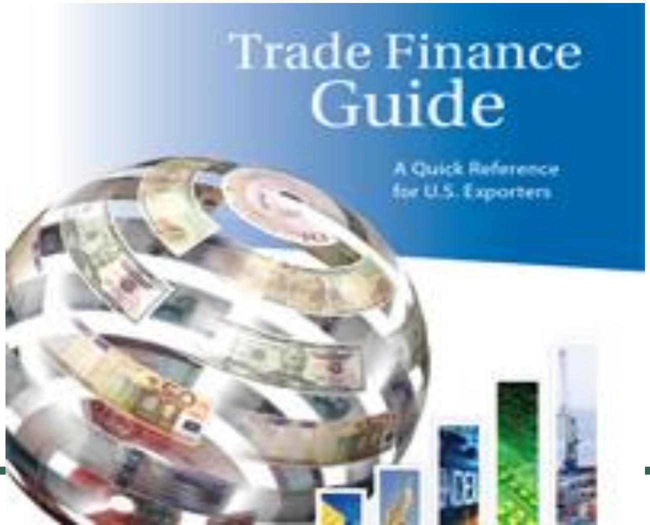
Chapter 5:

FACTORING AND FORFEITING

Chapter 5: Factoring and Forfeiting

Objectives:

- Understand concept of Factoring and Forfeiting, their feature and procedure
- Evaluate different type as well as Pros and Cons of each form
- Compare Factoring and Forfeiting
- Make decision of applying Factoring and Forfeiting.



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I. Factoring

1. Concept:

- ❖ Cen. 13 had debt collection and short-term credit
- ❖ Cen. 17-18 had trade agency sold based on trade credit
- ❖ Receivables financing is the procedure by which debts are sold in the market to increase liquidity. The mechanism for such dealings is based on assignments of debts.
- ❖ International factoring is one specific type of receivables financing, besides forfaiting, leasing and securitization.

1. Concept

- International factoring is one specific type of receivables financing.
- Factors have existed to receive payment and refund to sellers
- Factoring represents the **sale** of outstanding **receivables** related to export of goods by the exporter to overseas buyers.

1. Concept

A factoring contract means a contract pursuant to which a supplier may or will assign accounts receivable to a factor, **whether or not for the purpose of finance**, for **at least one** of the following functions:

- \- Receivables ledgering
- \- Collection of receivables
- \- Protection against bad debts

(Article 1 - General Rules For International Factoring – FCI)

1. Concept

Unidroit Convention on International Factoring (28 May 1988)

Factoring contract ”means a contract concluded between one party (the supplier) and another party (the factor) pursuant to which:

(a) the supplier may or will assign to the factor receivables arising from contracts of sale of goods made between the supplier and its customers (debtors) other than those for the sale of goods bought primarily for their personal, family or household use;

(b) the factor is to perform at least two of the following functions:

- finance for the supplier, including loans and advance payments;
- maintenance of accounts (ledgering) relating to the receivables;
- collection of receivables;
- protection against default in payment by debtors;

(c) notice of the assignment of the receivables is to be given to debtors

Law on credit institutions, 2010, VN

Article 4. Interpretation of terms

- 17. ***Factoring*** means a form of extension of credit to a goods seller or buyer through redeeming receivable or payable amounts arising from the purchase or sale of goods or provision of services under a contract on goods purchase or sale or service provision while **reserving the right to claim** such amounts.

Law on credit institutions, 2010, VN

- **Credit extension** means an agreement allowing an organization or individual to use a sum of money or a commitment allowing the use of a sum of money on the repayment principle by such professional operations as lending, discount, financial leasing, factoring, bank guarantee and other credit extension operations.

1. Concept

Art.2- Decision No1096/2004/QD-NHNN dated 6Sept2004

- Factoring is type of credit provided by credit institutions to seller through purchasing receivables arising from sale of goods under sale contract.

It is to be replaced by Circular No.02/2017- NHNN dated 17/5/2017 from 30/9/2017.

- Factoring contract means an agreement between factor and its customer to the establishment, modification or termination of rights and obligations of these parties related to factoring

1. Concept

- 4 main functions:
  - Finance the working capital
  - Receivables ledgering
  - Collection of receivables
  - Protection against bad debts

2. Classification

- In terms of geographic area
  - Domestic factoring
  - International factoring
- In terms of factor system
  - One factor system factoring
  - Two factor system factoring
- In terms of client of factor
  - Import factoring
  - Export factoring

Domestic and international

- Domestic factoring
  - Underlying transaction between seller and buyer who are resident/same country
- International factoring
  - Underlying transaction between parties in different countries or non resident and resident.

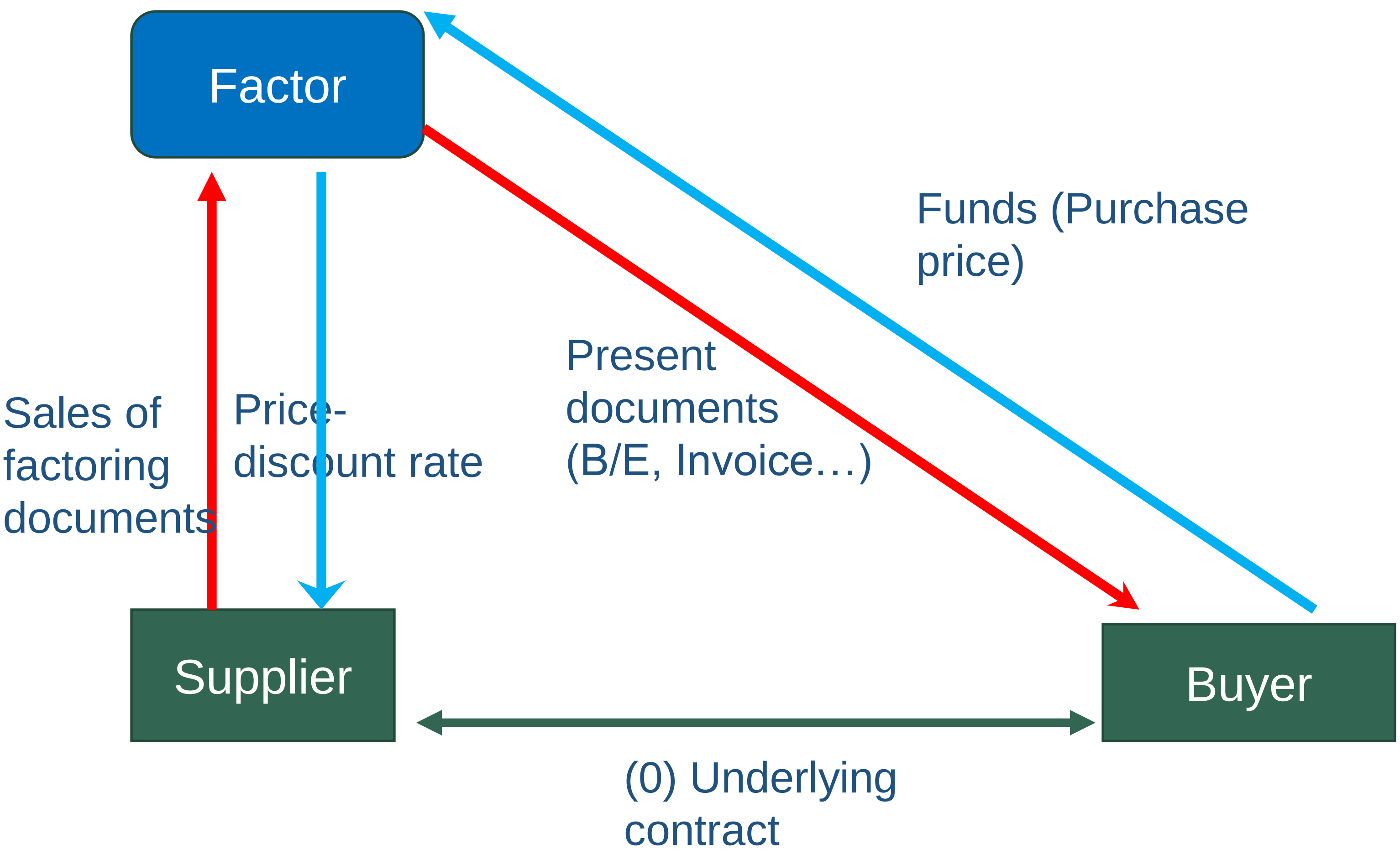
One factor and two factor system

- In terms of factor system
  - One factor system factoring: usually used for domestic factoring transaction. Factoring service is provided by only one factor.
  - Two factor system factoring: for international factoring

Reason for using two factor system factoring

- Geographic distance
- Difference in language, rules,
- Partner relationship
- Knowledge on partner’s credit standing

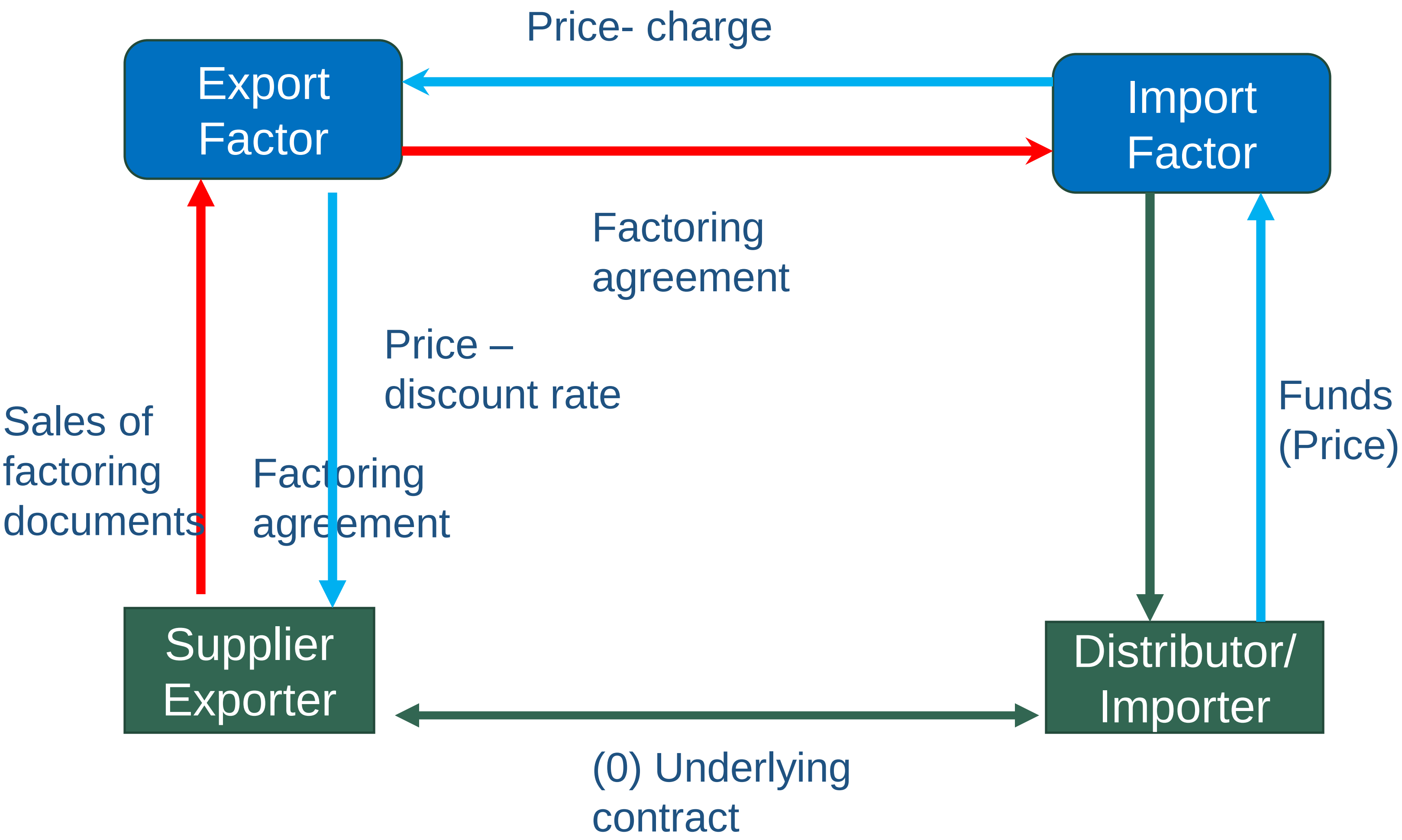
One factor system factoring



Two factor system

- The two factor system is supported by the existence of chains of correspondent factors.
- These where established for the purpose of facilitating the cooperation between import and export factors by the development of common rules and accounting procedures.
- There are members of factoring chains in most major trading nations.
- Some of them restrict their membership to one factor per country (closed chains), while others are open to the participation of multiple factors in the same country (Factors Chain International).

Two factor system factoring



2. Classification

- In terms of operating mechanism
  - Direct Import- Export factoring
  - Back to back factoring
- In terms of risk of non-payment
  - Recourse factoring
  - Non recourse (without recourse) factoring
- In terms of sharing information
  - Disclosed factoring
  - Undisclosed factoring

Direct import and export factoring

- **Direct import factoring** connotes the situation where the exporter assigns debts to a factor in the country of the debtor.
  - where there is a substantial volume of exports to a specific country.
  - cheap and time efficient method of debt collection but not serve the aim of providing finance to the exporter.
  - The factor provides a debt collection service and does not enquire into the creditworthiness of the importer.
- Prepayments are not possible because that would expose the factor to high risks.

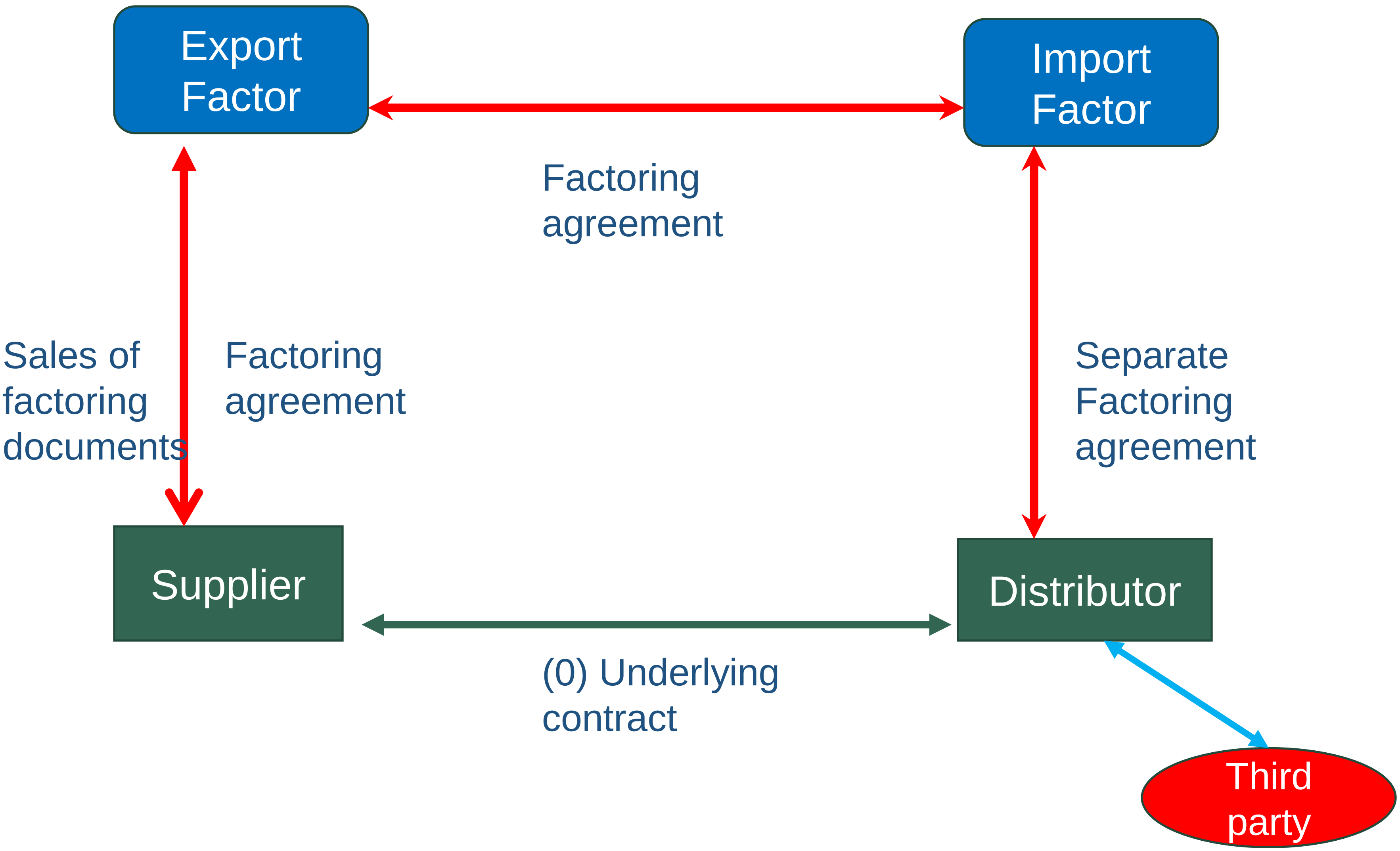
Direct import and export factoring

- **Direct export factoring** does operate as an alternative to the two factor system.
- The factor is appointed in the exporter’s own country and deals with all the aspects of the factoring arrangement including the provision of financing and the assessment of the financial position of the importer.
- This system is inexpensive and facilitates the communication between the exporter and the factor.
- However, all the advantages of the two factor system relating to the import factor’s proximity to the importer and his jurisdiction can be listed here as disadvantages.
- Communication problems with the debtor, credit risks and the occurrence of disputes are the most important problems.

Back to back factoring

- is an arrangement most suitable for debts owed by the exclusive distributors of products to their suppliers.
- The structure is similar to the ones already considered with one material difference.
- The difference lies in the existence of a separate factoring agreement between the import factor and the distributor.
- Included in that arrangement is a right to set off credits arising from the domestic sales of the distributor with his debts to the supplier
- This is to guard against default by the distributor due to the fact that the goods have already been sold to third parties and thus the supplier cannot take a security interest over them to guarantee repayment of the debts

Back to back factoring



Recourse Factoring

- 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.
- Up to 75% - 85% of the Invoice Receivable is factored.
- Interest is charged from the date of advance to the date of collection.

Ex: In India, VN factoring is done with recourse.

Non-recourse Factoring (Without recourse)

- 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.

Disclosed factoring

- Disclosed factoring is the arrangement under which the exporter enters into a factoring agreement with the financial house and assigns the benefit of the debts created by the sale transaction to them.
- **The importer is then notified and effects payment to the factor**. The arrangement is usually on a non-recourse basis

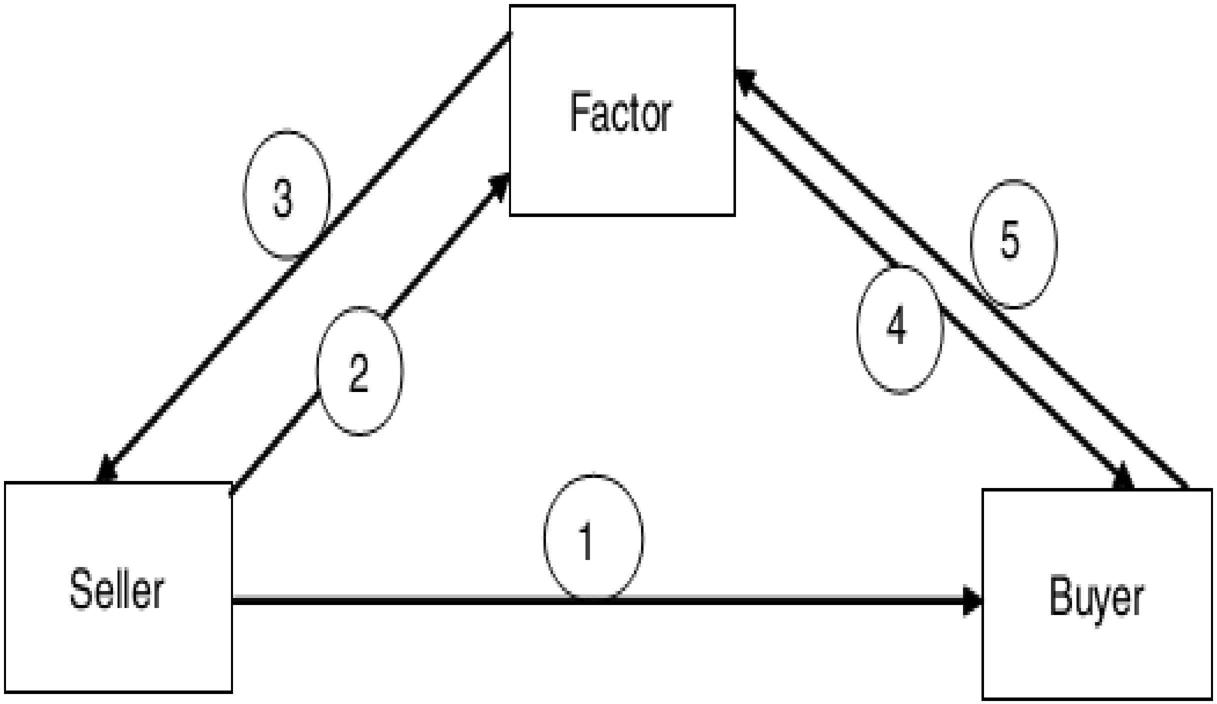
Undisclosed factoring

- Undisclosed factoring, which is usually undertaken on a recourse basis, does not involve the importer.
- The agreement is made between the factor and the exporter and the importer remains bound to pay as agreed under the sales contract.
- In receipt of payment, the exporter holds the funds in a separate bank account as trustee for the factor

3. Parties to Factoring

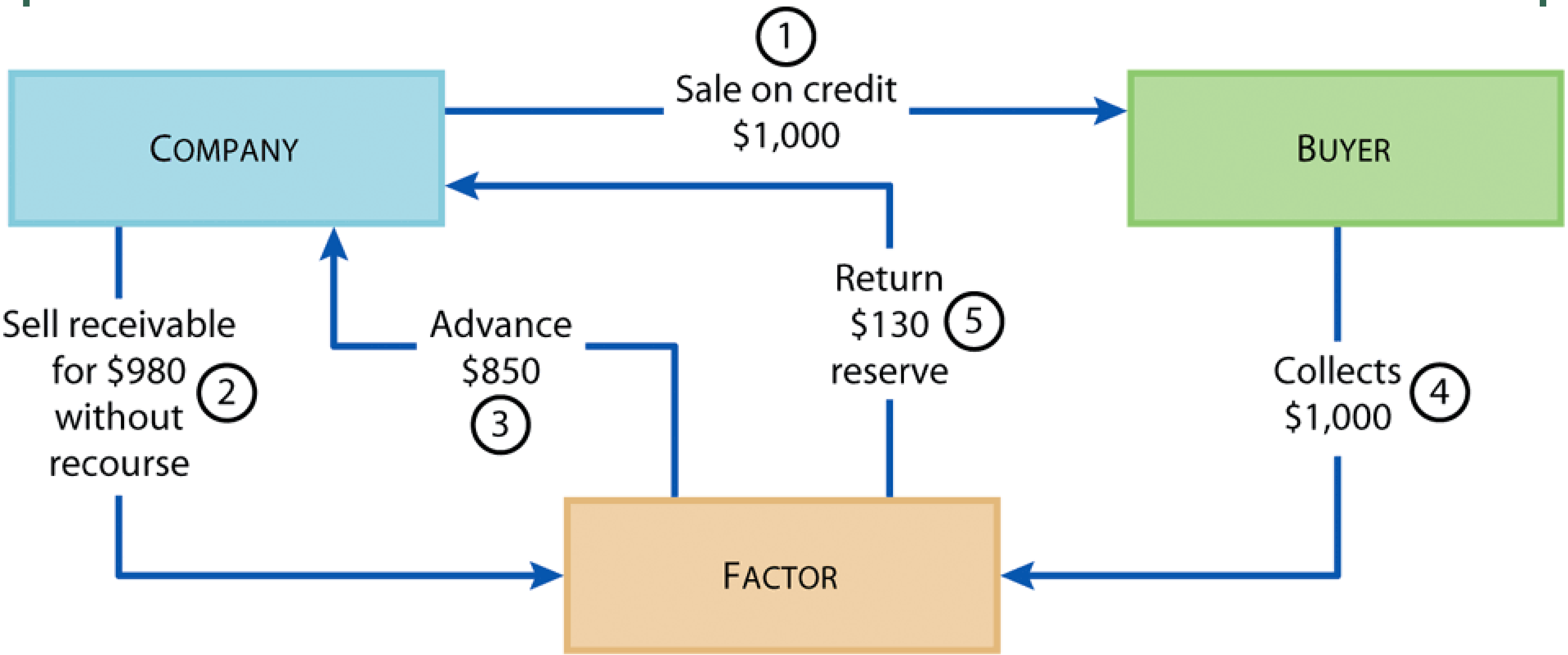
- Parties:
  - Factor agency
  - client or seller
  - debtors or buyers

3. Parties to Factoring



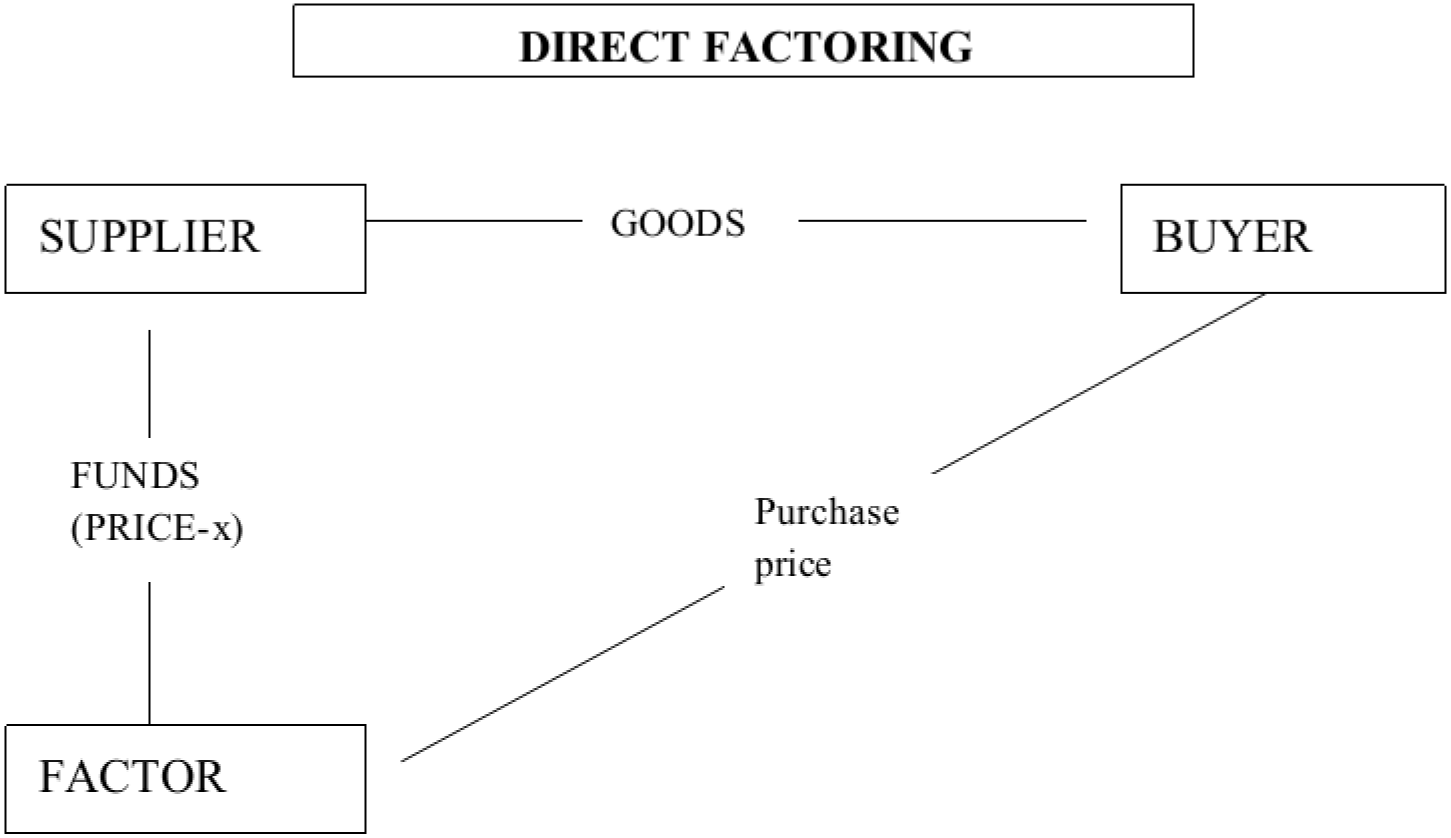
4. Procedure of Factoring

How Factoring Works



Note: Factor will keep $130 reserve if buyer does not pay.

4. Procedure of Factoring



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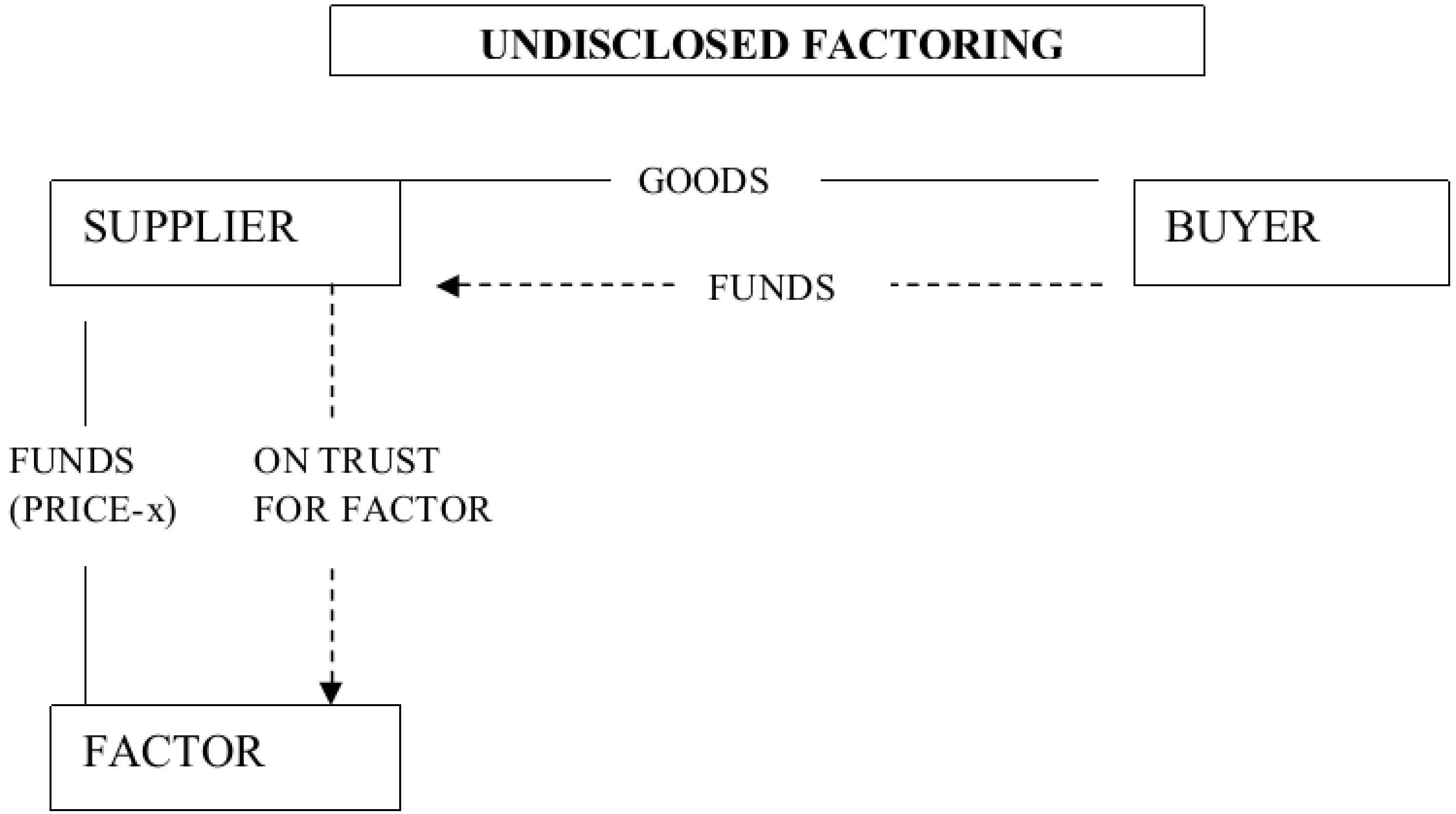

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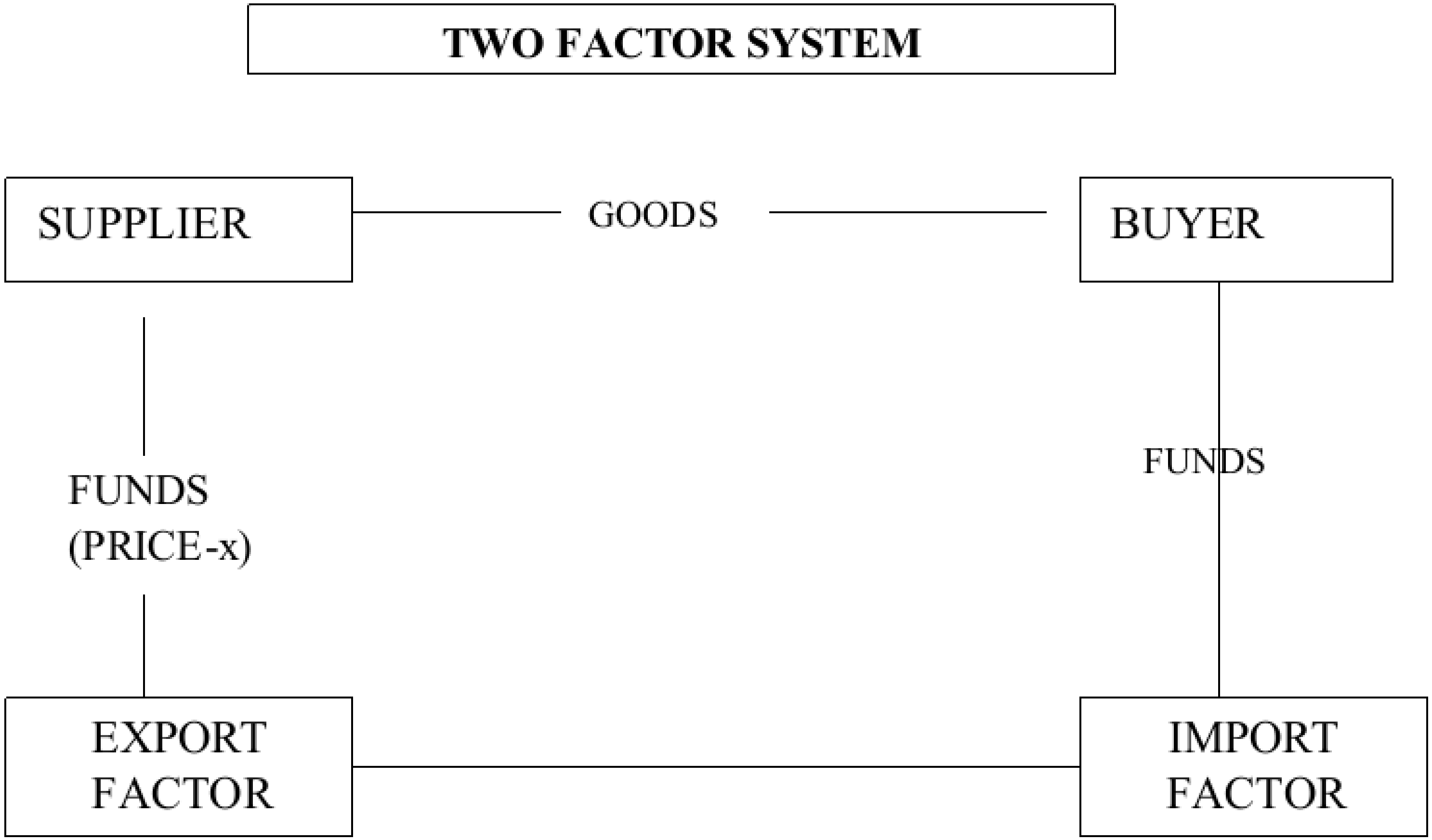


5. Application of Factoring

- Pros:
  - Improve working capital flow and money management
  - Limit the risk through non-recourse factoring
  - Improve the competency & creditability
  - Factor can be strategic partner
- Cons:
  - Higher cost than credit/discounting
  - Limit the credit lines
  - Usually medium-term
  - Complicated Law and Rules related

II. Forfaiting

- Forfaiting (or Forfeiting) is a mechanism by which the right for export receivables of an exporter (Client) is purchased by a Financial Intermediary (Forfaitor) without recourse.
- Deals with receivables relating to deferred payment exports in medium-long-term >< Factoring deals with short term receivables
- Have secondary market in London for forfating papers

1. Concept of Forfaiting

- Forfaiting or without-recourse financing is a method of trade finance whereby the forfaiting bank purchases, on a without-recourse basis, unconditional debt obligations arising from the provision of goods and/or services which are due to mature at a future date.
- The term originates from a forfait finance which simply means that the exporter forfeits all rights to future receivables in exchange for immediate payment.

2. Features of Forfaiting

❖ Features

- Forfaitor discounts documentary with non-recourse → exporter transfer all inherent risks to the forfaitor
- Goods are usually mechanics or projects with long-term payment (5-7 years)
- Fixed rate basis (Libor + %)
- Documentary needs to be guaranteed by 3rd party

2. Features of Forfaiting

Some of the advantages of forfaiting to the exporter can be summarized as follows:

- conversion of a credit transaction into a cash transaction
- elimination of all political and credit risks
- simple documentation
- improve liquidity
- elimination of exchange risks

For the importer, forfaiting gives him the flexibility to pay for his goods on deferred terms of credit and at a fixed interest cost.

3. Application

- Forfaiting is a financial technique designed to meet the challenge of difficult markets, and although several of the areas to which it was best applied originally now trade without the need to seek medium- to long-term finance, it still has an important role to play in international trade.
- Forfaiting can provide a way for exporters to finance sales to valued corporate clients even in the most difficult circumstances.

3. Application

- Goods financed can include commodities, capital equipment, spare parts and services which may originate from any country because, unlike ECAs, forfaiters face no restrictions concerning the origin of goods.
- Where an export has been agreed for a forfait finance, if it should be frustrated the finance can still be available if the goods are sold internally.

3. Application

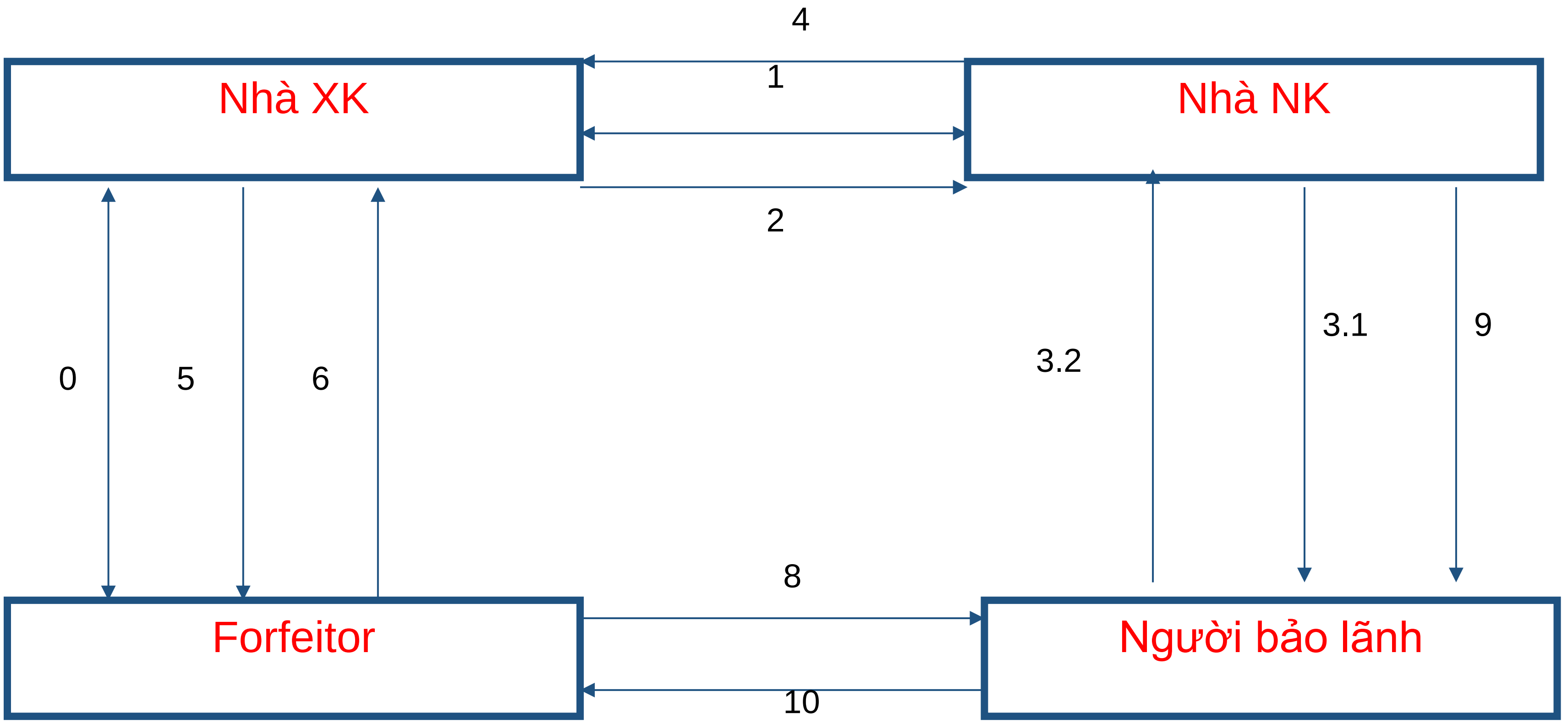
❖ Pros:

- Improve working capital flow
- Credit Sale gets converted as Cash Sale
- Finance available up to 100% of value (unlike in Factoring)
- Pass the inherent risk & Interest risk and Inflation (without recourse)
- Reduce Bad debt

❖ Cons

- High cost (all related inherent risk & Interest risk)

Forfeiting procedure



Forfaiting Process