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INDIA FACTORING REPORT | 2023

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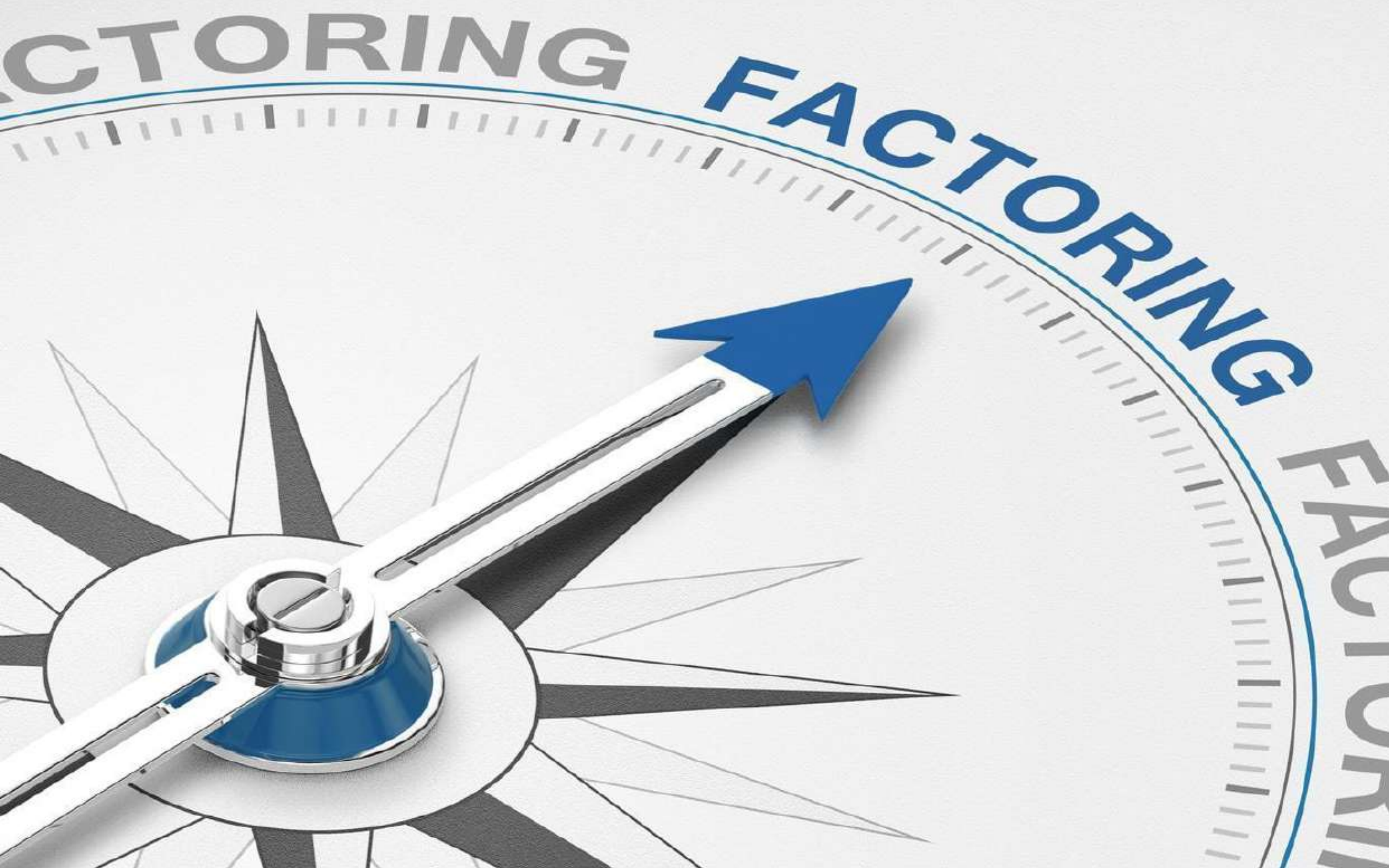


Introduction

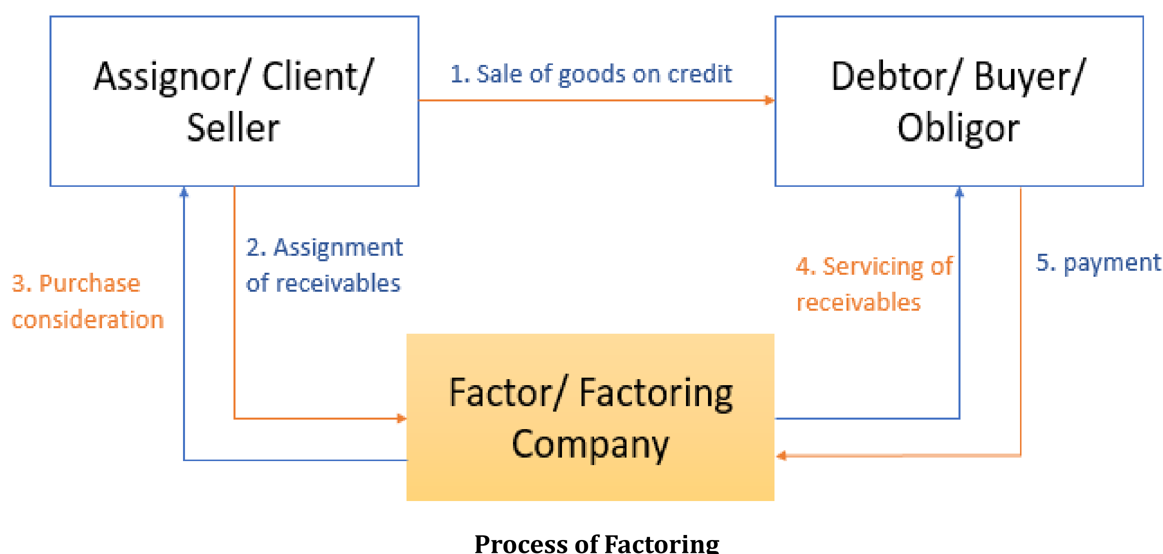
Receivables form a major part of the current assets of a company and management of such receivables is the most important concern for the company. Factoring is a financial option for the management of receivables. It is a tool to obtain quick access to short-term financing and mitigate risks related 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:



Process of Factoring

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:

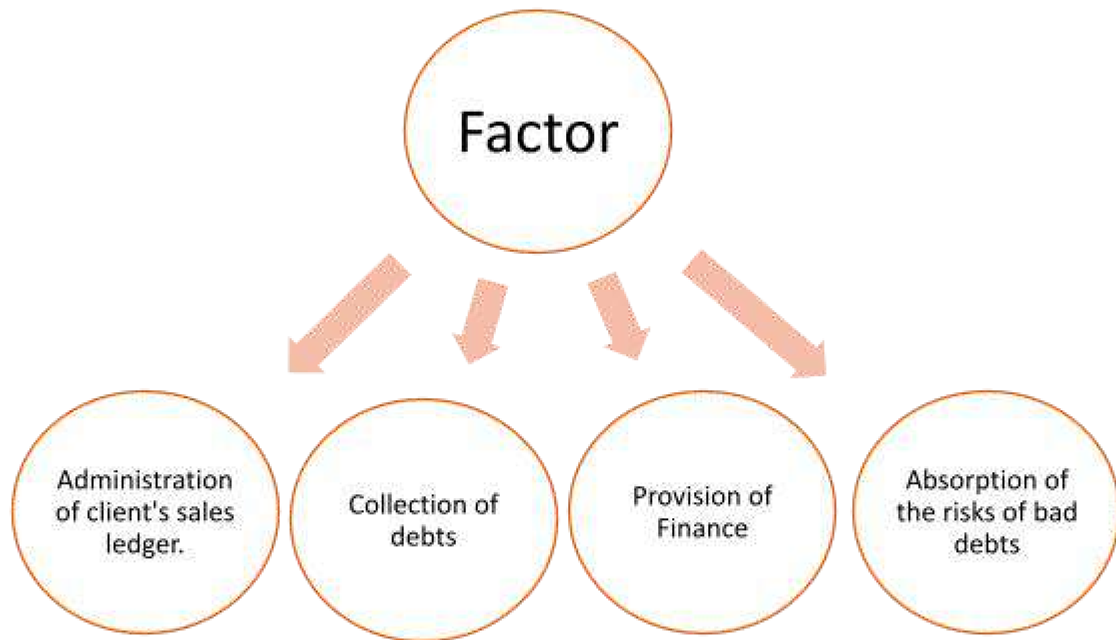


Figure B: Tasks performed by a Factor

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

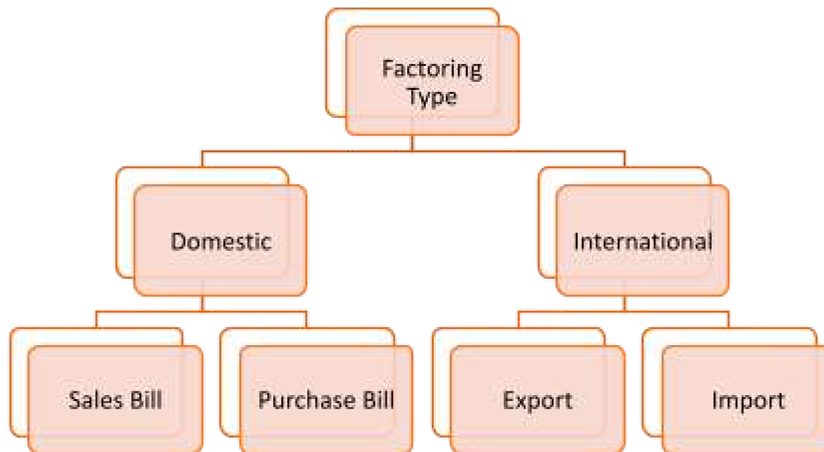
Basis	Factoring	Securitization
Used By	Factoring as a source of finance is mostly used by manufacturing and trading companies.	Financial Institutions and non-banking finance companies are the major players indulging in securitisation.
Types of Assets	It is executed by assigning short term assets such 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

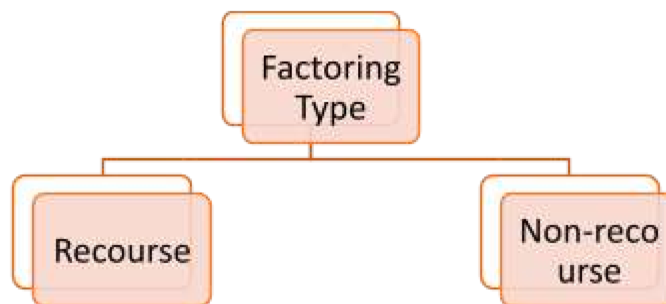
Types of Factoring

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

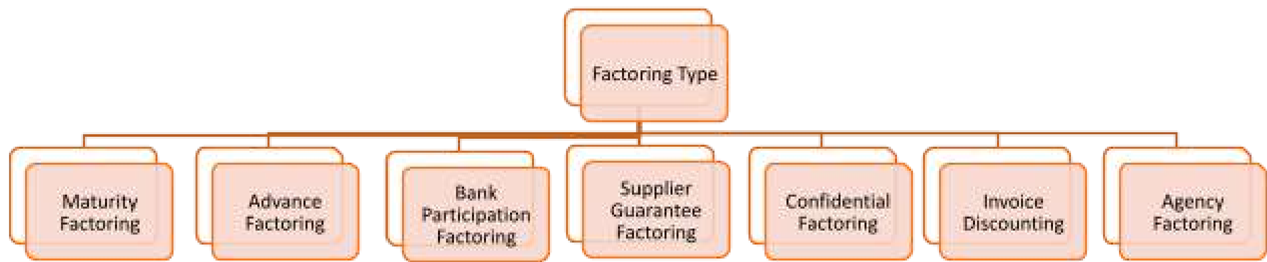


Figure C: Types of Factoring

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.

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

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

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.

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

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

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