

Basics of Factoring in India

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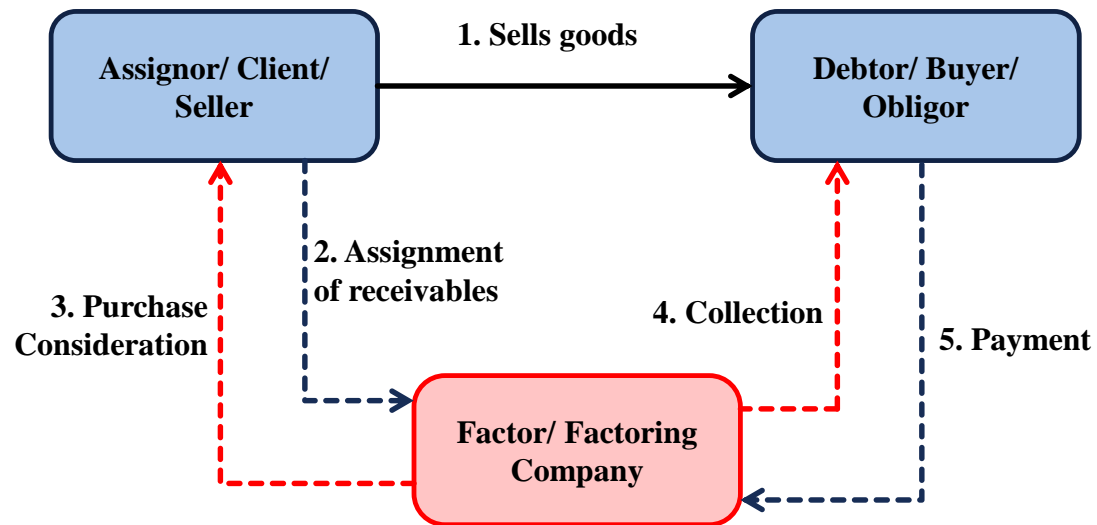
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- *Based out of Kolkata, New Delhi & Mumbai*
- *We are a team of consultants, advisors & qualified professionals having over 32 years of practice.*

Our Organization's Credo:

Focus on capabilities; opportunities follow



Factoring Process



Step 1 - A company sells good on credit to its debtor.

Step 2 - The company, in order to get quick term short financing and mitigate the risk associated with the payment delays and defaults by the buyer assigns the receivables to a factor

Step 3 - A factor makes payment to the company at a discount.

Step 4 - On the expiry of credit period, the debtor of the company will make full payment to the factor, not to the company.

Step 5 - The difference between full payment received by the factor and discounted payment made to the company is the profit for the factor.

What is Factoring

- Factoring is an **Invoice Management Tool**
- It is a tool to obtain quick access to short-term financing and mitigate risks related to payment delays and defaults by buyers.

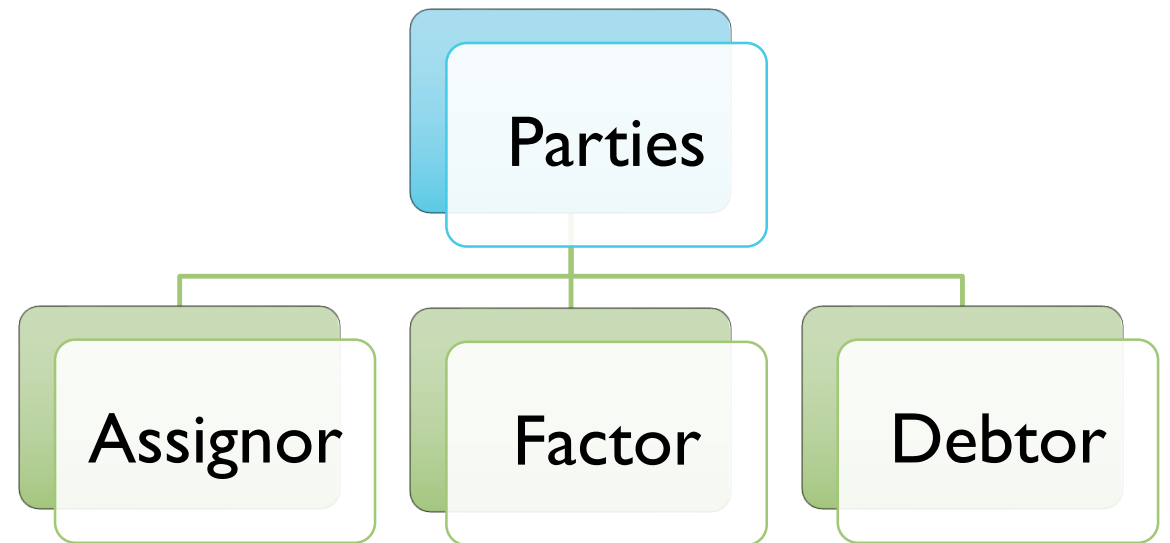
*“Money Today is better than
Money Tomorrow” –*

The cause as well as effect of Factoring

- As per 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.”*

Parties to Factoring

- **Assignor-** Owner of the receivable.
- **Factor-** NBFC or Bank where
 - 50% or more of its income and financial assets must be attributed to factoring business.
 - Certificate of registration need to obtained by it from RBI.
- After the proposed amendment Bill, 2020- all NBFCs will be permitted to do factoring. Banks can do factoring without prior approval of RBI.
- **Debtor-** Person liable to the assignor to pay any receivable or discharge an obligation in respect of the receivable.
 - The nature of receivable could be existing, accruing, future, conditional or contingent.



Why Factoring?

- It provides protection from the risk of bad-debt.
- Better Administration - The amount of time taken to monitor credit, manage collection and evaluate buyer's creditworthiness gets saved.
- It is not the security interest created in the favour of factor. The ownership of bill receivables is transferred to the factor.
- Positive impact on the balance sheet providing more liquidity and solvency to the company.
- The focus is not on the creditworthiness of the company but value of receivables and quality of debtors. Thus, making easier for companies to raise finance.
- It fulfills immediate financial needs of a company.

Why Factoring?

For the Seller

- Reduces the risk of a Working Capital Deficit
- Positive impact on the balance sheet providing more liquidity and solvency to the company.
- Protects from risk of bad-debt (except in 'Recourse Factoring')
- Better Administration - The amount of time taken to monitor credit, manage collection and evaluate buyer's creditworthiness gets saved.

For the Buyer

- Internal Source of Finance
- Money is parted away with at a later stage

Illustration

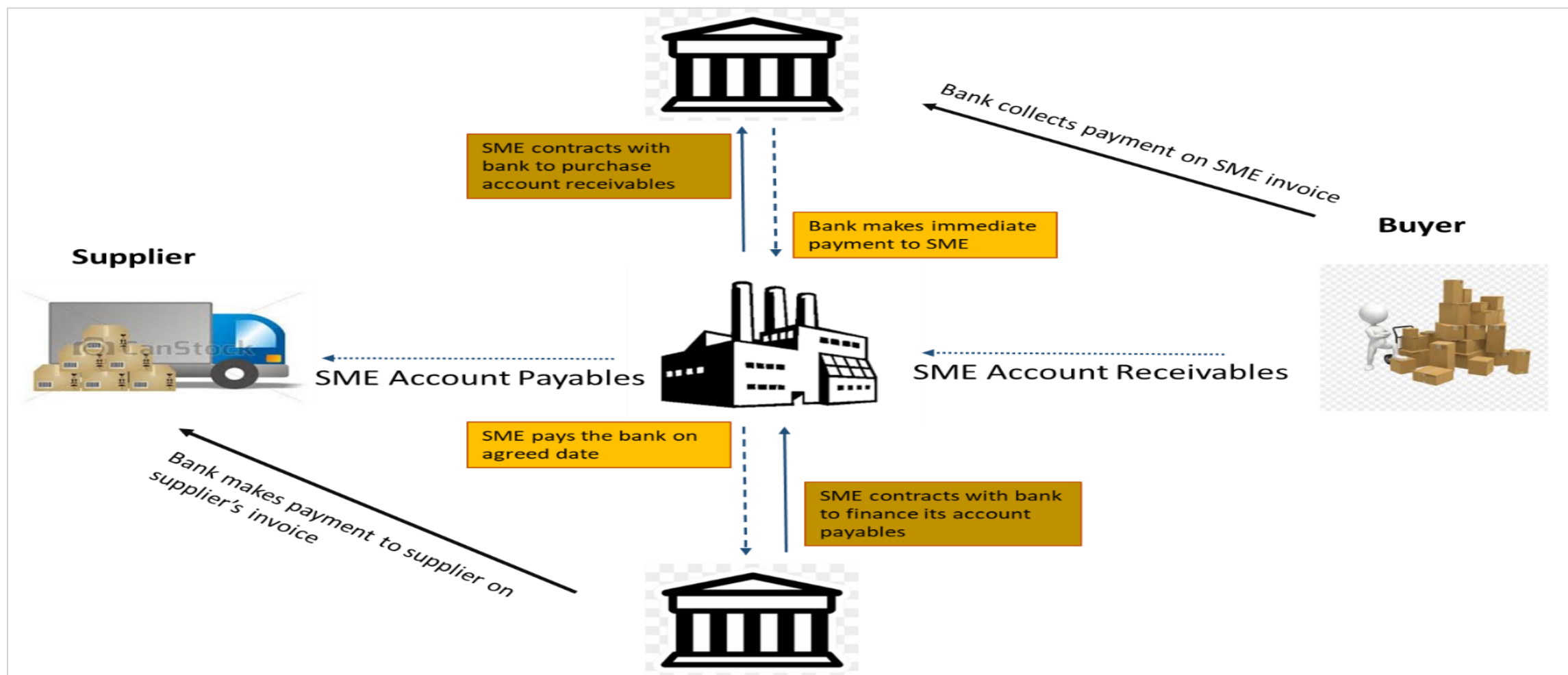
- **ABC Ltd.'s annual sale credit** – Rs. 48,00,000/
- **Credit Period** – 3 months
- **Bad Debts** – 5% of the credit sales
- **Factor Fee** – 10% (Non recourse)
- **Admin. Overhead** – reduces by Rs. 8,000/- p.m.
- **Advance interest** – 15% p.a.
- **Reserve** – 25%

What will be the annual effective cost of factoring?

Recourse vs. Non-recourse?

Computation of Cost of Factoring		
Particulars	Particulars	Amt. (Rs.)
Credit Cycle	3 months	-
No. of Credit cycles	$12 / 3 = 4$	-
Credit Sale in each cycle	48L/ 4 months	12,00,000
Less: Reserve	@25%	(3,00,000)
Advance by the Factor		9,00,000
Interest on advance (A)	@15 * ($\frac{1}{4}$)%	33,750
Factor Fee (B)	@10% * 12L	1,20,000
Savings on Bad Debt (C)	@5% * 12L	60,000
Savings on Admin Cost (D)	Rs.8,000*4	32,000
Cost of Factoring/ cycle	(A+B)-(C+D)	61,750
Effective Cost (E)	Cost/ Advance	6.86%
Annual Effective Cost (F)	(E)*4	27.44

Accounts Payable vs. Accounts Receivable Financing



Factoring vs. Bank Financing

Bank Financing	Factoring
There is a loan/ line of credit extended.	There is no loan extended
Debt servicing is an additional burden	Financing is received based on outstanding receivables. There is no additional burden of debt servicing
Funding with collateral	Usually without collateral unless the ticket size is large
Lines of credit/ funding limits are increased with additional collaterals/ guarantees etc	Access to finance increases with the increased accounts receivables the company generates
Availability largely for clients with established track records.	The credit worthiness of the debtor is most important
Funds made available may or may not be used for business purposes	Enables cashflow management, eases cashflow mismatches

Factoring vs. Other Modes of Invoice Financing

Factoring vs. Bill Discounting

- Bill discounting is where an invoice is discounted by the seller with the bank and the full amount of the bill is recovered by the bank from the debtor
- Bill discounting is an individual and one off exercise where each bill is separately assessed and discounted.

Factoring vs. Cash Credit

- Cash credit is a funding facility for meeting the working capital requirements
- Cash credit facility enables the seller to draw on working capital requirement at short term notice
- The margin that the bank retains in cash credit is very high as banks cannot chase the debtors for recovery of the amount drawn.
- As against cash credit, factoring has thin margins comparatively and there is a sale of the receivables only after they are in existence.

Factoring vs. Other Modes of Invoice Financing

Factoring vs. Forfaiting

- Forfaiting is very similar to factoring and is an off-balance sheet mode of financing typically used in case of cross border transactions
- Forfaiting helps in eliminating the interest rate fluctuations as the receivables are discounted upfront and the exporter is absolved of all risks in the transaction
- Forfaiting is typically a one-time transaction rather than a continuing relationship, but the only distinguishing factor between factoring and forfeiting is the tenure of the receivables that are purchased.

Factoring vs. Securitization

- Securitisation is the creation of securities from the receivables sold to a special purpose vehicle for creating bankruptcy remoteness and using the capital market window for sale of receivables, which is missing in factoring.

Factoring in India

- Factoring volume of India has increased by 12% in 2019 at over 5000 million euros.
- Factoring turnover of India in 2019-
 - Domestic- € 4,500 million
 - International- € 589 million

Factoring Volume over the years (in million €)

2014	2015	2016	2017	2018	2019
4,340	3,700	3,881	4,629	4,532	5,089

Laws Relating to Factoring



Factoring Regulation Act, 2011

Factoring Regulation (Amendment) Bill, 2020

The Non-Banking Financial Company - Factors (Reserve Bank) Directions, 2012

Factoring Regulation Act, 2011

The Act deals with the registration of factors, how assignment of receivable will be conducted, rights and obligations of the parties, registration of assignments and offences and penalties for non-compliance of directions of RBI.

Factoring Regulation (Amendment) Bill, 2020

The scope of the term “receivables” is expanded, all types of NBFCs permitted to do factoring. power to make regulations to the RBI, expansion of the role of Trade Receivables Discounting system are some of the key highlights of the bill.

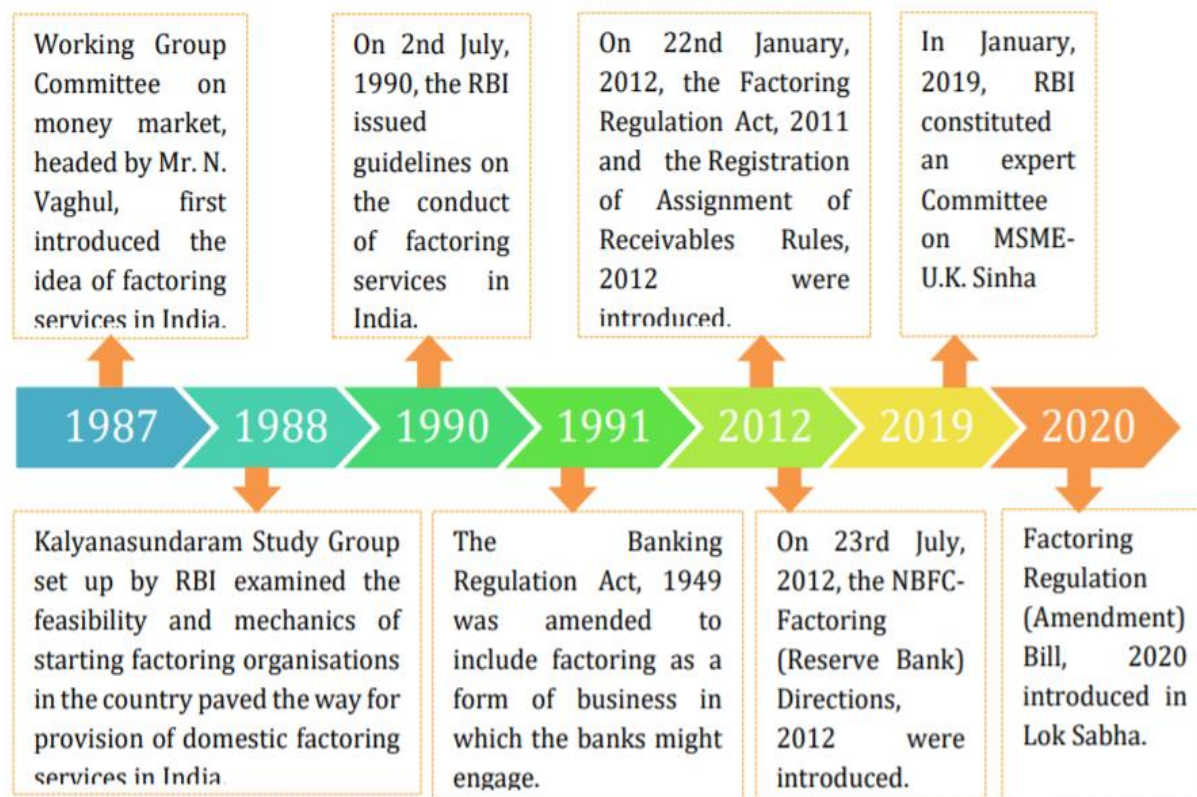
The Non-Banking Financial Company - Factors (Reserve Bank) Directions, 2012

The provisions of these Directions shall apply to every NBFC Factor registered under the Act.
Lays down prerequisites like minimum NOF; Asset-Income Criteria

Key Highlights of the Act

- **Registration** – Minimum NOF & Income-Asset Criteria
 - Not required by banks; statutory bodies; Gov. companies;
- **Collection of information from Factors** – RBI has the right to issue directions
- **Notice to the debtor** – The factor cannot demand payment from the buyer without issuing a notice demanding payment, along with the proof of authority to collect the same
- **Discharge of liability of debtor on payment to the Factor** – Payment of receivables specified in the notice shall fully discharge the debtor making the payment
- **Assignor to be trustee of assignee** – if the seller receives any payment of account of assigned invoices, the same is considered to be kept in trust for the factor

Factoring Regulation (Amendment) Bill, 2020



Key Highlights –

- Extended scope of the term “Receivables”
- All types NBFCs permitted to do factoring
- Expanding the role of TReDs Platform

See: <http://vinodkothari.com/2020/10/legal-framework-for-factoring-favorably-amended-for-nbfcs-and-msmes/>

Report of the Standing Committee

- The Amendment Bill was referred to a Standing Committee of Finance chaired by Shri. Jayant Sinha
- The Standing Committee has endorsed the Amendment Bill, with a view that the proposed amendments complement the expanding factoring volumes in India, which in turn warrant an efficient-liquid market, and regulatory clarification

See: <http://vinodkothari.com/2021/02/factoring-law-amendments-backed-by-standing-committee/>



Credit Insurance for domestic factoring

- To provide additional protection to the factor
- To promote factoring companies to lend more aggressively



Specialised MSME Funding Entities

- To grant status of 'specialised MSME Funding Entities' to Factoring Companies
- To ensure that a major portion of corpus is earmarked for the benefit of MSMEs



Adoption of best Technology & Security Standards

- Establish guidelines to adopt technological and security standards like Blockchain



Promote Educational Initiatives

- So as to enable stakeholders to be aware, and optimally use resources