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92926

INVESTMENT PROPOSAL
FOR
DIRECT GUARANTEE AUTHORITY

US$2,500,000 NON-RECOURSE EXPORT FINANCE GUARANTEE FACILITY

ON BEHALF OF

MIDLAND BANK AVAL, LIMITED

OFFICE OF INVESTMENT
BUREAU FOR PRIVATE ENTERPRISE

January 18, 1989

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

INVESTMENT PROPOSAL
FOR
DIRECT GUARANTEE AUTHORITY

MIDLAND BANK AVAL, LIMITED

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Note: Segments of this IP were drawn from the paper "Trade Development in Asia and the Near East," Mr. D. Cahn, 1987 and "Review of Activities Designed to Encourage International Trade and Direct Foreign Investment in ANE Client Countries," Mr. L. Rudel assisted by Mr. P. Ide, 1987, among other published and unpublished works.

NON-RECOURSE EXPORT FINANCE GUARANTEE FACILITY

I. EXECUTIVE SUMMARY

The project

1.01 PRE proposes to utilize $2,500,000 of its direct guarantee authority to promote the flow of trade credit to A.I.D.-assisted countries. This global facility will be administered by the New York office of Midland Bank on behalf of it's subsidiary Midland Bank Aval, Ltd.

This project will attract an equal amount of private sector credit to match our 50% guarantee of trade related notes to mobilize $5 million in new revolving trade credit. The project will center on "Forfaiting." Forfaiting is the term generally used to denote the buying, without recourse, of obligations, usually trade drafts or promissory notes arising from international trade transactions.

This proposal has been developed as a PRE project in support of A.I.D.'s "Trade and Investment" initiative. Our goal is to provide a credit bridge between U.S. exporters and importers in A.I.D. countries.

This project is expected to evolve into a joint effort among, A.I.D., U.S. & F.C.S. (Commerce Department), OPIC, EXIM, and the USAID missions.

Products

1.02 Midland Bank will purchase trade notes (at a discount) resulting from LDC importers' purchase of U.S. goods on credit. These notes can be held by the participating IFI as earning assets under PRE's guarantee, or used as liquidity instruments through resale in the secondary market without PRE's guarantee. Through this facility Midland Bank will become the "noteholder" (forfaiter) and purchase, without resource to the U.S. exporter, promissory note(s) issued by LDC importers.

Each promissory note eligible for coverage under this guarantee facility will have the following characteristics:

A. Amount - $500,000 or less with PRE guaranteeing up to 50% or a maximum of $250,000

B. Origin: Any A.I.D.-assisted country

C. Repayment: Up to five (5) years

D. Interest Rate: Fixed at market

E. Currency: US Dollars

F. Origination: Through Midland Bank

G. Purpose: Export of U.S. capital goods

<u>Risk</u>

1.03 As an unsecured guarantor to Midland Bank, PRE's risk is multifaceted.

- Transactional risk (default) by the LDC importer and/or their local bank which will avalize (guarantee) their notes.

- Country risk (economic and political) in the LDC's to which U.S. exports are directed and from which our guaranteed notes must be repaid.

- Institutional risk (credit and liquidity) in Midland Bank to act as forfaiters on our behalf.

- Exchange risk (non-convertibility) in LDC importers not having access to U.S. dollars to meet repayment.

- Legal risk, with A.I.D. becoming the holder in due course of defaulted notes forwarded to us by Midland Bank (at A.I.D.'s request).

These risk factors are present in many A.I.D. projects. We believe the risk to PRE in this facility is manageable based on PRE's position as a guarantor to an IFI which will share these underlying risks with PRE. Midland Bank will use their standard credit approval policy in acceptance of notes. Our participation would be directive to support U.S. exporters who want to sell U.S. goods (additive) to an A.I.D. country but require some credit support to do so.

Project Timetable

1.04 The IOP was approved in 1988. The Loan Review Board has already passed favorably on this project.

IP	2/89
P/A Signing	3/89
First Disbursement	8/89

II. TRANSACTION SUMMARY

The following are the major terms of the proposed Non-Recourse Export Finance guarantee facility between PRE and Midland Bank.

These terms are subject to further negotiation by all parties, as well as certain A.I.D. standard requirements and restrictions.

AMOUNT: $2,500,000

GUARANTEED IFI: Midland Bank
and/or
Midland Bank Aval, Limited

OWNERSHIP: Privately owned and operated (National origin, British)

PURPOSE: To partially guarantee, up to 50%, trade notes resulting from the exportation of U.S. capital goods to A.I.D.-assisted countries.

CO-FINANCING: Our non-funded A.I.D. guarantee will mobilize at least $5 million in additional trade credit on a revolving basis for A.I.D.-assisted countries.

The following terms and conditions will govern our project agreement between PRE and Midland Bank.

TERM OF GUARANTEE: Seven (7) years from signing Contract of Guaranty.

SUB-NOTES: Up to five (5) years.

FIRST DRAWDOWN: Within one (1) year from execution of the project agreement.

GUARANTEE FEE: 1% p.a. on utilization collected semi-annually in advance.

GRACE PERIOD/
COMMITMENT PERIOD: Up to nine (9) months, at no cost, prior to disbursement.

SECURITY: Aval of importers bank.

INTEREST: N/A

PREPAYMENT: N/A

<u>CURRENCY OF PAYMENT</u>: All fees are payable in U.S. dollars.

<u>TRANSACTION SIZE</u>: A maximum transaction size of U.S. $500,000 (principal and interest) for any one subborrower (50%/$250,000 guaranteed). PRE's guarantee is in U.S. dollars. Underlying guaranteed notes are also to be in U.S. dollars.

<u>CONDITIONS PRECEDENT</u>: All notes placed under PRE's umbrella guarantee are to cover the exportation of U.S. capital goods to the private sector in an A.I.D. country.

<u>SUBBORROWER RESTRICTIONS</u>: All subborrowers will be private sector importers (No parastatal ownership permitted).

<u>REPORTING</u>: Semi-annually. Standard A.I.D./PRE forms.

<u>SETTLEMENT OF CLAIMS</u>: Any defaulted notes covered by A.I.D.'s guarantee will be covered up to 50% up to the maximum of $250,000 per any one subborrower by drawing against our guarantee payable through the Office of Financial Management.

<u>TECHNICAL ASSISTANCE</u>: PRE/I and PRE/PD will provide up to $150,000 from core funds including the PEDS and Financial Markets projects to support education in selected A.I.D.-assisted countries and the U.S.A. on the concept of forfaiting. Joint marketing efforts by PRE with selected USAID's will be covered by these funds. This component will include a provision for Mission "buy-ins" of another $100,000 in PD&S funds for country specific replication work. An action plan for this activity is attached as Annex D.

III. FORFAITING - NON-RECOURSE EXPORT FINANCING

"A forfait" describes a financial technique which combines the characteristics of many other kinds of trade instruments. It is generally classed as a "supplier" credit: that is, the exporter is required to provide financing as an integral part of the sale of goods and services. Assuming the exporter does not choose to retain this risk on his own books as a receivable, he may consider structuring the transaction to include negotiable notes which they can sell to a bank or private investor, hence the origin of "a forfait" paper.

Today it is one of the most common methods of financing international trade in capital goods coming out of Western Europe. This technique is most useful to obtain financing for less-developed countries (LDC's) outside normal banking channels. The bulk of all A.I.D.-assisted countries are LDC's and many do not have access to additional credit through formal banking channels.

The market for non-recourse paper of this kind started in the 1950's and originally concentrated on East-West trade. Most transactions covered shipments of raw materials which could be rapidly converted into manufactured goods and reexported, requiring a simple, short-term trade financing mechanism. The market for such paper is now virtually worldwide, and includes medium-term transactions as well.

Forfaiting can be described as follows:

As in normal letter-of-credit operations, the obligation to pay is represented solely by an underlying note or bill of exchange, and is completely separated from the commercial transaction.

It is in the form of negotiable bills of exchange or promissory notes including only the most essential terms of a legal obligation to pay: fixed amounts and maturity dates, and the names of the obligor and, in most cases, their guarantor.

The note stands on its own, without recourse to either the exporter or any intermediary purchaser. An endorser can of course be held liable for fraud or misrepresentation, but not for non-payment.

"A forfait" paper is normally issued on a discount basis, that is, the interest rate is implied in the principal amount due; this practice means that most "a forfait" notes do not indicate an interest rate on their face, and are sold "flat", i.e., for a fixed cash price. More recently some paper has been sold based on an explicit interest rate, using a fixed rate or some established floating rate benchmark.

Interest is calculated on a 360 day basis, although the alternative 365 day basis is sometimes used, as agreed during the negotiations between the exporter/importer and their forfaiter.

The term is usually five years or less, and occasionally for less than one year. The interest rate calculation usually includes compensation for 5-10 days grace after each payment date to allow for delays in transit on repayments.

Amounts of individual notes are generally $1 million or less to facilitate easy marketability, but larger amounts are also common.

There is generally no security, and the notes rank as junior obligations of the debtor. However, many importers who avail themselves of the "a forfait" technique are sufficiently weak credit risks to require a guarantee or aval from an established international bank to provide a marketable note. Most often the guarantee is from an institution in the importer's country, meaning that the commercial risk may be guaranteed but the country risk remains.

Notwithstanding, due to its junior status, "a forfait" paper has generally been excluded from restructurings because of its special importance in everyday trade, the fact that the paper is often held by small investors with whom it would be difficult to negotiate new terms, and because of problems in reconstructing an interest rate on discounted notes.

"A forfait" notes are usually denominated in commonly traded convertible Eurocurrencies such as U.S. Dollars, Deutschmark, Swiss Francs or Yen. But exotic currencies are not unknown depending on the size of the transaction and the confidence of local "a forfait" traders to market the paper.

The note or bill of exchange is expressed in the simplest terms, without the usual covenants and protections often found in bank loan agreements, such as representations and warranties (conditions precedent), acceleration and cross default provisions, restraints on issuing senior debt ("pari passu" clauses), and various restrictive financial ratios. An "a forfait" note does not even indicate the law or courts ("jurisdiction") governing disputes -- not a trivial matter with respect to a business transaction which may involve four or five different countries.

Payment must be unconditional and without any reductions for fees or withholding taxes. Nonetheless, taxes may be imposed by the government where the note is discounted or paid, and the investor should be aware of such potential levies.

Individual notes can be separated and sold independently of the others, and may obviously bear a different amount, maturity and even interest rate. This divisible feature significantly improves the marketability of the underlying loan transaction.

Forfaited paper is basically a two-name obligation, involving a debt of the local importer and the unconditional guarantee of their bank. In most cases, only the guaranteeing bank's credit is involved in assessing the credit. The forfaiting house will supply a list of local banks whose aval or guarantee it will accept for the amount and term required. In most cases, these are the largest and best-known local institutions with some international standing.

Through close business connections and published rate sheets, most forfaiting houses are in close contact with other forfaiting institutions, but there are often differences, both in price, appetite for term credit and country availability, from one forfaiting house to another.

Despite its relative simplicity, non-recourse financing can be more expensive than other forms of credit because the lender has so little protection against loss, despite the presence of a guarantee. This is in contrast to the commercial paper market in the United States, which is very similarly structured but remains the cheapest source of funding for many large companies. The key difference is of course that prime American commercial paper borrowers are first-rate credits and the paper is rarely longer than 180 days, while a forfait borrowers -- even with a guarantee of a local bank -- generally represent far less than a prime risk.

Advantages and Disadvantages of Forfaiting

(1) Advantages

A forfaiting situation is likely to be successful when the U.S. exporter is unwilling to finance on open account or retain the LDC's importer's note on their books. This may be because they are unwilling to assume the risk, or need the cash for continuing business. Of course the exporter has to weigh the cost of forfaiting against profit margins and other exposure to the same country (many exporters will carry a certain amount of such risk on their own books, but they usually have internal limits).

Forfaiting is most advantageous to increase business with countries who remain creditworthy, but where the exporter does not wish to increase their exposure.

The documentation is relatively simple and transactions can be finalized with a minimum of legal complications.

The loan is divisible into as many parts as there are notes, as each note represents a complete "loan" and is a legally binding obligation. Thus it becomes easier to market because investors seeking smaller portions, or only certain maturities, can find paper to suit their individual portfolios or risk-appetite.

(3) Disadvantages

Forfaiting *may* be more expensive if other bank credit is still available.

For the holder of the notes, the limited documentation may offer less legal protection in the even of default. But practice has shown that debtor countries are most unwilling to default on such paper, or include it in reschedulings, because of its importance to their everyday import-export business.

A Typical Transaction (see chart no. 1)

An exporter, such as AJAX, Inc., is preparing to offer to sell a drill press to Djibouti. The importer, under foreign currency restrictions, will not consider bids without certain financing terms, e.g., five years maturity, 20% due annually in semi-annual payments. Sometimes the importer will also specify that financing costs cannot exceed a fixed percentage rate (in which case the excess needs to be factored into the overall price).

AJAX, Inc., has the following alternatives: (1) keeping the obligations on open account, or in the form of notes, in its own portfolio of receivables; (2) selling the notes with recourse (to avoid expanding its balance sheet); (3) selling the notes without recourse. For many less-developed countries, the U.S. exporter might only consider the latter alternative, for risk-control reasons.

Before making its offer, AJAX is then likely to approach several of its commercial banks to review their interest in financing the transaction, involving direct financing to the importer, or a transaction which includes the importer's bank, in either case a "buyer's" credit. This form of financing was traditionally used for large, long-term projects. More recently such syndications have been established for smaller, shorter-term purchases of capital goods as they provided more formal documentation than the open lines of credit which U.S. banks had previously relied upon for trade financing.

Alternatively, AJAX may consider structuring the notes in "a forfait" form as a "supplier's credit", negotiated with one of the specialty forfaiting firms. To strike a deal, AJAX will have to accept a discounted price for the Djibouti notes which reflects not only their maturity but the Djibouti risk; once sold, AJAX is only required to indemnify the holder against suits rising from non-delivery or faulty workmanship.

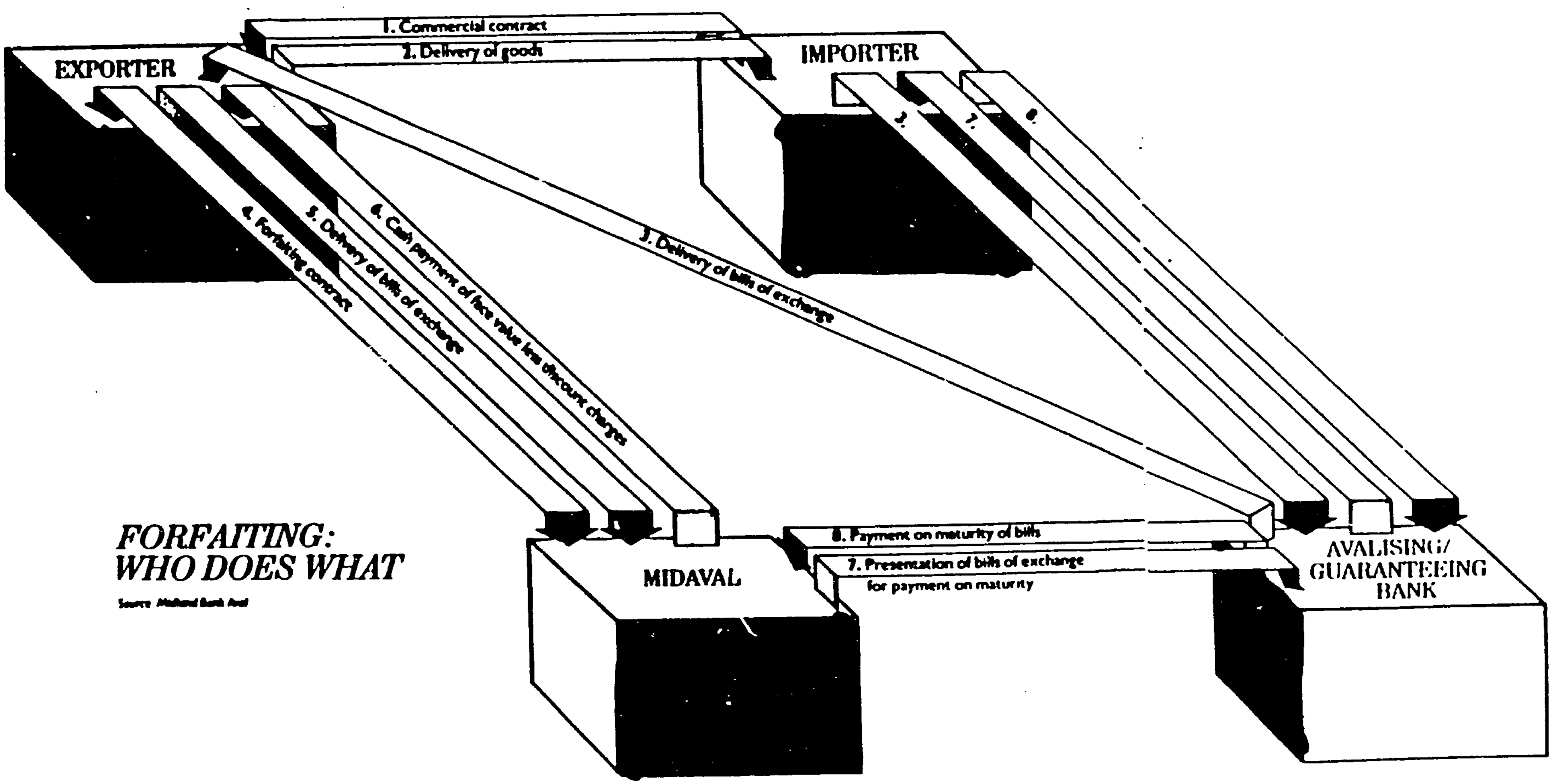
Conclusion

Non-recourse financing has been very successful in Europe in promoting trade with less-developed countries; the technique offers a flexible yet clear alternative in many cases where other forms of credit are unavailable. With the many reschedulings of recent years, however, some countries have simply been eliminated in using this financing method, while for more developed countries the competition has driven interest spreads down. This situation suggests that the time has come for risk-sharing between exporter and importer.

For the especially disadvantaged countries, it is unlikely that traditional "a forfait" financing is the solution, as the risks are simply too great for a financial intermediary to earn a reasonable profit. Even in Europe, forfaiting doesn't work for these particularly credit-poor nations. In such cases, guarantee programs sponsored in whole or part through donors may be the only alternative.

The growth of non-recourse financing in Europe along with the proven success of their export companies, suggest that smaller U.S. companies may need to become more knowledgeable about supplier credits in planning their export strategies with A.I.D.-assisted countries and their counterpart private sector importers.

CHART 1


1. Commercial contract
2. Delivery of goods
EXPORTER
IMPORTER
3. Delivery of bills of exchange
4. Forfaiting contract
5. Delivery of bills of exchange
6. Cash payment of face value less discount charges
3.
7.
8.
8. Payment on maturity of bills
7. Presentation of bills of exchange for payment on maturity
MIDAVAL
AVALISING/ GUARANTEEING BANK
FORFAITING: WHO DOES WHAT

IV. PARTICIPATING INTERMEDIATE FINANCIAL INSTITUTION

Since the "a forfait" market was started, and is still based, in Europe, PRE has the highest chance of success in tapping this financial resource through European institutions. Only private sector intermediate financial institutions (IFI's) are being considered. A cross section of forfaiting houses who already have a solid business base in the developing world are targeted.

Screening included consideration of the existence of branch offices in the USA to act as feeders of transactions to the European forfaiting market. An effort to enlist those houses with a broad geographical representation in the USA (i.e., New York, Chicago, Los Angeles) is also a part of the IFI selection process.

Introductory meetings with a number of IFI's were held in Zurich and London, and negotiations with a short list of forfaiters took place in September 1988. As a result, PRE has selected Midland Bank Aval, Limited as our IFI for this project. Our project will be housed with their U.S. representative at the below address:

Midland Aval
560 Lexington Avenue
New York, NY 10022
Tel: (212) 207-6611
Telex: 233261 MITUS UR
Fax: (212) 755-3458

CHART 2 (Outlines the Bank's ownership at 12/31/87)

Class of shareholder	*Number of shareholders*	*Percentage of total*	*Number of shares held*	*Percentage of total*
Women	45,649	42.91	37,369,315	6.84
Men	39,101	36.75	35,493,423	6.49
Joint accounts	16,340	15.36	38,812,298	7.10
Assurance and insurance companies	629	0.59	43,129,731	7.89
Commercial and industrial companies	774	0.73	85,842,403	15.70
Charities, local authorities, hospitals, colleges, etc	461	0.43	9,243,452	1.69
Nominee companies	2,881	2.71	245,516,419	44.92
Pension funds and pension trustees	157	0.15	16,766,310	3.07
Investment trusts and funds	395	0.37	34,453,032	6.30
	106,387	100.00	546,626,383	100.00

Shares held	*Number of shareholders*	*Percentage of total*	*Number of shares held*	*Percentage of total*
1-100	9,178	8.63	541,466	0.10
101-250	15,662	14.72	2,792,370	0.51
251-500	22,679	21.32	8,638,473	1.58
501-1,000	28,079	26.39	21,150,488	3.87
1,001-5,000	27,986	26.31	53,653,775	9.81
5,001-10,000	1,316	1.24	9,262,428	1.69
10,001-25,000	568	0.53	9,335,326	1.71
25,001-50,000	272	0.26	10,579,586	1.94
50,001-250,000	397	0.37	48,925,670	8.95
250,001 and over	250	0.23	381,746,801	69.84
	106,387	100.00	546,626,383	100.00

V. CURRENT MARKET IMPERFECTIONS

The constraints and opportunities to effective participation in a free and open system of international trade can be grouped into the following categories.

1. Active government barriers. These include such policies as tariffs and quantitative restrictions, restrictive import licensing, import substitution subsidies, government monopolies, etc. Many investment restrictions also inhibit the trade which often accompanies investment.

2. Passive government barriers. These encompass insufficiencies in the law, including lack of recognition and enforcement of property rights in general and of intellectual property in particular, lack of contract enforcement, and ineffective criminal sanctions against fraud, embezzlement, and other business crimes. Reputable international traders, both buyers and sellers, often will refuse to trade with a country which lacks such protections. Other passive barriers include administrative delays and unpredictability which inhibit trade and investment, often by domestic parties as well as foreign ones.

3. Financial barriers. Trade will be inhibited in countries where financial markets are not sufficiently developed to meet the needs of businesses for working capital, trade financing and, long-term lending (for imports of machinery, construction material, and other capital goods)

4. Business transactions and linkages. At the basic level, business representatives in a country must have the know-how and sophistication to understand, negotiate, and enter into the full range of international business transactions and relationships, including manufacturers representation, dealerships, licensing and franchise arrangements, co-marketing and co-production agreements, joint ventures, etc. The application of this capacity includes the development of private sector institutions and practitioners to promote individual transactions in international trade (both imports and exports), as well as long-term trade and investment relationships.

5. Market information. Signals from the marketplace of international trade will not be heard or heeded by businesses in a country which lacks institutions or sophistication to understand them. This includes more than knowing where demand exists for what can be produced. It extends to packaging and quality standards and other factors which enhance market entry.

No one project can address all these constraints. PRE's targeted intervention through this non-recourse exporter finance guarantee facility (forfaiting) is directed to influence institutional change through a transactional activity. The thrust of our effort is to mitigate financial barriers. These are both internal to developing countries and external in the credit risk perception that U.S. exporters and financial institutions in developed countries have in dealing with smaller importers in developing countries.

Institutional Investor's 1988 Country Credit Ratings are attached as Chart 3. This ranks 112 countries by order of risk acceptability for forfaiting. Those A.I.D. countries ranked between 57-112 are the principal targets for this project.

Missions can work with PRE's Revolving Fund, Financial Markets and Private Enterprise Development projects to stimulate the development of appropriate institutions and mechanisms to support the financial requirements of A.I.D.-assisted countries to more fully participate with U.S. firms in two way trade and investment.

CHART 3

FZ

FINANZ AG ZÜRICH
FINANCE SA ZÜRICH

INSTITUTIONAL INVESTOR'S* 1988 COUNTRY CREDIT RATINGS

MARCH 1988

Rank 1-56 suited for forfaiting (margin over matching Libor) Basis points:

Basis points	Rank March 1988	Rank Sept. 1987	Country	Foreign debt US$ bio	Institutional Investor Credit Rating	Six-Month Change	One-Year Change
	1	1	Japan		94.6	−0.8	−1.4
	2	3	Switzerland		94.1	1.0	−0.1
	3	2	West Germany		93.1	−1.0	−1.1
37.5	4	4	United States		91.0	−1.5	−3.1
	5	5	Netherlands		87.0	0.6	0.0
	6	6	United Kingdom		86.7	0.3	0.0
	7	7	Canada		85.9	−0.1	−0.6
	8	8	France		84.9	0.1	0.9
	9	9	Austria		84.1	0.7	0.9
	10	11	Sweden		80.8	0.4	1.0
50.0	11	10	Norway		80.3	−1.1	−1.9
	12	12	Finland		78.5	0.3	0.6
	13	13	Italy		77.6	0.6	0.6
	14	14	Belgium		77.4	0.9	0.7
	15	15	Taiwan		76.3	1.5	1.8
62.5	16	16	Singapore		75.4	1.6	0.6
	17	19	Spain		73.5	1.3	1.8
	18	18	Denmark		73.0	0.4	0.1
	19	17	Australia		70.7	−2.2	−5.7
	20	20	Hongkong		69.2	0.6	−0.1
	21	22	U.S.S.R.		65.4	0.1	−0.1
	22	21	New Zealand		65.2	−0.2	−1.9
	23	23	China		64.8	0.2	−2.0
75.0	24	25	South Korea		62.5	1.9	2.7
	25	24	Ireland		62.4	0.0	−0.8
	26	26	Saudi Arabia		60.3	−0.3	−0.4
	27	27	Kuwait		58.5	0.3	−0.4
	28	28	East Germany		58.4	0.9	2.1
100.0	29	31	Portugal		56.5	2.2	2.3
	30	29	United Arab Emirates		56.3	0.9	0.9
	31	32	Thailand		55.9	2.2	2.3
	32	30	Malaysia		54.4	−0.2	−2.6
	33	33	Qatar		54.3	0.7	0.5
	34	35	Czechoslovakia		54.3	1.2	1.3
	35	34	Bahrain		53.7	0.6	0.3
125.0	36	36	Iceland		52.8	1.3	1.1
	37	37	Oman		50.2	−0.1	−0.3
	38	38	India		49.9	0.2	−0.7
	39	39	Bulgaria		47.7	−0.4	−1.1
	40	41	Greece		46.5	0.8	−0.5
	41	40	Hungary		46.4	−1.5	−3.3
	42	42	Indonesia		43.2	−0.7	−2.4
	43	42	Algeria		42.6	−1.2	−3.3
	44	44	Cyprus		42.2	1.9	2.1
	45	45	Turkey		40.5	0.5	0.8
	46	47	Colombia	15	39.1	−0.1	−0.7
150.0	47	46	Trinidad & Tobago		38.4	−1.7	−2.1
	48	48	Papua New Guinea		37.4	−0.9	−1.3
	49	49	Cameroon		36.0	−0.7	−1.9
	50	51	Jordan		36.0	0.4	−1.3
	51	50	Venezuela	33	35.8	−0.3	−1.1
	52	55	Israel		34.6	1.5	1.6
	53	52	Gabon		33.7	−0.7	−4.1
	54	54	Barbados		33.6	−0.1	−0.8
	55	58	Rumania		33.3	2.2	2.0
	56	53	Tunisia		33.2	−0.9	−3.4

Rank March 1988	Rank Sept. 1987	Country	Foreign debt US$ bio	Institutional Investor Credit Rating	Six-Month Change	One-Year Change
57	57	South Africa		32.3	1.0	0.5
58	60	Pakistan		31.1	1.1	0.8
59	62	Kenya		30.7	0.9	0.5
60	56	Brazil	114	29.4	−2.3	6.1
61	59	Yugoslavia	21	29.0	−1.9	−2.7
62	61	Panama		28.6	−1.3	−2.1
63	64	Uruguay	3	28.4	0.5	0.9
64	65	Mexico	105	28.0	0.9	0.6
65	63	Paraguay		27.7	−1.4	3.5
66	69	Mauritius		27.6	3.3	1.2
67	67	Chile	20	27.2	0.9	1.2
68	66	Ivory Coast	9	26.1	0.4	1.3
69	68	Argentina	49	24.8	0.3	0.0
70	75	Morocco	17	24.0	1.5	0.6
71	73	Philippines	29	23.7	0.3	1.5
72	72	Egypt	9	23.6	0.1	2.0
73	70	Ecuador	[illegible]	23.2	0.9	3.1
74	74	Libya		23.2	0.4	1.4
75	71	Sri Lanka		23.1	0.5	−2.1
76	76	Zimbabwe		23.[illegible]	1.6	0.2
77	—	Nepal		22.7	—	—
78	77	Nigeria	27	20.4	−0.4	1.6
79	80	Senegal		19.4	1.2	0.7
80	78	Iran		18.3	0.0	1.2
81	84	Syria		18.0	1.2	0.8
82	82	Poland		17.8	0.9	1.4
83	81	Costa Rica	4	17.6	0.6	0.7
84	79	Bangladesh		17.2	1.0	2.0
85	—	Swaziland		16.8	—	—
86	88	Jamaica	3	15.9	1.3	0.4
87	83	Malawi		15.7	1.2	0.9
88	87	Iraq		14.7	−0.6	1.9
89	86	Dominican Republic		14.2	−1.4	−0.7
90	89	Peru		14.0	0.5	−1.0
91*	92	Guatemala		13.9	1.3	0.8
92*	85	Congo		13.9	2.0	1.5
93	91	Seychelles		13.7	0.6	0.9
94	93	Honduras		12.9	0.8	0.2
95	90	Cuba		12.8	−0.6	−1.3
96	94	Angola		11.7	0.7	0.2
97	96	Zambia		10.9	0.8	0.6
98	97	Zaire		10.6	0.7	0.7
99	95	Liberia		10.1	−0.5	−0.4
100	99	Tanzania		10.0	0.6	−0.8
101	100	Grenada		9.1	0.1	0.6
102	—	Mozambique		9.0	—	—
103	103	Bolivia	4	8.8	0.7	1.1
104	101	Ethiopia		8.7	−0.2	−0.6
105	104	El Salvador		8.4	0.4	0.4
106	98	Haiti		8.0	−1.9	1.9
107	102	Lebanon		7.6	−0.6	1.5
108	105	Sierra Leone		7.0	1.0	0.4
109	107	Nicaragua		5.5	0.2	0.4
110	106	Sudan		5.3	−0.6	1.2
111	108	Uganda		5.2	0.0	0.2
112	109	North Korea		4.0	0.3	0.6

VI. CONTRIBUTION TO DEVELOPMENT

A.I.D.'s role in encouraging international trade with its client countries stems from a recognition that trade provides a vehicle for the efficient transfer of resources, needed for sustained and efficient economic growth. Trade is often referred to as an instrument of growth. The main theme of the World Bank's "World Development Report 1987" is growth through trade. It demonstrates that free trading policies work better than protectionism in giving LDCs the best chance for rapid economic growth.

A typical exporter, looking around the world for opportunities, would seek a higher return on his business in an LDC than he would in an industrialized, open market country to compensate him for his perceived barriers to entry and higher business risks. Even among LDCs, the rates of return needed to attract foreign trade will vary, depending on local conditions (political stability, corrupt practices, government restrictions, etc.). This is reflected in the rates shown on Chart 3.

A.I.D. project activities, policy dialogue and conditionality are interventions designed to reduce the severity of these market imperfections, thereby increasing the flow and reducing the cost of capital, technology, goods and services for its client countries. Expanded trade offers the potential for LDC to tap into additional private sector resources to contribute to its economic development goals.

A.I.D.'s policy for trade development, as described in the A.I.D. Policy Paper, "Trade Development" dated July 1986, "...is designed to encourage LDCs to utilize international trade as a key instrument in the process of achieving broad based, sustained economic growth, and place a greater reliance on complementary domestic competitive markets that support more open trade policies. A major focus of the trade development policy is on building developed country and LDC private enterprise ties on a continuing, long term basis, consistent with broad American objectives of trade liberalization.

"...the policy directs that A.I.D. policy dialogue, programs, and projects (1) establish a policy environment that is conducive to private enterprise and expanded participation in international trade; (2) encourage the transfer of technology, skills, and information required to expand and diversity LDC agricultural and industrial bases for export production in areas with comparative advantages; (3) support trade and investment promotion efforts; (4) introduce or expand private sector competition in the export or import of essential or economically important commodities; (5) broaden the scope of export development projects to provide for greater U.S. - LDC two way trade opportunities; and (6) encourage prudent investments in infrastructure to improve an LDC's trade position.

"...even if program or project interventions may not be called for, policy dialogue activities should be considered and carried out if at all possible...."

Other A.I.D. policy documents, which elaborate on these basis guidelines are:

- A.I.D. Policy Paper - Financial Markets Development, August 1988;
- A.I.D. Policy Paper - Private Enterprise Development, Revised March 1985;
- A.I.D. Policy Paper - Co-Financing, May 1983 (see Annex C attached).

A. Impact of Trade on A.I.D. Policy Areas

The proposed PRE intervention offers positive results in several A.I.D. policy areas.

6.01 This is first and foremost a capital markets project as the trade bills and notes underlying each export into an LDC will be negotiable. This is expected to have a rippling effect on local and foreign markets that trade in "a forfait" paper.

6.02 Private sector development is promoted by helping privately owned firms gain access to U.S. capital goods through the credit enhancement features of this non-recourse export finance guarantee facility.

6.03 The project has considerable potential for institutional building in modifying the image of A.I.D.-assisted countries credit worthiness to the international trading and financial community acting as IFI's for this project.

6.04 An element of technology transfer exists in the movement of U.S. capital goods into A.I.D.-assisted countries upgrading their current production capabilities and introducing new manufacturing techniques.

B. Relationship to CDSS

This project meets the trade and development objectives of the CDSS for numerous USAIDs in the three A.I.D. regional bureaus.

C. <u>Relation to PRE Objectives and Policies</u>

This project also meets PRE's guidelines for management of Revolving Fund and Direct Guarantee Authority investments. These are as follows:

6.05 <u>Has a demonstration effect</u> by introducing a new financing mechanism as: (a) an additional source of suppliers credit for the importation of capital goods; and (b) an alternative to public sector subsidized facilities.

6.06 <u>Is innovative</u> by illustrating how A.I.D. can join with the private sector to mobilize additive trade credit on commerical terms for our client countries.

6.7 <u>Targets development impacts appropriate to A.I.D.-assisted countries</u> by responding to identified credit constraints on the importation of capital goods necessary for the expansion of the private sector in LDC's.

In addition, the project will meet the required guidelines as follows:

- Each guaranteed IFI will be for U.S. $3 million or less.
- PRE's guarantee is for 50% or less of each project.
- Subloans will be priced at market rates set by the IFI's.

A.I.D.'s direct guarantee will be issued under Section 108 (as amended) as legislatively permitted.

VII. MONITORING

Monitoring will be ongoing throughout the life of the project. A specific reporting form will be tailored to track performance under this guarantee facility.

Of interest to A.I.D. is the establishment of a base line of activity to our target market (A.I.D.-assisted countries) prior to our facility and periodically thereafter. This will be required to measure additionality and determine sustainability.

Key information to be tracked on a semi-annual basis will include:

- New countries accepted by IFI's as a result of our guarantee.
- Increased country risk limits for countries already serviced by IFI's as a result of our guarantee.
- New local banks accepted as avalizing institutions on "a forfait" notes as a result of our guarantee.
- Increased aval credit limits for local banks already acceptable to IFI's as a result of our guarantee.
- More favorable credit terms to SME's as a result of our guarantee, i.e., lower rates, large credit line, longer loan terms, etc.
- Others to be defined.

In addition, Midland Bank's financial health will be monitored to cover:

- Annual audited financial statements.

Responsibility for project monitoring will reside with PRE.

VIII. EVALUATION

The first evaluation of this demonstration project will be conducted by PRE two years following the initial issuance of our guarantee. The evaluation is intended to provide guidance to A.I.D. and Midland Bank as to adjustments in project design and implementation which would improve developmental results. Additionally, the evaluation will formulate conclusions as to the project's replicability by the regional bureaus and/or individual USAID's.

Specific issues to be addressed as part of the evaluation will include:

- Responsiveness of LDC importers and U.S. exporters to this method of trade credit.
- Distillation of the different procedures used by Midland Bank to deliver this credit to SME importers in A.I.D.-assisted countries.
- Identification of actions taken within A.I.D.-assisted countries and IFI's which have affected the success of this project.

The evaluation will be conducted by technical consultants retained by PRE.

IX. PROPOSED TIMETABLE - Midland Bank

° Summary of Concept	8/88	(Done)
° Investment Opportunity Proposal	11/88	(Done)
° Loan Review Board	12/88	(Done)
° Project Agreement Negotiations	1/89	
° Investment Proposal	2/89	
° Project Agreement Signing	3/89	
° First Disbursement	8/89	

X. REPLICATION

The linkage of trade with investment by U.S. companies tends to follow satisfactory trading experiences. U.S. companies, particularly mid-sized companies, want to learn about local operating conditions and business practices, and need a chance to identify suitable local partners, before exposing themselves to the risks of equity investment. This project is designed to assist that process.

Policy dialogues on trade is generally suspect by LDC officials for advancing U.S. commercial interests. Consequently, such dialogues tend to have limited impact on the LDCs trade policy. Assistance projects which focus on technical and administrative improvements in the absence of policy changes have disappointing results. USAID efforts to raise the level of sophistication of the public debate on trade policies encourage local interest groups to argue for policy changes or provide data and analysis to policy makers to demonstrate the efficacy of policy change, may contribute to locally self-generated policy changes. These limitations argue for long and sustained efforts by mission personnel, and flexibility to respond quickly but thoughtfully to opportunities. It is believed that this project can produce those opportunities.

In discussing trade related activities with host governments, USAID leverage may be limited as these activities often have a low priority on the part of the host government when they are competitive with other public sector activities for funding out of the A.I.D. country aid level. As a result, we encourage some provision for replication by the regional bureau's and PRE's Revolving Fund to insure a sizeable activity. The additive nature of this arrangement can insure host country acceptance.

Private sector projects are sometimes asked to serve many A.I.D. objectives to gain approval. In some instances, this causes the project design to become skewed and negatively impacts the core project objective. Every effort will be made not to over design follow-on projects. Modifications are expected, however, the crux of the project will remain trade credit for the benefit of SME's in A.I.D.-assisted countries.

This project covers activity No. 1. Follow on projects are envisioned as follows:

Activity No. 1 - FY 1989

- PRE
- $10,000,000 (total)
- European IFI's
- SME importers in selected A.I.D.-assisted countries

Activity No. 2 - FY 1990

- PRE and/or Regional Bureau's
- $10,000,000 (each)
- American and European IFI's
- Region specific (i.e., Africa)

Activity No. 3 - FY 1991

- Selected USAIDs
- $10,000,000 (each)
- American and/or local IFI's
- Country specific (i.e., Philippines)

It is believed that the long term, sustained effort required to influence trading patterns and produce a positive developmental impact can best be accomplished through the layering of projects.

The dissemination of information in the USA and in selected A.I.D.-assisted countries through a joint effort of USGA's is required to ensure the success of this initiative.

ANNEXES

A. Risk Analysis - Forfaiting

B. Financial Data on Midland Banking Group

C. A.I.D. Policy Papers

- Trade Development
- Private Enterprise Development
- Co-Financing
- Financial Markets Development

D. Technical Assistance Component

E. The Guide to Export Financing 1988, published by Euromoney Publications

ANNEX A

Risk Analysis

The issuance of an PRE guarantee as a suppliers credit enhancement for U.S. exporters selling to SME's in A.I.D.-assisted countries involves a number of significant risks, including but not limited to the following:

- Transactional risk in the default of the SME importer and/or their local bank which has avalized their notes.

  By allowing Midland Bank to select subborrowers under their normal credit and aval standards, this risk factor should be mitigated. Since IFI's will be at risk for at least 50% of the guaranteed trade notes we can assume a level of commercial prudence in acceptance of transactions to be housed under our guarantee.

- Country risk in the economic and political environment in which A.I.D. does business. This is a given we must accept as part of our developmental mandate. Our project is designed to support trade in those countries most in need of credit enhancement.

  Because of the maximum 5 year life of the subloans, and the bulk of trade credit being for shorter tenors, we have the same level of risk as the commercial lenders to these countries.

- Institutional risk in the credit and liquidity of the IFI's used to deliver this trade credit project. The risk of the importers is guaranteed (avalized) by their local bank. The risk of that local bank is shared 50/50 between the Midland Bank and A.I.D.

  The IFI we have selected is a major firm with substantial financial debth (see Annex B). It is most unlikely that they would fail during the seven year life of this project. As such, institutional risk is not a major factor in this project.

- Exchange risk in the non-convertibility of local currency to U.S. dollars to repay our guaranteed trade notes is the area of most concern.

  Under our guarantee to the Midland Bank, we not only guarantee repayment, but we stipulate repayment in U.S. dollars. As a result, the importer could fully repay his loan to his local bank in local currency, his local bank could be willing but unable to convert this local currency to U.S. dollars. This would trigger a call on our U.S. dollar guarantee even though the importer has delivered local currency for settlement. This is a key element of the "a forfait" market and our guarantee facility--it calls for repayment on time and in U.S. dollars.

  A.I.D. has no direct control on this risk factor and is exposed for up to 50% of the face value of trade notes not repaid in U.S. dollars. We see no available method to hedge this risk at this time.

- Legal risk in A.I.D. becoming the "holder in due course" of defaulted notes forwarded to us by IFI's once collection efforts have been exhausted. It would then be our decision to move into the courts, or not, to seek repayment. Based on past experience, this area has proven to be a sensitive one. Alternatives will be worked out with GC/PRE to address this concern.

These risk factors are present in many PRE projects and deemed manageable. Nevertheless, losses will occur.

With the conversion of the Revolving Fund to a direct guarantee authority leveraged off reflows, future activities will be even more dependent on the income streams from past projects. This project has only one income flow, the guarantee fee. In order to determine the total annual income flow and the level of losses it could support on a breakeven basis, Table 1 has been prepared.

TABLE 1

Fee Income on Guaranteed Notes

Fee Rate	Full Utilization	Annual Income 1/
1% p.a.	U.S. $2,500,000	U.S. $25,000

Assumptions

1/ Full disbursement of guarantee facility and funds available to cover losses.

In conclusion, it has been determined that this project has a limited income generation capability as compared to fully funded facilities that earn a fee and an interest rate. As a result, the risk of loan losses exceeding fee income is possible.

ANNEX B

Financial Data on IFI's

The consolidated financial statements for the Midland Banking Group are attached without comment.

Based on the size of our guarantee facility with Midland Bank in relation to their aggregate size in assets and known prime parentage, they are accepted as creditworthy and liquid without further analysis.

A copy of their latest annual report is available upon request. An independent credit report from "Moody's" is also attached.

Consolidated balance sheet

31 December 1987

Notes		1987 £m	1986 £m
	ASSETS		
12	Liquid assets	6,316	7,975
	Items in course of collection	690	579
	Certificates of deposit	1,186	527
13	Dealing assets	2,603	2,622
14	Investments	1,463	2,385
15	Debtors	864	1,388
16	Advances and other accounts	34,355	36,641
		47,477	52,117
17	Trade investments	21	24
18	Investments in associated companies	106	128
20	Premises and equipment	846	900
		48,450	53,169
	LIABILITIES		
21	Current, deposit and other customer accounts	41,679	46,082
	Notes in circulation	—	277
22	Other liabilities	1,895	1,970
		43,574	48,329
23	Deferred taxation	71	280
24	Long-term borrowings	317	273
25	Subordinated loan capital	945	1,094
26	Perpetual floating rate notes	858	1,082
	Minority interests	99	90
	Shareholders' funds		
27	Share capital	547	232
27	Share premium	1,036	276
28	Reserves	1,003	1,513
		2,586	2,021
		48,450	53,169

Consolidated profit and loss account

Year ended 31 December 1987

Notes		1987 £m	1986 £m
	Interest receivable	4,907	5,428
	Interest payable	3,314	3,757
	Net interest income	1,593	1,671
	Other operating income	1,124	1,099
	OPERATING INCOME	2,717	2,770
	Operating expenses	1,985	2,007
	Trading profit before charge for bad and doubtful debts	732	763
	Charge for bad and doubtful debts	230	357
	TRADING PROFIT	502	406
6	Share of profits of associated companies	9	28
	Profit before exceptional item	511	434
[illegible]	Exceptional item	(1,016)	—
	(LOSS)/PROFIT BEFORE TAXATION	(505)	434
8	Taxation	(58)	172
	(LOSS)/PROFIT AFTER TAXATION	(447)	262
	Minority interests	(9)	20
	(Loss)/profit before extraordinary items	(456)	242
9	Extraordinary items	63	—
	(LOSS)/PROFIT ATTRIBUTABLE TO MEMBERS OF MIDLAND BANK PLC	(393)	242
10	Dividends	90	63
	(DEFICIT)/RETAINED PROFIT	(483)	179
11	(Loss)/earnings per share	(125.3)p	77.5p*

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Five year summary

		1987 £m	1986 £m	1985 £m	1984 £m	1983 £m
Profit before exceptional item and taxation		511	434	351	135	225
(Loss) profit before taxation		(505)	434	351	135	225
Taxation credit (charge)		(58)	172	207	160	106
(Loss) profit before extraordinary items		(456)	242	122	62	118
(Loss) profit attributable		(393)	242	122	45	114
		£m	£m	£m	£m	£m
Shareholders' funds		2,586	2,021	1,847	1,655	1,844
Minority interests		99	90	235	486	483
Perpetual floating rate notes		858	1,082	892	–	–
Subordinated loan capital		945	1,094	998	1,294	971
Total capital resources		4,488	4,287	3,972	3,465	3,333
Current, deposit and other customer accounts		41,679	46,082	52,461	56,598	48,207
Advances and other accounts		34,355	36,641	41,473	44,858	39,106
Total assets		48,450	53,169	58,074	61,483	52,613
Return on average shareholders' funds						
– before exceptional item and taxation		24.1%	21.2%	17.5%	12.0%	12.5%
– before taxation		(24.9%)	21.2%	17.5%	12.0%	12.5%
Return on average equity						
– profit before exceptional item and taxation		23.6%	20.8%	16.4%	5.9%	10.3%
– profit before taxation		(23.3%)	20.8%	16.4%	5.9%	10.3%
– profit attributable		(18.9%)	12.5%	6.8%	2.5%	6.6%
Free capital ratio		8.3%	7.2%	5.9%	4.4%	4.6%
Loan capital ratio		38.8%	48.1%	41.8%	33.3%	26.8%
Average shares in issue (millions)	a	365	311	309	308	262
Earnings per share						
– adjusted for 1987 rights issue	a	(125.3)p	77.5p	39.4p	20.2p	45.1p
– before adjustment			104.2p	53.0p	27.1p	60.6p
Dividends per share	a	20.1p	20.1p	19.0p	19.0p	18.6p
Dividend cover	b	–	3.9	2.1	1.1	2.4
Shareholders	c	106,387	104,494	110,331	98,750	90,818
Average base rate		9.7%	10.9%	12.2%	9.7%	9.8%

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Midland Bank PLC

London, England

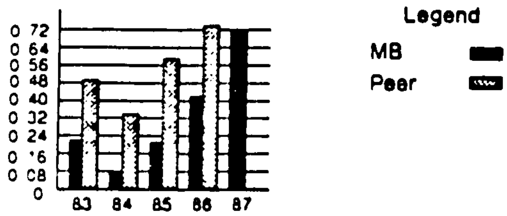
Ratings

Category	Moody's Rating
Bank Deposits	
Long-term	Aa2
Short-term	P-1
Long-Term Debt	
Senior	—
Subordinated	A2
Commercial Paper	P-1

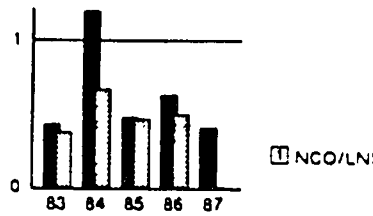
Contacts

Analyst	Phone
Stephen Shippie	(212) 553-1653
Jan B. Konstanty	

Return On Assets



Asset Quality [1]



Operating Statistics

Midland Bank PLC
[2] Peer Group Average

	[3] 1987		1986		1985		1984		1983	CAGR/Avg.
ROA (avg.)	**0.72**	0.74	**0.42**	0.59	**0.21**	0.34	**0.07**	0.49	**0.22**	0.04
ROE (avg.)	**18.95**	15.72	**12.49**	13.71	**6.79**	8.41	**2.51**	10.41	**6.60**	1.89
NCO % Loans	**0.41**	0.50	**0.63**	0.47	**0.48**	0.67	**1.20**	0.38	**0.43**	0.63
Net Int. Margin	**3.28**	3.46	**3.27**	3.36	**3.22**	3.50	**3.00**	3.64	**3.07**	3.17

Balance Sheet Statistics

Midland Bank PLC
[2] Peer Group Average

	[4] 1987		1986		1985		1984		1983	CAGR/Avg.
Assets (Bil L)	**48.5**	59.1	**53.2**	53.7	**58.1**	57.0	**61.5**	49.0	**52.6**	0.21
Equity (Bil L)	**2.6**	2.9	**2.0**	2.3	**1.8**	2.1	**1.7**	2.3	**1.9**	10.20
Equity/Assets	**5.34**	4.77	**3.80**	4.38	**3.18**	3.69	**2.74**	4.62	**3.61**	3.73
Res/Loans	**4.82**	2.54	**3.01**	2.51	**2.55**	2.23	**2.20**	2.08	**2.06**	2.93
NPA % Loans		0.74	**—**	1.34	**2.10**	1.97	**3.30**	1.65	**2.53**	—
NPA % Eq + Res		21.58	**—**	44.74	**75.09**	63.00	**109**	41.94	**68.40**	—

[2] Peer Group: Barclays Bk, Midland Bk, Nat'l Westminster Bk, Lloyds Bk, Standard Chartered Bk

[3] For the twelve months ended December 31 [4] As of December 31 [5] Compound annual growth rate.

Opinion

Moody's Aa2 rating of Midland Bank PLC for its long-term deposits is based on its strong market position in the U.K. despite the Crocker Bank experience which negatively affects earnings and capital position of the bank.

Midland retained certain assets after the sale of Crocker to Wells Fargo Bank. These assets included significant LDC exposure which has exacerbated the bank's current LDC situation. The bank has established provisions to cover up to 28% of its exposure to 30 troubled countries. However, existing LDC exposure remains a concern and a continuing brake on more substantive profitability. Midland combines its position as England's third-largest clearing bank (particularly in core deposits) with a generally prudent approach to lending to the developed world. These factors should continue to contribute to improved results in the intermediate term. The bank also has made a rights issue and disposed of certain low priority businesses to enhance its capital position. The announcement of an equity infusion from Hong Kong & Shanghai Bank further improves Midland's capital measures. We expect Midland will continue to focus on strengthening its capital measures. Rationalization of certain activities has already resulted from the group's new links with the Hong Kong and Shanghai Banking Corp., notably the closing of Midland's Institutional Equity Trading at Greenwell Montagu.

ANNEX C

A.I.D. Policy Papers

- Trade Development
- Private Enterprise Development
- Co-Financing
- Financial Markets Development

(Available upon request from PPC)

A.I.D. Policy Paper
Trade Development

U.S. Agency for International Development
Washington, D.C. 20523
July 1986

35

A.I.D. Policy Paper

PRIVATE ENTERPRISE DEVELOPMENT

(REVISED)

U.S. Agency for International Development
Washington, D.C. 20523
March 1985

36

A.I.D. Policy Paper

CO-FINANCING

U.S. Agency for International Development
Washington, D.C. 20523
May 1983

37

A.I.D. Policy Paper

Financial Markets Development

Bureau for Program and Policy Coordination
U.S. Agency for International Development
Washington, D.C. 20523

August 1988

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ANNEX D

Technical Assistance
Component

ANNEX E

The Guide to Export Finance 1988

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The Guide to Export Finance 1988

Published by Euromoney Publications

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CHAPTER 1

Forfaiting

By Robert Scallon, Barclays Bank PLC

In the introduction to this section, it was noted that the competitive climate, the debt crisis, the Consensus changes and the downturn in activity in the capital goods importing Third World countries had led to a constant search for alternative ways of utilising appropriate finance. One of the sources of finance which has become much more widely used in recent years is the forfaiting market.

Forfaiting

It must be said at the outset that, while there is no fixed definition of forfaiting, the following features are common to most forfait transactions:

a) without recourse to the exporter;
b) fixed interest rate finance;
c) guaranteed by a bank or other institution;
d) discounting of bills of exchange or promissory notes;
e) not insured by an official export credit agency or private insurance company.

The essential point about forfaiting is that it is flexible and the institutions providing the finance are ready to adapt the service to try to meet the needs of the exporter and the importer. Forfait (from the French) implies "non-recourse": the exporter is giving up his rights to the payment; the bank is waiving recourse to the exporter in the event of non-payment. The scenario illustrated in Exhibit 1.1 is a very simplified version of a typical forfait transaction.

What forfaiting is: how it works

Forfaiting is the non-recourse discounting of export receivables. It is a form of supplier credit, i.e., the supplier offers credit terms to the buyer and then sells the debt to the bank without recourse. Some non-banks also provide this service and this is implied whenever the words "bank" or "forfaiteur" are used in this chapter. It is probably more suitable for contracts where the supplier's obligations under the contract have been fulfilled by shipment of goods. Very large and complex contracts are usually better financed by a loan of some kind. Rather than insure the risk of non-payment by the buyer, the exporter asks for a bank guarantee of the trade paper. This provides for immediate payment in the event of buyer default. The guarantee is usually given by the importer's own bank which should know his financial condition best. Such a guarantee (or aval) makes the debt represented by bills of exchange or promissory notes more attractive to the forfaiting bank.

The bank guarantee can take the form of an aval or the bills or a separate letter of guarantee. An aval which takes the form of a bank signature on the face of the bills preceded by words such as "*Bon pour aval*" is simpler and preferred by the forfaiteur. A guarantee is a document separate from the bills and needs to be assigned when the bills are forfaited.

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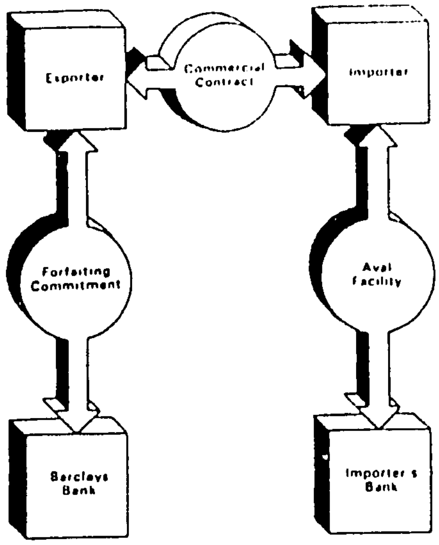
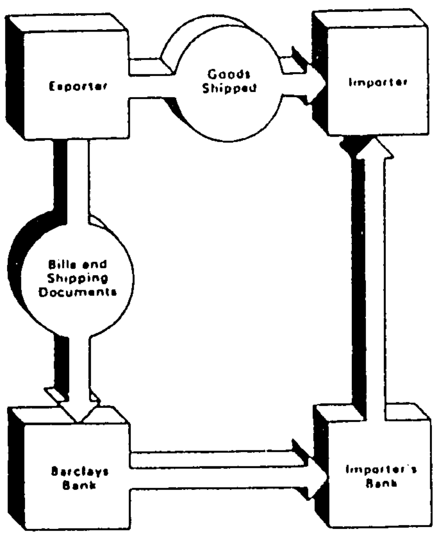
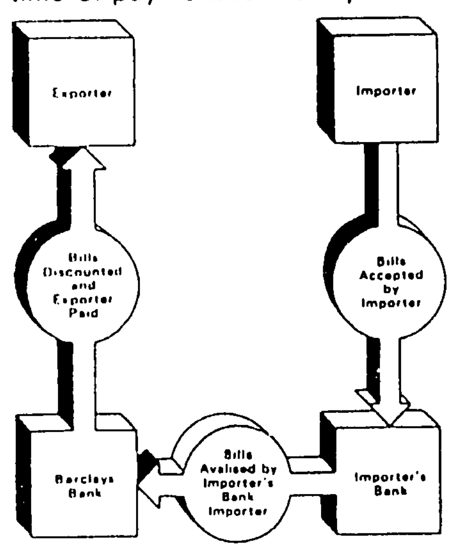
Events at the time of contract.



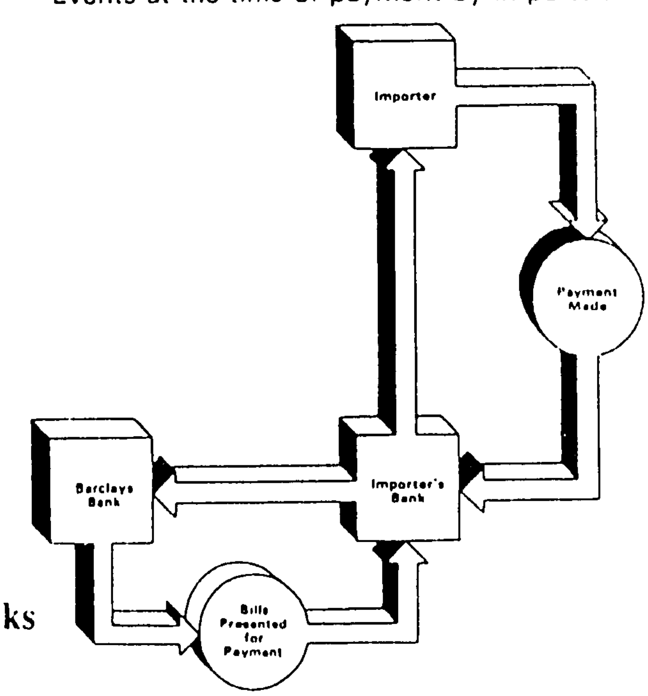
Events at the time of shipment.



Events at the time of payment to the exporter.



Events at the time of payment by importer.



: How forfaiting works

Forfaiting is appropriate for the medium and larger export contracts, particularly for those involving medium-term credit. Short-term credit or contracts of low value seldom lead to bills or notes and bank guarantees and, without these, a bank cannot so satisfactorily execute a discount (it might make an advance against the export receivables while also relying on the standing of the exporter).

These guaranteed bills or notes, examples of which are shown in Exhibit 1.2, are negotiable instruments which can be bought and sold by banks and other investors. (Where "bills" are referred to in this text, it usually covers promissory notes as well.) Having a secondary market for such forfait paper increases the ability of the bank providing forfait finance to the exporter to take on different risks and make quick decisions.

The bank aval removes the need to evaluate in depth the standing and credit-worthiness of the buyer. The forfaiteurs have essentially to consider the guarantor bank's standing and, of course, the importing country's economic situation. The commercial risk on the buyer has been eliminated for the forfaiteurs; but the bank risk remains and, more importantly, so does the country risk. Thus the forfaiteurs are able to come to quick decisions as to whether they will buy a debt or not.

There are two variations on this basic theme of forfaiting, the first being where the export has already taken place and the trade paper is immediately available for discount, the second where the exporter seeks the assurance from the forfaiting bank that the latter will buy the trade paper when it becomes available for discounting in the future (after shipment). In the latter case, the exporter usually requires to know what discount rate will be applied to the bills or note in the future. This will mean that any movements in interest rates in the particular currency between the time the bank commits to buy the trade paper at a particular discount rate and the time the discount takes place will not affect the exporter. This elimination of interest rate risk is similar to the protection against exchange rate movements which is provided by a forward exchange contract (or other similar hedging device). The forfaiteur is ready to assist the exporter with the calculation of the interest rate and amounts to be incorporated into the commercial contract.

Costs and fees

A commitment fee is charged by the bank for undertaking to forfait a transaction and to hold a discount rate for a specified period of time, typically up to 12 months. Similarly, there is a fee for giving the exporter an option to enter into such a commitment. This is usually called a bidding fee and is similar in intent to the "Tender to Contract" cover provided to exporters to cover them against exchange rate fluctuations during the time from the submission of their tender to the award of the contract.

Forfaiting quotations by banks are therefore expressed in terms of discount rates, commitment fees, bidding fees.

The discount rate is a reflection of the bank's cost of funds (usually expressed as LIBOR for the credit period concerned), plus a margin or premium above that for the risk the bank is taking and the profit it wishes to make. The discount rate will be applied to the face value of bills or notes being discounted, i.e., the principal and any interest added to it, and any fees charged will also be calculated by reference to the face value.

The only other major factor involved in a forfait quotation and therefore in the actual discounting is the so-called "days of grace". This is an estimate of the number of days' delay the forfaiting bank will experience before the funds reach the bank's own account. Any delays would otherwise cost the bank money which the bank would have difficulty recouping, since the exporter is no longer involved in the transaction and the importer

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Exhibit 1.2: Examples of instruments which can bear an aval

International BILL OF EXCHANGE (draft)

....
(place and date of issue)

....
(currency and amount in figures)

On .... (date) fixed

for value received, pay *against this bill of exchange*

to the order of .... (name of beneficiary)

the sum of .... (amount in letters)

effective payment to be made in .... (type of currency) only,

without deduction for and free of any tax, impost, levy or duty

present or future of any nature under the laws of .... (country of debtor)

or any political subdivision thereof or therein

This bill of exchange is payable at .... (domicile) .... (signature of drawer(s))

Drawn on .... (name and address of drawer (debtor))

Accepted .... (signature of drawer (debtor))

International PROMISSORY NOTE

....
(place and date of issue)

....
(currency and amount in figures)

On .... (date) fixed

for value received I/we .... (names of maker(s))

promise to pay *against this promissory note* to the

order of .... (name of beneficiary)

the sum of .... (amount in letters)

effective payment to be made in .... (type of currency) only.

without deduction for and free of any tax, impost, levy or duty

present or future of any nature under the laws of (country of maker(s))

or any political subdivision thereof or therein.

This promissory note is payable at .... (domicile) (signature of maker(s)) is unlikely to be interested. There is usually no reference to interest for late payment on the bills or notes and, in any event, it may not be the importer's fault that funds are late arriving: alternatively the importer may not be allowed by his authorities to pay delay interest. The days of grace are added to each maturity date and the discount calculated to that later date. The bank is thus deducting a charge for anticipated late payment.

The typical commitment fee is 1% p.a., and the actual level of fee is a decision for the forfaiteur on the particular risk. The bidding fee is set at a similar level but will be higher on the riskier transactions.

The discount rate is often referred to as a "straight discount rate" (this means simple discount, i.e., non-compounding, just as there is no compounding in simple interest). Alternatively, the rate is quoted as a "discount to yield"; this is shorthand for "a discount rate sufficient to yield an interest rate of". A discount to yield is therefore effectively an interest rate (comprising the cost of funds and the margin as previously explained), which can be compared to the interest rate charged on a loan to the importer for the same transaction. Most banks quote straight discount rates but can quote either, since they have the information to hand, thanks to microcomputers.

These microcomputers will also help the banks, and therefore the exporters, to work out the interest rates and amounts to be included in the commercial contract. It has already been explained that the discount rate is applied by the forfaiting bank to the face value of the bills or notes. The face value has been agreed between the buyer and the seller, but most exporters appreciate the assurance from the bank that a particular interest rate combined with a specific discount rate will be certain to provide the "cash price" they were seeking for the goods.

Banks provide these calculations and revise them during the negotiation period, as the contract value and currency change, the credit period and repayment programme alter, the interest rates fluctuate and the name of the guarantor bank is ascertained. However, it should be emphasised that the interest rate paid by the importer according to the commercial contract and the discount rate charged to the exporter by the bank are completely separate.

The interest rate laid down in the commercial contract is dictated by many things, e.g., government regulation, the importer's own wishes and the competitive situation, and does not depend only on the level of commercial interest rates. In some Middle Eastern countries, the central bank lays down that interest may only be paid at a rate of 7% or 8% p.a., regardless of the currency or the period. The Soviet Union is very specific about the interest rates it will pay for each different currency. The importer may insist on paying the Consensus rate or a rate more analogous to a soft loan. Indeed, the commercial contract may not specify an interest rate at all but simply the amounts payable at the various maturity dates (there being no breakdown between principal and interest).

Whatever route is followed, the commercial contract will specify how much the face values of the bills or notes are to be or how they are to be calculated. The discount rate quoted by the forfaiting bank will subsequently be applied to those face values. (Sometimes separate bills or notes are produced for interest, without the amounts being labelled interest; this does not affect the transaction.)

Discounting provides cashflow to the exporter, while non-recourse discounting eliminates risks of non-payment and any effect on his banking facilities. If the exporter wishes simply to eliminate the risk of non-payment but is happy to carry the funding himself, he will take out insurance, whether from an official export credit agency or from a private insurance company. Many large companies retain export receivables on their books; they may already have large cash resources or they may find it cheaper to borrow in their own names than to forfait the receivables. However, there is nothing to prevent the company from forfaiting the receivables at a later stage, e.g., when cashflow may

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be needed, when interest rates have fallen, when country risks have improved or when balance sheet date is approaching.

Timing

As part of the terms of payment in the commercial contract, the buyer and the seller will have agreed on how the bills of exchange or promissory notes are to be created. There are three ways in which "cash" terms of payment could be expressed:

1) cash before shipment;
2) cash after shipment, but with the bank's undertaking a guarantee that the payment will take place;
3) cash after shipment, but with the importer's undertaking that the payment will take place.

Similarly in a "credit" situation there are three ways:

1) Guaranteed bills in notes are provided to the exporter before shipment.
2) A documentary credit provides a bank's undertaking to accept term bills (or avalise them after acceptance by the importer).
3) The importer undertakes to obtain a bank's undertaking or guarantee to pay when the bills or promissory notes are presented to the bank with the shipping documents after shipment. (Normally the documents will be routed as in the second diagram of Exhibit 1.1.)

The forfaiteur is not concerned how the exporter obtains the debt instruments. He will not normally discount them until he has received them and found them to be in order. The decision on the method of obtaining the bills or notes lies with the exporter in conjunction with the importer and stems from experience and thus from the degree of trust in their trading relationship.

If the exporter can get the bills before shipment, the discount can take place very soon thereafter. If the shipping documents have to reach the importer before the bills or notes are completed and sent back to the exporter, the discount will be delayed, possibly for four to six weeks after shipment. The latter is more normal, since most buyers, and certainly most banks, will not commit their names to an undertaking to pay until the goods have been shipped. If the exporter has obtained the forfaiting bank's firm commitment to discount, he can rely on that and be confident that the importer will fulfil his side of the contract (he will have obtained a letter of credit and/or insurance of the pre-credit risks, if he felt them to be necessary).

The advantages of forfaiting

For the exporter

There are a number of advantages to the exporter, not all of which will, of course, apply in any given situation:

1) The finance is provided without recourse, once the exporter has fulfilled his obligations under the commercial contract and submitted the correct documentation to the bank. For the exporter, this non-recourse aspect means:
   a) fluctuations of interest rates during the credit period do not affect the exporter (if the bank has committed to a fixed discount rate in advance, then

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fluctuations of interest rates during the commitment period have similarly no effect);

b) fluctuations in exchange rates after the discount do not affect the exporter (assuming he has contracted in a foreign currency);

c) the risk on the buyer, the buyer's bank and the buyer's country has been eliminated;

d) the problems of sales ledger administration and payment collection are eliminated.

2) Thus, for the post-shipment period, there is no need to take out insurance, pay premia, make claims or wait during the claims waiting period.

3) The exporter can offer 100% finance, if that will help the importer or make the exporter's bid more competitive, providing the exporter is able and willing to forego a downpayment (assuming, of course, the forfaiting bank is happy with that arrangement).

4) The repayment programme can be flexible to suit the importer and the importing country's regulations. If a longer grace period before the first repayment or annual repayments or some other departure from normal practice will suit the importer's cashflow and is acceptable to the forfaiting bank, it can be incorporated. There are, of course, no internationally agreed credit terms to be adhered to, such as apply in conventional export credit.

5) The country of origin of the goods or their component parts is of no concern to the forfaiteur; he is interested in the buyer, the buyer's bank and the buyer's country. Thus there are no predetermined limits on "foreign content". This point is, of course, of particular importance when multi-sourcing is involved.

6) There are no firm rules as to whether certain goods qualify for short- or medium-term forfait finance. Each bank must make up its own mind whether the terms of payment are reasonable for the goods and contract value involved.

7) An account relationship with the forfaiting bank is not obligatory. The exporter can use the bank best suited to his purpose for each contract. Each transaction is dealt with and put together separately. Since the discount is without recourse, the bank will be happy to deal with non-customers (although it will wish to satisfy itself as to the *bona fides* of the exporter and his ability to fulfil the export contract).

8) The exporter's banking facilities are not affected by the forfait facility.

9) Little publicity attaches to forfait transactions; the competition will not know that this method of finance has been used and the importer may well not know that his bills have been discounted without recourse.

10) Forfait transactions can be put together quite fast and require relatively simple documentation. There is, for example, no complex or lengthy loan document to be agreed with a range of institutions and their lawyers.

11) On low risk countries, the pricing will be very fine; on high risk countries, the cost will be a lot higher but this may be preferable to financing the export with recourse to the exporter or not financing the export at all.

For the buyer/importer

The advantages to the importer are similar and inter-related:

1) speed, flexibility and simplicity;
2) 100% finance may be available;
3) goods sourced from different countries can be financed in the same package;
4) the repayment programme and interest rate can be made to conform to import regulations and can be adapted to cashflow needs;
5) if a letter of credit is not used, the related banking charges may be lower;
6) finance can be made available in a wide range of currencies;
7) availability of finance or credit, despite the absence of insurance cover from the public or private sector in the exporter's country.

For other institutions

Forfaiting also has some appeal to banks and other institutions. The marketability of the bills or notes gives the banks more flexibility. The banks can earn profits on the margins charged and on their treasury management. The banks are providing a wider range of export services to their customers, who will therefore not need to deal with other banks. They can acquire forfait assets in the secondary market, without necessarily having a large customer base.

Forfaiting and the official export credit schemes

Official export credit agencies tend to promote capital goods exports in one or both of two ways:

a) by insuring the exporter against buyer default and a range of political risks
b) by providing, or assisting in providing, fixed rate finance at preferential interest rates.

Since commercial banks are often involved in the provision of the finance, the agencies in some countries are prepared to provide some insurance cover or guarantee to the banks against default by the buyer or the buyer's bank.

However, when forfaiteurs seek to benefit from these schemes, the following problems arise:

1) The insurance policy is usually in the name of the exporter and provides for payment of a certain percentage of claims after a specified waiting period. How, for example, can the bank provide non-recourse finance to the exporter without the policy becoming void because the exporter no longer has an insurable interest?

2) How will the agency provide its guarantee for bills or notes? Will it avalise or endorse them? If so, the trade paper becomes a tradeable instrument with government backing. The ministry of finance or treasury which controls the issue of government securities and the pricing at which they are issued would probably be averse to the idea.

3) How would any interest rate support be provided in a fixed rate discount situation? The official agencies usually make up the difference between fixed preferential rates offered to the buyer and a floating commercial rate plus margin. This difference is settled at regular intervals throughout the credit period. They have

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not traditionally provided support by paying the difference between a preferential fixed rate and a commercial fixed rate plus margin, nor have they paid it up front in one lump sum (even in net present value form) at the time of discount. Making up the difference between two fixed rates would mean that the agencies could not take advantage of subsequent drops in floating interest rates nor suffer from subsequent rises in such rates. In addition, paying the difference "up front" would concentrate the interest rate support for the whole credit period in the current year's budget, with arguably undesirable effects.

4) The official agencies have tight rules about what goods qualify for fixed rate export finance, what credit periods are allowed, how much foreign content is permitted, what percentage of the risk must be borne by the exporter, etc. These rules contrast with the flexibility of the forfait market and with its non-recourse nature.

Some or all of these problems and questions have made it difficult for forfaiting to operate in conjunction with the official export credit agencies. In many cases these questions have been addressed only in recent years and differing and sometimes unclear answers have emerged.

In the UK, ECGD is considering the position but it is not currently possible to obtain ECGD's guarantee or interest rate support for forfait transactions. The insurance policy obtained by the exporter may be assigned to the forfaiting bank but recourse to the exporter will have to be retained for the uninsured portion. Furthermore, the claims waiting period complicates matters for the banks. Also there could be contractual disputes with the result that the insurance policy would not cover a claim and the forfaiting banks would be left exposed.

Eximbank in the USA is reviewing all these questions but has come to no firm conclusions. COSEC in Portugal and CESCE and ICO in Spain are also considering the position. The question does not seem to have been addressed in Japan.

COFACE in France insists on retaining recourse to the exporter or to the banks; the latter have their own COFACE policies which allow them to offer non-recourse finance to their customers (but without interest rate support). The only exception was supplier credit for sales to the USSR where COFACE will waive recourse, but banks are now able to provide non-recourse finance under COFACE cover for OECD and Middle East countries. In Belgium OND will provide insurance for capital goods exports being financed by banks on an *à forfait* basis up to Bfr50 million and Copromex will provide interest rate support. This enables the banks to offer non-recourse finance for their exporting customers but only 10% of supplier credits are done on an *à forfait* basis.

Swiss banks are prepared to take assignment of the exporter's ERG policy, which may permit the exporter to remove such supplier credits from his balance sheet; but the banks retain recourse for contractual disputes and the uninsured portion of the finance.

The Finnish Guarantee Board is prepared to guarantee 100% of an *à forfait* transaction but there is a two-month waiting period for claims. If commercial rates are used, the F-guarantee will be issued directly to the Finnish commercial bank concerned. If preferential rates are involved, the Finnish Export Credit Board will provide the credit.

In Austria, OKB provides the banks with a forfaiting policy which enables them to provide non-recourse finance to the exporter (they take the risk for the uninsured portion themselves) and to get the benefit of fixed rate refinancing provided by OKB.

In West Germany, Hermes is prepared to provide cover for exports financed *à forfait*. However, the regulations issued for this purpose are not proving popular with exporters and banks and the scheme is little used.

In Italy, where export insurance and interest rate support are administered sepa-

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rately, it is possible to obtain the latter on an *à forfait* transaction. Furthermore SACE permits the assignment of its insurance policy to the financing bank. The distinction between non-recourse and with recourse financing is somewhat blurred but in 1985 at least 30% of Italian exports involving medium-term credit were financed *à forfait*.

NCM in the Netherlands is prepared to provide a separate direct guarantee to Dutch banks for non-recourse supplier credit. This, therefore, provides some of the elements of *à forfait* finance but the exporter will also have taken out NCM cover.

The Export Finance and Insurance Corporation (EFIC), part of the Australian Trade Commission, can see no impediment to a finance house's insurance policy being used for a capital goods export and, if the transaction is eligible for Consensus rate finance, interest make-up could be paid to the forfaiting bank holding the policy. EFIC is also considering endorsing the trade bills or notes, thus providing its guarantee and creating highly tradeable paper.

In Canada EDC will provide its guarantee to the financing bank for 85% of the contract value but will not pay interest make-up to the bank. Alternatively, EDC will forfait the paper itself at commercial rates. Neither alternative has so far been widely used.

The situation generally regarding official support for exports financed *à forfait* is not clear and different agencies have adopted different postures. No doubt the position will change and be clarified, as most parties now probably see some merit in co-operation and compromise.

Special considerations

As a general rule, cross-border lending is more complex than domestic lending. Two or more sets of laws, regulations and systems are involved and, with supplier credit, where the credit is arranged through the intermediary of the supplier instead of directly to the buyer (as with a buyer credit or a domestic loan), an additional party is brought into play.

However, there are some considerations which particularly affect forfaiting, a few of which have already been mentioned:

a) The pricing, with the straight discount rate, the commitment fee, the bidding fee and the days of grace, is distinctive to forfaiting.

b) The fact that an aval is recognised under some countries' laws and not others (the laws of all EEC member states except the UK and Eire recognise it). The alternative is a bank guarantee or, in certain circumstances, a bank acceptance or a bank endorsement or a standby letter of credit.

c) The fact that the contract interest rate and the forfaiteur's discount rate are distinct and may be very different. The discount rate is applied to the face value of the bills from the date of discount to the maturity dates; the longer the discount is delayed, the shorter the period to maturity and therefore the greater the proceeds of the discount.

d) The amount of interest may be calculated in a different way from that of the discount. The calculation of interest tends to ignore weekends and bank holidays and to count 365 or 366 days in the full year. The bank doing the discount uses the convention of 360 days in the year (except possibly for sterling where 365 days is used) and takes the weekends and holidays into account (fees are calculated in the same way).

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e) Some guarantors limit the assignability of their guarantees. The Bank for Foreign Trade of the USSR issues its guarantees in favour of the exporter only. Any assignment has to be authorised by that bank, which reserves to itself the right to buy in the bills or notes on the same terms as those offered by the forfaiting bank. Algerian bank guarantees are not assignable at all. Indonesian banks are not authorised to issue guarantees.

f) The forfaiting bank has to take into account any stamp duty not paid on the bills or notes and any withholding tax that might be levied on the payment of the bills at maturity. Bank charges are also a consideration. The forfaiteur cannot turn to the exporter for reimbursement unless, perhaps, the latter has deliberately misled the bank or the two parties agreed on this at the outset.

g) The shipping date is important to the forfaiteur because it dictates the length of the commitment period and therefore the size of the commitment fee. Many banks find it difficult to enter into a fixed rate commitment more than 12 months ahead of shipment, as the risk of substantial interest rate fluctuations becomes greater and the political situation in the importing country more uncertain. The size of the fee is important if the exporter is going to include it in his contract price or in the interest rate to be paid by the importer.

h) The commitment fee is charged at a higher rate than on loans, essentially because of the risk the bank is running by taking on a fixed rate obligation. With loans the fee covers only the bank's commitment to lend and take on exposure to a particular risk, most importantly country risk. Such a fee is often charged at 0.5% p.a., whereas a forfait commitment fee is typically 1% p.a. This is normally payable quarterly in advance.

Forfaiteurs in the market

A growing number of banks and other financial institutions are offering forfaiting. It is very much an international market, with banks in Switzerland assisting Italian exporters, banks in Luxembourg doing it for German exporters and so on. The secondary market where banks can trade the bills or notes among themselves is largely concentrated in London, but Zürich remains an important centre and there are forfaiteurs in Paris, Geneva, Vienna, Brussels, etc.

There are three activities within the market: investing (buying trade paper with a view to holding it until maturity); trading (buying with a view to reselling in the near future); and broking (simultaneously buying and reselling). Most banks tend to concentrate on one of these approaches, whether they are buying directly from exporters or from other banks.

From the exporter's point of view, it makes little difference which philosophy his bank adopts, provided he gets a professional service at a competitive price.

Many banks use subsidiaries for forfaiting, as it is a specialised function requiring flexibility, a sophisticated treasury operation and quick decision-taking. The following is a list of some of the forfaiteurs (there are others):

Italian banks tend to use their London subsidiaries (Credito Italiano International, B.C.I. Ltd), although there are other centres (Société de Banque Européenne in Luxembourg).

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The **Swiss** operations are concentrated in Zürich, with a few in Geneva (SBV Finanz, Finanz AG, Banque Cantrade, Créafin, Compafina).

The **French** often use their London branches (Crédit Commercial de France, Société Générale, Banque Paribas), although they have operations in Paris (Intercomi and BDEI).

There are **consortium banks** in London in this field (International Commercial Bank, Scandinavian Bank).

East European banks have subsidiaries in London and elsewhere which provide forfaiting. The Bank for Foreign Trade of the USSR uses its Zürich branch and its subsidiaries which include Moscow Narodny Bank in London, Donau Bank in Vienna, East West United Bank in Luxembourg, Banque Commerciale pour l'Europe du Nord in Paris and Ost-West Handelsbank in Frankfurt. The Hungarians have Hungarian International Bank in London and Central Wechsel- und Creditbank in Vienna. Zivnostenska Banka (Czechoslovackie) uses its London branch.

The **UK clearing banks**, Barclays, Lloyds, Midland and National Westminster, all offer forfaiting, although only Midland uses a dedicated subsidiary (Midland Bank Aval).

For the **United States**, Chase Manhattan Bank, Security Pacific and Citibank provide a forfaiting service, as do Irving Trust and First Chicago.

The **Scandinavians** have in London the Union Bank of Finland, PK Banken and London Interstate Bank. Some have Luxembourg subsidiaries too.

The **German** banks have strong forfait operations in Luxembourg (Hypobank, Bakola), Zürich (Dresdner Forfaitierung) and London (Bakola).

A number of **non-banks** offer forfaiting. Some of them are brokers based in Milan, such as Fineurop and Eurofintrade. Paris has L'Lione, and there are a few in West Germany. London is the centre for a number of them (London Forfaiting Company, Kaines, PB Trade Finance), and they maintain other offices round the world.

The **Dutch** have Monaval in Zürich, N.M.B. Interunion in Paris and Amrobank in London.

Austrian forfait interests in London are represented by Creditanstalt and Österreichische Länderbank.

From **Canada**, Bank of Nova Scotia, C.I.B.C. and Bank of Montreal in London are interested in forfaiting.

Among **Australasian** banks, Westpac and A.N.Z. have forfaiting units in London.

This list is not exhaustive but it does demonstrate the broad spread of forfaiting banks in the market.

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