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FACTORING SERVICES IN INDIA: A STUDY

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ABSTRACT

Factoring is one of the upcoming sources of finance for SMEs in India. It is particularly, relevant if a company is growing on a daily basis and when new customers are added regularly; there are chances of ending up with huge invoices. The notion that SMEs experience disadvantage in relationship with the capital market i.e. the existence of credit rationing and also finance gaps in their relationship with banking institutions have been popular for decades. This problem often directs many businesses to look for alternative source of finance like factoring. The study shows that the demand for factoring services will tend to reflect the impact of acute cash shortage due to delayed payment by debtors causing liquidity problems. From the research it is also evident that SMEs use these services during their start-up and growth stage, since this is the stage were organizations find it difficult to raise finance due to lack of financial data about its performance history. Even though the service providers of factoring charge 10%-15% of the receivables as their commission still there are organizations that prefer factoring services.

Factoring service, which is perceived as complimentary to bank finance, enables the availability of much needed working capital finance for the small and medium scale industries especially those that have good quality receivables but may not be in a position to obtain enough bank finance due to lack of collateral or credit profile. Factoring is making the small and medium enterprises prosper in one way or the other in terms of financial stability. It offered dedicated services to the SMEs in managing their working capital diligently. 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. Further, a large section of Micro and Small Enterprises need handholding. The lack of financial literacy represents a formidable challenge for MSE borrowers underscoring the need for facilitation by banks in these critical financial areas. To effectively and decisively address these handicaps, RBI introduced a mechanism called factoring, which provides liquidity to SMEs against their receivables and can be an alternative source of working capital. World over, factoring is a preferred route of accessing working capital for SMEs and even larger organizations. Factoring became even more popular, since it did not require the same sort of credit checks. Small business, startups and rapidly growing businesses benefitted especially from this increase in factoring. Factoring grew as a service as business people found their options contracting. This paper is based on secondary data and prepared with a view to analyze the pros and cons of factoring services and its magnitude.

KEYWORDS

Factoring, SMEs, Credit Checks, Small Business, Financial Literacy, Working Capital etc.

INTRODUCTION

Receivables constitute a significant portion of current assets of a firm. However, for investment in receivables, a firm has to incur certain costs such as costs of financing receivables and costs of collection from receivables. Further, there is a risk of bad debts also. It is, therefore, very essential to have a proper control and management of receivables. In fact, maintaining of receivables poses two types of problems; (i) the problem of raising funds to finance the receivables, and (it) the problems relating to collection, delays and defaults of the receivables. A small firm' may handle the problem of receivables management of its own, but it may not be possible for a large firm to do so efficiently as it may be exposed to the risk of more and more bad debts. In such a case, a firm may avail the services of specialized institutions engaged in receivables management, called factoring firms. At the instance of RBI a Committee headed by Shri C. S. Kalyan Sundaram went into the aspects of factoring services in India in 1988, which formed the basis for introduction of factoring services in India. SBI established, in 1991, a subsidiary-SBI Factors Limited with an authorized capital of Rs. 25 crores to undertake factoring services covering the western zone.

OBJECTIVES OF STUDY

The current Study concentrated on the following objectives:

- To know the concept, types of Factoring in India.
- To know the Factoring Services in India, and role of Reserve Bank of India.
- To know the Challenges faced by the Factoring Sector.
- To know the Role of Factoring in Indian SMEs.,
- To know the Factoring in another Emerging Market in India.

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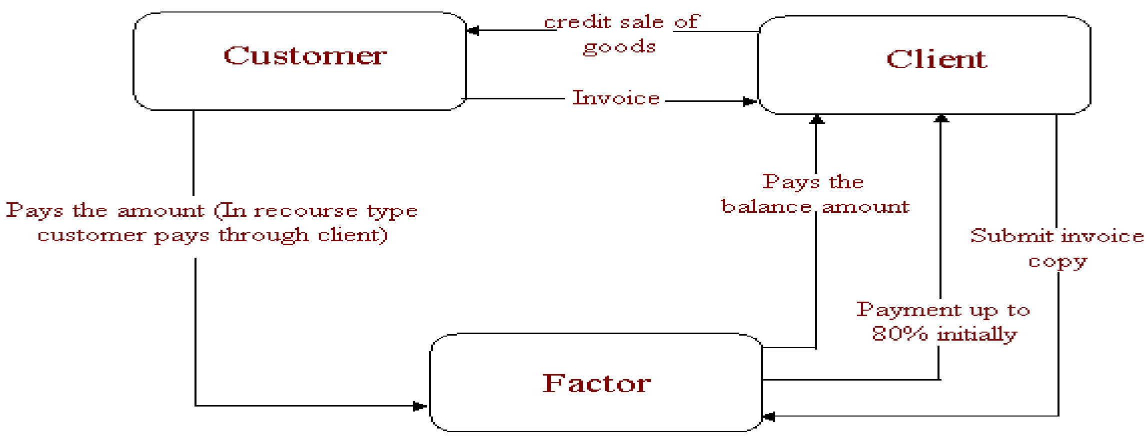
SCOPE OF STUDY

The present study only concentrates on factoring financial services .And the study confined to only Indian Factoring.

What is factoring?

Factoring is a financial option for the management of receivables. In simple definition, it is the conversion of credit sales into cash. In factoring, a financial institution (factor) buys the accounts receivable of a company (Client) and pays up to 80% (rarely up to 90%) of the amount immediately on agreement. Factoring company pays the remaining amount (Balance 20%-finance cost-operating cost) to the client when the customer pays the debt. Either the factor or the client depending upon the type of factoring does collection of debt from the customer. We will see different types of factoring in this article. The account receivable in factoring can be for either a product or service. Examples are factoring against goods purchased, factoring for construction services (usually for government contracts where the government body is capable of paying back the debt in the stipulated period of factoring. Contractors submit invoices to get cash instantly), factoring against medical insurance etc. Let us see how factoring is done against an invoice of goods purchased.

Figure-1



Sources: Authors Compilation

Characteristics of Factoring

- Usually the period for factoring is 90 to 150 days. Some factoring companies allow even more than 150 days.
- Factoring is considered to be a costly source of finance compared to other sources of short-term borrowings.
- Factoring receivables is an ideal financial solution for new and emerging firms without strong financials. This is because credit worthiness is evaluated based on the financial strength of the customer (debtor). Hence, these companies can leverage on the financial strength of their customers.
- Bad debts will not be considered for factoring.
- Credit rating is not mandatory. However, the factoring companies usually carry out credit risk analysis before entering into the agreement.
- Factoring is a method of off balance sheet financing.
- Cost of factoring=finance cost + operating cost. Factoring cost vary according to the transaction size, financial strength of the customer etc. The cost of factoring varies from 1.5% to 3% per month depending upon the financial strength of the client's customer.
- Indian firms offer factoring for invoices as low as 1000Rs.
- For delayed payments beyond the approved credit period, penal charge of around 1-2% per month over and above the normal cost is charged (it varies like 1% for the first month and 2% afterwards).

DIFFERENT TYPES OF FACTORING

- Disclosed and Undisclosed
- Recourse and Non-recourse

A single factoring company may not offer all these services.

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Disclosed: In disclosed factoring client's customers are notified of the factoring agreement. Disclosed type can be either recourse or non-recourse.

Undisclosed: In undisclosed factoring, client's customers are not notified of the factoring arrangement. The client himself undertakes sales ledger administration and collection of debts. Client has to pay the amount to the factor irrespective of whether customer has paid or not. However, in disclosed type factor may or may not be responsible for the collection of debts depending on whether it is recourse or non-recourse.

Recourse Factoring: In recourse factoring, client undertakes to collect the debts from the customer. If the customer does not pay the amount on maturity, factor will recover the amount from the client. This is the most common type of factoring. Recourse factoring is offered at a lower interest rate since the risk by the factor is low. Balance amount is paid to client when the customer pays the factor.

Non-Recourse Factoring: In non-recourse factoring, factor undertakes to collect the debts from the customer. Balance amount is paid to client at the end of the credit period or when the customer pays the factor whichever comes first. The advantage of non-recourse factoring is that continuous factoring will eliminate the need for credit and collection departments in the organization.

FACTORING

To you, as a provider of goods or services, this is a process where India Factoring pre-pays against the credit invoices that you regularly raise on your established clients. In settlement of this obligation, your clients pay India Factoring on the respective due dates directly.

HOW IT WORKS

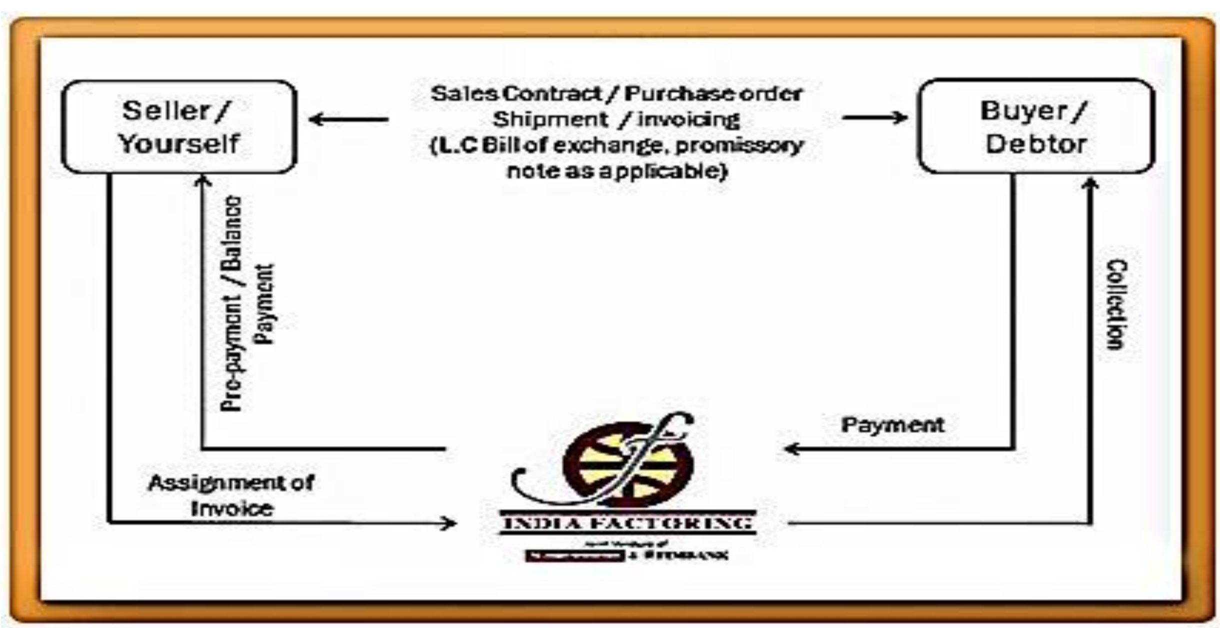
You deliver goods or services to your client and raise an invoice.

On an on-going basis, all such invoices of a pre-agreed buyer, along with supporting trade documents are assigned to India Factoring.

India Factoring advances you a pre-payment as early as the next business day on receipt of such documents (subject to being in order).

On settlement of the respective invoice by your buyer to India Factoring, the balance amount (if any) is credited to your account.

Figure-2



Sources: Authors Compilation

BENEFITS

- You benefit from predictable cash flows linked directly to performed sales.
- Readily convert credit receivables to cash, as India Factoring will provide pre-payment immediately.
- On submission of complete documentation, funding normally by next business day. Quick turnaround times ensure incremental cash flow planning and management.
- India Factoring can additionally provide credit assessment on customers, new or existing.
- Free monthly Account Receivable reporting, sales ledger administration and debtor follow-up.
- No additional debt created on your balance sheet.
- Your "credit line" grows as your business expands. Extremely scalable form of advantage.
- Possibility of outsourcing your receivables collections process, allowing you to focus on your

ADVANTAGES OF FACTORING

Factoring is becoming popular all over the world because of various services offered by the institutions engaged in it. Factors render services ranging from bill discounting facilities offered by the commercial banks to total takeover of administration of credit sales including maintenance of sales ledger, collection of accounts receivables, credit control, protection from bad debts, and provision of finance and rendering of advisory services to their clients. Thus factoring is a tool of receivables management employed to release the funds tied up in credit extended to customers and to solve problems relating to collection, delays and defaults of the receivables. A firm that enters into factoring agreement is benefited in a number of ways; some of the important benefits are outlined below:

- The factors provides specialized services with regard to sales ledger administration and credit control and relieves the client from the botheration of debt collection. He can concentrate on the other major areas of his business and improve his efficiency.
- The advance payments made by the factor to the client in respect of the bills purchased increase his liquid resources. He is able to meet his liabilities as and when they arise thus improving his credit standing position before suppliers, lenders and bankers. The factor's assumption of credit risk relieves him from the tension of bad debt losses. The client can take steps to reduce his reserve for bad debts.
- It provides flexibility to the company to decide about extending better terms to their customers.
- The company itself is in a better position to meet its commitments more promptly due to improved cash flows.
- Enables the company to meet seasonal demands for cash whenever required.
- Better purchase planning is possible. Availability of cash helps the company to avail cash discounts on its purchases.
- As it is an off balance sheet finance, thus it does not affect the financial structure. This would help in boosting the efficiency ratios such as return on asset etc.
- Saves the management time and effort in collecting the receivables and in sales ledger management.
- Where credit information is also provided by the factor, it helps the company to avoid bad debts.
- It ensures better management of receivables as factor firm is specialized agency for the same. The factor carries out assessment of the client with regard to his financial, operational and managerial capabilities whether his debts are collectable and viability of his operations. He also assesses the debtor regarding the nature of business, vulnerability of his operations; and assesses the debtor regarding the nature of business, vulnerability to seasonality, history of operations, the term of sales, the record of accomplishment and bank report available on the history.

LIMITATIONS

The above listed advantages do not mean that the factoring operations are very free from any limitation. The attendant risk itself is of very high degree. Some of the main limitations of such transactions are listed below:

- It may lead to over-confidence in the behavior of the client resulting in over-trading or mismanagement.
- The risk element in factoring is accentuated due to possible fraudulent acts by the client in furnishing the main instrument "invoice" to the factor. Invoicing against nonexistent goods, pre-invoicing (i.e. invoicing before physical dispatch of goods), duplicate-invoicing (i.e. making more than one invoice in respect of single transaction) are some commonly found frauds in such operations, which had put many factors into difficulty in late 50's all over the world.
- Lack of professionalism and competence, underdeveloped expertise, resistance to change etc. are some of the problems, which have made factoring services unpopular.
- Rights of the factor resulting from purchase of trade debts are uncertain, not as strong as that in bills of exchange and are subject to settlement of discounts, returns and allowances.
- Small companies with lesser turnover, companies having high concentration on a few debtors, companies with speculative business, companies selling a large number of products of various types to general public or companies having large number of debtors for small amounts etc. may not be suitable for entering into factoring contracts.

FACTORING IN INDIA AND ROLE OF RESERVE BANK

Factoring service, which is perceived as complimentary to bank finance, enables the availability of much needed working capital finance for the small and medium scale industries especially those that have good quality receivables but may not be in a position to obtain enough bank finance due to lack of collateral or credit profile. By having a continuous business relationship with the factoring companies, small traders, industries and exporters get the advantage of improving the cash flow and liquidity of their business as also the facility of availing ancillary services like sales ledger accounting, collection of receivables, credit protection etc. Factoring helps them to free their resources and have a one-stop arrangement for various business needs enabling smooth running of their business.

The Kalyanasundaram Study Group set up by the Reserve Bank of India in January 1988 to examine the feasibility and mechanics of starting factoring organisations in the country paved the way for provision of domestic factoring services in India. The Banking Regulation Act, 1949 was amended to include factoring as a form of business in which the banks might engage. Reserve Bank of India issued guidelines permitting the banks to set up separate subsidiaries or invest in factoring companies jointly with other banks. However, it was generally felt that absence of Factoring Law was one of the major impediments in the growth of factoring business of the country including the heavy stamp duty over assignment deed, ambiguity in the legal rights of Factors in respect of receivables etc.

Government of India enacted the Factoring Act, 2011 to bring in the much-needed legal framework for the factoring business in the country. It has provided definitions for the terms factoring, factor, receivables and assignment. The Act also specifies that any entity conducting factoring business would need to be registered with RBI as NBFCs; while exempting banks, government companies and corporations established under an Act of Parliament, from the requirement of registration with RBI for conducting factoring business. The Act, thus, gave clarity to the activity of assignment of receivables and granted exemption from stamp duty on documents executed for the purpose of assignment of receivables in favour of Factors thereby making the business more viable. The Act also envisages that all transactions of assignment of receivables shall be registered with the Central Registry established under the SARFAESI Act, 2002 to reduce the possibility of frauds and for strengthening the due diligence process for the clients.

The Act has given powers to the Reserve Bank to stipulate conditions for 'principal business' of a Factor as also powers to give directions and collect information from factors. Subsequent to the passing of the Act, the Reserve Bank has created a separate category of NBFCs viz; NBFC-Factors and issued directions for their regulation. The prudential norms as applicable to NBFCs engaged in lending business, has also been extended to the NBFC-Factors. Further, the RBI also regulates bank finance to factoring companies and the factoring business conducted by banks.

CHALLENGES FACED BY FACTORING SECTOR

Though the enactment of the Factoring Regulation Act has potentially removed all the major impediments that the factoring sector faced in the country, nevertheless, the sector has few other items on its wish list, the primary among which are introduction of credit insurance in the factoring business and extending the scope of SARFAESI Act to cover NBFCs for speedy enforcement of security interest. As regards credit insurance, the Finance Minister, in the Union Budget 2013-14, has made an announcement for setting up a Credit Guarantee Fund with SIDBI for factoring, with an Rs 5 billion corpus. As far as extension of the provisions of the SARFAESI Act to NBFC is concerned, the final call rests with the Government of India.

Low penetration of factoring business in the country remains a challenge, which could be because of lack of awareness among the users. With the necessary law now in place, sincere attempts need to be made by the industry through its associations and other for a for articulating the benefits of factoring as not just an alternative source of finance but also an avenue for providing a bouquet of financial services vis-à-vis traditional finance, to small scale industries. They should be able to identify the untapped potential clientele, especially in various SME industry sectors, and create awareness on how the higher cost of factoring vis-à-vis the traditional finance is justifiable and cost effective for the businesses in the end. Factoring companies should also constantly endeavor to upgrade their expertise on both technological front as also on the operational level for offering cost effective services to their clientele.

ROLE OF FACTORING IN INDIAN SMEs

Small and Medium Enterprises (SMEs) in India have seen exponential growth over the last decade. According to the latest reports by the SME Chamber of Commerce and the Ministry of Micro, Small and Medium Enterprises, India currently has more than 48 million SMEs. These SMEs contribute more than 45% of India's industrial output, 40% of the country's total exports. Yet, these SMEs continue to struggle on multiple accounts. While credit and finance issues challenge some, others are struggling to cope with stringent regulatory environment. SME sector of India is considered as the backbone of economy employing 60 million people, create 1.3 million jobs every year and produce more than 8000 quality products for the Indian and international markets. With approximately 30 million SMEs in India, 12 million people expected to join the workforce in next 3 years and the sector growing at a rate of 8% per year, Government of India is taking different measures to increase their competitiveness in the international market.

FACTORING IN ANOTHER EMERGING MARKET: INDIA

We considered it essential to include another emerging market and the status of our desired business in it, as it gives the reader an idea about the problems, environment, solutions, and essentially creates a benchmark to understanding the basic characteristics of factoring in emerging markets. In spite of the various differences between the Russian and Indian credit markets, we believed the overall goal, nature and structure of companies entering such markets and the logistics of factoring would follow similar patterns. In the 1980ís, India was witness to a virtual deregulation of its capital market, giving birth to a number of innovative financial instruments and schemes were born.

The policy of the power-that-be helped in the development of the money market and capital market movers tried to transplant successful schemes of the west. However, despite all of their efforts over the years, the small-scale sector was unable to recover its dues from the medium and large industries particularly in the public sector, and thus the small-scale units faced a liquidity bind because of their inability to collect dues. Available market data revealed that funds locked up in book debts were increasing at a faster rate than growth in sales turnover or inventory buildups. Clearly, factoring was the only remedy available. While the worldwide factoring turnover was nearly $ 500 billion (1998), the factoring market in India is relatively non-existent with only a few small players, although the market demand is estimated to be around a $ 1 billion (according to a State Bank of India report). In India, factoring is considered as a source of short-term financing and is viewed purely as a financing function ñ as a source of funds to fill the void of bank financing for receivables for small-scale and other industries. This often leads to a catch 22 situation and in launching of factoring services in India; the thrust should be on the twin areas of receivables management and credit appraisals, especially since the small-scale sector lacks these sophisticated skills. Recent government efforts have tried to maintain a thrust of the continuing momentum of economic reforms that have been announced in the Union budget, as well as the Credit Policy (such as tax breaks for exporters and importers, terms of trade etc.).

During the year, the Reserve Bank of India (RBI) has tried to boost liquidity and reduce the cost of funds to banks, by reducing bank rates, cutting CRRís and reducing the repo rate. It further announced the reduction of interest rates on export financing and rationalizing the former. In light of this news, several agencies have boosted export financing and also tightened their provisions, so as to better 21 support and help the core of Indian exports, the small and medium scale business sector; such as the following: - The Export Import Bank of India (Exim Bank), a pioneer in the forfaiting business in India and having detailed knowledge of the Indian market, recently announced a tie up with Westdeutsche Landesbank Girozentrale (WestLB), Germanyís 4th largest banking group, to offer factoring and forfaiting services to Indian exporters. This would be a logical step as structured trade financing is still in its infant stage in India. WestLB is a major international player in the business of factoring and forfaiting and other trade finance projects. In addition to the above, the International Finance Corporation (IFC) has evinced interest in taking up a stake in the venture, aiming at around 25%, with WestLB having 40% and Exim Bank having 35%. A relatively small initial equity base is planned, along with the commitment of other financially strong equity holders to provide lines of control at competitive prices when required and give the new firm adequate financial advantage.

With the setting up of this organization, it will no longer be necessary for Indian exporters to approach foreign institutions for their financing needs. The setting up of a new multi-product company offering export factoring and forfaiting under one umbrella will be particularly beneficial to small and medium enterprise (SME) exporters, who are the backbone of the country's exports. Thus in lieu of the recent rise in international trade movements and in an effort to capitalize on the market, several key players in the Indian market, such as the Exim Bank, the State Bank of India and other financial agencies have stepped on the pedal to bolster their efforts and plans towards factoring and financing. Of course, we have to keep in mind that the presence of an efficient and strong legal system is the single most important factor in fostering the growth and success of factoring, and factoring as it is becoming clear, can only thrive in conjunction with a favorable legal framework and judicial support ñ which India, along with Russia, still needs to perfect!

Factoring Companies in India

- Canbank Factors Limited: http://www.canbankfactors.com
- SBI Global: http://www.sbiglobal.in
- The Hongkong and Shanghai Banking Corporation Ltd: http://www.hsbc.co.in/1/2/corporate/trade-and-factoring-services
- IFCI Factors Limited: http://www.ifcifactors.com
- India Factoring and Finance Solutions Pvt Ltd: http://www.indiafactoring.in
- Global Trade Finance Limited: http://www.gtfindia.com
- DBS: http://www.dbs.com
- Export Credit Guarantee Corporation of India Ltd: https://www.ecgc.in/Portal/productnservices/maturity/mfactoring.asp
- Citibank NA, India: http://www.citibank.co.in

- Small Industries Development Bank of India (SIDBI): http://www.sidbi.in/fac.asp
- Standard Chartered Bank: www.standardchartered.co.in

CONCLUSION

Factoring service, which is perceived as complimentary to bank finance, enables the availability of much needed working capital finance for the small and medium scale industries. Factoring is becoming popular all over the world on account of various services offered by the institutions engaged in it.

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