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Factoring – An Untapped Resource For Indian SMEs

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ABSTRACT

Factoring service, which is perceived as complimentary to bank finance, enables the availability of much needed working capital finance for the small and medium scale industries especially those that have good quality receivables but may not be in a position to obtain enough bank finance due to lack of collateral or credit profile. Factoring is making the small and medium enterprises prosper in one way or the other in terms of financial stability. It offered dedicated services to the SMEs in managing their working capital diligently.

During the 1960s, 1970s and 1980s, interest rates were on the rise and banks were increasingly regulated. This made it difficult for companies to get traditional financing. Further, a large section of Micro and Small Enterprises need handholding. The lack of financial literacy represents a formidable challenge for MSE borrowers underscoring the need for facilitation by banks in these critical financial areas. To effectively and decisively address these handicaps, RBI introduced a mechanism called factoring, which provides liquidity to SMEs against their receivables and can be an alternative source of working capital.

World over, factoring is a preferred route of accessing working capital for SMEs and even larger organisations. Factoring became even more popular, since it did not require the same sort of credit checks. Small business, startups and rapidly growing businesses benefitted especially from this increase in factoring. Factoring grew as a service as business people found their options contracting.

This paper is based on secondary data and prepared with a view to analyse the pros and cons of factoring services and its magnitude.

KEYWORDS : Factoring, SME, Working Capital, Receivables, Liquidity

INTRODUCTION

Factoring is a form of business financing under which a business entity sells its receivables to a third party (or factor) at a discount and receives immediate payment to finance its business. It is a useful financial tool for micro and small enterprises and helps such entities manage resource constraints, delayed payments and receivables management. However, in the absence of a consolidated legal framework regulating factoring in India, it has so far played a limited role in business financing.

The Factoring Regulation Act 2011 provides for and regulates the assignment of receivables and is intended to provide a much-needed legal framework for factoring in India. The act came into force in February 2012, except for Section 19 (registration of assignment of receivables transactions), Section 20 (public inspection of the central registry's records), Section 21 (penalties for non registration) and Section 32 (central government powers to make rules under the act), which came into force as of April 2 2012.

The central government has also notified the Registration of Assignment of Receivables Rules 2012. These rules set out in detail the procedure that must be followed by a factor when registering an assignment with the central registry.

In order to commence or carry out the business of factoring, a factor (other than a bank, a corporation established under an act of Parliament or state legislature or a government company) must obtain a certificate of registration from the Reserve Bank of India (RBI). A company that is registered as an NBFC with the RBI and is engaged in factoring business as its principal business. Must apply for registration as a factor within six months of the date on which the act came into force. Such entities may continue to carry on their factoring business until a certificate is issued (or refused).

OBJECTIVES

- To know the history of Factoring
- To know the characteristics and types of Factoring
- To know the factoring companies in India
- To know the role of factoring in Indian SMEs

HISTORY OF FACTORING

Almost since the dawn of civilization, there has been factoring. Factoring is a way of advancing funds for expected payment. In the earliest times of civilization, 4,000 years ago, the Mesopotamians used factoring in their business dealings. However, factoring was not terribly regular.

The ancient Romans used a form of factoring by selling promissory notes on a secondary market at a discount. Factoring gained true popularity, however, in trade between the American colonists and their European buyers. Prior to the American Revolution, merchants in the colonies sent raw materials, from timber to wool to cotton to furs, to British and European merchants.

However, sending the goods such long distances could get expensive. And in the meanwhile, waiting for payment to come back across the Atlantic from Britain and Europe could cause delays in being able to do what was necessary to harvest and plant and process new orders. In order to get around these problems, the British and European merchants paid the colonists in part for the materials.

This way, the colonists had an advance with which to continue their operations. These eased cash flow and created a streamlined process for ensuring that trade continued unabated. As society progressed after the American Revolution, and as the Industrial Revolution came, the focus of factoring changed. Credit became more important to factoring. The credit of the company itself was not as important as the credit of its clients.

Indeed, in many cases, factors helped companies figure out which of its customers were the most credit worthy. This way, factors could also help companies keep their cash flow moving. They advanced companies capital based on what was owed them by their credit worthy customers.

Before the 1930s, the most popular industries for factoring were the garment and textile industries. These are industries that rely on raw materials. In order to make sure that companies could continue to buy raw materials to produce clothing and textiles, factoring was used. However, it soon became evident, after World War II, that factoring could work effectively for any business that invoiced others.

During the 1960s, 1970s and 1980s, interest rates were on the rise and banks were increasingly regulated. This made it difficult for companies to get traditional financing. Factoring became even more popular, since it did not require the same sort of credit checks. Small business, startups and rapidly growing businesses benefitted especially from this increase in factoring. Factoring grew as a service as businesspeople found their options contracting.

CHARACTERISTICS OF FACTORING

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

TYPES OF FACTORING IN INDIA

1. Full Factoring

This is also known as "Without Recourse Factoring ". It is the most comprehensive type of facility offering all types of services namely finance sales ledger administration, collection, debt protection and customer information.

2. Recourse Factoring

The Factoring provides all types of facilities except debt protection. This type of service is offered in India. As discussed earlier, under Recourse Factoring, the client's liability to Factor is not discharged until the customer pays in full.

3. Maturity Factoring

It is also known as "Collection Factoring ". Under this arrangement, except providing finance, all other basic characteristics of Factoring are present. The payment is effected to the client at the end of collection period or the day of collecting accounts whichever is earlier.

4. Advance Factoring

This could be with or without recourse. Under this arrangement, the Factor provides advance at an agreed rate of interest to the client on uncollected and non-due receivables. This is only a pre-payment and not an advance.

5. Invoice Discounting

In this arrangement, the only facility provided by the Factor is finance. In this method the client is a reputed company who would like to deal with its customers directly, including collection, and keep this Factoring arrangement confidential.

The client collects payments from customer and hands it over to Factor. The risk involved in invoice discounting is much higher than in any other methods.

6. Bulk Factoring

It is a modified version of Involve discounting wherein notification of assignment of debts is given to the customers. However, the client is subject to full recourse and he carries out his own administration and collection.

7. Agency Factoring

Under this arrangement, the facilities of finance and protection against bad debts are provided by the Factor whereas the sales ledger administration and collection of debts are carried out by the client.

8. Export Factoring

Factoring can be applied to both domestic and international trade in goods and services. Export factoring comes into play when a domestic company (the exporter) uses factoring services.

FACTORING COMPANIES IN INDIA

The following list shows the major players in factoring services

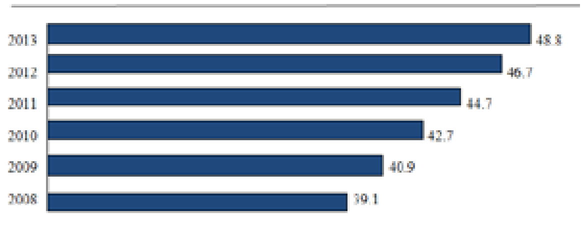
- Canbank Factors Limited
- SBI Global
- The Hongkong and Shanghai Banking Corporation Ltd
- IFCI Factors Limited
- India Factoring and Finance Solutions Pvt Ltd
- Global Trade Finance Limited
- DBS
- Export Credit Guarantee Corporation of India Ltd
- Citibank NA, India
- Small Industries Development Bank of India (SIDBI)
- Standard Chartered Bank

ROLE OF FACTORING IN INDIAN SMEs

Small and Medium Enterprises (SMEs) in India have seen exponential growth over the last decade. According to the latest reports by the SME Chamber of Commerce and the Ministry of Micro, Small and Medium Enterprises, India currently has more than 48 million SMEs. These SMEs contribute more than 45% of India's industrial output, 40% of the country's total exports. Yet, these SMEs continue to struggle on multiple accounts. While some are challenged by credit and finance issues, others are struggling to cope with stringent regulatory environment.

SME sector of India is considered as the backbone of economy employing 60 million people, create 1.3 million jobs every year and produce more than 8000 quality products for the Indian and international markets. With approximately 30 million SMEs in India, 12 million people expected to join the workforce in next 3 years and the sector growing at a rate of 8% per year, Government of India is taking different measures so as to increase their competitiveness in the international market.

Figure 1 Total Number of SMEs in India (2008-2013)



Source: Ministry of Micro, Small and Medium Enterprises (MSME)

SMEs developed in a manner, which made it possible for them to achieve the objectives of:

1. High contribution to domestic production
2. Significant export earnings
3. Low investment requirements
4. Operational flexibility
5. Low intensive imports
6. Capacity to develop appropriate indigenous technology
7. Import substitution
8. Technology-oriented industries
9. Competitiveness in domestic and export markets

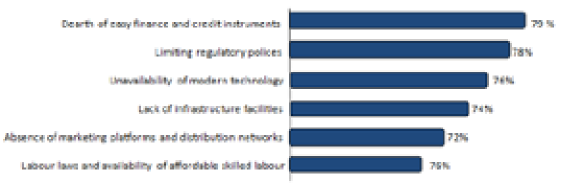
With this huge potential, backed up by strong government support, Indian SMEs continue to post their growth stories. Despite of this strong growth, there is huge potential amongst Indian SMEs that still remains untapped. Once this untapped potential becomes the source for growth of these units, there would be no stopping to India posting a GDP higher than that of US and China and becoming the world's economic powerhouse.

Challenges faced by SMEs

- Non-Availability of adequate/timely funds specially for growing SMEs.
- Delayed payments.
- Lack of R & D.

- Fluctuations in the cost of production; especially raw materials like steel, aluminum, polymers
- Lack of proper market information
- First to get affected from economic slowdown
- Poor adaptability to changing trade trends
- Non-availabilityoftechnicallytrainedhumanresources&lackofmanagementskills
- Lack of access to technological information and consultancy

Figure 2 Challenges faced by Indian SMEs



Source: Ministry of Micro, Small and Medium Enterprises (MSME)

Traditional Sources of finance for SMEs
•Existing shareholders and directors funds ("owner financing")
•Overdraft financing
•Trade credit
•Equity finance
•Business angel financing
•Hire purchase and leasing

Problems in raising funds

- Absence of history/successful track record.
- Traditional finance normally available subject to adequate security/collateral.
- Perceived to be high risk
- Lack of market information

Factoring As a Lifeline in the Business Rescue Process
Factoring offers an alternative as it provides funds based on the transaction strength rather than merely collaterals and strong financials of the borrower. Timely payments from customers will help SMEs in reducing their working capital requirements leading to lower interest costs, improved profitability and a positive impact on the long-term health and sustainability of India's SME sector. Delays in settlement of dues adversely affect the recycling of funds and business operations of the SME units.

It is, therefore, critical to ensure that the small entities are able to raise liquidity against their receivables. This problem can be institutionally tackled by factoring, which provides liquidity to SMEs against their receivables and can be an alternative source of working capital. World over, factoring is a preferred route of accessing working capital for SMEs and even larger organisations. Some banks and financial institutions in India have already launched factoring services. To provide a legislative framework for factoring services, the Parliament has recently passed the Factoring Regulation Bill that would address delays in payment and liquidity problems of micro and small enterprises.

With the increasing competition, globalization and the uncertainty due to the global downturn, SMEs will have to continuously incorporate the latest technology into their production processes as well as in their marketing and management functions, to cut costs, gain efficiency and consistency. The Prime Minister's Task Force on SMEs recommended several measures having a bearing on the functioning of SMEs, viz., credit, marketing, labour, exit policy, infrastructure/technology/skill development and taxation.

The ability of SMEs to adjust to the competitive pressures that come with trade liberalization and globalization will depend on the level of skills available domestically. Given the growing requirements of the SME sector and the huge 'demographic capital' we possess, significant efforts are still needed to enhance the skill and entrepreneurship development. Investment needs to be made in a big way on skill and entrepreneurship.

CONCLUSION
The role of a factoring business is yet to gain ground in India wherein small and medium enterprises (SMEs) struggle to get funding support from banks on concern of asset quality. At a little higher cost of funds, a factoring company can well be the liquidity generator to scoot the SME growth engine.

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