Export credit: foreign currency contracts

Over the last few years, the arrangements for supporting UK exports invoiced and financed in sterling have been continually expanded.[1] Until autumn 1976, however, support for exports invoiced in foreign currencies was limited to Export Credits Guarantee Department cover for the equivalent sterling value of these exports at the time cover commenced. This meant that if an exporter had a contract invoiced in foreign currency, and sought to protect himself against exchange risks by selling forward his future currency receipts under the contract or by borrowing foreign currency against these expected receipts, he might suffer some loss in meeting his obligations. The sterling provided under his ECGD policies could be insufficient to meet these obligations, if he did not receive the payments due under the export contract, and if sterling had depreciated since his ECGD cover commenced.

In order to remove this obstacle to contracting in foreign currencies, the Secretary of State for Trade announced in August 1976 that, as from October that year, ECGD cover for contracts expressed in certain major foreign currencies, and supported either by use of the forward exchange markets or by foreign borrowing, would be related to the sterling exchange rate obtaining at the time the UK exporter met his currency obligations (if this would be more favourable to him). For business on credit terms of up to six months, ECGD would consider paying, without additional premium, up to 10% more than they would have done under the previous arrangements. Exporters with business on extended terms could select any percentage of additional cover they wished, subject to a pro rata increase in premium. Finally, for specific business ECGD would provide sufficient cover to meet any amount of exchange loss.

This improvement in export credit cover for contracts invoiced in foreign currency was followed, in December 1976, by the Chancellor of the Exchequer's announcement that in addition support would be given for the *financing* of UK exports in foreign currency.[2] The Chancellor stated that the Government believed that, by funding medium and long-term export credit in foreign currency instead of in sterling, the burden of export credit on public expenditure, on the public sector borrowing requirement and on the balance of payments could be reduced; steps were therefore being taken to encourage the use of foreign currency financing, and to control the rate at which new offers of fixed-rate sterling finance would be approved by ECGD.

Accordingly, in February this year, the Secretary of State for Trade outlined a number of measures aimed at bringing about a switch of the financing of UK exports on *buyer credit* from sterling to foreign currency. In future, ECGD would only underwrite larger projects where these were financed in foreign currency. Such financing would normally be required for all project business with certain countries, and would be actively sought in a number of others. Furthermore, ECGD-guaranteed sterling finance would no longer be available for contracts with a substantial foreign element, and general purpose sterling lines of credit would not be established or renewed, unless previous lines had been rapidly and fully utilised. To encourage this switch, interest on foreign currency buyer credits would be held to the minimum rates established under the international guidelines

[1] These arrangements are currently being reviewed.

[2] A number of schemes to encourage foreign currency financing of UK exports had been considered by government departments and the Bank of England. But nothing came of these schemes so long as the financing of medium and long-term credits in sterling at fixed and favourable rates was supported by the Government and exporters were neither compelled nor given an incentive to adopt foreign currency financing.

announced in June 1976 (and renewed for a further six months in June 1977). Finally, eligible foreign currency contracts would enjoy the more favourable terms of the cost escalation cover hitherto available for sterling cash contracts alone.

Under the foreign currency buyer credit arrangements outlined above, ECGD give the lending banks a guarantee on the whole of their lending against repayment default by the buyer. Secondly, while overseas borrowers pay fixed rates of interest on these buyer credits at the minimum rates established under the international guidelines, the return received by the lending banks is set by ECGD at a market-related rate of LIBOR[1] plus a margin. This margin is established specifically for each contract by ECGD. If LIBOR plus this margin at any time during the loan exceeds the fixed interest paid by the overseas borrower, ECGD pay the difference to the lending banks. In the reverse situation, the lending banks pay the difference to ECGD.

These two features of ECGDs support for banks financing foreign currency buyer credits are very similar to the arrangements for supporting sterling buyer credits. Another feature, whereby exporters taking advantage of ECGD cover are liable to recourse by ECGD if they are in breach of contract, is the same under both schemes. In one respect, however, ECGDs support for foreign currency buyer credits differs radically from the sterling arrangements. Under the latter, the Government automatically refinance the London and Scottish clearing banks' fixed-rate sterling lending (on supplier as well as buyer credit) beyond a certain percentage – currently 21% – of their non-interest-bearing sight deposits in sterling. There is no such automatic refinancing under the foreign currency buyer credit arrangements.

Nevertheless, foreign currency buyer credit lending may, in effect, be refinanced in certain circumstances. Financing banks are usually only willing to commit themselves to foreign currency lending for maximum periods of between five and seven years (on the basis of variable interest rates, and with roll over periods sometimes as short as three months). Because the total period of a buyer credit may be longer than this, however, it has been necessary to devise a means of converting this variable rate funding into the longer-term, fixed-rate, lending typically required to support major export projects. Thus, under the financial agreement between the lending banks and the foreign buyer, there is a joint commitment of the lending banks *and* ECGD to provide fixed-rate finance for the entire credit period. The lending banks commit themselves to lend for the maximum period they regard as possible. But if this is shorter than the length of the buyer credit, and at the end of their commitment period the lending banks are unable to extend their lending, and replacement financing banks cannot be found, ECGD take over the whole of the loan. ECGD may also take over the loan from the lending banks before the expiry of their commitment if conditions in the euro-currency market are considered by ECGD to necessitate such action.

ECGD support for buyer credits financed in foreign currency is generally limited to US dollars and deutschemarks. One reason is that exporters may wish to make use of forward exchange markets. Unless an exporter has borrowed against his foreign currency receipts, he has the option of selling them forward at the time the contract is signed. However, on long-term buyer credits the manufacturing period, and hence the time over which the exporter will receive progress payments financed by loan drawings, may be as long as four or five years from the date of contract. Because

[1] London inter-bank offered rate.

forward markets extending significantly beyond the traditional short-term maturities exist only in US dollars and deutschemarks, ECGD support for buyer credit financing in foreign currencies is generally limited to these two currencies. Even then, in order to ensure that adequate forward markets in US dollars and deutschemarks are available up to five years forward, it has been necessary on occasion for the Bank of England to be the counter-party to an exporter's bank when the latter would otherwise be unable to conclude forward deals.

The main features of the foreign currency buyer credit scheme – the total guarantee to lending banks against buyer default on repayment, the arrangements for ensuring that lending banks receive a market-related rate of return on such lending, the arrangement for ECGD recourse against exporters in breach of contract, and the ECGD guarantee to borrowers that buyer credits will run their full term – were established at the beginning of the scheme. The Bank of England's counter-part rôle mentioned in the previous paragraph was made available shortly afterwards. Another subsequent development was the passing in March of the International Finance, Trade and Aid Act, under which ECGD were granted statutory power to give foreign currency guarantees, subject to a limit of SDR 10 billion.

These arrangements have been further modified by the introduction of ECGDs tender-to-contract scheme. Until August this year, although an exporter could fix the sterling value of his future foreign currency receipts at the date of contract (by selling them forward at that time), he was unable to do so at the time of submitting his tender. Under an amendment to exchange control regulations in March 1972, an exporter could sell his expected foreign currency receipts forward from the time of tender to the time of contract signature. But if he won the contract, forward sales of foreign currency receipts to match the actual terms of the export contract would then have to be undertaken at the forward rates ruling at that time. These might, however, differ markedly from those ruling at the time of the tender. At the time of tendering, an exporter could not protect himself against fluctuations in forward rates between that time and the date of the contract. In August, therefore, ECGD introduced a facility whereby, for an additional premium, they would provide protection against movements in exchange rates in the period between the making of a tender and the signing of a contract, by guaranteeing that if forward exchange rates were to alter by more than 3%, an exporter winning a contract would receive the same sterling outturn for the contract, less the 3% margin, as he would have obtained had he sold forward his currency receipts at the date of tender. If actual sterling proceeds fall short of the guaranteed sum, ECGD pay the difference; and if they exceed it, the excess is paid to ECGD (in both cases, less the 3% margin).

The other major development this year has been the establishment of criteria to determine which banks are eligible to lead lending syndicates for buyer credit. In order to ensure parity of competition – so far as this is possible – between all banks wishing to do this business, it was announced in October that such banks must in future be authorised banks for the purpose of the Exchange Control Act and also registered in the United Kingdom.[1] It is further required that, where a bank fulfils these criteria but is substantially owned by a non-UK registered company, it should not extend participation in the syndicate to other banks in its group, unless such other banks are themselves eligible to arrange financing under the scheme.

[1] All authorised banks registered in the United Kingdom are subject to the Bank of England's capital adequacy and other prudential requirements.

Since the introduction of the scheme for financing buyer credits in foreign currency, some $400 million of foreign currency loans backed by ECGD cover have been concluded. The total of foreign currency financing business under active consideration by ECGD now exceeds $3 billion.