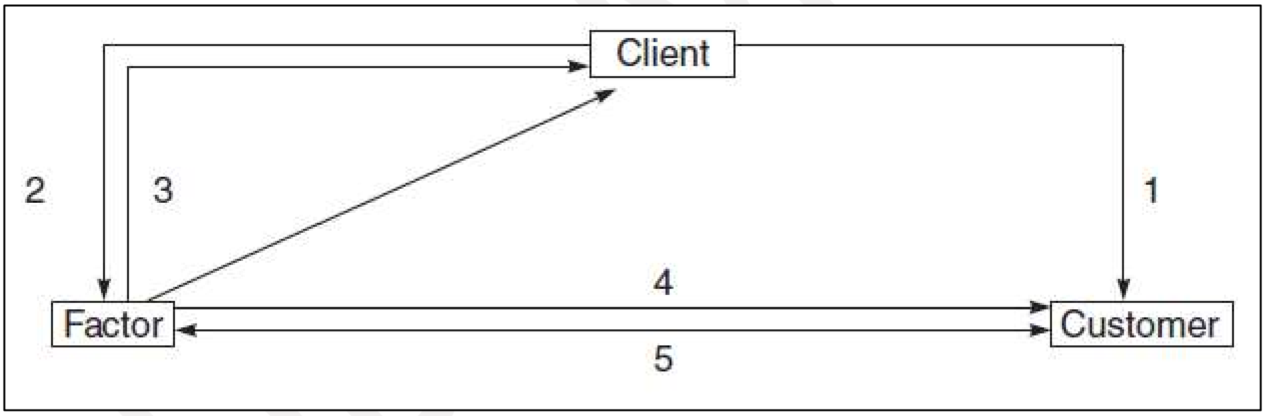
Factoring and Forfaiting

Factoring

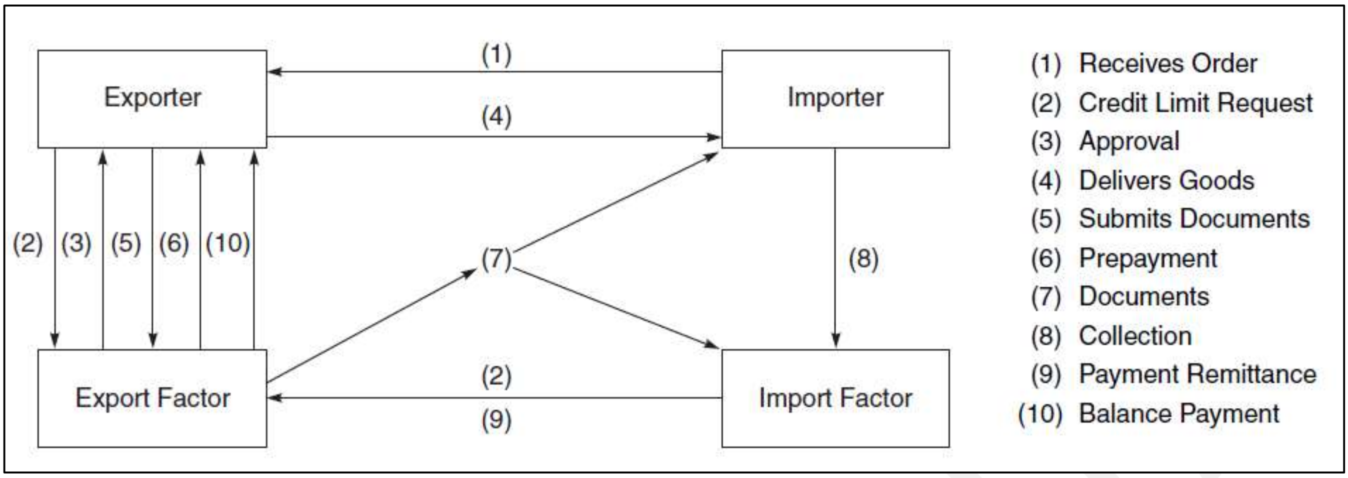
- It is an arrangement between financial institutions or banks (factor) and business concern (suppliers) which provides goods and services to its customers on credit, wherein the factor buys out client (suppliers) book debts.
- **Factoring mechanism (domestic arrangement)** is explained below:
    - Customer places an order for good / service with the client on **credit**
    - The client delivers the good / service and sends invoice to customer (stating that the amount of the good / service must be paid to the factor with whom he has made an arrangement)
    - The client also sends invoice to factor
    - The factor makes prepayment up to 80% of the amount of the good / service and sends periodic statements to the customer
    - Customer makes payment to the factor
    - Factor makes balance 20% of the payment to the client

1. Customer places an order with the client for goods and/or service on credit; client delivers the goods and sends invoice to customers.
2. Client assigns invoice to factor.
3. Factor makes prepayment upto 80 per cent and sends periodical statements.
4. Monthly statement of accounts to customer and follow-up.
5. Customer makes payment to factor.
6. Factor makes balance 20 per cent payment on realisation to the client.



- There is always a difficulty of foreign languages, fear of distance, stringent customs and laws, ocean barriers which inhibit entrepreneurs to venture into export business (which also affects country's exports)
- Factoring is a service that relieves exporters from the fear of credit losses enabling them to offer their products to overseas customers
- **Factoring mechanism (international arrangement)** is explained below:
    - The exporter receives an order from importer and is able to estimate financing requirement
    - The exporter provides export factor with contact details of importer (customer) along with estimates of credit limit
    - The export factor forwards these details to the correspondent import factor in the relevant country
    - On approval of exporter's credit limits, the exporter enters into factoring agreement with the export factor
    - The exporter ships the goods / services to the importer
    - The exporter submits invoice, airway bill, customs tax invoice, etc. to the export factor
    - The export factor scrutinises the documents and makes prepayment as agreed upon to the exporter
    - The export factor sends these documents to the corresponding import factor in the relevant country
    - The import factor contacts the customer (importer) and collects payment from them

- The import factor sends this amount to the export factor
- On this collection, the export factor makes the balance payment to the exporter

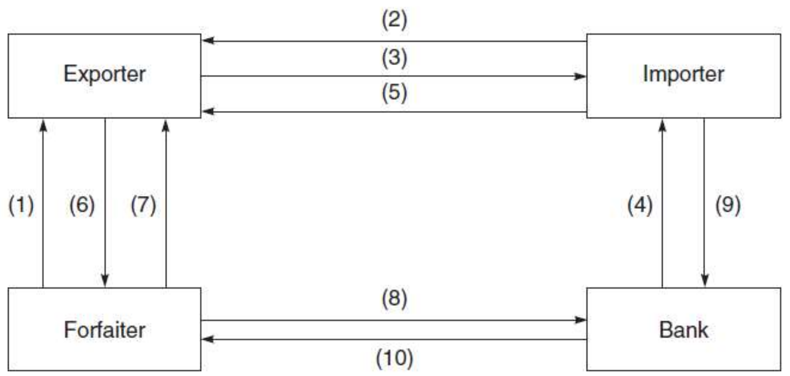


- **Benefits** of factoring:
  - Exporter deals with only one factor even if his exports are spread across different countries
  - Exporter can also obtain experience and advise from export factor in terms of legal laws and business practices
  - The exporter's risk and debts can be reduced
  - Exporter can expand business into new markets
- **Types of Factoring:**
  - **Recourse factoring**
    - The factor provides all kinds of facilities except debt protection.
    - So the factor purchases the receivables on the condition that loss arising on the account of non – recovery will be borne by the client.
    - So the credit risk is now with the client.
    - Factor does not participate in credit sanction process.
    - This is very popular in developing countries.
  - **Non-recourse factoring**
    - Most comprehensive type of factoring arrangement offering all types of services, namely:
      - ✓ Finance
      - ✓ Debt protection
      - ✓ Collection
      - ✓ Advisory services
      - ✓ Etc.
    - Most important characteristic is that the factor gives debt protection that is protection against bad debts to the client.
    - In other words, in case the customer fails to pay, the factor will incur all the losses arising from the bankruptcy of the client's customers.
    - Hence, credit risk is with the factor.
    - Factor participates in credit sanction process.
    - That is why the factor charges are very high.
    - It is a method usually found in developed countries like USA or UK.
  - **Maturity factoring**
    - Also known as **collection** factoring.
    - It is the type of factoring service where the client sells his invoice to the factor and in return, the factor pays the client for such invoices either on the date of maturity or any date after the date of maturity.
    - In this, the factor does not pay any money in advance.

        - There is no risk to the factor.
        - Very nominal fees are charged.
    - **Advance factoring**
        - It implies payment in advanced.
        - As soon as the invoice is sent to the factor, the invoice amount less commission and margin are paid to the client.
        - After realisation of invoice (customers pay cost of the receivables to the factor), the margin is paid to the client by the factor.
        - Margin ranges anywhere from 5% to 25%.
    - **Cross border factoring**
        - Same as factoring mentioned in international arrangement.
        - There are 4 parties.
        - It is also called **two factor system** of factoring.
        - Foreign currency is involved.
        - Factor covers exchange risk also.
        - Client (exporter) in agreement with export factor and assigns him with export receivables.
        - Export factor in agreement with import factor and has arrangement for credit evaluation and collection of payment.
        - Import factor in agreement with importer (customer) and that customer has to pay import factor.
        - Import factor collects payment and remits to export factor who passes on the proceeds to exporter after adjusting his advance, if any.

Forfaiting

- It is non-recourse long-term financing of international trade
- It converts the exporter's credit sale into cash sale
- By transforming the exporter's credit into cash, it protects the exporter from all risks associated with selling overseas on credit
- Trade receivables (TR) are bills of exchange, promissory notes, letters of credit etc.
- The exports surrenders these TR to forfaiting agency which pays him in cash after deducting some charges
- The forfaiting agency then collects the dues from the importer
- Thus, forfaiting enables exporters to offer long-term financing to importers of capital goods from India
- **Modus Operandi** of forfaiting:
    - At the request of the exporter, the forfeiter provides the exporter with a written commitment to purchase the debt from him on non – recourse basis.
    - The exporter and importer sign a commercial contract.
    - The rest of the shipping documents are prepared, and the goods are shipped from exporter to importer.
    - The importer's bank provides guarantee at the request of the importer.
    - This guarantee document is forwarded to the exporter by the importer.
    - The exporter forwards this guarantee document along with other forfaiting documents to the forfeiter.
    - On receiving complete documentation, the forfeiter makes payment to the exporter in cash on non – recourse basis.
    - On maturity of invoice, the forfeiter presents all documents to the importer's bank.
    - The importer makes payment to the guaranteeing bank.
    - The bank, after receiving the payment, pays the forfeiter on due date.



(1) Commitment to Purchase Debt.
(2) Commercial Contract.
(3) Delivery of Goods.
(4) Gives Guarantee.
(5) Hands Over Documents.
(6) Delivers Documents.
(7) Makes Payment.
(8) Presents Documents for Payment.
(9) Repays at Maturity.
(10) Payment to the Forfaiter.

- **Benefits** of forfaiting:
    - Exporter is absolved from all types of risks – commercial, political, transfer, interest and exchange
    - It improves liquidity of exporter as it converts credit sales to cash sales
    - Helps exporter undertake more exports
    - Increases volume of business and the exporter can expand into risky countries
    - Documentation procedure is simple so forfaiting is easy and efficient
    - Does not affect existing bank limits of the exporter
    - Forfaiting is transaction specific; so does not require the exporter to get into long-term agreement with the forfeiter

Difference between factoring and forfaiting:

Basis of comparison	Factoring	Forfaiting
Meaning	Converts receivables into ready cash and don't need to wait for payment at a future date	Forfeiter purchases claims from exporter in return for cash payment
Maturity of receivables	Involves account receivables of short term maturities	Involves account receivables of medium to long term maturities
Goods	Trade receivables on ordinary goods	Trade receivables on capital goods
Finance up to	80-90%	100%
Type	Recourse or non – recourse	Non – recourse
Cost	Cost of factoring borne by the seller (client)	Cost of forfaiting borne by the overseas buyer
Secondary market	No	Yes
Negotiable instrument	Does not deal in negotiable instrument	Involves dealing with negotiable instrument