ABSTRACT

For more than last two decades, forfaiting has been emerging as an alternate notable source of finance in global trade transactions. This article attempts to determine the effectiveness of forfaiting as a finance tool by suggesting measures to make it popular for exporters particularly among small and medium enterprises.


INTRODUCTION

Forfaiting has been emerging as an eminent international trade finance tool, with special reference of exporters. Since, its basic characteristics is ‘Without Recourse’ (Delinquency born by the Institution or bank), it could prove to be of great benefits to the exporters.

For more than last two decades, forfaiting has been emerging as an alternate notable source of finance in global trade transactions. The concept is relatively unknown in the Indian context through it is likely to emerge very soon as a new paradigm in the financial market. This article attempts to:

- Determine the effectiveness of forfaiting as a finance tool.
- Suggest measures to make it popular for exporters particularly among small and medium enterprises.
- Suggest institutional framework for its sustained benefits.

OBJECTIVES

1. Determine the effectiveness of forfaiting as a finance tool.
2. Suggest measures to make it popular for exporters particularly among small and medium enterprises in India.
3. Suggest institutional framework of it.

Meaning and Its Operations

Now a day we come across many situations when people are not able to adapt to it, resulting into anger. The term ‘forfeit’ is a French word denoting ‘to give something’ or ‘give up one’s rights’ or ‘relinquish rights to something’. In forfaiting scheme, the exporter abandons his right to receive payments in future for immediate upfront cash payments by the forfeiter. Thus, it is an unconventional channel through which credit sales can be converted into cash sale for an exporter. The entire responsibility of recovering the amount from the importer rests with forfeiter. It is always ‘without recourse’ means that in case the importer makes the default, the forfeiter cannot revert to the exporter.
for the compensation and he would eventually bear the risk of bad debt. To add comfort; this is generally guaranteed by an acceptable bank in importer’s country.

Normally, a forfaiting is used to handle international transactions worth more than $100000. However, this limit could be changed to encourage MSME units to take maximum advantage of this facility. Traditionally, forfaiting is available at pegged rate, medium term (one to five years) finance. However, forfainers now have become very flexible about the terms they would be accepting it.

**Mechanics of Operation**

Following would be the flow of operation.

1. The exporter enters into an agreement with a potential buyer in the importing country for undertaking a project execution/delivery of capital goods.

2. The exporter approaches the forfainer for availing the forfaiting facility. Normally the following information needs to be submitted to the forfainer.
   a) Importing country and details of importer
   b) Amount, currency and period of finance sought for
   c) Details of goods to be exported
   d) Date of delivery of goods
   e) Date of delivery of documents to the forfainer
   f) Nature of security instruments namely bills, promissory notes etc.
   g) Repayment schedule
   h) Necessary authorization for exports etc.

3. The forfainer makes necessary enquiries regarding the country and the importer risk. However, since the period of credit is substantial, the risk involved is high. Guarantee from an international bank of repute known to the forfainer is insisted upon unless the buyer is the Government or well reputed MNC. Such guarantee should be unconditional and irrevocable during the currency of the contract. This is a necessary condition for any forfaiting transaction to occur since the forfainer has no security on the eventual default of the buyer. This guarantee can take either of the two forms:
   (i) Deferred payment guarantee executed by the bank or
   (ii) ‘Aval’ for bills of exchange or promissory notes

4. Depending on the nature of transaction and availability of guarantee, the forfainer indicates consent for offering finance simultaneously quoting the possible discount rate. On execution of the forfaiting contract between the forfainer and the exporter, delivery of goods takes place.

5. Subsequently, on delivery of a valid bills/notes payment to the full extent of face value less discount charges is made by the forfainer to the exporter.

6. On maturity the bills/notes are presented by the forfainer to the guaranteeing bank.

7. The availing bank, whether receiving the payment or not from the importer, reimburses the bill amount to the forfainer.
The entire process is exhibited in the following chart:

Forfaiting Charges

Normally the pricing of a forfaiting transaction consists of the following components:

(i) Discount fees towards providing finance. The level of funding costs is determined by the cost of money in the Euro-market for the particular financing period.

(ii) Front end management fees for handling the transaction.

(iii) Option fees for covering risks in currency and interest rate variations. This margin varies from country to country.

(iv) Commitment fees (normally up to six months) between the time of the agreement with the exporter and the actual receipt of the bills/notes on delivery of the goods.

LITERATURE REVIEW

According to Gregory Bernardi (2012), it requires extensive process of due diligence particularly to ensure the compliance with anti-money laundering and other regulatory requirements. According to HSBC (2011) forfaiting would take care of sovereign risk as well as commercial bank risk. As per ‘Trade and Forfaiting Review’, the short term market potential is very large compared to long term one whose size is limited to a few kind of goods such as machinery, equipment and turnkey plants.

Gains to MSME Exporter

Exporters need to be encouraged through proper and adequate institutional and banking support. With proper framework, exporters will be benefitted as under:

- It is cent percent funding ‘without recourse’; to the seller of the obligations.
- Transactions are concluded on fixed or floating interest basis. Thus these deals are flexible in nature.
- Forfaiting transfers the payment risk, political as well as country risk of the importing country from the exporter to the forfaiter.
Protection is available from the interest rate risk and exchange rate fluctuations.

Forfaiting converts credit based transactions into cash based transactions.

It increases the ability to offer credit terms, without affecting cash flow and without taking risk of the buyer.

Exporter’s balance sheet gets improved, as it does not need to carry accounts receivables.

Documentation of such transactions is usually concise and simple.

**OPERATIONAL PROBLEMS**

The problems are many before the service can be launched in India. Some of the important issues to be considered in this regard are:

- Lack of access to any authentic common source of information.
- Expensive system of multiple databases maintained by individual forfaiters.
- High stamp duty on assignments.
- High cost of operations and consequent erosion of profitability for the forfaiters.
- No fool proof legal framework which is capable of protecting the interest of the forfaiter.
- Lack of access to wider funding sources on the same scales as would be available to other finance companies.
- Reluctance on the part of banks to issue a disclaimer certificate enabling the purchase of export proceeds by the forfaiter.

Suggestions for boosting its usefulness covering Small and Medium Enterprises (SMEs)

**Extending Institutional Framework**

This product, though helps in boosting country’s exports is not being used by existing bankers. The institutional framework like creation of dedicated subsidiary or non-banking finance company is yet not developed.

**Sensitising Exporters**

Exporters are required to be sensitised about the benefits, process and procedure to avail the benefits of forfaiting. They need to be educated by conducting seminars, workshops and through one to one meeting. They also need to be conveyed as to when they should contact forfaiter for getting its benefits.

**Other Successions**

(i) Before the export contract is entered, the exporter, after due diligence should ensure that forfaiting arrangements will be extended without any subsequent hassles.

(ii) There should be adequate use of bank guarantee from the importers bank in view of high interest rate for fixed medium term loan. Guarantee will serve as additional comfort to access foreign sources of funding.

(iii) Exporters also should be clearly conveyed that this arrangement is without recourse, they are not responsible for payment if importer defaults.

(iv) There is a need to develop a window for forfaiter so that they get adequate resources to offer these services to SME units.

(v) There is also a need to create secondary market for this instrument, where it could be transferred or assigned with the least cost.
In order to encourage forfaiting business at an international level, it is necessary to designate export contracts in leading international currencies rather than only in local currencies.

**Forfaiting and Secondary Market Operations**

For forfaiting to embark on a new height, existence and development of secondary market is an essential precondition. This is because a forfaiter may not be inclined to hold the discounted bills/notes upto maturity because of its own cash flow considerations. In the secondary market, forfaiters buy and sell such papers to each other in the usual manner of tradeable securities. However, every transaction in the secondary is done on without recourse basis i.e. the holder of the paper can only go to the original guarantor (availing bank) and not to the previous forfait owner or to the exporter.

**International Development and Indian Perspective**

Forfaiting in the modern organized form developed about twenty years ago through financial deals between West German Exporters and Comecon Importers, mainly the Soviet Union and Czechoslovakia. However, during last few years forfaiting as an alternate source of deferred export finance has extended to cover all sorts of countries and trade. Even it has covered export projects to underdeveloped country like Ethiopia and Socialist nation like Vietnam. The emergence of its operation could offer both facilities namely unlimited finance and total credit cover to an exporter and automatically became a popular instrument in the world’s financial services market.

In India, in respect of deferred payment exports, post shipment credit is available from banks on subsidized terms. Further, EXIM Bank also has its own finance schemes for medium/ long term project exports. ECGC cover is also available for such finance. However, export projects especially for capital goods; turnkey projects etc. are showing an upward trend.

Therefore, forfaiting if introduced in India in real sense may open up an alternate window for availing finance especially for export projects from small and medium enterprises.

**CONCLUSION**

Forfaiting provides a flexible, simple and creative alternative to traditional trade finance and would be of great benefit to buyers in developing countries. Further, it is a 100 percent without recourse financing and so more useful to small units. It also eliminates the need for export credit insurance by the exporter. The great benefit also lies in protection against interest rate risk and exchange rate fluctuations. This service after considering the reforms in better institutional framework, will provide a great deal of comfort to SME units as they do not have accessibility and availability of funds compared to large corporates. It also provides the relief to SME sector in terms of collateral security not being required under this arrangement.

**REFERENCES**

3. HSBC China on Forfaiting, retrieved from www.business.hsbc.co.in.