TRADE FINANCE

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Collection of bills

- A method of payment in international trade
- Customers pay their bills at any of the bank's branches.
- Mechanism:

  - Exporter dispatches goods to importer
  - Instructs the bank to send the shipping documents to the importer's bank .
  - Importer's bank acts on behalf of exporter's bank to collect payment from the importer.
  - Bill of Exchange
  - Shipping documents are released only when payment or acceptance has been made.

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- <u>Exchange rate risk:</u>

  - It’s a permanent risk that will remain as long as currencies remain the medium of exchange.

  - Companies quote a price for the goods using a reasonable exchange rate

  - But, economic events may upset even the best laid plans

  - Currency hedging is used to avoid the risks.

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- **Pre shipment finance:**

  - Issued by financial institution when the seller wants the payment of goods before shipment

- **Post shipment finance:**

  - Issued by financial institution to a seller against a shipment that has already been made.

- **Bill discounting:**

  - Banks take bills drawn by the seller towards his customer and pays the seller immediately deducting some amount as discount/commission
  - Seller bank's responsibility to send documents and bill of exchange to buyer's bank .

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LETTER OF CREDIT

- A letter of credit is a document issued by the issuing bank on behalf of buyer to the seller which promises to pay for the goods or services on completion of stated terms.
- Players

– Buyer	Applicant
– Seller	Beneficiary
– Buyer's Bank	Issuing Bank
– Seller's Bank	Advising Banks

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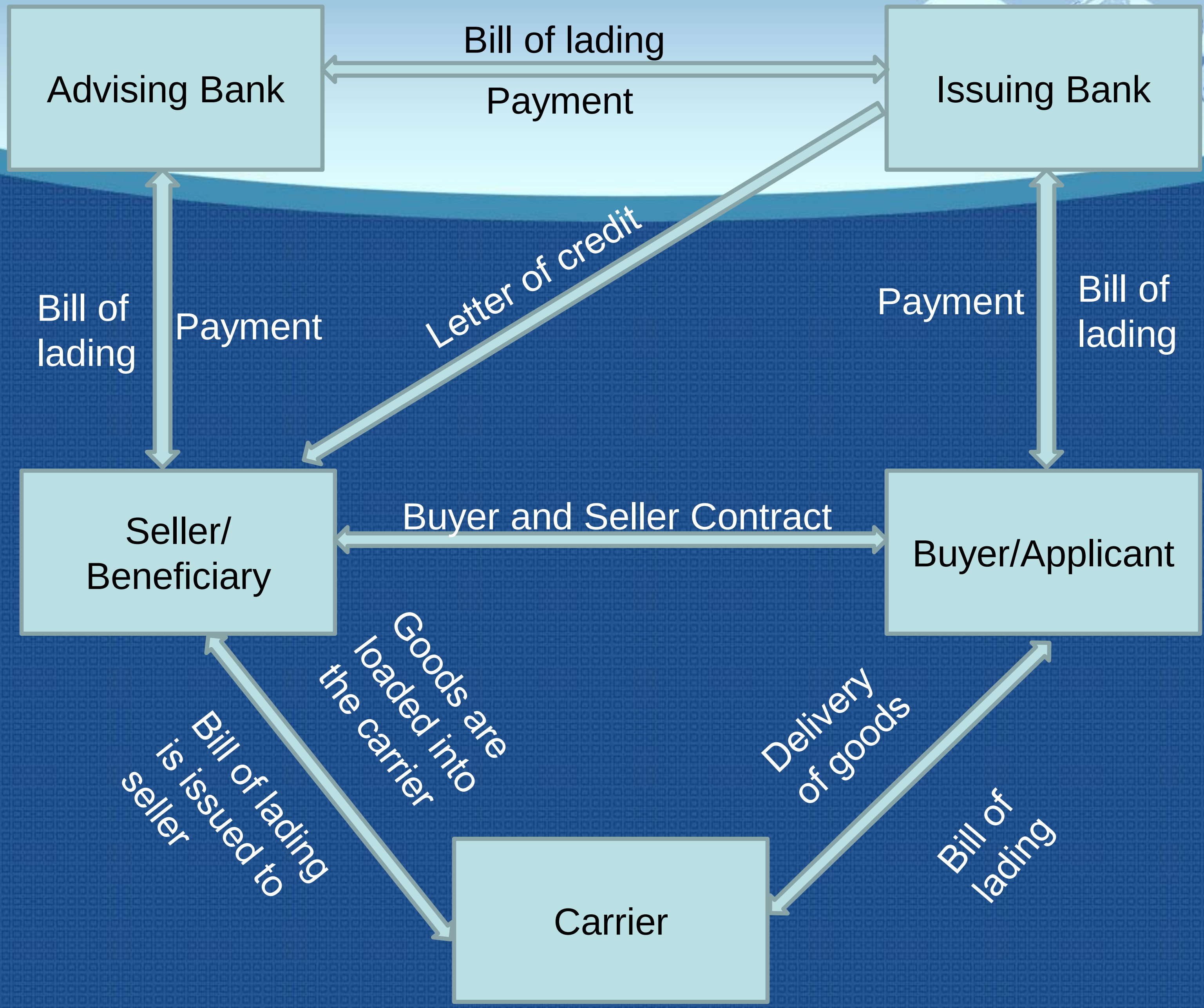
Advising Bank
Bill of lading
Payment
Issuing Bank
Bill of lading
Payment
Letter of credit
Payment
Bill of lading
Seller/ Beneficiary
Buyer and Seller Contract
Buyer/Applicant
Goods are loaded into the carrier
Bill of lading is issued to seller
Delivery of goods
Bill of lading
Carrier
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UCP 600

- Uniform Customs and Practices for documentary credit 600 came into existence on July 1, 2007
  - UCP 600 Application (Article 1)
  - Irrevocable and Revocable credits(Article 2)
  - Definition and Interpretation (Article 2 & 3)
  - Expiry Date (Article 6)
  - Time Allowed Banks for Document Review (Article 14)
  - Non-Matching Documents (Article 14)
  - Non documentary requirement
  - Original Documents (Article 17)

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Open Account System

- Open account—also called open credit—involves delivery of your goods or services to the buyer with an invoice requesting payment at a certain time after delivery.

- Applicability:
  - Secure trading relationships
  - Competitive markets

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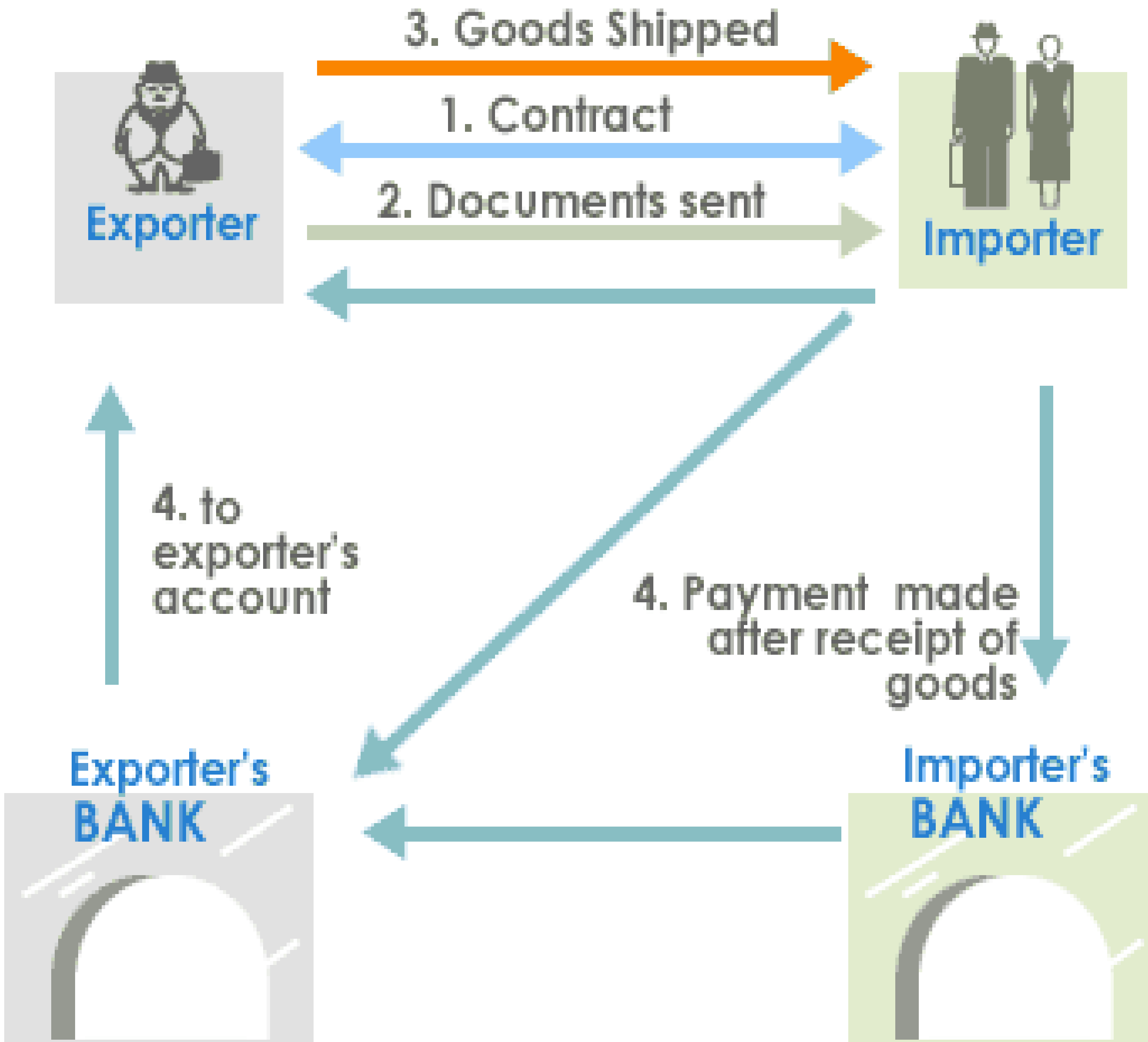
3. Goods Shipped
1. Contract
2. Documents sent
Exporter
Importer
4. to exporter's account
4. Payment made after receipt of goods
Exporter's BANK
Importer's BANK

Characteristics

- Risk:
  - Intentional defaults
  - Ability to pay
  - Delayed payment
- Pros:
  - Boost competitiveness in market
  - Building trust
- Cons:
  - High risk of non-payments
  - Currency exchange rate risk

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Advanced payments

- An arrangement whereby the Exporter is trusted to ship the goods after receiving payment from the Importer.

- The Importer sends payment directly to the Exporter and waits for the Exporter to send the goods and documents.

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Goods Shipped after receipt of payment
1. Contract
Exporter
Importer
2. Docs
2. Docs
2. Docs
3. to exporter's account
3. Payment before dispatch
2. Docs
Exporter's BANK
Importer's BANK
2. Docs
3. ...routed thru banks

Characteristics

- **Advantages to Exporter:**

  Assumes no risks

- **Disadvantages to Exporter:**

  None

- **Disadvantages to Importer:**

  Assumes all risks

  Opportunity cost of using company's cash resources until goods are received.

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INTERNATIONAL PAYMENTS RISK SPECTRUM

HIGHEST RISK TO EXPORTER

LEAST RISK TO IMPORTER

- **Open Account**

- **Payment in Advance**

LEAST RISK TO EXPORTER

HIGHEST RISK TO IMPORTER

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FORFAITING

"Forfait" is derived from French word 'A Forfait' which means surrender of fights.

Forefaiting is a mechanism by which the right for export receivables of an exporter (Client) is purchased by a Financial Intermediary (Forfaiter) without recourse to him.

It is different from International Factoring in as much as it deals with receivables relating to deferred payment exports, while Factoring deals with short term receivables.

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FORFAITING (contd…)

- Exporter under Forfaiting surrenders his right for claiming payment for services rendered or goods supplied to Importer in favour of Forefaiter.
- Bank (Forefaiter) assumes default risk possessed by the Importer.
- Credit Sale gets converted as Cash Sale.
- Forfaiting is arrangement without recourse to the Exporter (seller)
- Operated on fixed rate basis (discount)
- Finance available upto 100% of value (unlike in Factoring)
- Introduced in the country in 1992.

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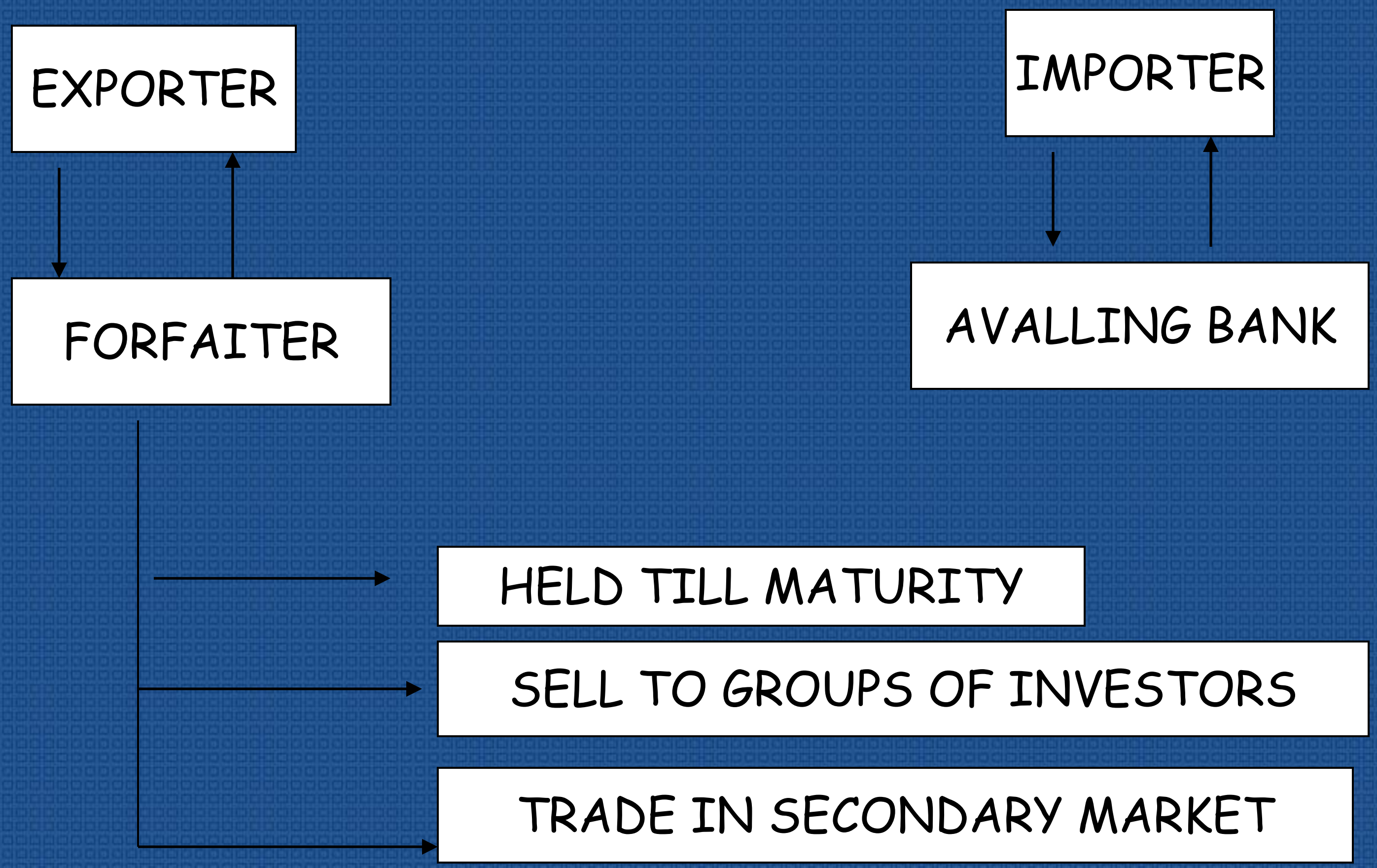
MECHANICS OF FORFAITING



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ESSENTIAL REQUISITES OF FORFAITING TRANSACTIONS

- Exporter to extend credit to Customers for periods above 6 months.
- Exporter to raise Bill of Exchange covering deferred receivables from 6 months to 5 years.
- Repayment of debts will have to be avallised or guaranteed by another Bank, unless the Exporter is a Government Agency or a Multi National Company.
- Co-acceptance acts as the yard stick for the Forefaiter to credit quality and marketability of instruments accepted.

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IN FORFAITING:-

- Promissory notes are sent for avalling to the Importer’s Bank.
- Avalled notes are returned to the Importer.
- Avalled notes sent to Exporter.
- Avalled notes sold at a discount to a Forefaiter on a NON-RECOURSE basis.
- Exporter obtains finance.
- Forfaiter holds the notes till maturity or securitises these notes and sells the Short Term Paper either to a group of investors or to investors at large in the secondary market.

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CHARACTERISTICS OF FORFAITING

- Converts Deferred Payment Exports into cash transactions, providing liquidity and cash flow to Exporter.
- Absolves Exporter from Cross-border political or conversion risk associated with Export Receivables.
- Finance available upto 100% (as against 75-80% under conventional credit) without recourse.
- Acts as additional source of funding and hence does not have impact on Exporter's borrowing limits. It does not reflect as debt in Exporter's Balance Sheet.
- Provides Fixed Rate Finance and hence risk of interest rate fluctuation does not arise.

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CHARACTERISTICS OF FORFAITING (contd….)

- Exporter is freed from credit administration.
- Provides long term credit unlike other forms of bank credit.
- Saves on cost as ECGC Cover is eliminated.
- Simple Documentation as finance is available against bills.
- Forfait financer is responsible for each of the Exporter's trade transactions. Hence, no need to commit all of his business or significant part of business.
- Forfait transactions are confidential.

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COSTS INVOLVED IN FORFAITING

- Commitment Fee:- Payable to Forfaiter by Exporter in consideration of forefaiting services.
- Commission:- Ranges from 0.5% to 1.5% per annum.
- Discount Fee:- Discount rate based on LIBOR for the period concerned.
- Documentation Fee:- where elaborate legal formalities are involved.
- Service Charges:- payable to Exim Bank.

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FACTORING vs. FORFAITING

POINTS OF DIFFERENCE	FACTORING	FORFAITING
Extent of Finance	Usually 75 – 80% of the value of the invoice	100% of Invoice value
Credit Worthiness	Factor does the credit rating in case of non-recourse factoring transaction	The Forfaiting Bank relies on the creditability of the Avalling Bank.
Services provided	Day-to-day administration of sales and other allied services	No services are provided
Recourse	With or without recourse	Always without recourse
Sales	By Turnover	By Bills

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COMPARATIVE ANALYSIS

	BILLS DISCOUNTED	FACTORING	FORFAITING
1. Scrutiny	Individual Sale Transaction	Service of Sale Transaction	Individual Sale Transaction
2. Extent of Finance	Upto 75 – 80%	Upto 80%	Upto 100%
3. Recourse	With Recourse	With or Without Recourse	Without Recourse
4. Sales Administration	Not Done	Done	Not Done
5. Term	Short Term	Short Term	Medium Term
6. Charge Creation	Hypothecation	Assignment	Assignment

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WHY FORFAITING HAS NOT DEVELOPED

- Relatively new concept in India.
- Depreciating Rupee
- No ECGC Cover
- High cost of funds
- High minimum cost of transactions (USD 250,000/-)
- RBI Guidelines are vague.
- Very few institutions offer the services in India. Exim Bank alone does.
- Long term advances are not favoured by Banks as hedging becomes difficult.
- Lack of awareness.

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STAGES INVOLVED IN FORFAITING:-

- Exporter approaches the Facilitator (Bank) for obtaining Indicative Forfaiting Quote.
- Facilitator obtains quote from Forfaiting Agencies abroad and communicates to Exporter.
- Exporter approaches importer for finalising contract duly loading the discount and other charges in the price.
- If terms are acceptable, Exporter approaches the Bank (Facilitator) for obtaining quote from Forfaiting Agencies.
- Exporter has to confirm the Firm Quote.
- Exporter has to enter into commercial contract.
- Execution of Forfaiting Agreement with Forefaiting Agency.
- Export Contract to provide for Importer to furnish avalled BoE/DPN.

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STAGES INVOLVED IN FORFAITING:- (contd…..)

- Forfaiter commits to forefait the BoE/DPN, only against Importer Bank's Co-acceptance. Otherwise, LC would be required to be established.
- Export Documents are submitted to Bank duly assigned in favour of Forfaiter.
- Bank sends document to Importer's Bank and confirms assignment and copies of documents to Forefaiter.
- Importer's Bank confirms their acceptance of BoE/DPN to Forfaiter.
- Forfaiter remits the amount after deducting charges.
- On maturity of BoE/DPN, Forfaiter presents the instrument to the Bank and receives payment

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STAGES INVOLVED IN FORFAITING:- (contd…..)

- Export Documents are submitted to Bank duly assigned in favour of Forfaiter
- Importer’s Bank confirms their acceptance of BoE/DPN to Forfaiter.
- Forfaiter remits the amount after deducting charges.
- On maturity of BoE/DPN, Forfaiting Agency presents the instruments to the Bank and receives payment

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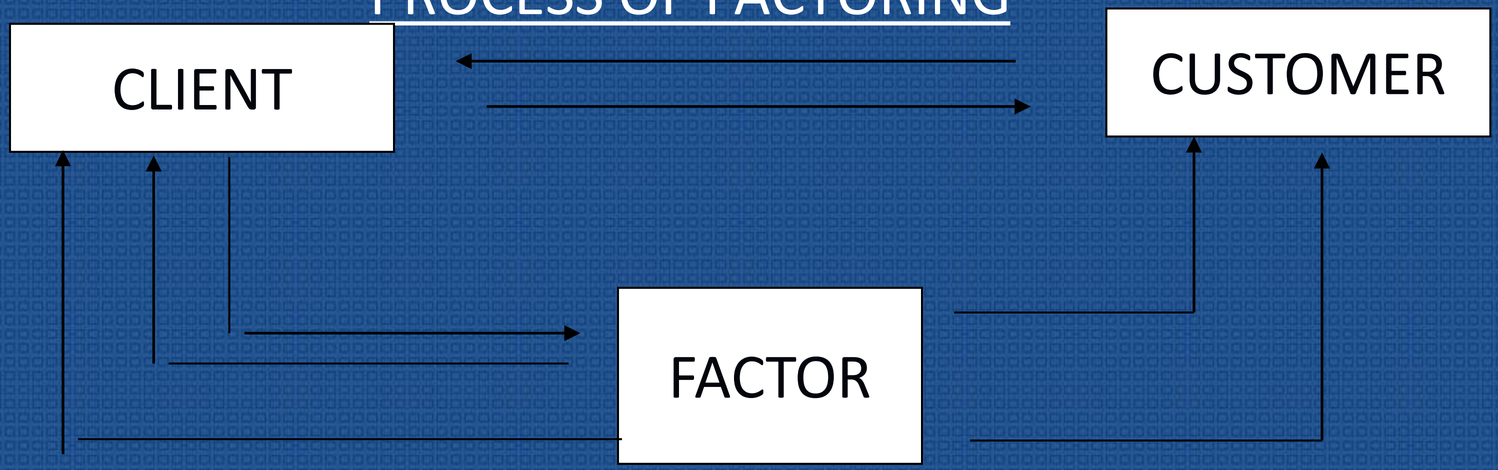
WHAT IS FACTORING ?

Factoring is the Sale of Book Debts by a firm (Client) to a financial institution (Factor) on the understanding that the Factor will pay for the Book Debts as and when they are collected or on a guaranteed payment date. Normally, the Factor makes a part payment (usually upto 80%) immediately after the debts are purchased thereby providing immediate liquidity to the Client.

PROCESS OF FACTORING



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Characteristics of Factoring

- The normal period of factoring is 90 days and rarely exceeds more than 150 days.

- It is costly. Credit rating is not mandatory.

- Factoring is not possible in case of bad debts.

- It is a method of off balance sheet financing.

- Cost of factoring is always equal to finance cost plus operating cost

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SERVICES OFFERED BY A FACTOR

- Follow-up and collection of Receivables from Clients.
- Purchase of Receivables with or without recourse.
- Help in getting information and credit line on customers (credit protection)
- Sorting out disputes, if any, due to his relationship with Buyer & Seller.

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PROCESS INVOLVED IN FACTORING

- Client concludes a credit sale with a customer.
- Client sells the customer's account to the Factor and notifies the customer.
- Factor makes part payment (advance) against account purchased, after adjusting for commission and interest on the advance.
- Factor maintains the customer's account and follows up for payment.
- Customer remits the amount due to the Factor.
- Factor makes the final payment to the Client when the account is collected or on the guaranteed payment date.

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MECHANICS OF FACTORING

- The Seller sells goods to the buyer and prepares invoice with a notation that debt due on account of this invoice is assigned to and must be paid to the Financial Intermediary.
- The Seller submits invoice copy only with Delivery Challan showing receipt of goods by buyer to the Factor.
- The Factor after scrutiny of these papers allows payment The balance is retained as Retention Money. This is also called Factor Reserve.
- The drawing limit is adjusted on a continuous basis after taking into account the collection of Factored Debts.
- Once the invoice is honoured by the buyer on due date, the Retention Money credited to the Client's Account.
- Till the payment of bills, the Factor follows up the payment and sends regular statements to the Client.

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CHARGES FOR FACTORING SERVICES

- Factor charges Commission (as a flat percentage of value of Debts purchased) (0.50% to 1.50%)

- Commission is collected up-front.

- For making immediate part payment, interest charged. Interest is higher than rate of interest charged on Working Capital Finance by Banks.

- If interest is charged up-front, it is called discount.

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TYPES OF FACTORING

- Recourse Factoring
- Non-recourse Factoring
- Maturity Factoring
- Cross-border Factoring

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RECOURSE FACTORING

- Upto 75% to 85% of the Invoice Receivable is factored.
- Interest is charged from the date of advance to the date of collection.
- Factor purchases Receivables on the condition that loss arising on account of non-recovery will be borne by the Client.
- Credit Risk is with the Client. Factor does not participate in the credit sanction process.
- In India, factoring is done with recourse.

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NON-RECOURSE FACTORING

- Factor purchases Receivables on the condition that the Factor has no recourse to the Client, if the debt turns out to be non-recoverable.

- Credit risk is with the Factor. Higher commission is charged.

- Factor participates in credit sanction process and approves credit limit given by the Client to the Customer.

- In USA/UK, factoring is commonly done without recourse.

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MATURITY FACTORING

- Factor does not make any advance payment to the Client.
- Pays on guaranteed payment date or on collection of Receivables.
- Guaranteed payment date is usually fixed taking into account previous collection experience of the Client.
- Nominal Commission is charged.
- No risk to Factor.

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CROSS - BORDER FACTORING

- Exporter (Client) enters into factoring arrangement with Export Factor in his country and assigns to him export receivables.
- Export Factor enters into arrangement with Import Factor and has arrangement for credit evaluation & collection of payment for an agreed fee.
- Notation is made on the invoice that importer has to make payment to the Import Factor.
- Import Factor collects payment and remits to Export Factor who passes on the proceeds to the Exporter after adjusting his advance, if any.
- Where foreign currency is involved, Factor covers exchange risk also.

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STATUTES APPLICABLE TO FACTORING

- Factoring transactions in India are governed by the following Acts:-

a) Indian Contract Act
b) Sale of Goods Act
c) Transfer of Property Act
d) Banking Regulation Act.
e) Foreign Exchange Regulation Act.

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WHY FACTORING HAS NOT BECOME POPULAR IN INDIA

- Banks’ reluctance to provide factoring services
- Bank’s resistance to issue Letter of Disclaimer (Letter of Disclaimer is mandatory as per RBI Guidelines).
- Problems in recovery.
- Factoring requires assignment of debt which attracts Stamp Duty.
- Cost of transaction becomes high.

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STAGES INVOLVED IN EXPORT FACTORING

- Exporter (Client) gives his name, address and credit limit required to the Export Factor.
- Export Factor submits the details of Buyer to the Import Factor.
- Import Factor decides on the credit cover and communicates decision to Export Factor.
- Export Factor enters into Factoring Agreement with Exporter.
- Overseas Buyer is notified of this arrangement.
- Exporter is then free to ship the goods to Buyers directly.
- Exporter submits original documents, viz., invoice and shipping documents duly assigned and receives advance there-against (upto 80%).

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STAGES INVOLVED IN EXPORT FACTORING (contd…..)

- Export Factor despatches all the original documents to Importer/Buyer after duly affixing “Assignment Clause” in favour of the Import Factor.
- Export Factor sends copy of invoice to Import Factor in the Debtor’s country.
- Import Factor follows up and receives payment on due date and remits to Export Factor.
- Export Factor, on receipt of payment, releases the balance of proceeds to Exporter.

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