Forms of forfaiting

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Abstract. In the following note, the concept of forfaiting as well as various forms of forfaiting are discussed. The following criteria are used to distinguish different forms of forfaiting – type of financial instrument that secures a receivable, placing of risk, additional services, number of parties to a transaction, territorial range. Based on those criteria, specific forms of forfaiting are briefly characterised.

Introduction – the concept of forfaiting

Forfaiting is a form of medium and long-term financing that is used in international trade (cf., Czerwińska-Kayzer, 2006). Forfaiting involves the purchase of future receivables of goods or services suppliers by specialized forfaiting institutions (cf., Kreczmańska-Gigol, 2010). Kim (2021) writes that forfaiting in international trade is defined under *The Uniform Rules for Forfaiting* (URF 800, cf. Article 2). Forfaiting has two fundamental functions in business transactions:

• financing function,
• guarantee function.

The first function enables the exporter to maintain financial liquidity or to collect the required capital within a relatively short period of time. The guarantee function means that the exporter is protected against the risk of the debtor's insolvency.

According to Marciniak-Neider (2004), the average value of forfaiting transactions is 2-5 million USD. Some forfaiting institutions determine the bottom transaction limit at, for example, 100,000 USD. Forfaiting institutions collaborate globally within the framework of the International Forfaiting Association (www.forfaiters.org), established in 1999. The Association has developed the rules of conduct for handling forfaiting transactions – the Market Practice Guidelines – making international cooperation of forfaiters much easier.

The parties to a forfaiting agreement are (cf., Czerwińska-Kayzer, 2006; Kreczmańska-Gigol, 2010):

- the seller of receivables – an economic operator engaged in production, commercial or service activities,
- the forfaiting institution – the purchaser of cash receivables,
- the debtor,
- the issuer of a security for the receivables subject to a forfaiting agreement,
- the intermediary forfaiting institution.

Forms of forfaiting

The following criteria can be used to distinguish various forms of forfaiting (cf., Kreczmańska-Gigol, 2010; Marciniak-Neider, 2004; Stecki, 1994; Tokaj-Krzewska, 1999):

- ✓ type of financial instrument that secures a receivable,
- ✓ placing of risk,
- ✓ additional services,
- ✓ number of parties to a transaction,
- ✓ territorial range.

Type of financial instrument that secures a receivable (cf., Marciniak-Neider, 2004)

Depending on the type of the financial instrument that secures the receivables that are subject to a forfaiting agreement, there are the following forms of forfaiting: (1) bill of exchange receivables forfaiting, (2) non-bill of exchange receivables forfaiting and (3) forfaiting of unsecured receivables (cf., Marciniak-Neider, 2004).

In the case of bill of exchange receivables forfaiting, the security is a bill of exchange or promissory note, usually backed by a bank. In the case of non-bill of exchange receivables forfaiting, the security is usually a deferred payment letter of credit, but it can also be a standby letter of credit, bank guarantee or insurance policy (ibidem). In economic practice, receivables in forfaiting transactions are usually secured by promissory notes. According to Marciniak-Neider (2004), promissory notes are more popular than bills of exchange because of the nature of commitments. In a promissory note, the exporter as the beneficiary may release himself from liability for payment by adding the "without recourse" clause. If he does that, none of the subsequent holders of the promissory note may request the exporter to pay the note, if the main debtor refuses to pay. In the case of a bill of exchange, the exporter is not only the beneficiary and first endorser but also the issuer of the bill. Because, according to the bill of exchange law, the drawer cannot release himself from the liability to pay a bill, there exists the right of recourse to the exporter. Sometimes, receivables subject to a forfaiting agreement are not secured at all. This, however, happens in special circumstances, usually when the importer has a high financial standing and good business reputation, and the forfaiting institution has no concerns about him. In practice, forfaiting of unsecured receivables applies to large international companies (ibidem).

Placing of risk (cf., Stecki, 1994)

Depending on the placing of risk, the following types of forfaiting are identified: (1) genuine forfaiting (in German: *echtes Forfaiting*) and (2) non-genuine forfaiting (in German: *unechtes Forfaiting*) (cf., Stecki, 1994). In genuine forfaiting, the seller of receivables is released from responsibility for the receivables he sells. The full responsibility is transferred to the buyer of receivables, that is the forfaiting institution. Meanwhile, the receivables are permanently transferred to the forfaiter. The forfaiter has no right of recourse to the seller of receivables, if, for example, the debtor becomes insolvent. This way, the forfaiter accepts all the risks related to the recovery of the receivables he buys (Stecki, 1994). In the case of non-genuine forfaiting, the forfaiting institution does not accept the risk related to receivables, which means that, in the case of the debtor's insolvency, the receivables are transferred back to their seller. It should be noted that such arrangement is contrary to the idea of forfaiting, and non-genuine forfaiting is, in fact, a regular receivables sales agreement.

Additional services (cf., Stecki, 1994)

Depending on whether or not additional services are offered, forfaiting is classified as: (1) extended forfaiting and (2) regular forfaiting. In extended forfaiting, the forfaiting service is combined with extra (additional) services provided by the forfaiting institution (cf., Stecki, 1994). In extended forfaiting, the forfaiting service is combined with extra (additional) services provided by the forfaiting institution (Stecki, 1994). These services may include verifying the debtor's financial standing, applying for the required foreign exchange permits, analysing the financial markets of certain States or undertaking marketing activities.

The extra services cost extra money, increasing the total cost of forfaiting.

Number of parties to a transaction (cf., Stecki, 1994)

Depending on the number of parties involved in a transaction, forfaiting is classified as: (1) direct forfaiting, (2) indirect forfaiting, (3) hermes-forfaiting, (4) confirming forfaiting and (5) subsequent forfaiting (cf. Stecki, 1994). In direct forfaiting (in German: direktes Forfaiting), a financial institution purchases receivables from the seller (or supplier) of goods and services. The subject of direct forfaiting may be either a domestic or foreign forfaiting institution that does not act through intermediaries (Stecki, 1994). In indirect forfaiting (in German: indirektes Forfaiting), a forfaiter purchases receivables from an intermediary forfaiting institution, rather than from the seller of goods and services. In most cases, indirect forfaiting involves receivables from export-import agreements. Hermes-forfaiting was for the first time used in the UK (also known as additional cover), and later it became popular in the Netherlands and Germany (Stecki, 1994). Hermes-forfaiting may be used for receivables from debtors established in developing countries. A government provides an additional cover (in German: Deckblattbuergschaft) for export receivables that have already received the government's Hermes cover (ibidem). There are three types of hermes-forfaiting. The first type, called "open", is when an exporter sells his receivables to a forfaiting institution with the government's consent. These receivables are covered by a guarantee of the government of the exporter's country. Often, the Hermes cover is provided by a special-purpose vehicle controlled by the government. The rights arising from the Hermes cover are transferred to the forfaiter and the government agrees to maintain the cover when the owner of the receivables changes. Additional cover provided by the government applies only to the forfaiting institution that purchases specific export receivables. By providing a cover, the government undertakes to pay receivables, if:

- the exporter is in breach of his contractual obligations,
- the exporter is late with the payment of an amount due from him (the period of delay is determined in the cover),
- the importer refuses to pay, claiming that the capital goods delivered to him are defective,
- the authorities of the importer's State refuse to issue a permit for the importer to pay his liabilities (ibidem).

In the latter type of hermes-forfaiting, the receivables covered by a forfaiting agreement become detached from their original legal basis (contract for the delivery of capital goods) and instead are founded on a new legal basis, which is the additional cover of the government of the exporter's country. The sales of receivables remain non-confidential, the same as in the case of the open type of hermes-forfaiting. There is also the third, still different form of hermes-forfaiting. The exporter pays receivables from a loan granted by the forfaiter. The loan granted by a forfaiting institution is secured by an additional cover provided by the government of the exporter's country. In the third type of hermes-forfaiting, the importer usually takes an active part in efforts to secure the forfaiting institution's loan for the exporter. The use of hermes-forfaiting is rather limited. The reason are the rigorous conditions for its use. Another important hindrance to the development of hermes-forfaiting is the fact that it does not explicitly relieve exporters from the numerous risks of international trade in capital goods (cf., Stecki, 1994). Confirming forfaiting was developed and is the most commonly used in the UK. Forfaiting is combined with confirming when the receivables covered by a forfaiting agreement come from an agreement with the confirmed clause. This clause is included in an export agreement following careful examination of the importer's financial standing and business reputation by a specialised confirming house in the importer's country. Once the confirmed clause is added to an agreement, the confirming house assumes all the risks associated with the confirmed export agreement. Subsequent forfaiting is when the forfaiter makes the receivables he has purchased the object of subsequent forfaiting agreements. Usually, the forfaiter has fewer capital resources than the companies to whom he sells the receivables he has purchased.

Territorial range (cf., Stecki, 1994)

Depending on the geographic criterion, the following types of forfaiting are identified: (1) domestic forfaiting (in German: Inland-Forfaiting) and (2) international forfaiting (cf., Stecki, 1994). Depending on the geographic criterion, the following types of forfaiting are identified: (1) domestic forfaiting (in German: Inland-Forfaiting) and (2) international forfaiting. Domestic forfaiting means purchasing receivables arising from domestic transactions. Both the parties to a forfaiting agreement and the debtor operate in the same country. Otherwise, forfaiting is international. In that case, the parties to the basic legal relationship (delivery, sales, services) are established in different countries. It often happens that the forfaiting institution is established in yet another country than the parties to the basic legal relationship.

According to Stecki (1994), international forfaiting is associated with numerous currency problems and risks that are missing from other forms of forfaiting. Consequently, the interest rates in international forfaiting are usually much higher than in domestic forfaiting.

In this note, we defined the term 'forfaiting', and proposed a simple classification of various forms of forfaiting based on five criteria distinguished in the literature. The presented classification can be useful to financial managers and, in general, all persons interested in the practice of forfaiting transactions. This note can be also used as an introduction to forfaiting business.

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