
LC VIEWS

Newsletter No. 107, March 2007

Aval vs. LC

The debate on alternative trade finance products

AVAL vs. LC

Editor's Note : During my study tour to the banking City of London during 1990, I read an article, in the library of the Institute of Bankers at Lombard Street, that says avalization is better than LC. Keeping in view the nagging problem of payment rejections in LC method there is now debate to think of, and efforts to introduce, alternative methods of payment and financing. This newsletter debates the alternative of aval. The debate concludes LC is better.

Ravi Mehta, Ph.D.

Contributors to this newsletter



Jee Cheng Meng
(main contributor)



T. O. Lee
(supporting contributor)

Avalization vs. Letter of Credit

Jee Chen Meng's insight



East or West, LC is the best

1 Introduction

Letters of credit (“L/C”) and avalization are common lingo that trade finance practitioners should be familiar with, in particular, relating to their applications in export financing, namely, **forfaiting**. At the outset, it is necessary to emphasize that the L/C being plain vanilla is yet one of the most versatile trade financing instruments that mankind had ever created. As a standalone financing instrument, the export L/C represents an irrevocable undertaking, issued in favor of the exporter, by the Issuing Bank. Although L/Cs are used in forfaiting arrangements, it is the exporter who obtains the unconditional financing commitment of the forfaiter.

Practitioners have attempted to draw a comparison between L/C and forfaiting, trying to determine which stands out as a “superior” financing instrument. Interestingly, one can add a twist to this debate and ask, “Which is the better technique – the L/C or the (road-less-traveled) Avalization? At the outset, it is important to highlight that while avalization is associated with forfaiting; aval is not the equivalent of forfaiting. As such, this article does not attempt to compare forfaiting vis-à-vis the L/C.

The use of L/Cs as a trade financing instrument is generally well-understood. Therefore, this article seeks to examine the following, in brief, the application of (i) Avalization and the (ii) L/C respectively, within the forfaiting framework.

2 Mode of Payment

The main financial trade instruments, in-use, are bills-based claims [i.e. Bills of Exchange (“B/E”) and Promissory Notes (“P/N”)] and book receivables. They suffice as evidence of the underlying trade and the buyer’s obligations to honor payment. These trade receivables can be covered by:

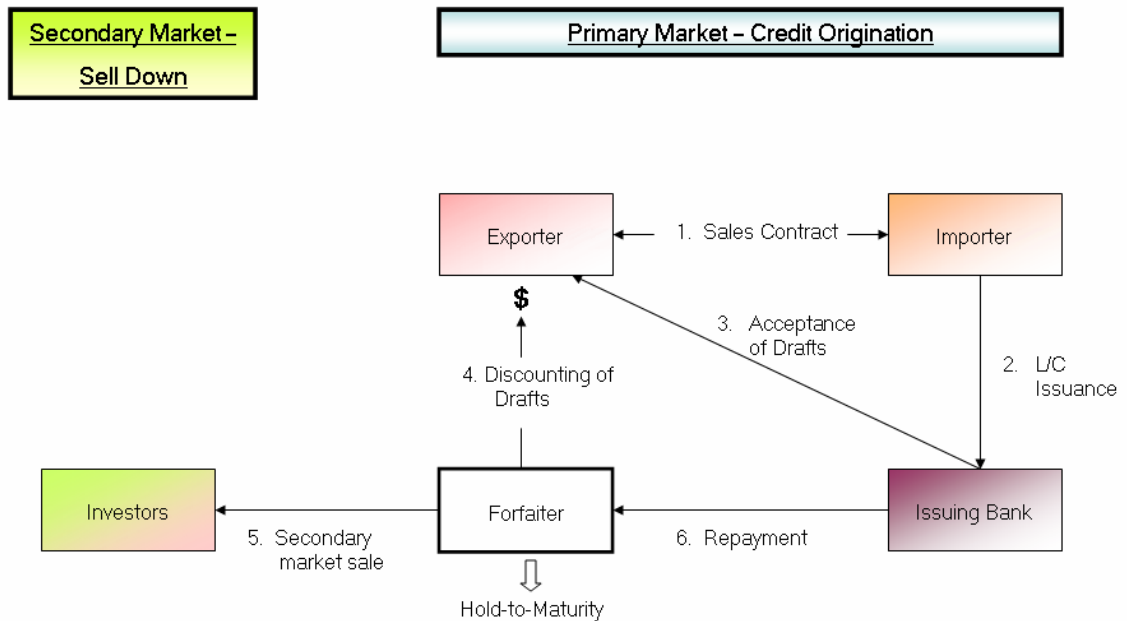
- L/Cs
- Confirmation (Open and/or Silent)
- Avalization
- Guarantee

3 Forfaiting

The term, “forfeit”, means to “give up”. In the context of export financing, it means that the exporter is giving up his rights to receive payments [under the underlying transaction] to the forfaiter in consideration for a discounted value received immediately. In essence, forfaiting is a **debt-discounting mechanism**, in which the forfeiter buys, from the exporter, at a discount, and without recourse, an “asset” i.e. a L/C, a B/E, a P/N, a guarantee, etc.

The mechanics of a forfaiting transaction (depicting the application of L/C) is simplified diagrammatically, as follows: -

Schematic Flow of Forfaiting



(i) Application of L/C in Forfaiting

To discount a L/C, the L/C should be issued to allow the exporter to draw bills of exchange on the Issuing Bank, with the accepted B/Es being returned to the exporter against presentation of credit-conforming documents. The forfaiter then discount the B/Es, which can be endorsed for payment to the forfaiter. This type of credit is referred to as an Acceptance L/C and is referred to under *Article 9a (iii) of UCP 500*.

The uniqueness of the L/C is that it serves as an evidence of “debt” for forfaiting purposes. As such, where the L/C is available for Deferred Payment, the exporter can obtain a commitment from a reliable forfaiting house to discount the L/C proceeds. The L/C, serving as an evidence of “debt” for forfaiting purposes, does not require a B/E and thus obviates avalization. While some practitioners are in favor of applying the Deferred Payment L/C in forfaiting, others however, opined that the “exclusion” of B/Es may make render discounting more difficult, as the exporter will need to formally assign the rights

of payment to the forfaiter and the Advising / Paying Bank will need to acknowledge the assignment to the forfaiter.

(ii) Application of Aval in Forfaiting

An aval is the application of a stamp indicating *Bon pour aval* i.e. 'good for guarantee' to a P/N by a financial institution that has become the primary obligor. It is a guarantee in that the obligation to pay an avalized note is **unconditional** upon the Avalising Bank [note: As opposed to the irrevocability but not unconditional feature of L/Cs]. In addition to avalization, a guarantee is used especially where the effect of an aval in law is uncertain. The guarantee is therefore used to cover the possibility that something might go wrong with the Avalising Bank's reimbursements.

L/C as a payment mode may not be applicable in circumstances where the financing tenor is medium to long-term. While it is practically possible, banks may not choose to issue L/Cs greater than 365 days. Instead, the underlying obligation could be evidenced by P/Ns and avalized by a financial institution that is domiciled in the importer's country. The availing bank assumes the role of the primary obligor, akin to that of an L/C Issuing. Herein, lies the beauty of avalization, at least from a credit risk perspective. An aval signifies the additional, unconditional and irrevocable payment obligation of the Avalizing Bank. The most favored form of negotiable instrument for trading in the forfaiting secondary market is the P/N, which is subject to less statutory precedent as compared to a B/E ^{note}.

Note: Unlike the B/E, the P/N only represents an obligation on the part of the Issuer. For the exporter, there is no liability for payment of the bill. As part of a forfaiting transaction, the exporter can exempt itself from the endorser's obligation as defined in the bill of exchange legislation using the non-liability clause.

For example, if the transaction involves the sale and purchase of capital equipment, the required financing may extend up to 5 or 7 years. Assuming if the importer requires a 5-year financing, it could issue notes, payable at six-monthly intervals. The first note will mature in 6 months, the second note maturing in 12 months and so on until the debt is repaid in full. The benefits of forfaiting using avalized P/Ns could be viewed, as follows: -

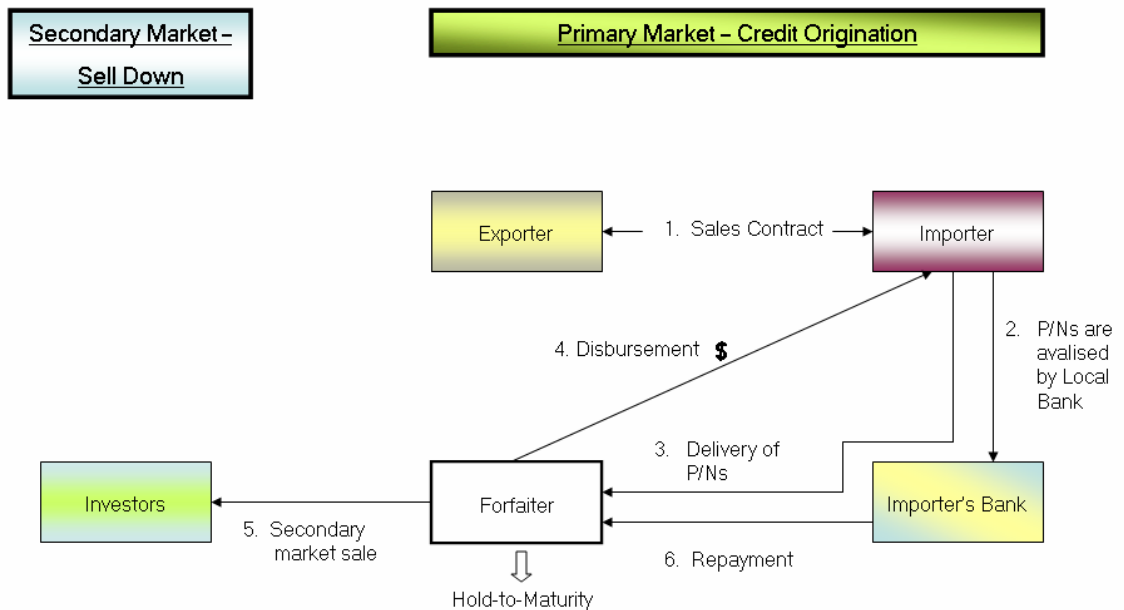
- The financial obligation of the importer is repayable via a "self-liquidating" mode i.e. against the useful life of the good as well as over a longer horizon.

- Forfaiting offers a non-recourse financing to the exporter, with monies disbursed upfront, albeit on a discounted basis. This enhances the exporter's cash flow management.
- The forfaiter has the option of retaining the debt obligations, as liquid instruments [in countries that impose mandatory liquidity requirements, P/Ns suffice as "acceptable" near cash instruments], in his books and/or to sell-down the P/Ns to other interested financial institutions.

4 Further Application of Avalization on a "Structured" Basis

While the mechanics of forfaiting financing are applied conventionally in export financing, it is possible to structure it into an import financing tool that is, financing the importer's purchase of goods and services from overseas. Unlike conventional forfaiting, this arrangement is initiated by the importer. In addition, this facility does not require the issuance of L/C, as the underlying "asset" is P/Ns.

Forfaiting as an Import Finance
- Promissory Notes Discounting



The above is only but one of the potential applications of forfaiting and the use of avalized notes.

Conclusion

The Aval is generally not as well-understood as the L/C. The good-old L/C still offers comfort to many traders alike. Is the L/C necessarily better than the Aval? To give a definite stand that one is better than the other will inevitably raise “objections” between the two camps of supporters. In practice, it is more important that a lender and/or trade finance practitioner understand the applications of each trade instrument to optimize its value. An analogy – I like the harmonica. I may be biased. However, is it necessarily true that a harmonica is non-comparable to a grand piano? It depends on what song we choose to play. A piano cannot effectively express the “inherent sadness” of the good old Japanese folk tunes. And definitely, a piano, however, grand, finds no place when it comes to the BLUES. We should not, at this juncture, start speculating whether the Aval or the L/C being the harmonica.

T. O. Lee's Comparison: LC is better being backed by rules, while Aval is lawless



Proponent and exponent of LC

Dear Ravi,

This subject is more suitable for Chen Jee Meng as a product within structured trade finance in which he is excelled.

Having said that, I would like to express some of my views on avalization vs. L/C as follows:

From an open mind, I would regard that the English article that you have read may not be wrong theoretically, at least to a certain extent, in saying that avalization is better than L/C.

From a practical point of view, I totally disagree. My reasons are:

- 1 The L/C system is now broadly acknowledged and familiarized by the trade community. If you ask a trader in the street what is an L/C he would tell you that it is a bank's payment guarantee. But if you ask the same person what is avalization, he would open his mouth and wonder what you are talking about. A China trader may ask: "Is it a new space technology from China?" So even if avalization were better than L/C (which I deny), it would take a century or more to make it as popular as L/C is today.
- 2 A bank opens its door to make profit and would not be interested in promoting an alien product to the bank's customers. Even if the bank is willing to do so, can it guarantee that the same customer will come to the same bank for avalization services? Let the education be done by government institutes, not us businessmen. This would be the general response.
- 3 Avalization has no rules, not to mention internationalized "Bible" class rules such as the UCP. Big players would hesitate for its effectiveness in case of dispute resolution. Some underdeveloped countries may not have the concept of avalization in its trade legislations. What the trader can rely upon? I am afraid only the Bills of Exchange Act, that can be also available to an L/C asking for drafts.
- 4 In avalization, there is no supporting peripheral products such as those available in L/C, for example, ISBP, eUCP, DOCDEX Decisions, ICC Opinions and ICC statements, to help the parties understand more about L/C and be quoted in the law courts as basis of one's claims or defenses.
- 5 Avalization involves only one bank that adds avalization to the drafts. In L/C we may have more comprehensive services from nominated bank, confirming bank, transferring bank, assigning bank and back-to-back L/C issuing bank. Avalization is a restaurant serving only vegetarian menu whilst in an L/C restaurant, one may order curries, rotisserie, sushi, Thai and dim sum. We do have such a buffet restaurant in Toronto.
- 6 A red clause or green clause L/C is offering similar services as avalization, although in different procedures in providing pre-shipment financing.
- 7 One unique feature about avalization is that avalization can work both ways as avalization can be provided by the buyer's banker as well as the seller's banker. But reciprocal Ls/C can provide concurrently a two way street financing that avalization cannot compete.
- 8 There are abundance of L/C precedent cases but very few in avalization. Hence, from risk management point of view, legal counsel would hesitate to recommend avalization to replace L/C. It is also difficult to find an avalization expert witness.
- 9 One thing good for avalization is that in determination of applicable law, avalization is much simpler than in L/C.
- 10 Avalization is doomed to disappear in the near future as in electronic trade there will be no draft involved but a draft is the core element in avalization. So why should we promote a sun set product? In comparison, L/C as a much matured product has its residue value for at least another 10 years in China and Middle East.

Editorial Team

Editor: Ravi Mehta, Ph.D.

Technical Advisor: T. O. Lee

Associate Editor: Kim Christensen

Contributing Editors: Jia Hao; Laxmanan Sankaran;

Marek Dubovec; Jee Meng Chen; Pradeep Taneja; Zahoor Dattu
Contact: aal6@hotmail.com; www.lcviews.com