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Factoring and Forfaiting

Chapter Objectives

This chapter will enable you to develop an understanding of the following:

1. *The meaning of factoring*
2. *The origin of factoring*
3. *The types of factoring*
4. *The factoring mechanism*
5. *The factoring charges*
6. *The legal aspects of factoring*
7. *The advantages of factoring*
8. *The comparison of factoring with bills discounting and cash credit*
9. *International factoring: Need and Benefits*
10. *Flow chart of international factoring transaction*
11. *International factoring charges*
12. *Factoring in India*
13. *Meaning of forfaiting*
14. *The origin, characteristics, need, and benefits of forfaiting*
15. *The flow chart of a forfaiting transaction*
16. *The pricing of a forfaiting transaction*
17. *The difference between forfaiting and factoring*
18. *The growth of forfaiting in India*

INTRODUCTION

With the advent of globalization and liberalization, competition among firms—both domestic and international—has increased. Globally, mergers and acquisitions are a common phenomena. Indian corporates have to guard against hostile takeovers. Both environmental and technological changes are rapid and a firm's strategy has to constantly keep pace with these changes. Moreover, there has been a slowdown in economic activity globally. Financial markets all over the world are facing rough weather. In this scenario, management of cash and receivables is of utmost importance to both corporate giants and small firms. Many business have collapsed for want of liquidity. The key to success lies in converting credit sales into cash within a short period of time. There are many traditional methods such as cash credit, bills discounting, and consumer credit through financial intermediaries that help in raising short-term funds against credit sales or receivables. Recently, new financial services, such as factoring and forfaiting, have come into existence to assist the financing of credit sales and, thereby, help the business unit to tide over the liquidity crunch.

FACTORING

Factoring is a continuing arrangement between a financial intermediary known as the factor and a business concern (the client) whereby the factor purchases the client's accounts receivable/book debts either with or without recourse to the client. This relation enables the factor to control the credit extended to the customer and administer the sales ledger.

Besides purchase of accounts receivables, a factor may provide a wide range of services, such as the following:

- Credit management and covering the credit risk involved.
- Provision of prepayment of funds against the debts it agreed to buy.
- Arrangement for collection of debts.
- Administration of the sales ledger.

Factoring is a collection and finance service designed to improve the client's (seller's) cash flow by turning his credit sales invoices into ready cash. In very simple terms, factoring is an activity of managing the trade debts of a business concern. The factor controls the credit extended to the customers and administers the sales ledger.

The Origin of Factoring

Modern factoring came into existence in the 1920s. Factoring as financing against receivables got a boost in the 1930s but there was no comprehensive framework of statutory law for a factoring arrangement. In the UK, factoring came into existence in the form of invoice discounting. The factoring market grew there in the late 1960s. In 1976, the leading factoring companies of the UK formed the Association of British Factors (ABF). The factoring business has now thrived in Italy and Asia-Pacific countries. They are also experiencing a tremendous growth in the factoring business.

Types of Factoring

Based on the features built into the factoring transactions, different types of factoring arrangements have come into existence.

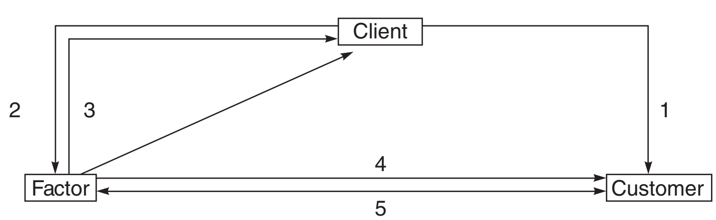
- **Recourse factoring:** In recourse factoring, the factor purchases trade debts and essentially renders collection service and maintains sales ledgers. But, in case of default or non-payment by a trade debtor, the client refunds the amount to the factor. Hence, recourse factoring does not include bad-debts protection. It is popular in the developing countries.
- **Non-recourse factoring:** Under non-recourse factoring, the factor's obligation to the client becomes absolute on the due date of the invoice, irrespective of the payment made or not made by the trade debtor. In other words, if the trade debtor fails to make a payment, the factor cannot recover this amount from the client. In non-recourse factoring, factor charges are high as they offer the client protection against bad-debts. The loss arising out of irrecoverable receivables is borne by the factor. This type of factoring arrangement is found in developed countries such as UK and USA, where reliable credit rating services are available.
- **Advance and maturity factoring:** Sometimes, the factor and the client make an arrangement whereby the factor pays a pre-specified portion of the factored receivables in advance to the client on submission of necessary documents. This type of arrangement is known as advance factoring. The balance portion is paid upon collection or on the guaranteed payment date. Generally, factoring is advance factoring and factor pays 80 per cent of the invoice amount in advance.

  Under maturity factoring no advance payment is made by the factor but payment is made only on the guaranteed payment date or on the date of collection. Maturity factoring is also known as collection factoring.
- **Old line factoring:** Old line factoring is also known as full factoring as it provides an entire spectrum of services, such as collection, credit protection, sales ledger administration, and short-term finance. It includes all features of non-recourse and advance factoring.
- **Cross-border factoring/International factoring:** In domestic factoring, three parties are involved, namely, customer (buyer), client (seller), and factor (financial institution or intermediary) while in international factoring there are four parties, namely, exporter (client), importer (customer), export factor, and import factor. Thus, in international business transactions, factoring services are provided by factors of both countries, that is, the exporter country's factor and the importer country's factor. This is known as cross-border factoring or international factoring.
- **Invoice discount:** Invoice discount is a variant of factoring. It provides finance against invoices backed by letters of credit of banks. The factor provides finance once the letter of credit opening bank confirms the due date of payment.

Factoring Mechanism

The mechanism of factoring can be explained with the help of the following flowchart (Figure 20.1):

1. Customer places an order with the client for goods and/or service on credit; client delivers the goods and sends invoice to customers.
2. Client assigns invoice to factor.
3. Factor makes prepayment upto 80 per cent and sends periodical statements.
4. Monthly statement of accounts to customer and follow-up.
5. Customer makes payment to factor.
6. Factor makes balance 20 per cent payment on realization to the client.



Source: SBI Factors and Commercial Services.

Figure 20.1 A Flowchart of Factoring Transaction

The client sends an invoice to his customer in the usual way but adds a notification that the invoice is assigned to and must be paid to the factor with whom he has made an arrangement.

The client then submits copies of invoices to the factor with a schedule of offer accompanied by the receipt, delivery *challan*, or any other valid proof of despatch.

The factor provides prepayment upto 80 per cent of the invoice value and follows-up with the customers for realization of payments due. The balance payment is made immediately on realization. The factor sends a monthly statement of accounts to the client to keep him informed of the factored invoices.

Factoring Charges

Factors charge finance charges and service fees.

- **Finance charge:** Finance charge is computed on the prepayment outstanding in the client's account at monthly intervals. Finance charges are only for financing that has been availed. These charges are similar to the interest levied on the cash credit facilities in a bank.
- **Service fee:** Service charge is a nominal charge levied at monthly intervals to cover the cost of services, namely, collection, sales ledger management, and periodical MIS reports. Service fee is determined on the basis of criteria such as the gross sales value, the number of customers, the number of invoices and credit notes, and the degree of credit risk represented by the customers or the transaction. Both these charges taken together compare very favourably with the interest rates charged by banks and financial institutions for short-term borrowings.

Legal Aspects of Factoring

- Upon entering into a factoring arrangement, the client agrees to serve a notice of assignment in the prescribed form to all customers, whose receivables have been factored.
- The client agrees to provide all copies of invoices, *challans,* and other evidences relating to the factored account and also remit any payment received, if any, by him against the factored invoices.
- The factor requires a power of attorney to assign the debts and to draw negotiable instruments in respect of such debts.
- The legal status of the factor is that of an assignee.
- In case of multiple finance (*i.e.*, a part of book debts is financed by bank and part by factoring), the letter of disclaimer is required by factor so that there is no duplicate charge and double financing is avoided.
- Factoring transactions attract stamp duty to assign all debts.

Advantages of Factoring

Factoring is beneficial to the client, his customers, and banks.

Benefits to the Client

The benefits to the clients are as follows:

- The client's credit sales are immediately converted into ready cash as the factor makes a payment of around 80 per cent of the factored invoices in advance. This proportion of finance is higher than the bank finance against credit sales.
- The client can offer competitive credit terms to his buyers which, in turn, enable him to increase his sales and profits.
- The cash realised from credit sales can be used to accelerate the production cycle.
- The client is free from the tensions of monitoring his sales ledger and can concentrate on production, marketing, and other aspects. This results in a reduction in overhead expenses and an increase in sales and profits.
- Factoring results in a close internation among working capital components of the business. Efficient management of one component can have positive impact on other component. For example, an increase in liquidity enables the firm to avail of discounts on purchases of raw materials.
- The factor provides a comprehensive credit control system by analyzing payment history. This helps in assessing the quality of the debtors and monitoring their financial health.
- The client can expand his business by exploring new markets.

Benefits to Customers (Buyers)

The benefits that the customers enjoy are as follows:

- Factoring facilitates the credit purchases of the customers as they get adequate credit period.
- Customers save on bank charges and expenses.
- The customer has not to furnish any documents. He has merely to acknowledge the notification letter, that is, an undertaking to make payment of the invoices to the factor. Customers are furnished with periodical statements of outstanding invoices by the factor.
- Factoring does not impinge on the customer's rights vis-a-vis the supplier's in respect of quality of goods, contractual obligations, and so on.

Benefits to Banks

Factoring improves liquidity of the clients and, thereby, improves the quality of advances of banks. Factoring is not a threat to banking; it is a financial service complementary to that of the banks.

Comparison of Factoring with Bills Discounting and Cash Credit

Both bills discounting and cash credit are like factoring as they are short-term sources of finance but they differ in many respects from factoring.

Bills Discounting vis-á-vis Factoring

- Bills discounting is an individual transaction in the sense that each bill is separately assessed and discounted. Factoring is a financial service provided by a financial institution/intermediary on a whole turnover basis. Factoring is the provision of bulk finance against several unpaid trade invoices. This gives the client the liberty to draw desired finance only.
- In case of bills discounting, each bill has to be individually accepted by the drawee, which takes time. In factoring a one-time notification is taken from the customer at the commencement of the facility.
- Bills discounting is an expensive short-term source of finance as stamp duty is charged on certain usance bills together with bank charges. In case of factoring, no stamp duty is charged on the invoices and hence it is less expensive than bills discounting.
- Bills discounting involves more paper work as compared to factoring.
- In case of bills discounting, the grace period for payment is usually three days while in case of factoring, the grace period is higher.
- Bills discounting requires submission of original documents such as bill of lading, *challans,* and invoices. Only copies of such documents are required in factoring.
- In bills discounting, charges are normally upfront whereas there are no upfront charges in case of factoring. Finance charges are levied on the amount of money withdrawn.
- Bills discounting is not an off-balance sheet mode of financing while factoring is.
- Bills discounting is more domestic-related and usually falls within the working limits set by the bank for the customer. Factoring may be domestic or international and is not concerned with the working capital limits set by the bank.
- Bills discounting does not involve assignment of debts while factoring involves assignment of debts.

Cash Credit vis-á-vis Factoring

Commercial banks allot two types of credit limits for their clients—the cash credit limit and the loan limit. The cash credit limit is for working capital requirement and is short-term in nature. The cash credit funds can be withdrawn at a short notice for working capital requirements.

- In cash credit, the margin retained on receivables is usually 40 to 50 per cent as banks have no means of following up sundry debtors, while in case of factoring, the margin retained is 20 per cent.
- In case of cash credit, the drawing power on the basis of stock statements is computed once a month. If invoices are raised between submission of stock statement, no money can be drawn against them. Factoring is like cash sales—prepayments against invoices are made as and when they are factored.

- In case of cash credit, the client has to submit various statements to the bank while no statements are to be submitted to the factor. On the contrary, the factor furnishes various reports to both the client and the customer.
- The bank does not provide collection services to its clients while a factor renders debt collection service to its clients.
- In case of cash credit, once a book debt exceeds its usance period, it is removed from the eligible list. In factoring, the factor allows generous grace period on factored receivables.
- To avail cash credit facilities, processing fees are about one per cent of the limit and interest is linked to the prime lending rate. In case of factoring, the maximum processing fees are fixed and finance charge is linked to the cost of funds.

Thus, factoring tends to increase the number of rotations by converting credit sales into cash sales in a manner that banks cannot accomplish.

International Factoring

International factoring facilitates international trade. It is a comprehensive range of receivables management and financing services wherein a factor provides an exporter with at least two of the following services:

- Credit management and bad debt protection.
- Credit guarantee.
- Finance upto 90 per cent of the invoice value on shipment to approved debtor.
- Collection services.
- Professional sales ledger and analysis.

International factoring eases much of the credit and collection burden created by international sales. Export receivables that can be factored should have the following characteristics:

- The buyer's country should be covered by the factor.
- The exporter's performance obligation should be completed at the time the exporter presents an invoice for prepayment.
- There should be multiple shipments or a continuous sales flow on an ongoing basis with the same buyer or buyers. There should be assignment of the whole turnover with a buyer on a continuous basis.
- Factoring transactions are best suited for credit periods upto 180 days and factoring facilities are typically provided for 'open-account' transactions. In the absence of this, the buyers would have to open a letter of credit (LC), thereby blocking bank limits.

- When the seller and buyer are located in different countries and a factoring agreement takes place it is called international factoring.

Need for International Factoring

An exporter requires international factoring services to relieve him of the problems of collecting receivables in a foreign country and the tensions arising from the unfamiliarity with the customer's creditworthiness. Moreover, the demand for open account trading, where the importer makes the payment after he receives the goods, has expanded globally and Indian exporters are also required to offer similar terms to importers in order to remain competitive. This has created a demand for better credit risk protection services arising out of importers delaying payments or not making any payments at all. International factoring provides credit assessment and protection, financing and collection services to exporters for regular sales in open account terms. International factoring requires no collateral or letter of credit (LC). A letter from a bank to a foreign bank authorizing the payment of a specified sum to the person or company named is known as letter of credit (LC). Letters of credit are widely used as a means of payment for goods in foreign trade.

An export factor in India pays 90 per cent as advance on the approved invoices and also gives a 100 per cent risk protection on the receivables in the event of the buyer's failure to pay including insolvency.

Benefits of International Factoring

The exporter deals with only one factor even if his exports are spread across different countries. He can obtain experience of the correspondent factor not only in terms of getting an access to the creditworthiness of the buyer but also in legal laws and business practices of these countries. The exporter's risk and bad debts are reduced. He can expand his business by exploring new markets.

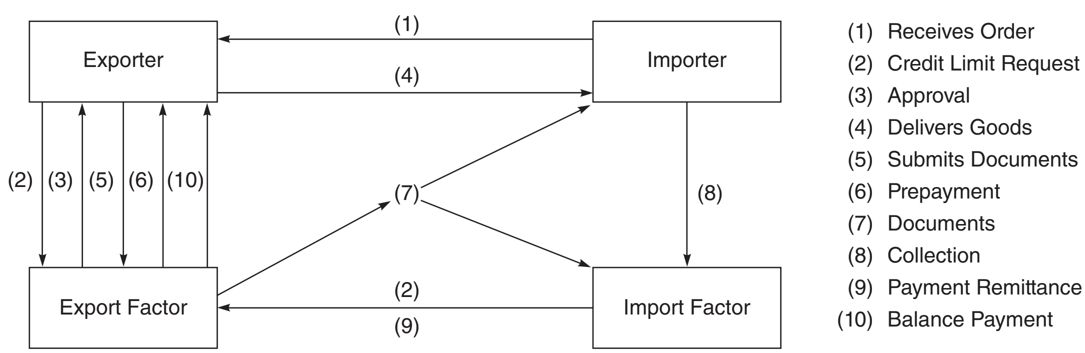
The importer also benefits as he pays the invoice amount to a factoring company in his own country. This is similar to making payment to domestic suppliers. The importer gets an access to open account credit terms. In the absence of this, he would have to open letter of credit (LC), thereby blocking his bank limits.

Flow Chart of International Factoring Transaction

In international factoring, there are four parties, that is, the exporter (client), the importer (customer), the export factor, and the import factor (Figure 20.2). International factoring is a two factor system. The export factor services the needs of clients in India while the import factor undertakes the credit assessment of customer keeping in view the macro-conditions of the country and industry specific factors. It also undertakes collections and follow-up required for realization on maturity.

In international factoring, there is no bank involved in the transaction. All the necessary documentations and the RBI formalities are performed by the export factor who is an authorized dealer.

- The exporter receives an order or regularly receives orders from an importer or importers and is able to estimate the financing requirement.
- The exporter provides the export factor with contact details of its customers alongwith estimates of the credit limits. The export factor forwards these details to correspondent import factors in the relevant country.
- On approval of the exporter's credit limits, the exporter enters into a factoring agreement with the export factor.
- The exporter ships the goods to his customer (importer).
- The exporter submits the relevant documents such as invoice, bill of lading/airway bill, GR form, and so on to the export factor.
- The export factor scrutinises the documents and makes a prepayment as agreed upon to the exporter.



Source: Global Trade Finance Private Limited.

Figure 20.2 International Factoring Transaction

- The export factor directly forwards the documents to the customer(s) under advice to the correspondent factors.
- The correspondent factor (import factor) follows up with the customers and collect payments from them.
- The correspondent factor (import factor) collects the payment and immediately remits it to the export factor.
- On collection, the export factor credits the balance payment to the exporter's account after adjusting for prepayments made.

Factoring is most suitable for manufacturing and trading companies. It is also suitable for advertising agencies, solicitors and legal firms, architect firms, medical firms, construction and engineering contracts, and software firms.

International Factoring Charges

In international factoring, there are two types of charges: discount charge and service charge. The factor levies a discount charge for prepayment and service charge for allied services, which includes a 100 per cent risk protection. The charge is generally calculated as a percentage on a flat basis on the gross invoice value.

Factor Chain International

Established in 1968, Factor Chain International (FCI) is a global network of leading factoring companies whose common aim is to facilitate international trade through factoring and related financial services. The FCI network consists of 270 factors in 74 countries. It provides modern and effective communication systems to enable factors to conduct their business in a cost effective way. It also provides a legal framework to protect exporters and importers. It has developed standard procedures of factoring to maintain a universal quality. It also undertakes worldwide promotion to position international factoring as the preferred method of trade finance.

According to FCI, the growth rate in international factoring is greater than the growth rate in domestic factoring.

Factoring in India

The RBI formed a committee headed by C. S. Kalyanasundaram, a former managing director of the State Bank of India (SBI) to examine the need for and scope of factoring organizations in India. The committee submitted its report in December 1988 and recommended introduction of factoring services in India. The RBI advised banks to take up factoring activity through a subsidiary.

SBI Factors and Commercial Services The State Bank of India, in association with the State Bank of Indore, the State Bank of Saurashtra, the Small Industries Development Bank of India, and the Union Bank of India set up the SBI Factors and Commercial Services in February 1991. SBI Factors commenced operations from April 1991. SBI Factors was the first factoring company to be set up in India. It has a 45 per cent market share in this business. SBI Factors offers domestic, export, and import factoring services.

SBI factors offers two types of products under domestic factoring:

1. **Bill 2 cash** (Receivables factoring facility)—the seller invoices the goods to the buyer, assigns the same to SBI factors, and receives prepayment up to 90 per cent of the invoice value immediately. The balance amount is paid to the client when the customer pays to SBI factors. This facility can be 'with recourse' or 'without recourse'. Without recourse factoring is a finance option, which is an off-balance sheet item, and it improves Return on Assets (ROA) substantially.

Box 20.1 Factor Chain International (FCI)

Country Profile INDIA (2016)

Number of Factoring Companies:	10
Domestic Factoring Turnover (in Millions of EUR):	2.5
International Factoring Turnover (in Millions of EUR):	1.2
Total Factoring Turnover (in Millions of EUR):	**3.7**

FCI Members

ECGC Limited
Blend Financial Services Ltd
IFCI Factors Ltd. (Foremost Factors Limited)
SBI Global Factors Limited
Standard Chartered Bank (Trade, Transaction Banking)
The Hongkong and Shanghai Banking Corporation Ltd. (Factoring & Receivables Finance)
Genpact India
DBS Bank Ltd
India Factoring & Finance Solutions Pvt Ltd
YES BANK Limited

Source: www.fci.nl

2. **Cash 4 purchase** (Purchase bill factoring)—facilitates instant payment for purchases made and is generally sanctioned in conjunction with receivable factoring facility or export factoring facility.

Under Export Factoring Facility known as Vishwavyapar, it factors invoices drawn on overseas buyers and makes a prepayment of up to 90 per cent of the invoice amount, immediately. Its Import Factoring Service enables buyers/importers to purchase the goods from foreign suppliers on credit without Letter of Credit or Bank Guarantee, *i.e.*, on open account terms. The importer makes the payment to the import factor (SBI Factors) and not to the exporter. SBI Factors assume the credit risk on evaluation of the importer and provides the credit cover to the Export Factor. The cost in this regard has to be borne by the exporter through the Import Factor. It also undertakes to pay the Export Factor under guarantee, in case, the approved account receivables remain unpaid 90 days past due.

Global Trade Finance Private Limited was set up in September 2001 by West Deutesche Landesbank Girozentrate, EXIM Bank of India, and International Finance Corporation for promoting cross-border factoring services. In March 2008, the SBI acquired 92.85 per cent stake and the remaining 7.15 per cent is with Bank of Maharashtra. It is the only provider of international factoring, domestic factoring, and forfaiting services under one roof in India.

Non-Banking Financial Company – Factor (Reserve Bank) Directions, 2012.

Introduction

The central government notified the Factoring Regulation Act, 2011 on January 22, 2012. The aim of the Act is to regulate factors and assignment of receivables in favour of factors, as also delineate the rights and obligations of parties to assignment of receivables. Under the Act, factoring companies other than banks, government companies, etc., (Section 5 of the Act) would be registered with the reserve bank as NBFCs and would be subject to prudential regulations by the reserve bank. In accordance with the above, a new category of NBFCs, viz., Non-Banking Financial Company-Factors was introduced and separate directions were issued to them for meticulous compliance.

1. Applicability of the Directions The provisions of these directions shall apply to every Non-Banking Financial Company-Factor registered with the RBI under Section 3 of the Factoring Regulation Act, 2011.

2. Registration and Matters Incidental thereto

(i) Every company registered under Section 3 of the Companies Act, 2013 intending to undertake factoring business 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;

(ii) Existing NBFCs that satisfy all the conditions enumerated in these directions may approach the regional office where it is registered, along with the original CoR issued by the bank for change in their classification as NBFC-Factor within six months from the date of this notification. Their request must be supported by their statutory auditor's certificate indicating the asset and income pattern;

(iii) An entity not registered with the bank may conduct the business of factoring if it is an entity mentioned in Section 5 of the Act, i.e., a bank or any corporation established under an Act of Parliament or State Legislature, or a government company as defined under Section 617 of the Companies Act, 1956; and

(iv) A new company that is granted CoR by the bank as NBFC-Factor shall commence business within six months from the date of grant of CoR by the bank.

3. Net Owned Fund

(i) Every company seeking registration as NBFC-Factor shall have a minimum Net Owned Fund (NOF) of ₹5 crore;

(ii) Existing companies seeking registration as NBFC-Factor but do not fulfil the NOF criterion of ₹5 crore may approach the Bank for time to comply with the requirement.

4. Principal Business

(i) An NBFC-Factor shall ensure that its financial assets in the factoring business constitute at least 50 per cent of its total assets and the income derived from factoring business is not less than 50 per cent of its gross income

(ii) An existing NBFC registered with the bank and conducting factoring business that constitutes less than 75 per cent of total assets/income was required to submit to the bank within six months from the date of the notification dated July 23, 2012, 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 as NBFCs was required to raise the asset/income percentage as required at 7(i) above or unwind the factoring business within a period of 2 years from the date of the above notification. It would be granted CoR as NBFC-Factor only after it reaches the required asset/income percentage.

In view of the above, the criteria regarding asset and income of factoring companies eligible for bank finance have been reviewed. Accordingly, banks can henceforth extend financial assistance to support the factoring business of factoring companies which comply with the following criteria:

(a) The companies qualify as factoring companies and carry out their business under the provisions of the Factoring Regulation Act, 2011 and notifications issued by the reserve bank in this regard from time to time.
(b) They derive at least 75 per cent of their income from factoring activity.
(c) The receivables purchased/financed, irrespective of whether on 'with recourse' or 'without recourse' basis, form at least 75 per cent of the assets of the factoring company.
(d) The assets/income referred to above would not include the assets/income relating to any bill discounting facility extended by the factoring company.
(e) The financial assistance extended by the factoring companies is secured by hypothecation or assignment of receivables in their favour.

5. Conduct of Business The NBFC-Factors shall conduct the business of factoring in accordance with the Act and the rules and regulations framed under the Act from time to time.

6. Prudential Norms

6.1 The provisions of Systemically Important Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2015 or Non-Systemically Important Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2015 or Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007, as the case may be and as applicable to a loan company shall apply to an NBFC-Factor.

6.2 The receivable acquired under factoring which is not paid within such period of due date as applicable, should be treated as Non-Performing Asset (NPA) irrespective of when the receivable was acquired by the factor or whether the factoring was carried out on "with recourse" basis or "non-recourse" basis. The entity on which the exposure was booked should be shown as NPA and provisioning made accordingly.

6 A. Exposure Norms-Single and Group Borrower Limits The facilities extended by way of factoring services would be covered within the overall exposure ceiling specified in the Systemically Important Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2015 or Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007, as applicable. The exposure shall be reckoned as under:

(a) In case of factoring on "with-recourse" basis, the exposure would be reckoned on the assignor.
(b) In case of factoring on "without-recourse" basis, the exposure would be reckoned on the debtor, irrespective of credit risk cover/protection provided, except in cases of international factoring where the entire credit risk has been assumed by the import factor.

7. Submission of Returns The submission of returns to the reserve bank will be as specified presently in the case of registered NBFCs.

7A. Risk Management Proper and adequate control and reporting mechanisms should be put in place before such business in undertaken.

(a) NBFC-Factors should carry out a thorough credit appraisal of the debtors before entering into any factoring arrangement or prior to establishing lines of credit with the export factor.
(b) Factoring services should be extended in respect of invoices which represent genuine trade transactions.

(c) Since under without recourse factoring transactions, the factor is underwriting the credit risk on the debtor, there should be a clearly laid down board-approved limit for all such underwriting commitments.

8. Export/Import Factoring Foreign Exchange Department (FED) of the reserve bank gives authorization to factors under FEMA, 1999. Therefore, NBFC-Factors, intending to deal in forex through export/import factoring, should make an application to FED for necessary authorization under FEMA, 1999 to deal in forex and adhere to the terms and conditions prescribed by FED and all the relevant provisions of the FEMA or rules, regulations, notifications, directions or orders made thereunder from time to time.

8 A. For the purpose of exchange of information, the assignor will be deemed to be the borrower. Factors and banks should share information about common borrowers. Factors must ensure to intimate the limits sanctioned to the borrower to the concerned banks/NBFCs and details of debts factored to avoid double financing.

Factors Inhibiting the Growth of Factoring in India

The factoring industry has grown phenomenally extending to over 90 countries around the world. More than 1 lakh businesses are currently using factoring to settle trade transactions with some seven million customers worldwide. The worldwide factoring volume is now over €2,376 billion a year. In the US, there are 120 factoring companies with a total turnover of €95,000 million. Asia is the second largest continent for factoring forming 23.8 percent of the world total factoring volume. China is the largest factoring market in Asia. In India, the domestic and international factoring volume is 2500 million euros and 1200 million euros, respectively. Higher domestic and international factoring volume is also expected to grow in India following the deregulation of some of the rules on factoring by the Reserve Bank of India. The factoring volume is quite low in India. The factors inhibiting the growth of factoring volumes are as follows:

- Lack of a credit appraisal system and authentic information about customers and clients restricts the growth of this business. As against this, in the UK and the USA, companies like Dunn and Bradstreet are engaged in credit appraisal systems. Factors rely on their reports to enter into factoring arrangements.
- Higher stamp duty on assigning of debt increases the cost of the client which reduces factoring arrangements.
- Non-availability of permission to factoring companies for raising their debt restricts their financing capacity and thereby the growth of the market.

To remove such limitations and to boost factoring, the following can be suggested:

- Eliminate or reduce the stamp duty.
- Develop a separate company which would give a true and fair credit appraisal report, covering all aspects of the client and his customers account.
- The debt raising capacity of factoring companies should be increased.
- A factoring law which would address the present inadequacies and impediments should be framed and passed.
- Workshops and seminars should be organized by factoring companies to increase awareness and usefulness of factoring among small scale units.
- Factoring companies should extend their network of branches especially to those areas where small scale units are located.

FORFAITING

Forfaiting has emerged as an important instrument of short- to long-term financing of international trade.

- Forfaiting is a non-recourse long-term financing of international trade.

Forfaiting is the discounting of international trade receivables on a 100 per cent without recourse basis. Forfaiting converts the exporter's credit sale into a cash sale. By transforming the exporter's credit into a cash transaction, it protects the exporter from all the risks associated with selling overseas on credit. Trade receivables, include bills of exchange, promissory notes, book receivables and deferred payments under letters of credit. The exporter surrenders trade receivables to the forfaiting agency, which pays him in cash after deducting some charges. The forfaiting agency then collects the dues from the importer on expiry of the same period. Thus, forfaiting enables exporters to offer longer-term financing to importers of capital goods from India.

Origin of Forfaiting

The term 'forfait' in French means to 'relinquish a right'. Here, it refers to the exporter relinquishing his right to a receivable due at a future date in exchange for immediate cash payment, at an agreed discount, passing all risks and responsibilities for collecting the debt to the forfaiter.

Forfaiting evolved in the 1960s. This concept was originally developed to help finance German exports to the Eastern bloc countries. The buyers of the Eastern bloc countries required credit and their need could not be fulfilled through the then existing modes of finance. This gave birth to a new concept—forfaiting.

Initially, it was in Switzerland that many forfaiting houses mushroomed but over the last decade, London has been the main centre for this market.

In India, the RBI vide its circular AD (GP Series) No. 3 dated February 13, 1992, approved forfaiting as an export financing option. Exim Bank was the first institution which got approval in 1992 to finance exports through forfaiting. Forfaiting facility is provided by an international forfaiting agency and a forfaiting transaction is routed through an authorized dealer (AD). This authorized dealer provides services such as handling documentation and providing customs clarification for GR form purposes. Forfaiting proceeds are to be received in India as soon as possible after shipment but within the 180-day period specified by the RBI for all exports.

Initially, forfaiting developed as a fixed interest rate and medium-term (3 to 5 years) financing. Now it can be tailor-made to suit the exporter's requirements on the basis of interest rate, credit period, moratorium, and variable shipment schedule. Forfaiting can now be structured on a floating rate basis as well as for shorter and longer periods ranging between 60 days to 10 years. It is also possible to finance multinational corporates or state-owned entities risks. Earlier, the concept was restricted to post shipment finance. Now the concept has been extended to provide pre-export finance, structured trade finance, project finance, and even working capital.

Characteristics of a Forfaiting Transaction

- Forfaiting is 100 per cent financing without recourse to the exporter. This means that the exporter is insulated against the possibility of default in payment by the importer.
- Trade receivables are usually evidenced by bills of exchange, promissory notes, or a letter of credit. The trade receivables are required to be denominated in a freely convertible currency. The most common currency denominations are the US dollar and euro.
- Credit periods can range from 60 days to 10 years.
- Forfaiting is flexible as it can be structured on fixed interest rate basis as well as floating rate basis and can be tailor-made to accommodate variations in terms such as credit period, and shipment schedule.
- An importer's obligation is normally supported by a local bank guarantee or an aval. An aval means an unconditional financial obligation; it takes the form of an endorsement on a debt instrument like a promissory note or bills of exchange. The act of giving an aval is known as avalizing. It represents an irrevocable, unconditional, and fully transferable guarantee given by the foreign buyer's local bank and is normally a requirement in forfaiting transaction.
- Forfaiting is suitable for high-value exports such as capital goods, consumer durables, vehicles, consultancy and construction contracts, project exports, and bulk commodities. Forfaiting is also suitable for low value but repetitive products, including pharmaceuticals, dyes and chemicals, cotton textiles and yarn, leather and garments, granite, handicrafts, and carpets.

Forfaiting is used in the following situations:

- There is a request for deferred payment for more than 60 days.
- The contract is for at least USD 1,00,000 or its equivalent, in a freely convertible currency, and when each shipment is not less than USD 25,000.
- Either a letter of credit or a bank guarantee is available or the exporter believes that the buyer is an acceptable stand alone risk.
- The sale is made to a buyer in a high credit risk country.
- The exporters' own bank limits are inadequate or not available.

Need for Forfaiting

- Forfaiting is a non-recourse and off-balance sheet financing. It eliminates all risks from the exporter's books.
- Commercial banks usually do not fund credit risks beyond 180 days. Hence, for financing long tenor receivables, forfaiting is the only option.
- Forfaiting helps in eliminating interest rate fluctuation as it involves upfront discounting. The interest cost is known to both the exporter and importer and is built into the contract thereby providing protection against adverse interest rate fluctuations.

Benefits of Forfaiting

- The exporter receives the full export value from the forfaiter. It is superior to the traditional discounting of bills wherein a part of the export proceeds are deducted by the bank.
- The exporter is absolved of all the risks attached to the transaction. In other words, it eliminates risks such as commercial risk, political risk, transfer risk, interest risk, and exchange risk.
- It improves the liquidity of the exporter as it converts credit sales into a cash transaction.
- It also relieves the balance sheet of contingent liabilities and helps the exporter to undertake more exports.
- It enhances the competitive advantage of the exporter by enabling the exporter to provide more credit, which increases the attractiveness of his offer. This, in turn, increases the volume of business and his ability to do business in risky countries.
- It relieves the exporter from administration and collection hassles.
- Its documentation procedure is simple, enabling exporters to forfait transactions quickly and efficiently.
- It does not affect the existing banking limits of the exporter.
- Forfaiting is transaction specific and hence does not require a long-term banking relationship with the forfaiter.
- The exporter saves on insurance costs as forfeiting obviates the need for export credit insurance.
- Forfaiting is beneficial to the importer also. For the importer, forfaiting is an alternative form of financing capacity that increases and diversifies borrowing capacity, speeds the conclusion of commercial contract, avoids restrictive borrowing covenants, and frees him from administrative and legal hassles.

Flow Chart of a Forfaiting Transaction

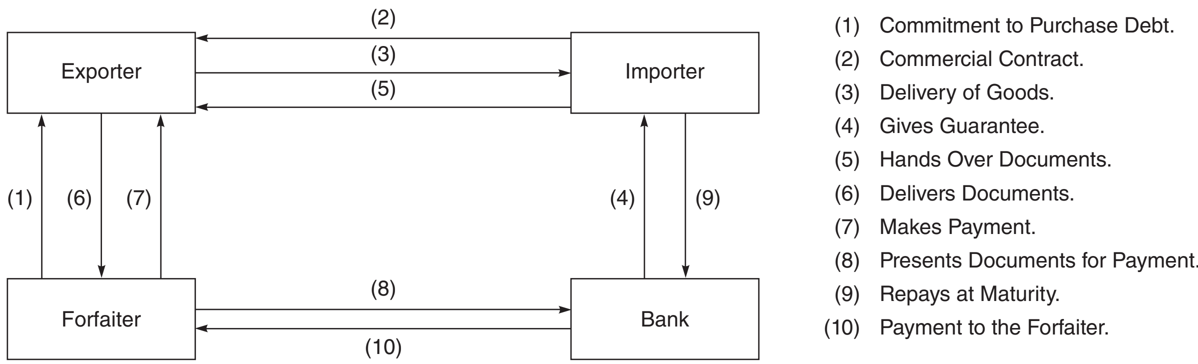
The mechanism of forfaiting can be explained with the help of the following flowchart (Figure 20.3):

- At the request of the exporter, and normally nearer the time of shipment, the forfeiter provides the exporter with a written commitment to purchase the debt from him on a without recourse basis.
- The exporter and the importer sign the commercial contract.
- A forfaiting certificate is provided by the authorized dealer (AD) to be attached to the goods received form prior to submission to customers. The rest of the shipping documents are prepared as per the commercial contract. The goods are then despatched to the importer.
- The importer's bank provides guarantee at the request of the importer.
- The guarantee is forwarded by the importer to the exporter.
- The exporter then assigns the guarantee in favour of the forfaiter and forwards other documents relating to forfaiting.
- On receipt of complete documentation, the forfaiter makes the payment to the exporter on a without recourse basis.
- On maturity, the forfaiter presents the documents to the importer's bank for payment.
- The importer makes the payment to his guaranteeing bank.
- The importer's bank guaranteeing the transaction makes the payment to the forfaiter on due date.

Pricing of a Forfaiting Transaction

The pricing consists of four elements: discount rate, commitment fees, grace days, and handling fee.

- **Discount rate:** Discount rate is the interest element and reflects the cost of funds. It is the rate at which the face value of a negotiable instrument is discounted. The discount rate is usually quoted as a margin over London Inter-Bank Offer Rate (LIBOR). The margin depends upon the country/bank risk and the credit period. A high country risk and longer credit period will attract higher margins.



Source: Global Trade Finance Private Limited.

Figure 20.3 A Flowchart of a Forfaiting Transaction

- **Commitment fees:** The commitment fees is calculated from the date the forfaiter is committed to undertake the financing until the date of discounting.
- **Grace days:** These are the number of days beyond the stated maturity. They represent the anticipated number of days required for transmission and receipt of funds at maturity. It normally ranges from two to five days and can extend upto 15 days and beyond.
- **Handling fee:** A handling fee is applicable for documentation and custom clarification.

Difference Between Forfaiting and Factoring

- Forfaiting is usually for international credit transactions of long-term maturity periods ranging between 90 days and upto 5 years. Factoring is for transactions of short-term maturities not exceeding six months.
- Forfaiting is 100 per cent financing without recourse to the exporter. Factoring can be with recourse or without recourse depending on the terms of transaction between the seller and the factor.
- In forfaiting, the cost (charges) consists of three elements—discount rate, commitment fees, and handling fees, which are ultimately borne by the importer. The cost of factoring is usually borne by the seller.
- In forfaiting, the complete sales ledger of the exporter is not handled by the forfaiter. Forfaiting, structuring, and costing is tailor-made and on a case-to-case basis. Under factoring, the factor handles the entire sales ledger at a predetermined price. Factoring requires the assignment of whole turnover with a buyer on a continuous basis. Factoring is a continuous and revolving facility.
- The fundamental difference between factoring and forfaiting is the difference in the risk profiles of the receivables, which has implications for the cost of services.
- In forfaiting, there is a forfaiter and a bank involved in the transaction while in international factoring, there is a two factor system—the export factor and the import factor, with no bank involved in the transaction.

Growth of Forfaiting in India

Forfaiting is a non-course financing wherein the proceeds are to be received in India as soon as possible after shipment but within the 180 days period specified by the RBI for all exporters. A forfaiting transaction is to be routed through an authorized dealer, who apart from handling documentation will also provide customs certification for GR form purposes.

The EXIM Bank was the first institution to get an approval from the RBI to finance exports through forfaiting. The Indian exporter still relies on an LC or an Export and Credit Guarantee Corporation (ECGC) insurance for the post shipment period. To popularize this concept, EXIM Bank has been organizing workshops and seminars. But compared to the forfaiting business of more than USD 500 billion in the developed countries, the volume of forfaiting business in India is comparatively quite low.

In September 2001, to encourage forfaiting, the Global Trade Finance Limited was born to promote market-driven export financing solutions for small and medium sized Indian exporters, operating in an increasingly competitive world environment. Global Trade Finance Limited offers forfaiting and export factoring to Indian exporters under one roof in India and has received the necessary approvals from the RBI.

Conclusion

Both factoring and forfeiting are new trade financing services. The combined global market for these services is estimated to be USD 700 billion and India is widely recognized as the top 10 countries where the use of factoring and forfaiting is expected to rise significantly in the coming years.

KEY TERMS

Advance Factoring	International Factoring and Forfaiting.	Non-recourse Factoring	Recourse Factoring
Factoring	Maturity Factoring	Old Line Factoring	

SUMMARY

1. Factoring is an activity of managing the trade debts of a business concern. The factor controls the credit extended to the customers and administers the sales ledger.
2. The different types of factoring arrangements are : recourse factoring, non-recourse factoring, advance and maturity factoring, old line factoring, cross-border factoring/international factoring, invoice discount.
3. Factoring is beneficial to the client, his customers, and banks.
4. International factoring facilitates international trade. It is a comprehensive range of receivables management and financing services wherein a factor provides an exporter with at least two of the following services: credit management and bad debt protection, credit guarantee, finance upto 90 per cent of the invoice value on shipment to approved debtor, collection services, and professional sales ledger and analysis.
5. In international factoring, there are four parties, that is, exporter (client) importer (customer), the export factor, and the import factor. International factoring is a two-factor system. The export factor services the needs of clients in India while the import factor undertakes the credit assessment of customer keeping in view the macro-conditions of the country and industry specific factors. It also undertakes collections and follow-up required for realization on maturity.
6. Forfaiting has emerged as an important instrument of short to long-term financing of international trade.
7. Forfaiting is the discounting of international trade receivables on a 100 per cent without recourse basis. It converts the exporter credit sale into a cash sale. For financing long tenor receivables, forfaiting is the only option. It helps in eliminating interest rate fluctuation as it involves upfront discounting.
8. Forfaiting is used when: there is a request for deferred payment for more than 60 days; the contract is for at least USD 1,00,000 or its equivalent, in a freely convertible currency; and when each shipment is not less than USD 25,000; either a letter of credit or a bank guarantee is available or the exporter believes that the buyer is an acceptable stand alone risk; the sale is made to a buyer in a high credit risk country and the exporters' own bank limits are inadequate or not available.

REVIEW QUESTIONS

1. What is factoring? Explain the types and mechanism of factoring.
2. How does factoring differ from bills discounting and cash credit?
3. What is international factoring? How does it differ from forfaiting? Explain the mechanism of international factoring.
4. State the major factors inhibiting the growth of factoring in India.
5. Explain the concept of forfaiting. What are the benefits of forfaiting?

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