FORFAITING A USER'S GUIDE WHAT IT IS, WHO USES IT AND WHY?

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Abstract

Italian and West German exporters have long been familiar with Forfaiting and still provide the bulk of the market. UK, Scandinavian, Spanish and French exporters are latching onto the possibilities of the technique with enthusiasm. The American and Canadians, meanwhile, have been slow to catch on (some Forfaiters think it is because they are suspicious of its simplicity coupled with a lack of complex documentation).

For people who are not using the technique, below is a concise introduction to Forfaiting using questions those new to the technique would typically ask.

What is Forfaiting?

Forfaiting is the purchase of a series of credit instruments such as drafts drawn under time letters of credit, bills of exchange, promissory notes, or other freely negotiable instruments on a "non-recourse" basis (non-recourse means that there is no comeback on the exporter if the importer does not pay). The Forfaiter deducts interest (in the form of a discount), at an agreed rate for the full credit period covered by the notes. The debt instruments are drawn by the exporter (seller), accepted by the importer (buyer), and will bear an aval, or unconditional guarantee. The guarantee will normally be issued by the importer's bank, but some strong corporates can be accepted without a bank guarantee.

In exchange for the payment, the Forfaiter then takes over responsibility for claiming the debt from the importer. The Forfaiter either holds the notes until full maturity (as an investment), or sells them to another investor on a non-recourse basis. The holder of the notes than presents each receivable to the bank at which they are payable, as they fall due.

When should Forfait be used?

Forfaiting is used for international trade transactions. Normally, a Forfaiting house would not expect to handle transactions worth less than $100,000.

Traditionally, Forfaiting is fixed rate, medium term (one to five years) finance, but Forfaiters have become very flexible about the terms they will accept.

Some houses will accept paper with tenors up to ten years; and in other cases for shorter periods, down to 180 days. The market for paper generally ranges between one and ten years, depending upon the country/importer financed and the guarantor.

Payments will normally be made semi-annually in arrears, but most Forfaiters will accommodate payments which are made quarterly, semi-annually, annually, or on a bullet basis. These can include capital and interest repayment holidays. There is no need to have a ready-made transaction to sell the Forfaiter. Many houses structure deals themselves, and will advise on credit terms, which debt instruments to ask for, and help price the deal.

What information does a Forfaiter need?

The Forfaiter needs to know who the buyer is and his nationality; what goods are being sold; detail of the value and currency of the contract; and the date and duration of the contract, including the credit period and number and timing of payments (including any interest rate already agreed with the buyer). He also needs to know what evidence of debt will be used (either promissory notes, bills of exchange, letters of credit), and the identity of the guarantor of payment (or avalor).

What documents are required by the Forfaiter from the exporter?

Usually required are:

a) Copy of supply contract, or of its payment terms
b) Copy of signed commercial invoice
c) Copy of shipping documents including certificates of receipt, railway bill, airway will, bill of lading or equivalent documents
d) Letter of assignment and notification to the guarantor
e) Letter of guarantee, or aval The aval is the Forfaiters' preferred form of security of payment of a bill or note. For an aval to be acceptable, the avalizing bank must be internationally recognized and credit worthy.

The aval may be placed on the face of the note. Sometimes a guarantee is issued instead of an aval, particularly in some countries that may not recognize the aval as legally binding. Usually it is provided in a separate letter. Alternatively, the Forfaiter may be happy to accept a blank endorsement by a guarantor. Standby letters of credit may also be used.

The most important point to remember is that any guarantee should be IRREVOCABLE, UNCONDITIONAL, DIVISIBLE, and ASSIGNABLE.

Once the Forfaiter has all this information, indications or quotations can be given immediately by phone or fax. A commitment can be given prior to contract or delivery, and options can be given to assist the exporter in the final negotiation of the contract.

What are the commonly used debt instruments?

Many U.S. exporters prefer to have the importer's bank open a letter of credit to cover their debt under a supplier's credit. The bank issues a deferred payment letter of credit that specifies a series of one or more time drafts which the bank will accept (guarantee) upon presentation of the usual documents required by an LIC. The letter of credit does not have to be transferable, or confirmed by the advising bank in the exporter's country; but it must be subject to the Uniform Customs and Practice for Documentary Credits (UCPDC) of the International Chamber of Commerce, Paris (UCP 500).

Promissory notes or bills of exchange (or drafts) are actually the most commonly Forfaited debt instruments. Under a Forfaiting agreement, a promissory note or bill of exchange/draft is issued for each installment of the supplier's credit thus documenting the existence of a claim of the exporter on the importer that is totally abstract: that is, it is unconditional irrevocable, and divorced from the underlying trade transaction.

How much will it cost?

As far as possible, Forfaiters will ensure that the buyer, not the seller, incurs charges involved in a Forfait transaction. Sometimes this will involve changes to the structure of deals concluded, but Forfaiters stress their flexibility in tailoring deals to suit the exporter's needs. When faced with competition for the contract, exporters may choose to absorb some of the fees or financing cost to make the transaction more attractive to their buyer.

Charges depend on the level of interest rates relevant to the currency of the underlying contract at the time of the Forfaiter's commitment, and on the Forfaiter's assessment of the credit risks related to the importing country and to the avalizing (or guaranteeing) hank

Briefly, the interest cost is made up of:

- A charge for the money received by the seller, which covers the Forfaiter's interest rate risk. In effect, this covers the Forfaiter's refinancing costs and is invariably based on the cost of funds in the Euromarket. Forfaiters calculate this charge on the LIBOR (LIBOR is the London Interbank Offer Rate) rate applicable to the average life of the transaction. On a five-year deal, for example, repayable by ten semiannual installments, the average life of the transaction is 2-3/4 years. The LIBOR rate for this period would be used.

- A charge for covering the political, commercial, and transfer risks attached to the avalor/guarantor. This is referred to as the margin, and it varies from country to country, and guarantor to guarantor.

- Additional costs (which are also included in the Forfaiter's calculations) include a "days of grace" charge; and when necessary, a commitment fee. Days of grace are an additional number of days interest charged by the Forfaiter which reflect the number of day’s delay normally experienced with payments made from the debtor country. These range from none to, say, 10 days on some countries.

How soon does an exporter get his money?

Many houses claim that exporters get 100 per cent finance in about two days after presentation of the proper documents. Practices vary between houses.

So how does it all work in practice?

In a typical Forfait transaction, the sequence is as follows:
The exporter approaches a Forfaiter who confirms that he is willing to quote on a prospective deal, covering the export in x months' time bearing the aval of XYZ Bank.

If the transaction is worth $1M, the Forfaiter will calculate the amount of the bills/notes, so that after discounting the exporter will receive $1M, and will quote a discount rate of 'n' per cent. The Forfaiter will also charge for 'x' days grace and a fee for committing himself to the deal, worth 'y' per cent per annum computed only on the actual number of days between commitment and discounting. The Forfaiter will stipulate an expiry date for his commitment (that is, when the paper should be in his hands).

This period will allow the exporter to ship his goods and get his bills/notes avalized and to present them for discounting. The exporter gets immediate cash on presentation of relevant documents, and the importer is then liable for the cost of the contract and receives credit for 'z' years at 'n' per cent interest.

Many exporters prefer to work with Forfait brokers who, because they deal with a large number of Forfait houses, can assure the exporter of competitive rates on a timely and cost effective basis. Such brokers typically charge a nominal 1% fee to arrange the commitment. This is a one-time fee on the principal amount and frequently is added to the selling price by the exporter. The broker frequently consults with the exporter to structure the transaction to fit the Forfait market.

How does Forfaiting compare with officially supported export credits?

An interesting comparison may be made between Forfaiting and official supported credits, (through the country's Eximbank).

It should be remembered, that Forfaiting is a complementary method of finance to officially supported export credits. Nevertheless, Forfaiting does offer exporters some real advantages over EXIM.

Forfaiting allows the exporter greater flexibility in structuring a deal, particularly where goods are being supplied from a country where EXIM requirements on local and foreign content cannot be met under existing regulations.

Further, if a buyer insists on 100 per cent financing (only 85 per cent finance is available under EXIM rules), then Forfaiting could supply the remaining l5 per cent.

Typically, unless it is a very large or complex deal, a Forfaiter will be able to indicate within a couple of days whether financing is available or not. It may take longer for EXIM to come through with a commitment.

In addition, Forfaiting is 100 per cent without recourse. Once the Forfaiter has bought the paper, the exporter can collect the cash and even forget the entire transaction. Finance can also be obtained for countries that are off cover from official export credit insurance (and there are no insurance premiums to pay).

SUMMARY

Forfaiting provides a flexible, creative alternative to traditional international trade financing methods, and is particularly useful for transactions with buyers in developing nations.

This USER'S GUIDE can be used by the credit manager to explain the mechanics to sales personnel and overseas importers. It also may be useful in explaining Forfaiting to company executives to whom the credit team reports.

As a final note to the credit manager: When the corporate treasurer says the costs of Forfaiting are above the cost of funds, remind him that Forfaiting eliminates:
COUNTRY / POLITICAL RISK
CURRENCY / TRANSFER RISK
FINANCIAL / COMMERCIAL RISK
Because instead of a receivable the corporation has cash in hand without recourse.

Definitions:

POLITICAL RISK:	Lack of foreign exchange in a country Default of a sovereign entity General moratorium on external debt Cancellation or non-renewal of export or import licenses Delay in transfer of payments War, civil war, or other events that prevent a buyer from making payments
TRANSFER RISK:	After a foreign buyer makes the required payment in local currency the funds cannot be converted to the currency required by the sales contract and transferred to the country of the exporter
COMMERCIAL RISK:	Risk of nonpayment on an export credit by a buyer or borrower in the event of Bankruptcy, insolvency, protracted default, and / or failure to take up the goods that have been shipped according to the sales contract

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