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FORFAITING : A TECHNIQUE OF EXPORT FINANCING

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In the context of an increasing thrust on export promotion, forfaiting has an important role to play. Forfaiting is the discounting of export receivables on a without-recourse basis. Over a period of time it is likely to emerge as an alternative source of trade finance especially for deferred exports. With the recent introduction of forfaiting service by EXIM Bank, export financing technique is expected to receive the required impetus. In this paper the author has explained the operating machinery of forfaiting, its benefits as well as shortcoming.

Forfaiting is a non-recourse purchase by a bank or other financial institution (forfaitor) of receivables arising from an export of goods and services. It is a french term meaning "to surrender on relinquish one's right to something", It would imply that the exporter surrenders his right to receive payment under an export receivable falling due for payment at an agreed discount, passing all the risks and responsibilities for collecting the debt to the forfaitor. Forfaiting is done without recourse, i.e. the forfaitor cannot go back to the exporter for the recovery of the money which the importer may not have paid him.

It is a technique to help an exporter to sell his goods on credit and yet receive the cash well before the due date. This export financing technique is mostly employed for financing goods on medium term deferred basis. In certain circumstances, forfaiting may also be used to finance goods for a duration of around a year or so. This technique is currently being introduced by the Reserve Bank of India for promoting India's exports.

The concept was originally developed in the mid-60s to help finance the West German exports to Eastern Block countries. Subsequently with the increased volume of trade between the developed and developing countries, the exporters from the former were in search of some alternate mode of trade finance as the buyers of the latter countries required credit that could not be offered through the traditional means of finance. Forfaiting provided a suitable channel for grant of more flexible credit to the exporter under such a situation.

Forfaiting: The Need In India

At present, commercial banks provide concessional finance in various forms for export transactions. Refinance is undertaken by the Reserve Bank of

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India and the Export-Import Bank of India (EXIM Bank) against short term add medium term export credits respectively as granted by commercial banks. The Exim Bank has diverse schemes to cater to the financing needs of medium and long term exports. Besides, the Export Credit and Guarantee Corporation give insurance cover against export credits extended to Indian exporters. However, it has been observed that the benefits are generally monopolised by the large and well established exporters. As such, there has been a long felt need to take care of export financing in respect of small and new exporters.

Moreover, the interest rates of an official export credit schemes are coming closer to the commercial interest rates because of international agreements. This has led to a decline in the attractiveness of the traditional modes of export financing. Financial institutors and banks should therefore take a hard look at forfaiting as an alternate mode of export financing so as to put the Indian exporters at par with their competitors from other countries and enable them to play a significant role in export promotion.

Operating Mechanism

The mechanism of operations of International forfaiting is explained below:

1. The exporter enters the negotiations with a potential buyer in the importing country for undertaking a project execution/delivery of capital goods etc.
2. The exporter approaches the forfaitor for availing the forfaiting facility. The forfaitor normally seeks the following information from the exporter :

    a) importing country and details of importer;
    b) details of goods to be exported and date of delivery of goods,
    c) the price and currency in which goods to be shipped are invoiced and period of finance sought for,
    d) date of delivery of documents to the forfaitor,
    e) repayments schedule,
    f) nature of security instruments, namely, bills, promissory notes etc.,
    g) necessary authorisation for exports etc.

3. On receiving this information, the forfaitor makes necessary enquiries regarding the country and the importer related risks. In case the importer is not a first class one like Govt. or well reputed MNC. The forfaitor normally insists on an unconditional and irrevocable guarantee from international banks.
4. The forfaitor gives his consent for financing upto a certain limit depending on the nature of transaction and the availability of guarantee.

5. The exporter, on receiving the commitment from the forfaitor executes a contract with the overseas buyer.
6. Then notes (trade obligations) are signed by the importer and given to his local bank for necessary guarantees.
7. The importer's bank guarantees the notes and forwards them to the exporter's bank with instructions to release them to the exporters against shipping documents.
8. The exporter ships the goods and present the shipping documents to his bank. The exporter bank releases the notes to the exporter and forwards the shipping documents to the importer through importers bank.
9. The exporter submits the B/E or promissory notes to the forfaitor and receives payment to the full extent of face value less discount charge.
10. The forfaitor is, then required to present the bills/notes to the guaranteeing bank on maturity. The guaranteeing banks reimburses the bill amount to the forfaitor irrespective of whether he receives the payment from the importer or not.

Structure of Forfaiting Cost

The discount at which the export receivables are sold to the forfaitor is the cost involved in forfaiting. This cost of forfaiting transaction normally consists of the following components:

1) discount fee towards providing finance,
2) fee for handling the transaction,
3) option fee for covering risk currency,
4) commitment fee (normally upto 12 months) between the time of agreement with the exporter and the actual receipt of the bills/notes on delivery of the goods.

Comparing the cost of export credit under traditional methods and under forfaiting would indicate that exporters have to pay about 1.5 per cent more for forfaiting. However, an exporter may be willing to pay the extra amount because of the additional services provided by the forfaitor e.g. the exporter's botherations about administering the sales ledger and collection of payment are taken over by forfaitor and the finance is provided by the forfaitor without recourse. Also, the exporter need not go for export credit insurance as currency risk and interest rate variations are taken up by the forfaitor.

In India, exporters of leather, tobacco, machine tools, readymade garments, electronic and electrical goods, computer software etc. who are comparatively small and many in number, may find the services of forfaiting quite attractive. Across the board, forfaiting is cheaper for all the first grade classification countries in various export credit schemes..

Benefits of Forfaiting

Forfaiting has a great deal of advantages over traditional sources of financing. The technique benefits the exporters mainly in the following respects:

a) The most outstanding benefit of forfaiting is that the exporter gets immediate payment upto the full value of bill/notes at a discount. He need not wait fill the collection of bills. Advance payment received from the forfaitor improves the cash flow position of the exporter.
b) The finance is provided to the exporter without recourse. It frees him from all credit risks and uncertainties. At times, even the risks of currency and interest rate variations are taken up by the forfaitor. The exporter need not go for export credit insurance.
c) The exporter can save valuable time and money as administration of sales ledger and collection of debt is undertaken by the forfaitor.
d) It helps in improving the competitive power of exporter as an exporter can offer 100% finance to the importer through the forfaiting agreement which makes the exporters bid more attractive.

Once forfaiting is introduced on a major scale, country itself will be benefitted in the following respects:

a) rapid growth of exports from the country,
b) immediate inflow of foreign exchange.

Shortcomings

However, there are following hurdles in the process of forfaiting:

i) Exporter's bank may not like to commit funds for the length of period that the exporter may desire.
ii) The importer's banks may refuse to guarantee payment.
iii) It may also happen that the exporter's bank may not agree to forfait deals involving an importer from a financially weak country.
iv) Certain prerequisites to launch the forfaiting technique successfully may not be present.

These prerequisites are:

a) appropriate and adequate legal framework,
b) data base regarding importers as well as importing countries,
c) secondary market (Existence of secondary market is an essential pre-requisite as a forfaitor may not be inclined to hold the discounted bills)

notes upto maturity because of its own cash flow considerations,

d) possible amendments to FERA (Foreign Exchange Regulation Act 1973) in terms of documentation, procedural mechanism the liability of the exporter realise the export proceeds etc.

Forfaiting: The Indian Perspective

Forfaiting which has recently been introduced in India, can open up an alternate window for availing finance as well as debt protection especially for export projects from small and medium enterprises.

Reserve Bank of India has recently given approval to start forfaiting services in the country as there is a bright future for Indian deferred exports, mainly in respect of engineering goods. As the principal surveyor of deferred export credit, the EXIM Bank is supposed to act as an intermediary between the Indian exporter and a forfaiting agency abroad. Indian exporter under the present forfaiting arrangement can discount their export receivables without recourse with forfaiting banks/agencies abroad and the EXIM Bank will act as a facilitator for such transactions between forfaiting agencies abroad and Indian exporters. The programme represents a new funding source for Indian exporters to exchange their exports to existing and new markets. According to EXIM Bank's annual report 1993-94, four forfaiting transactions were facilitated during the year covering export of commercial vehicles to Ghana, gems to Japan, printed cotton fabrics to UAE and mechanical power transmission projects to Australia.

Conclusions and Suggestions

Finance is a crucial part of any export package and quite often winning or losing an export contract hinges on the kind of financial package being offered. Finance for exports needs to be fast, cheap and flexible and on all these counts forfaiting does the needful. Forfaiting as a method of export financing is becoming increasingly popular.

Though it is heartening to see that the Exim bank, the major player in the sphere of international finance, has taken the much needful and long-awaited initiative in the international forfaiting arrangements, a lot needs to be done on this front. Some suggestions in this regard are given in the following lines:

a) Exim Bank should not act as a facilitator only in forfaiting agreement as is done presently. To exploit the full potential of the technique it should come forward to act as a forfaitor. This will really be a boon to Indian exporters which will in turn give a real boost to the export trade.

b) Steps should be taken by the RBI to extend the forfaiting at the commercial bank level if possible. With major Indian commercial banks having entered the merchant banking business in a big way, this should not be a difficult job.

c) Possibility of setting up a separate institution for participating in the international forfaiting operations should also be explored.

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