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Factoring Services in Indian Financial Market

The Recent Trends

ABSTRACT

Factoring is an unique financial innovation and a quite popular mechanism of managing, financing and collecting receivables in developed world. It has just been introduced in India. In fact, factoring ensures a definite pattern of cash inflows from credit sales, continuous factoring may virtually eliminate the need for the credit and collection department, which will substantially cut down in the fixed cost of Supplier. This paper suggests that prospects of factoring services are wider and better in India in all respect.

Since 1991, the structual reforms in the various sectors of the Economy form part of the strategy of improving efficiency by encouraging compositness of the system as a whole. Today is the era of the specilisation in the service function, new areas are gaining wider acceptability like credit cards, merchant banking, base finance, mutual funds, financial advisory services, rating agencies, housing finance and factoring services *etc*.

Factoring is not a new phenomena. It is a popular mechanism of managing, financing and collecting receivables in developed countries like UK and U.S.A. and has extended to a number of other countries in the recent past. In India it is of very recent origin.

1. GENESIS

The term ‘Factor’ has its origin in the Latin word *Facere* meaning to make or to do or to get things done originally. Factors acted as selling agents, they facilitated the flow of merchandise from the manufacturers to customers. The functions of a factor included finding out customers for the manufacturer’s products, stock his goods, sell them and finally collect sales proceeds and remit them to the manufacturer. Thus, the functions of a factor in olden days included stocking, marketing and distribution as well as administration and financing of credit. The modern factor has specialised in credit collections and financial services, leaving the market and distribution functions to the manufacturer.

Today factoring includes sales of receivables of specialised firms called factors, factors collect receivables and also advance cash against reciavables to solve the client’s (Firm) liquidity problem. For providing their services they charge interest on advance and commission for other services. It is both a financial as well as management support to a client. Factoring is a business involving a continuing legal relationship between a financial institution (the factor) and business

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concern (the client) selling goods or providing services to trade customers whereby the factor purchases the clients book-debts (Account Receivables) and in relation thereto controls the credit extended to customers and administers to the sales-ledger. The mechanism of factoring is as follows :

* The customer (buyer of goods) places the order with the supplier.
* The supplier along with the factor fixes the credit limit for the particular.
* The supplier supplies the goods and sends the invoice to the customer with instruction to make the payment to the factor, simultaneosly sends a copy of the invoice to the factor.
* The factor makes payment to the supplier to the extent of 70-80%.
* The factor follows up and collect the payments from the customer.
* The factor pays the balance due to supplier-client.

2. PRESENT STATE OF FACTORING IN INDIA

The RBI constituted a study group under the chairmanship of C.S. Kalyan Sundaram former managing director of SBI to study the feasibility of starting factoring organisations in India. As per the suggestions of this study group, the Government of India decided to introduce factoring services with a view to mitigate the hardships being faced by small and medium enterprieses in managing receivables and in order to contain the growing phenomenon of the debts. Four banks were allowed to stard factoring services--SBI to undertake factoring services in Wester Region, Canara Bank in the Southern Region, PNB in the Northern Region and Allahabad Bank in Eastern Region. In addition, the small industries development bank of India (SIDBI) to provide factoring services to small and tiny sector. Indian financing organisations are on the constant look out for newer opportunities of growth and profitibility. Newer forms of financing that are available in advance countries are being introduced in Indian market.

3. FACTORING V/S BILL DISCOUNTING

Both are basically means of financing of working capital. Factoring service is an arrangement under which factor assumes the responsibility for collection of debt, maintains the sales-ledger and attends to other book-keeping duties, factoring arragement is normally on a continuous basis. As new receivables arise they are sold to the factor and proceeds are credited to the client's account. Under the bill discounting scheme, a supplier of goods discounts the income for sale of goods with his banker and if the bill is dishonoured by the buyer, the amount is recovered by bank from the seller. Factoring can not be rediscounted but can only be refinanced, whereas the discounted bills may be rediscounted any number of times before they mature for payment.

Factoring is done upto a maximum of 75% or 80%, the balance of 25% or 20% is released only when customer makes the payment. Whereas bills finance is extended mostly on 100% basis. Cost-wise also there is diffrence, as factoring is bound to cost the clients a littled more atleast than bill discounting facility. Thus, factoring has many similarities with bill discounting facility, however these are certain above mentioned distinct differences between factoring and discounting.

4. CLASSIFICATION OF FACTORING

Factoring is quite popular in developed countries over the years, a variety of factoring services have devices and perfected. These include, full factoring, maturity factoring, advance factoring and undisclosed factoring, invoice factoring and export factoring.

- **Full Factoring**

Under this category book-debts are purchased by by the factor assuming 100% credit risk, the full amont of invoices have to be paid to clients in the event of debts becoming bad. Collection of receivables and maintenance of sales-ledgers, credit control, credit production and finance services are renderd in this category. The client will be free to exceed the credit limit fixed for a customer but cover would be available to him only the credit limit fixed by the factor. The trait that cover would be available to him only the credit limit fixed by the factor. The trait that will be assigned to be factor notice will be given to the customer that the debt is so assigned and that he will get a proper discharged of the debt if the payment of invoice is made over to the factor. Prepayment of the invoice is made to the client upto about 80% of the amount and the balance is paid after the agreed period expires. The factor will send analysed statements of accounts to the client at the agreed periodicity. The client will be free to draw funds at any time upto the drawing limit, which will be adjusted for new invoice and invoices collected.

- **Maturity Factoring**

This type of factoring involves no financing abinitio and hence no drawing limit is made available to the client but the factor administers the client's sales ledger and renderds debt collection service. The amount of each invoice is made over the client at the end of the credit term or on an agreed maturity date less the factor's charges. This maturity date is decided upon at the commencement of the agreement by reference to the average time taken by the client to collect a debt. The maturity date bears no relation to the date on which the debt is actually due for payment as it is and estimated date of collection.

- **Advance Factoring**

This type of factor is prepared to pay for the debts in advance of receiving the payment due from the customers. This is only a prepayment and not at advance. A drawing limit will be made available to the client as soon as the invoices are accounted for. The factor will generally limit the amount prepaid to about 80% of debts. Besides charges for sales-ledger management and debt collection services, interest for the period for which funds are paid in advance will also be charged.

- **Undisclosed factoring**

In this type of factoring debts are assigned to the factor but the client maintains the sales-ledger and customers are not notified of the factors involvement. Debt collection is also organized by the client who makes over payment of each invoice to the factor, if advance payment has been received by him earlier. The factor keeps a check on its risk by receiving from the client and age-wise analysis of the debts at regular intervals. He can also inspect the sales-ledger of the client at regular intervals. The types of services which may be offered under an undisclosed level are very flexible. The charges vary with the range of services provided.

- **Invoice Factoring**

Under this arrangement, the factor purchases all or selected invoices of its client at a discount. Further, the factor does not maintain the sales-ledger or undertake debt collection, its only function being to provide finance. The advantage of this service is that the client is able to obtain short term relief from liquidity problems by taking advance without having to commit to regular factoring services.

- **Export Factoring**

The export factor, a party of the export trade transaction, helps the exporter to sell the goods abrad on open account basis, makes a prepayment to exports, take over the responsbility of maintaining sales-ledger, collection of debts and provides credit production. There are many small scale exporters who lose their entire goods and money through export transaction. As per RBI exchange control, regulations an exporter has to repatriate export within 180 days from date of shipment. With recent hike in export credit interest rates for bills outstanding beyond 90 days @18% per annum from date of advance and bills outstanding beyond 180 days @ 25% per annum from date of advance, the economic losses can be imagined. On one side, exporter is faced with severe restrictions and panelty from RBI for violation of FERA (FEMA) regulations namely the non-repatriation of export proceeds. On the other side, the steep hike in export credit interest rates. Exporters would be happy if their proceed are received fast without any teething problems and the exports factor plays an important role here.

5. COST & BENIFITS OF FACTORING

Factoring attracts the types of charges-discount charge and service fee. The discount rate levied on the prepayment drawn by the client normally tellies with the bank lending rate. The service charge on the other hand range from .5 to 2% of the invoice value depending upon the types of factoring service rendered and the volume of transaction. The pricing of factoring services as assessed by the Kalyana Sundaram Group is given below.

Funding Cost (9 to 12% at present)	12 to 16%
Collection cost	1%
Bad debts provision	1%
Spread	2%
T = Pricing to Customer =	**16 to 20% p.a.**

According to the group the price for financing services offered by the factors can be around 12 to 16% p.a. and the agreegate price for all other services may not exceed 2.5 to 3% of the debt services. Such pricing should be enable the factors to reach a level of business which will generate reasonable rate of return on their investment.

There are certain benefits which result from factoring the receivables the major benefits of factoring services are as under -

1. Factors which are generally automated will offer comprehensive service of total sales and accounts administration.
2. It will reduced the pressure and time on chasing debts eliminate, to a great extent, the risk of customers moving to other parties, on repeated demands.
3. The companies which want to boost cash flow and increase capacity utilisation can promptly get 80% of the net value of their debtors from the factor. It will improve the working capital management by quick cash inflows. Factors provide terminals so that management is fully away of the book debts and turnover.
4. As the money borrowed fora fix time, costs are reasonable and can be further reduced. Borrower/Client will pay service charge for the funds, he will use. It has in improving the current ratio of company and closer scruitiny by factors brings down based debts. The bank's image helps the factor in building business creditibility and connections.

6. RISK INVOLVEMENT IN FACTORING

Factoring involves risk also. Factors cover the risk of the debt default arising out of buyers insolving or financing inability to pay, 100% cover is provided where the factoring is on notified basis. Where the customer is not notified of the debt assignment, cover is provided only upto 80% defaults occuring on account of commercial dispute between the parties are not covered by factors.

In international factoring political risk assumes importance. Factors can cover this risk through organisation like the export credit guarantee organisation. By exception factors can obtain reinsurance cover through insurance companies. One shape of this cover generally obtained by factors is to cover the losses beyond a certain amount.

7. PROSPECTS OF FACTORING IN INDIA

Factoring is a well known method of raising short term financing in developed countries. Factoring is a method of converting a non-productive, inactive asset (book debt) into a productive asset (Cash) by selling book debts (receivables) to a company that specialised in their collection and administration, the factor provides following three basic services to clients :

* Sales-ledger administration and credit managment.
* Credit collection and protection against default and bad debt losses.
* Financing accomodation against the assigned bood debts.

Factoring is practiced in the US and other developed countries has still not caught up in India. It is treated more as a substitute for bill discounting. Factoring activity needs to be self sufficient without any subsidy from other operation. The success of this operation depends on a number of elements as given below :

- Effective management of operations to reduced drudgery of routine work and to make the factor's work more investigative and customer oriented. This would also include handling higher volumes of work with minimum investment.
- Ability to create and market better and newer products and services that customers would pay for.
- Maintain a comperative cost of operation. Factoring is essentially a financial service and the key cost of the business would be the average information technology, processing cost of a transaction in the organisation.
- Selection of credit worthy clients and customers so that the risk in factoring is within a managable limit. Selection should be based on credit information of the parties.
- The trends and requirements of the factoring services in India have analysed to determine key result area.

The RBI is keen on promoting factoring services in India, to meet the requirment of shot term financing based on receivables, instead of cash credit system. The introduction of factoring services has opened the floodgates for needy customers and there is scope for more players in the market. Factoring is the answer to every companies, cash flow problems. It will definitely emerge out of the closet in the years to come. With liberalisaton on the anvil, this is one area promising at about Rs. 5,000 crores and there is urgent need for factoring services in Chemicals, Engineering, Consumer durables, Textiles and Automobiles ancillaries as these industries are experiencing collection delays.

8. CONCLUSION

Now days, customers are demanding better service and are not ready to accept less than the best competitively available. A factor is in a position to employ specialists for the credit control and management since he has to cater to large number of firms and has substantial to invest. In fact factoring ensures a definite pattern of cash inflows from the credit sales. The credit management specialisation by the factor and his employment of highly skilled personnel for many clients allow enormous benefits for his individual clients. Thus, the firm can save cost of credit administration through breaking up a credit department avoiding cost of credit investigation, evaluation and collection and bad debt losses. Since the area of factoring services in India is still unexplored to large extent, there are wider and better opportunites to new enterpreneures in all sectors to come into existence. Keeping in view rapid economic reforms and global interactions factoring services can paly significant role to strength economic development by providing specialised credit management system.

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