Factoring – Transformation from nascent stage to growing stage in India

‘Factoring – Transformation from nascent stage to growing stage in India
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Abstract: A brief concept of factoring. Its Start up time, its advantages and disadvantages. The reason for factoring gaining its importance day by day. Nascent stage of factoring in India, but slowly increasing its edge and importance. How the increasing competitive mindset helping factoring to spread its arm in the banking sector. A study on who are the players in factoring market in India, how do they function. The upcoming trend of factoring in India. Different challenges faced by different factors coming into factoring business.

Introduction:

According to a common man the word factoring may mean in different ways.
According to the language of math – HCF or LCM or the factors which makes a number well defined is known as factor. Ex 12 = 3*4 or 6*2 or 12*1 where 1,3,4,6,12 are said to be factors of 12.
According to physics/chemistry/biology – we studied different factors involved in making a theory true.

So definition of factor differs with subjects. In language of finance – factoring is the process of sale of accounts receivable to factor (buyer) by the seller (company). The financial intermediary carrying on the process is known as Factor.

Detailed Study:

*What is accounts receivables?*

It is the amount which a customer owe to the company from where he have purchased some goods.

During journal entry company debits accounts receivable and credit revenue account, but when the customers pays the amount in cash then cash account is debited and receivable account is credited.

*Why account receivable is an important part to handle with?*

Company generally give credit to customers for payment in order to increase sales. If customers pays in time then the company tries to provide more and more services to that customers.

But if any customers donot make payment even after the end of credit period then this is a matter of concern for the company.

More and more delay causes account receivable to increase further and so the debtors list also increases.

This becomes a very hard situation to handle with. Specially if the corporate is a huge one, then to maintain accounts receivable becomes a headache for the company.

So to avoid this, factoring is an ideal solution. Seller sell all its accounts receivable to factor and obtain cash in turn which it would have received after. So firm donot have to experience unnecessarily cash crunch situation.

So in brief in process of factoring – 3 parties are involved viz Seller – factor – Buyer. But in return seller have to pay factor charges to factor for the services rendered to seller by factor.
How old is the concept of factor?

Factoring has been in existence long before ago during the reign of Mesopotamian King Hammurabi. Then it gets extended to 14th century during British Rule specially in textiles industries, but it gained its importance in 1905 from Canada, especially in American colonies. Now it is no more concentrated in America but have widespread to other countries also.

At that time factoring was used as a mode of advancing funds to the seller, before they received the payment from the buyer for the raw materials they sold.

But with industrial revolution factoring concept have changed as a mode of giving credit. The concept got revolutionized during 80’s with the growth of banking sector. And now the concept is gaining importance day by day because of the added advantages the corporates gained from factoring.

It is generally a well defined arrangement where financial institution engaged in factoring business provide an array of services like recording, collecting, controlling and protecting the book debts for its clients including the purchase of his bills receivable.

Functions of factoring:

1. Client's (firm) cost of maintaining receivable and collecting debts thereby is reduced much.
2. Cost of maintaining separate receivable/collection department (involved in recording, monitoring records, collecting etc) is avoided. Thus more and more save in time.
3. Client's concentration on other aspects of business like marketing, selling, advertising, production get improved much.
4. Reducing the risk associated with collecting receivable.
5. Factoring in one way help in financing by advancing major part of book debts immediately. So the firm donot have to take pain for other sources of finance as an when required.
6. Provides financial and business information regarding prevailing business trends, changing business policies and many more.

Types of factoring:
1. Recourse Factoring – Client bear all the risk, factor is not liable for any debts. Factor is not responsible for collecting debts from customers. So recourse factoring is cheaper than non-recourse.
2. Non Recourse Factoring – Factor bear all the risk beside providing services of collection of bad debts.
3. Advance Factoring – Factor advances to the client for the amount of receivable purchased.
4. Maturity Factoring – Factor provides dual services collection as well as insurance against debts.
5. Bank Participation Factoring – Bank provides advances not against the full receivables purchased but against a part of the receivable.
6. Disclosed Factoring – Name of the factor is disclosed in the invoices raised by the supplier.
7. International Factoring – Factoring services against export sales.

Factoring mechanism:

Steps involved in Domestic factoring (Refer to Figure no – 5). There are 3 parties involved viz seller (client), buyer (customers) and the intermediary – factor.

1. The customers buys goods from client and in return client gives invoice to customers.
2. The client now assigns/send invoice to factor.
3. Checking the invoice, the factor make prepayment advance of 80% /90% to client.
4. Factor sends statement of payment to customers.
5. Customers make full payment to factor.
6. Finally upon receipt of full payment from customers, factors make the balance payment to client.

In export factoring 4 parties are involved – client, customers, overseas correspondent and factor.
Steps: (Refer to Figure no-6)

1. Customers places orders to client.
2. Client fixes prepayment limit with factor.
3. Client delivers goods to customers.
4. Client sends a copy of invoices to factor.
5. Factors sends another copy of invoice to the overseas correspondent.
6. Based on the invoice, factor makes prepayment advances upto 80% /90% to client.
7. Customer make payment to overseas correspondent.
8. Overseas Correspondant make this payment to factor.
9 Finally after receiving the full amount factor make the balance 20% payment to client.

Now the question is which kind of business may opt for factoring.

- Business concern having high turnover, but now factors are also encouraging smaller concerns.
- The customer size should be more, otherwise it would be a costly affair.
- Where the customer accepts standard payment terms of the company.
- Where the customer accepts payment within reasonable credit period.

Factoring is not available for the business concern where:

- The customer is a general public not the commercial customers.
- The invoice size is very small.
- Too many disputes involved.
- It is not sound, not trustworthy and unreplicable.
- Customers are not prompt payment makers or make payment in parts. So factoring is possible for those companies where the customers are basically prompt in making payment.

**Factoring Vs Other means of financing**

- Factoring – Using own’s funds to finance
- Refactoring – Using other modes for financing like bank lines of credit, investor participations and the equity of the firm.
  - a. Most of the firms uses bank credit for financing, but here the firm is under pressure to pay off the debts. Which is not in factoring.
  - b. Again factoring only uses Time value of money concept – getting advances before the need is raised which is not in other case.
  - c. Bank credit needs many norms to be followed, so it is difficult to get finance from banks sometimes. Raising money from public is also a costly affair.
  - d. Again Banks normally analyse a customer’s last audited financial statements to assess the working capital finance requirements for cash credit. A factor provides funding based on the current and projected sales volume and is, therefore, more in line with the needs of the business.
  - e. Bank requires you to provide collateral security for providing credit facility. This is not required under factoring.
  - f. Factoring offers funding up to 90 per cent of invoice value whereas a bank provides between 60 and 75 per cent funding.
Factoring can be a valuable alternative for securing vital working capital, when a bank may be unable to provide financing due to some of the following situations:

- Start Up business with a limited track record.
- Rapid growth drives consistent increased capital needs.
- History of operating Losses.
- Minimal or Deficit net worth.
- Tax Liens in place.
- Past personal/business Bankruptcy or credit issues.

In brief, Factors make funding decisions based on the credit-worthiness of your customers; a bank makes credit decisions based on your company’s financial history, cash flow, and collateral. Because factoring is not a loan, no liability appears on your balance sheet. Most importantly, a factor makes funding decisions in days or hours—while banks generally take weeks or even months.

**Factoring Vs Bill Discounting:**

**Bill Discounting** is based on a customer’s last audited financial statements. Again, bill discounting is accessible when the buyers accept bills. **Factoring** on the other hand allows you to access instant cash against sales on delivery of goods. Submission of invoices to factors result in prompt payment of credit to client the next day.

**History of Factoring in India** –

Factoring in India started with the establishment of  
1. SBI Factors and commercial services Pvt limited in 1991 *(Refer to Figure No-1)*  
2. Can Factors Ltd., a subsidiary of Canara Bank also formed in 1991 *(Figure No -2 )*  
3. HSBC Factoring  
4. ECGC – Export credit guarantee corporation of India –Specialised in the business of export credit insurance since 1957 in order to reduce risk involved in export sales.  
5. CITI Bank  
6. Foremost factors limited- Foremost factor private ltd is established as a joint venture with National bank of America in 1997. Presently major shareholders are Mohan Group of companies and IFCI *(Refer to figure no – 3)*
7. b. Global Trade Finance (P) Ltd GTF commenced operations in September 2001, as a joint venture under the promoters - Export Import Bank of India (Exim Bank); West LB, Germany; and IFC, Washington (the private sector arm of World Bank). In December 2004, the shareholding pattern changed to 40% with Exim Bank; 38.5% with FIM Bank, Malta; 12.5% with IFC, Washington; and 9% with Bank of Maharashtra. Presently major shareholder are SBI and Bank of Maharastra (Refer to figure no - 4) 

Changing scenario of Factoring business in India:

Ø SBI Factors purchases the 91% stake in Global Trade Finance to gain a market share of around 75% in factoring business by April 2008.

Ø HSBC is going to provide factoring business for SME's specially in Mumbai, New Delhi, Kolkata, Pune, Bangalore and Chennai. SME with turnover of more than 5 crore can avail the facility of factoring from HSBC.

Ø HSBC ties up with New India Assurance for credit risk insurance.

Ø With the increasing demand for factoring services, foreign players such as Development Bank of Singapore (DBS) and GE Capital have shown their keen interest to getting into the factoring business in India. Both DBS and GE Capital have global exposure in the factoring business.

Ø Many global players in the field of banking (Standard Chartered Bank, Citi Bank, etc) are coming forward to India to carry on factoring business in SME segment since the scope for financing large corporates is reaching saturation point. SME sector plays a major role in India's present export performance, contributing to 45-50% of the Indian exports. Global Trade Finance has dedicated most of its facilities to the SME sector.

Ø With the growth of factoring business, credit insurance is also getting edge day by day today specially for the global factors who are operating in India.

Ø According to Factors Chain International, the observer of all factoring companies, India with just eight companies clocked a total turnover of Rs 19,860.5 crore in 2006 way below Japan's Rs 4,15,789.1 crore Taiwan's Rs 2,23,152.6 crore and China's Rs 7,97,771.1 crore in
Asia. The Indian factoring market has grown by 176 per cent from Rs 7,196.7 crore to Rs 19,860.5 crore between 2002 and 2006. Global leaders are the UK, France and Italy.

**Challenges faced by global factors operating in India**

Indian Market is attractive, but to get into it is not so easy for foreign markets. There are various reasons for this.

- **Factoring is a new concept which is not widely known among Indian business community.** Because of the banks' failure to "educate" potential customers on its benefits.

- **Debt recovery is very slow in India as compared to other developed countries.** Comparison of duration of debt recovery case resolution in (calendar days). India – 1420 days whereas on Average OECD – 351 days

- **Huge competition from Indian banks in this field.**

- **Increased interest rates impact sales either through increased financing costs or through reduced sales.** Foreign factors face lot of risk through a higher cost of capital and increased business risk as the credit risk of customers increases. And the ideal solution is credit insurance. Because of credit insurance with Atradius, Global Trade Finance's turnover grew 121% in its 2007 fiscal year and its total market share grew to 25% from 20% including a 70.4% share of export factoring and a 62.7% share of import factoring. But credit insurance is a newer concept in India. Where as ECGC started only export credit insurance in 1957.

- **In India assignment of debt is a very complicated process and involves stamp duty.** Stamp duty varies from state to state in India. As a result the process becomes expensive by nature.

- **No clear laws exist in India regarding transfer/assignment of debt, bankruptcy, debt recovery etc as in other countries,** so foreign operators have to face lots of problems.

- **Also proper information access is very slow in India.**
NBFC operating as factors is a difficult proposition in India as compared to banking sector as there is no protection under Debt Recovery Tribunal or securitization act.

**Conclusion:**

At the end it is to be concluded that factoring is now gaining its importance in India slowly with the increase in customer’s access to benefits of factoring. India’s future in factoring business seems to be luring on the facts obtained regarding the fast growth of 174% in only 4 years. So for factoring to be successful in India government regulation/policies need to be modified further so that more and more private players can come forward to start up their factoring business in India. Customer awareness about benefits of factoring is to be increased further to fight back the global leaders in factoring business.

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2. Financial Management – By I.M Pandey
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5. Venkatachari Jagannathan – “HSBC ties up with New India Assurance for credit insurance” 31 August 2006.
6. “Foreign majors want a pie of growing factoring biz”
   Posted online: 2006 www.business-standard.com

Tables and figures:
Figure – 1 Depicts stake of different banks in SBI
Factors and commercial services Pvt Ltd (54:20:10:10:6)
Source: www.sbfactors.com

Figure – 2 Depicts stake of different banks in Canbank
Factors Private limited (60:20:20)
Source: www.canbankfactors.com

Figure – 3 Depicts stake of different companies in
Foremost factors (49:48:3)
Source: www.foremostfactors.net

Figure – 4 Depicts stake of 2 banks in GTF
(92.03:7.97) Source: www.gtfindia.com

Figure – 5 Shows How domestic factoring works
Source: www.foremostfactors.net
Figure 6 Shows Process of factoring in export sales.

Source: www.foremostfactors.net

Recommended Read

- Convertible Notes in India - Raising fund from Foreign Investors
- Forced Merger in the history of India - Classic example of Limited Liability of a Company