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RBI FAQs muddle up Factoring Business in India

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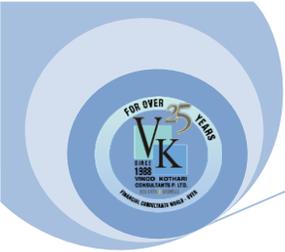
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Factoring as a form account receivables financing has been gaining momentum over the years now. The year 2014 witnessed the highest global volume ever in the history of factoring with volumes reaching as high as € 2.35 trillion. Further coming to India, the volumes witnessed a fall from € 5,240 million to €4,340 million accounting to a decrease of 17%. Also, the number of companies operating in the sector is 13 with 5 banks and 6 NBFCs. There are several factors which impede the growth of factoring in India¹. In this article we shall discuss how the RBI FAQs pertaining to NBFC-Factors pose a problem in the growth of NBFCs.

The background to the problem is a view, being taken by certain persons and authorities, that an NBFC cannot carry on the business of assignment of receivables at all, unless it is registered as a factoring company. The underlying basis for such a view is an FAQ of the RBI pertaining to the provisions of the Factoring Regulation Act, 2011, referred to later herein, which suggests that an NBFC either has to carry assignment of business in excess of 50% of its total assets, or has to bring it down to zero.

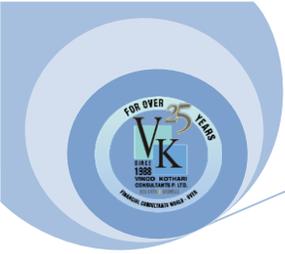
The Factoring Regulation Act, 2011 (“Act”) seeks to regulate the business of factoring in India. The Act, was passed, in line laws in several countries, to promote factoring, particularly cross-border factoring of receivables. As is quite often a travesty of law-making, a law may be passed to promote a business, but it ends up with a regulatory overtone. Thus, the law, admittedly enacted to promote factoring, was called the Factoring Regulation Act.

The preamble to the law provides its objective. It states: *“to provide for and regulate assignment of receivables by making provision for registration therefor and rights and obligations of parties to contract for assignment of receivables and for matters connected therewith or incidental thereto”*. While the preamble seems to suggest that the law is generically on assignment of receivables (so as to serve a detailed code, replacing sec. 130 of the Transfer of Property Act), the law is actually focused on assignments to factors, besides dealing with registration of factors.

In order to understand the operative provision relevant to the problem above, we first need to understand some key definitions – definition of a “factor” and definition of “factoring business”

Section 2(i) of the Act defines a *factor*, as follows:

¹https://www.india-financing.com/Factors_impending_factoring_why_is_factoring_not_picking_up_in_India_post_enactment_of_the_new_act.pdf



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*“factor means a **non-banking financial company** as defined in clause (f) of section 45-I of the Reserve Bank of India Act, 1934 (2 of 1934) **which has been granted a certificate of registration under sub-section (1) of section 3** or any body-corporate established under an Act of Parliament or any State Legislature or any Bank or any company registered under the Companies Act, 1956 (1 of 1956) engaged in the **factoring business;**”(Emphasis Supplied);*

The definition may be broken into 2 limbs as follows:

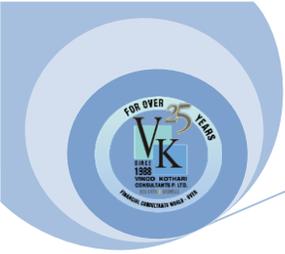
- (a) an NBFC which has been granted a certificate of registration under sub-section (1) of section 3; or
- (b) any body corporate established under an Act of Parliament or State legislature, or any Bank or any company registered under the Companies Act, 1956 engaged in factoring business.

The expression “engaged in the factoring business” evidently qualifies a body corporate under a law of Parliament or Bank or a company. In case of an NBFC, the grant of registration under sec 3 (1) of the Factoring Act will happen only if factoring is the principal business of such an NBFC. This is clear from NBFC Factor Directions, 2012, of the RBI, which defines an NBFC Factor as “a non-banking financial company as defined in clause (f) of section 45-I of the RBI Act, 1934 which has its principal business as defined in para 6 of these directions and has been granted a certificate of registration under sub-section (1) of section 3 of the Act”. Also, it is clear from both sec. 3 (1) of the Factoring Act as also the RBI Directions 2012 that registration as a factoring company can be granted by the RBI only to NBFCs. It is also evident that the expression “company registered under Companies Act 1956” does not include NBFCs, since NBFCs are explicitly covered by the first limb of the definition.

This brings us to the definition of “factoring business” in section 2(j):

*“factoring business means the business of acquisition of receivables of assignor by accepting **assignment of such receivables or financing, whether by way of making loans or advances or otherwise** against the security interest over any receivables but does not include-*

- (i) credit facilities provided by a bank in its ordinary course of business against security of receivables;
- (ii) any activity as commission agent or otherwise for sale of agricultural produce or goods of any kind whatsoever or any activity relating to the production, storage,



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supply, distribution, acquisition or control of such produce or goods or provision of any services;

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(Emphasis Supplied)

Section 2(a) of the Act defines *assignment*, it states that:

*“assignment means transfer by agreement, of undivided interest of any assignor in any receivable due from any debtor in **favour of a factor** and includes an assignment where either the assignor or the debtor, are situated or established outside India.” (Emphasis Supplied)*

The definition of “factoring business” also may be factorised into 2 limbs:

- (a) Acquisition of receivables by way of assignment;
- (b) Financing of receivables by way of security over the receivables, whether by way of loans, advances or otherwise.

There is an exception for grant of credit facilities by banks, but there is no exception in case of lending against receivables by any other person. Thus, even a loan against working capital is “factoring business” as per the clear definition of the law.

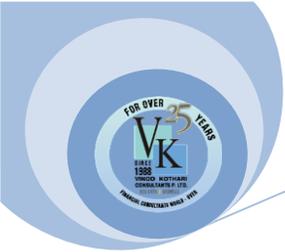
Section 3 of the Act deals with registration of factors. Section 3(1) of the Act states that:

“No factor shall commence or carry on the factoring business unless it obtains a certificate of registration from the Reserve Bank to commence or carry on the factoring business under this Act.”

Section 5 provides an exemption from the requirement of registration to banks, statutory corporations and government companies.

Further section 3(4) of the Act dealing with existing factoring entities empower the RBI to issue a registration certificate to an NBFC only and only if such NBFC carries on the factoring business as its principal business. The test provided to determine whether the ‘principal business’ of the NBFC is that of factoring is as follows:

- i. *If its financial assets in the factoring business are more than 50% of its total assets or such percent as may be stipulated by the RBI; and*
- ii. *If its income from factoring business is more than 50% of the gross income or such percent as may be stipulated by the RBI.*



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The NBFC Factor Directions ('Directions'), first issued vide notification of 23rd July, 2012², and later amended vide Notification No.DNBR.012/ CGM (CDS)-2015, dated March 27, 2015³ deal with registration of factoring entities. Direction 6 provides for the “principal business” requirement for an NBFC – Factor, as reproduced below:

“An NBFC-Factor shall ensure that its financial assets in the factoring business constitute at least 50 per cent of its total assets and the income derived from factoring business is not less than 50 per cent of its gross income.”

On combined reading of the above provisions of law, we can construe the following:

- a. No factor can carry the business of factoring, unless registered with the RBI
- b. Factoring business is construed to be a business of (a) either acquiring receivables by way of assignment; or (b) financing against receivables.
- c. Section 3 (4) of the Act states that an NBFC carrying factoring business as its principal business will need registration with RBI. The principality threshold will be the factoring business being 50% or more its income and assets or such as determined by RBI.
- d. RBI vide the Directions had notified the principality threshold to be at least 75% of its income and assets which was later revised vide Notification No.DNBR.012/ CGM (CDS)-2015, dated March 27, 2015 to be at least 50% of its income and assets.
- e. Therefore, it is only where an NBFC meets the principality threshold that the entity may obtain a CoR from RBI to be registered as an NBFC factor.

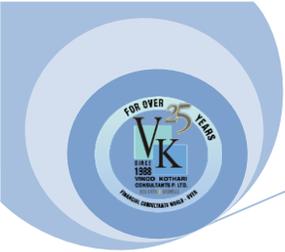
The language of sec 3 (1) is not “no **person** shall carry the business of factoring”. On the other hand, the language is “no **factor** shall carry the business of factoring”. Since a factor is defined to include an NBFC registered as a factor, and for registration, a principality of factoring activity is anyway a necessary condition, the provision of sec. 3 (1) ends up into a small circle – without being factor, you cannot carry factoring business; to be a factor, you have to be in factoring business.

On 3rd April, 2013, the RBI came out with its FAQs on NBFC-Factors⁴, which attempted to provide answers to questions relevant to factoring and NBFC-Factors. It is the FAQs that have created ambiguity on which entities can undertake factoring business. Some of

² http://rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=8159

³ <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=9623&Mode=0#N12>

⁴ <http://www.rbi.org.in/scripts/FAQView.aspx?Id=88>



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the answers from RBI indicate that there is a blanket bar on NBFCs other than NBFC-Factors to undertake factoring business at all. Relevant text of the FAQs are below --

“Q 4. What would happen with the existing companies registered with RBI as NBFCs and conducting factoring business that constitute less than 75 percent⁵ of total assets / income?”

Ans. Such a company shall have to submit to RBI, a letter of its intention either to become a Factor or to unwind the business totally, and a road map to this effect. The company would be granted CoR as NBFC-Factor only after it complies with the twin criteria of financial assets and income. If the company does not comply within the period as specified by the Bank, it would have to unwind the factoring business.

Q.6. If a company does not fulfill the principal business criteria for factoring and has no intention of getting itself registered as a Factor with the Bank, can it continue to do factoring activities with its group entities.

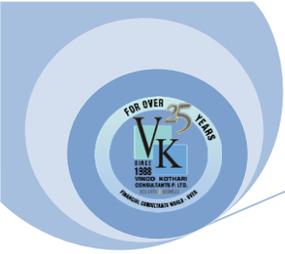
Ans : No. As per Section 3 of the Factoring Act 2011, no Factor can commence or carry on the factoring business without a) obtaining a CoR from the Reserve Bank, b) fulfilling the principal business criteria.”

If the answer to question 6 above is taken as stating the correct position of law, it will lead to an impossibility, illustrated by the following:

- NBFC, carrying factoring business, < 50% of total assets – cannot carry factoring business at all
- NBFC carrying factoring business > 50% of total assets – needs registration as NBFC-Factor, and can carry factoring business.

However, this is an impossibility. Evidently an NBFC will need registration as a factor, only if its factoring business reaches principality threshold. However, reaching the principality threshold itself is a process. No company can ever reach the principality overnight. If a company strategically decides to reposition itself into receivables financing business, it obviously has to start the business of receivables financing and gradually grow it over time. But then, if sec. 3 (1) is interpreted to mean that one cannot commence the business of factoring at all, until one reaches 50%, we are actually creating an impossibility, because we are almost like stipulating that from the very first day, the business has to be principal business, while at the same time, making sure that one never reaches there.

⁵ The same was amended to 50% vide Notification No.DNBR.012/ CGM (CDS)-2015, dated March 27, 2015



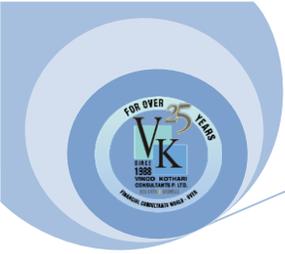
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It is an established maxim of law that law cannot impose an impossibility - *lex non cogit ad impossibilia*.

In fact, the absurdity arising from the circular language of sec. 3 (1) read with the definitions can easily be resolved, if we interpret the definition of “factor” and “factoring business” in the light of principality. The definition of “factor” in sec. 2 (i) does not say, a factor includes an entity engaged in factoring business, whether as principal business or otherwise. It simply talks about an entity engaged in factoring business. This should evidently mean, an entity engaged in factoring business either as the only business, or as principal business. Any other interpretation will lead to an absurd situation, because the definition of “factoring business” includes lending against receivables. With the exception of credit facilities granted by banks, no one will be able to give loans against receivables, because that will amount to being engaged in factoring business. So, all working capital lending by NBFCs, and indeed, all financing of receivables by all non-financial entities, will also be completely barred.

The admitted purpose of the Factoring Act was to promote factoring and financing of receivables, and not to stifle or scuttle the same. If the interpretation taken by the RBI in its FAQs is accepted, we are constricting factoring business to a handful of companies registered as NBFC-Factor, while denying not just factoring, but even working capital financing, to the 10000 –plus NBFCs. Surely, this interpretation does not achieve the purpose of the law, which was stated in the Statement of Objects and Reasons as follows:

“The Reserve Bank constituted a Study Group in January, 1998 under the Chairmanship of Shri C. S. Kalyansundaram, former Managing Director, State Bank of India for examining the feasibility and mechanics of starting factoring organisations in the country and making recommendations regarding its theory, constitution, organisational set-up, scope of activities and other related matters. The Committee had noted that inadequacy of working capital finance with its attendant liquidity problem has been one of the major stumbling blocks in the viable running of small scale industry units and recommended that factoring for small scale industries could be mutually beneficial to both factors and small scale industry units. Besides, the said Committee, various other Committees set-up for alleviating the problems of small scale industry units, by the Government and the Reserve Bank during the last decade [including the Prime Minister’s Task Force on Micro, Small and Medium Enterprises (2010)] have also recommended development of factoring services for small scale industries through policy and legislative prescriptions to address the problem of liquidity for the micro or small industries.



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RBI's FAQs are merely FAQs. They are the responses of the RBI staff based on interpretation of the law made by them. Neither are the FAQs a law, nor are they subordinate law. On the other hand, the only feasible interpretation which sustains the meaning of sec. 3, while at the same time serving the objects of the law, is that if an entity is principally engaged in factoring business, it must seek registration as an NBFC Factor with the RBI. If it is engaged in factoring business, but as a non-principal business, it cannot be granted registration anyway, but that does not mean it cannot carry on factoring business at all, as such an entity is not a “factor”.

To view our other articles on factoring click here: <http://www.indiafinancing.com/factoring.html>

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