

# LCs versus forfaiting

Despite the obvious merits of forfaiting as a financing method in emerging markets, its appeal is far from universal and many exporters, especially smaller ones, still cling to the use of export LCs for a wide range of reasons, such as prohibitively high minimum transaction amounts and pricing. The take-up – or rather lack of take-up – of forfaiting in India is a perfect case in point, as Ravi Mehta, a certified trade specialist and independent export-finance consultant, reports.

**N**ew kinds of export financing methods are being introduced all the time, meaning new export financing options are continually becoming available to exporters. But all export financing methods or options are not equally popular.

Take, for example, forfaiting in India. This type of financing became available in India's financial market from 1992 when the country's central bank, Reserve Bank of India (RBI), which administers the country's foreign-exchange matters and regulates banking, allowed foreign forfaiters to market their service and allowed the indigenous banks, authorised to deal in foreign exchange by the RBI (and hence called authorised dealers in India's banking language), to broker and market the foreign or imported forfaiting services.

Of course, there is use of both foreign forfaiting skills and indigenous marketing skills in India. The Export-Import Bank of India (Exim Bank) has collaborated with a foreign forfaiter, WestLB, to form a joint venture named Global Trade Finance, to market forfaiting services in India. Exim Bank has local knowledge while the foreign forfaiter has forfaiting skills.

The foreign forfaiters and their Indian agents are touting the advantages of forfaiting to Indian exporters with such slogans as "change a credit sale into a cash sale with forfaiting", "take cash without recourse in forfaiting", "make a long-term credit sale to boost exports and still maintain cashflow with forfaiting", "no risk of documentary discrepancies in



Forfaiting became available as a financing method in India in 1992, but is still less popular than LC business.

forfaiting as with LCs", "instant cash for deferred payment", "balance sheet not burdened by accounts receivables", "helpful in doing business with riskier countries", "interest-rate and exchange-rate fluctuation management in forfaiting", and so on.

But, despite its inherent advantages, forfaiting is still not terribly popular among Indian exporters, particularly smaller ones, or among India's international traders. The main reason is that the minimum transaction amount prescribed by foreign banks offering forfaiting services is too high for an average exporter in India, often \$1m. And pricing is a problem.

Soh Chee Seng, a consultant and technical adviser on trade-finance issues for the Association of Banks in Singapore and a member of the ISBP Task Force and UCP Drafting Group, says, "Exporters prefer LCs rather than forfaiting due to the pricing issue."

Vincent Maulella, a US-based LC specialist, says in his experience the export LC is "definitely" a better option and forfaiting "is not a well-known alternative to most export managers and is limited to those countries where aval is practised".

Meanwhile, Khalil Matar, a certified documentary-credit specialist in Saudi Arabia, says the LC remains very popular in the Middle East. This is true also of the

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Indian subcontinent – in fact the whole of Asia – as well as in Africa, Europe, and the Americas. The LC is ubiquitous and indigenous, while use of forfaiting services is neither worldwide nor widespread and is often by big exporters only.

Of course, in other parts of the world too, forfaiting is struggling, even in Western Europe where it originated.



**“LC financing is a standardised practice, while forfaiting is generally an arbitrary practice.”**

RAVI MEHTA

Margrith Lütschg-Emmenegger, executive vice president at FIMBank, discussing whether forfaiting is dead in *TFR* in July 2003, writes that forfaiting, despite its wide applications, still captures only a small part of its potential market. Why is this? She says: “I believe it originates from the fact that we cannot attract sufficient investors, which, in turn, means we cannot offer the best possible pricing and solution to our primary customers, the exporters/manufacturers.” In order to attract new investors, the first priority must be to agree to and adopt standard market practice, she argues.

This is now happening, with the advent of market practice guidelines for the International Forfaiting Association. But the International Chamber of Commerce has standardised only LC practice through its UCP 500 and ISBP 645, not LC-based forfaiting. The long-time existence and effectiveness of the regulatory UCP is one reason why the use of LCs remains a more popular option than forfaiting. LC financing is a standardised practice, while forfaiting is generally an arbitrary practice.

And while it is not yet clear how fully the forfaiting market will embrace the new market practice guidelines, documentary credit bankers around the world have, on the other hand, become addicted to the Paris-based ICC’s UCP rules, which have proven very successful in regulating documentary credit practice

and indirectly very helpful in promoting international trade.

However, in India, forfaiting practice falls under the control of the RBI, which is the foreign-exchange manager for and on behalf of the government of India. Forfaiting in India involves foreign exchange and is therefore under foreign-exchange management by the RBI.

#### One or the other?

On the question of export LCs versus forfaiting, Michael Rowe, technical editor of *DCInsight*, ICC’s quarterly, says one of the main differences is that the importer arranges for the issue of a documentary credit by a bank in the importer’s country as a means of providing an assured payment to the exporter, whereas in the case of a forfaiting transaction the exporter obtains the forfaiting commitment from a bank in the exporter’s country as a way of offering credit terms to the importer coupled with payment security to the exporter.

Documentary credits provide above all a secure means of payment, with, in some cases, short-term credit facilities, whereas one of the principal objectives of

payment under documentary credits depends essentially on presenting conforming shipping documents and related documentation, a procedure that seems to cause more and more anger and hair-splitting (ie, the current debate over clauses of bills of lading in the ICC Banking Commission).

In the case of forfaiting, the exporter is saved all this, since the documentary requirements are simpler. However, Rowe recommends that “in the wider context, I suspect that one of the most significant movements in trade finance may be a shift towards mixing different techniques together so as to provide an overall trade-finance service to clients, rather than a distinct range of separate products.”

Pavel Andrle, secretary of the ICC Banking Commission in the Czech Republic, says that an LC and forfaiting in combination can be helpful to the exporter; an export LC is not, of course, a substitute or direct competitor to forfaiting. Rather, forfaiting supplements the export LC as it provides financing in case of deferred payment or acceptance LC.

Reinhard Langerich, a retired banker from Denmark who is still a member of the ICC Banking Commission, also says an LC can be forfeited. He suggests that where an acceptance LC calls for a bill of exchange, the bill of exchange should be availed by the same bank that has issued/confirmed the LC.

**The avalisation requirement in forfaiting is cumbersome.**

forfaiting is to provide credit – traditionally medium-term credit – to the importer, as well as giving the importer assurance of payment through the forfaiting bank’s commitment to negotiate without recourse.

None of this is absolute, Rowe points out. “The two procedures can and do overlap at the edges, depending in particular on prevailing market conditions,” he says. Also, of course,

Where the LC is available for acceptance or deferred payment, the exporter – that is, the LC beneficiary – can get a commitment from a reliable forfaiting house to discount the LC proceeds, which is assigned (under article 49 of the UCP) to the forfaiter on a non-recourse basis. The LC itself can serve as an evidence of debt/guarantee for forfaiting purposes where it is available for deferred payment and does not

require a bill of exchange and thus obviate avalisation.

### Negotiating tactics

This idea of combining LCs and forfaiting gives rise to a question of negotiation versus forfaiting. The UCP uses the term “negotiation”, which the ICC has explained further in a position paper. Is forfaiting negotiation? Or, vice versa, is negotiation forfaiting? No.

## For Indian exporters, an LC is a trade necessity while forfaiting is a luxury.

Negotiation may or may not be without recourse as forfaiting is. In negotiation there may be no assignment. In negotiation the exporter may not be free from LC payments administration and collection as in forfaiting. For negotiation, a bill of exchange or promissory note is not required, nor is avalisation or a letter of guarantee. Negotiation may be under reserve or against the exporter’s indemnity, but still it is popular because negotiation requirements are not difficult to comply with.

The avalisation or letter-of-guarantee requirement in forfaiting is cumbersome. In negotiation, full-face value may be advanced and interest may be charged on the value given later when LC payment comes in, for a period between the date of value given and the date of trade payment received. Negotiation is cost-effective for short-term financing.

In the case of even medium or long-term financing, for which forfaiting is suitable, forfaiting may still not be preferred because of pricing, and alternate methods may be used to secure financing, like tangible collateral from the exporter or a bank guarantee. Guarantee and negotiation play an important role in India’s export financing market.

LCs may remain a better option than forfaiting for the following reasons:

- LC usage is governed by UCP rules and facilitated by the ISBP. The existence of UCP rules and ISBP

clarifications help exporters prepare and assert compliance. There are non-legal LC payment dispute resolution mechanisms available to the exporter, such as Docdex.

- An LC has the advantages of irrevocability, transferability, assignment, negotiation, confirmation, discrepancy waivers and amendment with the exporter’s consent or initiative, all offered by the UCP – which make the LC a safer payment mechanism and a more cost-effective financing mechanism. There is a risk of discrepancies, but the discrepancies can be rectified or waived.
- Negotiation under LCs for post-shipment finance is easily workable, easily available, and easily affordable. It may be without recourse. Banks have skills and experience for negotiation. Negotiation is thus a popular and traditional local alternative to forfaiting, which may be a foreign service for which local skills may not be available. Negotiation is indigenous; forfaiting may or may not be indigenous. In India, there is an attempt to “Indianise” forfaiting: the RBI rules to regulate foreign forfaiting is an attempt in this direction. Local bankers in India are developing forfaiting skills, but still negotiation is popular – and more popular in India’s banking system, which is the country’s leading LC market. Nothing succeeds like negotiation in India.
- An LC has the potential to cover the risks forfaiting covers. It can be confirmed to cover political/transfer risks. It can be issued in the home currency of the exporter to cover foreign-exchange risk. If not in the home currency then with the help of hedging techniques, the LC can work well as a risk-management mechanism.
- An LC can serve as collateral for back-to-back LC and pre-shipment

finance, called packing credit in India’s banking language.

- An LC can facilitate credit insurance with maximum cover at minimum cost.
- An LC can be issued and handled by indigenous banks, even in developing countries or emerging economies – that is, LC service is not imported for local marketing. Forfaiting, on the other hand, may be a foreign service.
- An LC is easily accessible, affordable, usable and more beneficial – hence preferable. India’s exporters are mainly small businesses. They don’t offer long credit periods, so they don’t need pricey and cumbersome forfaiting. For them, an LC is a trade necessity while forfaiting is a luxury.
- Its self-handling by the exporter can be learned easily, or its handling can be outsourced.
- LC stipulations can be mutually contracted by the exporter and his or her buyer for specificity, clarity and relevancy; for convenient LC compliance management and customs compliance management; and for effective cost management, delivery management and risk management.

The best example of LC popularity and forfaiting failure is India, where forfaiting has not become popular because of its faulty marketing – faulty because it is not consistent with the business characteristics of India. You may be able to take your forfaiting service to India because the RBI permits it, but you may not be able to take the exporter in India, who is an LC addict, to your localised forfaiting service if you set up arbitrary or ineffective eligibility and marketing criteria.

Foreign forfaiters must acclimatise forfaiting to the Indian environment. The same criteria set in Europe or the United States may not work in India. So it is necessary to adopt the marketing approach (to sell what the buyer needs, the way the buyer likes it) and not the selling approach (to sell what you want to sell, the way you want to sell it). □