

FORFAITING - CASH MADE FROM LOAN

MILJKOVIĆ ALEKSANDAR, MILJKOVIĆ LJUBOMIR

Faculty for Education of the Executives, Novi Sad, Serbia

Abstract: *Bank are dealing with in present times many activities. Traditional activities, such deposits, or loans, definitely is not dying but they made smaller and smaller share of total profits. Banks now performs many operations in which they not even do business with their customers and that provide them a large capital at their disposal. Business of a bank deposit are ordinary retail business with a single digit commissions, as well as forfeiting work worth of several million Euros.*

This way of redemption of long-term receivables in Serbia is almost underrepresented. One of the reason is underdeveloped legislation, so for these reasons, we attribute importance to this paper.

In addition to factoring, in Serbia has recently appeared a relatively new form of financing of export credits - forfeiting. It involves the purchase of long-term export receivables, minus the appropriate amount, based on the presentation of documents by which importer guarantees repayment of debt.

Keywords: *Forfeiting, banking, factor, buyer, receivables, exporter, importer*

1. INTRODUCTION

In recent years, one of the most important banking jobs becomes factoring. It is present particularly in developed countries, although in our country, its spirit is already obvious. In fact, it is purchasing of foreign debts. For example, the sale of certain goods resulting receivable seller to the purchaser, which is required to settle this over a certain period of time. This activity may deal with banks and insurance companies, as well as some other specialized companies. They buy off debts paid by the seller immediately reduced the amount of his claim for the agreed percentage (e.g. 10%). Factoring is often profitable to the seller because it improves its liquidity because it comes to cash before maturity, and it frees up a variety of financial risks that occurred over time. Of course, the factor (customer receivables) provides itself in the way that such claims must be in good financial standing and covered with a variety of guarantees, so it minimizes the credit risk, i.e. the inability to collection a debt at maturity. Factor in addition to redemption claims provides other services too, such as account management, a variety of transport services and freight forwarding services, help in choosing the customers ... and for that charge a special fee of 0.75 - 2% of the value of work.

Factoring has an upward trend in the world. In 1999, the global sales were €557 billion, and last year was one billion and 17 billion Euros. The reason may be that there are some countries where seven years ago there was none factor, i.e. where there was no traffic of this type, such as Croatia, Luxembourg and the United Arab Emirates, where now we are talking about hundreds of million Euros of annual turnover. Of all the countries, the greatest growth of factoring was in the UK - 237.2 billion in 2005, while speaking the continents, during the last year the highest turnover was in Europe - 715.5 billion Euros.

Given the fact that factor may purchase claims in their own country or abroad, we distinguish domestic and international factoring. International is much more complex, and therefore much more risky.

In addition to factoring, there is another very similar type of work - forfeiting. Forfeiting is similar to factoring, so we can even say they are, except one of the main differences, almost identical. Namely, Forfeiting is the redemption of long-term receivables for capital goods with a repayment period of usually 5 years, and can be from 6 months to 7 years, in annual installments. The size of the transaction may be at least \$50,000 and a maximum of \$10 million, if the higher amounts funded through a consortium. Therefore, the basic difference is whether it is a short (factoring) or long (Forfeiting) financing of sale. Technique is the same.

For these reasons, we give a classic example of factoring:

- The nominal amount of the invoice: 1.000.000, 00 Dinars
- Maturity date: 60 days
- Factoring Fee: 1.2%
- Interest rate: 8% per year, variable
- The administrative cost per invoice: 100.00 Dinars
- Advance payment: 80%

Day one

- The seller issues an invoice and submits it to the Purchaser and Factor

Day 2

- Factor after signing the Treaty of Cession pays 80% of the nominal value of the invoice on the account of Seller, i.e. 800,000.00 Dinars reduces for the factoring fee and administrative cost ($12000.00 + 100.00 = 12,100.00$ Dinars)
- The amount of the advance payment: $1,000,000.00 \times 80\% = 800,000.00$ Dinars
- Advance payment on account minus the factoring fee and administrative expense: $800,000.00 - 12,100.00 = 787,900.00$ Din

Day 61

- The factor pays the seller the remaining 20% of the nominal value of that invoice, i.e. 200,000,00 Dinars reduced by factoring interest accrued on the amount of advances $800,000.00 \text{ Dinars} \times 8\% \text{ per year} \times 60 \text{ days}/365 \times 100 = 10,520,55$ Dinars
- The remaining amount to be paid: $200,000.00 - 10,520.55 = 189,479.45$ Dinars
- Thus, the total cost of factoring is 2.3% of the nominal amount of the invoice.

Forfeiting, as we mentioned earlier is similar to factoring, i.e. it uses the same „technique“, and it is about buying off the long-term receivables for capital goods with a repayment period of 6 months to 7 years, usually in semi-annual installments.

2. HISTORY AND DEVELOPMENT

Forfeiting was created in fifties of the last century as a form of financing between buyers of the Eastern bloc and sellers of the Western. Today it is used to finance trade with countries in transition. In the beginning, largely unknown, because it was practiced by the banks in Switzerland, known for its discretion, that weren't publishing data on technology and trade, is widely used today. It is estimated that three percent of the world volume of trade is financed by Forfeiting. In 1999, an International Forfeiting Association of companies and banks involved in Forfeiting was founded – which has 140 members from around the world and in Serbia, except in some marginal transactions, it is almost underrepresented. Foreign Exchange Act and related regulations concern the transfer of assets and liabilities arising from foreign trade transactions of residents, making Forfeiting business legally possible. In order to improve and the efficiency of the usage of this instrument, it is possible to improve existing regulations.

Forfeiting is at the very beginning, in our country and worldwide. There is potential and scope for its development, but the question is how it will going to work. The legislation for this type of debt collection does not exist, i.e. the same rules apply as for factoring.

2.1. Small and medium enterprises are having the greatest benefits

The main difference between factoring and forfeiting is that those are, in terms of forfeiting, the long-term receivables with a term of payment of several years, and factoring in terms of short-term receivables. The size of the transaction may be at least \$ 50,000 and a maximum of ten million dollars, if the higher amounts funded by a consortium.

In practice, it is considered that the exporters using forfeiting transfer credit transaction into a cash business. The procurement of goods is enabling for importer or equipment on credit terms in a simpler and more efficient way than through traditional banking instruments.

Due to the structure of Serbian exports, which represented the sale of retail goods, such as equipment, with longer maturities of six months to five years, this instrument can be used sporadically in this segment.

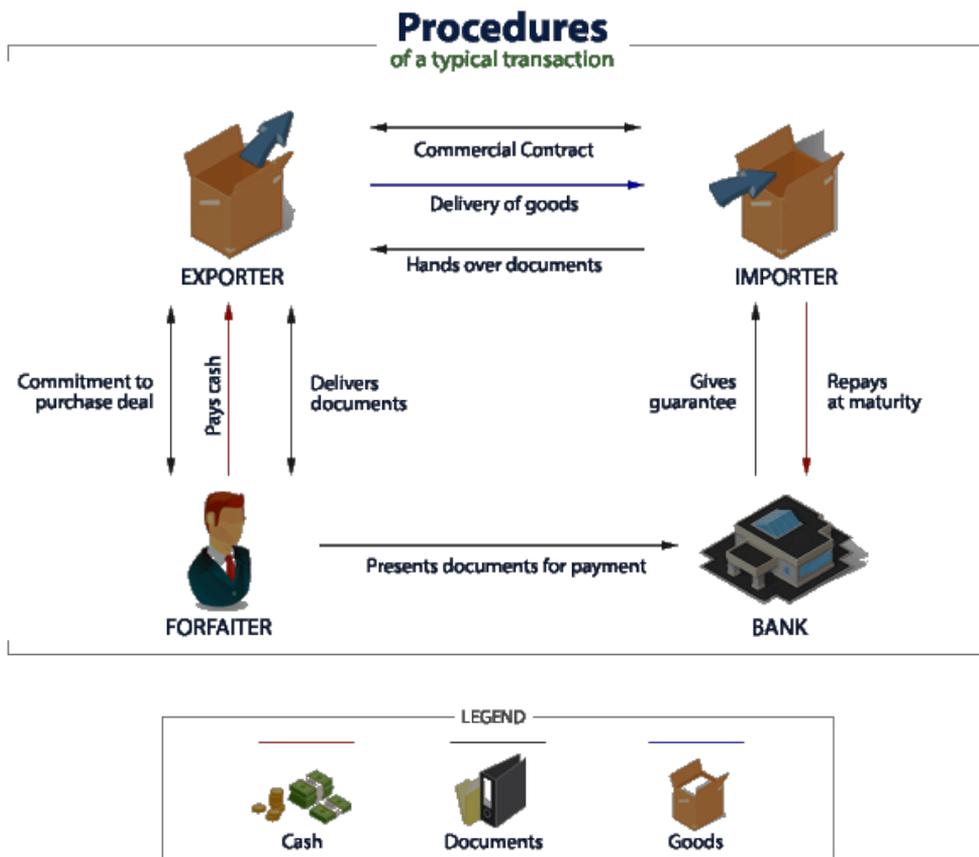
In contrast, in the segment of importing equipment, particularly for small and medium enterprises, this instrument can bring revolutionary changes. Small and medium businesses can offer their own bills instead of paying their suppliers, with avals of most domestic banks, which are not owned by foreign founders, and aval is certainly easier to get than credit. As explained above, the suppliers can cash these bills immediately upon delivery and this credit transaction from its point of view is treated as cash.

Forfeiting is often used for high value export transactions whose subjects can be:

- Capital Assets
- Consumer Goods
- Vehicles
- Consulting and construction contracts
- Stock products
- Simple documentation

Forfeiting requires minimum documentation due to the types of instruments involved in the transaction, such as promissory notes, drafts, and letters of credit because of their portability through endorsements or assignments.

Forfeiting improves cash flow while other banking instruments are staying unchanged. Converting credit transaction to the cash by forfeiting, the balance sheet is free of debts, bank loans, or uncertain liabilities.



Source: <http://www.marfinfactors.gr/html/page.asp?Lang=3&PageID=7>

Figure shows the necessary documentation and gives an illustration of the banking business during the implementation of banking contract.

3. THE RISKS OF FORFEITING

When it comes to forfeiting risks while contracting the price of the transaction, as a price should be proposed the Libor rate plus a margin. The margin will depend on the country, guarantees available, and due dates will reflect all the possible risks as well as the general situation in the international market due to the potential sale on the secondary market.

4. RESUME

Forfeiting is the international credit business in a broader sense, so legal regime for credit transactions with foreign countries, under the Law on credit relations with foreign countries, will be applied. This agreement is similar to the factoring agreement, which assumes a claim, and other entities occur (bank importer, agent bank). It is distinguished by the following:

- Factoring is the purchase of short-term receivables,
- Forfeiting is the purchase of long-term receivables,
- Factoring business activity is wider than forfeiting,
- In factoring, more claims are processed through so-called global assignment,
- In forfeiting, there is only one claim.

It is necessary need to inform the exporters on concept and benefits of forfeiting. Forfeiter takes the risk of collectability of receivables on itself.

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