# Fractured Factoring: Amendments may give a push to a potent trade finance solution

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## Background

In 2012, the Factoring Regulation Act, 2011[1] (Act) was enacted to regulate the assignment of receivables to factors, provide for the registration of the factoring companies carrying on factoring business, and lay down the rights and obligations of parties to the contract for assignment of receivables.

The preamble to the law provides its objective as follows – "*to provide for and regulate assignment of receivables by making provision for registration therefore 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 the assignment of receivables (to serve a detailed code, replacing section 130 of the Transfer of Property Act), the law is focused on assignments to factors, besides dealing with registration of factors.

Though the said Act was framed to regulate factoring, but the legislation failed to promote it. The result has been quite obvious, given the years of existence of the law, factoring continues to be at a low level.

It is quite difficult for a regulator to understand the exact setup when a business needs protection, promotion, and motivation, rather than just protection. There is always a trade-off for regulators in market liquidity and protection. However, excessive regulation tends to defeat the purpose of regulation itself. Factoring in India has been one such sector in finance which never took off either due to excessive regulation or structural issues in the way of conducting business.

In January 2019, the Reserve Bank of India had constituted an expert committee on micro, small and medium enterprises under the Chairmanship of Shri U.K. Sinha to suggest long-term measures for the economic and financial sustainability of the said sector. Considering the recommendations of the committee, amendments were proposed in the Factoring Regulation Act, 2011. Consequently, in September 2020, the Factoring Regulation (Amendment) Bill, 2020[2] was introduced in Lok Sabha, to address the aforesaid issues to a certain extent. The Bill has been referred to the standing committee and is yet to be passed by the Lok Sabha.[3]

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[1] The Factoring Regulation Act, 201- http://legislative.gov.in/sites/default/files/A2012-12.pdf
[2] https://www.prsindia.org/sites/default/files/bill_files/Factoring%20Regulation%20Bill%2C%202020.pdf
[3] There has been some confusion because of erroneous report that the bill has been passed.

This write-up intends to discuss the situation of factoring globally and specifically in India and then get into the details of the proposed amendments, the rationale behind the changes, and the likely impact.

## Global Trends

Factoring is now universally accepted as vital to the financial needs of small and medium-sized businesses. As international trade continues to increase, the opportunities for the factoring industry are growing at a similar pace. Factoring has helped businesses become more competitive in complex world markets. Factoring, as a form of account receivables financing, has been a widely accepted mode of asset-backed financing world-over.

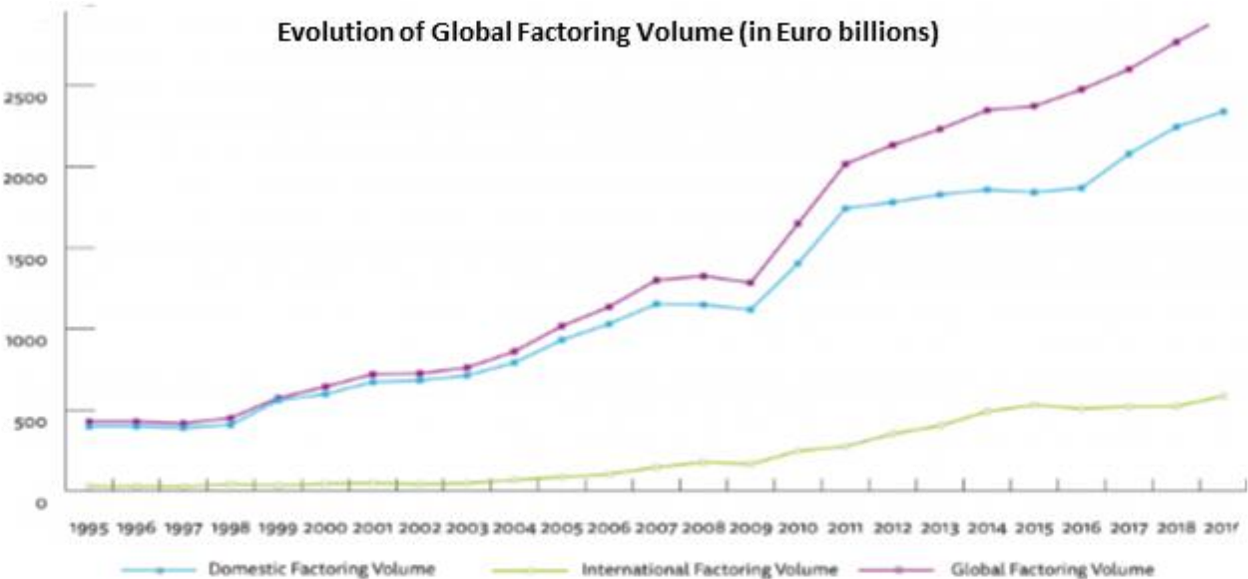



Figure 1: Global Factoring Volume

As indicated in the figure above, in 2019, global factoring volume reached 2.9 trillion euros. While Europe accounts for the majority of the world's domestic volume of factoring (67%), new markets account for the highest growth in factoring volume, with the leading regions being the Middle East (12.4%), Africa (10.8%), and South America (8.9%).

The Asia Pacific region represents 23% of the global volume. In 2019, over 494000 million euro worth of business was conducted in Greater China alone. Factoring volume in India increased by 12% in 2019 at over 5000 million euros.

The table below gives a bird's eye overview of factoring volume and share in terms of volume globally:

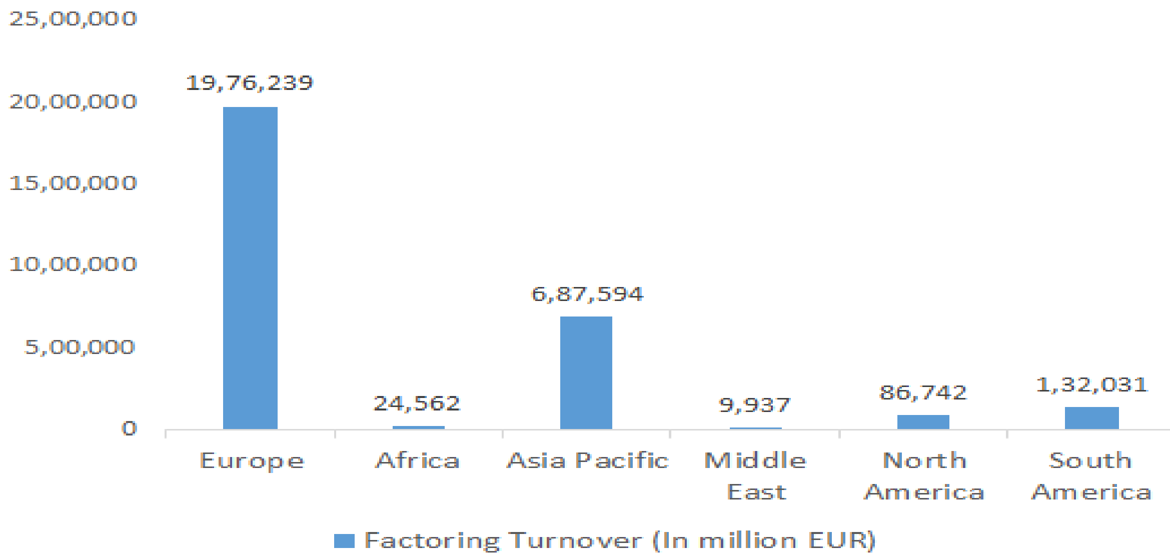



**Figure**: Global Factoring Industry by Turnover
Source: FCI Annual Review 2020

China continues as the world's largest traditional receivables finance markets since 2013, accounting for an annual factoring turnover of about € 400,504 Million by the end of the year 2019. The playing field, apart from China, is predominantly occupied by the European countries of Italy, France, and Spain with 15%, 11%, and 10% share respectively, and followed by the UK with 8%, and Germany, Japan, Poland, and Taiwan at 4% each, of the total international factoring volume. The table below shows factoring volumes in certain major countries compared to the factoring volumes in India.

| **Factoring Volume (In million EUR)** | | | | | |
|---|---|---|---|---|---|
| Country | 2014 | 2015 | 2016 | 2017 | 2018 |
| UK | 350,622 | 376,571 | 326,878 | 324,260 | 320,193 |
| USA | 97,670 | 95,000 | 89,463 | 87,000 | 87,821 |
| China | 406,102 | 352,879 | 301,635 | 405,537 | 411,573 |
| Japan | 51,072 | 54,184 | 49,466 | 37,284 | 49,348 |
| India | 4,340 | 3,700 | 3,881 | 4,269 | 4,532 |
| Italy | 183,004 | 190,488 | 208,642 | 228,421 | 247,430 |
| France | 226,598 | 248,193 | 268,160 | 290,803 | 320,409 |
| Germany | 189,880 | 209,001 | 216,878 | 232,431 | 244,300 |

Source: Annual Review Report 2019 | FCI

## Global Law and Regulation

The UNIDROIT Principles of International Commercial Contracts (UPICC) constitute a non-binding codification or "restatement" of the general part of international contract law. In 1988, the UNIDROIT Convention on International Factoring was adopted in Ottawa, Canada[4]. The Factoring Convention entered into force in 1995 and has been ratified by 9 States. The outcome of the UNIDROIT Convention on International Factoring was passed as a regulatory piece, complete with registration requirements, penalties, and inspection.

International factoring represents only 21% of global factoring volume, whereas domestic factoring accounts for 79%. Despite the growing importance of factoring, no intergovernmental organisation had adopted a factoring model law until now to assist States in undertaking reforms to improve their domestic legal frameworks.[5]

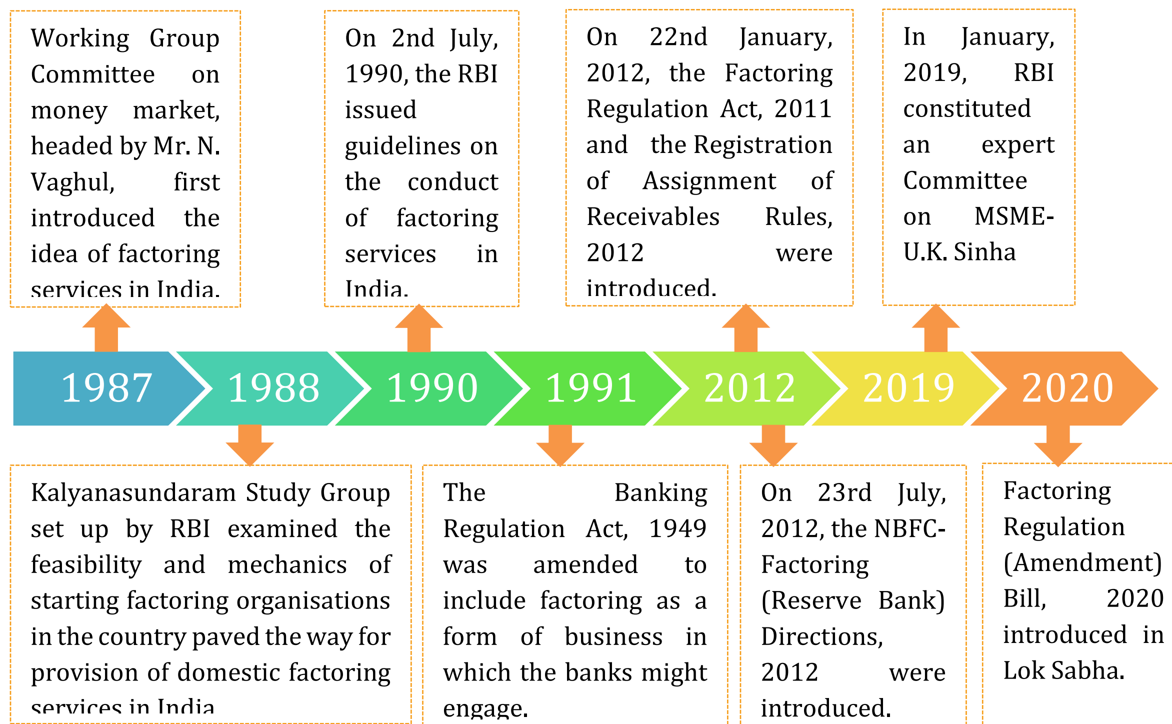
## Indian Context

Factoring is fast becoming a potent method of working capital financing, as entities move away from asset-centric models to operation-centric businesses. Credit is the norm of business, and credit requires working capital. Traditional working capital finance is based on sanctioning of limits, whereas factoring is need-based, and is completely scalable[6]. The journey of factoring in India can be viewed as follows:

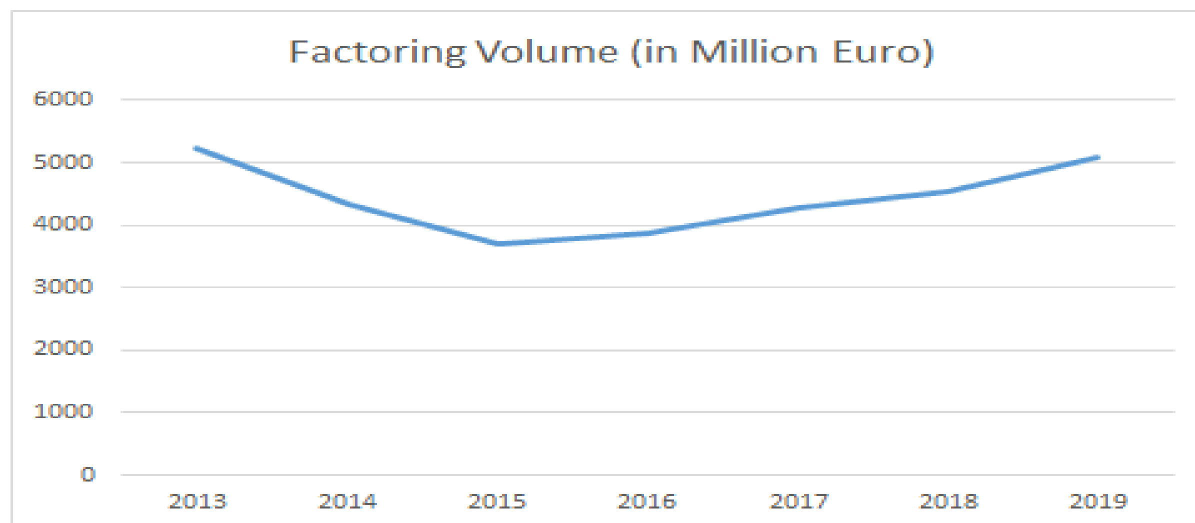
[4] https://www.unidroit.org/instruments/factoring

[5] UNIDROIT has constituted an expert group committee to develop model law on factoring in coordination with United Nations Convention on Assignment of Receivables in International Trade (2001), UNICITRAL Legislative Guide on Secured Transactions (2007) and UNICITRAL Model Law on Secured Transactions (2016) <https://www.unidroit.org/work-in-progress/factoring-model-law>

[6] Our book named "Guide to Factoring- A Comprehensive Guide to Factoring and Assignment of Receivables" deals with the basics and structure of factoring in detail.




While the case for factoring never required emphasis, unfortunately, in India, the factoring business has had several stumbling blocks. While the government has made efforts to provide a facilitating regulatory environment for factoring business to develop, the fog does not seem to have cleared out completely, and hence, the fact is that factoring has never developed in India. The factoring volumes in India, over the last few years has been depicted herein below:




Source: FCI

Post the enactment of the Act in 2012, the NBFC Factor Directions ('Directions')[7], were issued vide notification of July 23, 2012, and later amended vide Notification No.DNBR.012/ CGM (CDS)-2015, dated March 27, 2015[8] deals with the registration of factoring entities.

To start from the beginning the regulatory problem and ambiguity in the factoring market persisted at the time of enactment of the Act and NBFC-Factoring (Reserve Bank Directions), 2012. Section 3 of the Act provided that no factor shall commence or carry on factoring business unless it obtains registration from RBI. Further, the RBI Factoring Direction provided principal business requirements, i.e. financial assets in the factoring business constituting at least 50 percent of its total assets and the income derived from factoring business is not less than 50 percent of its gross income. This rule was in effect putting the cart before the horse.[9] Since 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 a receivables financing business, it has to start the business of receivables financing and gradually grow it over time.[10]

In March 2017, the Indian Securitisation Foundation had made a representation to the RBI for seeking clarification on the position of NBFCs carrying factoring activities as non-principal business activity. ISF had specified that one of the major reasons for factoring activity not growing in the country is lack of awareness, which itself is caused by an extremely narrow market. There is no reason why from a policy perspective the business of factoring should be constricted to registered factoring companies only. After all the avowed objective of the Factoring Act was not to restrict factoring but to promote it, and the interpretation taken in the RBI FAQs is not as per section 3 and is only restricting business.

With the introduction of the Factoring Regulation (Amendment) Bill, 2020 by the Lok Sabha, the position is expected to be clarified that NBFCs whose financial assets and income from factoring business is less than 50% of its total assets or gross income may carry out factoring business and will not be required to register as NBFC-Factor.

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[7] https://www.rbi.org.in/Scripts/BS_CircularIndexDisplay.aspx?Id=7462

[8] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=9623&Mode=0

[9] Our detailed critique write up on RBI Faqs and Factoring Regulation titled 'RBI FAQs muddle up Factoring Business in India' available at <http://vinodkothari.com/wp-content/uploads/2017/03/FAQs_on_factoring_by_RBI-1.pdf>

[10] Indian Securitisation Foundation (ISF) reprised the matter to the RBI and had made representations to the regulator, on providing clarity on the position of NBFCs carrying factoring activities as non-principal business. Dated March 28, 2017, available at < https://www.indiansecuritisation.com/product1/21490771025.pdf>

# Amendments to the Act

## Extended scope of the term “Receivables”

As per the proposed amendment, the definitions of "assignment", "factoring business" and "receivables", shall be amended to bring them in consonance with international definitions.

The term “Receivables” shall be defined as follows-

> *"receivables" means the money owed by a debtor and not yet paid to the assignor for goods or services and includes payment of any sum, by whatever name called, required to be paid for the toll or for the use of any infrastructure facility or services;*

From the bare perusal of the provisions framed under UNIDROIT Convention on International Factoring, it becomes apparent that the definitions will be aligned with the convention. The rules framed by the convention specifically governs factoring contracts and assignments of receivables. The convention rules apply to ‘receivables assigned’ under a ‘factoring contract’ arising from ‘sales of goods’ which shall include services and supply of services.[11]

## All types NBFCs permitted to do factoring

Section 2(j) of the Factoring Regulation Act, 2011 defines factoring business as-

> *“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, supply, distribution, acquisition or control of such produce or goods or provision of any services.”*

At present, the factoring business can be carried out by either banks or NBFC-Factors. The Reserve Bank of India (RBI) is the regulatory body supervising the factoring business. Banks can undertake factoring business without the prior approval of RBI. However, NBFCs intending to carry out factoring business as their principal business are required to obtain prior approval from RBI.

Further, the Act states that the NBFCs which intend to engage itself in the factoring business have to fulfill the principality test. To determine whether the principal business of the NBFC is factoring, it needs to fulfill the following conditions

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[11] Article 1 (3) and Article 2 of the Unidroit Convention on International Factoring 1988

*"(a) if its financial assets in the factoring business are more than fifty per cent. of its total assets or such per cent. as may be stipulated by the Reserve Bank; and*
*(b) if its income from factoring business is more than fifty per cent. of the gross income or such per cent. as may be stipulated by the Reserve Bank."*

There was a major problem that persisted post the enactment of the Act, due to which there has been a lot of debate and criticism around the conduct of factoring business by NBFCs. The underlying basis for such a view was the FAQ of the RBI on the provisions of the Factoring Regulation Act, 2011, which suggested 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.

As per the proposed amendment to the definition of "factoring business", trade credit financing by NBFCs will not constitute factoring. Earlier only banks facilitated trade credits were excluded from the definition of factoring business. However, according to the amendment in the definition, even NBFCs providing trade credit facilities shall be excluded.

Further, section 3 of the Act is proposed to be amended to widen the scope of financiers and to permit other NBFCs also to undertake factoring business without any principality threshold.

## Expanding the role of TReDs Platform

The introduction of an online mechanism for financing trade receivables of MSME through the Trade Receivables electronic Discounting System (TReDS) has been an enabler for the rise of factoring volume in the Indian market. TReDS is an electronic discounting platform where multiple financiers (NBFC-Factors and other financial institutions) can participate on the platform.

The MSME Ministry had issued a notification[12] mandating all large companies, with a turnover of Rs 500 crores or above, to mandatorily on-board on TReDS, to allow the MSME receivables from larger companies to be funded and traded on the receivables exchanges.

In furtherance to the Budget 2020 announcement to widen the scope of financiers[13] and as per the proposed amendment, NBFCs other than those NBFCs whose principal business is factoring, shall be permitted to discount invoices on Trade Receivables Discounting System.

Further, the Trade Receivables Discounting System concerned shall be permitted to act as agents of financiers for filing registration of charges with the Central Registry as it would bring operational efficiency.

[12] http://egazette.nic.in/WriteReadData/2018/191729.pdf
[13] Refer our earlier write-up on the budget announcement- http://vinodkothari.com/wp-content/uploads/2020/02/Budget-Booklet-2020.pdf

## Power to make regulations given to the RBI

**Snapshot of the amendments**

- ✓ Change in definition of assignment, factoring business, receivables
- ✓ Addition of new definitions- regulations, Trade Receivables Discounting System
- ✓ All NBFCs allowed to do factoring business (whether principally or not)
- ✓ The time limit for filing particulars of transactions with CERSAI linked with regulations (in place of 30 days time)
- ✓ Receivables financed on TReDS platform also required to registered with CERSAI
- ✓ Power to formulate regulations given to the RBI

A new section 31A has been proposed to be inserted to empower the Reserve Bank of India to make regulations concerning factoring business. It states as follows-

*"31A. (1) The Reserve Bank may, by notification, make regulations consistent with this Act to carry out the provisions of this Act.*

*(2) In particular, and without prejudice to the generality of the foregoing power, such regulations may provide for all or any of the following matters, namely:—*

*(a)* ***the manner of granting certificate of registration*** *under sub-section (4) of section 3;*

*(b)* ***the manner of filing of particulars of transactions with the Central Registry*** *on behalf of factors under sub-section (1A) of section 19;*

*(c) any other matter which is required to be, or may be, specified by regulations.*

*(3) Every regulation shall, as soon as may be after it is made by the Reserve Bank, be forwarded to the Central Government and that Central Government shall cause a copy of the same to be laid before each House of Parliament, while it is in session, for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the regulation, or both Houses agree that the regulation should not be made, the regulation shall, thereafter, have effect only in such modified form or be of no effect, as the case may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that regulation."*

Further, the powers of RBI would include laying down rules with respect to the time period, form and manner for registration of invoice and satisfaction of charge. The time period is recommended to be reduced in order to check the possibility of dual financing.

Section 32 of the Act provides the power to formulate rules to the Central Government and the RBI has a consultative role in the same. Empowering the RBI, being the regulator of financial markets, will ensure that the regulations are aligned with the needs for the business of factoring.

## Conclusion

Though the very purpose of the said Act was to address the problems of delay in payment and liquidity faced by all enterprises, including MSMEs, there has not been any actual redressal till date. The proposed amendments are expected to help MSMEs significantly, by providing added avenues for getting credit facility, especially through TReDs Platform. Also, the NBFC industry would welcome the expansion of scope for carrying out factoring business.