Factoring and Forfaiting- Novel Financial Tools
(A Boon for Financing Receivables in Domestic and International Trade)

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Abstract

Irrespective of the type of goods and services, and the nature of souk whether domestic or international, an organization is compelled by the market and competitive forces, to offer some credit period to the purchaser/importer though it blocks the precious funds creating the problems of liquidity besides other associated risks like bad debts etc. Factoring and Forfaiting are the two novel financial tools that help the organizations to overcome this problem with ease. The terms *factoring* and *forfaiting* are mixed up often. While factoring finances the domestic sales up to 180 days credit period, forfaiting is used to finance exports with credit period ranging between few months to several years. Factoring is different from bill discounting as the later is a borrowing with the use of the current assets i.e. Accounts receivable as collateral for the Loan. Forfaiting may be called a factoring in International Trade whereby the forfaiter offers 100% financing to the exporters without recourse. Factoring only covers commercial risk, whereas forfaiting additionally covers political and other risks. In India factoring services were launched by SBI in 1991 through SBI Factors & Commercial Services. Other prominent players are EXIM Bank and Canbank Factors Limited. These and some other banks/institutions are also providing forfeiting services. Secondary data has been used in this article as gathering primary data on this subject was difficult being treated as sensitive matter by businesses entities. The research paper while dealing with the process and benefits of forfaiting and factoring also casts a glance at the international scenario and the future prospects
KEYWORDS: - Credit, Creditworthiness, EXIM Bank, Exporter, Factoring, Forfaiting, Importer, Invoice.

INTRODUCTION:

An effective Financial System is a *sine qua non* for the pursuit of economic growth both at *macro and micro* level which is equally true for a business organization as well as the country. An organization uses a combination of various financial instruments to establish the business/industry and then to operate the same. The enterprise has to finance its assets through equity and loans in the initial stage and various financial tools and financial services in the operational stage for the working capital needs. Thus it is imperative for a business enterprise to use a judicious blend of different financial tools for effective and efficient financial management. This article deals with two novel financial services availed by the organization for working capital management, namely Factoring and Forfaiting. While these services are commonly used in many foreign countries, in spite of its huge advantages they are less popular and less in vogue in India. It is nearly impossible for any producer, manufacturer and service provider to sell the goods and services without offering credit though credit sales have certain inherent risks like risks of bad debts and other incidental and consequential risks. Factoring and Forfaiting offers best solution for these problems. Factoring involves the conversion of credit bills into cash and the risks associated with it are borne by the factoring agents. The unique feature of Factoring Agencies is offering services in one package by financing inventories and receivables thus helping the organization to unlock the money in working capital. Factoring is also called "Invoice Discounting" or "Receivables Discounting" which can be with recourse or without recourse. The discounting rates vary and cover loss of interest, loss of principal and interest in the worst case scenario. The Reserve Bank of India (RBI) in January 1988 constituted a study group under the Chairmanship of C.S. Kalyansundaram Ex- Managing Director of State Bank of India (SBI), to examine the feasibility and mechanics of starting factoring organizations in the country; and the RBI has already taken steps in this direction as per the recommendations of the study group. The other important financial tool is known as Forfaiting enabling the exporters to convert their credit sale in to cash. The Forfaiter helps the exporters in "Risk Management". The word Forfaiting is derived from the French word "Forfait" which means surrender of rights. In export financing context this is an arrangement by which the exporter surrenders export receivables to the Forfaiting Agency and receives the full value of exports before realization. It is a technique deployed for financing goods on medium term deferred basis. Forfaiting is the non recourse purchase of receivables by financial institutions/Banks arising in the export trade. In consideration the Forfeiting Agency deducts a discount fee in advance which is the London Inter Bank Offered Rate ***(LIBOR).*** The popularity of Forfating is increasing because of the limitations of the conventional export financing. Due to the technological innovation and omnipresence of market and competitive forces a business organization cannot afford to sell all the goods/services on cash basis either in the domestic or International trade. In such a situation these financial tools are a boon for the business organizations to solve its liquidity problems by unlocking the cash from working capital and also for the efficient credit and risk management.

FACTORING:

In India the factoring services were launched by State Bank of India in 1991 by promoting SBI Factors & Commercial Services Pvt. Ltd. (SBIF). In March 2008, SBI acquired a controlling stake in Global Trade Finance Ltd. (GTF) a Company promoted by EXlM Bank and decided to merge SBIF and to derive a synergy of operations. The merger was completed on 1st April 2009. The merged Company has been named as SBI Global Factors Ltd. (SBIGFL). There other players in the market Canbank Factors Limited, Union Bank, IDBI to name a few. Selling goods on credit and favorable terms to the customers is important and imperative for a business enterprise and a key to sustain, achieve volume, growth, and increase its market share. Factoring also helps the organization for efficient risk management and solving the problem of liquidity. Factoring is also called "invoice discounting" or receivables discounting. It is a debt collection service where the Factor usually a financial institution/bank, finances the book debts/ receivables of the client. Presently the factoring service is available only as a funding of sundry debtors but in the wider scale it can cover the administration of the client's sales ledger, appraising the credit worthiness of debtors, evaluating the credit risk and also recovering the dues from the debtors. Factoring helps the organization to use the working capital efficiently and thereby reduce the interest burden and indirect costs of operations. A good factoring agency should have strong infrastructure/facilities like due diligence or verification cell, collection and recovery department and a good marketing team. Factoring arrangements are worked out and finalized between the client and the factor which may include appraisal of creditworthiness of the buyer, the credit period, maximum credit limit, factoring charges, tactic to recover bad debts, maintaining the separate ledger etc.

- The various stages and steps involved in Factoring are enumerated below:-
  - The client (seller) places an order with the buyer.
  - An agreement is then finalized between factor and the seller.
  - Contract for sales is finalized and the goods delivered.
  - After execution of sales the invoice with notice to pay to the factor is sent to the buyer.
  - The copy of invoice and other documents are sent to the factor who keeps the sales ledger.
  - The factor after verification of invoice and documents prepays up to 80% of the invoice value to the client. The factor sends monthly statements of accounts to the client and follow up action is taken for unpaid invoices.
  - The buyer settles the payment on the expiry of agreed credit period (due date).
  - The balance (margin) i.e. 20% or so is paid by the factor to the client after deducting the factoring charges.

- **Types of Factoring Services:** Factoring services are generally categorized into ***six*** main categories-Recourse and Nonrecourse Factoring, Full Factoring, Maturity Factoring, Advance Factoring, Undisclosed Factoring and Invoice discounting. Moreover there are factoring with bank participation, International factoring and supplier guarantee factoring. In nonrecourse factoring; the factor assumes the risk for bad debts and has no recourse available against the debtor. In mature factoring; assistance is given for recoveries of bad debts. In bank participation factoring; the firm creates a floating charge and then borrows against the reserves. Under the supplier guarantee scheme the firm acts as an intermediary between the supplier and the customer. Thus the factor takes care of the collection of dues from both the parties like suppliers' dues from the client and the client's dues from the buyer. International Factoring is the services availed in the export trade. Exporters of goods and services like machine tools, readymade garments, leather, tobacco, gift article, jewelry, etc can avail the benefit of factoring by choosing a reputed factoring agency.

- **Factoring and bill discounting**: There are many similarities between Factoring and bill discounting. The common feature being both makes the finance available to the client against receivables. In both the transactions the agency keeps some margin while providing finance which may vary between20% to 30%; or more depending upon various aspects like nature of goods, creditworthiness of the buyer, credit period etc. However there are some differentiating facets e.g. while in bill discounting transactions the bills can be rediscounted number of times before maturity period and the last holder is only entitled to full payments of dues. The bills purchased as per the factoring contract cannot be discounted again at the best it can be refinanced if necessary.

- **Advantages & Disadvantages**: The major advantages and disadvantages of factoring are delineated below:
  - The first and foremost advantage is the effective utilization of the working capital as the money due from debtors is not blocked.
  - The factor is responsible for recovering the dues from the debtors thus saving the supplier from the unnecessary hassles of collection of dues and eventually the risk of bad debts.
  - Perhaps the major benefit is Liquidity as the supplier gets prompt payment from the factor.
  - The requirement of minimum business and other parameters is not insisted upon by many factoring agencies.
  - The client is able to maintain better current ratio which boosts its financial position.
  - Better management of inventory is possible as the payment to the debtors is assured.
  - It is especially most beneficial to the new companies as they get regular supply of funds.

It is additionally beneficial for all the parties involved in factoring arrangements to have linkages with the banks which enable them to borrow money from banks by assigning the bills. Similarly the client can borrow from the bank and avail other services from the factor. This way the factoring arrangement works for the benefit of all the parties.

- **Disadvantages:** The factoring is expensive and sometimes the costs can be prohibitive and as high as 20% to 25%. This can spell disaster for a new organization that is facing cut throat competition in the business.
- In order to afford the cost of factoring the markup or profit margin on the products should be more than the factoring charges which may not be possible unless the supplier is operating in the monopoly or oligopoly market.
- A situation of mismatch of the cash flow can arise if the factoring arrangement and inventory management are not handled properly.

FORFAITING:

The practice of forfaiting began during the cold-war era mid 1940s to mid 1970s in response to matching the requirements of West-European exporters to the needs of state-owned East-European firms. The massive invasion of technological innovations and inventions has turned the world in to a global village opening new vistas for International Business (Import & Exports), and borderless Trade. But International Business and Trade, poses many challenges as the marketers are dealing with strangers who may be like aliens in certain situations. Thus International Business requires deep understanding of several aspects such as consumer behavior, creditworthiness of the buyer, the banking and warehousing facilities, the laws and political system prevailing in foreign land, etc. In common parlance Forfaiting is a financial transaction involving the purchase of receivables from exporters by a forfeiter who assumes all the risks associated with the receivables by charging fees commonly known as margin. However the forfaiter may be immunized from certain risks due to the default on the part of the exporter, like non performance of the contract, non compliance of the laws, submission of fake documents etc for which exporter could be sued by the forfeiter. Major characteristics of forfaiting are: Credit is extended to the importer for a period ranging from 180 days to some years. Minimum transaction size is normally Rs2 to Rs5 crores ($250, 000, to $500,000) depending on the nature of goods/services, creditworthiness of the parties, and local laws. The payment is normally accepted in any major currency. A letter of credit or a guarantee is given by a bank, usually based in the importer's country. The contract can be for either goods or services. It is essential that the receivables should be evidenced by a promissory note, a bill of exchange, a deferred-payment letter of credit and letter of forfaiting. This also helps the exporter to claim ***Duty drawback on FOB price.*** In simple words forfaiting is the non-recourse discounting of export invoices/receivables where the exporter has no recourse and all the rights, risks against the importer stand vested in the forfaitor. The exporter in return gets immediate cash payment from the forfaitor. The Government of India established Export-Import Bank of India, ***(EXIM Bank)*** offers state of art services like; Research & Analysis of a vast range of products, Marketing Advisory Services creating and enhancing export capabilities of Indian companies, Export Advisory Services offering information, advice and support, enabling exporters to evaluate international risks and exploit export opportunities etc. Moreover the EXIM Bank provides two major financial services i.e. I] Line of Credit (LOC) a financing mechanism extending support for export of projects, equipment, goods and services from India and II] Buyer's Credit- a facility for import of eligible goods and services from India on deferred payment terms. ***SBI Global Factors*** is another institution in India offering forfaiting facilities. In foreign countries large number of Banks and Corporate houses are engaged in Forfaiting business while India has very few institutions providing such services.

- The various stages and steps involved in Forfaiting are delineated below:
  - The parties i.e. exporter and importer have to negotiate and finalize the contract.
  - The exporter then approaches to either EXIM bank or other forfaiter and submits all the necessary documents like shipping bills, G.R. Forms etc.
  - The risk appraisal is done either by the forfaiter or other agencies/Indian arm of International forfaiter.
  - After the risk appraisal the forfaiter calculates and settles on the discount rate. It may be noted that the discount rates are subject to the approval of the EXIM bank.
  - After finalizing the discount rates the exporter quotes the price to the importer taking into consideration the forfaiting costs.
  - A final contract is then executed with the importer by the exporter. Simultaneously a forfaiting contact is executed by the exporter with the forfeiter through EXIM bank which is necessary because EXIM bank has to issue certain certificates of authorization.
  - The exporter gets the bills discounted through the forfaiter and the later then presents the same to the importer on due date for payment or avail the option of refinancing via secondary market.
  - The forfaiting costs comprise of the discount fees, documentation fees and commitment fees. The documentation charges are for verification of bills etc, discount fees is the interest charges, the commitment fees is around 1% to 2% and all are payable by the exporter to the forfaiter.

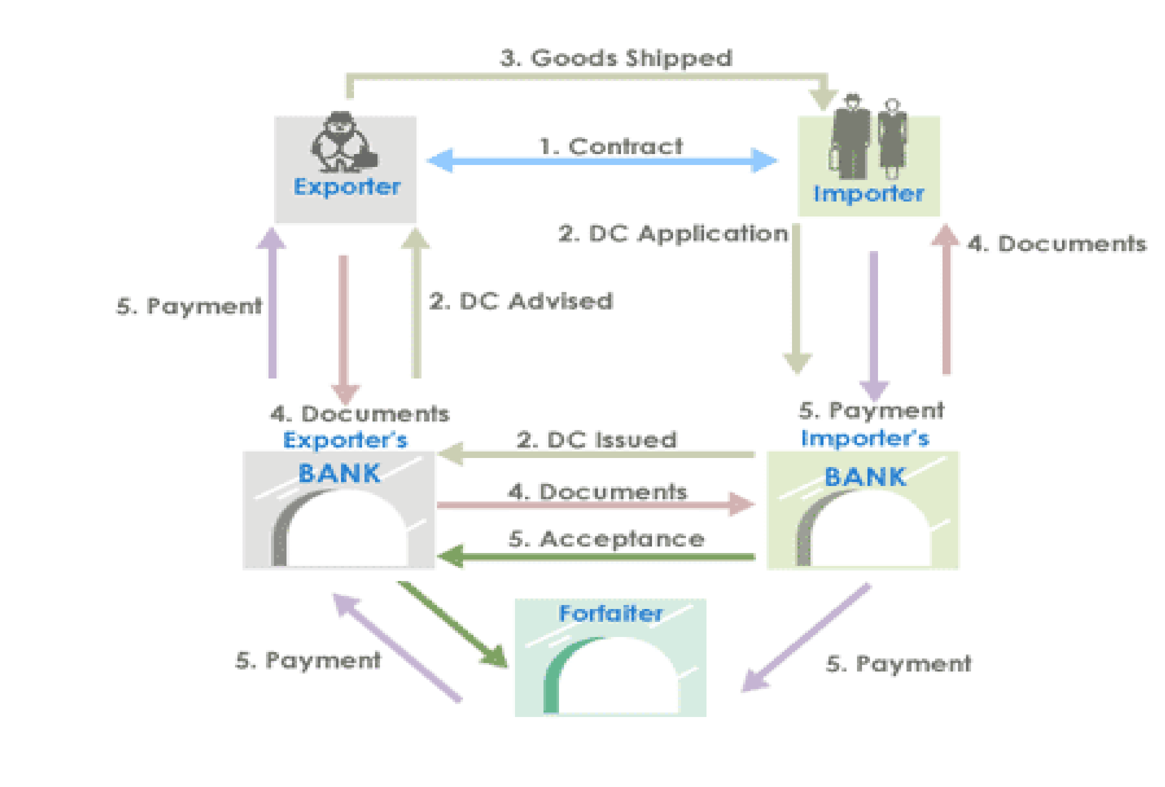
- **Factoring and Forfaiting**: Forfaiting is export financing practiced largely in Europe in which a forfaitor usually a bank or a finance company purchases freely-negotiable instruments such as letters of credit and bills of exchange at a discount from an exporter. This arrangement is without recourse to the exporter who is relieved of all commercial, political, exchange rate, and interest rate risks, but is liable for any defect/deficiency in the underlying transaction. Factoring is short term finance while forfaiting is for longer maturity dates and the periods varying between 180 days and as long several years (3-5-7 yrs). Forfaiting is available for 100 % of the payment amount, but only for relatively larger sums while factoring is available with a margin. Forfaiting implies the guarantee whereas such a guarantee is not necessary in factoring.

- **Advantages & Disadvantages:** The various advantages of Forfaiting are-
  - The major benefit of Forfeiting is the flexibility. The Forfaiting arrangements can be worked out to suit the requirements of the exporter.
  - Forfaiting is tailor made facility and it is easy also. However the economic and political scenario of the importing country should be thoroughly checked.
  - The creditworthiness of the importer need not be separately verified as the guarantee letter issued by the bank is sufficient proof of the financial soundness of the importer.
  - Forfaiting without recourse implies that the exporter is free from all the risks like fluctuations in the foreign currency rates, interest rates etc.
  - Forfaiting is also suitable for all types of exports be it capital goods, consumer goods or other commodities.
  - **Disadvantages**: The laws of the importing and exporting countries are different as such resolving the disputes may entail higher costs and more time.
  - Sudden upheaval in the political, economic and social scenario in importing country may pose risks to the exporter or vice a versa. For instance the recent war type activities in Iraq have affected imports of crude oil for India burdening the common man with hike in petrol prices.
  - Many times the Forfaiting costs can be very high. Moreover the minimum transaction value also creates difficulties for the exporter.

FORFAITING & GLOBAL SCENARIO:

The origins of the forfaiting market can be traced in the changes that world economic structure witnessed during the early sixties, when trade between ***Western and Eastern Europe*** was re-established. The growing importance of trade with developing countries in ***Africa, Asia and Latin America;*** boosted forfaiting market to an international level. By definition, these transactions are part of trade and project finance. The discounting method used is linked to the forfaiting market, a subset of export/import trade finance. Forfaiting is derived from the French term, “a forfeit”, which means to forfeit. In a forfeit transaction the exporter or borrower, after pledging notes or bills, forfeits his rights to future payments to the funder. This method was devised to finance exports of capital goods from West German manufacturers to the growing markets of Eastern Europe, which were opening up in the late fifties and early sixties. Short of hard currency for such imports, the East Europeans declared that they could not operate within the restraints of the traditionally acceptable three to six month credit periods, and sought credit for five to ten years, with semi-annual payments. The inherent financial and political risks of the Eastern European bloc countries were too vague and uncertain for the ***West German*** exporters. They also required speedy cash settlements to invest in new projects, for which they were seeking refinancing instruments. Moreover the West German exporter's bankers also considered Eastern Europe as "too risky", and felt that the requested credit periods were too long, especially at fixed rates of interest. Consequently, a group of financers in ***Switzerland*** decided to do what the West German banks could not, i.e., discount the promissory notes or bills of exchange without recourse to the exporter, a financial commitment that became known as forfaiting. Simply stated, if the importer or his bank failed to pay on the due dates, this would not be the responsibility of the exporter, but the forfaiting house (***Swiss Banks in those days***), which financed the transaction will carry all the risks. This resulted in the Swiss market being developed and ***Zurich*** became the center for such transactions in the Sixties, thus assisting the West Germans' economic revival. Many countries across the world have financed their government and infrastructure development projects through these transactions with the approval of course of the G-7 Nations. As the coverage of forfaiting enlarged, it is even finding a place in state and federal financing in ***UK & US*** and the Bureau of Private Enterprise is engaged in guaranteeing forfait transactions. Because of its popularity, new applications for forfaiting are constantly being developed such as shorter and longer credit terms, application to services, sans aval, floating rates, government guarantees, and so on. As far as the scenario in Asia is concerned Forfaiting started from 1995 in ***Japan*** although its economy had been wavering after the massive earthquake that struck Kobe. Japan's much vaunted earthquake preparedness was shattered but this has created opportunities for forfaiting. The practice of forfaiting is relatively new to ***China,*** but it is catching up fast. In the early 1990s, some of the overseas branches of ***Bank of China*** (BOC) started to offer forfaiting services to their customers and later on, it was introduced to the Chinese mainland around 2000. In the past few years, the forfaiting market in China has developed fast. In 2001, BOC became the first bank in China to offer forfaiting to domestic clients and currently it claims the top position with a primary market share of > 40%. BOC joined the International Forfaiting Association (IFA) in 2003 and now holds the chairmanship of the IFA North and East Asia Regional Committee (NEARC), which was constituted in June 2005. The ten members of NEARC include the four state-owned commercial banks and some of the major joint-stock banks in ***China***. In ***India*** forfaiting facility presently is available through EXIM Bank, SBI GLOBAL FACTORS and few other banks and there is a huge potential for the development of forfaiting business in future. Some of the leading Banks and Corporate houses offering forfaiting in foreign countries are- Association of Trade & Forfaiting In The Americas, Inc. (ATFA) New York, London Forfaiting New York, Mezra Forfaiting London and Bank of China to name a few.

 # Diagram of forfaiting process.



(Source-Google images)

SUMMARY AND CONCLUSION:

Factoring has emerged as an alternative financing option for the receivables in India and is gaining popularity and preferred over the bills discounting by many businesses. In January 1988 Reserve Bank of India (RBI), constituted a study group under the Chairmanship of C.S. Kalyansundaram Ex- Managing Director of SBI, to examine the feasibility and mechanics of starting factoring in the country. The study group estimated that >60% financing options are available for open accounts and mostly all organizations irrespective of its size and nature of business would opt for factoring. Though factoring has become popular in India but the bill discounting is still more preferable. Despite the fact that during the past two decades the apex bank is trying to develop the factoring as an alternative financing option for receivables yet the business community has shown some reluctance. RBI should initiate steps to make factoring more preferable among all the organizations and especially for SSIs and SMEs. Moreover the facility of refinancing should be allowed. It should also promote some special factoring agencies and encourage the public sector banks/financial institutions to venture in to this business segment. Furthermore to arrest the trend of bad debts some stringent measures need to be taken so that the factoring becomes an attractive business proposition for the new players.

- The practice of forfaiting began during the cold-war era mid 1940s to mid 1970s in response to matching the requirements of West-European exporters to the needs of state-owned East-European firms. Forfaiting is an increasingly popular form of private financing for sales transactions though previously thought to be rather exotic. In India forfaiting may not be very common or popular like Europe where banks and other corporate houses are engaged in forfaiting business on a large scale. Forfaiting business is found even in some of the Islamic Banks though very sparse. In addition to UK more and more American financial institutions are offering the facility, which is now considered a useful alternative to Exim Bank and FCIA versions of supplier credit, even for small and medium-sized exporters. Presently the forfaiting facility is available mainly through ***EXIM Bank*** and ***SBI GLOBAL FACTORS*** in India but there is a huge gap between the supply and demand scenarios. Thus forfaiting offers a great potential for Public sector and Private sector banks/financial institutions in India considering the increase in export trade. Forfaiting can become more attractive if i] the minimum value of transactions is reasonably reduced, ii] Banks and financial institutions are encouraged for undertaking forfaiting business, iii] awareness about advantages of forfaiting is spread among the business community iv] The Government of India takes initiative to establish a forfaiting agency to offer the facility on the subsidized rates as an incentive to the Indian exporters.

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