Note

Factoring NBFC Directions – RBI creates confusion by flawed language

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The new RBI's Factor Directions have a portion – clause 6, which, read in plain language may be interpreted to mean that NBFCs which are not principally engaged in factoring business cannot do any factoring business at all. Factoring business, as defined in the law, includes any assignment of receivables. Read together, these two sentences may be mean an non-factoring NBFC cannot buy any receivable at all. Such confusion has already been created by the language of the Directions.

Our article below sets the situation right. We prove below that there is no reason for NBFCs to get jittery with the new Directions.

Genesis

The Reserve Bank of India, vide a notification dated 23rd July, 2012 has issued 'The Non-Banking Financial Company – Factors (Reserve Bank) Directions, 2012[1] ("**Directions**") which seems to have created confusions of sorts.

Direction 6(ii) provides for the "principal business" requirement for an NBFC – Factor and are reproduced below –

> ***6 (i)*** *XXX*
> *(ii) An existing NBFC registered with the Bank and conducting factoring business that constitute less than 75 percent of total assets / income shall have to submit to the Bank within six months from the date of this notification, a letter of its intention either to become a Factor or to unwind the business totally, and a road map to this effect. However such NBFCs shall raise the asset/income percentage as required at 6(i) above or unwind the factoring business within a period of 2 years from the date of this notification. They will be granted CoR as NBFC-Factors only after they reach the required asset/ income percentage.*

The reading of the above Direction indicates that in the event the requirements set out in the Direction 6(ii) above are not satisfied, i.e. if the factoring business constitute less than 75% of the total assets/ income, as stated above, then the registered NBFC would have to submit to the RBI a letter of intention to become a factor by meeting the 75% threshold or unwind the business totally and provide a road map to this effect. The time period given to raise the factoring business to the specified 75% threshold, in case the NBFC decides to carry on the factoring business, is 2 years from the date of the Directions.

This may be interpreted to mean that either an NBFC needs to ensure that the factoring business constitutes not less than 75% of the total assets / income or wind up. However, surely this could not have been the intent of RBI, as this would result in NBFCs not undertaking any assignment transactions which are prevalent and usual in the market. We, herein, discuss the Directions along with the The Factoring Regulation Act, 2011 ("**Act**") threadbare, to try and capture the intent of RBI, which the language of the Directions seemingly has failed to establish.

[1] http://www.rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=7462

Applicability of the Directions

Direction 2 states that these Directions are applicable to the NBFC – Factors registered with the RBI under Section 3 of the Act. Therefore, it is clear that the Directions are applicable only where a Factor is carrying out factoring business as its principal business in terms of the Section 3 of the Act, as stated above.

As per Section 3 of the Factoring Regulation Act, 2011 **("Act")** every factor has to be registered with the Reserve bank of India ("**RBI**"). The said Section 3 provides as follows:

(a) A factor shall commence or carry on the factoring business only upon obtaining a certificate of registration from the RBI;

(b) A registered Non Banking Financial Company ("**NBFC**") engaged in factoring business as its *principal business* shall make an application for registration as a factor to the RBI within 6 months from the date of commencement of the Act (the Act was notified on January 22, 2012);

(c) The test provided to determine whether the *principal business* of the NBFC is that of *factoring* is as follows:

   (i) If its financial assets in the factoring business are more than 50% of its total assets or such percent as may be stipulated by the RBI; and

   (ii) If its income from factoring business is more than 50% of the gross income or such percent as may be stipulated by the RBI.

Our Analysis:

(a) **NBFCs carrying out factoring business with less than 50% of the asset/ income dedicated to factoring business:** Section 3 of the Act clearly states that an NBFC needs to get registered as a Factor only where the threshold of 50% of assets and income is crossed. Hence, for all those NBFCs which do not cross the threshold limit the Directions will not apply at all. Therefore, there is no need at all for such an NBFC to think of bringing the factoring volume to zero or unwind the busines.

(b) **NBFCs carrying out factoring business with more than 50% of the asset/ income but less than 75% of asset/ income dedicated to factoring business:** Any NBFC carrying on the factoring business as its principal business, i.e the factoring business constitutes at least 50% of the financial assets and income and registered under the Act with the RBI, will have to comply with Directions as stated above. For the purpose of clarification any NBFC-Factor, as per the aforementioned Directions will have to ensure that the factoring business constitutes not less than 75% of the total assets / income. Where the factoring business constitutes more than 50% of asset and income base but less than 75%, the NBFC-Factor will have to provide RBI with a letter of intent to either meet the 75%

threshold or to unwind and also provide a road map to the effect. Thus, effectively any NBFC-Factor carrying out factoring business between the 50-75% of asset and income level, will have to either bring the factoring business to over and above 75% threshold or unwind.

(c) **NBFCs carrying out factoring business with more than 75% of asset/ income dedicated to factoring business:** These NBFCs are compliant with the present Directions.

Conclusion

While the language of Direction 6(ii) has left scope of ambiguity, with NBFCs contemplating whether the current Directions make it impractical to carry out assignments if the threshold limits as stated in the Directions are not adhered to, in our view, the intent is not to throttle business altogether. The Directions only apply to NBFC-Factors registered under Section 3 of the Act and, hence, all other NBFCs do not fall under the periphery of these Directions.

Therefore, where factoring is the principal business, the Directions ensure stricter adherence to norms ensuring that the factoring business cannot constitute financial assets and income between 50% and 75% of the total assets and gross income, respectively, from the factoring business.

Our other research articles on the topic:

Note on Credit Factoring and Bill Discounting , by Mr. Vinod Kothari

Note on Legal Issues on Factoring Business in India , by Ms. Nidhi Bothra

NBFC – Factors : Ambiguities continue, by Mr. Anshuman Nandi also published in *moneylife*

Factoring Regulation Act, 2011 throws obligation on NBFC, by Mr. Anshuman Nandi