



Factoring: An Alternate Payment Method in International Trade

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Abstract

Factoring is a global industry with a vast turnover and has gained significant importance in the recent years. This method of payment was used in order to ensure that companies could continue procure raw materials and produce output without any interruption. Factoring helped businessmen getting benefits in having consistent cash flows, reduced credit risks and investing their productive time on their core activities. After having seen the impact of Industrial Revolution, both the domestic and international factoring started gaining popularity at an impressive rate in most of the countries. Although there are several methods of settlement like open account, advance payment and documentary collection, a strong alternative called factoring has been most widely used by businesses in different parts of the world to settle their international trade transactions. This paper focuses on understanding the concept, its growth, comparison of trends in terms of volume of factoring services worldwide and its growth in India.

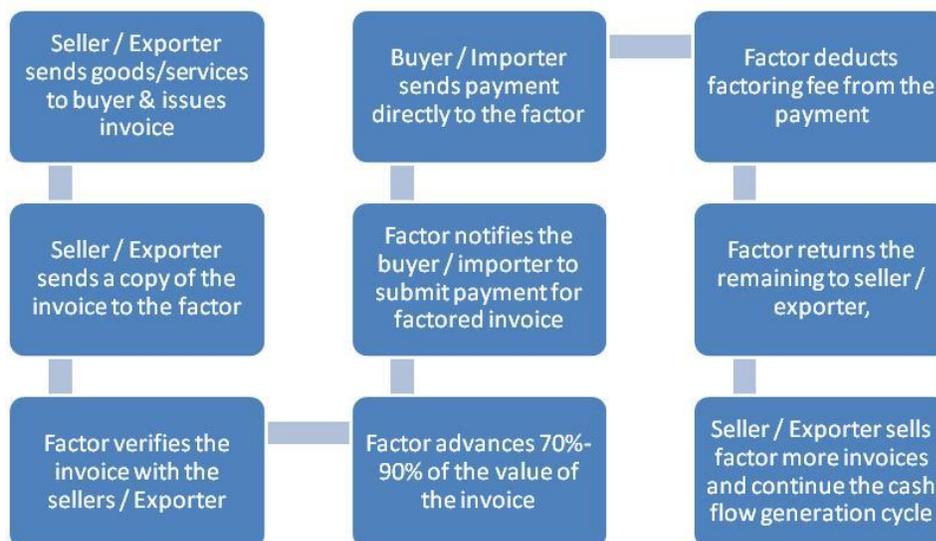
Introduction

Factoring has been in existence since the dawning of trade and commerce. It can be traced back to the period of a Mesopotamian king Hammurabi. A pervasive use of the concept began in American colonies before the revolution started. During those times raw materials like timber, fur and cotton were shipped from the colonies and before they reached the destination merchant bankers in London and other parts of Europe used to advance funds for the raw material. The practice was very beneficial to the colonists, as they didn't have to wait for the money to begin their harvesting again. With the Industrial Revolution the concept of factoring got narrowed down to credit. In the 60's and 70's with an increase of interest rates there was a surge in private



factors. The trend strengthened in 80's with further increase in interest rates and changes in the banking industry.

Under factoring, business concerns sell their invoices i.e. accounts receivables to a factoring company in exchange for an immediate advance on the invoice value, thereby, allowing companies to cash in on their sales without having to wait for payments to come in from customers in due course. Thereafter, the factor collects the full amount from the debtors and pays the balance amount due to the business concerns. This service is usually provided for a fee which is dependent on the sales volume, number of customers, number of invoices and credit notes and degree of credit risk in the customer or the transaction.



Factoring is widely used in transportation, medical, staffing, construction, manufacturing and services sectors.

Different types of factoring

There are four major types of factoring:

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

In undisclosed factoring, client's customers are not notified of the factoring arrangement. Client has to pay the amount to the factor irrespective of whether customer has paid or not.

In recourse factoring, client undertakes to collect the debts from the customer. If the customers don't pay the amount on maturity, factor will recover the amount from the client.



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.

International Factoring

Factoring has become well established in developing countries, in particular in those that are highly industrialised. In various Asian countries, the growth of factoring has been dramatic while in Latin America, financial institutions continue to join the industry. Similar growth has occurred in Central Europe, the Baltics and the Middle East. As international trade continues to increase, so too do the opportunities for the factoring industry.

Role of factoring in international trade

In open account terms payment is received many weeks or even months after delivery. International factoring provides a simple solution regardless of whether the exporter is a small organisation or a major corporation. The role of the factor is to collect money owed from abroad by approaching importers in their own country, in their own language and in the locally accepted manner. As a result, distances and cultural differences cease to be a problem.

Objectives of the study

- To understanding the concept of factoring as an alternative of the trade payment methods
- To analyse the factors are responsible for the growth of factoring in India.
- To know the effect of growth of factoring in India.

Sources of Data and Methodology

The data relating to factoring business has been obtained from: (a) <http://www.factors-chain.com>. Information is also extracted from online web sources.

Research Design

The design is the structure of any scientific work. It gives direction and systematizes the research.

There are two main approaches to a research problem:

- Quantitative Research
- Qualitative Research



Review of literature

Moore (1959) has discussed elaborately the different aspects of factoring including the problems, accounting, and comparison with accounts receivable financing. Shay et al (1968) have examined banks moving into factoring because of the higher return by assuming higher risk. They have concluded that in time many banks will offer factoring, resulting in better service to high risk borrowers from both the banking and the financial establishments. Moberly (1979) notes that factoring is of great value to the growing companies. He has mentioned that a growing company often faces the problems associated with overtrading. The factor is usually in a position to finance 80% of the value of debts.

The Kalyanasundaram (1988) Committee set up by RBI (Reserve Bank of India) has examined the feasibility and mechanics of starting factoring organizations in India. The study has suggested that there is a sufficient scope for introduction of factoring in India which will be complementary to the services provided by the commercial banks.

International Factoring is getting popularity in case of international trade instead of Letter of Credit (Banerjee, The Daily Financial Express April 2006). International Factoring Survey (1998), Khonstamm(1999) pointed that more and more countries are introducing international factoring and their exporters are turning their back to the letter of credit. Banerjee, (The Daily Financial Express, April 2006) mentioned that due to the security and margin requirements, the importers (even though bonafied) have to face serious time constraints and other problems for opening an L/C with the bank. Tarter (1997) mentioned that international factoring -- the sale of accounts receivable to international finance companies with the resources, expertise, and local presence to actively manage trade risk -- is providing a solid platform for success.

Vydani (2003) pointed out that at present, the importance of international factoring as a modern approach to the financing of claims in foreign trade is increasing. International factoring is one of the important forms of financing receivables in international trade. Under international law, the Ottawa Convention of 1988 and the Convention on Assignment of Receivables in International Trade govern it, which is now ready for signature by the individual states. In addition Freddy (2007) pointed that “those engaged in international factoring or otherwise financing receivables across borders may well encounter difficulties if they do not recognise the marked differences in the laws of jurisdictions other than their own covering assignments and the rights and obligations of debtors in relation to assigned debts”.

Factoring Services in India

Factoring service in India is of recent origin. The ‘Study Group for Examining Introduction of Factoring Services in India’ popularly known as Kalyanasundaram Committee, which was appointed by Reserve Bank of India (RBI) in 1988, found an abundant scope for factoring



services and strongly advocated for the introduction of these services in India (Kuvalekar 1997, p.1).

Suggestions of C.S. KalayanaSundaram Committee Jan 28, 1988

1. Introduction of Factoring services in India to complement the services provided by banks. Export Factoring can also be launched.
2. Factors should cover wide range of industries embracing all sectors of economy.
3. The cost of funds should not be more than 13.5% per annum. Factors will have to charge the price for services at a rate not higher than banks. The price for administrative services may not exceed 2.5 to 3 % of debt services.
4. Factoring agencies may be promoted on zonal basis. One each for North, South, East and West
5. Banks have considerable experience in financing and collection of receivables.
6. The Committee has recommended that the Government may enact a suitable legislation for the levy of penal interest for delayed payment from the debtors beyond specified period. It has also recommended that the Government should exempt assignment of factored debts from stamp duty.

The companies which provide factoring in India are Canbank Factors Limited, SBI Factors and Commercial Services Pvt. Ltd, The Hongkong and Shanghai Banking Corporation Ltd. Global Trade Finance Limited, Export Credit Guarantee Corporation of India Ltd, Citibank NA, India and Small Industries Development Bank of India (SIDBI): It is quite implied that factoring is a very easy and fast method. Still, it has not seen a substantial growth in India, as compared to China and Vietnam.

There are certain hiccups that have come up in the way of realizing the full potential of factoring in India. One of the main reasons for it is the legal framework of India. Generally factoring companies need legal protection as all advances are uncollateralized, protection for the same is not provided.

Government of India enacted the Factoring Act, 2011 to bring in the much needed legal framework for the factoring business in the country.

How the 2011 legislation differs and hopes to make an impact

- Any company can begin offering factoring services by registering with Reserve Bank of India as a non-banking finance company (NBFC) and will be under aegis of the current laws pertaining to NBFCs and also the 2011 Factoring Regulation Act.
- Meanwhile, banks established under an Act of Parliament can also provide such services without further registrations with the RBI.



- The law requires that all factoring transactions be registered with the Central Registry established under the SARFAESI Act of 2002.

Growth of the factoring industry in India

Unfortunately in India, the factoring business has had several stumbling blocks. While the government has made efforts to provide a facilitating regulatory environment for factoring business to develop, the fog does not seem to have cleared out completely.

The overall worldwide growth in factoring is estimated at 12%. Europe has the largest market representing 64% of the world volumes with a growth of 18% during the year. America's growth was 10%, whereas Australia recorded impressive growth of 40%. Asia saw a fall in volume.

Total Factoring Volume by Country in the last 7 years (in Millions of EUR)								
ASIA								
	2007	2008	2009	2010	2011	2012	2013	Var
Armenia	50	7	7	14	14	0	62	
China	32,976	55,000	67,300	1,54,550	2,73,690	3,43,759	3,78,128	10%
Hong Kong	7,700	8,500	8,079	14,400	17,388	29,344	32,250	10%
India	5,055	5,200	2,650	2,750	2,800	3,650	5,240	44%
Indonesia					3	3	819	
Israel	800	1,400	1,400	1,650	1,650	1,422	1,060	- 25%
Japan	77,721	1,06,500	83,700	98,500	1,11,245	97,210	77,255	- 21%
Korea	955	900	2,937	5,079	8,087	8,000	12,343	54%
Lebanon	176	306	420	450	327	301	352	17%
Malaysia	468	550	700	1,058	1,050	1,782	1,782	0%



Qatar			23	23	75	75	88	17%
Singapore	3,270	4,000	4,700	5,800	6,670	8,670	9,970	15%
Taiwan	42,500	48,750	33,800	67,000	79,800	70,000	73,000	4%
Thailand	2,240	2,367	2,107	2,095	3,080	4,339	3,348	- 23%
United Arab Emir.	340	1,860	1,910	2,000	1,750	2,900	3,500	21%
Vietnam	43	85	95	65	67	61	100	64%
Total Asia	1,74,294	2,35,425	2,09,828	3,55,434	5,07,696	5,71,516	5,99,297	5%
AUSTRALASIA								
Australia	33,080	32,546	39,410	44,915	57,491	49,606	62,312	26%
Total Australasia	33,080	32,546	39,410	44,915	57,491	49,606	62,312	26%
TOTAL WORLD	13,00,016	13,23,957	12,82,782	16,47,541	20,14,350	21,30,743	22,30,479	5%

Source: Factors Chain International

While the volume in the Asia increased by over three times, India's growth rate is disappointing. Other Asian nations such as China, Korea and UAE have shown over 10 times growth rate in the volume.

Accumulative Turnover Figures for All FCI Members								
	EUR	<i>INCREASE</i>						
	2007	2008	2009	2010	2011	2012	2013	2012/2013
Invoice Discounting	2,19,914	2,06,915	1,97,993	2,04,527	2,37,884	3,02,030	3,30,518	9%
Recourse	1,68,683	1,67,860	1,59,037	2,34,889	3,08,752	3,06,187	3,39,644	11%



Factoring									
Non-Recourse	2,37,585	2,43,413	2,42,444	2,83,198	3,31,257	3,52,353	3,44,863	-2%	
Factoring									
Collections	13,934	25,940	23,806	23,394	26,018	27,786	31,399	13%	
Total Domestic									
Factoring FCI	6,40,116	6,44,128	6,23,280	7,46,008	9,03,912	9,88,529	10,46,425	6%	
Export Factoring	68,424	88,244	75,654	1,26,032	1,62,972	1,92,573	2,19,285	14%	
Import Factoring	17,416	22,363	17,626	23,584	30,943	36,707	50,481	38%	
Export Invoice	32,430	33,801	40,353	29,818	51,069	85,163	87,447	3%	
Discounting									
Total International									
Factoring FCI	1,18,271	1,44,408	1,33,633	1,79,434	2,44,983	3,14,442	3,57,213	14%	
<i>Grand Total FCI</i>	7,58,386	7,88,537	7,56,913	9,25,442	11,48,895	13,02,971	14,03,638	8%	
World Domestic									
Factoring	11,53,131	11,48,943	11,18,100	14,02,331	17,50,899	17,79,785	18,27,680	3%	
World International									
Factoring	1,45,996	1,76,168	1,65,459	2,45,898	2,64,108	3,52,446	4,02,798	14%	



<i>World Total</i>	<i>12,99,127</i>	<i>13,25,111</i>	<i>12,83,559</i>	<i>16,48,229</i>	<i>20,15,007</i>	<i>21,32,231</i>	<i>22,30,477</i>	<i>5%</i>
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Source: Factors Chain International

International factoring is growing at a fast pace compared to domestic factoring in the last 7 years.

FACTORING TURNOVER BY COUNTRY IN 2013 (in Millions of EUR)				
ASIA				
	Nr. of Companies	Domestic	International	Total
Armenia	6	50	12	62
China	27	2,95,451	82,677	3,78,128
Hong Kong	15	7,750	24,500	32,250
India	12	5,000	240	5,240
Indonesia	1	808	11	819
Israel	8	1,010	50	1,060
Japan	4	76,425	830	77,255
Korea	19	7,343	5,000	12,343
Lebanon	1	305	47	352
Malaysia	5	1,425	357	1,782
Qatar	1	55	33	88
Singapore	9	6,530	3,440	9,970
Taiwan	21	28,000	45,000	73,000



Thailand	15	3,312	36	3,348
United Arab Emir.	5	2,000	1,500	3,500
Vietnam	8	20	80	100
Total Asia	157	4,35,484	1,63,813	5,99,297

Source: Factors Chain International

India has a very few number of companies operating factoring services as against the number of companies in smaller nations in Asia.

The growth trends mentioned above support the fact that there is enormous scope for expansion worldwide and India is no exception to this. The potential in India is estimated at an annual turnover of Rs. 15000 to Rs. 20000 cr, but large portion is untapped because of the following reasons:

- Non-Recourse factoring is almost missing
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Why Factoring has not become popular in India

The overall worldwide growth in factoring is estimated at 12%. Europe has the largest market representing 64% of the world volumes with a growth of 18% during the year. America's growth was 10%, whereas Australia recorded impressive growth of 40%. Asia saw a fall in volume.

The growth trends mentioned above support the fact that there is enormous scope for expansion worldwide and India is no exception to this. The potential in India is estimated at an annual turnover of Rs. 15000 to Rs. 20000 cr, but large portion is untapped because of the following reasons:

- 1) Though Factoring is similar to Bill Discounting, what people fail to understand is that similarity is only in one aspect, i.e., both provide short term finance against receivables. Factoring also provides a package of other services which many people are not aware of.
- 2) Recourse factoring only provides financing but not credit covers, whereas in case of non-recourse factoring, in the event of default of a customer, the factor will bear the risk of bad debt. However, the facility, which will attract more clients, is almost missing, in India.
- 3) Factors have not been successful in creating awareness about the concept of factoring. The customers are still not aware of the extra benefits and services they can enjoy through factoring; they are not demanding these services from factoring service providers.



4) Bankers do not permit their Customer to Shift their Business to Factors: Every businessman invariably has dealings with a bank.

5) Other reasons include Bank's resistance to issue of Letter of Disclaimer (LoD is mandatory as per RBI Guidelines), Factoring requires assignment of debt which attracts Stamp Duty, Cost of transaction being high and problems or recovery etc.

Challenges faced by factoring sector

Low penetration of factoring business in the country still remains a challenge which could be on account of lack of awareness among the users. 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 long run. Factoring companies should also constantly endeavour to upgrade their expertise on both technological front as also on the operational level for offering cost effective services to their clientele.

Future plans of growth of factoring in India:

The long held view that India is just a services hub is also changing fast. India's manufacturing sector is making rapid strides and could really be the base for the next wave of growth. There is a well-known saying in investment circles that you should invest in an emerging economy when the first international airport is built and you should exit when the second airport comes up i.e., exit at the first signal of over-investment. China may soon reach the second airport stage. In that event,

1. India would make an even bigger potential growth story in the years to come. India is evolving from a command economy focused on self-sufficiency to becoming a key link in the global economic chain.
2. India is well positioned by geography, language, and historical association to service customers in advanced economies. India also has historical trading links with the Middle East and Africa as well as its own South Asian neighbours.
3. As the manufacturing base of a country expands, the scope for factoring also increases. At the micro level, factoring is tailor-made for a company on the path of high-octane growth; just as at the macro level it is suited for a growing economy like India.
4. There is only one direction in which factoring can go in India: upwards. As the awareness level about the benefits of factoring increases, factoring will spread its wings across the length and breadth of the country.



Conclusion

In order to ensure 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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