repos are increasingly used by traders and processors in the value chain. The commodity is sold to a third party, with the agreement that the seller will buy back the product after a given period of time. The product is usually stored in a bonded warehouse during the period of third party ownership. The financial institution has to consider the performance of the storage company. For the seller, a repo is usually more cost-effective than a bank loan. By selling the product, however, the seller might incur a tax obligation in the short run. For the financial institution, the fact that the client does not own the collateralized asset facilitates disposal of the asset in case of non-payment. The potential of repurchase agreements as an innovative agricultural export financing instrument is recognized increasingly by experts in the sector.

c) Financial leasing. A purchase on credit designed as a lease with an agreement of sale and ownership transfer once full payment is made (usually in installments with interest). The financier retains ownership of goods until full payment is made, making recovery easier in the event of non-payment, while allowing agribusinesses and farmers to use and purchase machinery, vehicles, and other large-ticket items without requiring the collateral otherwise needed.

STRUCTURED FINANCING

Structured financing tools are specialized products that facilitate and expand financial availability – they frequently involve third parties outside the value chain. Most commonly they take the form of loan guarantees. A third party will provide a guarantee to the lender, shifting risk (partially or wholly) from the value chain participant. The following characteristics apply:

- The third party guarantor represents less of a risk
- The third party receives a fee for its services
- The third party can be a private firm or even a government institution.

Governments in Mexico, for example, have used this as a policy instrument to incentivize financial institutions to lend to agriculture.

a) **Synthetic securitization.** Synthetic securitizations of trade finance portfolios have been the most common mode to date for involving non-bank investors. Transactions release capital for reinvestment, but do not provide liquidity relief, as banks continue to provide funding for the loans originated. In these structures, outside investors take a first or second loss position against a portion of a bank's trade finance portfolio in exchange for a payment stream from the bank. The investor guarantee is established via cash collateral, held in escrow at the bank involved in the transaction.

b) **Loan guarantees.** Loan guarantee schemes provide guarantees to groups denied access to credit by covering a share of the default risk. In the case of default, the lender recovers the value of the guarantee. Guarantees are usually used in conjunction with other financial instruments and can be offered by private or public sources to support increased lending to the agricultural sector. There are both agricultural loan and export credit guarantees. The later are generally handled by a country's export promotion agency, providing the insurance cover on an ad valorem fee that takes creditworthiness of the importer and country risk into consideration.

3. RISK MITIGATION

Risk mitigation includes financial products used to reduce risk by transferring it to a third party – through the use of insurance, futures, and forward contracts. These products appeal to financial institutions because they can be offered to all value chain participants. Their role might vary depending on the type of institution and regulations in the market in which it operates. Financial institutions might take on the risk directly, act through a subsidiary, or alternatively sell part of the risk to a specialized company or broker. In some cases, the financial institution's role can be limited to providing financing for the operation.

a) **(Export credit) insurance.** Insurance products reduce risk by pooling regular payments of many clients and paying out to those affected by losses. Payment schedules are set according to statistical data of loss occurrence and mitigate the effects of loss to all participants in the value chain from natural disasters and other calamities.

Export credit insurance reduces or eliminates risk of loss of cash income from the export sale. The Export-Import Bank in the US (Ex-Im Bank), for example, assumes 90 to 100% of the risk relating to commercial and political upheaval, such as inconvertibility of currency, bankruptcy, protracted default, or war. Export credit insurance allows exporters to provide qualifying international buyers with advantageous terms of credit. When the buyer's lender is unable or unwilling to loan because of risk, export credit insurance provides cover and enables the lender to extend credit. Furthermore, a company's working capital cash flow improves when a lender's line of credit is insured. 60 export credit agencies operate in countries across the world including Brazil, China, India, Japan, Canada, and many European countries.

b) **Forward contracts.** A forward contract is a sales agreement between two parties to buy/sell an asset at a set price and at a specific point in the future. Both variables are agreed at the time of sale. Forward contracts allow price hedging of risk and can also be used as collateral for obtaining credit. The volatile nature of the foreign exchange (FX) market poses a risk of unfavorable currency movements, which can lead to significant financial losses from otherwise profitable export sales.

c) **Futures.** Futures contracts (or 'futures'), are standardized forward contracts to be traded in futures exchanges. Standardization facilitates ready trading through commodity exchanges. Futures provide price hedging, allowing trade companies to offset price risk of forward purchases with counterbalancing of futures sales.

Who finances?

The largest global banks account for a quarter to a third of the global supply of bank-intermediated trade finance (not just agriculture), with local and regional banks providing the remainder. Banks with the largest reported trade finance assets include HSBC and Standard Chartered (UK), Bank of China and Industrial and Commercial Bank of China (China), Deutsche Bank (Germany), JP Morgan Chase (United States), etc.

In emerging market economies for which data are available, local banks account for the majority of trade financing. Moreover, the share provided by local banks appears to have increased in recent years. For example, around 80% of trade finance in India was provided by domestic banks (including foreign-owned subsidiaries) in 2012, up from 60% four years earlier.

The market for commodity trade finance and agricultural trade finance has been dominated by European banks, particularly French, Swiss, and Dutch banks, which reportedly provide up to 80% of the financing for commodities trading worldwide. However, as some institutions have had to reduce balance sheet size and their reliance on US dollar financing, they have scaled back lending – bringing their share in commodities financing down to about 50%. US and Asian banks, as well as banks in the Middle East, have stepped into the breach to some extent by increasing their share of financing for commodity trading.

Multilateral development banks (MDBs) have established a global network of trade finance facilitation programs. These include International Finance Corporation (IFC), Asian Development Bank (ADB), the European Bank for Reconstruction and Development (EBRD), the Inter-American Development Bank (IDB), and the African Development Bank (AfDB). One of the main instruments MDBs provide is guarantees.

Innovations in agricultural export finance

Currently, the instrumentation of trade finance is undergoing a period of innovation.

Financial innovations include the growing use of interlinked supplier-buyer-producer-bank financial arrangements to reduce cost and risk (supply chain finance). Building on these value chain linkages can greatly reduce the need for cash payments and transactions – decreasing financing costs. Banks are automating documentary processing across entire supply chains, often linked to providing credit (e.g. through receivables discounting), another growing area of trade finance activities. 'Bank payment obligation' represents further progress – a payment method that offers a similar level of payment security to that of LCs, but without banks physically handling documentary evidence.

Technological innovations include the application of information and communication technologies in mobile banking, mobile technical support, electronic networks, and improved management information systems to accommodate tailored financial services – all of which have made value chain finance more feasible. These advances open up new ways to geolocate goods. Innovative physical electronic tagging helps pinpoint the geographic location of certain goods, making it easier to use them as collateral – improving market access and financing, especially for smaller players.

Case studies

Rabobank, Indonesia

Rabobank is a leader in commodity trade finance. It facilitates (exporting) clients' trade transactions involving bank and/or country risk, and provides a range of services, largely consisting of confirmation and discounting of export letters of credit. Through its Structured Inventory Products (SIP), the bank offers ownership-based financing solutions as an alternative to regular financing, providing customers with liquidity and/or a stock management tool. In a SIP transaction, Rabobank becomes the temporary legal owner of physical goods through a purchase and sales agreement, commodities exchange or third party, in contrast to other forms of secured financing, where the bank lends against a security over goods.

In Indonesia, Rabobank provides commodity finance (short-term financing for trading companies and producers of agriculture products). Products include commodity repos, documentary credits and guarantees, country risk coverage, and commodity price risk management.

It also provides structured trade & commodity finance (STCF), financing Indonesia's main commodities. These include palm oil, cocoa, coffee, rubber, sugar, and tea. STCF products include pre-export and pre-payment finance, structured inventory finance, etc.

Root Capital, Latin America and Africa

Root Capital is a nonprofit social investment fund providing alternative finance for grassroots businesses in rural areas of developing countries. It makes loans in the range of USD 25,000-1,000,000, targeting enterprises with environmentally sustainable practices that are exporting high-value products in sectors like agriculture, timber, and fisheries.

Root Capital has developed an export finance model where it lends against signed purchase agreements between enterprises and their buyers. Typically, the borrower is eligible for a loan of up to 60 percent of the value of the export contracts.

The purchase agreement, in effect, becomes the collateral — a discrete, future revenue stream pledged by the borrower to repay the loan. When the borrower delivers to the buyer, the buyer pays Root Capital directly, which in turn deducts loan principal and interest and pays the difference to the borrower. Root Capital's due diligence and monitoring systems help identify any risks to the transaction, such as weather issues, strikes, or non-payment.

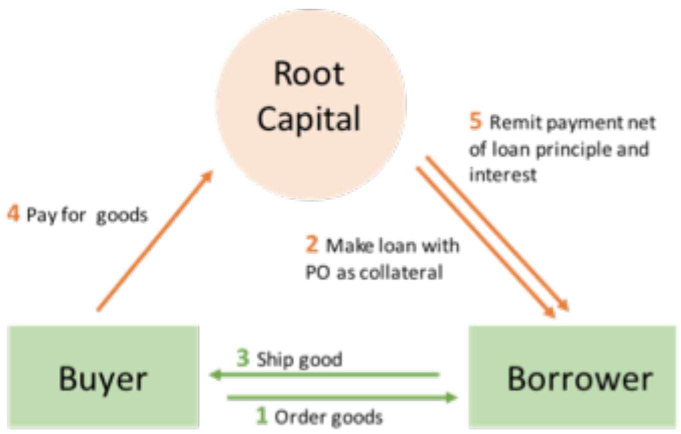

Figure 1: Root Capital loans

Since 1999, Root Capital has disbursed more than USD 900 million in credit to over 600 businesses in Africa and Latin America. The repayment rate on loans is about 97%, yet most clients continue to have few, if any, alternatives for affordable credit. Root Capital has applied this value chain finance model with 125 U.S. buyers, ranging from specialty importers, such as Equal Exchange and Sustainable Harvest, to large global buyers, including General Mills, Green Mountain Coffee Roasters, Pier 1 Imports, Starbucks Coffee Company, The Body Shop, The Home Depot, and Whole Foods Market. By understanding the strength of produce, the supplier (the borrower), and the buyer (the importer), Root Capital is able to use the strength of these trading relationships to determine the creditworthiness of the borrower (the strength of the buyer-supplier relationship is ultimately the collateral underpinning the loan).

Conclusion

An array of financial tools is available to help banks support exporting agricultural enterprises. Innovations, such as using contracts as collateral, offer new opportunities for financial institutions to participate in a growing market set to become increasingly important in the future, and increase their potential revenue streams in a sustainable and managed manner. Key to any expansion of agricultural export financing is understanding the value chain and the relationship between buyers and suppliers, and accurately assessing the risk of each transaction.