

Analytical Views

FACTORS IMPENDING FACTORING

-- Why is factoring not picking up in India post enactment of the
new Act?



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Why is factoring not picking up post enactment of Factoring Act, 2011?

Introduction

Factoring as a form account receivables financing has been a widely acceptable mode of asset-backed financing world-over. Unfortunately in India, the factoring business has had several stumbling blocks. While the government has made efforts to provide a facilitating regulatory environment for factoring business to develop, the fog does not seem to have cleared out completely.

We spoke to several of the industry players to try and understand the mood of the market, opportunities, issues and challenges concerning the industry post the Factoring Regulations Act, 2011 came into effect. This article captures the grappling issues faced by the market players and we pose some possible solutions for the same.

Under factoring, business concerns sell their invoices *i.e.* accounts receivables to a factoring company in exchange for an immediate advance on the invoice value, thereby, allowing companies to cash in on their sales without having to wait for payments to come in from customers in due course. Thereafter, the factor collects the full amount from the debtors and pays the balance amount due to the business concerns. This service is usually provided for a fee which is dependent on the sales volume, number of customers, number of invoices and credit notes and degree of credit risk in the customer or the transaction.



The concept of factoring is not new and, in fact, dates back to the Roman Empire. It is a \$1 trillion industry worldwide and worth more than \$100 billion in the United States, according to Factors Chain International, a global network of factoring companies.

In India, however, in the absence of a legal framework regulating factoring for long, it has so far played a limited role in business financing. India's factoring turnover in 2012 was around 3500 million euros in domestic and 3650 million euros in total as compared to a total of 21,32,231 million euros worldwide.¹ The Indian factoring volume grew at approx. 38% from 2009 to 2012. However, India's factoring volume stands at a mere 0.17% vis-à-vis worldwide factoring volume.

¹ Data from Factors Chain International <http://www.fci.nl/fci-members/select-a-member/asia?c=IN>



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Some of the challenges that factoring companies were facing in India were a) no specific law for assignment of debt; b) no recovery forum available to the factoring NBFCs viz. DRT or under SARFAESI Act; c) Lack of access to information on credit worthiness and d) assignment of debt involves heavy stamp duty cost. Some of these issues were addressed with the Factoring Regulation coming into effect in 2011.

The Factoring Regulation Act 2011

The Factoring Regulation Act 2011, which came into force in February, 2012, regulates factoring business in India and provided the much-needed legal framework for factoring in India. The intension of the legislature behind introducing this Act was to promote the concept of factoring, making it more visible & organized and providing clarity on the process of assignment, rights and obligations of parties to contract for assignment of receivables.

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

- a) Amendment to the Indian Stamp Act 1899, by inserting Section 8D, which exempts payment of stamp duty on all agreements for assignment of receivables in favour of a factor. The Act considerably reduced transaction costs for factoring arrangements, which were earlier liable for high rates of stamp duty.
- b) Every factor to register the particulars of every transaction of assignment of receivables in its favour with a central registry, set up under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SARFAESI Act).² A centralized database was aimed at reducing frauds and facilitating factors to verify whether a certain set of receivables had already been assigned in favour of a third party.

Continuing bottlenecks post the enactment of the Act

While the Factoring Act does specifically resolve some of the key problems that the industry has been facing, in practice the conditions haven't improved much since its enactment. We spoke to some of the industry players to get an insight into the current bottlenecks in growth of the new business volumes in factoring and below is a summary of the findings.

² <http://cersai.org.in/CERSAI/ISP/IBACRTermsConditions.jsp>



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- a) **Lack of Awareness:** Most businesses in this sector felt that lack of awareness in the corporate world of the presence of such a method to meet their working capital requirements posed the biggest challenge in the growth of this sector. Factoring services are not easy to find since there are few institutions providing access to these services.
- b) **Banks better placed to offer such services:** Banks have an advantage of CASA. 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.
- c) **Availability of better options:** Banks provide various lines of credits to corporates which are well known and provide simpler options for the clients. Obtaining factoring services may seem cumbersome and a client would rather prefer an overdraft facility offered by the banks, which involves a simpler process and is easy to obtain. Where corporate seek funding above the bank funding, that is where the factors have a role playing. Over and above these the turn-around time for factors is very slow, so clients prefer banks over factors.
- d) **Non-availability of Credit Insurance:** Internationally the practice of credit insurance is prevalent in factoring by which factoring companies mitigate their risk and exposure on clients with the help of credit insurance.³ However, in India, currently credit insurance is not permitted. Currently the Factoring Act does not permit partial or no recourse on the client; factors to have full recourse on the corporates. This creates two kinds of problems, one, for the clients it acts as a hindrance for limiting its sales to the debtors to the extent of facility available from the factor company and two, for the factoring company credit insurance would facilitate export factoring, which is currently dormant in India.
- e) **No notification from states with regard to waiver of stamp duty:** The market players have been carrying an impression that though the Factoring

³ <http://www.coface.com/> - a world leading business credit insurance and credit management service provider



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Act provides for waiver of payment of stamp duty on factoring agreements no clarification has been issued by the states, given that payment of stamp duty on agreements is discretionary for individual states.

However, in the opinion of the author such a clarification from each of the states may not be required at all.

The Schedule to the Factoring Regulation Act requires insertion of Section 8D to the Indian Stamp Act, 1899, which is a *non-obstante* clause and provides that factoring agreements shall be exempted from stamp duty. While the insertion is in Indian Stamp Act and the confusion may be because of some states having their own stamp laws, the non-obstante clause overrides any law that may existing or for in force for the time being which includes the state stamp acts as well.

- f) **No access to debt recovery platforms:** Another major drawback to the Factoring business in the non-availability of debt recovery platforms to NBFCs, such as Debt Recovery Tribunals and under the SARFAESI Act. In the absence of recourse to frauds and default on the part of the debtor, this sector is less attractive to new entrants. Moreover no collateral security is available to secure the position of the factoring companies.
- g) **Fake Bills:** The current challenge that factoring companies are facing is that of fake bills. This problem is pertinent to the textile, iron and steel and pharmaceuticals industries. Several factors have accounted for losses due to the fake bills issue.
- h) **Limited Reach:** The major clients of factoring companies are typically the Small and Medium Enterprises (SMEs) who find this route more preferable as bank loans are not easily available to them.

Issues pertaining to Export Factoring

Export factoring is a service offered under an agreement between a factoring company and an exporter whereby the factor purchases the exporter's short-term foreign account receivables for cash at a discount from the face value, assumes the risk on the ability of the foreign buyer to pay and handles collections on the receivables. Export contributes approx. 17% - 18% to India's GDP of which SMEs contribute to more than 40% of the country's total export. Availability of export factoring is expected to drive the growth of India's export industry in addition to helping the SMEs to avail credit to their benefit.



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However there are several reasons why export factoring has not picked up. There are two types of export factoring a) ECGC backed and b) two way factor; among the two the former is least preferred amongst factors owing to several problems on settlement of claims. In case the debtor defaults the payment clearance becomes a time taking task, thereby acting as a deterrent for factors to use this mode of export factoring. The two way factor is far more efficient and preferred mode of export factoring amongst Indian factors but this mode itself is not free from bottlenecks.

In a two way factor process the Indian factoring company would have a tie-up with a international factoring company in the country where the debtor is located. These international factoring companies have credit insurance typically. Hence if the debtor does not pay, the payment is received from the international factoring company very promptly.

The Road Ahead

From the discussion with the several factoring company we could gather that while the Factoring Act has provided for a facilitating environment, it has not been enough for factoring to grow. Some of the key issues that need redressal are:

- a) **Introduction of Credit Insurance:** Introduction of credit insurance in the factoring business can provide a major boost to the factoring business volumes, particularly for export factoring.
- b) **Applicability of the provisions of Negotiable Instruments Act, 1981:** Section 138 of the Negotiable Instruments Act provides for imprisonment liability or payment of penalty or both for dishonour of cheques. Similarly Section 25 of Payments & Settlement System's Act, 2007 provides for imprisonment or fine or both in case of dishonor of electronic fund transfer. Similar penal provisions may be introduced in the Act for the factors with regard to fake bills.
- c) **Applicability of SARFAESI:** Currently SARFAESI Act is not applicable for NBFCs. If provisions of SARFAESI Act could be used by factors it would enable them to have faster and easier asset recovery.

For the factoring business to grow while there are several business environment issues such as lack of awareness amongst clients, slow turn-around time, there are several regulatory factors that can catalyze the growth of factoring into India.

Read our articles on:

Legal Issues on factoring business in India at <https://india-financing.com/factoring%20business-%20legal%20issues.pdf>

Factoring NBFC Directions – RBI creates confusion by flawed language at <https://india-financing.com/RBI factoring directions article.pdf>