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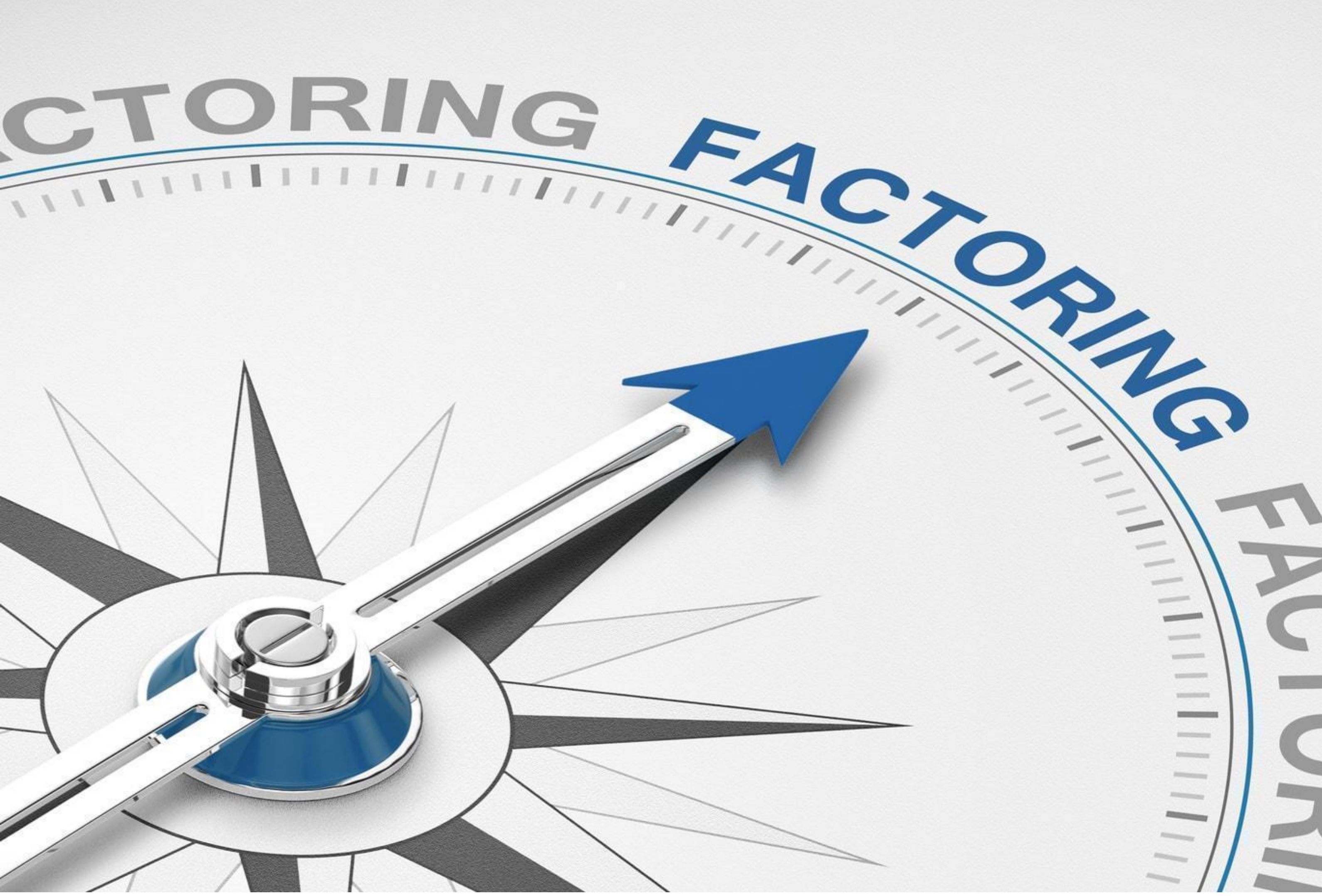
INDIA FACTORING REPORT | 2023

Contents



Introduction

Receivables form a major part of the current assets of a company and management of such receivables is the most important concern for the company. Factoring is a financial option for the management of receivables. It is a tool to obtain quick access to short-term financing and mitigate risks related to payment delays and defaults by buyers. In the process of factoring, the seller sells its receivables to a financial institution ("Factor") at a discount. After the sale, there is an immediate transfer of ownership of the receivables to the factor. In the due course of time, either the factor or the company, depending upon the type of factoring, collects payments from the debtors. Factoring helps the company to improve the cash flows and cover the credit risk of the company.

Factoring falls within the broader term "trade credit"; it is an alternative method of seeking working capital finance. Working capital is the life blood of an organisation, and as the present-day business model has tried to minimise investment in fixed assets, the major capital requirement for businesses, is working capital. This is more so in case of smaller businesses, which are understandably less fixed capital-intensive. The two major components of working capital are receivables, and inventories. Receivables can be taken care of, substantially, by factoring, and inventories, at least partly, may be funded by reverse factoring (discussed later).

Basic transaction structure

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:

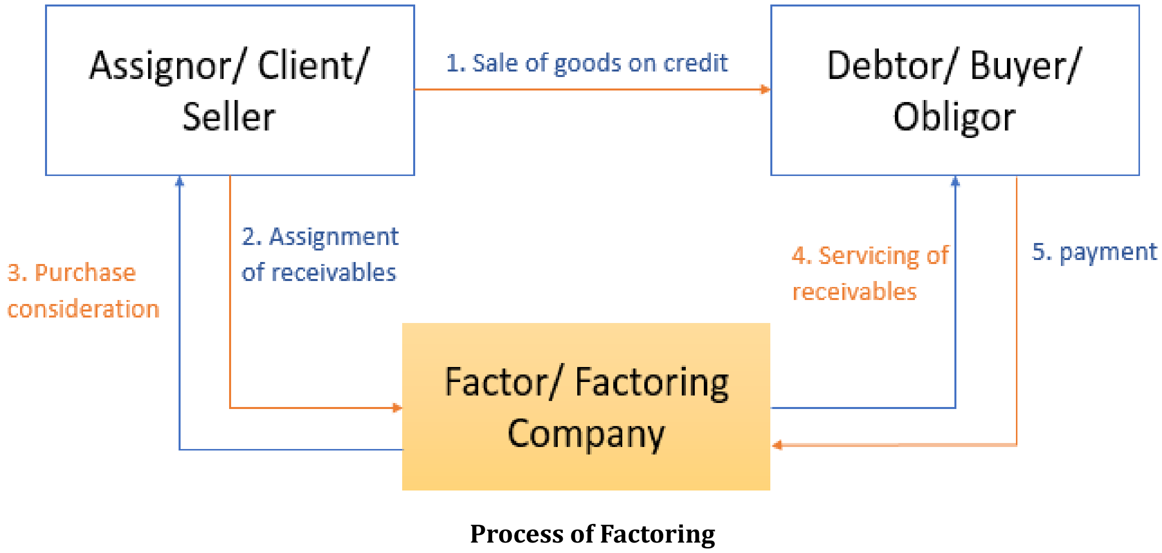


Figure A: Process of Factoring

A factoring transaction commences with the Seller selling its goods or services to the Buyer on credit and raising an invoice on getting a confirmation of satisfaction from the Buyer about the goods or services rendered. Once the confirmation is received the Seller issues an Invoice which is to be paid after a credit period as decided mutually by the Seller and the Buyer/Debtor. Now since the Seller is in need of funds he approaches a Factoring Company or Factor to seek upfront liquidity against the whole or part of receivables from the Buyer/Debtor. The Factoring Company or Factor is assigned those receivables and in return it discounts the value of receivables and pays the discounted value upfront to the Seller. Consequent to the transfer of ownership of the receivables, the Factoring Company or Factor comes into the shoes of the Seller and takes care of the servicing of receivables, and thereby on due date, the Buyer pays the entire invoice amount to the Factoring Company or Factor.

History of Factoring

The term "factor" comes from a Latin word 'facere' which means 'to make' or 'to do.' Factoring has evolved to be specialised financial service. 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, the 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.

The ancient Romans used a form of factoring by selling promissory notes on a secondary market at a discount. Factoring gained true popularity, however, it was restricted to trade between the American colonists and their European buyers. Prior to the American Revolution, merchants in the colonies sent raw materials, from timber to wool to cotton to furs, to British and European merchants. However, sending the goods such long distances could get expensive. And in the meanwhile, waiting for payment to come back across the Atlantic from Britain and Europe could cause delays in being able to do what was necessary to harvest and plant and process new orders. In order to get around these problems, the British and European merchants paid the colonists in part for the materials. This way, the colonists had an advance with which to continue their operations. These eased cash flow and created a streamlined process for ensuring that trade continued unabated. As society progressed after the American Revolution, and as the Industrial Revolution came, the focus of factoring changed. Credit became more important to factoring. The credit of the company itself was not as important as the credit of its clients. In 1904, the first account receivables financing company was formed in Chicago.

Before the 1930s, the most popular industries for factoring were the garment and textile industries. These are industries that rely on raw materials. In order to make sure that companies could continue to buy raw materials to produce clothing and textiles, factoring was used. However, it soon became evident, after World War II, that factoring could work effectively for any business that invoiced others.

During the 1960s, 1970s and 1980s, interest rates were on the rise and banks were increasingly regulated. This made it difficult for companies to get traditional financing. Factoring became even more popular, since it did not require the same sort of credit checks. Small business, startups and rapidly growing businesses benefited especially from this increase in factoring. Factoring grew as a service as business people found their options contracting.

In the present day, factoring is defined to include the following business

1. purchasing accounts receivable;
2. guaranteeing the seller against customer credit failures (without recourse factoring);
3. billing, ledgering, and collecting the receivables; and
4. financing clients' operations, either by advances before maturity against the accounts purchased, or by loans

A Factor provides for the following basic services:

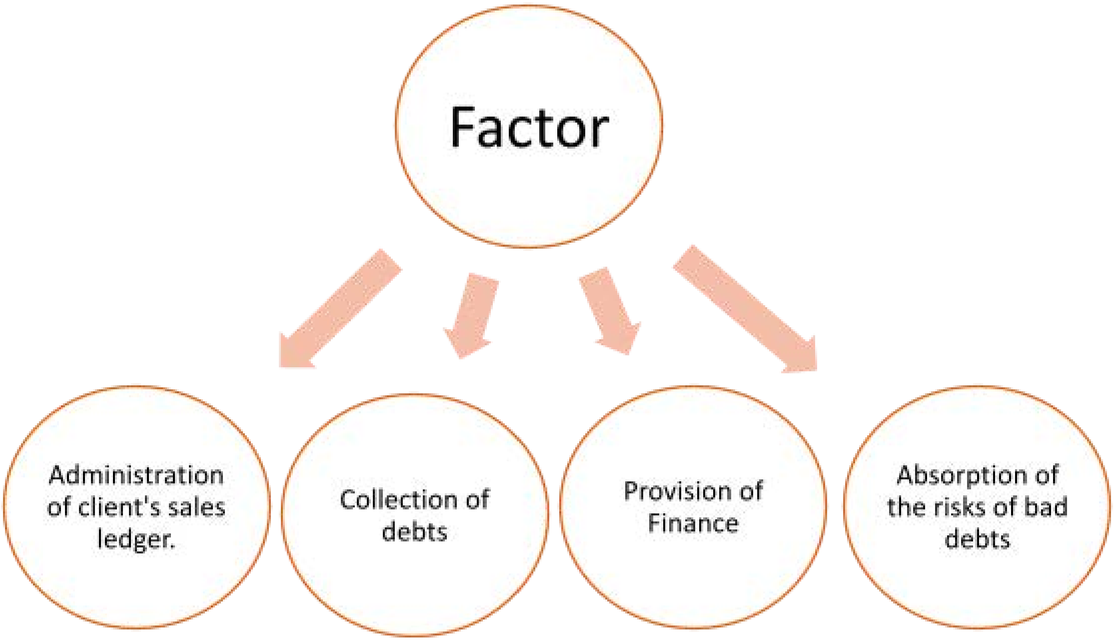


Figure B: Tasks performed by a Factor

Factoring and Bill Discounting

There is a very thin line of difference between factoring and bill discounting. Bill discounting, unlike factoring, is always with recourse to the client, whereas factoring may be with recourse or without recourse. Generally, there is no notice of assignment given to the customer in case of bill discounting and collections are done by the lender, unlike factoring, where debt collection is done by the factor. Factoring can be called a bundle of financing and servicing functions, whereas, bill discounting function is purely financial.

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. The merit of factoring lies in the simplicity of the concept which is well understood and accepted.

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 current assets minus current liabilities (trade creditors). 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 short-term funding leading to lower weighted average cost for working capital finance as longer term finance generally is accompanied by higher cost.

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 to 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 are regulated financial entities who undertake a through credit assessment of such debtors before entering into the assignment agreement.

5. It is an alternative 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.	Preservation of Equity	Typical bank lending norms stipulate minimum equity for working capital gap, which is not the case with factoring transactions.
2.	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.
3.	Reduction of short-term debt burden	Factoring enables clients to avoid increasing short-term debt burden and increase the return on capital.
4.	Cheaper purchase cost	Faster payment for liabilities results into cheaper cost of purchases.
5.	Off-balance sheet source of funding	Factoring is an off-balance source of funding leading to the balance sheet becomes lighter.
6.	Minimizes Risks with Credit investigation	To mitigate the degree of collection risk, many factoring companies offer a credit investigation service that garners reliable data about the buyer's reputation in the market as well as its financial strength. Using this information, the seller can reduce risks when it comes to collection and curate a high-quality list of customers.
7.	No Stamp Duty	The Factoring Regulations Act, 2011, has provided an exemption for stamp duty on the assignment of receivables to a "Factor" as defined under the said Act
8.	Insurance Cover	Factoring acts as an insurance cover against receivables as it provides upfront payment to the seller and thereby protects it from bad debts in the case of non-recourse factoring.
	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 thereby facilitates 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.	Alternative Method	Factoring is an alternative method of funding and does not reduce other lines of credit available. It is

		one of the non-traditional alternative means, in addition to traditional bank financing,
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.

Difference between Factoring and Traditional Bank Finance

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 creditworthiness of the debtor is most important.

Difference between Factoring and Securitization

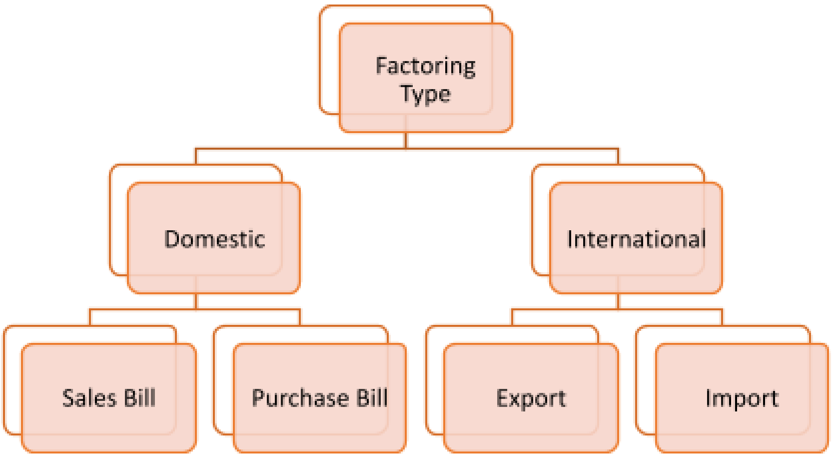
Basis	**Factoring**	**Securitization**
Used By	Factoring as a source of finance is mostly used by manufacturing and trading companies.	Financial Institutions and non-banking finance companies are the major players indulging in securitisation.
Types of Assets	It is executed by assigning short term assets such as trade debts and receivables.	Debts generally of medium- and long-term nature are used.
Process	Factor purchases the trade debts and receivables and generally pays upto 80% of their value in the first instance and thereafter on due date it realises the money from the debtor. Consequently, the 20% is paid off minus some service charges to the seller.	Debts are transferred by the originator to a special purpose vehicle (SPV) which thereafter issues tradable securities to investors that are backed against the assets transferred.
Risk	With transfer of receivables, the risk is also transferred to the Factor provided it is a non-recourse factoring.	The Master Directions on SSA requires the originator to withhold some amount in the form of Minimum Retention Requirement (MRR) and thereby only partial risk is transferred to the SPV.
Registration	There is pre-requirement of obtaining a RBI approval for commencing as a factoring firm.[1]	There is no need for the SPV to obtain a RBI authorisation.

[1] Registration of Factors (Reserve Bank) Regulations, 2022 - https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12222&Mode=0

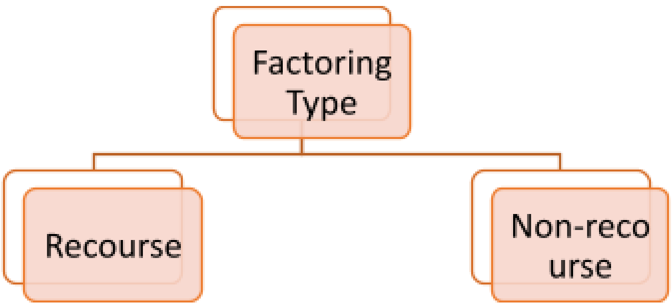
Types of Factoring

A Factoring transaction may be divided into following categories based on the transaction type:

1. **On the basis of geographical distribution**



2. **On the basis of credit risk protection**



3. Other types of factoring

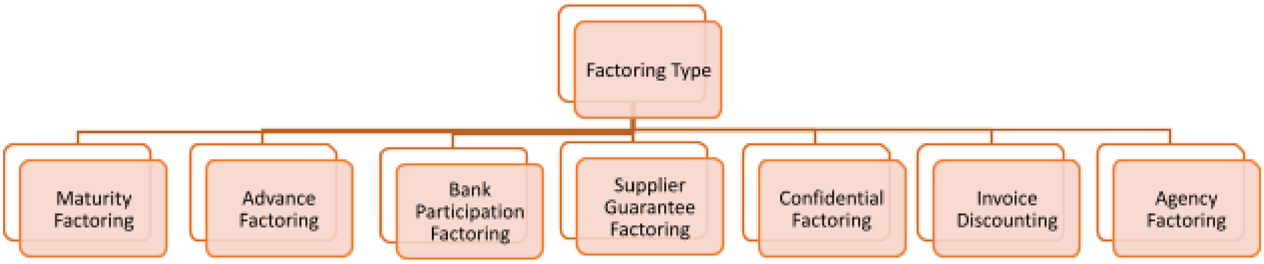


Figure C: Types of Factoring

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 an 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
Invoice Basis(Non hole turnover)	In such kinds of factoring, the assignment is undertaken based on each invoice issued. The Details which are required to be provided for such type of factoring in provided for in Form 1 of Registration of Assignment of Receivables (Reserve Bank) Regulation Regulations, 2022
Whole Turnover Basis	Typically, factoring is much more whole-turnover oriented than single transactions. It is normal for a factoring agreement to be for a year and include all (or most all) of the domestic or international accounts receivable sold on credit terms. The Details which are required to be provided for such type of factoring in provided for in Form 1 of Registration of Assignment of Receivables (Reserve Bank) Regulations, 2022

Evolution of Factoring in India

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

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

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

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

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

2012: On 23rd July, 2012, the NBFC-Factoring (Reserve Bank) Directions, 2012 were introduced.

2020: The Factoring Regulation (Amendment) Bill, 2020 was introduced with objective of allowing more players in the business of factoring.

2022: Chapter VII dealing with specific directions applicable to NBFC Factors & NBFC ICC registered under the Factoring Regulations Act, 2011 was introduced as a chapter under theMaster Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking

2022: Chapter VI dealing with specific directions applicable to NBFC Factors was introduced as a chapter under the Master Direction - Non-Banking Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016

Regulatory Framework for Factoring in India

Basic Laws of Transfer of Receivables

Transfer of Property Act, 1882
Indian Stamp Act, 1899

Regulatory Statutes

Factoring Regulation Act, 2011
Registration of Factors (Reserve Bank) Regulations, 2022
RBI's Guidelines for Factoring Companies
Registration of Assignment of Receivables (Reserve Bank) Regulations 2022
Guidelines for Trade Receivables Discounting System
Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016
Master Direction - Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016

Payment Mechanisms and certainty of payments

Negotiable Instruments Act,1881
Payment and Settlements Systems Act, 2007
MSME Act, 2006
Foreign Exchange Management Act, 1999.

Registration of Security Interests/Transfers

Registration provisions under SARFAESI Act, 2002.

Factoring Regulation Act, 2011

The Factoring Regulation Act, 2011 ('Act')[2] 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, was passed, in line with the laws in several countries, to promote factoring, particularly cross-border factoring of receivables. The Act formally defined the terms 'factoring business', 'factor', 'receivables' and 'assignment', among others to give them a legal validity.

The preamble to the law provides its objective. It states: "*to provide for and regulate assignment of receivables by making provision for registration there for 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 was actually focused on assignments to factors, besides dealing with registration of factors.

Thereafter in the year 2020 the Factoring Regulation (Amendment) Bill 2020 (subsequently, Factoring Regulation (Amendment) Act 2021, No.21 of 2021[3]) was introduced with the objective of allowing more players in the business of factoring. This Bill amended key definitions of the 2011 Act such as 'Receivables', 'Assignment' and 'Factoring Business' so as to increase their ambit. Moreover through this amendment

[2] https://www.indiacode.nic.in/bitstream/123456789/2116/1/AA2012__12.pdf

[3] https://egazette.nic.in/WriteReadData/2021/228831.pdf

the provisions vis a vis registration of transactions was also amended by mandating factors to register the details of every transaction with the Central Registry.

Objectives of the Act

The Factoring Regulations Act, 2011 deals with the following

- To provide and regulate assignment of receivables by making provision for registration, rights and obligations of the parties to contract.
- To define the rights and obligations of parties to contract for assignment.
- Stating the penalties and offences for the Act.
- Exempting factoring transactions under the Act from stamp duty.
- Granting primacy to rights of a factor over any other claims.

Definitions

Factoring Business

*Section 2(j) of the Factoring Regulation Act, 2011 defines **"Factoring Business"** as*

" Business of acquisition by way of assignment of receivables of assignor for a consideration for the purpose of collection of such receivables or for financing whether by way of making loans or advances or otherwise, against such assignment, but does not include—

(i) credit facilities provided by a bank or a non banking financial company 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;

XX"

Factor

*Section 2(i) of the Factoring Regulation Act, 2011 defines **"Factor"** as*

"A non-banking financial company as defined in clause (f) of section 45-I of the Reserve Bank of India Act, 1934 which has been granted a certificate of registration under sub-section (1) of section 3 or anybody corporate established under an Act of Parliament or any State Legislature or any Bank or any company registered under the Companies Act, 1956 engaged in the factoring business."

Registration (Section 3)

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

Assignment of receivables

- Section 7(1) of the Act requires written agreement for assignment of any receivables even if the receivable is subject to a right of set-off or any other defences. The assignor is obligated to disclose to the Factor any such right or defence. Further, the proviso to this section states 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"*.

- Section 7(2) states that on execution of the instrument, the rights of the assignor shall vest in the factor and the factor shall have an absolute right to recover such receivable as the assignor had.

- However, Section 8 of the Act says that the assignee of a receivable shall not be entitled to demand payment of the receivable from the debtor unless notice of such assignment is given to the debtor by the assignor or the assignee along with express authority in its favors granted by the assignor.
- Section 9 of the Act states that once notice has been given, the debtor shall get discharged from all his liability in respect to the receivables set out in such notice upon payment to factor.
- In absence of notice of assignment, any payment collected by assignor from debtor will be held in trust for the factor. Also as per section 13, where a debtor makes any payment to an assignor which represents payment due on an assigned receivable, such payment shall be held in trust by the assignor on behalf of the assignee.

Debtor Protection

- Section 15 of the Act states that no factoring of debt can affect the rights or obligations of the debtor, without the express consent of the debtor in writing, including the terms and conditions of the contract.
- Consequent to the assignment of receivables, payment instructions to the debtor may be changed to the limited extent of changing the name of person, address or account to which payment needs to be made. Such modification of payments terms between the debtor and assignor shall not modify the amount, place of payment or the date of payment of the debt.
- Further, the obligations of the debtor cannot be increased by virtue of the factoring agreement. For example, if the debtor was not liable to penal interest, he will not be liable even on factoring. Also, if the assignor did not have any lien/security over the asset, the factor also will not have the same.
- Section 16 of the Act states that the debtor will remain entitled to set off rights available at the time of assignment, or defences arising from the same contract from which the receivables arose.
- However, if the assignor commits any breach of the original contract with the debtor, such breach does not entitle the assignor to recover damages from the assignee pursuant to the factoring transactions.

Notice of Assignment

- As per section 7 (2) of the Act, *on the execution of an agreement in writing for assignment of receivables, all the rights, remedies and any security interest created over any property exclusively to secure the due payment of receivable shall vest in the assignee and the* ***assignee shall have an absolute right to recover such receivable and exercise all the rights and remedies*** *of the assignor whether by way of damages or otherwise, or* ***whether notice of assignment as provided in section 8 is given or not****.*
- Section 8 of the Act restricts the assignee from demanding payment of the receivables from the debtor unless notice of such assignment is given to the debtor by the assignor or the assignee. It states-

  Any assignee of a receivable shall not be entitled to demand payment of the receivable from the debtor in respect of such receivables unless notice of such assignment is given to the debtor by the assignor or the assignee along with express authority in its favours granted by the assignor.

- Further, Sections 11 and 15 of the Act which contain provisions regarding rights and obligations of parties to contract for assignment of receivables and principle of debtor protection, respectively provide that a debtor shall not be liable to make payments to the assignee unless notice of assignment is served upon the debtor.

- From the above, it can be concluded that as long as the assignor remains the servicer for the receivables, a notice of assignment is not required. However, in case the servicer is changed or the assignee intends to demand repayment from the debtors, a notice of assignment is required to be given.

- The objective of serving a notice of assignment is to make the debtor aware of the change in the creditor. The concurrence of the debtor is not required for an assignment of receivables to be effective.

- Not serving a notice of assignment may have the following implications for the assignee:

    1. The debtor shall continue to be entitled to make payments to the assignor in respect of assigned receivables in accordance with the original contract and such payment shall fully discharge the debtor from corresponding liability under the original contract;
    2. There shall be no obligation upon the debtor to intimate the assignee the details of the deposits or advance or payment on account made to the assignor or to provide any other information to the assignee relating to the receivable if called upon by the assignee to do so;
    3. Right to set off (against the assignor) shall continue to accrue to the debtor till the time notice of the assignment is received by the debtor;
    4. Any agreement made between the assignor and the debtor that affects the assignee's rights in respect of that receivable, before service of such notice, shall be effective as against the assignee, and the assignee shall acquire rights in the assigned receivables, as modified by such agreement.

Registration of Assignments (Chapter V)

- Every factor is required to file particulars of assignment of receivables in his favor with the Central Registry[4] under section 20 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI) in Form I within a period of 30 days from the date of such assignment and such form shall be authenticated by a person specified in the form for such purpose by use of a valid digital signature.

[4] CERSAI has been designated as the Central Registry under the SARFAESI - https://www.cersai.org.in/CERSAI/home.prg

- In cases where the trade receivables are financed through a Trade Receivables Discounting System, the obligations with respect to registration and satisfaction shall be undertaken by the Trade Receivables Discounting System on behalf of the Factor.
- Further, the satisfaction of any transaction of assignment of receivables on realisation of the receivables fully is required to be filed in Form-II.

Benefits of Registering

- The Enforcement of Security Interest and Recovery of Debts Laws and Miscellaneous Provisions (Amendment) Act, 2016 has introduced sections 26D and 26E to the SARFAESI Act, 2002 which deals with effect of non-registration of the security interest with the CERSAI. The induction of these Sections into the SARFAESI framework will have the following impact:
  a) The company will be able to enforce only those security interests which have been registered with the CERSAI under the SARFAESI Act. Therefore, if the company fails to register the same, it will lose its power to enforce security interest under the SARFAESI Act.

  b) Further section 26E provides that if the security interests are registered, the claim of the secured creditor shall enjoy a priority of over all other claims for debt, or claims for revenue or taxes on the proceeds from the sale of the assets.

Penal Provisions (Chapter VI)

- Failure to file assignment or realisation
  - Fine of Rs 5000 per day
  - Additional penalties can be imposed for contravention by the RBI and offences are subject to criminal prosecution upon a complaint by the RBI. 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.

RBI Guidelines for NBFC-Factor

The governing framework issued by the Reserve Bank of India can be classified into the following:

- The NBFC Factor Directions ('Directions')[5], first issued vide notification of 23rd July, 2012 by RBI, and subsequently amended vide Notification No. DNBR.012/ CGM (CDS)-2015, dated March 27, 2015 and later amended vide Notification No. DNBR (PD) CC.No.049/03.10.119/2015-16, dated April 11, 2016 deal with registration of factoring entities.
- Chapter VI of the Master Direction - Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016.[6]
- Chapter VII of the Master Directions- Non Banking Financial Company- Systemically Important Non-Deposit taking and Deposit taking Company (Reserve Bank) Directions, 2016.[7]
- Registration of Factors (Reserve Bank) Regulations, 2022.[8]
- Registration of Assignment of Receivables (Reserve Bank) Regulations, 2022.[9]

[5] NBFC-Factor Directions (2012) - https://rbi.org.in/scripts/FS_Notification.aspx?Id=7462&fn=14&Mode=0
Review of 2012 Directions (2016) - https://m.rbi.org.in/scripts/BS_NBFCNotificationView.aspx?Id=10286
[6] https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=10585
[7] https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=10586
[8] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12222&Mode=0
[9] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12223&Mode=0

Meaning of NBFC-Factor

NBFC- Factor means a non-banking financial company fulfilling the Principal business criteria i.e. whose financial assets in the factoring business constitute at least 50 percent of its total assets and income derived from factoring business is not less than 50 percent of its gross income, has Net Owned Funds of Rs. 5 crore and has been granted a certificate of registration by RBI under section 3 of the Factoring Regulation Act, 2011.

Entry point norms for NBFC-Factors

- Must be an NBFC as defined in clause (f) of Section 45-I of the RBI Act;
- Must have a minimum Net Owned Fund (NOF) of Rs. 5 crore;
- Must ensure that the financial assets in the factoring business is not less than 50% of its total assets and its income derived from factoring business is not less than 50% of its gross income;
- Must ensure that proper and adequate control and reporting mechanisms are put in place before factoring business is undertaken.
- NBFC ICC satisfying the following criteria:
  - Does not accept deposits
  - Total assets of Rs 1000 crore and above
  - Net Owned Fund of atleast Rs. 5 crore

The Companies fulfilling the aforesaid criteria can apply to RBI to grant a certificate of registration (CoR) as NBFC-Factor as provided under section 3 of the Factoring Regulation Act, 2011.

Compliances by NBFC-Factors

Conduct of business	The NBFC-Factors shall conduct the business of factoring in accordance with the Factoring Regulation Act, 2011 and the rules and regulations framed under it from time to time.
Asset classification	A receivable acquired under factoring which is not paid within six or three months of due date as applicable, shall be treated as non-performing asset (NPA) irrespective of when the receivable was acquired by the factor or whether the factoring was carried out on "with recourse" basis or "without-recourse" basis.

Export / Import Factoring

NBFC Factoring intending to deal in forex through export/import should make an application to FED for necessary authorization under FEMA, 1999 to deal in forex and adhere to the terms and conditions prescribed by FED and all the relevant provisions of the FEMA or Rules, Regulations, Notifications, Directions or Orders made thereunder from time to time.

Risk Management

The NBFC-Factor shall carry out a thorough credit appraisal of the debtors before entering into any factoring arrangement or prior to establishing lines of credit with the export factor.

In case of a non-recourse factoring transaction, the NBFC-Factor underwrites the credit risk on the debtor and therefore, there shall be a clearly laid down board approved limit for all such underwriting commitments.

Further, the NBFC-Factors and banks shall share information about common borrowers. Also, NBFC-Factors shall ensure to intimate the limits sanctioned to the borrower to the concerned banks / NBFCs and details of debts factored so as to avoid double financing.

Other applicable provisions

NBFC-Factors must comply with the other prudential norms as applicable to NBFCs

Reverse Factoring

Reverse Factoring is a financial technology solution that mitigates the negative effects of longer terms of payment to help buyers and suppliers optimize their working capital. Reverse factoring improves cash flows, reduces supply chain risk, and provides predictable return on investment for funders by linking buyers, suppliers and financial organisations.

Reverse factoring is an alternative financing solution where a supplier finances their receivables via a process started by the ordering party, in order to help their suppliers receive more favorable financial terms than they would have otherwise received for operational and other pass-thru costs incurred in providing services to the ordering party. Reverse factoring is seen as an effective cash flow optimisation tool for companies outsourcing large volume of services . The benefit to both parties is that the company providing the services can get the outstanding value of their invoices paid in 10 days or less vs. the normal 30-45 day payment terms while the ordering party can delay the actual payment of the invoices (which are paid to the bank) by 120-180 days thus increasing cash flow.

Reverse factoring is a traditional approach to modern day supply chain finance. Under reverse factoring, the suppliers sell invoices to banks or financial institutions at a predetermined discount rate. By selling invoices the supplier gets immediate access to cash whereas buyers get more time to pay the invoices.

Reverse factoring is said to be a cheap source of short-term finance option for the buyers the discount rate at which the invoice is settled by the bank/financial institution is lower than buyer's own sources of operating funds.

Reverse factoring is when a bank or finance company, on initiation by the buyer/ ordering party, commits to pay a company's invoices to the suppliers at an accelerated rate in exchange for a discount. It is unlike traditional invoice factoring, where a supplier wants to finance his receivables.

Reverse Factoring enables:

- Upfront payment to supplier
- Enables company to encash benefit of discounts on upfront payments
- Strengthens supply chain with ready access to funds
- MIS support on receivables

Mechanics of reverse factoring

Reverse factoring is a process whereby the buyer initiates the factoring transaction to help his supplier finance their receivables more easily and typically at a lower interest cost than what would usually be offered.

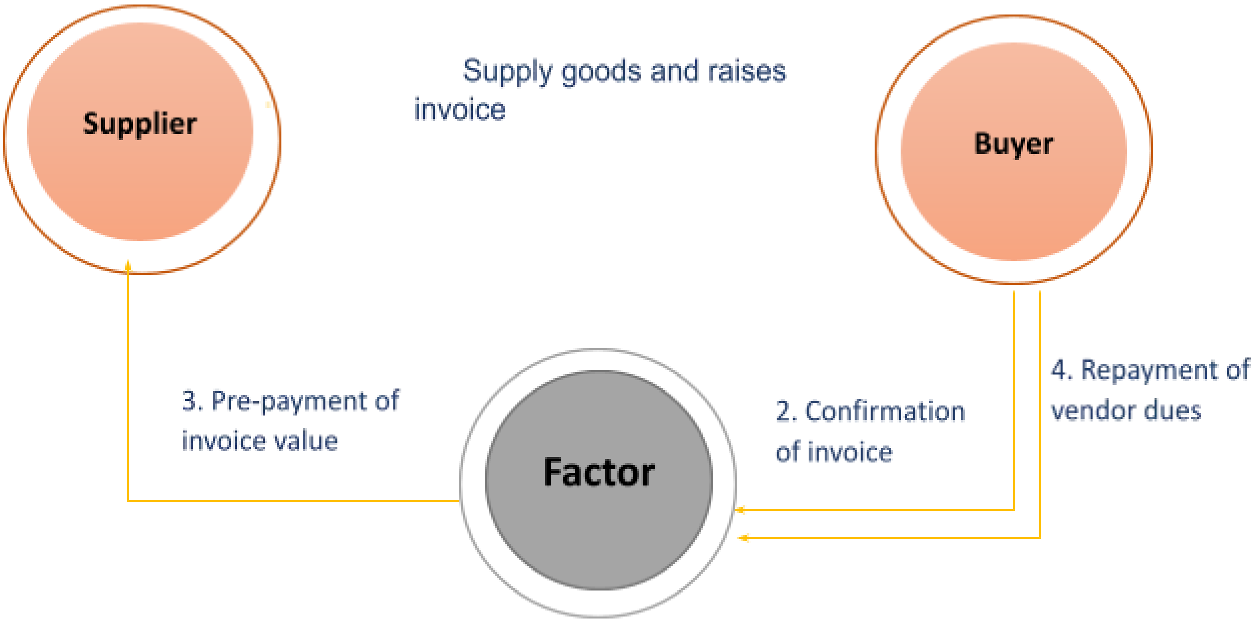
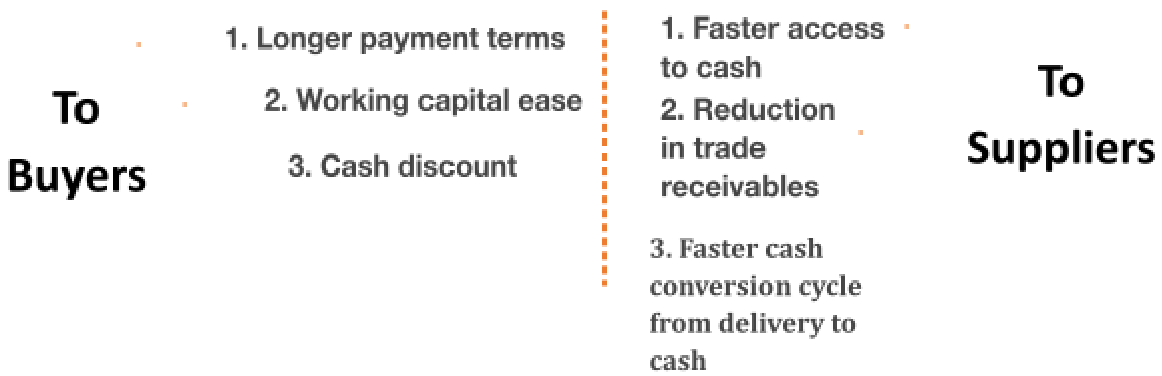


Figure D: Reverse Factoring Process

Under this process, the first step is that the buyer places an order with the supplier. The supplier then fulfils the order and raises invoice in favour of the buyer. The buyer then approves the supplier's invoices and confirms that it will pay the financial institution for these at invoice maturity. The supplier discounts the invoices with the factor at a predetermined discount rate and receives the funds straight away. On the maturity date, the buyer makes the payment to the factor as agreed between the factor and the buyer.

Benefits of reverse factoring



Why is reverse factoring important?

Reverse factoring is beneficial for MSMEs because ordinary factoring requires comprehensive credit information on all the borrower's customers, which may be difficult and costly to determine in countries with weak credit information systems. Further it allows firms to transfer their credit risk and borrow on the credit risk of its creditworthy customers. This may allow firms to borrow greater amounts at lower costs.

Another importance of reverse factoring is that it provides benefits to both lenders and buyers. Lenders are able to develop relationships with small firms with high quality customers without taking on additional risk. This may provide cross-selling opportunities and allows the lender to build a credit history on the small firm that may allow additional lending. The large buyers may be able to negotiate better terms with its suppliers by engineering a reverse factoring arrangement and providing its customers with working capital financing.

Reverse Factoring is an effective solution to weaknesses in credit information on buyers, which increases the difficulty of collecting credit information on a large number of buyers.

Reverse factoring is growing at high speed. As per the FCI Report, the position of Reverse Factoring has grown in the year 2018 to a typical 12% from a typical 8% last year world-wide. However, it can be said that the reverse factoring market is growing but in general it is on a development stage. As published in the FCI Annual Report[10], Reverse Factoring displayed a higher appetite (refer figure D) among its member with larger investments-rated corporate buyers having developed Supply Chain Factoring programs.

[10] https://fci.nl/en/news/fci-launch-2022-annual-review?language_content_entity=en

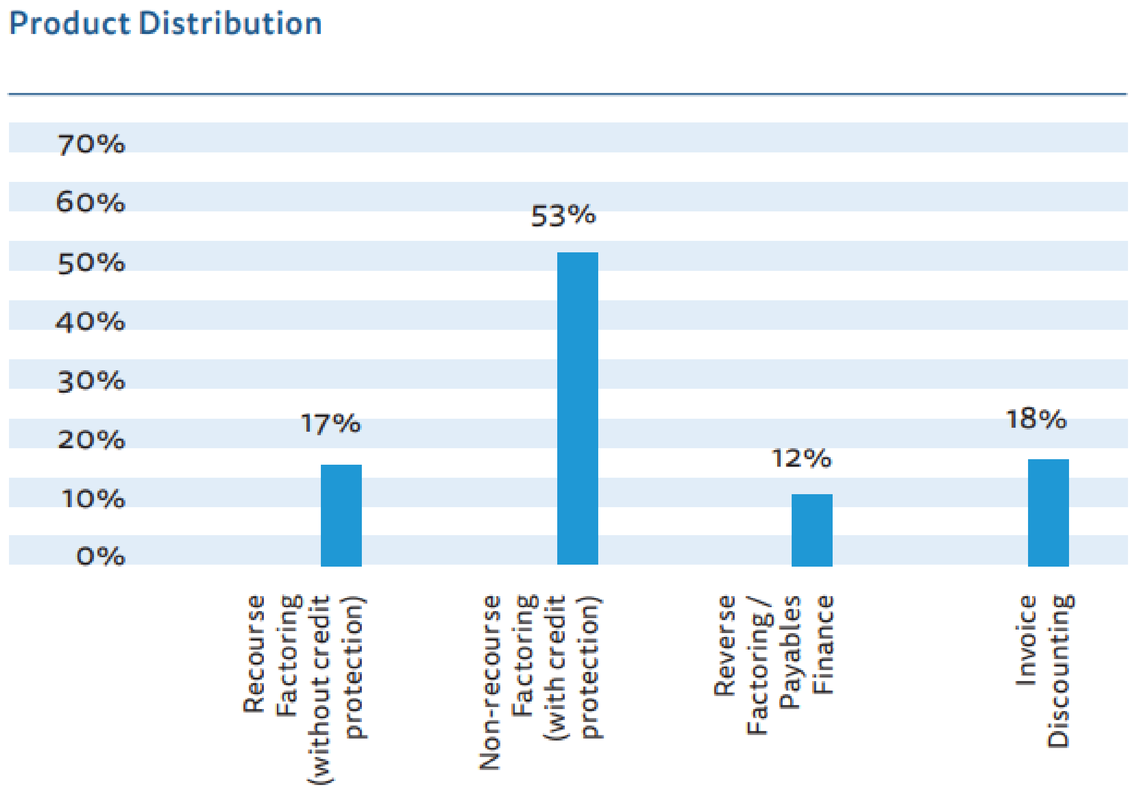


Figure E: Share of Reverse Factoring

Source: 2021 GIAR Report

Implementation of Reverse Factoring in TreDS

While analysing the current framework with respect to liquidity management of Micro Small and Medium Enterprises, the RBI *vide* Report of the Expert Committee on Micro, Small and Medium Enterprises dated June 25, 2019 opined that the reverse factoring has not picked up on the TReDS platform and therefore it needs to be promoted keeping in mind the inherent advantages of reverse factoring. In line with this reasoning the Expert Committee recommended that a second TReDS window should be created for easy access to supplier financing. [11]

[11] https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=924

Export Factoring in India

Introduction

Export factoring bundles together credit protection, export working capital financing, foreign accounts receivables bookkeeping and collection services- all in one product. It is the sale of foreign accounts receivable by a seller (exporter) to a factoring company at a discount, where the financier (factor) assumes the risk of default of the foreign buyer and handles collection on the receivables. The factor will purchase the accounts receivables or invoices, which are raised once the exporter ships the goods to the buyer (importer). Export financing is usually without recourse wherein the financier takes the payment risk of the importer.

Export factoring is a financing solution available to the exporter which allows the exporter to offer open account terms, a better liquidity position and allows it to be increasingly competitive. It can also be viewed as an alternative to export credit insurance, long-term bank financing or other high cost debt.

Export factoring allows trade to be carried out on open account terms and assists especially where there are short-term sales of products and where there may be risk of non-payment. It 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.

Process flow

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. This fulfils the exporter's immediate liquidity requirements, reduced credit burden and provides for better financial planning. Additionally, the exporter's risks associated with the international trade are also transferred to the export factor.

The exporter sells goods to the importer and raises invoice on the importer. The importer agrees to pay the exporter at the end of the agreed credit period. The exporter sells the receivables to an export factor without recourse and receives a certain percentage of the invoice value upfront. At the end of the maturity period, the export factor collects the payment from the importer.

Advantages of Export factoring

Immediate cash injection	Export factoring is the process of conversion of credit sale into cash without recourse to the exporter. The exporter sells their invoice receivables to the factors and immediately receives working capital. This immediate injection of cash helps the exporter to strengthen the company's daily operations and allow a smooth flow of business.
Business growth	The exporters increase their sales volume by offering open account terms to their importers, enabling the importers to place larger orders.
Reduced Risk	The factoring companies guarantees payment from the importers. In case the importer defaults on a payment due to bankruptcy or insolvency, the exporter does not have to bear the default.
Collection management	The factoring companies handles the collection of payment from the importer, taking away the hassle of collection management from the exporters. The exporters do not have to worry themselves about the different time zones or language barriers and they do not have to take the foreign exchange risk.
Improves cash flow and working capital	The exporters are paid upfront by the factoring companies and therefore, they have access to capital for materials or to fund growth and investments.
Competitive advantage	The export business is expanding tremendously and to keep pace with the fast-changing world, the exporters are required to sustain competition. An exporter that offers open account terms can have competitive edge over others and win business in a competitive marketplace.

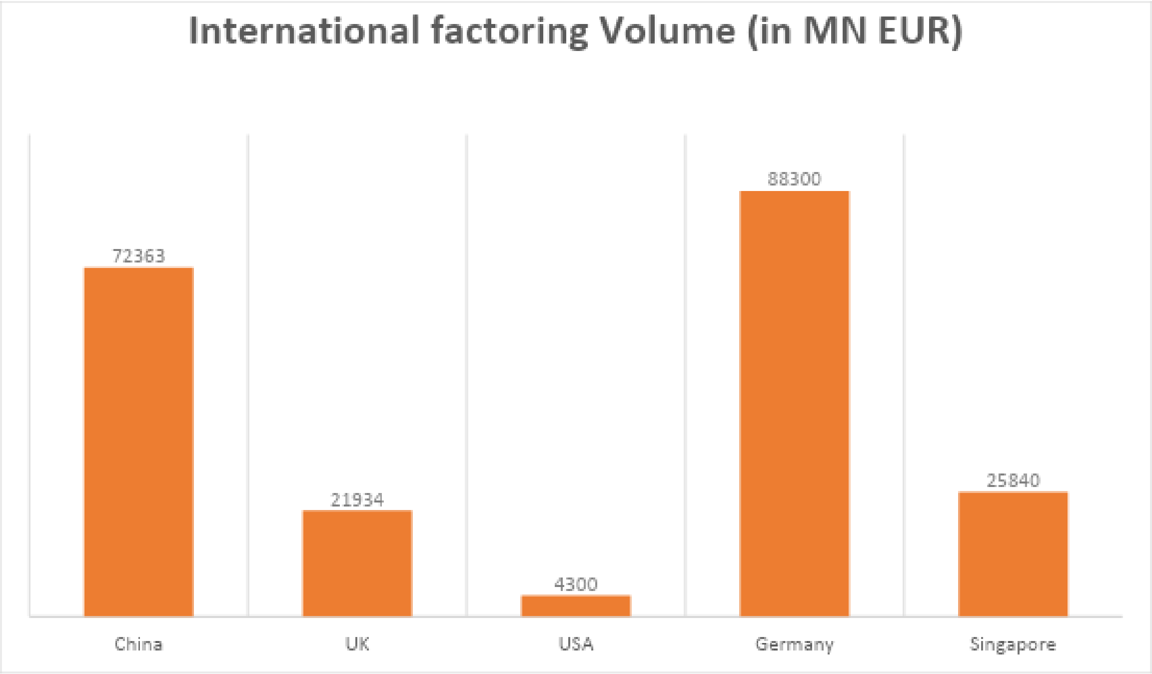
Why is demand for Export Factoring rising?

Export contributes 21.4% to India's GDP.[12] In July 2022, 130 of the 31 export sectors monitored by the Indian Ministry of Commerce saw positive growth. Exports from India in December 2022 are estimated to be USD 61.82 Billion, showcasing a slight fall of (-) 5.26% over the same period last year.[13] [14]. Therefore, it is worth noting that the export business continues to hold steady and the exporters require steady working capital to sustain competition. This is where the need for export factoring crops up.

Currently, the exporters are increasingly becoming more comfortable with export factoring and therefore, the demand for export factoring in India is rising. However, the export factoring in India, if compared globally, is growing at a very slow pace. The reasons for this slow growth are discussed below in the article.

Global Scenario

According to the data from FCI's 2021 Annual Review[15], in the year 2021, the factoring volume in China was as high as 72,363 Million EUR for the international market (both export and import). In UK, the total factoring volume was 328,429 Million EUR, out of which 21,934 Million EUR was of the international market. The factoring volume for Germany and Singapore were also quite high in terms of international factoring. However the numbers in USA were not as high, as depicted in the graph below:



[12]https://data.worldbank.org/indicator/NE.EXP.GNFS.ZS?end=2021&locations=IN&name_desc=false&start=1960&view=chart

[13]https://commerce.gov.in/wp-content/uploads/2023/01/Press-Release-December-2022.pdf

[14] https://tradingeconomics.com/india/exports-of-goods-and-services-percent-of-gdp-wb-data.html

[15] https://fci.nl/en/annual-review

Figure F: International Factoring volumes across countriesReasons for slow growth of export factoring in India as compared globally

Globally, cash credit and overdraft facilities are not easily available and hence the finance happens through factoring. Also, their legal system is strong to back such a facility. However, in India, cash credit and overdraft facilities are more acceptable to the borrower. Debtors do not easily accept the assignment and are not ready to pay directly to factors. Even the banks have apprehensions about factoring and consider it as a competitor.

The NBFC-Factors providing export factoring services are financed by the banks. The banks charge a high rate of interest to the NBFC factors. The NBFC Factors, further, charge additional interests on it. Therefore, the exporters receive the factoring facility at a very high rate of interest. In the global scenario, the cost of funding is low. The exporters receive the amount at a low rate, say 4% or 5%.

Further, there are no significant players in Indian market. And even those under operations function on a very small scale.

Major Players

The following are the major players providing export factoring services to the Indian exporters to provide them easy access to steady working capital.

Based out of United States of America

Drip Capital[16] offers finance to Indian exporters selling to buyers in North America, Europe, Middle East and the Asia Pacific. Drip Capital has built a strong presence across India having financed over $100 million of trade across export domains in the following four industries: Garment and Textiles, Processed/Packaged & Frozen Food, Engineering Products, and Agro Commodities. The seller is required to fill an application form by providing their business information and the details of the buyers. Once, the application form is filled, their credit team evaluates the application form and accordingly, approve the credit limit. The approval of finance is based on the export performance of the exporter and the buyer's credit reputations. After the approval of the credit limit, the exporter is required to submit its invoice along with lading or airway bill and it shall receive and advance disbursement of up to 80% of the net invoice value within 24 hours. Drip Capital provides a credit limit up to $2.5 Million.

An exporter who utilises Drip Capital's finance facility will have to bear three types of charges:

- Processing fee- this is a one type fee and it ranges from 0.4% to 1% of the total credit facility that is approved.
- Factoring fee- this is charged for each invoice. The amount that is levied ranges from a low of 0.4% of net invoice value to 1% of net invoice value.

[16] https://www.dripcapital.com/products/export-factoring/

- Interest- this ranges from 4.5% to 9% per year. It is calculated on the actual number of days for which the finance facility is utilized.

The fees and charges are not collected upfront. They are deducted from the payment that is made to the exporter when the amount is received from the buyer. The processing fee is deducted at the time of the first such payment. At the end of the payment tenure, when the payment is received from the importer, Drip subtracts charges and remits balance amount to the exporter.

RTS International[17] provides customized financial solutions for international clients exporting product to the U.S. and Canada. Once the title is transferred to the importer, the exporter generates an invoice for sale. The exporter sells the invoice to the Company and gets paid 80%-90% of the total invoice value upfront. At the maturity period, RTS International collects the money from the buyer and returns the reserve balance to the exporter minus a fee for assuming the collection risk. It solves short-term cash flow issues for exporters in a variety of industries, including manufacturing, textiles, transportation, agriculture and seafood.

RTS International has an average monthly exporting volume of $200,000 or more in U.S. dollars. Besides the factoring fee, RTS International charges an ancillary fee. Factoring fees are determined by monthly volume, creditworthiness of the buyers and other conditions. Most contracts have an annual renewal fee.

Based out of Germany

Tradewind[18] (formerly known as DS-Concept) is a global provider of trade finance solutions for SMEs. It offers non-recourse international export factoring. It helps the companies to accelerate cash flow, improve collections and control exposure to bad debts. Tradewind evaluates the credit worthiness of the importer and sets a credit limit on the exporter. The exporter submits its invoice and receives payment with 24-48 hours. It provides factoring service on a non-recourse basis. The exporter’s invoice is purchased in exchange for an advance of up to 95% of the total invoice value. Once the invoice is paid in full by the importer, Tradewind send the exporter the remaining balance.

Based out of United Kingdom

Stenn International Limited (“Stenn”)[19] is non-bank trade finance provider specialized in cross-border trade. The buyers receive open account terms, allowing later payments, while overseas suppliers are paid earlier with the guarantee of payment in full. This creates working capital without tying up valuable credit lines or using collateral. It purchases invoices on a non-recourse basis and the exporter receives up to 100% of the invoice value less a small discount at shipment of goods. The importer receives goods from the buyer and convert them to revenue without tying up availability under existing

[17] https://www.rtsinternational.com/page/about-us
[18] https://www.tradewindfinance.com/
[19] https://stenn.com/

credit lines or outlaying cash for procurement. As per its press release[20] dated April 20, 2018, it had closed $10 million in new factoring and supply chain facilities with clients in varying industries and countries.

PrimaDollar[21] is a UK-based trade finance platform working with exporters and importers on a global basis. The exporter receives payment from PrimaDollar at the time of shipment against the shipping documents. The importer pays the company the invoice amount at the end of the agreed credit period. The company takes the buyer credit risk and they work on a global basis. PrimaDollar is a trade finance company. Both international factoring and trade finance offer solutions to support the international supply of manufactured goods, like garments, household goods, consumer electronics or any other merchandise that is generally shipped and sold in shops to retail customers. Both international factoring and trade finance products help to address the cash flow gap that the exporters face.

Trade finance is a significantly better solution for the emerging markets supply chain than alternatives like international factoring. This is because the cost of trade finance is a lot cheaper than international factoring. In trade finance, the typical cost involved is 5% to 12% per annum depending upon the importer's location, credit quality and size of the purchase order. Whereas, in case of international factoring, the typical cost involved is 10% to 24% pe annum.

[20] https://stenn.com/archives/742
[21] https://www.primadollar.com/

Regulatory Framework governing Export Factoring

Factoring Act, 2011 (Factoring Act)[22]

As per section 2(p) "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.

And, as per section 2(a) "assignment" means transfer by agreement to a factor of an undivided interest, in whole or in part, in the receivables of an assignor due from a debtor and includes such transfer **where either the assignor or the debtor is situated or established outside India**.

In accordance with the provisions of the Factoring Act, a Factor, Client or a customer may be located outside the territory of India and such a transaction shall be governed by the provisions of the Factoring Act and Foreign Exchange Management Act (FEMA).

As per section 31(1)(d) the provisions of the Act shall not apply to foreign exchange transactions except receivables in foreign currency.

The Factoring Act provides that 'banks', as defined in the Banking Regulation Act, 1949 are not required to be registered as factors for the purposes of carrying out the factoring business. However, Non-Banking Financial Companies (NBFCs) engaged in the factoring business are required to be registered in accordance with the provisions of the Factoring Act. The factor commencing the factoring business shall obtain a certificate of registration from RBI.

However, this Act extends to whole of India. Therefore, the overseas factoring companies providing factoring services to the Indian exporters are not covered under the Factoring Act.

Further, section 19 of the Factoring Act states that every factor is under the obligation to register themselves with the Central Registry set up under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFESI) and file the particulars of every transaction of assignment of receivables in his favour with the Central Registry. Further, upon realisation of the assigned receivables or settlement of the claim against the debtors, the Factor would be required to file for satisfaction of the assignment of receivables in its favour, in such manner and subject to payment of such fees as may be prescribed in this behalf. Additionally, in the event the TReDS platform is used as a factoring mechanism, then in such cases, the obligation to register with the Central Registry and thereby comply with all the filling related matters shall be undertaken by the TReDS platform on behalf of the Factor.

[22] https://indiacode.nic.in/bitstream/123456789/2116/1/201212.pdf

Since, the overseas factoring companies are not covered under the Factoring Act, therefore, the companies are not required to register themselves with the Central Registry.

Foreign Exchange Management (Export of Goods & Services) Regulations, 2015 (FEMA Regulations)[23]

- Declaration

Para 3 states that in case of export of goods, the exporters are required to furnish a declaration to the specified authority containing the true and correct material particulars including the amount representing the full export value.

Further, in case of export of services, the exporter may export the services without furnishing any declaration but shall be liable to realise the amount of foreign exchange which becomes due on account of such export, and to repatriate the same to India.

- Realisation and Repatriation

The exporter of the goods or services shall take all reasonable steps to realise and repatriate to India the amount of foreign exchange which is due or has accrued to him within 9 months from the date of such export.

In case of export factoring, the exporter receives around 80%-90% of the invoice value upfront and once the export factor collects the amount on the maturity date from the importer, the reserve balance is received by the exporter. However, the exporter shall be responsible for realisation of the full export proceeds within 9 months from the date of raising the invoice.

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. Further, with the growth in exports, the demand for export factoring has also seen a major rise. However, India is still laid back as compared to export factoring market globally.

[23] https://www.rbi.org.in/scripts/BS_FemaNotifications.aspx?Id=10256

Market for factoring in India

Since its inception, factoring business has made a significant progress in India. 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 total factoring volume has increased in the past 7 years. The factoring volume was highest in 2013 and subsequently decreased till 2015. In the years 2016 and 2017, there was again a rise in the volume. The following graph depicts this increase.

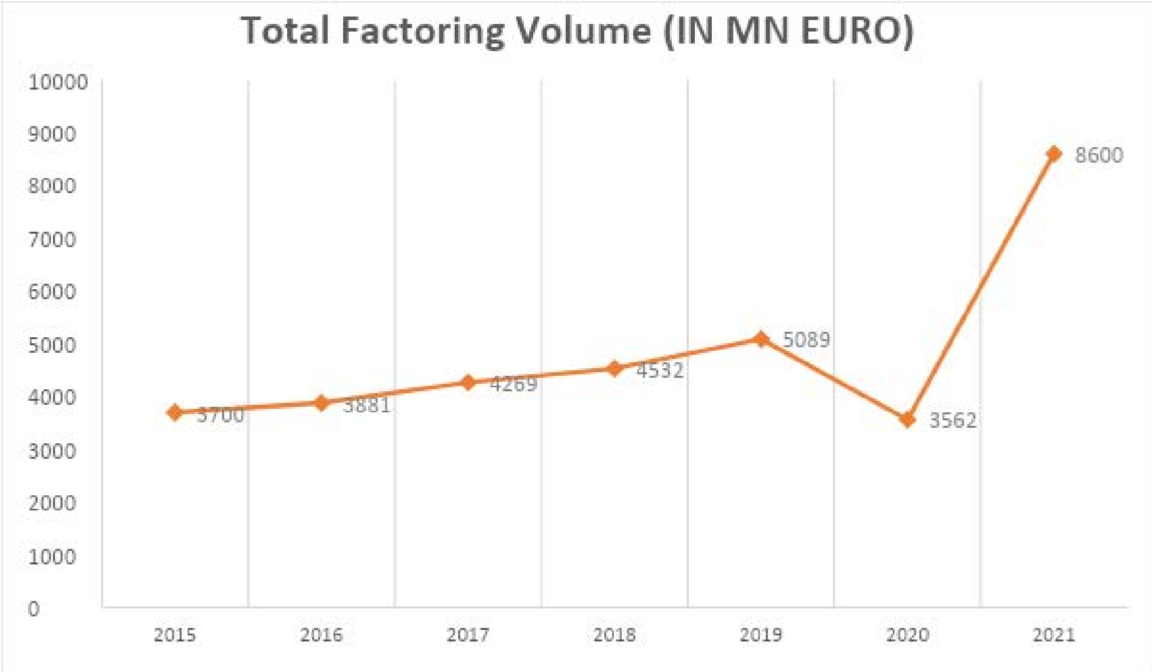
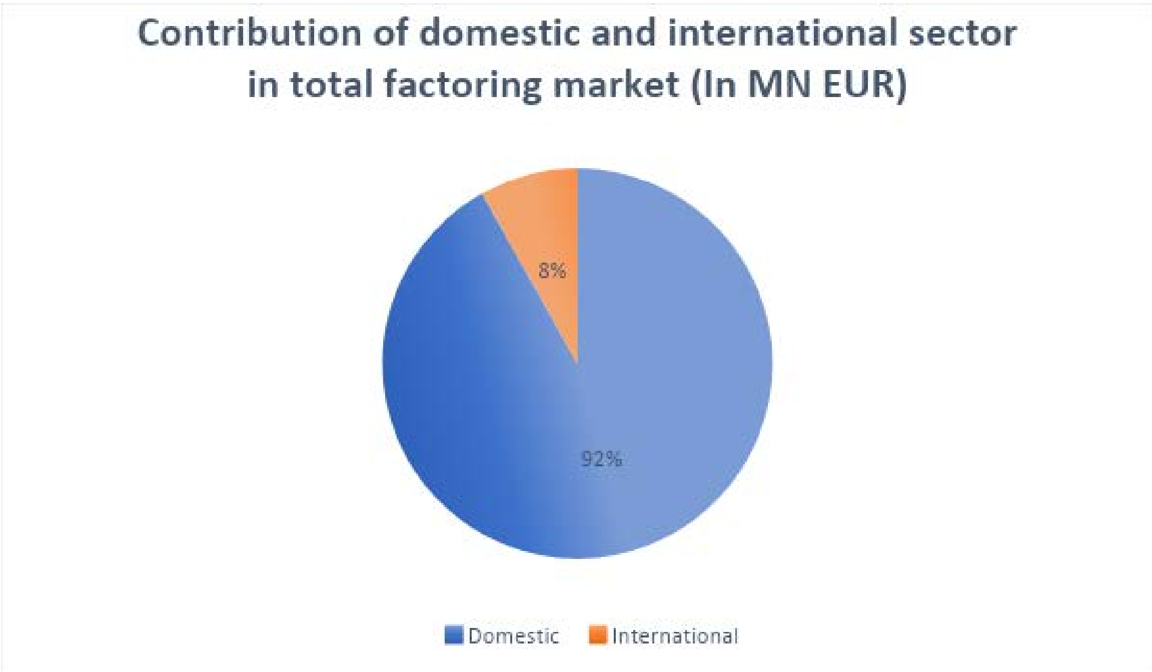


Figure G: Total Factoring Volume in India over the years

Source: FCI Annual Report (2022)

In the year 2021, the total volume of factoring was8600 million EUR. Out of this major contribution was from the domestic sector[24] (7900 million EUR). . The following pie chart shows the percentage contributed by the domestic and international sectors in the total factoring volume in the year 2021.



[24] https://fci.nl/downloads/Annual%20Review%202018.pdf

Figure H: Contribution of domestic and international sector in total factoring market of India

SBI Factors and Commercials Limited was the first factoring company to start its operation in India in April, 1991. Since then a number of companies have started factoring business in India. As on December 31, 2022,t, there are only 8 NBFC factors registered with RBI with SBI Factors and Commercials Limited being the only factor with a substantial asset size (NBFC Middle Layer) .

The List of NBFC Factors registered with RBI as on December 31, 2022 [25] are:

NBFC Factor Name	Regional Office
SBI Global Factors Ltd. [Formerly - Global Trade Finance Limited]	Mumbai
Arth Padarth Factors And Finance Pvt Ltd	Mumbai
Canbank Factors Limited	Bangalore
Ifci Factors Ltd.	New Delhi
India Factoring & Finance Solutions Pvt Ltd	Mumbai
Pinnacle Capital Solutions Private Limited	Patna
Siemens Factoring Private Limited	Mumbai
121 Finance Private Limited (Old Name Yerrow Finance And Investments Private Limited)	Mumbai

Way Forward

The Government in order to further penetrate the factoring activities in India specifically for the MSMEs sector has approved the creation of Credit Guarantee Fund for Factoring with a budget of Rs, 500 crore. This fund encourages and incentivises factors to extend their lending to MSMEs against factored loans by sharing part of their risk, thereby resulting in an increase in actual credit availability for MSMEs. These initiatives, along with better economic environment, should assist to propel the growth of the factoring sector and transform the face of traditional working capital financing in the country.

[25] https://rbi.org.in/Scripts/BS_NBFCList.aspx

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Trade Receivables Discounting System (TreDS)

An institutional framework is devised for facilitation of electronic bill factoring exchanges, which could electronically accept and in turn auction the MSME bills against large companies, to make the payment to MSMEs more prompt. The RBI introduced Trade Receivables e-Discounting System (TReDS) vide its notification[26] dated 3rd December, 2014. Recently, the MSME Ministry issued a notification[27] mandating all large companies, with a turnover of Rs 500 crores or above, to mandatorily on-board on TReDS, so as to allow the MSME receivables from larger companies to be funded and traded on the receivables exchanges.

The TReDS platform enables discounting of invoices/bills of exchange of MSME sellers against large corporates, including government departments and public sector undertakings, through an auction mechanism to ensure prompt realisation of trade receivables at competitive market rates. financiers participate in the auction. It

[26] http://www.rbi.org.in/scripts/bs_viewcontent.aspx?Id=2904
[27] http://egazette.nic.in/WriteReadData/2018/191729.pdf

addresses the twin issues facing MSMEs- prompt encashment of receivables and elimination of credit risk.

Micro, small and medium enterprises (MSMEs) supplying to top-notch corporates can get their invoices discounted at or close to banks' benchmark lending rates if they get on to the TReDS. This is so because financiers, such as banks and non-banking finance companies (who are into factoring business), discount suppliers' invoices on the TReDS platform based on the strength of the corporate buyers' credit rating. In other words, MSME suppliers can get their invoices discounted at lower interest rates on TReDS if their corporate buyers' credit rating is strong.

Eligibility to set up and operate TreDS

Entities desirous of setting up and operating the TReDS should fulfil 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 as to check system manipulation.

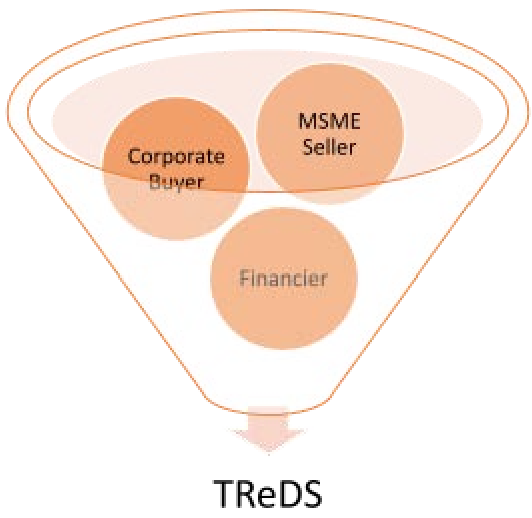
Regulatory framework

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.

Participants on a TReDS Platform

There are three participants who are required to register themselves on the TReDS platform.

1. **Corporate Buyer-** Corporates including companies and other buyers including Government Departments and Public Sector Undertakings and such other entities as may be permitted by the RBI are required to onboard themselves on the TReDS platform.
2. **MSME Seller-** MSME entities as per the definition of the Micro, Small and Medium Enterprises Development Act, 2006 (MSMED Act).
3. **Financiers-** Banks, NBFC Factors, Financial Institutions and such other Institutions as permitted by the RBI.



Existing TReDS Platforms

TReDS is an RBI regulated trading platform for buying and selling receivables on a bidding model. Currently, RBI under the Payment and Settlement System (PSS) Act 2007 has issued TReDS license to only three companies in India and they are:

Receivables Exchange of India Ltd (RXIL)[28], is a joint venture promoted by Small Industries Development Bank of India (SIDBI), the apex financial institution for promotion and financing of MSMEs in India and National Stock Exchange of India Limited (NSE), the premier stock exchange in India. RXIL was the first entity to receive the approval from Reserve Bank of India (RBI) on December 01, 2016 to launch India First TReDS Exchange. It started operations in January 2017. Hindustan Aeronautics Ltd (HAL), the strategic state-owned aerospace and defence PSU, executed its first digitized invoice discounting transaction on RXIL TReDS platform on June 14, 2018, when it accepted the digital invoice uploaded by Narendra Udyog, a Nasik based MSME (micro category) vendor. This made HAL the first PSU to transact on TReDS across platforms. The transaction was financed by Bank of Baroda and stands settled.

A.TREDS Ltd[29]., a joint venture between Axis Bank and mjunction services, is an entity approved by the RBI to operate its TReDS platform. The platform is named "**Invoicemart**". The platform was launched in July, 2017 and in its first year of operation, it has successfully processed over 30,000 invoices worth 750 crores. As on March 19, 2019, the platform had over 100 buyers (corporates) and 23 financiers like State Bank of India, Bank of Baroda, DBS Bank, Lakshmi Vilas Bank, among others and had crossed Rs. 2500 crores in business volume.

RBI granted approval to **Mynd Solutions**[30] in Dec 2015, to set-up and operate TReDS under the PSS Act 2007. Mynd solutions is one of the very few entities approved to set up the exchange which is to be known as **M1 Exchange**. The rate of interest charged on this platform ranges between 8.5 and 10 per cent. While PSU factoring companies such as SBI Global Factors and Canbank Factors have already been active on M1Xchange, more and more PSU banks like Punjab and Sind are getting onboard lately. Standard Chartered Bank successfully completed its first Trade Receivable Discounting System (TReDS) digital factoring transaction on M1xchange. The Bank had purchased the digital factoring unit of MSME supplier of Godrej Agrovet Ltd. Additionally, in November 2022, the M1 Exchange partnered with the MSME Ministry for integration of the Udyam Portal

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[28] http://www.rxil.in/
[29] https://www.invoicemart.com/about-us.html
[30] http://www.m1xchange.com/

with TReDS, this particular joining of hands is considered to be a game changer to solve the credit gap challenges faced by MSMEs in India.

The platforms generally, charges the following types of fees:

- Registration fees
- Transaction fees
- Annual fees

Based on our analysis, we observe that the commercials vary from participant to participant and are mentioned in the master agreement executed between the buyers, suppliers and financiers.

As on November 2022, the aggregate transaction value on all the three existing platforms has been over rupees 1000 crore. Further, the total number of participants on these platforms at present are (approx.):[31]

	Buyers	**Sellers**	**Financiers**
RXIL	987	13154	54
Invoicemart	1188	16643	50
M1 exchange	1134	13939	50

TreDS Process flow

TReDS is a highly regulated platform. The system and the process flow has been designed in such a way that each participant in the scheme i.e. the corporate buyer, the MSME seller and the financers enjoy uninterrupted services while discharging their functions and interests of all the parties are satisfied. The TReDS ensure registration of all the parties to this transaction on the platform.

The process starts with the supply of goods by the MSME sellers to the buyers, subsequent to which the MSME sellers generate invoices/bills of exchange in favour of the corporate buyers. The MSME creates a 'factoring unit' on the TReDS which is then further verified by the corporate buyer through the available invoices/bills of exchange against them. The TReDS will ensure separate module for transaction and factoring units can be created under each module. Factoring unit can generally be of an entire bill/invoice amount or in multiples of pre-defined face value. The factoring unit shall also mention the details of the buyer and the seller, the due date, the issue date and the

[31] https://www.rbi.org.in/Scripts/TREDSStatisticsView.aspx?TREDSid=9

tenor etc. It shall be ensured that the TReDS provides a filtering mechanism for such factoring units.

Once these factoring units are available on the platform the financers registered with the platform place bids for their financing for which the TReDS provide a window platform. Once the MSME seller accepts the bids the financer receives information pertaining to it. Thereafter the funds are credited to the account of the MSME seller on the basis of T+2 settlement system. Thereafter there is an assignment of debt to the financer by the MSME seller and the corporate buyer is entitled to pay the financer on the due date. TReDS shall ensure sending due notifications to corporate buyer before the due date. The unfinanced factoring units existing on the platform, shall be financed by the corporate buyer outside the platform. It is the responsibility on the corporate buyer's bank to credit the funds in the account of the financer at the end of the process, non-compliance of which would make the corporate buyer defaulter and would attract penalty against it.

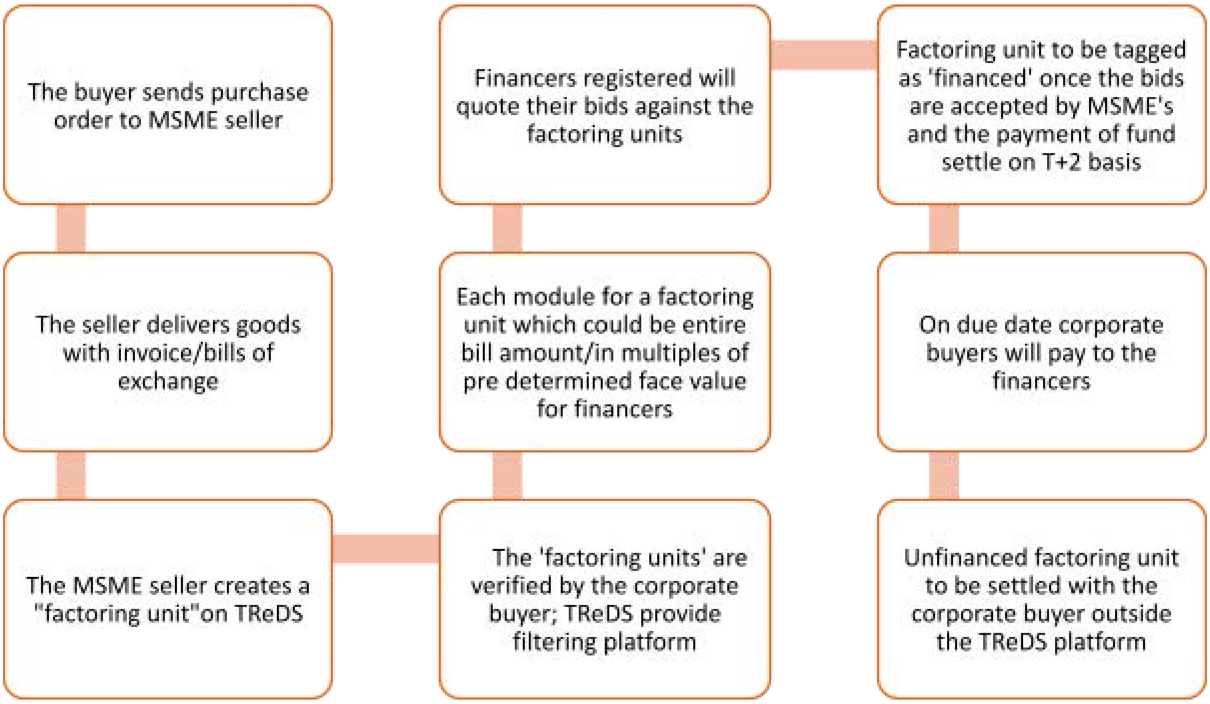


Figure G : TreDS process flow in brief

Integration of TReDS with the GSTN's e-invoicing portal.

The Factoring Regulation (Amendment) Bill, 2020 came out with a proposal to integrate the TReDS platform with the GSTN's e-invoicing portal so as to exchange data between these portals on real time basis. This integration would enable measuring of credit scores of several corporate and government entities. Moreover, the issue with respect to fake invoicing is also intended to be resolved by virtue of this integration.

Global Scenario

The Invoice platforms in the UK are split into two types. The first variant being Invoice trading platforms where Investors buy Invoices through a bidding process. The second variant is Supply Chain Finance platforms, where the bidding process is replaced by agreements between the buyer, seller and the Investor. The following are electronic invoicing platforms in the U.K. –

- **Platform black**- It is one of the U.K. based electronic invoice auction platform for MSEs which started its first auction in 2012. There is retail as well as institutional investors on boarded on the platform.
- **MarketInvoice**- It is another online invoice auction platform which was launched in 2011. Its biggest supporter is the U.K. Government which buys invoices from the MarketInvoice as part of the British Business Bank initiative.
- **Funding invoice**- It is another invoice auction platform in U.K. which charges SMEs a fee on each invoice they fund through their platform. There is no monthly subscription or listing fees. A typical fee structure could be 2.75% of an invoice's values for 30 days, and then 1% for each 30 days thereafter[32].

In Latin America, there are a number of companies, which are seen operating in this area. They are:

- **TREFI (Peru) -** This platform allows fiduciary agents to purchase SME's accounts receivable at discounted rates while managing the risk held between the SME's and the fiduciary agents, thereby strengthening the SME's liquidity and enabling it to extend credit to its clients.
- **Mesfix (Colombia) -** it is a market place that connects investors with SMEs who wishes to sell their invoices and allows for multiple funders to finance a part or all of a certain invoice.
- **Facturedo (Chile) -** It allows SMEs to participate in auctioning their invoices in an easy, flexible, and fully online manner.
- **InvoiNet (Argentina) -** It is an open marketplace for reverse factoring electronic invoice financing. It connects the suppliers with multiple lenders on a collaborative platform.
- **E-Factor Network (Mexico) –** It is a platform for that enables electronic financing services for participating suppliers who wish to discount their receivables.

- **E-Fund SME** is a Singapore incorporated company, founded and wholly owned by the Singapore business leaders. The eligible SMEs who can onboard on this platform are Singapore registered Pte Ltd Co. or LLP. The advance amount shall be disbursed within 48 hours from verification by the buyers.

[32] https://fundinginvoice.com/about/faqs/

Buzz around TReDS

The TReDS platform had not been in much momentum for the last few years. A major reason for drawback is that only MSMEs registered under the MSME Development Act, 2006, can onboard on the TReDS platform, and the fact remains that major chunk of the MSMEs are unregistered. The number of MSMEs registered on Udyog Aadhaar Memorandum (UAM) Portal from September, 2015 to 12th July, 2018 is nearly 48.40 lakh. Out of which 43,18,841 are registered as micro, 5,00,942 as small and 19,766 as medium enterprises.[33] As on date, the UAM Portal shows that the total number of registered MSMEs are 92, 68,159[34].

Further, based on practical experience of operating the TReDS platform it has been observed that big corporate houses are not comfortable with uploading of invoices on online platforms. Being a transparent system, these corporates are not appreciating the fact that they are required to ensure the settlement of the MSME invoices within the prescribed period of 45 days from the date of acceptance of goods or services rendered by the MSME. There is also a fear of disclosure of information about their MSME suppliers to their competitors.

However, with the increase in the government pressure for promoting and pushing the MSME sector for the industrial development, the government is giving more emphasis on registering with the TReDS platform. The Reserve Bank of India had prescribed guidelines for the TReDS platform, defined under 'Guidelines for setting up of and operating the trade receivables discounting system' issued on December 03rd 2014 (updated on July 2, 2018)[35]. TReDS being an institutional mechanism to bring the MSME's and the corporate buyer and the financer on the same platform for financing the receivables of the MSME's, the government has left nothing undone in providing the best benefits to the MSME's through the scheme.

A wave can be witnessed currently regarding the registration of the parties on the platform. The government is striving to inculcate a sense amongst various companies to register on this platform in order to provide working capital needs to this sector. The government has also identified various state-run companies, public sector banks, other private and public limited companies to register themselves on the platform and act as financers of the receivables of the MSME's.

The volume of Factoring Units that were uploaded and financed on the TReDS platforms in September 2022 is provided in the table.

[33] http://pib.nic.in/PressReleaseIframePage.aspx?PRID=1539110
[34] https://udyogaadhaar.gov.in/UA/UAM_Registration.aspx (Viewed as on November 12, 2018)
[35] https://rbidocs.rbi.org.in/rdocs/Content/PDFs/TREDSGD0241C8FEF214D7DAD76487274D27742.PDF

TReDS	Factoring Units (FUs) uploaded		Factoring Units (FUs) financed	
	No. of FUs	**Value (Rs. ’000)**	**No. of FUs**	**Value (Rs. ‘000)**
A.TREDS Limited	13419	27319799	12509	25437636
Mynd Solutions Private Limited	9601	21101424	9207	20294025
Receivables Exchange of India Limited	18753	22471661	13426	20508449
Total	**41773**	**70892885**	**35142**	**66240111**

Overview of Factoring Industry Globally

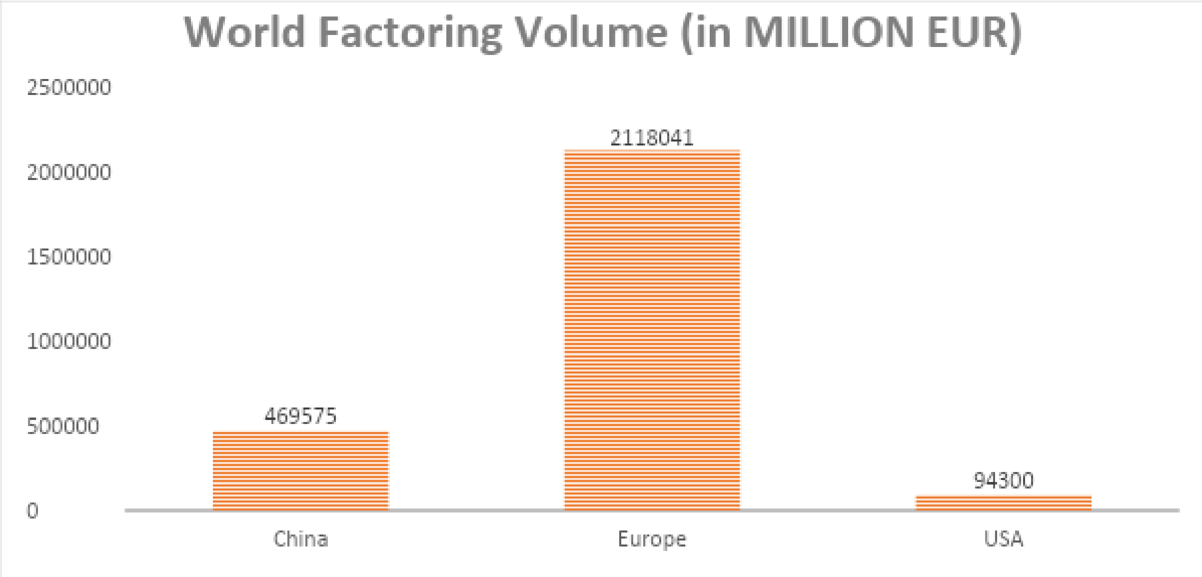
Factoring is now universally accepted as vital to the financial needs of small and medium-sized businesses. It has the support of government offices and central banks throughout the world. As international trade continues to increase, the opportunity for the factoring industry is growing at the same 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. The year 2021 witnessed, the total global factoring volume reached a figure of EUR 3093 billion with a GDP penetration of 3.91%.[36] bi

The Asia Pacific factoring has grown by 24.28% in the year 2021 from EUR 697,093 million in 2020 to EUR 751,096 million in 2021. Despite the onset of the global pandemic the numbers in this region grew at a considerable rate with substantial contributions from China, Japan, Taiwan and Hong Kong. .

The factoring volume in India in the year 2021 saw an exponential rise of 141.4% from EUR 3564 million in the year 2020 to EUR 8600 million in the year 2021. This was the

[36] Annual Review 2022, https://fci.nl/en/annual-review

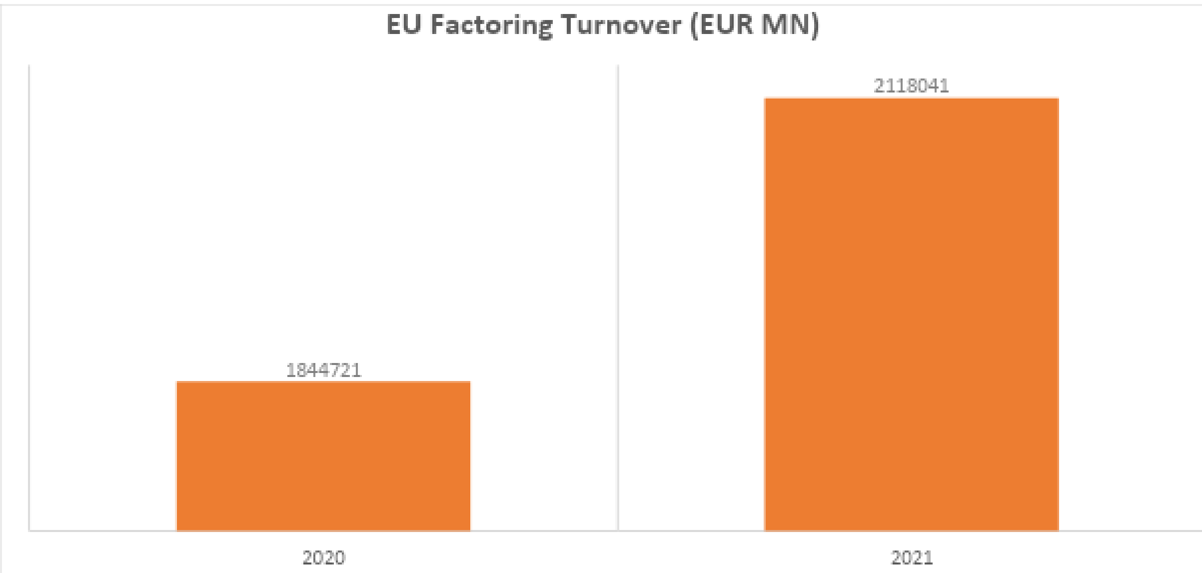
highest growth recorded by any country in the Asia Pacific. . The following chart shows a comparison of Indian factoring market with other Asian countries factoring market.



World factoring Volume

On account of the aftereffects of the pandemic, the share in the Total Factoring of the Asia Pacific fell from 42% in the year 2020 to 39% in the year 2021.

It is worth noting here that the data collected by the EU Federation for Factoring and Commercial Finance reported the factoring turnover in the first half of 2022 for the EU countries was EUR 954,644 million which comes down to a year-on-year increase of 21.5%[37] , Further, the following graph depicts the half yearly comparison of factoring turnover of EU countries in 2021 as compared to 2020.

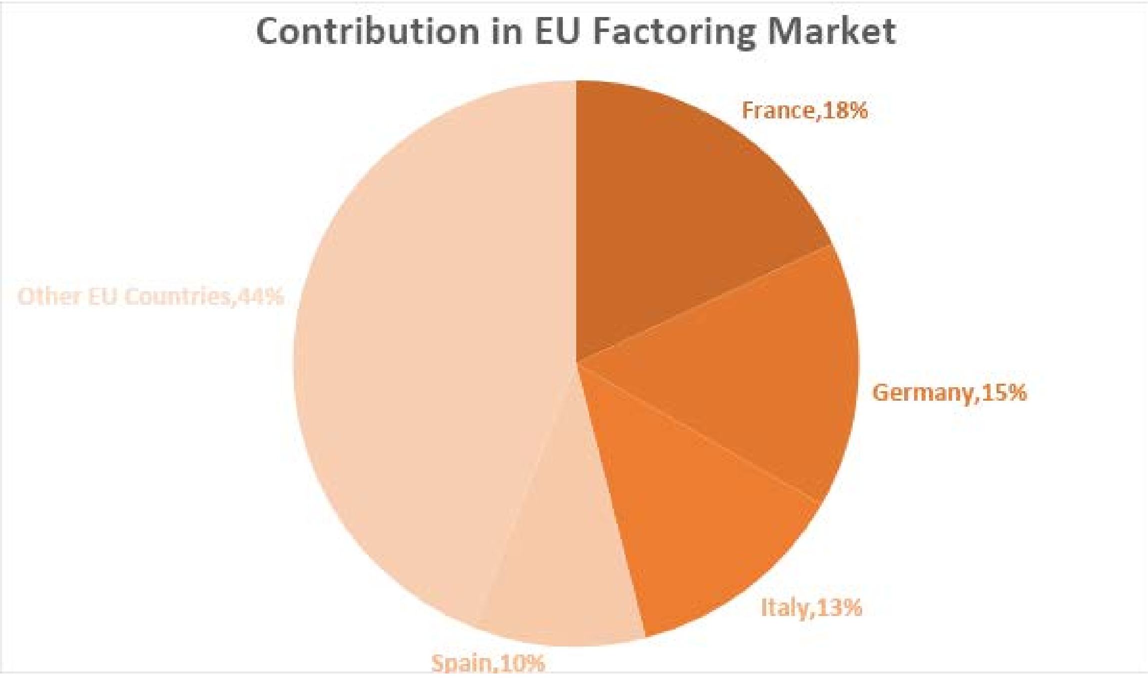


EU Factoring Turnover (Yearly comparison)

[37] https://euf.eu.com/

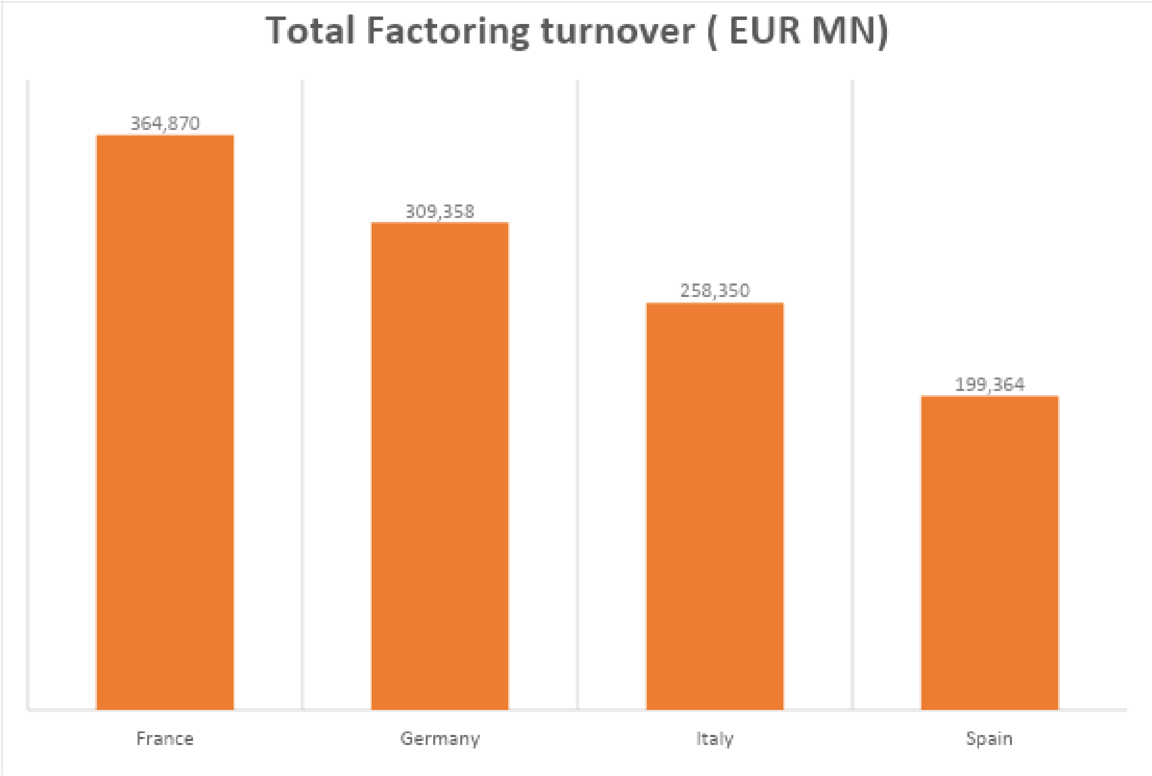
Even though the volume of factoring decreased in the year 2020 however it has plunged back significantly with the increase in the total turnover in the year 2021. Factoring through the years has confirmed its role as a key financial resource supporting the growth of the companies. Today, factoring is clearly identified as a secure short-term financing product committed to the real economy and employment in Europe.

The top countries as on 2021 represented 56% of the total EU market and those were:, France, Germany, Italy and Spain. The following pie chart shows the share of the top European countries in the total EU factoring market.



Major Contributors in the EU Factoring Market

In conclusion, the data collected by the EU Federation for the year 2021 shows the extent of penetration of factoring as a source of funding for companies across Europe. The turnover of the top countries, forming a significant part in the EU factoring market is represented below with the help of a graph.


Total Factoring turnover (EUR MN)
364,870
309,358
258,350
199,364
France
Germany
Italy
Spain

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Factors Impeding Factoring in India

Factoring in India has great potential but factoring volumes have been modest over years. 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 has also impacted the smaller players like SMEs who had been sub-contracted parts of such infrastructure projects.

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

- Lack of Awareness – Business entities are unaware of this available source of financing the working capital requirements.

- Existence of few players – There are very few institutions providing factoring services in India.
- Banks better positioned for factoring-
    - o As compared to banks, NBFCs have higher cost of funds;
    - o Banks facilities are fully secured whereas, factoring companies offer unsecured funding mostly;
    - o Higher operations costs for factoring companies as compared to banks;
    - o Banks do not prefer parallel lines of funding from factoring companies dissuading clients to approach factoring companies.
- Availability of better options-
    - o Banks offer several lines of credits, approaching factoring company for financing may be cumbersome;
    - o An overdraft facility may be easier to obtain;
- Non-availability of credit insurance-
    - o Credit insurance is prevalent internationally for factoring to mitigate the risk and exposure on clients;
    - o Factoring Act in India does not permit recourse on clients
        - ▪ This limits client's ability to obtain higher facility limit
        - ▪ Impedes factoring companies' exposure on a client, also disincentivises exposures in export factoring
- No access to debt recovery platforms-
    - o Factoring companies do not have access to debt recovery platforms
    - o Absence of recourse makes the sector less attractive for new entrants
- Limited reach-
    - o 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.

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.

Factoring is an accepted method of receivables financing across the globe and is regulated by a stringent set of rules and procedures. Initially, factoring was not a typical or mainstream financial service in the absence of a legislation. However, with the enactment of Factoring Regulation Act in 2011, the necessary legal framework is now in place for factoring volumes to grow. But unfortunately, reservations on part of corporates and PSU buyers to accept assignment of receivables made in favour of factors, issues with the legal system and dominance of banking have been restricting the growth.

The Factoring Regulation Act, 2011 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.

Export factoring is another lucrative area which the players may venture into. 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. Given the fact that the RBI and several other associations have been taking initiatives to create an awareness about factoring and its superiority as a receivable management service, an increase in the volumes is expected. 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.