Financing foreign trade

A guide by Germany’s private banks

Berlin, January 2015
1 Financing foreign trade: chances and challenges  
An export transaction is not solely about product attributes, prices and delivery periods. The foreign buyer or intermediary often wants to be provided with finance as well. If an exporter can offer such tailor-made finance, this gives him a major competitive advantage. Banks support him in this respect by making available payment instruments, analysing economic and political risks, providing advice and finance, as well as hedging typical foreign trade risks.

2 International documentary payment  
Besides handling clean payments, banks provide documentary payment instruments, where the transfer of funds is expanded to include additional risk hedging components. The most common instruments – documentary collection and the documentary letter of credit – are presented.

3 Structured trade finance  
Structured trade finance is short and medium-term finance secured by the underlying commercial transaction. The merchandise traded includes commodities and goods other than capital goods in particular, i.e. semi-finished goods, consumer goods for end-users and non-durable goods such as seasonal articles. Finance covers the different stages of the value chain, from extraction, production and processing to warehousing and trading. A closer look is also taken at structured commodity finance, transactional trade finance and warehouse finance, plus – outside classical banking business – export factoring to refinance trade receivables.

4 Medium and long-term export finance  
Finance running for more than twelve months falls within the medium and long-term export finance sector. The most important types of finance are supplier credit, in conjunction with forfaiting, and buyer credit. Other common types are project finance and export leasing.

5 Credit cover: bank guarantees, private and state-backed credit insurance  
Securing foreign trade transactions and their financing in case something goes wrong calls for custom-fit instruments. An importer seeking protection against, for example, late or incomplete delivery and subsequent defects, or an exporter seeking protection against non-payment by the buyer, can choose between bank guarantees and private and state-backed credit insurance. The risks are pronounced particularly in the medium to long-term export finance sector, as both the importer’s business performance and the political situation in the importing country are difficult to predict over any great length of time. What is more, where capital goods or plant and equipment are exported, risks already arise at the manufacturing and construction stages. For higher-risk countries, state-backed export credit insurance – the so-called “Hermes cover” provided by the German federal government – is therefore often obtained.
6 Hermes cover for trade and export finance
The German federal government provides cover for both short-term and medium to long-term export finance in compliance with OECD and EU rules. One of the most widely used instruments in trade finance is the whole-turnover policy, while the main instruments in export finance include supplier credit cover and buyer credit cover.

7 Hedging against interest rate risk and currency risk
Given the international nature of foreign trade finance and the sometimes lengthy credit periods involved, protection against interest rate risk and currency risk has an important part to play. These risks can be reduced with the help of hedging instruments, also known as derivatives. The aim is to increase companies’ costing security. This section explains how interest rate swaps, interest caps and forward exchange contracts function.

8 Glossary
Financing foreign trade: chances and challenges

With exports to the tune of €1,094 billion and imports amounting to €895 billion in 2013, foreign trade makes up one-third of German GDP. For Germany, foreign trade is the main guarantor of growth and employment, accounting for one in three jobs. What makes foreign trade finance important and how does it differ from domestic trade finance?

An export transaction is not solely about product attributes, prices and delivery periods. The foreign buyer or intermediary often wants to be provided with finance as well. If an exporter or merchant can offer such tailor-made finance, this gives him a major competitive advantage. Trade finance, i.e. short and medium-term funding of commercial transactions including the warehousing of commodities and stocks (e.g. semi-finished goods, spare parts, consumer goods), on the one hand, and export finance, i.e. medium to long-term funding in the capital goods or plant and equipment sector, on the other, are therefore highly important. In this booklet, the term “foreign trade finance” is used to refer collectively to trade and export finance1).

The positions of the seller and buyer of goods and services in foreign trade are initially no different from those in domestic trade: the seller (exporter) produces or (if a merchant) obtains the ordered goods and faces the risk of the buyer (importer) cancelling his order or being unable, unwilling or – due to political constraints, for example – not being allowed to pay for it. Conversely, the buyer relies on the seller supplying the goods or services promptly in the agreed manner.

What makes foreign trade trickier, however, is that the buyer and the seller are both resident in countries with different political and economic conditions, legal regimes, cultural traditions and business practices. Obtaining information about the importing country is not always easy, and in some cases compliance with separate statutory export regulations is required. What is more, goods often have to be transported over long distances and transactions settled in different currencies.

The risks involved in foreign trade may be generally subdivided into political risks and commercial risks.

Political risks: political unrest, acts of war, coups d’état or a change in economic system may give rise to the following risks in particular:

- Risk of delays in payment.
- Risk of expropriation and damage to the goods.
- Conversion risk in the importing country: the danger that, for economic or political reasons, payment of the purchase price by the importer to the exporter is not made in the contractually agreed currency.
- Transfer risk: the risk of government intervention in the trade and payment sectors with the result that, despite being willing to pay, the importer is prevented from settling his debt with a foreign creditor on time and in full.
- Risk of a moratorium: a temporary suspension of payments to creditors imposed by the debtor country.

1) There are no uniform definitions in either literature or practice. What is more, reference is made simply to export finance although import finance, which is also part of foreign trade, is often meant as well. By making a distinction between trade finance and export finance, we are adopting an approach frequently employed by banks.
Commercial risks comprise in particular:

- Risks pertaining to goods, e.g. the risk of failure to sell, risk of failure to take delivery, transport risk.
- Legal risks, e.g. product liability risk or breaches of export/import regulations.
- Payment risk, e.g. in the form of an unwillingness to pay, insolvency or default in the case of advance payment, payment on account and/or payment after delivery or performance.
- Currency risk, e.g. exchange rate fluctuations.

Task of the banking industry

Foreign trade finance is one of the private banks’ core corporate business products. Banks’ primary task is to provide payment instruments such as foreign credit transfers and foreign-currency cheques. Payment not tied to any special conditions such as the presentation of certain documents (e.g. transport documents) is referred to as “clean payment”. While settlement of international transactions through clean payment orders is quite straightforward (and thus not dealt with in this brochure) and relatively low cost, it is at the same time riskier, since the exporter does not know whether the importer will actually meet his payment obligation on the agreed date.

Besides handling payments, banks advise exporters, finance their projects and hedge typical foreign trade risks. This requires them to analyse and assess the political and economic risks associated with export business beforehand. They thus compile country reports and country ratings and regularly visit the countries concerned, unless they have already established a presence there through a representative office or branch. They also examine borrowers’ (= usually importers’) profit and loss statements, balance sheets and various financial indicators, credit-rate borrowers and analyse the sectors in which exporters and importers operate.
International documentary payment

In international documentary payment, clean payment, i.e. the transfer of funds, is expanded to include additional, risk-hedging components.

Documentary collection

In documentary collection, the exporter instructs his bank to collect the amount indicated in the documents evidencing shipment of goods from the payee (importer). He hands over documents (payment documents and/or commercial documents) to his bank (remitting bank), which it forwards (i.e. remits) to the importer’s bank (presenting bank/collection bank), instructing it to release the documents against payment (D/P = documents against payment) and/or acceptance of a draft, i.e. of an attached bill of exchange that has been drawn but not (yet) accepted (D/A = documents against acceptance).

The exporter thus only hands over the goods represented by the documents on a quid pro quo basis. The importer hence does not obtain possession of the goods until he has paid the invoice amount or accepted a draft. In this way, the exporter eliminates the risk of the importer failing to pay for the goods although he has received them. He still, however, faces the risk of the importer refusing to, or being late to, take up the documents.

The risk for the importer is that he pays for the goods before inspecting them and checking on quality, quantity and completeness.

Source: Möller, Ulrich: Praxisleitfaden Außenhandel im Bankgeschäft, bank-verlag medien, Cologne, 2009, p. 56 (adapted)
Documentary collection is safer than a simple undertaking to pay and is a good compromise where the importer does not want to use a letter of credit (e.g. because of the costs involved or because he would have to draw on his credit line to do so). Thanks to the internationally recognised Uniform Rules for Collections (URC) issued by the International Chamber of Commerce (ICC) in Paris, it is easy to handle.

Unlike with a documentary letter of credit (L/C), the buyer’s bank does not give an undertaking to pay, nor is it liable for the correctness of the documents or for honouring them. It is not allowed to release the documents before payment or acceptance, however. The buyer – and only the buyer – is liable to the seller for payment of the goods under the underlying contract of sale.

**Tip:**
If the customs and import regulations in the buyer’s country require the presentation of documents evidencing shipment of goods, documentary collection may be a low-cost alternative to a documentary L/C for compliance with these regulations.

**Tip:**
The exporter should only agree payment for the goods by documentary collection if, thanks to a long-standing business relationship with the importer, he is in no doubt about the importer’s ability to pay and his willingness to fulfil the terms of the contract, or if he has otherwise hedged credit risk (e.g. by means of bank guarantees, credit insurance or advance payments received). The exporter should, in addition, assess the political, economic and legal risks posed by the importing country as stable.

**Documentary letter of credit**

With a documentary letter of credit (L/C), the importer instructs a bank to pay a certain sum of money to the exporter within a certain period against presentation of the documents specified in the L/C. Unlike documentary collection, a documentary L/C contains, in addition to the promise to pay by the importer, a promise to pay by the bank. This promise is, however, abstract, i.e. unconnected with the underlying contract of sale. On presentation of documents in conformity with the terms of the L/C, and on adherence to the periods set in the L/C, payment of the L/C amount cannot be refused. Any claims by the importer against the exporter, e.g. resulting from complaints about the goods, can only be asserted outside the L/C. Conversely, when it comes to payment of the L/C amount, it does not matter if the goods were duly delivered despite being accompanied by faulty documents: payment is only made against presentation of documents in conformity with the terms of the L/C (see diagram on page 9).

A documentary L/C gives the exporter the security that he will receive payment if he can prove by submitting the relevant documents that he has made delivery in conformity with the terms of the contract. He may receive payment while the goods are still in transit; this is highly attractive for the exporter, as in this way he obtains liquidity early. What is more, the exporter is additionally protected by the promise to pay by the bank issuing the L/C, i.e. the importer’s bank.

**Tip:**
The main details for issuance of the L/C (date of shipment, L/C expiry date, period for presentation of the documents, etc.) should be fixed in the contract of sale.

**Tip:**
The exporter should check carefully whether the documentary L/C incorporates the contractually agreed items, particularly the price and terms of payment, description and origin of the goods, terms of delivery (e.g. freight costs, insurance), as well as the period of validity and date of shipment.

For the importer, payment by documentary L/C is attractive because it gives him a certain degree of security regarding delivery. However, the risk of
payment being made although the consignment is incomplete or damaged remains with him.

**Tip:**

Before concluding the contract of sale, it should be clarified that the parties involved are ready to do business on a documentary L/C basis. The importer in particular needs to be sure that his credit line is sufficient and that his bank considers his credit standing adequate and is thus prepared to issue an L/C on his behalf.

The technicalities and bank formalities involved are governed by the Uniform Customs and Practice for Documentary Credits (UCP) issued by the International Chamber of Commerce in Paris. The UCP are rules drafted by the private sector which are accepted by some 175 countries. They apply to all documentary L/Cs, forming part of their wording, and are binding for all parties.

For payment by L/C, knowledge of the documents used in foreign trade is important. These range from transport documents, e.g. consignment note, bill of lading, airway bill or forwarding agent’s international certificate of receipt, to insurance documents as well as commercial and customs documents. Further details are available from chambers of industry and commerce, forwarding agents, customs authorities, the German Federal Export Office (BAFA) and, when it comes to handling documents, banks.

The key cost components include the commission charged by the exporter’s bank for notification of a documentary L/C and checking the documents. This commission depends on the amount of the L/C. If the bank also confirms the L/C (see below), a risk-based commission that depends on the country risk and counterparty risk is payable. The importer’s bank levies

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**An unconfirmed documentary letter of credit: basic procedure**

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<thead>
<tr>
<th>Exporter L/C beneficiary</th>
<th>Importer L/C issuer</th>
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<tbody>
<tr>
<td>(5) Checks L/C</td>
<td></td>
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<tr>
<td>(4) Advice</td>
<td>(12) Debits importer’s account and forwards documents</td>
</tr>
<tr>
<td>(9) Honours payment claim</td>
<td>(2) Instructions to issue L/C</td>
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<td>(7) Hands in documents</td>
<td></td>
</tr>
<tr>
<td>(1) Contract of sale with agreement on payment by L/C</td>
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<tr>
<td>(8) Checks documents</td>
<td>(10) Remits documents</td>
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<tr>
<td>(3) Issues L/C</td>
<td>(13) Honours payment claim</td>
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<tr>
<td>(6) Shipment of goods</td>
<td>(11) Checks documents</td>
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<tr>
<td>(11) Checks</td>
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a fee for issuing the L/C, plus a charge for taking up and handling the documents. The exporter can price the cost of hedging the risk into the contract of sale. The L/C handling costs are usually shared equally by the exporter and the importer.

**Tip:**

While a documentary L/C is safer than documentary collection (thanks to the additional promise to pay by the importer’s bank), it is also more expensive and complex from an administrative point of view. If import regulations do not stipulate anything else and more insurance does not appear necessary, the volume of the export transaction should be large enough so that use of a documentary L/C makes economic sense.

**Tip:**

The exporter should clarify whether he wants a documentary L/C to be additionally confirmed, i.e. whether his bank is willing to give a payment undertaking of its own in the form of a confirmation. In this way, the exporter covers the economic risk of the bank issuing the L/C (= the importer’s bank) failing to pay and the political risk posed by the importing country (e.g. embargo, unrest, ban on payments). The promise to pay by the exporter’s bank is likewise abstract, i.e. unconnected with the underlying delivery contract, and is subject to a fee because this bank assumes the country risk as well as the credit risk on the part of importer’s bank.

The documentary L/C described above is a sight L/C, meaning that the exporter can request payment from his bank immediately after presentation of the documents in conformity with the terms and conditions of the L/C. Other types of documentary L/C are the deferred payment L/C, the back-to-back L/C, the revolving L/C and the reimbursement L/C. Further details are available from your bank.
Structured trade finance

Along with classical supplier credit and its forfaiting (see Section 4 on medium and long-term export finance), an important type of trade finance is structured trade finance. Structured trade finance is short-term (less than twelve months) and medium-term (1–5 years) finance that is secured by the underlying commercial transaction. The merchandise traded is mostly commodities and goods other than capital goods, i.e. semi-finished goods, consumer goods for end-users and non-durable goods such as seasonal articles. Finance covers extraction, production, processing, warehousing and trading. It is strictly transaction-based and usually secured by the financed commodities and goods, rights to these and/or rights and claims arising from the underlying contracts.

“Structured” means, in a general sense, that such finance typically has a special collateral structure. This ensures that certain sources of income are drawn on directly to meet the interest and principal payments resulting from finance.

When providing structured trade finance, the bank first takes a look at the borrower (= seller) and his performance over a prolonged period of time. An assessment of the borrower’s balance sheet is important, but not the sole deciding factor. A structure can be found whereby the risk posed by a financially weaker borrower is substituted by the lower risk posed by a highly credit-rated buyer or his bank. Buyers are therefore assessed in terms of their ability to meet their payment obligations in

Structured commodity finance – simplified overview

Source: BHF-Bank (adapted)
conformity with the terms of the contract. Finance is then geared to the merchandise and payment flows under the delivery contracts, i.e. to payment by the buyer of the goods delivered by the seller. The seller (= borrower) repays the loan from the proceeds obtained by selling the financed commodities or consumer goods. This is thus a self-liquidating financing structure.

**Structured commodity finance**

A classic example of structured trade finance is that in the commodities sector, known as structured commodity finance. Such finance covers exchange-traded commodities (e.g. oil, oil-based products or copper), commodities with standardised price attributes (e.g. gas, steel or chemicals), as well as commodities that are of strategic and major economic importance for exporting emerging markets: a bank grants a loan to a commodity producer in an emerging market, and this loan is repaid from the proceeds of the sale of the commodity to a buyer situated in an OECD country.

The advantage for the commodity producer is that he receives payment immediately, even though the buyer situated in the OECD country is often unable to settle at once since he frequently intends to further process and then sell on the delivered commodity, meaning that he will only have the funds he needs to make payment after he has done so.

With this type of finance, the emerging markets payment risk is replaced by the production risk and delivery risk posed by the borrower/commodity producer and the risk of failure to take delivery or to pay on the part of the buyer of the commodity situated in the OECD country. The delivery risk can be reduced by using additional types of collateral such as a commodity lien. Price and margin risk, as well as political risk, continue to apply. Where goods outside the commodities sector are involved, this kind of finance is also called pre-export finance (see diagram on page 11).

Where structured commodity finance or pre-export finance covers primarily the extraction, production and further-processing stages for commodities and goods, the starting point for transactional trade finance – in the form of drop shipping – is the trading phase. Warehouse finance may be important at any stage in the value chain.

**Transactional trade finance: drop shipping**

In drop shipping, the main type of transactional trade finance, the borrower is not the producer situated abroad but the importer situated in an OECD country (see diagram on page 13).

**Warehouse finance**

Warehouse finance can play a role between any stage of the value chain, i.e. extraction, production, further processing and trading. In warehouse finance, the value of warehouse inventory is used as collateral for finance. In this way, a company draws liquidity directly from its stocks. Finance grows in step with inventory levels, i.e. it is continuously adapted to changes in receivables and stocks. Semi-finished goods, perishable/obsolescent goods or licensed products are not normally suitable for warehouse finance.

**Export factoring**

An alternative to bank finance in the short-term trade sector as mentioned above is the use of factoring companies, which continuously purchase trade receivables with a maturity of up to 180 days. This requires conclusion of a general agreement in which an exporter undertakes to regularly sell all receivables to a factoring company. In return, the exporter immediately gets the outstanding invoice amounts for a fee. This gives him more liquidity (usually up
to 90% of receivables are purchased) and, provided he has entrusted the factoring company with billing arrears (dunning), eases his receivables management workload. The exporter is liable himself only for the validity of receivables, but not for the importer’s ability to pay. However, the factoring company only assumes the economic risk posed by the buyer, but not the political risks.

**Tip:**

Export factoring is suitable for revolving and high-volume business. In contrast, receivables resulting from small-scale or individual transactions are not usually purchased. Moreover, the commission charged by the factoring company is a not insignificant cost factor.

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**Transactional trade finance: drop shipping**

1. **Purchase agreement**
2. **Sale agreement**
3. **Loan agreement**
4. **Forwarding agent escrow agreement**
5. **Payment**

**Source:** Commerzbank (adapted)
Medium and long-term export finance

Finance running for more than twelve months falls within the medium-term (1–5 years) and long-term (more than 5 years) export finance sector. Given the longer period allowed for payment, the risks associated with such foreign trade finance are particularly pronounced, as both a company’s economic performance and the political situation in the importing country are difficult to predict over any great length of time. What is more, where exports of capital goods or plant and equipment are involved, risks already arise at the manufacturing and construction stage, since plants are built according to the buyer’s plans and requirements. If the buyer withdraws his order or if he is unable to pay, an alternative use or sale of the goods is hence virtually impossible. For this reason, export credit is often additionally secured (see Section 5 on credit cover).

The most important types of export finance are supplier credit, in conjunction with forfaiting, and buyer credit. Supplier credit was widely used for many years particularly in the short-term sector. In the meantime, it is increasingly common in the medium-term – and in some cases, the long-term – sector. A special type of finance is project finance.

Supplier credit with forfaiting
With a supplier credit facility, an exporter (= supplier) grants his buyer abroad (= importer) credit without going through an intermediate bank. Granting a supplier credit facility presupposes that the exporter has a sufficiently strong balance sheet and enough liquidity to be able to wait for repayment. In addition, he has to have and employ a certain amount of resources for monitoring credit facilities and collecting payments.

To relieve his balance sheet and ease his receivables management workload, as well as to create scope for financing new transactions, forfaiting may make sense for the exporter. This means assigning (without recourse) the entire receivable resulting from an export transaction, including the rights or claims of any private or state-backed credit insurer, to a bank or specialist forfaiting company. In return, and after deduction of forfaiting charges, the exporter receives the cash value of the purchase price. From the exporter’s perspective, a credit-based transaction therefore becomes a transaction settled directly in cash in which the foreign buyer does not need to be directly involved. Even after assigning the receivable, the exporter remains liable for its legal validity and due execution of the export transaction.

Tip:
Even if the exporter does not plan to refinance his receivable from a supplier credit facility until later, he should talk to his bank before negotiating the export contract in order to ensure that it is subsequently transferred as smoothly as possible.

Buyer credit
With a buyer credit facility, the exporter’s bank grants the buyer situated abroad or his bank a loan. The loan is paid out to the exporter and serviced by the importer. This is a “tied buyer credit facility”, i.e. the loan is “tied” to the delivery of goods by the exporter. The advantage for the exporter is that he receives the purchase price agreed in the export contract immediately upon delivery or performance. This relieves his balance sheet and increases liquidity, and he does not have to negotiate any credit terms, something he would have had to do if he had granted his customer a supplier credit facility himself.
Project finance

Project finance is often provided for large-scale projects. These are generally projects for which a legally independent and economically self-sustaining project company is set up. The bank does not assess the project initiators’ credit standing, but the commercial viability of the project. Consequently, the project should be able to finance itself from the revenue it generates (cash flow), and this revenue should be sufficient to cover debt-servicing payments. As the project is independent, the financing bank has no recourse to the project sponsors (non-recourse financing) or, if so, only to a limited extent (limited-recourse financing). Given the large scale of projects, several banks are usually involved in financing. The financing structure is, moreover, complex, calls for close involvement of the exporter and thus tends to be suited more to big companies and projects.

Export leasing

When it comes to durable capital goods such as machinery, containers or aircraft, exporters sometimes make use of export leasing. A frequently encountered arrangement is one whereby the exporter sells the goods to a domestic leasing company which then leases the goods to the importer for a certain period against payment of rental. The leasing company does not normally assume any liability vis-à-vis the importer and, in return, assigns to him any warranty-against-defect claims under the contract of sale concluded with the exporter.
Credit cover: bank guarantees, private and state-backed credit insurance

While documentary collection and documentary letters of credit are designed to ensure the smooth settlement of export transactions, additional instruments are needed to secure the aforementioned types of finance against transactions going wrong. An importer seeking protection against, for example, late or incomplete delivery and subsequent defects, or an exporter seeking protection against non-payment by the buyer, can choose between bank guarantees and private and state-backed credit insurance.

Bank guarantees
Under such guarantees, commercial banks give an independent (abstract) undertaking, on behalf and for account of a client (principal), to pay a sum of money to a third party (beneficiary) provided the conditions for availment set out in the guarantee are fulfilled. Particularly exporters of capital goods or plant and equipment are often asked by importers to provide a bank guarantee. The following are typical types of guarantee in favour of importers:

Bid bond: This type of guarantee provides protection in cases where a bidder (exporter) withdraws his bid after being awarded the contract under an invitation to tender. It is designed to cover the costs incurred by the (importer’s) tendering body for issuing a new invitation to tender.

Advance payment guarantee: Particularly where long manufacturing and delivery periods or customised products are concerned, such a guarantee ensures that an advance payment is refunded to the importer if the exporter fails to deliver the agreed goods or services.

Performance guarantee: This type of guarantee covers due performance of the contract and delivery on schedule. In the event of non-performance (with regard to construction and assembly, for example) or late delivery, the guarantor must provide compensation. Such a guarantee is particularly attractive to the importer, since it is independent of the exporter’s economic situation. It is much more effective than a contractual penalty, where the exporter would be the party obligated to pay. An enhanced performance guarantee, covering full performance of the contract including warranty risk, may also be obtained.

Warranty guarantee: Such a guarantee ensures that the delivered goods are free of defects and that any defects that subsequently arise will be remedied within a certain period of time. A warranty guarantee is often combined with a performance guarantee and used for capital goods or industrial plant and equipment.

Tip: Further details of these and other types of guarantee (e.g. bill of lading guarantee, customs guarantee, payment guarantee) are available from your bank. Private credit insurance firms provide guarantees as well.

Private and state-backed credit insurance
In addition to the financing and risk-hedging tools that a bank offers an exporter, the exporter can secure transactions through private or state-backed credit insurance. His choice of insurance depends on how he assesses the risks and, at the same time, on what sort of cover the insurer provides. Whilst private credit insurers often just cover commercial risks and either do not underwrite political risks at all or only if short-term contracts are involved, state-backed credit insurance covers political risks in long-term export transactions as well. If due execution of an export transaction appears jeopardised by political risks – particularly if the transaction has a long life and political developments in the importing country are thus hard to predict for
this period – state-backed insurance is advisable. If only the buyer’s credit standing poses a risk, private credit insurance is often cheaper.

**Private export credit insurance**

Private export credit insurance is based on a master agreement covering all an exporter’s exports to a region. A supplier credit limit is set for each of the exporter’s customers. Credit periods are usually between one month and six months, with longer periods possible in individual cases. Buyers’ credit standings are checked and continuously monitored by the export credit insurer.

The size of the insurance premium is fixed individually. Factors include the sector involved and its customary terms of payment, the exporting country and the volume of business insured, plus the charges for checking the foreign customers’ credit standings.

**Tip:** Some private insurers offer special export policies also for small companies with an annual turnover of up to €5 million.

**Tip:** For a list of private credit insurers in Germany and further information, visit the German government’s foreign trade portal iXPOS at www.ixpos.de.

To avoid any distortion of competition between private and state-backed credit insurers, it was agreed in the EU by way of a European Commission communication that the latter would withdraw from covering “marketable” risks. Risks are termed “marketable” if they relate to transactions with a maximum risk period of up to two years conducted with buyers from EU and OECD core countries (EU member states, Australia, Canada, Iceland, Japan, New Zealand, Norway, Switzerland and the United States). An exception at present is Greece, where the European Commission has allowed state-backed credit insurers in the EU to provide short-term credit cover until further notice.

**Federal export credit guarantees**

In Germany, the official state-backed export credit insurance scheme is managed by Euler Hermes and PricewaterhouseCoopers Wirtschaftsprüfungsgesellschaft (PwC) on behalf and for account of the German government. Euler Hermes acts as the leading partner in this consortium. The German export credit guarantees which cover the risk of default by the importer for economic and political reasons are thus widely known as “Hermes cover”.

In principle, only transactions deserving promotion, i.e. transactions which help to create jobs in Germany and where the risks are justifiable, can be covered. The bulk of cover is accounted for by exports to emerging markets and developing countries and thus to regions where no private credit insurance is available due to the often high political risks. The Interministerial Committee (IMC) sets an appropriate cover policy for each individual exporting country and therefore determines the scope and terms of the respective credit insurance arrangements. In the following section, the main types of cover are briefly outlined.

**Tip:** Detailed product information sheets (also in English), contacts and application forms, as well as a tool for calculating premiums, are available on the government’s website, the AGA (Foreign Trade and Investment Promotion Scheme) portal: www.agaportal.de.
Hermes cover for short-term business

For short-term foreign trade (i.e. which the OECD and EU define as involving credit periods of up to 24 months) with non-OECD countries, the German federal government offers four different types of cover: short-term specific cover, revolving specific cover, whole-turnover policies, and whole-turnover policies light. The goods usually covered in this area are consumer goods, raw materials, semi-finished goods and spare parts.

Take, for example, the comprehensive short-term cover known as whole-turnover policy: this is an inexpensive and uncomplicated way of insuring short-term receivables (with a credit period of up to twelve months). Whole-turnover policies are available to German exporters which regularly supply several buyers in various countries and have an annual export turnover eligible for cover of at least €500,000 spread over different markets. The policy runs for one year, and the exporter will receive a renewal offer around two months before it expires.

The exporter can decide which countries will be covered by the policy. Once a country has been included, however, all receivables due from private-sector companies in that country have to be presented for Hermes cover as soon as the amount due from a client exceeds €15,000.

Whole-turnover policies are not available to cover exports to EU member states or OECD core countries since risks in these countries are considered marketable, meaning that they can be insured.

Source: Association of German Banks
privately. Cover can, however, be granted to exports to Chile, Israel, Korea, Mexico and Turkey despite the fact that they are members of the OECD. Greece is another, temporary, exception to the rule.

**Tip:**
Short-term, recurring deliveries covered by a federal government whole-turnover policy can be assigned to the bank under a master agreement between the bank and exporter. The purchase of the receivables is normally without recourse to the seller and functions on a revolving basis. This guarantees an immediate flow of funds (cf. description of forfaiting in Section 4 on medium and long-term export finance).

**Hermes cover for medium and long-term business**
The OECD countries have agreed common guidelines for covering exports involving credit periods of more than two years. These guidelines – also known as the OECD Arrangement – set certain conditions, such as a sliding scale of minimum premium rates according to country and buyer categories, maximum credit periods for different types of product or a cap on the amount of local costs and third-country supplies which are eligible for cover. The intention is twofold: to avoid competition to provide funding at public expense and to prevent competitive distortion between exporters.

In addition, OECD members have agreed on guidelines and standards for addressing the environmental impact of projects (the “Common Approaches”), preventing and combating corruption, and lending to highly indebted developing countries (sustainable lending). All these aspects are examined by the federal government when deciding whether or not an export project is eligible for support.

Each member of the OECD sets its own cover policy for individual importing countries. If a country is considered high-risk, a ceiling may be placed on the maximum amount of risks to be covered. Cover may also be made conditional on the foreign buyer obtaining a bank or government guarantee.

A substantial number of medium and long-term exports are backed by a Hermes export guarantee. The most commonly used forms of cover are supplier credit cover and buyer credit cover.

**Supplier credit cover and its refinancing options**
If an exporter extends credit to its foreign buyer, this is called supplier credit. The receivables arising from the export contract can be insured with the help of supplier credit cover. The uninsured portion is 5% for political risks and normally 15% for commercial risks. But for a limited period of time until the end of 2016, the uninsured portion can be reduced to 5% on request against payment of a premium surcharge.

The exporter’s title to the receivables, including the claims arising under the supplier credit guarantee, can be assigned for refinancing purposes to a bank or forfaiting company. Hermes cover can make the forfaiting process easier, especially if the goods are destined for a high-risk country (see diagram on page 20).

**Buyer credit cover**
When buyer credit cover is taken out, the bank grants a loan to the foreign buyer or the foreign buyer’s bank. The loan is disbursed to the exporter and serviced by the importer. Buyer credit cover enables banks to insure 95% of the amount payable by the importer under the loan agreement; 5% of the risk is retained by the bank. The policyholder is the bank which extends the buyer credit. Buyer credit cover is an abstract guarantee. Abstract in this context means that a strict distinction is made between the export contract and the claim against the borrower: the loan and the claims arising under the buyer credit guarantee are therefore separate from the export itself. The bank’s right to compensation is triggered solely by non-payment by the borrower, regardless of whether or
not the borrower has grounds for filing a complaint against the exporter concerning the delivery (see diagram on page 21).

Problems with the underlying transaction or breaches of performance by the exporter have to be handled bilaterally between the exporter and the importer and between the exporter and the federal government. The federal government wants to avoid the complications that might arise if the importer (= borrower) refuses to repay the loan in the event of defective delivery. The exporter consequently remains involved in the contractual relationship with the bank by signing what is known as a letter of undertaking, in which it undertakes to provide the federal government with information about the underlying export transaction. In addition, the exporter has to agree to accept instructions from the government and undertakes, under certain circumstances, to release the federal government from its liability to pay compensation under the buyer credit guarantee. This includes, in particular, recognition of the federal government’s right of recourse if it has had to compensate the lending bank although the exporter itself is unable to claim compensation because, for instance, the foreign buyer has refused payment on the grounds that the delivery was incomplete or defective.

**Tip:**

If a bank applies for buyer credit cover, the exporter can for no additional charge take out a supplier credit guarantee (often called export guarantee or export cover) to cover, in particular, the risk of non-disbursement of the buyer credit. This arrangement is known as combined buyer credit cover. Should the exporter not want supplier credit cover, the bank can take out a separate guarantee to cover the risks arising from the loan (isolated buyer credit cover). In this case, too, the underlying export must be eligible for federal government support.

---

### Supplier credit with Hermes cover with an additional refinancing agreement

<table>
<thead>
<tr>
<th>Exporter</th>
<th>Importer</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Export agreement with deferred payment terms (e.g. of three years)</td>
<td>(3) Repayment of loan (e.g. in six half-yearly instalments plus interest)</td>
</tr>
<tr>
<td>(2) Supplier credit cover</td>
<td>Instead of (3): assignment for refinancing purposes of title to the receivables, including claims arising under the supplier credit guarantee</td>
</tr>
<tr>
<td>Instead of (3): Repayment of loan (e.g. in six half-yearly instalments plus interest)</td>
<td></td>
</tr>
<tr>
<td>Federal government/ Euler Hermes</td>
<td>Bank/ forfaiting company</td>
</tr>
</tbody>
</table>

Sources: AGA portal of the federal government, Association of German Banks
Manufacturing risk cover
A third major type of cover alongside supplier credit cover and buyer credit cover is manufacturing risk cover. This enables German exporters to insure themselves against direct and indirect production costs incurred in connection with an export. It is particularly advisable to take out manufacturing risk cover when custom-made products are involved since it will not normally be possible to sell them elsewhere if production is suspended. The uninsured portion is 5% for all risks.

Tip:
If the exporter does not apply for supplier or buyer credit cover in addition to manufacturing risk cover, a supplementary processing fee will be charged.

Isolated buyer credit with Hermes cover

Export
er
(1) Export agreement
(4) Delivery/performance
(5) Disbursement of loan in instalments as goods delivered/services performed
(3) Letter of undertaking
Federal government/Euler Hermes
(3) Buyer credit cover
Export
er’s bank
(2) Loan agreement
(6) Repayment of loan
Importer or
Importer’s bank

Sources: AGA portal of the federal government, Association of German Banks
Hedging against interest rate risk and currency risk

Hedging against the risk of changes in interest rates and exchange rates plays a key role in foreign trade. These risks can be mitigated with the help of hedging instruments, also known as derivatives. The objective is to increase the exporter’s costing security.

Hedging against interest rate risk
Around 70% of German companies which use hedging instruments protect themselves against fluctuations in interest rates. This is because of the comparatively high risk of interest rates changing over the life of a medium to long-term export loan. Loans with floating interest rates are usually agreed when international business is involved. By entering into an interest rate swap, under which the floating interest rate is exchanged for a fixed rate, or by purchasing a cap, the foreign buyer can achieve greater costing security.

Interest rate swap
When entering into a swap, the company and the bank agree to exchange differently based interest payments over a specified period of time. The underlying capital is not involved: the swap is confined to the interest payments. Floating rates can be swapped for fixed rates or vice versa. The floating rates are tied to an officially recognised reference interest rate, such as EURIBOR (European Interbank Offered Rate) or LIBOR (London Interbank Offered Rate).

Interest rate cap
A cap is a contractual agreement under which the buyer is guaranteed an upper limit on the interest rate in exchange for the payment of a premium. A floating interest rate cannot then exceed this specified limit over the life of the loan. This combines the advantages

An interest rate swap avoids unpredictable costs

Company (expects interest rates to rise over the life of the credit agreement)

Five-year credit line of €5m with floating interest rate to cover ongoing funding requirements

With interest rate swap
Costing security

Without interest rate swap
Unpredictable costs if interest rates rise

Source: Association of German Banks
of a floating rate, which enables the company to benefit from falling interest rates, with those of a fixed rate loan, i.e. a predictable overall interest payment.

When agreeing a cap, the bank and the company specify how long it will run for, where the maximum limit will be set, what reference interest rate will be used and what the underlying nominal amount will be. The company pays the bank a one-off premium when the agreement is concluded. While the cap is in place, the bank makes compensation payments to the company if, at the beginning of an interest rate period, the reference rate lies above the agreed cap.

Hedging against currency risk
When doing business in certain industries or with certain countries, it is often the case that invoices have to be prepared and paid in foreign currencies. The exporter will have to assume currency risk if the currency of the importing country or a third currency is specified as the invoicing currency (some transactions are always settled in dollars). If a third currency is agreed, currency risk will also be borne by the importer.

Forward exchange contracts can protect businesses against risks arising from currency fluctuations. If the importer of German goods will need euros, for instance, in several weeks’ or months’ time, it can agree today to buy a specified amount of euros on an agreed date and at an agreed rate. The bank will then take on the currency risk in exchange for a fee.

Combination of interest rate and currency swap
The combination of an interest rate and currency swap is called a cross-currency rate swap, also referred to as a cross-currency swap. It is an agreement between two counterparties to exchange interest payments and principals denominated in two different currencies. There are three main types:

### Interest rate cap

<table>
<thead>
<tr>
<th>Company</th>
<th>Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan, e.g. six-month EURIBOR + credit spread</td>
<td></td>
</tr>
<tr>
<td>Repayment</td>
<td></td>
</tr>
<tr>
<td>Compensation payment if six-month EURIBOR &gt; 3%</td>
<td></td>
</tr>
</tbody>
</table>

**Example:**
Funding amount: €1m  
Term: three years  
Reference interest rate: six-month EURIBOR  
Six-month EURIBOR: 2.20%  
Company purchases interest rate cap of 3%

Source: Association of German Banks
In a fixed-fixed cross-currency swap, the interest rate on both legs is a fixed rate.
In a floating-for-floating cross-currency swap, the interest rate on both legs is a floating rate. Cross-currency basis swaps are commonly used for major currency pairs, such as €/US$.
In a fixed-for-floating cross-currency swap, generally referred to as a cross-currency coupon swap, the interest rate on one leg is floating, and the interest rate on the other leg is fixed. Such swaps are usually used for a minor currency against the euro.

The cross-currency rate swap arose in response to a need for companies to grant loans in foreign currencies to subsidiaries abroad and exclude the currency risk associated with the principal and interest payments.

Forward exchange contract: the bank guarantees the customer a fixed exchange rate

Bank guarantees company A an exchange rate of 1.3 US$/€ on settlement in return for a fee
Agreement to buy ten pieces of machinery for US$10m; costing based on an exchange rate of 1.3 US$/€
Settled at exchange rate of 1.1 US$/€
Additional profit for A of approx. €1.4m
Unexpected loss for A of approx. €1.4m

Costing security for company A

Source: Association of German Banks
Glossary

Bank payment obligation (BPO)
Standardised commitment by the buyer's (= importer's) bank to pay the seller's (= exporter's) bank for standardised commercial transactions settled on open account. The BPO is based on electronic matching of data which buyers and sellers provide to their banks. In summer 2013, the International Chamber of Commerce issued a set of internationally recognised rules (known as the Uniform Rules for Bank Payment Obligations, URBPO) to increase settlement security.

Ceiling
Upper limit. In the context of export credit guarantees, ceiling means the maximum amount of cover that can be granted for exports to countries considered high-risk.

Collateral
Rights granted by the borrower to the bank to make it easier for the bank to recover its funds in the event of a default. Collateral for a loan may take the form of personal collateral (such as a guarantee) or real collateral (such as a property charge). Collateral generally reduces the expected loss a bank would have to bear in the event of a default.

Common Approaches
Short for the Recommendation of the Council on Common Approaches for Officially Supported Export Credits and Environmental and Social Due Diligence. The approaches are OECD guidelines, initially adopted in 2004 and most recently revised in 2012, which specify procedures and principles for analysing environmental and social issues connected with exports supported by the state.

Communication of the European Commission
Communications are measures and positions adopted by the institutions of the European Union which have no direct legal force. The Commission can, however, use communications to issue administrative guidelines on the application or interpretation of secondary law.

Comprehensive cover
In the context of export credit guarantees by the German federal government, German exporters are offered individual and comprehensive cover. The aim of comprehensive cover is to offer a much simpler, standardised form of insurance to take account of the mass nature of short-term credit. Instead of having to decide whether or not to cover individual transactions, a maximum amount of cover is made available and can be used repeatedly.

Consignment note
Also known as a bill of lading. A document listing details of the goods a ship is carrying.

Conversion risk
Risk that the ability to convert a currency is restricted or suspended. For economic or political reasons in the importing country (such as a lack of foreign currency reserves), the importer may not be able to pay the purchase price to the exporter in the contractually agreed currency.

Counterparty credit risk
Risk that the other party to an agreement will default.

Country rating
Assessment of a country’s ability to meet its international obligations on schedule and in the agreed currency. The assessment is based on an analysis of economic and political indicators.

Credit line
The bank and customer agree on a maximum amount of credit to be available on the customer’s account. The customer may draw on the full amount, but is not obliged to do so. The bank may charge commitment interest on a credit line which is not utilised.
Credit standing
Ability of someone who wants to take out a loan to repay the principal and interest.

Deferred payment letter of credit
See documentary letter of credit.

Documentary collection
The most commonly used method of collection in foreign trade. The exporter gives documents (payment documents and/or commercial documents) to its bank (remitting bank), which the latter forwards (i.e. remits) to the importer’s bank (presenting bank/collecting bank), instructing it to release the documents against payment or acceptance of an attached draft.

Documentary letter of credit (L/C)
Contractual guarantee by a bank acting on the instructions and for the account of a customer (importer) to pay an agreed price to the exporter within a specified period of time against presentation of certain documents. A sight L/C requires payment immediately on due presentation of the documents. A deferred payment L/C allows the exporter a period of time to effect payment.

Documents
Documents showing proof of dispatch, insurance, quality and/or other aspects relating to the goods. The most important types of documents include transport documents such as the bill of lading or airway bill, insurance documents, and commercial and customs documents such as commercial invoices, certificates of origin or packing lists.

Draft
A bill of exchange which has been drawn but not (yet) accepted by the drawee. In foreign trade, it functions as follows: the exporter draws a bill of exchange (draft) on the importer, who will be required to pay. Until the importer has signed the document, it is known as a draft. By signing, the importer accepts the request for payment. This step is known as acceptance.

Export finance
Instruments for funding the export of goods (usually durable capital goods and equipment) and services with medium-term (one to five-year) and long-term (more than five-year) maturities. The term "export finance" is often used in a way which also covers import finance, the other side of the same business.

Factoring
The company (exporter) sells receivables due from its business partners (importers) to a factoring company and, in exchange for a fee, obtains the outstanding amounts immediately. The factoring company, meanwhile, assumes the risk of default and, on request, takes on responsibility for collecting any arrears. The company continues to be liable for the validity of the claim. Unlike forfaiting, which covers individual transactions with short to medium-term credit periods, factoring requires the conclusion of a master agreement in which the exporter undertakes to sell all its short-term receivables to the factoring company on a regular basis.

Foreign trade finance
Umbrella term for trade finance and export finance.

Forfaiting
A bank or a forfaiting company buys the receivables due to a company (exporter) from its business partners (importers) and, in the event of an importer’s default, has no recourse to the exporter. Nevertheless, the latter continues to be liable for the validity of the claim. Unlike factoring, which requires the conclusion of a master agreement for short-term, recurring business, forfaiting covers individual transactions with short to medium-term credit periods.
**Forward exchange contract**
In a forward exchange contract, the purchase or sale, conclusion and performance of the agreement are carried out at different points in time lying outside usual settlement periods.

**Hermes cover**
Term commonly used for export credit guaranteed by the German federal government with the aim of protecting German exporters from economic and political risk. The export credit guarantee scheme is managed by a consortium consisting of Euler Hermes Deutschland AG and PricewaterhouseCoopers AG Wirtschaftsprüfungsgesellschaft (PwC).

**Interministerial Committee (IMC)**
The IMC decides on all applications for export credit cover and issues the corresponding German federal government guarantees. The committee is chaired by the Federal Ministry for Economic Affairs and Energy. Other members include the Federal Ministry of Finance, the Foreign Office, the Federal Ministry for Economic Cooperation and Development, Euler Hermes, PricewaterhouseCoopers and experts representing the banking sector and exporting industries.

**International certificate of receipt**
Transport document with which the forwarding agent confirms receipt of the goods.

**International Chamber of Commerce (ICC)**
The ICC was set up in 1919 and has its headquarters in Paris. Its objectives are to promote world trade and safeguard the principles of the free market economy, free trade and free enterprise.

**Leasing**
Agreement under which a manufacturer or leasing company (lessor) allows a lessee to use a movable or immovable asset (leased asset) for a specified period of time in return for a fee.

**Letter of credit**
Instruction from a customer (in this case importer) to its bank to pay a certain amount of money to a third party (payee, in this case exporter). The payment is only effected if the payee fulfils certain conditions. The most common type of letter of credit in foreign trade finance is the documentary letter of credit (see above).

**Liquidity**
Cash or assets which can easily be exchanged for cash.

**Local costs**
In the context of export credit guarantees, local costs are the cost of goods and services in the importing country and are not considered part of third-country supplies. Only a certain maximum percentage can be covered by an export credit guarantee.

**Marketable risks**
Since 2002, economic and political risks have been considered “marketable” if they relate to foreign trade with EU member states and OECD core countries involving credit periods of up to two years. Marketable means that private credit insurers are in a position to offer sufficient long-term insurance solutions. In the interests of subsidiarity, no state-backed cover is offered in this area.

**Maturity**
Contractually agreed point in time at which the redemption of a loan or bond, for instance, is due.

**Moratorium**
A temporary suspension of payments. Unilateral moratoriums are sometimes placed by debtor nations on international payments to their creditors.

**Organisation for Economic Cooperation and Development (OECD)**
An international organisation committed to democracy and the market economy. It has 34 member states and is based in Paris. The OECD is dedicated to the
objectives of promoting sustainable economic growth, more employment, higher standards of living and greater financial stability. It also wishes to support the development of other countries and help boost world trade.

OECD Arrangement
Agreement between OECD member states on certain guidelines for the state-backed cover of exports involving credit periods exceeding two years. The aim of the Arrangement is to prevent competition to provide funding at public expense and avoid competitive distortion between exporters. In the European Union, the OECD Arrangement has been implemented as binding legislation.

Rating
Assessment of a debtor’s credit standing, normally expressed as a standardised grade. The objective is to evaluate as accurately as possible the borrower’s likelihood of defaulting within the next twelve months. Credit ratings are calculated internally by banks when deciding whether or not to approve a loan and are also issued by external rating agencies for listed companies or individual bond issues, for example.

Recourse
Ability to seek compensation. In forfaiting, a bank or a forfaiting company buys receivables due to a company (exporter) from its business partners (importers) and gives up its right to seek compensation from the exporter in the event that the importer defaults on its debt.

Risk period
In the context of export credit guarantees, the risk period is the redemption period of the export credit plus half the run-up period to the transaction. The run-up period begins with the first delivery or drawdown (of a credit facility) and ends on the date when the buyer takes physical possession of the goods or equipment (this date is called “starting point of credit”).

Sight letter of credit
See documentary letter of credit.

Swap
Exchange of cash flows.

Third-country supplies
In the context of export credit guarantees, these are subcontracted supplies from a third country, i.e. neither the country of origin nor the country of destination of the export.

Trade finance
Instruments for funding the trade of goods (usually raw materials, semi-finished goods, spare parts or consumer goods) and services with short (less than one-year) and medium-term (one to five-year) maturities.

Transfer risk
The risk of government intervention in the trade and payment sectors with the result that, despite being willing to pay, an importer cannot settle its debt to a foreign creditor on time and in full.

Uniform Customs and Practice for Documentary Credits (UCP)
An internationally recognised framework issued by the International Chamber of Commerce to increase legal and settlement certainty in foreign trade. On 1 July 2007, a revised version known as UCP 600 came into force. UCP 600 applies to any letter of credit which expressly states that it is covered by these rules.

Uniform Rules for Collections (URC)
An internationally recognised set of rules issued by the International Chamber of Commerce to increase legal and settlement certainty in foreign trade.

Uninsured portion
In the context of export credit guarantees, the exporter’s share in the loss in the event of default on the covered loan.
fokus | unternehmen

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Previous publications in the series (in German only):

- Vorbereitung auf das Bankgespräch
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- Rating
- Gründungsfinanzierung
- Öffentliche Förderung
- Energieeffizienz – Potenziale heben und finanzieren
- Unternehmensnachfolge finanzieren
- Alternativen zum Kredit
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- Basel III – die Folgen für den Mittelstand
- Außenhandelsfinanzierung
- Verhinderung von Geldwäsche
- Langfristfinanzierung
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