Article

Export Factoring – Reducing risks in International Transactions

CS Dipanjali Nagpal
dipanjali@vinodkothari.com
Vinod Kothari & Company
31st July 2015

Check at: http://india-financing.com/staff-publications.html for more write ups.

Copyright:
This write up is the property of Vinod Kothari & Company and no part of it can be copied, reproduced or distributed in any manner.
Disclaimer:
This write up is intended to initiate academic debate on a pertinent question. It is not intended to be a professional advice and should not be relied upon for real life facts.

Risks Faced in International Trade:

In international trade, business in often conducted on open account basis, the payment for the goods or services exported is received after delivery. In addition to credit burden the exporter is exposed to exchange rate risk associated with change in the value of the currency, political risk as a result of instability in a country with which trade is conducted, commercial risk due to the possibility of nonpayment and transfer risk associated with currency outflow restriction imposed by the foreign country's central bank or pursuant to a debt rescheduling plan. Exports play an important role in boosting economic growth, maintaining balance of payments and a strong currency hence it is necessary to encourage exports.

Export Factoring - Factoring in International Transactions:

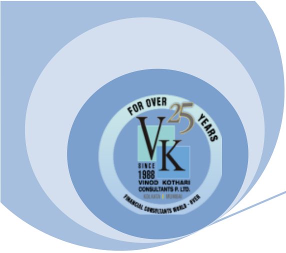
Factoring is a financial transaction in which a business sells its accounts receivables (i.e. invoices) to a third party (called the factor) in exchange for an immediate advance on the invoice value at a discounted rate. Factoring can be divided into various categories on the basis of the type of transaction. In international transactions factoring can be classified as i) Export and ii) Import Factoring.

When receivables due to an exporter are subject to a factoring arrangement it is called Forfaiting or Export Factoring. In Export Factoring an exporter sells receivables due to it from the importer by transferring or assigning them to a third party called the Export Factor or Forfaiter. This fulfills the exporter's immediate liquidity requirements, reduced credit burden and provides for better financial planning. Additionally risks associated with international trade are also transferred. The importer, whose receivables are transferred, now owes his liability to the Export Factor. The difference between the purchase price of the receivables and money received from the importer is the Export Factor's profit.

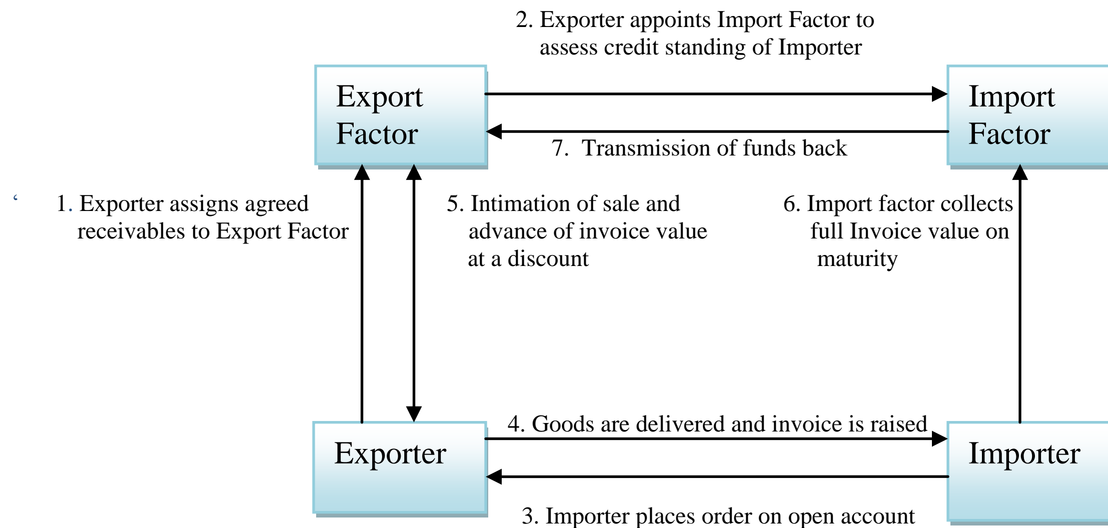
An Import Factor is appointed as a correspondent of the Export Factor in the country of the importer. The Import Factor assesses the credit worthiness of the importer and post shipment of goods or delivery of services, payment is received by the Import Factor on due date. Import Factoring enables the importer to purchase the goods from foreign suppliers on credit without letters of credit or bank guarantees.

If by virtue of the factoring arrangement receivables are transferred "without recourse", the export factor (purchaser of the receivable) must bear the loss if the account debtor (importer) does not pay the invoice amount. If the factoring arrangement provides for transferring the receivable "with recourse", the factor has the right to collect the unpaid invoice amount from the transferor (exporter). The question that arises here is whether recourse factoring is a true sale.[1]

[1] http://www.india-financing.com/images/Articles/Money_advanced_by_factor_a_loan_or_not.pdf



Process of Export Factoring - A diagrammatic representation:



Regulatory Framework for Export Factoring:

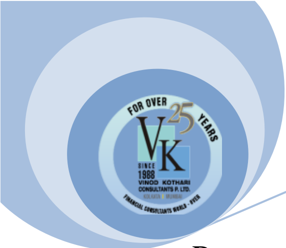
I. Salient Features of Factoring Regulation Act 2011

As per Section 2(p) "receivables" mean all or part of or undivided interest in any right of any person under a contract including an international contract where either the assignor or the debtor or the assignee is situated or established in a State outside India; to payment of a monetary sum whether such right is existing, future, accruing, conditional or contingent arising from and includes, any arrangement requiring payment of toll or any other sum, by whatever name called, for the use of any infrastructure facility or services.

As per Provisio to Section 7(1) Provided that if the debtor liable to pay the receivable or the business of factor is situated or established outside India, any assignment of receivable shall be subject to the provisions of the Foreign Exchange Management Act, 1999 (42 of 1999).

As per Section 26 the provisions of this Act shall have effect, notwithstanding anything inconsistent therewith contained in any other law for the time being in force or any instrument having effect by virtue of any such law.

As per Section 27 the provisions of this Act or the rules made thereunder shall be in addition to and not in derogation of the Negotiable Instruments Act, 1881 (26 of 1881), the Transfer of



Property Act, 1882 (4 of 1882), the Reserve Bank of India Act, 1934 (2 of 1934), the Banking Regulation Act, 1949 (10 of 1949), the Companies Act, 1956 (1 of 1956), the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (54 of 2002), the Micro, Small and Medium Enterprises Development Act, 2006 (27 of 2006) or any other law for the time being in force.

As per Section 31(d) the provisions of the Act shall not apply in foreign exchange transactions except receivables in foreign currency.

II. Applicability of Indian Stamp Act 1899

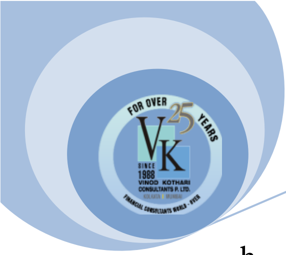
Section 8D of Indian Stamp Act 1899 exempts payment of stamp duty on all agreements for assignment of receivables in favour of a factor. There shall be no stamp duty costs for factoring arrangements, which were earlier liable for high rates of stamp duty and the duty applicable was state specific.

III. RBI's Notification[2] dated July 16, 2015

Authorised Dealer Category – I (AD Category –I) Banks have been permitted to provide export factoring services to exporters on 'with recourse' basis by entering into an agreement with the Import Factor (Overseas Institutions) without the approval of the RBI subject to compliance with guidelines issued by the Department of Banking Regulation in this regard. On the recommendation made by the Technical Committee on Facilities and Services to the Exporters AD banks have been permitted to factor the export receivables on a 'non-recourse basis', subject to conditions as under:-

a. AD banks may take their own business decision to enter into export factoring arrangement on non-recourse basis. They should ensure that their client is not over financed. Accordingly, they may determine the working capital requirement of their clients taking into account the value of the invoices purchased for factoring. The invoices purchased should represent genuine trade invoices.
b. In case the export financing has not been done by the Export Factor, the Export Factor may pass on the net value to the financing bank/ Institution after realizing the export proceeds.
c. AD bank, being the Export Factor, should have an arrangement with the Import Factor for credit evaluation & collection of payment.
d. Notation should be made on the invoice that importer has to make payment to the Import Factor.
e. After factoring, the Export Factor may close the export bills and report the same in the Export Data Processing and Monitoring System (EDPMS) of the Reserve Bank of India.
f. In case of single factor, not involving Import Factor overseas, the Export Factor may obtain credit evaluation details from the correspondent bank abroad.
g. KYC and due diligence on the exporter shall be ensured by the Export Factor.

[2] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=9945&Mode=0



h. If the aforesaid mentioned conditions are satisfied.

This notification is encouraging news for exporters who will be freed from the loss on account of default enabling them to do business in a wide range of countries with competitive advantage while reducing their risk on account of open account transactions in international trading.

As international trade grows Export Factoring is being accepted as vital to the financial needs of the exporters and is getting the necessary support from the government, specifically in the developing countries to stimulate this mode of funding.

Read our other articles on factoring visit http://www.india-financing.com/factoring.html