Note

NBFC- Factors: Ambiguities continue

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Note

The RBI issued directions but has not clearly spet out its intentions, which may give room to confusion in the mind of those who carry out factoring as an ancillary business.

On Monday, the Reserve Bank of India (RBI) brought into force a new kind of Non Banking Financial Company—Factors (Notification DNBS. PD.No. 247/CGM(US)-2012, dated 23 July 2012). An NBFC-Factor has to comply with the requirements of theFactoring Regulation Act, 2011 ("Act"). The RBI's direction would be applicable to all the NBFC- Factors which are registered with the RBI under Section 3 of the Act, which mandates every factor to obtain a certificate of registration from the RBI for carrying out or commence the business of factoring. Factoring is a financial transaction where an entity sells its receivables to a third party called a 'factor', at discounted prices. A factor means an NBFC, a body corporate or any other company.

It is unclear whether only those entities which are primarily engaged in a factoringbusiness, i.e. the financial assets in the factoring business constitute at least 75% of its total assets and its income derived from factoring business is not less than 75 % of its gross income, shall require classification as NBFC-Factors. The language under direction 4(i) of the Directions state that "*every company intending to undertaking factoringbusiness shall make an application for grant of certificate of registration (CoR) as NBFC- Factor to the bank as provided under Section 3 of the Act*". Even though the Directions highlight the requirements of factoring business as a principal business, the applicability of the Act and consequently the Directions for obtaining registration to carry out factoring business, whether or not as principal business, is not free from doubt.

Therefore technically, any entity (being a factor) carrying out a factoring business is required obtain registration as an NBFC-Factor. The only exceptions to the requirement of registration are banks or any corporation established under any statute of the Parliament or the state legislature, government (such as RBI, IDBI, National Bank for Agriculture and Rural Development, etc.) and a government company as defined under Section 617 of the Companies Act.

Implications on the existing entities carrying out factoring business

The obvious implication is for the existing entities (being factors) to make an application for reclassification as NBFC-Factors. The time limit for making such application has been set at six months from the date of the Directions.

This would mean that the conditions applicable to an NBFC-Factor shall be satisfied by the existing entities carrying out factoring business prior to reclassification as NBFC-Factor. In the event of an existing registered NBFC carrying out factoring business, as its principal business, that constitute less than 75 % of total assets/income shall have to submit to the RBI within six months from the date of the Direction a letter of its intention either to become a factor or to unwind the business totally, and a road map to this effect.*Therefore, the NBFC-Factor has to ensure to comply with this essential requirement offactoring business to constitute at least 75 % of total assets income*. If the existing NBFCs fail to meet the said benchmark, they will be forced to unwind the factoring business.

Additional burden on the existing entities is to increase their net owned fund ("**NOF**") to at least Rs5 crore, which in case of an NBFC, not being NBFC-Factor, is a maximum of Rs2 crore.

It is essential to obtain a certificate from a statutory auditor indicating that all conditions have been complied with by the entity for classification/registration as NBFC-Factor and that the certificate has been issued under Section 3 of the Act. If foreign direct investment ("**FDI**") is applicable, the minimum capitalization norms under the extant FDI policy of the RBI shall also be complied with.

An NBFC-Factor is also subject to the provisions of Non-Banking Financial (Non-deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 or Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007, as the case may be.

Where NBFC-Factors intends to deal in forex through export/import factoring, compliance with the Foreign Exchange Management Act, 1999, and the rules, regulations, notifications, directions or orders made there under from time to time, shall also be ensured.

Effect of the Directions

The ambiguity of applicability of the Act and consequently the Directions continues to prevail and there is no clarity on whether those entities not carrying out factoring business as their principle business are required to obtain registration as NBFC-Factor. Furthermore, language of the Directions also point towards a requirement for registrationas NBFC-Factor even if the entity intends to go for a factoring business.

Going by the language of direction 6 of the Directions, which requires an NBFC-Factor to ensure that the financial assets in the factoring business constitute at least 75% of its total assets and the income derived from factoring business is not less than 75% of its gross income, clearly shows that the factoring business shall be a principal business of a factor.

In our view the RBI has not clearly spelt out its intention to this effect, which may give room to confusion in the mind of those who carry out factoring business as an ancillary business.