India Factoring Report 2014

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Contents

Introduction

Factoring is a financial transaction and a type of debtor finance in which a business *sells* its accounts receivable (i.e. invoices) due from their debtors to a third party (called a factor) in exchange for an immediate advance on the invoice value at a discounted rate. Factoring allows businesses to cash in on their sales immediately without having to wait for payments to come in from customers in due course.

Generally, there are three parties involved in factoring transaction: a) the *factor* who purchases the receivables, b) the *seller* who sells the receivables, and c) the *debtor* who has the obligation to make payment to the seller.

A graphical representation of a factoring transaction is given below:

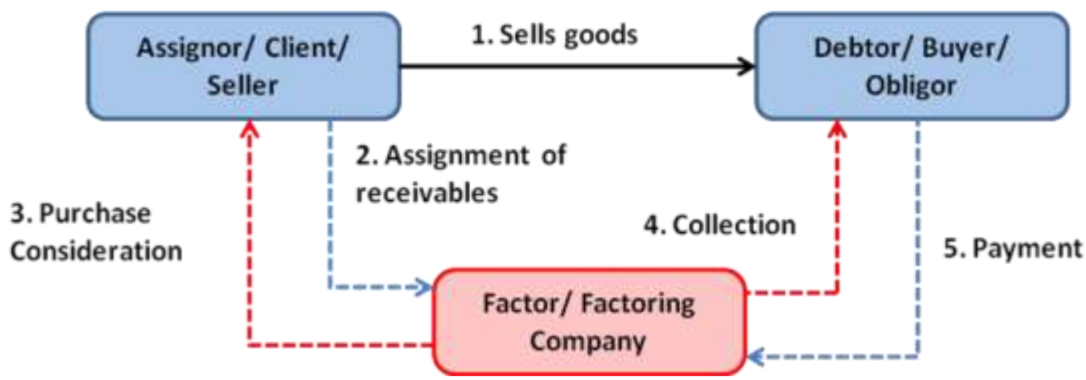


Figure 1: Process of Factoring

The concept of factoring dates back to the Roman Empire. Factoring progressed with the ever advancing business world and the concept picked up in the 19th century. In 1904, first account receivables financing company was formed in Chicago in the form of the CIT Group. Other asset based lenders began cropping up such as Mercantile Credit Co. of Chicago, later known as Continental Credit Trust (1908), Commercial Credit Co. (1920, Baltimore), Walter Heller & Co. (1920, Chicago), James Talcott & Co. (1935-36), Milberg Factors (1936) and Rosenthal & Rosenthal (1938). Factoring, later spread to the rest of the world in the late 1900s.

In the present day, factoring is defined to include the functions of:

(1) purchasing accounts receivable;
(2) guaranteeing the seller against customer credit failures;
(3) billing, ledgering, and collecting the receivables; and

(4) financing clients' operations, either by advances before maturity against the accounts purchased, or by loans on the security of stocks on hand or in the process of manufacture.

Legal Status of Factoring as a form of business

Identifying the important role played by factors in helping businesses to mitigate their credit risks and providing financial help to entities, the English Parliament, in 1695, passed an act providing for licensing and regulating terms of credit, and governing the time and the method of settlement between client and factor to protect the interest of a factor's operations.

Thereafter United States passed an Act in 1823 which provided the framework on factor's lien. New York was the first state in the United States to facilitate factor's liens. New York was the hub of import trade and a prominent textile distributing centre and sales market. It was primarily on this account that a large number of companies engaged in factoring emerged in New York. In 1910 the New York legislature passed a bill which provided that liens upon merchandise or the proceeds thereof, when created by agreement for the purpose of securing advances made or to be made, should not be void, provided only that the name of the person in whose favour lien was created and his designation as factor should be posted at the entrance of the place where the merchandise was stored. However this bill was vetoed by Governor Charles Evans Hughes on the ground that "it would ... facilitate secret liens and fraudulent transactions."

In 1911, the Bill was reintroduced with amendments requiring that a notice be filed setting out briefly the name and place of business of the lienor, the name of the person creating the lien, his interest in and the general character of the merchandise, and the time for which the agreement was to run. This became the Factor's Lien Act. Thereafter it has been amended several times. It applies not just to "factors," for the use of the term is a misnomer, but was designed for the benefit of lenders, including banks. This Factor's Lien Act of New York has been widely adopted by other American states with or without modifications.

The Government of India is a latecomer to the enactment of an act regulating factoring business. The Factoring Regulation Act, 2011 came into force on February, 2012 and has been discussed in detail in the following sections.

Economic Justification of a factoring transaction

Factoring is a form of asset based funding whereby factors purchase/ provide advances against the accounts receivables and facilitates raising funds against receivables.

Some of the motivations of factoring are as follows:

1) Small and mid-sized companies which are growing fast and are in need of working capital finance find it difficult to raise capital through traditional bank finance because of lack of assets which can be kept as collateral for such borrowing. Their main assets are the accounts receivables. Factoring aids these SMEs by providing them with the much needed working capital finance and eliminating the need of collateral in most cases.

2) In traditional working capital financing from banks, the extent of financing depends upon the working capital gap which is assets minus liabilities. However the level of financing under a factoring transaction is based on only the value of the assets being assigned. This results in higher amount of funding leading to lower weighted average cost for working capital finance.

3) Another advantage of funding through the factoring route is the benefit of accelerated cash flows. By purchasing the accounts receivables of clients, factors allow them to render goods on credit to customers thereby eliminating the discount factor on cash sales. Also by providing cash in lieu of the receivables, a factor enables its clients to make prompt payments to supplier and cash upon the discounts offered by such suppliers.

4) Factoring improves the debt culture in a company by getting recovery of the dues from such receivables within due dates. By assignment of debts, the assignor also passes of the responsibility of collection of such debts by the factors. When such responsibility of collection is outsourced to external agencies the possibility of default and delayed payment gets reduced, primarily because these factors undertake a through credit rating of such debtors before entering into the assignment agreement.

5) It is an add-on method of funding and does not reduce other lines of credit available. Factoring enables clients to avoid increasing short-term debt burden and increases return on capital.

Advantages of factoring

Financial Benefits		
Sl. no.	**Particulars**	**Details**
1.	Improves Liquidity	Traditional working capital finance is based on working capital gap (assets – liabilities). Factoring is based on asset only. Hence amount of funding goes up leading to lower weighted average cost for working capital finance.
2.	Preservation of Equity	Typical bank lending norms stipulate minimum equity for working capital gap, which is not the case with factoring transactions.
3.	Improves current ratio	The amount tied up in account receivables released by way of factoring may be used to pay off the current liabilities. This may have the effect of improving the current ratio position of the client.
4.	Cashflows become accelerated	By availing factoring facility the client can render credit to customers and eliminate discount paid to them. With the cash received, clients can then make prompt payments to the supplier and encash discounts offered by them.
5.	Reduction of short-term debt burden	Factoring enables clients to avoid increasing short-term debt burden and increase the return on capital.
6.	Increase in operating leverage	By releasing of funds from operating assets, the factoring process allows more investment in fixed assets thus increasing the level of operating leverage.
7.	Cheaper purchase cost	Faster payment for liabilities results into cheaper cost of purchases
8.	Off-balance sheet source of funding	Factoring is an off-balance source of funding leading to the balance sheet becomes lighter
Non financial benefits		

Sl. no.	Particulars	Details
1.	Credit Security	In case of factoring (non-recourse) the seller of receivables is free from the risk of bad debt. The factoring transaction acts like a shield to the seller and there by facilitating an effective credit control measure.
2.	Credit discipline	Receivables get realised on dates when collected by an external agency. Further, the factor's professional approach in collecting of debts inculcates a discipline among the customers which becomes seller's permanent asset.
3.	Add-on method funding	Factoring is an add-on method funding and does not reduce other lines of credit available
4.	Advantageous for SMEs	It is the most preferred way of financing for SMEs since it avoids the delays, as is the case for obtaining bank finance. Further there is regular reporting requirement to banks which is not the case with factoring.
5.	Collateral not needed	For obtaining bank finance, companies are required to keep their assets as collaterals for securing the payment. In factoring, the invoices serve as collateral and there is no need for additional collaterals for security. These collaterals may be preserved for long-term funding requirements of the company.

How is factoring different from traditional bank financing?

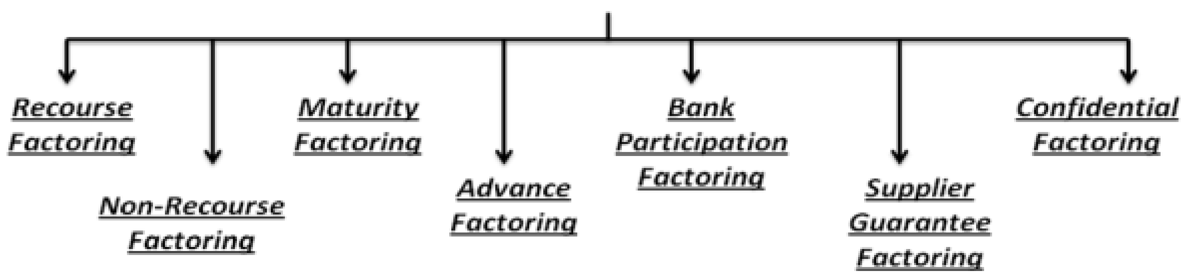
Sl. no.	Bank Financing	Factoring
1.	There is a loan/line of credit extended.	No loan is extended. Accounts receivable are discounted and payment is made by the factor to the seller.
2.	Debt servicing is an additional burden.	Financing is executed based on outstanding receivables. There is no additional burden of debt servicing
3.	Funding is done with collateral security.	Usually without collateral unless the ticket size is large.

4.	Lines of credit/funding limits are increased with additional collaterals/guarantees etc.	Access to finance increases with the increased accounts receivables which the company generates.
5.	Credit facility is extended generally to clients with established track records.	In this case the credit worthiness of the debtor is most important.

Types of Factoring

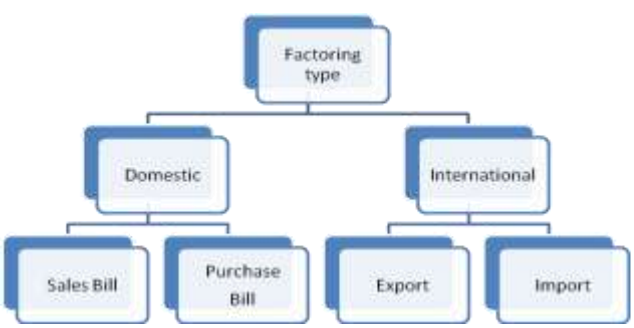
A factoring transaction may be divided into various categories based on the transaction type:

Types of Factoring

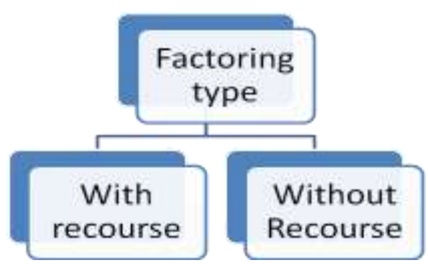


Factoring can further be classified on the basis of:

(i) Geographical Distribution



(ii) Credit Risk Protection



Below we discuss the aforementioned types of factoring:

- **Recourse Factoring** – As the name suggests the factor has recourse to the client in case of non-payment by the debtor. While the debt is assigned, the credit risk remains with the client.

- **Non-recourse Factoring** – It is also called old line factoring, wherein the risk of non-payment of invoices is borne by the factor. The factor does not have recourse on the client after the assignment of receivables takes place.

- **Advance Factoring** – Factors providing financial accommodation at the time of assignment of debt is advance factoring. The factor keeps a margin while funding, which is the client's equity and is payable on collections from the debtor. The factor pays the value of the receivables in advance and charges a higher factoring fees.

- **Maturity Factoring** – Is where the factor pays for the bills purchased at the time of maturity of the bill. Here the client is typically interested in non-fund based services from the factor.

- **Bank Participation Factoring** – Bank lends an amount equal to the client's equity in the assigned receivables and creates a floating charge over the same. This results in double financing for the client.

- **Supplier Guarantee Factoring** – This is also called *drop shipment factoring*. Here the client is typically an intermediary between the supplier and the customer. The factor guarantees the supplier for the invoices raised by the supplier on the client. The supplier raises bills on the customer and assigns the same to the factor. The supplier is able to make profits without financial involvement.

- **Confidential Factoring** – Where the factoring arrangement is confidential and the client continues to act as servicer with the customer and does not intimate the customer of the assignment.

- **Sales/ Purchase Bill Factoring** – It is the most common type of factoring whereby the assignor sells invoices (account receivables) to the factoring company in exchange of immediate advance of invoice value which enables companies to generate upfront cash on their sales. The factor in turn makes collection of receivables from the debtor.

- **Export Factoring** – Export factoring is the sale of foreign accounts receivable by an exporter to a factoring company at a discount, where the factor assumes the risk of default of the foreign buyer and handles collection on the receivables. It is seen as an alternative to letter of credit, as the importers insist on trading in open account terms. Export factoring eases the credit and collection troubles in case of international sales and accelerates cashflows thereby assisting in credit risk mitigation and provides liquidity in the business.

- **Import Factoring** - Import factoring enables n importer to purchase the goods from foreign suppliers on credit without letters of credit or bank guarantees. After entering into import factoring of receivables, the importer makes the payment to the import factor instead to the supplier.

Overview of Factoring Industry Globally

Factoring is now universally accepted as vital to the financial needs of small and medium-sized businesses. It has the support of government offices and central banks throughout the world. As international trade continues to increase, the opportunity for the factoring industry is growing at the same pace. Because international factoring works in a similar way to domestic factoring, exporters have realised that it can help them to become more competitive in complex world markets. Factoring as a form account receivables financing has been a widely acceptable mode of asset-backed financing world-over. During the year 2013, the total global factoring volume reached a record high of € 2.2 trillion which represents an increase of around 3% over a comparable data of the year 2012[1].

China continues as the world's largest traditional receivables finance markets accounting for a factoring turnover of about € 3,78,128 million[2]. The other significant players in the factoring industry, apart from China is predominantly occupied by the European nations such as UK & Ireland with 15.1% share, France with 9.2% share, Italy capturing 8.2%, Germany with 7.9% and Spain having 5.3% of the total international factoring volume. Europe accounts for a little over 60% of the total factoring volume in the world as the end of 2013 which has remained almost flat when compared to last year. This share has shrunk dramatically from 72% in the year 2007.[3]

It is worth noting here that Asia has gained in overall market share in the last six years. From the total factoring turnover recorded in 2007, Asia's market share more than doubled to 29% in 2013, with China leading the group capturing over 60% of Asia's total volume, followed by Japan and Taiwan.

[1] http://www.ifgroup.com/wp-content/uploads/2014/06/2013-Overview-Markets.pdf
[2] http://www.ifgroup.com/wp-content/uploads/2014/06/2013-Report.pdf
[3] http://www.ifgroup.com/wp-content/uploads/2014/06/2013-Overview-Markets.pdf

Evolution of Factoring in India

In 1987 the Working Group Committee on money market, headed by Mr. N. Vaghul first introduced the idea of factoring services in India.

Regulatory Framework for Factoring in India

Basic law of Transfer of Receivables

1. Transfer of Property Act
2. Stamp laws

Regulatory Statutes

1. Factoring Act
2. RBI's guidelines for factoring companies
3. Basic regulatory framework for NBFCs.

Payment Mechanism and certainty of Payments

1. Negotiable Instruments Act
2. Payment and Settlements law
3. MSME law
4. Foreign Exhange Management Act, 1999.

Registration of Security Interests/ Transfers

1. Registration provisions under

Kalyanasundaram Study Group set up by the Reserve Bank of India in January 1988 examined the feasibility and mechanics of starting factoring organisations in the country paved the way for provision of domestic factoring services in India.

On 2nd July, 1990, the RBI issued guidelines on the conduct of factoring services in India.

In 1991, The Banking Regulation Act, 1949 was amended to include factoring as a form of business in which the banks might engage.

Reserve Bank of India issued guidelines permitting the banks to set up separate subsidiaries or invest in Factoring companies jointly with other banks -

Several banks set up subsidiary companies

Some banks started these services departmentally.

On 22nd January, 2012, the Factoring Regulation Act, 2011 and the Registration of Assignment of Receivables Rules, 2012 were introduced.

The Non Banking Financial Company – Factoring (Reserve Bank) Directions, 2012 was introduced by the RBI on 23rd, July, 2012.

The Factoring Regulation Act, 2011

The Factoring Regulation Act, 2011 ('Act') was enforced to regulate and bring about a clarity to the process for assignment of receivables by making provision for such assignment to be complied with by 'Factors'. Before the introduction of this Act, the industry was unregulated and there were no clear guidelines for carrying on the business of factoring.

The Act formally defined the terms 'factoring business', 'factor', 'receivables' and 'assignment', among others to give them a legal validity.

Some salient features of the Factoring Act, 2011 are as follows:

a) Amendment to the Indian Stamp Act 1899, by inserting Section 8D, which 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.

b) Every factor to register the particulars of every transaction of assignment of receivables in its favour with a central registry, set up under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SARFAESI Act).2 A centralized database was aimed at reducing frauds and facilitating factors to verify whether a certain set of receivables had already been assigned in favour of a third party.

Registration [Section 3]

1. No factor shall commence / carry on business of factoring unless it obtains certificate of registration from RBI.
2. The Act clarifies that any Non Banking Financial Company (NBFC) engaged in factoring business as its principal business will have to have more than 50% of its financial assets/ income from factoring business.

Offences and penalties under the Factoring Act [Chapter VI]

- Failure to file assignment or realisation

  - Fine of Rs 5000 per day
  - Fines are imposed by criminal prosecution
  - Obligation attaches to every person who was responsible for business of the factor.

- Where the factor does not comply with the RBI directions, RBI may impose a penalty which may extend upto Rs. 5 lakhs and in case of continuing offence with an additional fine which may extend upto Rs. 10,000 for every day of continuing offence.

- Where there is contravention in compliance with the provisions of this Act or rules made thereunder and for which no specific penalty provisions have been provided for, he shall be punishable with imprisonment for a term which may extend upto one year, or with fine, or with both.

Applicability of Foreign Exchange Management Act, 1999

Where the debtor liable to pay receivables is situated/ established outside India, the provisions of FEMA Act shall be applicable. **[Section 7]**

Foreign Direct Investment in Factoring Companies

Factoring is one of the 18 activities listed in FDI circular. Hence, FDI in factoring companies is permitted which is subject to the usual minimum capitalisation norms.

Indian Factoring Market Overview

Post the enactment of the Act, the conditions existing at the macro and micro level have begun to show positive movement, which were undermined in absence of legal framework for regulating the factoring industry. However, it's still a long way to go as the factoring volumes have not gained much momentum in India and still offers an untapped market.

The Indian market constitutes a mere 0.23% of the world's factoring market and is constantly growing. In the year 2013, the total industry turnover was Rs. 39600 crores approx.[4] (Year 2012: Rs. 24000 crores) with a mere 0.37% GDP penetration[5]. The figures of 2013 indicate an exponential growth of about 82% from last year's figure[6].

The chart below compares the factoring market of India with that of other prominent Asian countries for the years 2013 and 2012[7] .

Country	Factoring Volume in 2013 (in €)	Factoring Volume in 2012 (in €)	Growth %
India	5,100	2,800	82.14%
China	3,78,128	3,43,750	10%
Hong Kong	32,250	18,000	79.17%
Indonesia	2,000	2,100	(4.76)%
Japan	80,000	98,100	(18.45)%
Taiwan	73,000	70,000	4.29%

Table 2: Volumes of Factoring

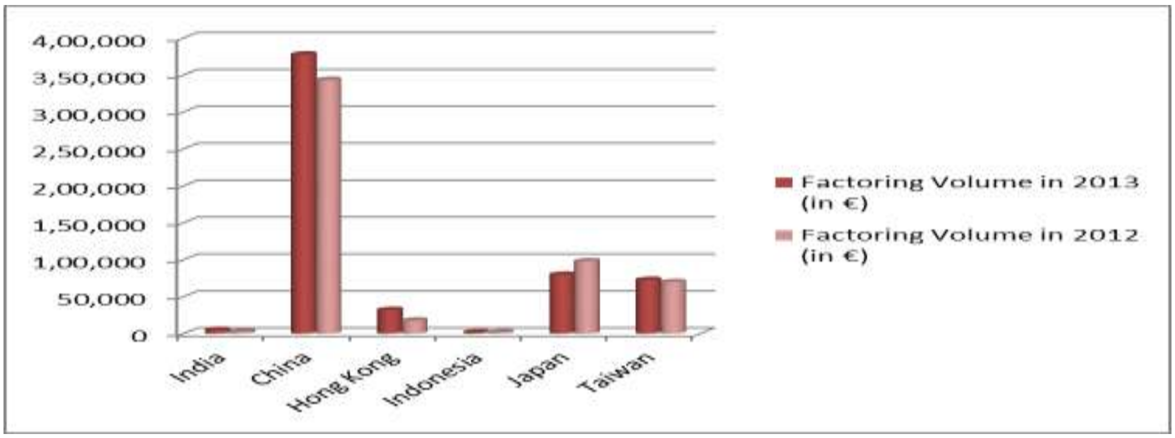


Figure 2: Factoring Volume

[4] €5100 million converted into Indian Rupees
[5] http://www.ifgroup.com/wp-content/uploads/2014/06/2013-Report.pdf
[6] when compared with the € figures
[7] http://www.ifgroup.com/wp-content/uploads/2014/06/2013-Report.pdf

Players in the Factoring Industry

At present there are 13 entities providing factoring services in the country. The figure has not seen any change from last year. The following table gives a list of the players in the factoring industry in India:

Sl. No.	Names	Type of Entity
1.	India Factoring and Financial Solutions Pvt. Ltd.	NBFC-Factor w.e.f. 4th February, 2014
2.	Canbank Factors Limited	NBFC, awaiting registration as an NBFC-Factor
3.	SBI Global Factors Limited	NBFC. Upon request by the company, the RBI permitted extension of time for the company to convert into an NBFC-Factor by March, 31, 2014
4.	IFCI Factors Limited	NBFC-Factor w.e.f. 27th December, 2013
5.	HSBC	Bank
6.	DBS Bank Ltd., India	Bank
7.	Export Credit Guarantee Corporation of India Ltd	Insurance Company
8.	Standard Chartered Bank	Bank
9.	Societe Generale	Bank
10.	Citibank N.A.	Bank
11.	Virtue Financial Services Pvt. Ltd.	NBFC
12.	NexGen Financial Solutions Pvt. Ltd.	SEBI Registered, Merchant Banking Company
13.	Bibby Financial Services (India) Private Limited	NBFC

Performance review of top Factoring Companies in India 2013-14

The following table provides a comparison of various performance parameters of 4 Indian factoring NBFCs *viz.* Canbank Factors Limited, SBI Global Factors Limited, IFCI Factors Limited and India Factoring and Finance Solutions Private Limited.

Our own study of Factoring volumes and other parameters were based on the results of our survey of the published balance sheets of these companies which, to our knowledge, are engaged in factoring business.

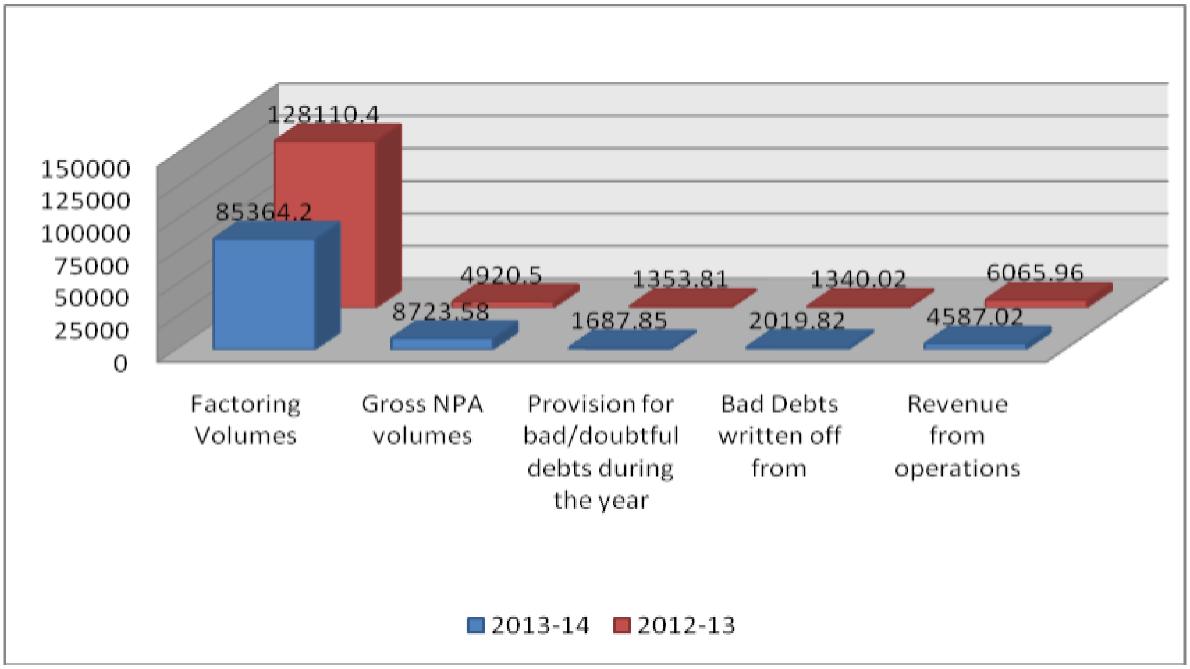
(In Rs. Million)

Parameters	CanBank Factors			SBI Global Factors			IFCI Factors			India Factoring		
	2013-14	2012-13	Change (%)	2013-14	2012-13	Change (%)	2013-14	2012-13	Change (%)	2013-14	2012-13	Change (%)
Factoring Volumes	27114.2	31230.4	**-13.18**	29600	54920	**-46.10**	28650	41960	**-31.72**	NA	NA	**--**
Gross NPA volumes	1299.59	956.4	**35.88**	4330	3470	**24.78**	2377.37	494.1	**381.15**	716.62	NA	**--**
Provision for bad/doubtful debts during the year	176.78	101.3	**74.51**	655.9	1010.5	**-35.09**	694.77	103.19	**573.29**	160.4	138.82	**15.55**
Bad Debts written off from	18.95	0	**--**	1534.4	970.3	**58.14**	219.89	209.12	**5.15**	246.58	160.6	**53.54**
Revenue from operations[8]	803.64	956.37	**-15.97**	1234.6	2196.2	**-43.78**	1337.33	1764.85	**-24.22**	1211.45	1148.54	**5.48**
Profit before tax	160.75	261.71	**-38.58**	-403.1	103.8	**-488.3**	-492.3	282.26	**-274.4**	58.6	30.62	**91.38**

As can be seen from the above table, FY 2013-14 has not been all that great for the factoring industry with the factoring turnover dipping from the last reported figures. Further there has also been an increase in the NPAs of factoring companies which can be a major cause of concern. Most of the above companies have suffered losses in the year with SBI Global Factors reporting a loss of over Rs. 403 million. The figures are not very encouraging of the state of the industry at the moment.

[8] Includes discounting charges, interest income earned, factoring charges, processing fees, set-up charges and application and administration charges

The above data has been represented graphically below for better understanding:



In this section we have reviewed in detail the financial statements of the top 5 factoring companies based on which we have derived various ratios as follows:

Particulars	**Canbank Factors Limited**			**IFCI Factors Limited**			**India Factoring and Finance Solutions Pvt Ltd**			**SBI Global Factors Ltd.**			**Bibby Financial Services (India) Private Limited**		
For the year ended 31st March	**2014**	**2013**	**2012**	**2014**	**2013**	**2012**	**2014**	**2013**	**2012**	**2014**	**2013**	**2012**	**2014**	**2013**	**2012**
Income /Total assets (%)	11.20	14.32	12.94	14.38	12.54	10.62	14.55	15.37	8.73	11.51	13.40	12.28	16.76	16.08	NA
Expenditure / Total Assets (%)	8.98	10.44	10.19	10.65	8.62	7.39	13.85	14.96	7.74	15.21	12.78	16.04	NA	NA	NA
Operating Exp[9] /Total Assets (%)	3.50	2.52	2.41	1.39	0.88	0.71	6.84	7.18	3.21	10.19	5.72	8.84	NA	NA	NA
Net NPA (%)	7.69	5.95	3.02	NA	NA	NA	4.20	NA	NA	14.55	10.82	8.50	NA	NA	NA
Return on Total Debts factored[10] (%)	6.63	10.24	9.38	5.75	13.32	14.98	8.54	8.44	5.58	1.50	8.41	3.85	NA	NA	NA
Return on Net Worth[11] (%)	5.46	10.01	9.74	-28.71	12.00	17.79	2.05	1.45	3.60	-15.47	0.85	-15.59	0.00	-18.76	4.79
Net worth (A) (Rs. millions)	1941.571	1858.964	1731.282	1237.747	1601.931	1412.217	1887.258	1848.546	1371.781	3681.9	4251.7	4215.3	281.942	486.6144	577.8982

[9] Operating Expenses = Total Expenses- Interest Expenses –Finance cost
[10] Return on Total Debts Factored = EBIT / Total Debts Factored
[11] Return on Net Worth = PAT / Net Worth

Particulars	Canbank Factors Limited			IFCI Factors Limited			India Factoring and Finance Solutions Pvt Ltd			SBI Global Factors Ltd.			Bibby Financial Services (India) Private Limited		
For the year ended 31st March	**2014**	**2013**	**2012**	**2014**	**2013**	**2012**	**2014**	**2013**	**2012**	**2014**	**2013**	**2012**	**2014**	**2013**	**2012**
On Balance Sheet Liability[12] (B) (Rs. millions)	4545.278	4234.588	6883.843	6983.458	9888.364	10550.72	5926.763	5288.174	6492.555	4971.5	9531.3	16651.4	126.932	288.7892	354.4143
Debt/ Equity Ratio (B/A)	2.28	3.98	3.98	5.64	6.17	7.47	3.14	2.86	4.73	1.35	2.24	3.95	0.45	0.59	0.61
Debts factored/ Total Assets Ratio	1.16	1.15	1.13	0.88	0.90	0.88	0.90	0.97	0.99	0.88	0.91	0.89	2.41	1.96	1.55
Growth in total debt factored (%)	8%	-25%	NA	-32%	-5%	NA	4%	-9%	NA	-37%	-29%	NA	-32%	5%	NA
Above 6 month receivables / total debts factored (%)	19.71	16.25	8.86	24.56	3.30	2.01	NA	NA	NA	35.78	27.12	15.82	65.26	30.28	20.66
Doubtful receivables/ total debts factored (%)	18.00	15.83	8.73	24.56	3.30	2.01	9.39	4.85	1.26	36.27	28.38	16.56	30.57	11.45	2.21
Funds in Use/ Total debts Factored (%)	82.99	83.97	86.95	84.86	81.15	69.32	NA	NA	NA	NA	NA	NA	67.16	57.21	65.30

[12] On Balance Sheet Liability = Long term borrowings+ short term borrowings + current maturity of Long term borrowing

Based on the figures above, it is very clear that the performance of the top factoring companies of India have been on a lower side during the year as compared to the year earlier. The doubtful debts have almost doubled up as compared to the last year also indicates poor quality of assets. The return on net worth has succumbed to almost half of last year's figure. Also what is alarming is the fact that the debt to equity ratio for most of these companies is very low. Considering the scale at which these companies operate, the fact that most NBFCs would leverage 6 to 7 times, it surely is incomprehensible for factoring companies to operate on such low leverage levels.

The poor performance of the top factoring companies indicates a not so favourable business environment for the factoring players. One of the potential reasons for this downfall can be the prevailing macro-economic conditions indicating a slower growth rate of the economy.

Challenges faced by the industry

One of the main factors responsible for the slow progress of the factoring industry attributes to the sluggish growth of the SME sector, which contributes 90% of the revenue for factoring industry. Factoring companies make available the much needed working capital finance to these MSMEs who may not be in a position to obtain enough bank finance due to lack of collateral or credit profile.

MSMEs play a critical role in economic empowerment of a large segment of the population and make sizeable contribution to the GDP and have been growing constantly. Despite its significant role in the inclusive development, the MSME sector still struggle with limited resources and remained stressed for liquidity. The slow development of large infrastructure projects have also impacted the smaller players like SMEs who had been sub-contracted parts of such infrastructure projects.

The general slowdown in the growth of the economy with widening trade deficit, depreciation of rupee and rising inflation, all have a role to play in the weak performance of the factoring sector.

General lack of awareness about factoring as a product has also been responsible for not witnessing new entrants in the business despite the regulatory aid through the Factoring Act being effective. To add to this, RBI's stand on the entities that can carry out factoring business (through the FAQs on factoring) have also led to ambiguity in this segment.

When compared to the international scenario, factoring in India faces certain drawbacks, namely:

- Lack of awareness among users
- Non-availability of Credit Insurance in India
- Factors in India generally insist on payment by way of post dated cheques which serves as additional security for the factoring companies. In case the cheque bounces, the factor has recourse under Section 138 of the Negotiable Instruments Act 1881.
- Limited reach since the major customers of this kind of financing is typically the SMEs who find this route more preferable as bank loans are not easily available to them

These factors serve as a hindrance to the growth of factoring in India since most of the assignor's are mid-sized corporations and SMEs who do not have collaterals to mortgage. Alternatively, if they had such readily available collaterals, they would have met their working capital needs through normal banking channels instead of factoring.

This pictures India as a country which is risk averse. All these safeguard measures to secure payment boils down to one reason – non-availability of credit insurance to the factoring companies. Another deterrent is the non-approachability to the debt-recovery tribunals by these factoring companies which makes them more cautious about defaults in payment.

Further banks are better placed to offer such services. When compared to banks, NBFCs possess some disadvantages inter alia, non-availability of owned funds, high-cost short-term borrowings for providing factoring services, higher interest rates etc. Further, banks facilities are fully secured, whereas it is mostly unsecured in case of factors. The higher cost of funds for factors, coupled with high operations cost, unsecured facility and thin spreads is making the environment highly challenging for the factors. On the other hand the bank rates are 1%-2% lower than that of the factors and the facility is fully collateralized. Also banks do not prefer parallel lines from factoring company along with their lines of credit as in case of priority of claims there may be issues with regard to their claims being subordinated to factor companies.

Regulatory developments in the Factoring Industry

Change in the principal business criteria

The RBI came out with a notification dated November 10, 2014[13], whereby the principal business criteria for the NBFC-Factors has been reduced to 50% from 75%, i.e. now the factoring companies should ensure that its financial assets in the factoring business constitute at least 50 per cent of its total assets and its income derived from factoring business is not less than 50 per cent of its gross income.

Establishment of a Trade Receivables Discounting System (TreDS)

The introduction of a trade receivables exchange platform by the RBI, vide its notification[14] dated 3rd December, 2014 is another step in the direction to enhancing the visibility of factoring in the Indian Economy. The notification of the RBI implements a concept paper on 'Micro, Small & Medium Enterprises (MSME) Factoring-Trade Receivables Exchange', issued earlier in March, 2014[15].

The motive behind the idea of the trade receivables exchange is to provide a platform where an eligible seller i.e. Micro, Small and Medium Enterprises (MSMEs) and a buyer for its receivables could put up on the exchange such receivables for purchase or factoring by eligible financiers. The receivable so financed becomes a "factoring unit[16]" and becomes eligible to be traded on the Exchange by way of secondary market transactions too.

Brief of TReDS

Scheme:

The TReDS will facilitate the discounting of both invoices as well as bills of exchange. Further, as the underlying entities are the same (MSMEs and corporate buyers) the TReDS could deal with both receivables factoring as well as reverse factoring so that higher transaction volumes come into the system and facilitate in better pricing. **The transactions processed under TReDS will be "without recourse" to the MSMEs.**

[13] http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=9328&Mode=0
[14] http://www.rbi.org.in/scripts/bs_viewcontent.aspx?Id=2904
[15] http://rbi.org.in/scripts/bs_viewcontent.aspx?Id=2804
[16] Factoring unit refers to an invoice or a bill which has been uploaded on the system for financing. This is a standard nomenclature used in the TReDS for such invoice or bills of exchange. Such Factoring Units may be created by either the MSME seller (in the case of factoring) or by buyers (in case of reverse factoring).

Participants

MSME sellers, corporate buyers and financiers – both banks and non-bank (NBFC factors) will be direct participants in the TReDS. The TReDS will provide the platform to bring these participants together for facilitating uploading, accepting, discounting, trading and settlement of the invoices / bills of MSMEs. The bankers of MSMEs and corporate buyers may be provided access to the system, where necessary, for obtaining information on the portfolio of discounted invoices / bills of respective clients. The TReDS may tie up with necessary technology providers, system integrators and entities providing dematerialisation services for providing its services.

Eligibility to set up and operate TReDS

Entities desirous of setting up and operating the TReDS should fulfill the eligible criteria in three aspects:

a) Financial Criteria:
   1. Minimum paid up equity capital shall be Rs. 25 crore
   2. Foreign shareholding in the TReDS would be as per the extant foreign investment policy
   3. Non-promoter entities cannot have shareholding in excess of 10% of the equity capital of the TreDS

b) Due Diligence of Promoters:

Promoters / promoter groups should be 'fit and proper', which would be assessed by the RBI depending on their past record of sound credentials and integrity; financial soundness and track record of at least 5 years in running their businesses.

c) Technological Capability:

1. Should be able to provide electronic platform for all participants;
2. A robust MIS system with real-time dissemination about bills/ invoices, discounting and quotes;
3. A suitable Business Continuity Plan including a disaster recovery site;
4. Online surveillance capability which monitors positions, prices and volumes in real time so

Regulatory framework

The TReDS would be governed by the regulatory framework put in place by the Reserve Bank of India under the Payment and settlement Systems Act 2007. The activities of the TReDS as well as those of the participants in the TReDS would be governed by the relevant legal and regulatory provisions. As such the processes and procedures of the TReDS should be compliant with such legal and regulatory provisions which may be issued and amended from time to time by respective authorities.

How TReDS work?

The functioning of TReDS can be divided into two phases –

(i) In the first phase, the TReDS would facilitate the discounting of the factoring units by the financiers resulting in flow of funds to the MSME with final payment of the factoring unit being made by the buyer to the financier on due date.

(ii) In the second phase, the TReDS would enable further discounting / re-discounting of the discounted factoring units by the financiers, thus resulting in its assignment in favour of other financiers.

Though it is too early to say how beneficial and successful the TReDS system is going to be for the factoring industry, this is surely going to raise an interest among the financial sector to test shallow waters and access its effectiveness.

Future Outlook

Factoring and reverse factoring has not gained much momentum in India and still offers an untapped market. Factor products offer greater flexibility compared to other instruments used for working capital finance. The availability of timely and adequate bank finance without the necessity of collateral (since most of the factoring facilities are generally provided without collaterals) and third party guarantee is the major requirement of small first generation entrepreneurs.
The inherent nature of factoring is providing a complementary service to that of banks. They provide the much needed working capital for the SMEs, particularly those who possess good quality receivables but find it difficult to secure a bank limit due to lack of collateral or credit profile. Through availing factoring services these SMEs can improve the cash flow and liquidity of their business besides availing the other services viz. sales ledger accounting, collection of receivables and credit advisory services.

Though the current scenario looks unfavourable for the factoring industry with not many players in the market and growth being stunted, we hope that the position improves in the near future. By the enactment of the Factoring Regulation Act, 2011, the Regulators have tried to bring a standardized framework to the industry which has great potential to boost the economy in the times to come.

The Act has introduced several reforms to the way factoring has been carried out in India. It has not only reduced the tax incidence from the industry from doing away with the payment of stamp duty on assignment of receivables but has also clarified the relationship between assignor and assignee.

In order to enhance transparency in the Industry the Act requires every factor to register the particulars of every transaction of assignment of receivables with a central registry set up under SARFAESI Act, which aims to curb double financing of debtors and safeguards the interests of the factors.

The Government of India has taken several steps in order to revamp the industry. In the Union budget of 2012-13, the Central Government has made a budgetary provision of Rs. 500 crores to set up a Factoring Guarantee Scheme in line with the Credit Guarantee Fund Trust for Micro and Small Enterprises, which provides collateral free credit to MSMEs with credit limits upto Rs. 1 million which have proven to be significant for the development of the sector[17]. SIDBI has been entrusted with the task of setting up the Scheme.

Export factoring is another lucrative area which the players may venture into. International turnover posted by IFCI Factors for the FY 2013-14 amounts to Rs.

[17] As on January 31, 2013, the scheme's coverage in terms of numbers is about 1 million with guarantee covers for an aggregate loan amount of over Rs 48,000 crore

750 million and has been ranked as the 9th most improved export factor, the only Indian entity among the top 10) amongst the 270 odd Factors that are members of the FCI in overall performance and service quality rating, over the last year's rating.

In wake of the reforms and facilities being provided to the factoring companies, the intent of the regulators is clear though the intent may not have come as a reality as on date. The immense potential that this segment portrays, it is expected that the factoring will pick up and become the new buzzword in the financial services sector.