REPORT OF THE STUDY GROUP FOR EXAMINING INTRODUCTION OF FACTORING SERVICES IN INDIA

RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY

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December 19, 1988
Agrahayana 28, 1910(S)

The Governor
Reserve Bank of India
Bombay.

Dear Sir,

We are pleased to submit herewith the Report of the Study Group for examining introduction of factoring services in India .

Yours faithfully

C.S. Kalyanasundaram
(Chairman)

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T.K.K.Bhagavat
(Convener)

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CHAPTER I

INTRODUCTION

Background

1.1 In recent years, with growing industrialisation and consequential growth in the volume of industrial production and sales, timely collection and efficient management of receivables has assumed importance. At the same time, with the economy turning into a buyers' market in the current decade, suppliers have been experiencing delays in collection, causing working capital and other problems. Such delays affect the smaller suppliers more acutely because of their limited capacity to raise resources. Considerable concern in this regard has been expressed in various forums and attempts have been made, from time to time, to solve this and related problems.

1.2 Among the various measures taken in the recent past by the Reserve Bank of India (RBI) to alleviate the difficulties of suppliers were the guidelines issued to banks for implementation of the recommendations of the Working Group to review the system of cash credit (Chore Committee) relating to the Drawee Bill System. However, the banks found it operationally difficult to implement these guidelines and a Sub-Committee appointed by the RBI to review the Drawee Bill System suggested, inter alia, that a factoring organisation be promoted which could undertake the collection of dues on behalf of suppliers. Thereafter, in its report submitted in early 1987, the Working Group on the Money Market, headed by Shri N. Vaghul, also supported the idea of introducing factoring services. Suggestions to that effect have also been made in a few write-ups in newspapers/magazines. In addition, this matter was examined, in some depth, by an internal Group constituted in the Industrial Development Bank of India.)

Constitution of
the Study Group

1.3 It was under these circumstances that RBI issued a notification, on 20 January 1988, constituting a Study Group to examine the feasibility and mechanics of starting factoring organisation(s) in the country and making recommendations regarding its/their constitution, organisational set up, scope of activities and other related matters.

Composition of the
Study Group

1.4 The Study Group consisted of the following members :

1.	Shri C.S. Kalyanasundaram (formerly Managing Director, State Bank of India), Bombay.	Chairman
2.	Shri P.S. Gopalakrishnan, Chairman and Managing Director, Indian Overseas Bank, Madras.	Member
3.	Shri V. Mahadevan, Deputy Managing Director, State Bank of India, Bombay.	Member

4. Dr. A.C. Shah, Executive Director, Bank of Baroda, Bombay.	Member
5. Shri J.V. Shetty, Executive Director, United Bank of India, Calcutta. (Since appointed as Chairman and Managing Director of the bank.)	"
6. Shri S.A. Kamath, General Manager, Union Bank of India, Bombay.	"
7. Prof. Sampat P. Singh, Member of Faculty, National Institute of Bank Management, Pune.	"
8. Shri M.C. Satyawadi, Joint Secretary, Ministry of Finance, Government of India, New Delhi.	"
9. Shri G.P. Gupta, General Manager, Industrial Development Bank of India, Guwahati. (Since posted at Head Office, Bombay.)	"
10. Shri R. Vijayakrishnan, Assistant General Manager, Export Credit Guarantee Corporation of India Ltd., Bombay. (Since posted as Regional Manager, ECGC, Madras.)	"

11. Shri R. Srinivasan, Member
Legal Adviser,
Legal Department,
Reserve Bank of India,
Bombay.

12. Shri O.P. Sodhani, "
Controller,
Exchange Control Department,
Reserve Bank of India,
Bombay.

13. Shri T.K.K. Bhagavat, Convener
Chief Officer,
Industrial & Export Credit Department,
Reserve Bank of India,
Bombay.
(Since posted as Chief Officer, Department of Banking Operations and Development, RBI.)

14. Shri N. Raghunathan, Member
Additional Secretary and Development Commissioner(SSI),
Ministry of Industry,
Government of India,
New Delhi.
(As from 29.2.1988)

(A copy of the Notification regarding the constitution of the Study Group is furnished in Annexure I.)

Terms of reference

1.5 The terms of reference of the Study Group were as under :

(a) To consider whether in the Indian financial system there is need and scope for one or more factoring organisations to effectively alleviate the problems faced by suppliers of goods and services in receiving payments therefor within a reasonable period.

(b) If there is scope for such organisations, to examine approximately how many of them need to be established and what should be their constitution.

(c) To suggest whether these organisations should be in public or private or joint sector or in all these sectors.

√(d) To examine whether any changes need to be made in the present legal framework to promote factoring business; if yes, on what lines.

√(e) To consider the feasibility of extension of factoring services to exporters.

√(f) To make recommendations in respect of any other matter directly related to the issue of introduction of factoring services.

Methodology of Study

1.6 Given the nature and volume of the work, the Group constituted committees to look into certain specific areas. The undermentioned three committees were, therefore, constituted, viz.,

(a) Demand Assessment Committee.

(b) Legal Committee.

(c) Committee on Export Factoring.

(The names of the members of each committee are given in Annexure II.)

1.7 To collect background information relating to the concept and mechanics of factoring, the Group made reference to several textbooks on the subject, as also to write-ups thereon which have appeared in foreign magazines, journals and periodicals, from time to time.

1.8 The Group also devised a comprehensive questionnaire and forwarded it to select banks, trade/industry associations and organisations to elicit their views on the various aspects regarding introduction of factoring services in India. (A copy of the questionnaire is furnished as Annexure III.)

1.9 In addition to the above, the Group held meetings with representatives of banks, trade/industry associations, financial institutions and finance companies, as also a few eminent academicians, economists, financial experts, management consultants, etc., to obtain first hand information of the problems faced by the industrial units in realising their credit sales and whether factoring services could mitigate the problems on account of delayed payments to suppliers and improve the efficiency in collections. The details of dates, venues and participants in various meetings are given in Annexure IV.

1.10 The aforementioned responses of the concerned parties, however, reflected their understanding and perception of factoring services based mainly on the published material on the subject and not on actual experience in the field. The Group, therefore, felt it necessary to supplement the available material and responses by visiting a few organisations engaged in factoring business or dealing with related matters for a fairly long time. Accordingly, a team comprising the Chairman, the Convener of the Group and the Chairman of the Committee on Export Factoring, visited Italy, Netherlands, the United Kingdom (U.K.) and the United States of America (U.S.A.) for a fortnight in June-July 1988 and discussed with experienced bankers, executives of factoring organisations and other officials, all related conceptual, practical and legal issues in respect of both domestic and international factoring. A summary of the discussions held abroad is furnished in Annexure V.

Meetings of the Study Group

1.11 The Study Group held its first meeting on 22 February 1988 at Bombay and subsequently held 17 meetings at Bombay, New Delhi, Calcutta, Madras and Bangalore, inclusive of the meetings held with invitees.

Acknowledgements

1.12 The Study Group is grateful to all individuals and organisations, listed in Part I of Annexure VI, for conveying their views on various issues regarding introduction of factoring services in India and for furnishing their responses to the Group's questionnaire on the subject. The Group also places on record its deep appreciation of the valuable contribution made by the three Committees constituted by it and particularly expresses its thanks to Sarvashri A.R. Barve, General Manager, State Bank of India, S. Bhattacharya, Deputy Manager, Export - Import Bank of India (Exim Bank), V. Ananthkrishnan, Chief Executive, FEDAI, G.P. Muniappan, Joint Controller, RBI and R.C. Rai, Joint Chief Officer, RBI, for participating in the meetings of the Committee on Export Factoring and

also to Shri J. Radhakrishnan, Chief Law Officer, State Bank of India, for participating in the meetings of the Legal Committee. Special thanks are also due to Shri R.C. Mathur, General Manager, State Bank of India, for his valuable contribution by way of provision of useful reference material, participation in meetings and generally providing supportive assistance to the Secretariat.

1.13 The Secretariat for the Study Group, provided by the Industrial & Export Credit Department (IECD), RBI, Bombay, was headed by Shri D.N. Samarth, Joint Chief Officer. The Study Group is extremely grateful to him for the excellent and valuable assistance rendered by him in organising the work and drafting the report. The Study Group also places on record its thanks to Smt. Nanda S. Dave, Industrial Credit Officer, for her able assistance in arranging the meetings and drafting the minutes of various meetings, as also in the drafting of the report.

CHAPTER II

RELEVANCE OF FACTORING SERVICES TO INDIA

2.1 Before discussing the need for factoring services in India and other relevant issues, it would be appropriate to take an overview of the financing and other facilities that are presently available to sellers of goods and services and the limitations of the current arrangements.

A. Services currently available

(1) Financing Services

2.2 As is well known, the commercial banks in India primarily provide working capital finance (including that for receivables) to Trade and Industry, their credit requirements being computed taking into account, inter alia, the trade credit normally given to the buyers of their goods and the norms, if any, prescribed by RBI for the purpose. The manner in which the receivables are financed takes one or more of the following modes :

(a) Purchasing/discounting of bills of exchange payable on demand or after a specified usance. In these cases, banks generally give full credit for the amount and do not retain any margin.

(b) Allowing overdraft/cash credit against hypothecatio of outstanding book debts, after maintaining an appropriate margin.

(c) Allowing overdraft/cash credit against bills sent for collection through the bank, after maintaining a margin which is generally lower than that in the case of book debts.

(d) Allowing overdrafts/cash credit against amounts due from Government/Semi-Government agencies in respect of supplies made to them, or purchasing such 'supply' bills supported by invoices and delivery challans, after maintaining an appropriate margin.

2.3 The actual mode of financing in individual cases depen upon the practices obtaining in the trade and upon the convenience of borrowers. While the banks do finance the receivables as stated above, such finance is with recourse to the supplier who bears the risk of default by the debtor. The bank's credit support to the supplier is, thus, for a limited or pre-determined period and, on the expiry of the said period, if the dues are not realised, it generally calls upon the supplier/borrower to repay the finance.

2.4 RBI has, from time to time, issued guidelines to banks to encourage bill financing and induce sellers to move away from effecting credit sales on open account basis, to facilitate timely realisation of dues. Accordingly, the interest cost on bills discounted has been kept lower than the minimum interest rate chargeable for cash credit/overdraft facilities. Banks have also been advised that financing of inland credit sales of their larger borrowers by way of bills should not be less than 25% of their aggregate limits for such financing and that they should move towards more and more of bill finance. The existing policy framework, while encouraging bill financing, also recognises the preponderance of open account sales, collection of which has to be systematised to minimise the delays.

2) Collection services

2.5 Banks do provide collection services in respect of bills, whether they are purchased/discounted by them or not. Bills accepted for collection are sent to their own branches or branches of other banks for presenting them to the drawees for acceptance/payment and realising the amounts. However, banks do not undertake collection of book debts (i.e., open account sales) of their customers.

3) Insurance cover for receivables

2.6 The finance extended by any bank, irrespective of the method of financing, is always with recourse to the seller, i.e., if the buyer of goods/services fails to make payment therefor within a reasonable period or refuses to make the payment for any reason, the bank recovers the amount involved from its customer, viz., the seller. In the case of advances granted to Small Scale Industrial (SSI) units, including bills purchased/discounted, the credit risk of a bank (on account of financial failure of a unit) is covered by the credit guarantee scheme of Deposit Insurance & Credit Guarantee Corporation of India (DICGC) but not that of a seller of goods/ services. In other words, the seller/supplier has at all times to reimburse to the financing bank the amount of dishonoured bills and he enjoys no protection against the default by buyers. Insurance cover is, however, available to exporters from the Export Credit ~~xxx~~ Guarantee Corporation of India Ltd.(ECGC) and this aspect is further discussed in the Chapter on Export Factoring.

B. <u>Limitations of the current arrangements</u>

2.7 The services rendered by banks in financing/collection of receivables are considered to be inadequate for meeting all the requirements of sellers in the present conditions. The main problem faced by sellers is the pressure on their working capital resources on account of their inability to obtain timely payment for their credit sales. While for sales on open account a seller does build in his price the interest element for the period the credit is normally expected to be outstanding, often no interest is realised for the period the payments are delayed beyond the estimated time. In the case of products which are manufactured and supplied by a number of units, on account of competition, they are not in a position to insist on payment of overdue interest and hence frequently suffer erosion in profit margins and working capital deficits.

2.8 As reported to the Study Group, both in written responses and during meetings, the public sector (comprising Central and State Governments, their departmental entreprises such as Railways, Posts and Telegraphs, Telephones, State Electricity Boards, Public Works, etc. and Government owned undertakings) is a dominant purchaser of goods and services from units of varied sectors. In a large number of cases, the fortunes of the suppliers are closely tied to their ability to obtain repeat orders from the public sector and also receive, at the same time, timely payments therefor. Several medium/large public sector concerns, as also some of the medium/large private sector concerns, are stated to be habitually late in making payments, the delays ranging upto six months or even more. At times, payments are made by them only when fresh supplies are made on credit. The system of inspection of goods, before payments are released, also contributes to delays.

2.9 Several respondents have indicated that the slackness in the payments system is fairly widespread. Besides, many units attribute the delays on their part in making payments to difficulties experienced in realising their own dues, thus indicating interdependence of different sectors in ensuring timely payments. It is perceived by many that if the receivables due from the larger buyers, both from the public and private sectors, are collected more promptly, there would be a noticeable improvement in the payments system all around.

2.10 (The problem of delays could be mitigated, if not completely eliminated, if there is an efficient system of receivables management and collection machinery. At present, only very few organisations, even among the larger ones, have separate credit management departments ~~to~~ exclusively to attend to these matters. Most of the suppliers, particularly those in the SSI sector, could hardly afford a separate staff for keeping the books for credit sales and for credit administration, including debt collection. Often-times, when payments are inordinately delayed, the concerned entrepreneurs are required to attend to their recovery personally. Consequently, they are unable to give due attention to improving their products and enlarging their markets. Many among proprietors and managers of such units feel that if they could be relieved of the time consuming work involved in accounting of sales, arranging for finance, effecting recoveries, etc., they could profitably concentrate on increasing production and sales development. They would also welcome professional advice and guidance in respect of potential markets, selection of buyers, credit terms to be offered, etc.)

2.11 While some information on creditworthiness and reliability of buyers in far off places could be obtained through the banks, the information so available is not adequate for the supplier to know the operational, financial and market status of the buyer to decide upon credit terms which may be offered.

2.12 On account of non-availability of adequate information relating to buyers in far off places and of a facility to obtain cover for credit sales, many sellers tend to adopt a cautious sales strategy. It was ~~indicated~~ felt to the Group that if an agency were to provide insurance cover for their credit sales at a reasonable cost, they would endeavour to push their sales by offering appropriate credit terms to their buyers.

2.13 ~~The Group~~ has considered the desirability and usefulness of factoring services to suppliers of goods and services in India keeping in view the aforementioned current position regarding credit sales management and recovery of dues.

C. <u>Factoring services ~~as an alternative~~</u>

2.14 Factoring services, in one form or the other, are being extended on a fairly large scale in U.S.A., U.K. and most of the countries in the European continent. In the recent past, they are also being extended in some of the Central/South American countries, as also in countries in the South-Eastern and Far Eastern parts of Asia. Factoring in these countries covers both international trade and domestic trade. The U.S.A. and European nations accounted for 90% of the global factoring turnover during 1986. A brief note tracing the evolution of factoring abroad is furnished in Annexure ~~VII~~.

2.15 Factoring does not have a concise definition and it has been defined in various ways. Some of the definitions of factoring services are indicated in Annexure VIII.

2.16 Briefly, modern factoring involves a continuing arrangement under which a financing institution assumes the credit control/protection and collection functions for its client, purchases his receivables as they arise (with or without recourse to him for credit losses, i.e., customer's financial inability to pay), maintains the sales ledger, attends to other book-keeping duties related to such accounts receivables and performs other auxiliary functions. (The mechanics of domestic factoring are illustrated in Annexure IX.) The aforementioned services performed by Factors, as also their merits and limitations, are discussed below in detail.

(1) Maintenance of sales ledger

2.17 The Factor undertakes to maintain the client's sales ledger, for a service charge. Hereunder, an invoice is sent by the client to the customer, a copy of which is marked to the Factor. The client does not have to maintain individual sales ledgers for his customers as the Factor maintains them on his behalf. Besides, the Factor reports to the client the current status of his receivables, as also receipts of payments from the customers and, as part of a package, may generate other useful informative reports. These reports may be on a daily/weekly/monthly basis or at any other agreed periodicity. The Factors, on account of handling large volume of operations, are in a position to computerise their operations and hence are equipped to perform book-keeping services far more efficiently and expeditiously than an average business concern could do on its own.

(2) Collection of accounts receivables:

2.18 Factoring relieves the client of the onerous collection problems as under this arrangement the Factor undertakes to collect the receivables of its clients. This results in two-fold benefit to the clients :

(a) Reduction in cost of collection by way of savings in manpower, as also time and efforts.

(b) Enabling the client to concentrate on improving the purchase, production, marketing and other managerial aspects of the business.

2.19 In organising collection services, the Factor does not resort to stringent measures as they would be detrimental to the interests of its clients' relationship with their customers and also affect its own business with the client. The use of trained manpower with infrastructural back up (e.g.,computers) enables a Factor to systematically follow up and make timely demand on the debtors to pay the amounts. The debtors are, in turn, more responsive to demands or reminders from a Factor as they would not like to go down in the esteem of a credit institution such as a Factor.

(3) Credit Control and Credit Protection

2.20 An important aspect of factoring is that it leads to better credit control. The factoring organisation is able to provide quality services in this area as it builds up, over a period, extensive information files (generally computerised) on the financial standing and credit rating of individual customers and their track record of payments. On the basis of assessment of creditworthiness of potential customers, a Factor is able to advise its client on whether to extend credit to a buyer or not and, if it is to be extended, the amount of credit which could be extended, as also the period therefor. Further, the Factor establishes credit limits for individual customers indicating the extent to which it is prepared to accept the client's receivables on such customers without recourse to the client. The client is provided by the Factor with a list of individual approved customers and their respective limits.

2.21 The Factor is thus in a position to advise its client(s) about the customers who could be extended more liberal credit terms or with whom it might not be desirable to do business. This is possible because the Factor generally serves many clients who sell to the same customer and hence would become familiar with the overall position of a particular customer even before the client has had an occasion to transact business with him. This specialised service of Factors assists the clients to handle a far greater volume of business with confidence than would have been possible otherwise.

2.22 Credit protection provided by Factors involves its undertaking to purchase, without recourse, to the client (supplier), every debt of approved customers (within the stipulated credit limit) which arises from the sale of goods. Under this service, the Factor assumes the risk of default in payment by customers only in case of customers' financial inability to pay.

(4) <u>Financing of receivables</u>

2.23 The key feature of factoring is that a Factor purchases the book debts of the supplier-client at a price and the debts are assigned in its favour; such factoring could be with or without recourse. Where the arrangement is with recourse, the Factor essentially renders collection service. This is because the Factor would expect the supplier to refund the funds advanced by it, in case of non-payment by the buyer. But, under without recourse arrangement, the Factor's obligation to pay to its clients becomes absolute on the due date of the invoice. Further, the Factor purchases the suppliers' receivables, while the banks only finance receivables by way of advance. This characteristic of factoring results in the suppliers' balance sheet disclosing an improved current ratio.

(5) Advisory services

2.24 Besides the above services, Factors may render certain advisory services by virtue of their specialised experience in financial and credit matters and extensive credit information they possess. As a credit specialist, a Factor makes comprehensive studies of economic conditions and trends and thus is in a position to advise its clients of impending developments in their respective industries. Many Factors have within their employ individuals with extensive manufacturing experience who can even advise on work load analysis, machinery replacement programmes and other technical aspects of a client's business.

2.25 Due to the scope of their operations, factoring organisations develop close relationships with various individuals and non-factored concerns within an industry and are in a position to furnish information about sales agents/seasoned personnel who may be employed to advantage by their client(s). In the course of the close and continuing relationship which factoring entails, the client has an ever-present source of guidance, based upon the Factor's first hand experience with the client's own business and its particular problems, as well as upon the Factor's widespread experience with the industry.

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2.26 Notwithstanding the advantages of factoring services, they are not quite suitable or necessary for the following categories of business concerns:

(a) Those selling principally on cash terms.

(b) Those which undertake job works.

(c) Those wherein progress-payments are involved.

(d) Those which are prone to frequent disputes between sellers and buyers.

(Type of Factoring Services)

2.27 Over a period, the Factors world over have devised different types of factoring services to suit the requirements of their clients. The various services, however, fall under one of the following six main types:

(1) Full factoring (also called 'oldline' factoring).

(2) Recourse factoring.

(3) Maturity factoring.

(4) Advance factoring.

(5) Undisclosed factoring (also called confidential factoring).

(6) Invoice discounting.

The special features of each type of factoring services are discussed below.

(1) <u>Full Factoring</u>

2.28 (a) Under this category, the following four services are rendered, viz.,

(i) Collection of receivables and maintenance of sales ledgers.

(ii) Credit control.

(iii) Credit protection, i.e., insurance cover for customer's default.

(iv) Finance.

(b) Since the Factor provides the cover for the customer's default, it approves the customer as a credit risk, based on information on his creditworthiness. On this assessment, a monetary limit is fixed for each customer upto which trade credit provided by the client will be taken over by the Factor without recourse to the client, i.e., the Factor will assume credit risk of these debts.

(c) The client will, of course, be free to exceed the credit limit fixed for a customer but cover would be available to him only upto the credit limit fixed by the Factor.

(d) The liability of the Factor under without recourse service will cover only the defaults arising out of customer's financial inability to pay, i.e., essentially a credit risk. If the payment is withheld for reasons of dispute regarding inherent defect in goods, quality, quantity, counter claim, etc., recourse will be available to the Factor against the client. The specific occasions when the Factor will have right of recourse will depend upon the precise terms of the factoring agreement.

(e) The trade debts will be assigned to the Factor. Notice will be ~~given~~ given to the customer that the debt is so assigned and that he will get a proper discharge of the debt if the payment of the invoice is made over to the Factor.

(f) Prepayment of invoices 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.

(g) The client will be free to draw funds at any time upto the drawing limit, which will be adjusted for (i) new invoices and (ii) invoices collected.

(h) The Factor's charge to the client will comprise:

(i) Charge for rendering sales ledger management and debt collection services.

(ii) Premium for taking over the risk of debt default.

(iii) Interest on the funds provided to the client from the date of drawing to the maturity date of the invoices.

These charges may be quoted as a single item or each component of the charge may be separately quoted.

(i) The Factor may also provide only collection service in respect of accounts receivables of unapproved customers or for receivables in excess of fixed limits for approved customers.

(2) <u>Recourse Factoring</u>

2.29 (a) The Factor does not give any protection to the client against a customer's failure to pay debts and thus it does not assume the credit risk of the debts. Hence it may not be necessary for the Factor to either approve the customer or fix a credit limit.

(b) If the customer does not pay the invoice on maturity for any reason the Factor is entitled to recover from the client the amount paid in advance.

(c) The Factor's fees will comprise the following:

(i) Charge for sales ledger management and debt collection service.

(ii) Interest for the period on the amount drawn by the client.

In all other aspects, it is akin to Full Factoring.

(3) <u>Maturity Factoring</u>

2.30 (a) This type of factoring involves no financing ab initio hence no drawing limit is made available to the client but the Factor administers the client's sales ledger and renders debt collection service.

(b) The amount of each invoice is made over to 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 an 'estimated date of collection'.

(c) Such factoring could be with or without recourse. If it is without recourse, the amount will be made over to the client regardless of whether the Factor has been able to collect the invoice or not. If the debtor becomes insolvent, on proof of insolvency, payment will be made to the client even before maturity. In with recourse factoring, the Factor will either pay the client on collection of the invoice or on maturity date with recourse later on.

(d) The Factor's fees will comprise the following :

(i) Charge for sales ledger management and debt collection service.

(ii) In case of 'without recourse' service, premium for taking over the risk of debt default.

(iii) In case of 'with recourse' service, when customer does not pay the invoice, interest on the funds provided to the client from date of payment to the date of recovery of amount advanced.

(4) Advance Factoring

2.31 (a) This type also could be with or without recourse. Under this arrangement, the Factor is prepared to pay for the debts in advance of receiving the payment due from the customers (debtors). This is only a prepayment and not an advance.

(b) 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 assigned.

(c) Besides charges for sales ledger management and debt collection services, interest for the period for which funds are paid in advance (discounted value of invoice) will also be charged.

(5) Undisclosed Factoring

2.32 The types of factoring services described hitherto have one thing in common, viz., in each case, the Factor is providing the sales ledger administration, collecting the debts directly from the customers and the Factor's interest is notified directly to the customers. Thus, the arrangement which exists between the Factor and his client is disclosed and the Factor is keen to ensure that all debtors are aware that debts should be paid directly to it. However, there is another type of factoring in which the customers are not informed/notified about the arrangements between the Factor and the client. The special features of this type, viz., Undisclosed Factoring, are indicated below:

(a) 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 Factor's involvement.

(b) The Factor, however, gets a copy of the invoice which it accounts for and provides the client with either debt default cover or finance or both, as desired.

(c) Debt collection is also organised by the client who makes over payment of each invoice to the Factor, if advance payment has been received by him earlier.

(d) The Factor keeps a check on its risk by receiving from the client an age-wise analysis of the debts at regular intervals. It can also inspect the sales ledger of the client at regular intervals.

(e) The types of services which may be offered under an undisclosed label are very flexible. They may be on non-recourse basis and/or seasonal and/or on selective basis.

(f) The charges vary with the range of services provided.

(6) Invoice Discounting

2.33 (a) This is a variant of undisclosed 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.

(b) The advantage of this service is that the client is able to obtain short term relief from liquidity problems by taking advances without having to commit itself to regular factoring services.

General Observations :

2.34 It would be seen from the foregoing that the services provided by Factors are quite varied and a very large number of suppliers in India could benefit from availment of one or more of these services. The need for giving serious consideration to introduction of factoring services in India arises not only out of the limitations of the banking industry in providing the needed finance, credit protection or collection services, but also on account of the fact that many manufacturers, etc., appear to be in need of a range of services for managing their receivables in a manner more efficient than they have been doing on their own. Numerous sellers, particularly from the SSI sector, are in need of advice on various aspects relating to extension of credit to buyers, recovery of dues and other issues relating to management of receivables. In this regard, the practices and position vary from industry to industry and only those with specialised knowledge about the concerned industry and the state of the market could provide useful advice.

For various reasons, banks may not be able to develop such expertise and hence the alternative of Factors, who have developed such expertise, would be appreciated. The Factors could also be more flexible than banks in providing finance because they would have a better appreciation of the seller's portfolio.

2.35 ~~The Group is~~ of the view that it would certainly be of great assistance to our Industry and Trade if factoring services are made available in our country to supplement the services provided by the banks in regard to receivables. At the same time, ~~the~~ Group would like to caution that factoring, per se, would not be a complete solution for delays and defaults in payments. Nonetheless, it is expected that the professional approach of Factors in credit assessment, collection of debts, management of sales ledgers and accounting of transactions, should bring about noticeable improvement in the payments culture.

2.36 There are certain issues pertaining to factoring business which need to be considered while taking a view on introduction of factoring services in India. Of these, whil the issues relating to estimation of the potential demand for such services, the pricing of the services, the infrastructural facilities necessary for providing them efficiently and the type of organisations which may provide them, have been examined in Chapter III, the matter of linkages between banks and Factors has been discussed in Chapter IV. Thereafter, the specific issues relating to factoring services for units in the SSI sector and exporters are discussed in Chapters V and VII respectively.

CHAPTER III

ISSUES RELEVANT TO INTRODUCTION OF FACTORING SERVICES IN INDIA

3.1 As mentioned in the previous Chapter, there are advantages in factoring services but unless they are tailor made to suit the specific needs of the clients and are offered at a reasonable price, they are not likely to be availed of. Further, this being a new type of service with which the business community in India is not familiar at present, it might require a lot of promotional and marketing efforts on the part of the Factors to crystallise the demand. Thus, ventures in this area may have to contend with a slow growth and substantial marketing/developmental costs in the initial stages. The promoters would, no doubt, assess the economic viability of the venture and like to be assured of a reasonable return on their investment at least in the medium term, say, a period of three to five years. In making a reasonable assessment of profitability, the Factor would have to estimate the demand for these services, the costs involved, the acceptable level of pricing and work out the organisation required. In this exercise, the Factor would also have to keep in view the services presently offered by the banks and the prices charged by them. These aspects are discussed in detail in the following paragraphs.

(1) Demand

3.2 While a large number of suppliers is likely to avail of one or more factoring services in due course, it is difficult to arrive at a definite conclusion about the quantum of demand, both in the immediate future and in the long run. Nonetheless, a reasonably realistic assessment of demand is considered essential since substantial investment would be required to be made by the factoring organisations in the early stages.

3.3 In this context, it is also necessary to recognise that all the suppliers may not be interested in availing of the entire package of factoring services, i.e., sales ledger management, collection services, credit protection and finance, but may initially seek only such of the services as they consider most suitable for their immediate requirements. Thus, those suppliers who are having satisfactory financial arrangements with banks, may like to continue with such arrangements and consider availing of only the sales ledger management and/or credit protection service(s).

3.4 It is also to be noted that many suppliers who are either outside the banking fold at present or those who would like to shift from banks to Factors in the expectation of better assistance, may not be considered as acceptable clients by the Factors as they too would be selective in this respect. Thus, in purchasing the book debts, particularly on 'without recourse' basis, the Factors would carefully screen the creditworthiness, track record, etc. of the potential clients, as well as their customers and agree to take up only such business as is considered by them as reasonably sound. As a result, to a certain extent, some of the demand which appears probable on the surface, may not materialise into actual business.

3.5 Giving due allowance to these aspects, the Group had proposed to base its assessment of the potential demand, broadly on the responses from the various parties to whom its questionnaire was addressed and whom it met for Group interface. However, most of the respondents conveyed their views in this regard in very general terms. While many indicated that various industrial units, particularly those from the SSI sector, would like to avail of factoring services, rarely an indication of the quantum of the likely demand, aggregate or from specific sectors or groups of industries, was given. Although a few respondents did indicate a rough estimation of the aggregate demand on the basis of gross sales of all manufacturers, convincing reasons in support of the conclusions drawn were not furnished. Similarly, although some respondents gave their assessment on the basis of the available figures of aggregate bank credit by way of bills purchased and discounted, it cannot be considered as a proper basis as the Factors are more likely to be approached for financing, collection, etc. of open account sales, i.e., other than those which are made through bills.

3.6 For the purpose of making a reasonably accurate assessment, data relating to the aggregate quantum of credit sales, the break-up of such sales into those through bills and on open account, average period of credit allowed, age-wise distribution of aggregate outstanding debts, the extent of delays in realisation and other relevant aspects were absolutely essential. Such data, however, were not available; perhaps, the respondents, too, were similarly handicapped in providing a reliable estimate.

3.7 In the absence of the type of data indicated above, I / are ~~the Group~~ ~~has~~ attempted to assess the demand on the basis of data relating to value of output of the manufacturing sectors. At the same time, since it is felt that the demand for factoring services would not be uniform from the medium/large and SSI sectors, it has to be assessed separately.

Accordingly, the following model has been developed for making an assessment of potential demand :

(in rupees)

	SSI	Medium/large
1. Value of output (assumed)	100	100
2. Of which credit sales constitute (on the basis of responses)	80	75
3. Sales through bills (as reported)	16 (20% of credit sales)	25 (33.3% of credit sales)
4. Sales on open account (i.e., 2-3)	64	50
5. Outstanding credit sales on the basis of average collection period (as reported)	16 (90 days)	6.25 (45 days)

3.8 It emerges from the above model that about 64% of the output of the SSI sector and 50% of the output of the medium/large sector is sold on open account basis. The value of the output of the manufacturing sector ~~ie~~ is estimated at about Rs.1,50,000 crores ~~by~~ in 1989-90, with the SSI and medium/large sectors contributing more or less equally. As such, the value of outstanding open account credit sales available for financing (i.e., item 5 above) at any point of time would amount to Rs.12,000 crores in the case of the SSI sector and Rs.4,500 crores for the medium/large sector. While the extent to which banks are currently extending finance against these receivables is not known, even if it is assumed that it is as much as 50%, the business available to the Factors would still be substantial. Conservatively, it is assessed that the aggregate potential demand for factoring services would be about Rs.4,000 crores.

3.9 While the model primarily gives an indication of the expected demand for financial services of Factors, it can also be made use of for assessing the demand for the other services. Thus, the entire sales made on open account basis (i.e., 64% of total sales of SSI sector and 50% of total sales of the medium/large sector) constitute potential business for collection services of Factors; the actual demand in the initial years would, however, be rather limited as the Factors themselves will take some time for stabilising their operations. Nonetheless, it can be assessed that the demand for these services in about five years' time could be around 10% of aggregate open account sales of all the sectors.

3.10 The responses received by the Group indicate that, by and large, while there is delay in receiving payment from buyers, the incidence of bad debts in different sectors is not significant. As such, the demand for credit protection services of Factors by the sellers, would be mainly to assure themselves of timely payment on a predetermined date. On the other hand, no clear picture about the demand for sales ledger management service has emerged, inasmuch as, while some of the industrial units (including those in the medium/large sector) would like to avail of such a service, they would prefer to await the development of requisite infrastructure with the Factors; the prices quoted for these services would also be a material issue in their availment. Broadly, the demand for credit protection and ledger management services in the first three to five years may be assessed at about 1% of gross credit sales.

3.11 While an assessment of the aggregate demand which is likely to emerge for factoring services has been attempted, such demand is not expected to be uniform from units of different sizes in various industries. In fact, while appreciating the need for factoring services, it may be noted that not all the sectors/industries may require or benefit from factoring. On the basis of the responses conveyed to the Study Group in the course of meetings, replies to questionnaire, etc., the Group is of the view that, in the early years, the demand for factoring services would primarily emerge from units in the SSI sector and those medium/large units which are experiencing delays in collection of receivables, particularly in the undermentioned industries :

(i) Engineering (especially light engineering).
(ii) Textiles.
(iii) Consumer durables.
(iv) Automobile ancillaries.
(v) Chemicals.

3.12 The Study Group is of the view that, while it should be the objective of factoring institutions to offer their services to all industries and all sectors in the country with a view to attaining balanced risk dispersal, care has to be taken to make sure that the concerned institutions acquire an in-depth knowledge of the working of the industries concerned before assuming any risks. In other words, apart from the fact that the demand side would open up gradually as discussed earlier, even from the supply side the unfolding of the services to the varied industry sectors would have to be made conditional upon adequate building up of expertise and knowledge of operations and the organisation required to back them up.

(2) Infrastructural facilities required

3.13 Having been convinced that there would be a fairly good demand for factoring services in India, an important aspect that has to be considered is the paramount need for the proposed factoring organisations to become and be seen as cost effective and efficient. As such, the placing in position of infrastructural facilities which could ensure smooth operations at minimal cost, assumes priority of attention. Unless the factoring institutions, with their specialisation and infrastructure, can offer the services either at lower costs or more efficiently or both, there would be little incentive for industrial units to seek access to the Factors for their services. The elements of the infrastructure, essential for efficient operations, fall under four broad categories, as discussed below.

(a) Network of offices

3.14 Factoring organisations should be equipped to effectively handle the following activities :

(i) Collect and analyse credit information on buyers (customers) and guide the sellers (clients).

(ii) Study the debt portfolio of their clients, with a view to assessing the risks and determining the prices at which to offer the services.

(iii) Sanction limits and provide finance.

(iv) Undertake accounting of receivables and furnishing of analytical reports.

(v) Communicate with buyers at various places, collect the debts and transmit the funds.

(vi) Keep a vigilant watch on the clients/ customers to safeguard their own interests.

3.15 The abovementioned operations would need a network of offices, particularly as the clients would be making sales to customers spread over different parts of the country. While the factoring organisations will certainly need to have some branch offices of their own, the cost involved in having a wide network would be sizeable. Hence, setting up of a large network of offices by Factors may not be economical and/or feasible; instead, they may have to avail themselves of the facility of existing branch network of banks.

(b) Communication facilities

3.16 The factoring organisations would have to depend upon efficient communications network. While they can avail of the existing modes of communications like telephones, post and telegraph, these may not be adequate for handling, with the expected degree of despatch, the large volume of business which would be emanating from the Factors. Therefore, they will need the support of fast, more dependable and cost-effective modes like the dedicated/integrated communication networks.

(c) Computerisation

3.17 In most of the foreign countries, the growth of factoring has coincided with the growth of computer technology. It is realised that much of the accounting, follow up, furnishing of data to clients and other operations relating to receivables are considerably facilitated by utilisation of computers. Apart from the fact that computers can handle a larger volume of transactions with speed, accuracy and efficiency, they have also proved to be cost-effective in the long run. They are also useful in the matter of collection, storage, retrieving and sharing of information about the creditworthiness, etc., of clients and customers. The progress made by the computer industry in India in the past few years indicates that it would be in a position to meet the expected requirements of the factoring organisations in the country.

(d) Personnel

3.18 For the success of any factoring organisation, knowledgeable, trained and dedicated staff is an essential prerequisite. The Factors will usually need the following kind of specialised personnel :

(i) Computer specialists who can develop need based systems.

(ii) Persons who are well conversant with the working, financing methods and trade practices of different industries.

(iii) Financial analysts who can assess and take a view on the creditworthiness of clients/customers.

(iv) Managerial personnel.

(v) Personnel for follow up and collection of dues.

(vi) Legal personnel.

(3) Pricing of various services

3.19 The prevailing practice among the factoring institutions abroad is to quote rates according to the merits of individual cases. The criteria that generally weigh in this regard are creditworthiness of the customer, track record, quality of portfolio, turnover, average size of invoices, etc. Generally, there has been a band of charges within which quotations are given to individual customers, taking the above aspects into account.

3.20 While the criteria mentioned should hold good in our case also, the base level would depend upon the various costs to be borne by the factoring organisations, which, in turn, will form the basis for pricing various services. In this context, a very important element of cost would be the cost of funds, particularly as it is envisaged that the financing service would constitute a significant part of the aggregate business, at least in the initial years. The different ways in which Factors could raise funds are :

(i) promoters' contribution towards equity ;

(ii) raising equity capital from the public ;

(iii) acceptance of public deposits ;

(iv) issue of debentures for subscription by the public ;

(v) line of credit from bank(s);

(vi) borrowings from short term money market.

3.21 It may not be advisable for the factoring institutions to depend on any one source of funds. They have to attempt a mix from among the above stated sources to keep the cost of funds as low as possible, in any case not exceeding 13.5% per annum so that a reasonable spread is available. In this process, the proportion of bank borrowings to total funds and the rate of interest for such borrowings would be the crucial elements. The banks currently charge interest on cash credit/ overdraft facilities to non-priority sectors at a minimum rate of 16% per annum and, as such, that would be the rate the Factors may have to pay if they borrow from banks to supplement their resources. As the Factors will be competing with banks in the matter of financing receivables, they will have to charge their clients a rate not higher than that charged by banks. As such, they will not be able to pay the aforementioned rate of interest for their borrowings from banks as, otherwise, the price charged by them would become uncompetitive. Therefore, either the Factors may have to establish a special relationship with the banks to get a lower rate or they have to minimise their dependance on bank funds and rely on other sources.

3.22 In the Western countries, many of the major factoring institutions are subsidiaries of banks and they entirely look to the parent banks for funds. They are provided funds at interest rates ruling in the inter-bank market or at rates charged by a parent bank to its branches. Thus, the Factors have been able to get full benefit of the parent bank's support and keep down the cost of funds at levels lower than what they would have incurred, had they gone to the money market on their own. Perhaps, this approach would be worth emulating in our country in the case of those organisations which will be subsidiaries or associates of banks. Further, RBI may consider allowing such factoring organisations to raise funds from the Discount and Finance House of India Ltd., as also other approved financial institutions, against their usance promissory notes covering receivables factored by them, on the lines of the revised procedure under the Bills Rediscounting Scheme, recently advised to banks.

3.23 The other important element of cost would be the expenditure for the infrastructural facilities, such as, core manpower, premises, furniture, equipments, etc. This will be a fixed cost which will have to be spread over a volume of business, as higher the scale of operations and utilisation of various services, lower will be the average fixed cost. It may be stressed that each factoring organisation is likely to require fairly heavy investment in the early stages since, in addition to the main offices, it would require offices in at least some centres which may have to be linked by computer network and/or dedicated communication network. At the main office, the factoring organisations would also have to build-up, among others, strong credit and collection departments to handle efficiently the large volume of business, which would also involve substantial investment.

3.24 The Factors would quote appropriate prices for their services keeping in view the costs for different inputs. Further, while the price for finance would be on the basis of actual availment, for other services it would be related to the aggregate turnover. The prices quoted would also depend upon the quantum of owned funds, cost of borrowings from banks and others, costs under other heads, demand for different services, etc. The R.T.I. Group has assessed the cost for various inputs as under :

(a) Funds

Not more than 13.5% p.a.

(b) Others

		Range % of debt serviced
(i)	Screening	0.5 to 0.6
(ii)	Collection and sales ledger maintenance	0.6 to 0.7
(iii)	Cover for credit protection	0.5 to 0.6
(iv)	Other overheads	0.5 to 0.6
	Range :	2.1 to 2.5

3.25 The Group, thus, believes that the price for financin services offered by Factors may be around 16% p.a. and the aggregate price for all the other services may not exceed 2.5% to 3% of the debts serviced. Such pricing should enable them to reach a level of business which will generate reasonable rate of return on their investment. The Group also perceives that the Factors will have to operate at a level of efficiency much higher than that with which banks are currently handling the receivables of their customers.

(4) Organisational set up

3.26 The terms of reference for the Study Group specify that, in case it considers that there is scope for factoring organisations, it should make recommendations as to the number of such organisations which may be required for handling the estimated business, the nature of their constitution and whether they should be in the public or private or joint sector or in more than one sector. The Group perceives that there is sufficient scope for domestic factoring business which could become a commercially viable proposition in a few years, if not immediately. The Group also believes that there would be demand for the various services which Factors would offer, from units in all parts of the country, as the difficulties in regard to financing and management of receivables are not confined to specific areas.

3.27 As regards the number of factoring organisations which may enter the field, different views were conveyed to the Group. One of the suggestions made was for the setting up of one monolithic organisation which would handle the entire factoring business emanating from different parts of the country through its branches/offices; as against this, it has been suggested by some respondents that no restriction be placed on any one offering these services on commercial considerations and the field may be left open for all enterpreneurs, who may judge on their own whether this could be a profitable business.

3.28 The Group is not in agreement with either of the suggestions. In its view, only select promoter institutions/ groups/individuals with good track record in financial services and competent management could be permitted to enter into this new field, at least in the early years, because it is very important that the new institutions set good standards and build a good reputation to inspire confidence in the public. Whether further organisations may be allowed to compete with the then existing ones is a matter which could be decided on the basis of the experience gained and other relevant factors.

3.29 Another issue raised in this regard is about the coverage of industry sectors by such organisations. While some have suggested an industrywise approach (i.e., each organisation to offer services to units from specific industries, such as, textiles, engineering or consumer goods), the majority of respondents is of the view that such an approach may not be beneficial either for the Factors or their clients. In particular, since each of the factoring organisations would be required to have a network spread over different parts of the country, industrywise approach would not be an economical proposition. It has, generally, been suggested that initially the organisations may be promoted, preferably, on Zonal basis, say, one each for North, East, South and West. Such an arrangement will result in each organisation primarily catering to clients from their respective Zones and also handling business in other parts of the country through branches or through arrangements with factoring organisations in the respective Zones. Of course, it would be necessary for the organisations to follow a business strategy of associating themselves with industries about which they, through their staffing or that of their sponsoring organisations, have a good knowledge already and also will be capable of so equipping themselves within a short time.

3.30 So far as the ownership pattern of such organisations is concerned, the bodies xxx representing trade and industry, as also representatives of individual industrial units, were almost unanimous in their view that factoring business can succeed only if it is treated at par with other commercial entreprises and, as such, should be left to the private sector. According to them, entrepreneurs from the private sector have the experience and skills necessary to handle various types of factoring services. They would have an innovative approach in various areas and it could be ensured through competition that they are run with maximum efficiency. The personnel they employ would be service oriented and sufficiently productive to generate profits. A few respondents suggested that the field be left open to both private and public sectors. On the other hand, almost all banks are of the view that factoring business could very well be left to be handled by them as finance against receivables is a part of the total working capital credit required by their borrowers. A view was expressed that as the basic function of financial institutions was extension of term finance, they may not be suitable for undertaking factoring business, which mainly involves financing and collection of receivables, an area of short-term financing. The limited network available to financial institutions was also perceived to be a handicap.

3.31 The Group recognises that, as represented by many during the interface meetings, factoring organisations run by private entrepreneurs exclusively on profit considerations may not be able to, or rather inclined or attuned to, meet the varied requirements of the units from the SSI sector, which particularly need these services. It is likely that the terms and conditions prescribed by such organisations for acceptance of smaller units as clients, as also of their customers, would tend to be rather onerous or the rates quoted to such clients for different services may not be sufficiently economical for them. Another constraint which the factoring organisations in the private sector are likely to experience is that they may not be able to raise sufficient resources at competitive costs for handling business of the expected magnitude. The Group feels that the experience of leasing companies in this area is a pointer towards the difficulties which private factoring organisations may experience.

3.32 On the question whether factoring business should be handled by banks, some have expressed their reservations. They point out that, as it is, banks are not sufficiently involved in close follow-up of bills, including those purchased/discounted by them. It is also mentioned that in the screening and approval of clients and their customers for factoring purposes, banks are likely to adopt the same conservative and security oriented approach as is now being adopted by them in extending finance against receivables. It is also stated that specialised knowledge of particular industries and expertise in pursuing the receivables is not available, nor is likely to be adequately available, in banks. What is required for making factoring business successful is a more objective and incisively professional approach to these processes from very beginning, backed by information and specialisation.

3.33 The Group agrees that there are certain limitations in the working of the banks and they do have a certain conservative orientation. But there are also distinct advantages in the banks being associated with handling of factoring business. Firstly, they have considerable experience in financing and collection of receivables and, given the required orientation needed for factoring business, they would be able to perform very well. They also have access to credit information on both sellers and buyers and in this area, as also in the matter of collection, the large net work of branches spread over different parts of the country is a distinct advantage for banks. Another area in which banks have an advantage is the availability of sufficient financial resources for meeting all eligible and genuine requirements.

3.34 Taking into account all the aspects, the Group is of the view that while it may not be advisable for banks to take up factoring activity departmentally, the organisations which will handle this business should have atleast close links with banks. Such linkage will also provide credibility to the concerned organisations and would facilitate their acceptability by prospective clients. To be specific, taking into account the various dimensions of the problems, the Group considers that subsidiaries or associates of banks are ideally suited for undertaking factoring business. Such organisations would not only have the financial support of the parent organisations, but would also be in a position to take advantage of the large network of the latter's branches. They would also be able to command the use of the latest information (on line computer system) and communication (dedicated network) technology available in the country. Besides, in respect of individual parties, it would be possible to ensure close co-ordination between the bank(s) which extend working capital facilities and the Factor(s). Such organisations could, right from the stage of assigning of executives from the parent bank and the recruitment of personnel/ professionals from the open market, ensure that they are inducted into the right attitudes, orientation and culture so necessary to handle this specialised business. A distinctly different work culture and climate should be sustained,through appropriate organisational initiatives taken at the corporate levels.

3.35 Having taken a view that subsidiaries/associates of banks are most suited for taking up factoring business, the Group examined whether it may be left open to banks to float such organisations, singly or jointly with others, as a matter of their independent commercial judgement. It considers that such an approach may not be desirable as it could lead to excessive competition which may possibly turn unhealthy through too many Factors chasing the available business. The experience of merchant banking divisions/ subsidiaries of banks in respect of management of share issues and other related business indicates the need for a cautious and selective approach.

3.36 While private sector banks, both foreign and Indian, may be inclined to get involved in factoring business, their limited network of branches is perceived as an inhibiting element. Further, although most of the public sector banks have a large network of branches, the Group is not in favour of all of them undertaking factoring business initially. To start with, it would be desirable to have only four or five organisations and, as mentioned earlier, they could be formed on Zonal basis. The Group, therefore, suggests that such organisations may be promoted either individually by the leading public sector banks or jointly by a few among them. In addition, factoring activities could also perhaps be taken up by the proposed Small Industries Development Bank of India, preferably through a joint venture promoted by it in association with one or more commercial banks to take advantage of the latter's branch network, as well as experience in extension of working capital finance covering receivables.

3.37 Incidentally, in the U.K., the factoring business is being handled by subsidiaries of banks or departments of banks. The domestic factoring business, particularly, is being handled by subsidiaries of leading commercial banks. In the U.S.A., too, with some exceptions, factoring services are being provided by commercial banks or organisations backed by banks. This position has evolved over a period of time. Initially, there was a large number of small operators in the market but many among them did not succeed in their venture. Hence, they were either taken over by the banks or merged with factoring organisation set up by the banks. The process of mergers with and acquisitions by the banks in the U.K. and the U.S.A. has given banks strong factoring arms which have grown in size and coverage.

3.38 The association of banks with factoring activities is prevalent in different forms in other countries also. For example, Ifitalia, the biggest factoring organisation in Italy, has controlling interests in more than 50 factoring organisations which operate as separate entities but have the backing of Banca Nazionale Del Lavoro, the largest commercial bank of Italy. It may also be mentioned that the

Netherlands based Factors Chain International admits, as a member of its fold, for having access to the services of Import Factors in other countries, only those factoring organisations which have the backing of a bank or a financial institution.

CHAPTER IV

LINKAGES BETWEEN BANKS AND FACTORS

4.1 As mentioned in Chapter II, receivables of Industry and Trade in India are financed by the commercial banks by way of either overdraft/cash credit limits against hypothecation of book debts or bill purchasing/discounting facilities. In either case, the supplier bears the risk of default by the debtor; while in the case of bills purchased/ discounted banks expect the drawer to repay the advanced amount in case of delay/dishonour, in the case of overdraft/ cash credit arrangement, book debts older than the specified period are excluded from the drawing power. In other words, financial support is withdrawn just when the supplier of goods apparently needs it the most.

4.2 Under the existing arrangements, banks play no role to ensure timely payment of debts. The responsibility for timely collection of trade-debts rests entirely on the supplier of goods. However, not many suppliers have separate debt collection department and, generally, the Accounts Department, if at all, handles the job of following up the trade-debts, or the sales staff are required to do this follow-up in addition to their regular duties. The approach of most suppliers to debt collection is, generally, casual. It is mainly for this reason that most suppliers face the problem of delayed payments.

4.3 The serious implications on the profitability of a business due to delays in collection of trade-debts are generally not realised. In the initial stages, the supplier, in order not to lose the customer, bears with the delay in payments. If the customer is a large private/public sector organisation or a Government Department, these delays get prolonged; yet the supplier, unless he is a monopoly supplier, may not even be able to ask for interest for the extended credit period. The cost of carrying the book debt keeps going up imperceptibly, so much so that the transactions become unprofitable. The cumulative effect of a series of such transactions not only results in a liquidity crunch but also erosion in profits. When this stage is reached, both the client and his banker face a difficult situation.

4.4 As commonly experienced and observed, in many cases, liquidity crunch and, ultimately, erosion in profits, are the direct result of inefficient credit sales management. Whereas credit sales induce larger turnover, it is important that these credit sales are managed properly and professionally so that the debts are realised when they are due and the cash is recycled. Without the cash cycle being completed within the predetermined credit period, a rapid rise in credit sales can become a cause for sickness of the business.

4.5 In such a context, the services offered by a Factor assume importance. When book debts are assigned to it, the Factor assumes ownership rights on actionable claims. It, therefore, acquires an interest in ensuring that the relative invoices are paid on time. With its specialisation and professional approach, the Factor is able to recover the debts more promptly. Efficient administration of the credit sales, therefore, is inherent in the system. If the Factor fails to weave this efficiency into its system, it will not survive for long.

4.6 Since it is envisaged that the suppliers will be able to obtain financial services from both banks and factoring organisations, it will be necessary to provide for proper linkages between banks and Factors for ensuring that the aggregate working capital/receivables finance extended by the two agencies to any supplier does not exceed his total entitlement as admissible according to the lending norms laid down by RBI for banks. Such linkages would all the more be necessary in respect of suppliers who would be obtaining finance against receivables from banks, as well as Factors. Thus, there should be arrangements whereunder banks and Factors furnish to each other information relating to parties which approach more than one agency.

4.7 In this context, it is envisaged that, in some cases, there could be a three-party tie up, the debts being assigned to a Factor by the suppliers and the former borrowing from a bank. Alternatively, the supplier borrows from a bank and takes credit protection cover and sales ledger management services from a Factor. In such situations, the necessary linkage between the concerned bank and the Factor could be on the following lines :

(a) The Factor enters into a full factoring agreement with the bank's customer (the Factor's client). The client Avails of only the administrative services from the Factor and not the funding service. The bank, instead, provides the finance, which would in normal circumstances be provided by the Factor by means of prepayments.

(b) The result of the arrangement in (a) will be that the amount owed by the Factor to the client from time to time for the debts purchased will be approximately equivalent to the debts owed to the Factor by the debtors and as far as his own records are concerned, the client has substituted for the many debtors of uncertain standing, one debtor of high standing - one that will pay a substantial part of what is owed on demand.

(c) By assigning that one debt to the bank, the client may provide the bank with security for its advances to take the place of the prepayment facility.

(d) The client gives the Factor irrevocable instructions by which all amounts payable by the Factor to the client, for the debts purchased by the Factor, are to be paid to the bank.

(e) On instruction from the client, the Factor will report to the bank periodically (say, weekly) the amount that may be drawn from the Factor by the client by way of prepayment for the debts purchased. Such reports may include the basis on which the availability is made up, i.e., the amount of assigned trade debts outstanding at the time and the amount of unapproved and disputed debts within that total.

(f) The bank uses these reports as a basis for part or all of its lending and for the level of the facilities available from time to time.

(g) Although a factoring agreement provides for prepayment facility, the client will be unlikely to take prepayment from the Factor for two reasons, viz., (i) any prepayment must go direct to the bank and (ii) any such prepayment will reduce the amount shown on the Factor's availability report to the bank and thus the bank's facility.

4.8 The above mentioned arrangement will have the following implications :

(a) <u>For the client</u>

(i) His business relationship with his bank continues on the same footing as hitherto. Since he needs the bank's support for working capital, this continuity of relationship is important.

(ii) Conventionally, where the bank provides borrowings against book debts, margins retained are generally high. Under the arrangement recommended,such margins would be reduced and hence availability of funds will increase.

(iii) With this, the borrower-client can easily offer open account terms to his buyers. In a buyers' market, sellers' ability to increase sales on open account basis will give them a distinct advantage.

(iv) Since the client will continue to borrow from the banking system, the cost of raising funds for him will remain the same as of now. For example, for the eligible SSI units and export oriented units, funds will continue to be available at the concessionary interest rates - a distinct advantage indeed.

(v) With the administrative services and credit protection available from a Factor, the client will have no problems arising from delayed debt collection or bad debts.

He will, therefore, be able to concentrate on what he is capable of doing best, viz., producing goods and selling them. He can, therefore, endeavour to attain substantial increase in his turnover.

(vi) His cash flow will improve and, therefore, he will be able to plan his affairs with greater degree of confidence.

(b) For the bank

(i) With the introduction of a Factor, the bank will not be threatened with loss of business. On the contrary, factoring will be perceived as a complementary and beneficial service.

(ii) The quality of bank's lending will improve because of the better credentials of the Factor.

(iii) Prompter payment of invoices will make it possible for the bank to recycle the funds faster.

(iv) Since the bank will continue to provide finance against book debts, credit limits will remain subject to the lending norms of RBI.

(v) If the Factor is a subsidiary or an associate of a bank, it will contribute to the overall efficiency of the bank's operations and the growth of its business on sound lines.

(c) For the Factor

(i) The Factor will essentially provide administrative, collection and credit protection services and its obligation to pay the invoices will arise only on the due date. The need for the Factor to raise funds will be minimal as the need therefor would arise only when default arises.

(ii) The pricing of other services will not be high (between 0.5% and 3%) and, therefore, the Factor should be able to sell its services by emphasising the comparative cost-benefits to the suppliers and the other advantages accruing.

4.9 In the above model, pro-active service aspect of factoring is highlighted and it has been envisaged that financial assistance would continue to be provided by the bank. In the absence of such service intermediation, neither the clients, nor the banks, are able to administer credit sales efficiently. In these situations,when debt collection falters, there is no resilience available in the system, with the result that units tend to become sick. With the service support available from the Factor, sickness in industry can be reduced. Availability of such efficient service, provided by Factors who are properly and adequately organised would be of great help to trade and industry.

4.10 It needs, however, to be emphqsised that this is not the only area in which the bank and the Factor can collaborate. Their capabilities and skills may be somewhat different but by pooling these capabilities, the two can fill the gaps in working capital management by playing a complementary role to each other.

4.11 Generally, a large number of suppliers meet the requirements of a large corporate entity. One Factor specialising in dealing with such a buyer could provide its services to all these suppliers. Similarly, a Factor can cover the buyers located in a specific area, say in an industrial estate or a centre, where many units from the same industry have been traditionally located or where units of a sunrise or thrust industry tend to localise because of certain advantages involved. In such cases, while the suppliers will get their payments on due date, the Factor, with its intimate knowledge of the buyers, will be better placed to recover its dues. Further, besides debt collection service, the Factors may be able to provide effective market intelligence to the suppliers. If the market is volatile in nature, such information may ultimately prove helpful to the suppliers in avoiding risky or undesirable business.

4.12 For any business having prospects for rapid growth, availability of adequate funds' support is critical. Banks often find that, based on the available security, they cannot lend more, although, given further support, the business could grow. In such a situation, if a Factor steps in and commits cash on due dates, based on the buyer's credentials, the bank will be able to lend to the supplier with greater ease and confidence, at times even with lesser margins.

4.13 A business developing a new product, or a new market for an existing product, requires analytical market information. A Factor, operating with buyers in varied fields is often able to advise the supplier as to what the buyers are looking for. In fact, credit information on a large number of buyers can be supplied by the Factor to a new supplier in the market and thus help him in planning his marketing efforts on sound lines.

4.14 It is not uncommon for units to run into rough weather from time to time. At such times, counselling by someone who watches market developments from close quarters, is generally quite effective in warding off, or atleast minimising, the ill-effects of adverse developments. A Factor is well placed to play this role vis-a-vis the supplier, as well as the buyer. Its ability to diagnose the problems of the debtors (buyers) could help the debtors' bank(s) to take appropriate and effective steps in good time to the advantage of every one. In fact, the Factor can also provide help and support to the debtor directly by extending the credit period. In the U.S.A., it is learnt, the role of the Factors goes even beyond this inasmuch as they provide, in selective cases, direct lending to the debtors to tide over temporary liquidity crunches. A Factor is able to do this as it has quite intimate knowledge of the debtors and the markets they operate in. In India, the assessment by a Factor of the temporary difficulties of the debtor (buyer) can be useful for the bank, who, with the availability of continued complementary services from the Factor, may find it easier to extend this support.

4.15 Factors deal with a large number of buyers and suppliers on whom they hold latest and dependable credit information. They also keep themselves abreast with the position and trends in various industries. As such, Factors, together with the parent/associate banks, would be in a position to build up a comprehensive data bank, both industrywise and unitwise. This would enhance the appraising and supervisory capabilities of Factors, as also the banks. Besides, by virtue of their contacts with buyers, Factors would also be well placed to introduce new clients to the banks.

4.16 It would be apparent from the foregoing that close linkages between banks and Factors would be advantageous not only to them, but also to suppliers who would avail of factoring services. Besides, through proper monitoring of the businesses of sellers and buyers, the two agencies would be in a position to initiate timely action for preventing the units of sellers and, at times, also of buyers, from becoming sick. This feature also supports the Group's view that, in the Indian context, the factoring organisations may be subsidiaries/associates of banks, at least in the initial stages.

CHAPTER V

SSI UNITS AND FACTORING

5.1 According to its terms of reference, the Study Group is required to make recommendations relating to availability of factoring services for all sectors of trade and industry. However, being aware that the delays in receiving payments for the supplies made by them affect the units in the SSI sector more acutely, the Group has considered it essential to specifically offer its views in this Chapter about the relevance and importance of factoring services to this sector.

5.2 In the strategem of the economic development in India, the SSI sector has been assigned a crucial role. Its importance to the economy has been growing steadily over the years and its share of the value of the gross output of the entire manufacturing sector is estimated to be about 50% at present. Being generally engaged in labour intensive activities, the SSI units are looked upon as a major source in offering employment opportunities. Their contribution in the export field has also been significant. Commensurate with its importance, this sector has been accorded the status of a 'priority' sector for lending by banks and, in the matter of term finance, the Industrial Development Bank of India and the state level term lending institutions have been giving special support to it.

5.3 The special attention received by SSI sector has contributed to its rapid growth. Nonetheless, numerous units have been facing constraints in their operations on account of inadequacy of working capital, often caused by delays in receiving payments for their supplies. The responses received by the Group, both in writing and during inter-face, bear testimony to this position.

5.4 A large number of SSI units is managed by their promoters and/or persons with technical orientation, who are not adequately equipped to pay attention to areas of accounting and working capital management. By and large, such units do not have an organisational set-up and/or expertise in the area of credit management to attend to follow up and recovery of dues from suppliers. It is only when they experience liquidity crunch by reasons of delayed payments or other causes, that those managing such units direct their attention to collection of book debts. In such situations, they have to divert their time and energy to this task which would have, otherwise, been gainfully utilised for looking after the important areas of production, marketing, etc., which they are better equipped to handle.

5.5 It was conveyed to the Group that many SSI units are keenly looking forward to the availability of factoring services in the hope that they could sell their receivables to the Factors and be relieved of the problems arising from delayed collections and bad debts. The need and utility of factoring services to SSI units is therefore to be examined against this background. The Factors, with their systematic, specialised and professional debt collection facilities, would be in a position to assist SSI units in this area and ensure improvement in debt collection. In this context, the credit protection services of Factors would be of particular help to SSI units as it would entitle them to be assured of payment on a fixed date, as also protection against customer's default on account of his inability to pay.

5.6 Inadequacy of working capital finance with its attendant liquidity problems has been one of the major stumbling blocks in the viable running of SSI units. Banks have their own constraints in financing open account sales of SSI units; as such, not many among such units enjoy financing facility against book debts and, even when they do, a somewhat high margin is usually stipulated. Factors, as highlighted earlier, also assess the creditworthiness of customers and hence are in a better position to assess the security of book debts. Consequently, they are expected to be able to offer finance according to the requirements of their clients. SSI units would, thus, have access to another source of finance.

5.7 Some of the SSI units are presently being financed at concessive rates of interests by the banks. It is the Group's view that Factors should not be expected to assume such developmental role and accord special treatment or concessions to SSI units. In such a situation, to avail of concessive finance, the concerned SSI units could avail of finance from banks and the other services from Factors, as required on the lines of the linkage between banks and Factors spelt out in Chapter IV; such arrangements would be beneficial to both SSI units and banks. Banks will have better security for their advances to SSI units (as brought out in para 4.8) and, consequently, would be in a position to offer better terms to their SSI borrowers.

5.8 SSI units are often hampered in their timely and correct decision-making, for lack of a good management information system. With a factoring arrangement, units would have access to periodical flow of analytical data and information on their present and prospective customers and outstanding dues, as also market and industry trends. Factors will also be in a position to give them timely and expert advice regarding problems faced either generally by an industry or specifically by the units.

5.9 As already discussed in para 3.11, once factoring organisations are established, a substantial portion of demand for their services would emanate from units in the SSI sector. Factors, while considering establishment of factoring arrangements with sellers, attach importance in the assessment of credit risk to the seller's customers profile. As the SSI units cater largely to established medium/large scale units, they are, in fact, relatively low-risk and acceptable clients for a Factor. Given the large volume of business between SSI units and the medium/large units, this would undoubtedly prove to be one of the most attractive market segments for a prospective Factor.

5.10 It is felt that despite the vast potential demand, it would take some time before this demand could crystallize. The units in the SSI sector are very widely spread geographically, many among them being at centres far away from those where the factoring organisations are likely to commence their operations. Further, while in the case of factoring arrangement on a recourse basis the financial strength of the SSI unit assumes importance, this would not be a major criterion for the Factor where the buyer is financially sound. The Group, therefore, felt that while the SSI sector would greatly benefit from services of Factors, the range and reach of factoring organisations will develop and get strengthened only over a period of time.

5.11 The Group considered whether, to give an initial boost to factoring for SSI sector, the factoring organisations to be set up in the public sector, should be enjoined to undertake a specified percentage of their total business from the SSI sector. After deliberating, the Group felt that it may not be desirable to do so, especially in the initial stages, as it could endanger the commercial viability of the factoring organisations. Moreover, such a reservation may not be necessary at all, as the factoring organisations would be endavouring to spread their net as widely and as quickly as possible in their own interest as certain minimum volume of business would be necessary to ensure viability of operations and the SSI sector would be an important source for them. Perhaps, with the experience gained in factoring SSI transactions, such a stipulation could be prescribed in due course.

5.12 The Group is of the view that factoring for SSI units could prove to be mutually beneficial to both Factors and SSI units. While, on the one hand, SSI units could benefit from the wide range and flexibility of factoring services, on the other Factors would be assured of readily available substantial business from the SSI sector. Factors should, therefore, make every effort to orient their strategy to crystallize this potential demand.

CHAPTER VI

EXPORT FACTORING

Special features

6.1 The definition of factoring, the various variants of factoring services and other relevant conceptual aspects relating thereto have already been discussed. ~~in Chapter II.~~ These cover both domestic factoring and international factoring. Before considering the issue of introduction of international factoring in India, there is a need to understand certain special features involved in international factoring and these are discussed below.

6.2 The complete factoring package consists, as already indicated, of four different services, viz., financing, credit protection, accounting and collection of receivables. By and large, international factoring agreements comprise complete 'old line' service, with or without financing. The reason for this seems to be the complexities of cross border transactions and difficulties in credit assessment of the buyers. These are considerably more significant in international trade than they are domestically. Factoring services make exports selling as easy as domestic selling. The stages involved in operations of export factoring are indicated in Annexure ~~X.~~ II.

Need for export factoring

6.3 It is well known that risks assumed in granting credit are enhanced where a company is selling to customers abroad and the credit is on unsecured basis. The credit risk for exporters is greater, not necessarily because of any inherent financial weakness of importers; but for the following reasons :

(a) Difficulty in evaluating the creditworthiness of potential customers.

(b) Lack of or insufficient information about individual buyers, as also markets in a particular country.

(c) Credit terms granted by exporters tend to be longer than those in domestic trade.

(d) Customer's country of domicile may represent a credit risk, arising from perceived political instability or economic weakness.

(e) Existence of foreign exchange controls in many countries.

6.4 The above risks can be effectively countered by exporters obtaining the services of a factoring organisation. The main advantages of export factoring can be broadly classified as under

(a) It facilitates sales to customers abroad on open account.

(b) It protects the exporters from various risks in foreign trade, such as, currency devaluations and collection delays.

(c) It contributes to the expansion of the client's volume of business and overall customer base.

(d) It increases the client's cash flow, reduces his credit investigation cost and eliminates losses from bad debts.

6.5 The principal benefit of export factoring is that it enables the client company to sell to customers abroad on open account terms, providing for payment facilities after a period ranging from 60 to 180 days. Before the shipment is made, the Factor investigates the customer's creditworthiness and assumes responsibility for collecting all amounts owed, as well as affording credit protection. Because of this, the client is free to concentrate his energies on the merchandising side of business, i.e., expanding his volume of business and overall customer base.

6.6 Benefits of export factoring are also available to the importer because he obtains the goods on open account basis. He does not have to open a letter of credit, for which he has to pay a fee and lock up his funds towards meeting the commitment thereunder.

6.7 Export factoring also helps to insulate clients from the risks of currency devaluation in the customer's country before funds are collected. Exporters also face the problem of'externalisation' with certain problem countries and there are delays in repatriating the sale proceeds from such countries. Such risks and problems are overcome through factoring because the client company receives payment at home in local currency. However, the above risks have to be borne by the Export Factor.

Two-factor arrangement

6.8 The major difference in 'old line' international factoring vis-a-vis similar domestic factoring is that it is customary in international factoring to use a two-factor system. In a two-factor system, there will be an Export Factor(EF) in the exporter's country and an Import Factor (IF in the debtor's or importer's country. There are international factoring chains/groups which facilitate linking up of Factors in various countries and, as a result, any one factoring organisation can be acting both as EF and IF with respect to any other factoring organisation from a different country.

6.9 EF and IF will carry out different functions when servicing the client (seller/exporter/supplier). The responsibilities of the two Factors in a typical

two-factor arrangement will be as indicated below :

Role of EF

(a) EF will be the signatory of the factoring contract with the client (i.e., the exporter) and will thus be responsible to him for all parts of the factoring service.

(b) EF will be responsible to IF for the actions of the seller under the terms of an international factoring agreement propagated by the group the Factor belongs to

(c) EF will finance the client against the receivables that are assigned through it to the IF.

Role of IF

(a) IF will undertake the credit assessment of the debtors (buyers/importers/customers) after receiving applications from the client through EF. It will, wherever possible, establish credit lines on the debtors, thereby protecting the supplier against the debtors' inability to pay.

(b) All receivables against debtors in IF's country will be assigned to IF through EF and will be entered into IF's ledger. IF will maintain a complete account of the client's receivables in its country and forward comprehensive reports to the client, through EF, at regular intervals.

(c) IF will undertake control of the supplier's receivables and take whatever steps that are necessary to collect outstanding items, such as, maintaining communications with the debtors, sending out reminders, initiating legal measures and pursuing recovery of the client's outstandings.

(d) IF will receive funds from the debtors and book these amounts in the debtors' ledger and forward the funds with the necessary reports to EF.

(e) IF will pay to EF according to the terms and conditions of the mutual international agreements if it has undertaken the credit risk against a particular debtor and that debtor is unable to pay.

(f) IF will often be in a position to provide supplementary services, such as, generating additional reports (e.g., sales statistics), invoicing and collection of penal interest, settlement of agents' commission, etc.

6.10 The mechanics of the traditional two-factor system in international factoring are illustrated in Annexure XI. 7

Recourse factoring

6.11 There are situations in which a supplier chooses not to avail of the credit protection service because he either knows his customer intimately through years of trading or he may have arranged for some form of credit insurance, e.g., Government's export credit insurance scheme. In such a case, the traditional two-factor system would function as described above, with the exception that IF would be called upon to provide only its administrative service and not to cover the credit risk.

Single/direct factoring

6.12 Although majority of international factoring agreements are conducted along the lines of the above mentioned two-factor system, as volumes increased, a need was felt to provide variations of this service. There are a number of reasons for this need, of which one of the more important reasons is the cost aspect. The administrative benefits of the two-factor system may not, for example, warrant the additional cost of involving two Factors, particularly when the two concerned countries are in close proximity, represent similar cultural and linguistic environments and have very similar trade practices. One solution to such a situation is single or direct factoring.

Direct export factoring

6.13 In this type of factoring, EF will undertake all the administrative services that would have been undertaken by IF in a two-factor system, with the exception of credit assessment and credit protection. This service could also be called single/direct factoring. The mechanics of direct export factoring are illustrated in Annexure XII.

6.14 Direct export factoring will also, in some cases, be used when handling exports to countries where there are no factoring correspondents. It is, some times, necessary to provide a supplier with a total service to cover all countries, including those to which the correspondent network does not reach. This form of direct export factoring will often be provided in combination with the more traditional trading forms, such as, cash against delivery, letters of credit, etc. In such cases, the Factor will often take on the administrative service and use the banking network for handling the documents and yet provide the supplier with the usual accounting and reporting services, as well as, possibly, finance for the transactions. It may even be possible to combine such an arrangement with an outside credit insurance scheme. Thus, there could be several reasons for choosing this type of export factoring, but it will normally only be an alternative for a client who either does not want credit protection or who is already using some outside credit insurance scheme.

Direct import factoring

6.15 IFs are dependent on EFs for availment of their services and they experience situations where Factors in a country are not very active in marketing international services. Certain Factors will, therefore, occasionally offer their services directly to foreign suppliers that are selling their goods or services in their country. In some cases, exporters will, through outside parties, establish contact with Factors in the countries to which they are selling. The resultant agreements will be direct import factoring, which is illustrated in Annexure ~~XIII~~. VII.

6.16 Some of the disadvantages of direct import factoring include the difficulty (rather impossibility) of financing the exporter client. It is not only difficult to assess the financial position of a client in a different country, but also to evaluate the risks involved and the legal standing of factoring in that country; foreign exchange regulations may also preclude any financing of a client in a different country. There could also be communications problems, both of a linguistic nature and in explaining the differences in legal systems, trade practices, etc. Nevertheless, an increasing number of direct import agreements are being established.

Back to back factoring

6.17 Back to back factoring is a very specialised form of international factoring, used when suppliers are selling relatively large volumes to a few debtors for whom it is difficult for IF to cover the credit risk. It could be that the importer is a subsidiary of the supplier or simply that a debtor's financial situation does not warrant the credits that are necessary in that particular situation. In such cases, IF can sign a domestic factoring agreement with the debtor, whereby it will be getting the debtor's receivables as security for the credit line that it has been asked to establish in favour of EF. The mechanics of back to back factoring are illustrated in Annexure ~~XIV~~.

Cost of export factoring

6.18 The price of a factoring service will be established by EF as part of its agreement with the supplier. It will first negotiate the fees due to IF and charge the client a commission covering both its own and IF's dues. Usually, charges (excluding interest on funds advanced to client) vary between 0.5% to 3% of the business handled, depending upon the same considerations as in the case of domestic factoring.

Export factoring in India

6.19 The scope for introduction of export factoring in India has to be examined from various angles, including the following :

(a) Quantum of exports on open account terms.

(b) Need for strengthening export financing services.

(c) Adequacy of the existing arrangements in our country for providing protection against losses in respect of exports made on credit terms.

(d) Cost of factoring services as compared to existing services for finance, insurance, etc.

(e) Scope for bringing about prompt and efficient collection of export outstandings through factoring services.

(f) Whether introduction of factoring services can make a positive contribution to the growth of exports in the country.

(g) If exports are likely to grow because of factoring, sectors/commodities in export trade which are likely to take advantage of factoring services.

(1) Export of Indian goods against Letters of Credit (L/C)

6.20 The analysis of data of goods exported from India on L/C and non L/C terms indicates that 62% of exports during 1986-87 were on non L/C terms, while 38% were on L/C terms. The data on exports on open account terms are not available. Nonetheless, it is noted that Indian exporters predominently ship a large volume of goods (Rs.8466 crores in 1986-87) on non L/C terms. This indicates that if export factoring is introduced in India, it may evoke favourable response from Indian exporters, especially small exporters and new entrants to the export trade who find it ~~xxxxxxxxxxxx~~ difficult to secure L/Cs for their exports.

6.21 Even those exporters who are now able to secure L/Cs for their exports may find export factoring attractive for more than one reason. At times, Indian exporters find resistance from the overseas buyers to provide L/Cs. Further, L/Cs being transaction oriented, are not ideal for repetitive transactions where fast delivery schedules are prescribed. When documents under L/Cs are examined by banks, they apply the doctrine of strict compliance and this makes such transactions less flexible. In such situations, factoring services may be preferable to L/Cs for exporters. The interests of the exporter are protected under factoring also since EF, through its correspondents, checks the creditworthiness of the client's customer, extends credit lines and provides advances against submission of invoices. Factoring is ideally suited to a regular pattern of trading amongst buyers and sellers of goods and services.

(2) <u>Adequacy of existing export financing facility to Indian exporters</u>

6.22 Presently, financial assistance is extended by banks to exporters at pre-shipment, as well as post-shipment stages. The outstanding export credit as at the end of March 1987 aggregated Rs.3279 crores. Credit at the pre-shipment stage is being made available to exporters at the concessive rate of 9.5% p.a., subject to a maximum stipulated period of 180 days. If the shipment is likely to be delayed due to reasons beyond the control of exporters, credit for a further period of upto 90 days could be granted at the concessive rate of 11.5% p.a., subject to prior approval being obtained from RBI. Thereafter, the credit would attract the ceiling rate of interest at 14% to 15.5%

applicable to export credit. These concessions are, however, available only if the pre-shipment credit is adjusted by shipping the goods within 360 days from the date of advance. If such credit remains outstanding beyond 360 days, the entire interest concessions offered during the initial 180 days or 270 days (as the case may be) are withdrawn and the banks charge interest at the ceiling rate on export credit ab initio, i.e., right from the very first day of the advance.

6.23 At the post-shipment stage, in the case of short term export, concessive credit is granted depending upon the tenor of the bill, till the due date of the bill, subject to a maximum of 180 days. Such concession is withdrawn if the post-shipment credit is not adjusted by realisation of foreign exchange proceeds within 180 days of the due date.

6.24 In respect of deferred payment exports, post-shipment credit is available from banks at 8.65% p.a. for credit exceeding one year. In addition to the above, banks grant concessive credit against cash incentives, duty drawbacks, undrawn balances, retention money, etc. according to guidelines of RBI. For granting such concessive credit, banks are provided by Government of India, Ministry of Commerce, interest subsidy at the rate of 3% p.a. wherever interest is appropriately charged at 9.5% p.a. or 11.5% p.a. as the case may be and at the rate of 1.5% p.a. in respect of deferred credit charged at 8.65% p.a. The subsidy is provided from Market Development Assistance (MDA) funds and is subject to stipulations made under Export Credit (Interest Subsidy) Scheme, 1968.

6.25 In addition to arrangement for liberal export credit at lower rates of interest, RBI has evolved a scheme for providing refinance to banks as an incentive for extending more credit for financing the country's export trade.

Presently, the banks are provided export refinance at an interest rate of 9% p.a. to the extent of 100 per cent of the increase in export credit over the monthly average level of such credit for 1986.

6.26 The Exim Bank also has its own medium/long term refinance schemes for exports and banks are free to avail of such refinance from it. However, the banks have to surrender the subsidy claimed by them under Export Credit (Interest Subsidy) Scheme, 1968 to the extent they have availed of refinance from the Exim Bank.

6.27 In the Indian context, keeping in view the concessiona export finance available to exporters through the banking system, the advantages of factoring are not really connected to the financing element but to the complete package of services available thereunder. Further, factoring could be of particular help to small exporters and new entrants to export business.

6.28 If Factors (i.e., independent organisations other than banks) will be financing exports, it will be attractive to th exporters only if it is offered at the concessive rates, as offered by banks. For this purpose, banks may have to be permitted to provide finance to EFs at concessive rates of interest on which subsidy could be provided to the banks. In that case, the Export Credit (Interest Subsidy) Scheme, 1968, will have to be modified suitably for the purpose. This issue would have to be examined by RBI in detail.

6.29 As regards pre-shipment advances, they have to be made available to the exporters by the banks as at present and, therefore, no change in the procedure is contemplated. However, if pre-shipment credit is granted by the banks and post-shipment credit by the Factors, it will have to be ensured that the proceeds of the post-shipment credit granted by the Factors liquidate the pre-shipment credit granted by banks.

(3) Adequacy of existing arrangements for providing credit protection

6.30 The export credit insurance facilities provided by the Export Credit Guarantee Corporation of India Ltd. (ECGC) are very wide ranging and cover practically all the risks that are inherent in granting credit to foreign buyers; these facilities are quite inexpensive. The cost involved in availment of factoring services is likely to be higher than in the case of export credit insurance for one or two reasons. In a factoring arrangement, the services offered are wider than mere credit protection and, as such, the charges involved would obviously be higher. Further, the charges for factoring include the charges payable to IF as, normally, it is necessary to have a Factor in the importing country, who would ultimately be taking the credit risk. On the other hand, ECGC is a Government sponsored organisation, which provides insurance cover at a comparatively low rate of premium as its underwriting policies have an export promotional bias.

6.31 Another aspect to be considered is whether introduction of export factoring services in India would have an adverse impact on the working of ECGC in some measure. Since factoring will be done on a purely commercial basis, in all probability these services will be available to selected buyers and for exports to risk free countries. Thus, Factors will serve only sound export transactions to sound markets and, in the process, a substantial portion of the business that will go to ECGC will be relating to high risk transactions. Consequently, ECGC's own spread of risks will get reduced to its detriment and, as a corollary, ECGC's price for insurance cover may have to increase significantly; this, in turn, would affect the exporters and, resultantly, the business of ECGC itself.

6.32 At present, the service provided by ECGC is essentially one of credit insurance. It does not provide assistance in collection of the amounts outstanding and in the administration of sales ledger. Further, it provides insurance cover to the extent of about 90% of the amount involved, as against 100% protection which would be offered by the Factors. Therefore, under the emerging situation, ECGC may have to expand its package of services to be competitive vis-a-vis the Factors. It is learnt that the Export Credit and Insurance Corporation of Singapore Ltd., whose functions are akin to those of ECGC, itself provides export factoring services. If ECGC also undertakes factoring, it would have a major advantage in that, because of its considerable experience in export credit insurance and the affiliations with other credit insurers from around the world, it can factor sales to all the countries and need not restrict its operations only to countries where there is a corresponding IF. The subject of ECGC undertaking export factoring is further examined in Chapter VII.

(4) Cost of factoring services to exporters

6.33 Whether an exporter would prefer to avail of factoring services or will go in for the traditional method of export financing and credit protection will depend upon the cost to be incurred by him for factoring services. Cost of factoring will be higher where factoring is without recourse than where the facility is offered on with recourse basis. Factors do not, generally, finance receivables without recourse, unless they have full information about the buyer and his country. Factoring without recourse to exporters would be possible only in respect of exports to countries not facing any payments problem. In respect of such exports, the Factor in India would arrange to sell the debt to a Factor in the importer's country. In such a situation, charges of both the Factors would have to be borne by the exporter. In addition, since the two Factors would settle the remittance only through banking channels, some bank charges for effecting remittances would also be payable.

6.34 Costwise, a comparison could be drawn between traditional method of export financing and credit protection (where an export bill is purchased by a bank and proceeds paid to the exporter without waiting for payment by the overseas buyer) and export factoring. The extent to which EF will generally charge the exporter towards commission, etc., has been indicated earlier. The comparative cost for 180 days' export credit under traditional method of export financing (whether shipment is made on L/C terms or non L/C terms) and export factoring would be somewhat as under :

(A) <u>Cost under the traditional method</u>

(a) <u>Shipments made on L/C terms</u>

(i)	Cost of opening L/C to the importer	0.25%
(ii)	Cost of confirming L/C by a bank in India for ensuring payment to exporter without recourse	0.25%
(iii)	Interest for 6 months @ 9.5% p.a.	4.75%
(iv)	Other charges covering postage, collecting bank's charges, etc.	0.25%
	Total cost	5.5%

(b) <u>Shipments made on non L/C terms</u>

(i)	Interest for 6 months @ 9.5% p.a.	4.75%
(ii)	Other charges covering postage, collecting bank's charges, etc.	0.25%
(iii)	Cost of ECGC cover	0.50%
	Total cost	5.5%

It would be seen that the total cost involved works out to be the same irrespective of whether the shipment is made on L/C terms or non L/C terms.

(B) <u>Estimated cost involved in factoring</u>

(i)	Service charge of Factor in India	1%*
(ii)	Service charge of Eactor in importer's country	1%
(iii)	Discount charge for 6 months payable to IF, assuming the bill is drawn in US Dollars (Prime Rate, less 1%)	4.75%
(iv)	Other incidental expenses like bank charges for remittance, etc.	0.25%
	Total cost	7%

*This is an indicative charge. Generally, export factoring organisations overseas levy an all inclusive service charge ranging between 0.5% and 3%.

6.35 A comparison to the total cost under (A) and (B) above would indicate that the exporter would be required to pay about 1.5% extra by resorting to factoring. Nonetheless, exporters may still be willing to go in for export factoring because of the benefits of additional services rendered by the Factor. In addition to providing finance and credit risk protection, EF takes up the task of sales ledger management and debt collection. Exporters, being relieved from risks and administrative problems connected with their exports, could concentrate on increasing their production and export activities. This will add to their profit and they may not mind paying 1.5% to 2% extra charges to the Factor. However, there would be an outgo of foreign exchange by way of charges payable by EF in India to IF abroad in case two-way factoring is resorted to. It is envisaged that, in the long run, such outgo of foreign exchange may get neutralised on account of the premium earned by the Factors in India for providing services of import factoring.

(5) Conclusion

6.36 To sum up, introduction of export factoring in India will certainly provide an additional window of facility to the exporters. Since it will be optional for exporters to seek the services of EF or to go in for existing methods of export financing and credit protection, they will be the best judges to find out as to which facilities will be suitable for them. We need not, therefore, have any reservation in introducing this additional facility. Even if some extra cost will be involved, exporters may still prefer export factoring, in view of availability of additional services like sales ledger management and debt collection. In India, many export businesses may benefit by availing of export factoring services, e.g., businesses developing a new product, businesses developing new markets, businesses that are growing rapidly, etc. Exporters of certain goods/ services like leather, tobacco, machine tools and other engineering items, readymade garments, electronic and electrical goods, computer software, etc., who are comparatively small and many in number, may find the services of export factoring quite attractive.

6.37 On their part, EFs will be willing to service the exporters as realisation performance of Indian exporters as a whole has all along been satisfactory. They need not have the fear that they will be ending up with substantial bad debts of exporters. The data of total exports made from India during the period 1979-80 to 1986-87 and the amount outstanding as percentage to total exports in each year have been furnished in Annexure ~~XV~~ IX. It will be observed therefrom that the percentage of amounts outstanding beyond six months from the date of shipment to the total exports made, hovers around 4%. The position of realisation of export proceeds of shipments made by the Indian exporters is, therefore, sufficiently encouraging for interested organisations to offer factoring services to exporters from India.

Amendments in provisions of FERA 1973, Exchange Control Manual, Procedure for GR Forms, etc.

6.38 In connection with providing factoring services to exporters, certain changes may be required in the existing legal framework, FERA provisions, Exchange Control Manual provisions, etc. The relative issues are examined in detail in the following paragraphs.

6.39 Section 18 of FERA, 1973, provides for control over the proper accounting of the sale proceeds of goods exported from India. Sub-Section 18(1)(a) empowers the Central Government to prohibit export of any goods from India unless the exporter gives an undertaking to receive the full value of goods exported in a prescribed manner and within the prescribed time limit. Such undertaking is given by exporters on the export forms (GR/PP forms) prescribed for that purpose. These forms, with the declaration of exporters, are submitted by them to the Customs' authorities, in duplicate, at the port of shipment. Customs authorities give a serial number on both the copies of the forms and also certify the value declared by the exporter on the forms. The duplicate copy of the form is returned to the exporter who would submit the same again to Customs along with cargo to be supplied. After examination of the goods and certifying the quantity passed for shipment, the original is forwarded to RBI by the Customs and the duplicate copy is returned to the exporter for submission to the Authorised Dealer for negotiation of export documents.

6.40 It is a statutory requirements that an exporter should submit the duplicate copy of the GR/PP form, together with the shipping documents, to the Authorised Dealer, within 21 days from the date of shipment of goods. The duplicate copy of the form will be retained by the Authorised Dealer, till full export value has been realised. When proceeds are realised, Authorised Dealer will forward to RBI the duplicate copy certifying realisation.

6.41 If factoring is undertaken by an Authorised Dealer, no change need be made in the provision/procedure relating to submission of shipping documents for negotiation/collection by an exporter who will be the client of the bank acting as Factor. The only change that will be taking place will be that the exporter will be submitting the duplicate GR/PP form, together with the shipping documents, to the factoring division of the bank which, in turn, will give the shipping bill and the duplicate export forms to the International Division/Foreign Department of the bank for negotiation/collection.

6.42 If the Factor is a subsidiary of a bank or an independent company or an organisation like ECGC, the question that arises is whether they can receive the documents from the exporter and pass them on to an Authorised Dealer. In that situation also no amendments to the existing provisions of Section 18 of FERA may be necessary since the existing provisions of Section 18(8), which reads as under, can take care of the situation:

> "Without prejudice to the provisions of Sub-Section (1), where the Reserve Bank has permitted any authorised dealer to accept for negotiation or collection of shipping documents covering exports from his constituent (not being a person who has signed the declaration in terms of Sub-Section (1)), such authorised dealer shall, before accepting such documents for negotiation or collection, require the constituent concerned also to sign such declaration and thereupon such constituent shall be bound to comply with such requisition and the original declarant and such constituent signing the declaration shall each be considered to be the exporter for the purposes of this section, and shall be governed by the provisions thereof accordingly."

6.43 As per the above Sub-Section, the Authorised Dealers are permitted by RBI to accept, for negotiation or collection, all shipping documents covering exports from their constituents who are not the original exporters and have signed the declaration on export forms. Under this provision, a factoring organisation can accept the shipping documents from exporters, add their countersignature to the export forms and submit them to an Authorised Dealer for negotiation/collection.

6.44 The second question that may arise, in case factoring is to be introduced, is whether an exporter would be absolved of his responsibility of realisation of export proceeds once the bill/invoice is purchased by the Factor on without recourse basis and the exporter is paid, in rupees, the value of the bill/invoice. At present, when a shipping bill is transferred to another party by the exporter and the former submits it to a bank after countersigning the export form as required under Section 18(8) of FERA, the original exporter as well as the party countersigning the export form are responsible for realisation of export proceeds (vide Section 18(8) ibid). The same provision of FERA can be made applicable in the case of export factoring also. Further, if the Factor assumes responsibility for realisation of proceeds of bills/invoices handled by it, a number of complications may arise in enforcing various provisions contained in FERA in case of non-realisation of export proceeds. A Factor will not be caution-listed, nor need the Enforcement Directorate initiate proceedings against it in case the bill/invoice amount is not realised, as taking such an extreme step against EF would adversely affect the growth of export factoring. Hence, the issue may be decided as indicated in the following paragraph.

6.45 As per provisions of Section 18(8) of FERA, both the exporters and EF are liable for repatriation of the export proceeds once the exporter hands over the shipping documents to EF under the factoring agreement. This provision has to be modified by issue of a Notification by RBI under Section 18(8), indicating that, when factoring is done on with recourse basis, the exporter only will be liable for realisation of export proceeds. On the other hand, if the export factoring is on without recourse basis, the exporter will be relieved of the responsibility of realising export proceeds and the responsibility will rest with the Factor alone. However, RBI can be flexible by not taking extreme steps like caution-listing of EF, if export proceeds are not repatriated in such cases. In other words, when the bills are accepted by EF on without recourse basis, they should not be subject to the same type of treatment and penalty by RBI, as in the case of recalcitrant exporters who do not take effective steps for realisation of export proceeds.

6.46 In export trade, exporters have to make remittances outside India on many accounts like commission payments, settlement of quality claims, etc. In addition, the overseas buyers often demand reduction in invoice value before accepting delivery of goods. The question, therefore, arises whether such export claims should be settled by the Factor or the shippers. Even where IF is involved and it pays on behalf of the overseas importers, when a claim is preferred by the overseas importers on grounds of inferior quality of goods shipped, IF will pass on the claim to the Indian EF. Since many exporters will be dealing with EF, it will be cumbersome for it to prefer an application, either to an Authorised Dealer or RBI, for remittance of export claims in respect of various shipments made by its exporter clients. Therefore, it will be preferable if exporters continue to have the responsibility of settling export claims even if the bills/invoices are handled by the Factors. This is also the practice in other countries where commission remittances have also to be arranged by exporters and not by EF.

6.47 No change in the procedures to be followed for booking forward cover for exports with Authorised Dealers will be necessary if exporters obtain forward cover for the shipments to be made with them, even when the bills/invoices are to be factored by EF. If exporters do not obtain forward cover, but EF wants to enter into a forward contract with a bank in respect of the export bill/invoice factored by it or if the forward cover first obtained by an exporter has to be transferred in favour of EF due to the former approaching EF for factoring the export bill in respect of which forward cover was initially taken by it, such a facility should be available to EF so that it may not be exposed to exchange fluctuation risk. For this, the existing exchange control provisions regarding forward contracts for exports contained in Chapter 7 of the Exchange Control Manual would have to be suitably amended. It may also be mentioned that although EFs will be factoring export receivables, it is not necessary to permit them to operate in the interbank exchange market for this purpose.

6.48 If export factoring is introduced in India, there will be a need for uniform rules to provide a legal framework within which EFs have to operate. In that event, it is suggested that India may ratify and accept the Unidroit Convention on International Factoring, which is reproduced in Annexure XVI. Once this Convention is adopted, EFs in India should abide by the various rules contained therein while dealing with different parties abroad. Similarly, it would be beneficial for EFs to join one of the international chains of Factors, which lay down the guidelines ensuring smooth operations amongst its members.

CHAPTER VII

EXPORTERS AND FACTORING

7.1 As has been mentioned in the previous chapter, the relevance of L/Cs is on the decline in the international trade and, instead, the buyers are increasingly inclined to place orders with those who are willing to sell on open account terms. In this respect, the exporters from India would be at a disadvantage as compared to their counterparts in other countries as, on the one hand, they may experience difficulty in obtaining bank finance/ECGC cover for such sales and, on the other, when buyers do not pay, they may run into difficulties for not ensuring repatriation of export proceeds. While some information about such potential buyers could be gathered by the exporters through ECGC, the uncertainty would persist and, if there are delays in responding to the buyers' enquiries, the business may be lost to a competitor.

7.2 It will be noted that the Group is in favour of extending the factoring services to exporters in India, notwithstanding the fact that they are currently being extended credit at concessional rates by banks and ECGC provides the cover for the risks involved. This is primarily because it is felt that the existing arrangements do not appear to be adequate to meet the exporters' requirements in the current and emerging situation. To step up exports, which is the primary need of the hour, the exporters have to look for additional markets for the products which are already being exported and to find markets for other products. In both these areas, they have to compete with exporters from other countries which are exporting the same commodities.

7.3 Also, manufacturers in advanced countries are looking to India for providing a low cost manufacturing base for producing goods which may either be exported to third countries or to their own countries under buy-back arrangements. Besides, India provides them with a huge market for selling their products. The EFs supporting the exporters from these countries would be looking for the services of Factors in India to serve as IFs and, in turn, such Factors in other countries would expect EFs from India to offer them opportunity to serve as corresponding IFs.

7.4 In view of the above stated international trade opportunities, there is need for parties involved in the transactions to have reasonable freedom of choice from among various factoring agencies in India. Moreover, the experience of advanced countries where several financial instruments are being continually evolved to meet the needs of market compulsions indicates that the growth of exports in a country is aided by the multiplicity and quality of financial services, available to an exporter to choose from.

7.5. The Group has examined the question of the suitability of organisations for undertaking export factoring keeping in view the above aspects but, mainly, the interests of the exporters. It is recognised that, while availing of factoring services, the exporters would expect the continuance of the concessions and facilities which they are currently enjoying in regard to both credit availment and credit protection. Further, it has to be ensured that, on the one hand, an element of competition prevails among factoring organisations and the exporters are provided with a choice and, on the other hand, there is no excessive competition, particularly as the volume of business under export factoring may not be substantial.

7.6 Among the various organisations which have been dealing with exporters, banks and ECGC appear to be more eminently suitable for handling export factoring. Because of their considerable experience in financing exports/imports, dealing with the related documents and handling the foreign exchange transactions arising therefrom, banks through their subsidiaries/associates would be ideally suited for undertaking factoring of international trade of India. They have the advantages of having a vast network of branches and sufficient resources. At the same time, ECGC has the experience of several years in assessing the risks like credit risk, country risk, etc. involved in international trade and has built up information on numerous buyers spread throughout the world. The Group is of the view that besides the bank(s) sponsored Factors, ECGC or an organisation sponsored by it may be permitted to undertake export factoring, if they so decide on commercial considerations. It will, however, be necessary for the new organisation to seek approval of RBI to undertake export factoring business and also to function as IF.

7.7 In Chapter IV, the Group has indicated, in detail, a model for extension of factoring services domestically through linkages between the sellers, Factors and banks and the benefits likely to accrue therefrom to the sellers of goods and services. It is envisaged that appropriate linkages could also be arranged for ensuring that the exporters not only continue to receive finance and credit protection without any additional cost, but can also avail of the other services provided by a Factor. Such linkage could be on two models - under one model, ECGC would provide all the services expected from EF, except the financing service, which would be provided by bank(s), while under the other, the bank(s) sponsored Factor would provide all the services required, including credit protection, the finance being provided by bank(s).

7.8 In this connection, ECGC has represented that, as an export credit insurance organisation of long standing, it has the requisite expertise in buyer risk underwriting and country risk assessment, has built up records on more than 70,000 buyers all over the world and has developed mutually beneficial relationship with affiliates and agencies abroad. Further, in the process of effecting recovery of proceeds of exports in respect of which claims have been paid by the Corporation, it has been involved in the collection of debts. As far as maintenance of sales ledger is concerned, ECGC is of the view that this function does not require special expertise and could be easily organised by it. As such, instead of the banks undertaking export factoring either directly or through their subsidiaries/associates, the banks can provide export finance as at present and ECGC can provide credit insurance protection to the extent of 100%, instead of 90% as at present, and the other factoring services as required by the exporters. The exporter can get the transactions factored in respect of approved buyers and the post-shipment advances extended by a bank in respect of those transactions would stand guaranteed fully. ECGC's view is that, in such an arrangement where export factoring in the country is exclusively left to be handled by ECGC and finance being taken care of by the banks, the exporters, both big and small, will get the benefit of factoring services and a distortion in the premium structure and the resultant higher incidence of insurance cost in respect of ECGC's normal credit insurance business can be averted. Further, as far as the banks are concerned, they would stand protected to the extent of 100% without any cost to them. ECGC's view is that, if such a model for a linked approach is not adopted and the banks (or their subsidiaries/associates) are also asked to undertake full-scale export factoring, it will have an adverse impact on the risk portfolio of ECGC and would disturb the present insurance arrangement that has been beneficial to the exporting community, particularly the small exporters, in terms of reasonableness of cost, flexibility and range of insurance protection.

7.9 The Group has carefully considered this proposal. It agrees that ECGC has the capabilities to start functioning as a Factor (excluding provision of finance) without much difficulty or prolonged start-up period. It is also likely that the comparatively low cost of insurance cover provided by ECGC may induce the exporters to prefer the first of the two models mentioned above. The Group too, would commend to exporters the availment of the factoring services from the ECGC, in view of the lower cost advantage. However, the Group, at the same time, believes that an element of competition is absolutely necessary for ensuring that the exporters are always provided with satisfactory service and the exporter should be able, in an environment of competitition, to make his own choice and decision regarding the Factor whose services he will avail of. While it is true that the volume of business would be rather limited, at least in the initial years, this situation (the proportion of export factoring to total turnover including domestic factoring of any factoring organisation even in the advanced countries is very small, indeed) is not peculiar to India and with the expected growth in both imports and exports of the country, there is scope for more than one organisation to handle this business.

7.10 As pointed out by ECGC itself, it already has requisite experience, a data bank and established relationship with agencies and affiliates abroad. This, in the view of the Group, gives it an edge over banks as it could start factoring business within a short period, while banks will take a fairly long time as they would only be taking up export factoring after they are established in the domestic factoring market. Exporters, being already familiar with ECGC and its services, too, would feel confident of approaching ECGC for availing of its export factoring services. With an early start-up, backed by proven good service, ECGC would enjoy the advantages of a pioneer and first-mover in the field of international factoring and need not, therefore, apprehend any threat or challenge from later entrants.

7.11 The issues discussed in the previous paragraphs need also to be examined from the point of view of the Factors proposed to be set up. They, too, should have the choice and freedom of undertaking export factoring as soon as they are in a position to do so. The Group's understanding is that no Factor in the West restricts itself to only domestic factoring. In fact, a strong inducement or perceived challenge for starting the activity of factoring for any organisation is also to exploit the opportunities offered by international factoring. The Factors set up in India cannot be denied fulfilment of this aspiration and challenge. Also, they should be in a position to meet the reciprocal expectations of Export Factors in other countries, referred to in paragraph 7.3. The approach, in our view, should be towards more and more internationalisation of our financial services and agencies, to meet the needs of international trade and markets and towards integration of our tools and techniques with the financial systems of the world, which are tending to be characterised more and more by liberalisation and competitiveness. By reason of these larger policy considerations, too, the Group is not in favour of any restriction being placed on the suggested bank-sponsored Factors.

7.12 The Group is of the view that with the recently announced liberalised export-import policy, the volume of international trade in the country is bound to pick up in the coming years. At this juncture, export factoring services will greatly relieve the exporters of collection tasks, allowing them to devote attention singularly to improving the competitiveness of their products. In particular, small businesses which are developing a new product or new markets and are growing rapidly, are likely to find services of export factoring particularly attractive. As such, steps should be taken for introduction of export factoring services concurrently with the extension of such services for domestic sales. Incidentally, the officials of international organisations, such as, Unidroit and Factors Chain International, whom certain members of the Study Group had the privilege of meeting during their trip abroad, are also keen to see India emerging as a nation offering both export and import factoring services.

(Shri R.Vijayakrishnan, Regional Manager, ECGC, a member of the Study Group, wishes the Group to record that he is still of the view that ECGC should be exclusively entrusted with the responsibility of offering factoring services with such tie-up arrangements with the banks as the ECGC may like to have, for the reasons put forward by ECGC. To this extent, he dissociates himself from the conclusions of the Study Group.)

CHAPTER VIII

OTHER IMPORTANT ISSUES

8.1 Apart from certain specific issues like the need and scope for factoring organisations in India, the nature of their constitution, extension of factoring services to exporters and required legal framework, the terms of reference of the Study Group require it to make recommendations on other matters directly related to the issue of introduction of factoring services also. Some such matters are discussed in this Chapter.

(1) Effectiveness of factoring services

8.2 Some of the respondents to the Group's questionnaire, while conceding that factoring services do have a role to play in ensuring prompter payment of dues by buyers, have expressed doubts about its effectiveness in the Indian conditions. Some of them wonder whether the follow-up by Factors would have more impact than the follow-up currently being done by banks or by the sellers themselves or their agents. Another apprehension expressed was that if the Factors were to be more persistent and/or to adopt more compelling methods, the buyers might consider placing orders with other suppliers who may not engage Factors for collection of their receivables and this was particularly likely to happen in industries where a large number of suppliers keenly compete with each other for orders.

8.3 While these apprehensions appear to be genuine, it is to be noted that factoring is not intended as a mere follow-up of receivables. It envisages a system whereby an expertise would be provided in the total management of receivables of a supplier, apart from financial assistance. It encompasses all aspects right from the stage of deciding whether to give credit to a buyer or not, to determining the size of the credit limit, maintaining watch on buyers' financial solvency, sales ledger management, timely follow-up, developing an information system and advising on market conditions. The Group feels that the presence of Factors in the chain of debt collection would, therefore, be welcomed by all concerned in course of time.

8.4 It is also felt that many buyers may not have reservations about the follow-up measures of professional bodies like Factors; on the other hand, they may prefer to deal with Factors, rather than with a number of suppliers or their agents, some of whom may be inclined to adopt an unprofessional approach.

8.5 So far as the public sector and larger private sector units, who are the buyers, are concerned, the Group believes that they too would respond more favourably to approaches of Factors. The delays on their part in making payments take place due to various reasons, including the need to follow the prescribed procedures. Nonetheless, it is desirable to explore ways and means for ensuring that such delays are minimal. In this context, the Group recommends that Government of India may consider introducing legislation requiring Government agencies, public sector undertakings and others to pay interest for delays (beyond a specified period) in payments for supplies made to them, on the lines of the legal framework in some of the countries abroad and such legislation may also cover factored debts.

(2) <u>Need for educating business community</u>

8.6 As mentioned earlier, factoring is a totally new concept in our country. As such, there is a need for creatin an awareness among prospective users of these services. If their advantages are properly explained to promoters/manager of business concerns, many among them would consider availing services of Factors. The Group, therefore, recommen that as and when it is decided to promote factoring organisations, the business community should first be informe in detail about the nature and scope of these services and the benefits accruing therefrom. In this regard, the branches of banks could serve as a useful medium for extensive dissemination of information to interested parties. The bank officials, being aware of the problems currently faced by suppliers, would also perceive the advantages of factoring services and convey them to those making enquiries about these services.

(3) Computerisation of factoring operations

8.7 The role played by computers in the growth of factoring business in developed countries and the need for having similar facilities for factoring organisations in India, have been mentioned in Chapter III. The Group notes that the process of mechanisation and computerisation of operations of banks in India has started recently and would take time to become widespread. It is envisaged that within a short period, say after six months or so from commencement of factoring operations, the volume of business offered to Factors could be such that it may be impracticable for them to manually handle the functions expected of them. It is also assessed that substantial business would emerge from smaller units which normally issue a large number of invoices for small amounts and hence the load on Factors would be heavy. In this regard, it may neither be desirable nor practicable for the Factors to stipulate restrictions on the value of each invoice to be tendered to them.

8.8 The Group is of the view that Factors may not be able to extend their services efficiently, effectively and economically without the support of computers, as also quick and dependable means of communication. It, therefore, recommends that, concurrent with the consideration of the various aspects relating to commencement of factoring operations, the promoters should initiate measures for organising a net work of computers/dedicated lines linking their branches/agents in different parts of the country, for accounting and other activities involved in factoring business.

(4) Importance of credit investigation

8.9 The importance of up-to-date information relating to market reputation, financial standing, business prospects, etc. of buyers of goods and services to all those who are dealing or propose to deal with them, need hardly be stressed. At present there are no specialised agencies in India which collect and furnish information on creditworthiness, etc., of various units. In the U.K., the U.S.A. and other industrially developed countries, there are several agencies specialising in collecting and furnishing credit information. Business concerns generally co-operate with such credit investigation agencies in furnishing necessary information and any business concern which does not furnish the data to such agencies would itself be handicapped as suppliers who are unable to assess them may not like to deal with them. The factoring organisations in these countries depend considerably on the information provided by such agencies.

8.10 As mentioned in Chapter II, the arrangements in banks in India for collection and sharing of credit information are not adequate. In the field of credit rating of concerns, a beginning has been made only in the recent past. The Group suggests that the Central Government and RBI should initiate appropriate measures immediately for setting up agencies specialising in credit information collection and dissemination, irrespective of the needs of factoring organisations.

8.11 It is recognised that setting up of such agencies and building up of necessary information would involve considerab time. Hence, initially, Factors may have to rely on such information on clients/customers as could be collected throug banks or other sources. In course of time, Factors themselve should build up data on clients and customers. It may be stressed that availability of complete and reliable information about their clients and their customers would enable Factors to quote competitive prices for different services.

(5) RBI guidelines on bill culture and factoring

8.12 Among other services, Factors would be providing finance against receivables in respect of sales made on open account. In this connection, it is mentioned by some that encouragement to agencies offering these services would run counter to the recent initiatives of RBI for the promotio of bill culture. It is pointed out that it is precisely because of the delays in payment for sales made on open account that larger bank borrowers are required to effect at least 25% of their credit purchases and sales through bills and, over a period, increase the utilisation of bills. Further, it is contemplated that other borrowers should also be covered by such discipline in due course.

8.13 The Group, however, perceives no contradiction in supporting factoring services and RBI's guidelines regarding bill culture. Rather, these two initiatives are to be considered to be complementary to each other in meeting the overall objective of improving the payments system. RBI's instructions on bill financing do not completely rule out credit sales on open account, perhaps, appreciating the need for the suppliers to have such options and flexibility in marketing. In these circumstances, there need not be any hesitation in the concurrent introduction of factoring services, particularly as the Factors would be providing varied services and not only financing services.

(6) Forfaiting

8.14 In the financial systems of the developed countries, a wide range of facilities are available to finance international trade. One of the facilities is Forfaiting, which means encashing future receivables now (at a charge). The seller prefers immediate cash and, in the process, forfaits/ surrenders his rights or claims to payments which he would otherwise have received in future. In these countries, Forfaiting is being increasingly undertaken by banks to finance deferred payment exports.

8.15 Under this arrangement, the Forfaiter discounts bills of exchange/trade papers/promissory notes covering book debts arising out of exports on deferred payment terms. The Forfaiter purchases the claims from the exporter (seller) on a non-recourse basis and assumes the risks involved in international lending. The importer (buyer) arranges for an unconditional, irrevocable and freely transferable guarantee from any reputed bank or financial institution towards payment of bills of exchange, etc. In case of default, the Forfaiter has recourse to the guarantor for payment. The Forfaiter, after discounting the bills, etc., may wait till maturity thereof for payment or rediscount them in the secondary market.

8.16 Forfaiting is generally used for high value export transactions, where payment is spread over a period of time (e.g., capital goods, turnkey projects). As the volume of such exports from India is growing, it merits consideration as an additional method of financing, particularly as it also involves provision of credit protection.

8.17 Most Forfaiters operate in both the primary and secondary markets, i.e., besides purchasing trade debts from exporters, they also buy and sell forfaited trade papers from each other. As,at present, a strong secondary market is not operating in India, the Group is of the view that it will take a long time before Forfaiting can develop in India. In due course, nevertheless, it could be extended as an additional service by commercial banks/ Exim Bank/ECGC.

8.18 The Study Group has not examined the subject of Forfaiting in depth as it does not constitute a part of factoring but is an allied service extended to exporters.

CHAPTER IX

THE LEGAL FRAMEWORK

Introduction

9.1 The absence of a developed body of law in India governing factoring business in the modern sense, has been recognised as a handicap in the development of such business as and when it is taken up. At the same time, in the absence of demand from business interests so far, there has been no pressure on the legal system to consider requisite change and innovation.

9.2 The legal framework in which factoring business can be done with confidence must provide the following :

(i) define the rights, liabilities, duties and obligations of the parties involved, in a clear and comprehensive manner, so that the parties can plan their affairs with certainty ;

(ii) be supportive of the transactions and procedures involved, so that they may be undertaken and completed simply and inexpensively.

9.3 Viewed against the above requirements, the relevant Indian law, at present, does not completely and comprehensively deal with the various aspects involved in factoring business.

9.4 Basic to the operations of the Factor, is the effective conferment of a right on the Factor to collect the debts factored by it. Any financial involvement of the Factor depends on how far the legal framework gives support to it in the procedures involved in acquiring such a right and its enforcement. The legal framework must clearly establish not only the rights, inter se the Factor and the client (seller), but also the rights, inter se the Factor and the customer (debtor), and clearly deal with the effect of the actions of the client and the customer which may be opposed to the interests of the Factor. In other words, factoring business cannot develop unless the Factor is certain of what its rights are under the given legal framework so that it may judge for itself how best it should deal with the parties and the transactions concerned, to protect its interests.

9.5 Obviously, dealing as it does in the intangible (debt), the Factor does not have 'possession'. It can only have a right to receive the debt in most cases and unless this right is respected and the client and customer are prevented from dealing in such a manner as to defeat the rights of the Factor, there would be very little stope for the growth of factoring business.

The present law

9.6 The relevant Indian Law, at present, is to be found in section 130 of the Transfer of Property Act, 1882, which deals with the modalities of taking over debts which are actionable claims. It provides for a transfer of a debt by executing an instrument in writing. It also provides that, upon the execution of the instrument in writing, the transfer of the debt will be complete and effectual. Notice to the debtor is not necessary to complete the transfer. Upon the execution of such an instrument in writing, the debt vests in the assign At the same time, it is provided that if the debtor deals with the debt (except in cases where he is a party to the transfer or receives express notice of the transfer), such dealing shal be valid as against the transfer. Also, any defence or equity he may have against the creditor prior to receiving the notice of the assignment, will be unaffected by the transfer. In other words, the creditor cannot pass to the Factor a better title to the debt than he has against the debtor. In these respects, the Factor is in a position worse than that of an indorsee of a negotiable instrument who has taken it for consideration and is a holder in due course.

9.7 At present there is no law restricting the introduction of a stipulation in the contract of sale of goods or services that prevents the creditor from transferring or assigning the debt arising out of the sale of goods or services.

9.8 Indian Law, at present, does not have any express rules with regard to priorities between successive assignments of the same debt. On general principles, the assignee who comes in first with an assignment in his favour will have priority over the next assignment. But, in certain circumstances, where the first assignee is negligent and this negligence has led another person to take an assignment bonafide of the same debt later on, the courts have held that the second assignment could take priority over the first assignment.

9.9 One may now turn one's attention to a major stumbling block in the development of factoring business, viz., the incidence of substantial stamp duty that is required to be paid on assignment of debts. The stamp duties are prescribed not by the Union Government but by the States and each State has prescribed its own rates of stamp duty. The stamp duty is ad-valorem, based on the value of the debt assigned. Usually, it ranges from 1% to 2% of the value of the debt and there are no exemptions therefrom. Since the cost of factoring services would go up substantially by reason of the stamp duty involved on the assignments, it would act as a disincentive to the development of factoring business.

9.10 Apart from the above, since a proportion of the debts will not be paid in time and the Factors may be compelled to resort to courts for recovery of the assigned debts, it seems necessary to give some measure of legal support for quicker recovery of factored debts also.

Suggested legal framework

9.11 In view of the inadequacies noticed in the existing legal framework, the necessity to promote legislation to take care of the weakness in the existing system and to support the establishment of efficient and viable factoring organisations becomes obvious. The various aspects which may be covered by the proposed legislation are discussed below.

(1) Assignment of debts

9.12 If a Factor is utilised by the client only for the purpose of helping it to collect its debts, there is no need for the Factor to take an assignment of the book debts. In such cases, it would be acting merely as the agent of the client. But the attraction for factoring lies not merely in the help the Factor renders in quickening the process of collection, but also in the services that it offers in terms of credit protection and finance. It becomes necessary for the Factor to be in a position to collect the debts in its own right to secure its financial commitment. In such cases, the Factor must necessarily take an assignment of the book debts of the client. Once it takes an assignment of the book debts, the Factor becomes entitled, in its own name and to its own account, to collect and receive the book debts and deal with the proceeds in the manner agreed to between the Factor and the client. The existing provisions of section 130 of the Transfer of Property Act are quite adequate insofar as they require that an assignment is to be made by an instrument in writing.

(2) Stamp duty

9.13 On the question of stamp duty on the instrument of transfer, the single most important action that is required is to completely exempt stamp duty on assignments of book debts, perhaps not generally but specifically for assignments in favour of a Factor. The various States may be requested to remit the stamp duty in the interest of trade and business. Since, at present, no factoring business is done in India, remission of stamp duty would not result in any loss of existing revenue to the States. Therefore, there should be no disincentive for the States to remit the stamp duty. In countries where factoring has taken roots, assignments do not attract stamp duty and, where it does, exemptions have been granted for cases where the value of the transaction is not very large. In the U.K., stamp duty has been exempted for transactions where the debt is not more than £10,000.00.

9.14 Till such time assignments in favour of Factors are exempted from stamp duty, Factors can consider reducing the risks involved in not taking an assignment by offering only a collection service and credit protection without laying out funds before maturity. If the selection of the client, customer and the quality of debts has been made with appropriate care, it can be assumed that the Factor may not have to resort to legal action, except in a very small percentage of debts factored. In these cases, the Factor could take an assignment after actual maturing of the debts, using the power of attorney already executed in its favour by the client for this purpose. However, it must be conceded that this is not an entirely satisfactory arrangement from the Factor's point of view. It should also be mentioned, in this context, that prudence would dictate that, in the initial periods, especially when a Factor is setting up its business, it should do sizeable financing of receivables on with recourse basis and should continue to do so until it has built up good information base (industry, clients and debtors wise), developed expertise and generally gained sufficient experience. In fact, in the advanced countries, considerable factoring business, in the initial years of the factoring services, was, indeed, carried out on a with recourse basis.

9.15 Another approach would be to make a special statutory provision that, on receipt of a notice from the Factor that it has agreed to factor a debt, the debtor will not get discharge for the debt except by payment to the Factor, unless otherwise agreed to by the Factor. The effect of this provision would be that although the Factor is not entitled to take legal action to recover the debt in the absence of an assignment in its favour, the debtor is effectively prevented from paying it to any person other than the Factor. The Factor, if it does not receive payment on the due date, can take an assignment in its favour without the fear of its rights being defeated by a subsequent dealing between the debtor and the client. The merit of this approach is that assignments are taken only in respect of debts which are not paid on due date and, therefore, the total incidence of stamp duty on the Factor is considerably reduced and, at the same time, it remains protected till assignments are effected. It needs to be emphasised here that the approaches indicated are but expedient measures and if factoring is to be encouraged because of a felt need, there is no clear or satisfactory alternative to exemption from stamp duty being granted to assignment of receivables, at least in favour of factoring organisations. It is my opinion ~~We urge~~ that Governments should address themselves to this measure urgently, once it is decided that factoring services need to be introduced into our country. If, however, complete remission of stamp duty is not acceptable it may be considered for assignments upto a specified amount (say, upto Rs.2.50 lakhs) or for sales from units from specific sectors (like the SSI sector).

(3) <u>Notification to debtor and priorities</u>

9.16 As already stated, the existing law does not require the assignee (Factor) to give to the debtor notice that it has taken an assignment of the debt. But notice becomes necessary to prevent the debtor paying the debt to the client or to a subsequent assignee and also enables the Factor to claim the payment of the debt in its own right on the basis of the assignment. If stamp duties on assignments are waived, notice of assignment can be given by the Factor as a matter of course as soon as it 'approves' a debt for factoring. The procedure is simple and inexpensive. No further statutory support is necessary for the purpose. However, the question of priorities between successive assignments still remains. To remove any possibility of the priority of the first assignment in favour of the Factor being defeated, the proposed legislation could provide that subsequent assignments shall, in no event, have priority over the first assignment in favour of a Factor. A system of filing notice of the agreement between the Factor and its client (seller) in a central register, to be maintained by an appropriate statutory authority, may also be provided so that, before taking an assignment of a book debt, the intending assignee may verify from such register whether a prior factoring agreement exists. Since the strict rule of priority for the first assignment will be applicable only to assignments in favour of a Factor, only the few factoring organisations that come up will be filing notices and, therefore, there would not be much of an administrative burden in operating the filing system.

(4) Clog on factoring

9.17 A contract for the sale of goods or services can stipulate that the debts arising out of the sale cannot be assigned by the seller. Hence, a 'powerful' buyer may be able to insist on such a stipulation and effectively deny the seller the advantages of factoring. The proposed legislation could, therefore, provide that any such stipulation in the contract shall be of no effect. Article 9 of the Uniform Commercial Code in the U.S.A. incorporates such a provision.

(5) Support for realisation of debts through court action

9.18 There is very little scope for special support to Factors with regard to legal proceedings in courts for recovery of debts. But, to the extent that it is not quite clear that summary suit procedures are available for recovery of assigned debts, the Civil Procedure Code may be amended to clarify that factored debts can be recovered by resort to summary procedure under Order 37 of the Code.

9.19 The Order 37 provides for a summary procedure in respect of certain suits of negotiable instruments, viz., suits upon bills of exchange, hundies and promissory notes, suits in which the plaintiff seeks to recover a debt or liquidated damages in money payable by defendant,with or without interest The essence of a summary suit is that the defendant is not, as in an ordinary suit, entitled as of right to defend the suit. He must apply for leave to defend within 10 days from the date of the service of the summons upon him and such leave will be granted only if the affidavit filed by the defendant discloses such facts as the court may deem sufficient for granting leave to the defendant to appear and defend the suit. If no leave to defend is granted, the plaintiff is entitled to a decree. This Order is confined to superior courts (i.e., High Courts, City Civil Courts and Courts of Small Causes and other courts as specified by a High Court by notification in the official Gazette). The object underlying the summary procedure is to prevent unreasonable obstruction by a defendant who has no defence.

(6) Impact of money lending legislation

9.20 That part of the Factor's business which involves financing the seller, will be affected by the existing legislation on money lending in the various States. These legislations generally provide for a licensing system for money lenders, a specified system of accounting, furnishing of statements of accounts to the borrower and also restrictions on the rate of interest that may be charged on advances/loans. The State legislations, however, generally give power to the State Governments to exempt certain categories of transactions and/or certain categories of lenders. It will be necessary to persuade the State Governments to grant exemptions to Factors from their respective money lending legislations. The fact that factoring business would be allowed to be carried on only with the approval of RBI should help in the Factors getting the necessary exemptions.

(7) Regulation of factoring organisations

9.21 In the context of total lack of factoring facilities at present in India, it is clear that, apart from improving the existing legal framework as indicated above, certain developmental efforts are necessary for facilitating establishment of factoring organisations. To direct development of factoring on healthy lines, certain amount of legal regulation to restrict entry into factoring business seems necessary. The need for adequate financial resources, knowledge of trade and industry and skills in assessing the financial position of clients and their customers and the track records of buyers, should be the major eligibility criteria in determining the suitability for undertaking factoring business. Mushroom growth of factoring organisations without the necessary prerequisites would be detrimental to the economy and add fresh problems. Public interest would be protected by a system requiring licensing of Factors. Further, the appropriate authority should be legally empowered to give necessary directions to Factors in respect of minimum capital requirements and raising of deposits from the public, as well as in the general conduct of their business. Confidence in factoring as a major contributor towards speeding up the payments system will be enhanced by licensing and regulation, I ~~We~~ consider that RBI would be the appropriate authority for the purpose.

<u>Conclusion</u>

9.22 There is no disputing the fact that full factoring service, if properly conducted, will relieve managements of business units in industry or trade, whether in the small, medium or large sector, from the burdensome tasks of controlling/monitoring the credit which they grant to the customers, as well as collection of debts and, at the same time, provide financial assistance and protection against bad debts. Thus, these services are perceived as a viable management aid for the growth of such units on sound lines. But an efficient financial system, like factoring service, can sustain itself on a viable basis only if a conducive environment is created and fostered. ~~The Study Group,~~ so I hope that ~~therefore, urges that~~ expeditious steps ~~may be~~ taken by the Government of India to promote special legislation, as also to grant appropriate exemptions from and make amendments to the existing Laws referred to earlier in the Chapter, to subserve the objectives stated in earlier paragraph ~~9.2~~ above.

CHAPTER X

SUMMARY

Background

10.1 Purchasers of goods and services are often delaying the payments therefor, resulting in working capital problems for the suppliers, particularly the smaller ones. RBI has, therefore, taken several measures to alleviate the difficulties of the suppliers. Banks have, however, not been effective in implementing these measures because of operational constraints. As the extension of factoring services was perceived by RBI to be one of the measures which could assist in expediting collection of dues, it constituted, in January 1988, a Study Group to examine the feasibility and mechanics of starting factoring organisation(s)in India (paragraphs 1.1 to 1.3).

Composition and terms of reference

10.2 The Group, headed by Shri C.S. Kalyanasundaram, former Managing Director of State Bank of India, comprised senior officials from commercial banks, financial institutions, Government of India and RBI, as also a senior academician, having extensive knowledge in the fields of banking and finance. The terms of reference for the Study included consideration of need and scope for one or more factoring organisations in the country, the nature of their constitution, whether they should be in public, private or joint sector, the changes in legal framework that would be necessary for promoting factoring business, feasibility of extension of factoring services to exporters and other matters relating to factoring (paragraphs 1.4 and 1.5).

Methodology

10.3 The Group constituted a Committee each to look into specific areas of (a) demand assessment and feasibility, (b) legal issues and (c) factoring for exports. Further, it made extensive references to text books and write-ups in periodicals, etc., on the subject. It also solicited the views, on various aspects relating to the subject, from bankers, representatives of trade/industry associations and organisations and others, through written responses, to a comprehensive questionnaire devised by the Group and holding meetings with them at representative centres in the country. A team, comprising the Chairman, the Convenor and the Chairman of the Committee on Export Factoring, also visited a few developed countries for discussing conceptual, practical and legal issues relating to domestic and international factoring (paragraphs 1.6 to 1.10).

Concept and types of factoring services

10.4 The Group gathered that factoring services as a tool for assisting the suppliers in the matter of financing and collection of receivables is being extensively and increasingly used in several economically developed countries during the last three decades, although these services have been offered in one form or other since the nineteenth century in a few countries. Modern factoring involves a continuing arrangement under which a financing institution assumes the credit and collection functions for its client, purchases his receivables as they arise (with or without recourse to him for credit losses, i.e., customer's financial inability to pay), maintains the sales ledger, attends to other book keeping duties relating to such accounts receivabl and performs other auxiliary functions. The various services offered by Factors for domestic sales are of six types, viz.,

(i) Full Factoring, (ii) Recourse Factoring, (iii) Maturity Factoring, (iv) Advance Factoring, (v) Undisclosed Factoring and (vi) Invoice Discounting (paragraphs 2.14 to 2.16 and 2.27 to 2.33).

10.5 So far as international trade is concerned, it is customary to use a two-factor system whereunder there is an Export Factor and an Import Factor. Under this arrangement, while the Export Factor will provide financing and other services as required by the exporter, the Import Factor will undertake the credit assessment of importers, establish credit lines on them wherever possible, undertake control of receivables and take whatever steps that are necessary to collect outstanding dues. Recourse factoring, direct export factoring, direct import factoring and back-to-back factoring are some of the different variations of factoring services available to exporters (paragraphs 6.8 to 6.17).

Need for factoring services in India and assessment of demand therefor

10.6 Taking all the relevant aspects into account, the Group believes that there is sufficient scope for introduction of factoring services in India, which would be complementary to the services provided by banks. The Group is also of the view that the introduction of export factoring services in India would provide an additional facility to exporters (paragraphs 2.35 and 6.36).

10.7 There was sufficient indication from respondents that suppliers from different sectors would welcome factoring services. Since banks are already financing domestic receivables and providing credit against export receivables at concessional rates, many suppliers may prefer to avail of only one or more of the other services (i.e., administration of sales ledger, credit protection and collection of dues) offered by Factors, while continuing to avail of finance from banks. While quantification of the demand has not been possible, it is assessed that it would grow sufficiently so as to make factoring business a commercially viable proposition within a period of two/three years (paragraphs 3.2 and 3.3).

10.8 On the export front, it is perceived that there would be a fairly good availment of various services offered by Export Factors, as the exports from India on non L/C terms are as, much as about 60% of total exports. Even those exporters who are now able to secure L/Cs may find export factoring attractive as L/Cs, being transaction oriented, are not ideal for repetitive transactions. Also, there is growing resistance from overseas buyers to provide L/Cs (paragraphs 6.20 and 6.21).

10.9 With a view to attaining a balanced dispersal or risks, Factors should offer their services to all industries and all sectors in the economy. However, care has to be taken to ensure that the new institutions acquire an in-depth knowledge of the working of industries concerned before assuming the risks (paragraph 3.12).

Pricing of various services

10.10(i) The pricing of various services by Factors would depend on various aspects, such as, creditworthines of the customer, his track record, quality of portfolio, turnover, average size of invoices, etc. However, the base level would depend on the various costs to be borne by the factoring organisation, the most important element being the cost of funds (paragraphs 3.19 and 3.20).

(ii) Factors should attempt a mix from among the various sources of funds to keep the cost of funds as low as possible, in any case not exceeding 13.5% p.a. so that a reasonable spread is available. Since Factors will be competing with banks in financing receivables, they will have to charge their clients a rate not higher than that charged by banks (paragraph 3,21).

(iii) RBI may consider allowing factoring organisations to raise funds from the Discount and Finance House of India Ltd., as also other approved financial institutions, against their usance promissory notes covering receivables factored by them, on the lines of revised procedure under Bills Rediscounting Scheme (paragraph 3.22).

(iv) The Group is of the view that the price for the financing services would be around 16% p.a. and the aggregate price for all other services may not exceed 2.5% to 3% of the debts serviced (paragraph 3,25).

Organisational set up

10.11(i) Different views as regard to the number of factoring organisations, as also who should be their promoters, were placed before the Group. In the Group's opinion, in the beginning only select promoter institutions/groups/individuals with good track record in financial services and competent management should be permitted to enter into this new field (paragraphs 3.27 and 3.28).

(ii) As regards the coverage of industries/sectors by such organisations, it has been suggested that initially the organisations may be promoted on a Zonal basis, say, one each for North, East, South and West. Such an arrangement would obviate the necessity of each organisation having an all-India network (paragraph 3.29).

(iii) The Group is also of the view that there are distinct advantages in the banks being associated with handling of factoring business. Apart from the fact that they have considerable experience in financing and collection of receivables, they also have access to credit information on both sellers and buyers; besides, their large network of branches, as also availability of sufficient financial resources, would provide additional advantages to them (paragraph 3.33).

(iv) There was divergence of views on whether factoring business should be handled by banks departmentally or through their subsidiaries. Taking into account various dimensions of the problem, the Group is of the view that subsidiaries or associates of banks are ideally suited for undertaking this business. Initially, it would be desirable to have only four or five organisations which could be promoted, either individually by the leading banks or jointly by a few major banks having a large network of branches (paragraphs 3.34 to 3.36).

(v) Factoring activities could perhaps be taken up by the proposed Small Industries Development Bank of India, preferably in association with one or more commercial banks (paragraph 3.36).

Educating business community about factoring

10.12 Factoring being an entirely new concept, the Group recommends that as and when it is decided to promote factoring organisations, the business community should first be educated about the nature and scope of these services and the benefits accruing therefrom. In this regard it perceives that the branches of banks would serve as a useful medium for extensive dissemination of information (paragraph 8.6).

Mechanisation of factoring operations

10.13 Factors cannot extend their services efficiently, effectively and economically without the support of computers, as also quick and dependable means of communication. Therefore, concurrent with consideration of various aspects relating to commencement of factoring operations, the promoters should initiate measures for organising a network of computers/dedicated lines linking the branches/agents in different parts of the country for accounting, follow-up, remittances and other activities involved in factoring business (paragraph 8.8).

Credit investigation

10.14 Up-to-date reliable information relating to market reputation, financial standing, business prospects, etc. of parties engaged in buying and selling of goods and services is of utmost importance; however, at present there are no specialised agencies in India which collect and furnish such information, as are operating in industrially developed countries. Hence, the Central Government and RBI should initiate appropriate measures immediately for setting up such specialised agencies, irrespective of the needs of the factoring organisations. Till such agencies become fully operative, Factors may have to rely on such information on clients/customers as could be collected through banks or other sources, notwithstanding their limitations (paragraphs 8.9 to 8.11).

Linkages between banks and Factors

10.15 Since it is envisaged that the suppliers will be able to obtain financial services from both banks and factoring organisations, it is necessary to provide for proper linkages between banks and Factors. Thus, there should be arrangements whereunder banks and Factors furnish to each other information relating to parties which approach more than one agency. It is also envisaged that there could be a three party tie-up, the debt being assigned to Factors by suppliers and the former borrowing from banks. Alternatively, the supplier would borrow from bank(s) and avail of debt protection, collection and sales ledger management services from a Factor. Besides, there are other areas also in which banks and Factors should collaborate for better working capital management, in view of specialised knowledge, skills and contacts of the Factors. Such collaborative effort could help in prevention of sickness in units (paragraphs 4.6, 4.7, 4.10, 4.15 and 4.16).

SSI units and Factoring

10.16 SSI units have been facing constraints in their operations on account of inadequacy of working capital caused by delays in receiving payments for their supplies. A large number of SSI units is managed by their promoters and/or persons with technical orientation who are unable to pay continuous attention to the areas of debt collection, accounting and working capital management. By and large, such units do not have an organisational set-up and/or expertise in the area of credit management to attend to follow-up and recovery of dues from buyers (paragraphs 5.3 and 5.4).

10.17 SSI units perceive that Factors, with their systematic, specialised and professional approach, would be in a position to assist them in debt collection. The credit protection services of Factors would entitle them to be assured of payment on a fixed date, as also protection against customer's default (paragraph 5.5).

10.18 As regards financing of receivables, while Factors would provide another source of finance to SSI units, they cannot be expected to offer finance at concessive rates, as is presently being done by banks to eligible units. For continued availment of concessive finance, linkage between banks and Factors is suggested (paragraphs 5.6 and 5.7).

10.19 While the potential demand for factoring services from the SSI sector is estimated to be sizable, it would take some time before this demand could crystallize. In this connection, the Group considered the question of reservation of a specific percentage of total business of Factoring organisations for SSI sector, to give an initial boost to factoring for this sector. In its view, this may not be desirable, especially in the initial stages, as it could endanger the factoring organisations' commercial viability. Moreover, as factoring develops, such reservation may not be necessary at all(paragraphs 5.10 and 5.11).

10.20 The Group is of the view that factoring for SSI units could prove to be mutually beneficial to both Factors and SSI units and Factors should make every effort to orient their strategy to crystallize the potential demand from this sector (paragraph 5.12).

Export Factoring

10.21 The advantages of export factoring are not really connected to financing element, but to the complete package of a Factor's services. In view of the availability of concessional export finance by banks, financing by Factors will only be attractive if offered at concessive rates. For this, Factors will require finance from banks at concessive rates on which subsidy will have to be provided to the banks. Besides, the Export Credit (Interest Subsidy) Scheme, 1968, will have to be modified suitably. This issue needs examination by RBI in detail (paragraphs 6.27 and 6.28).

10.22 If pre-shipment credit is granted by banks and post-shipment credit by Factors, it will have to be ensured that the proceeds of the post-shipment credit granted by the Factors liquidate the pre-shipment credit granted by banks (paragraph 6.29).

10.23 Introduction of export factoring in India will certainly provide an additional window of facility to the exporters. Further, the position of realisation of export proceeds of shipments made by the Indian exporters is sufficiently encouraging for interested organisations to offer factoring services to exporters from India (paragraphs 6.36 and 6.37).

10.24 In case factoring is to be introduced, the question arises whether an exporter would be absolved of his responsibility of realisation of export proceeds once the Factor pays to the exporter the value of the bill/invoice factored by it. In this regard, in terms of Section 18(8) of FERA, 1973, both the exporters and Export Factors would be liable for repatriation of export proceeds. This provision has to be modified suitably by RBI, indicating that when factoring is done on 'with recourse' basis only, the exporter will be liable for realisation of export proceeds. When export factoring is on 'without recourse' basis, the responsibility will rest with the Factor alone. However, in the latter case, if export proceeds are not repatriated, RBI may not caution-list Export Factor and/or report the matter to the Enforcement Directorate, as is done in the case of exporters who fail to ensure repatriation of proceeds (paragraphs 6.44 and 6.45).

10.25 If factoring is introduced in India, Factors will need uniform rules to operate in the international market. It is suggested that India may ratify and accept the Unidroit Convention on International Factoring. Similarly, it would be beneficial for Export Factors to join one of the international chains of Factors (paragraph 6.48).

10.26 The Group is in favour of extending the factoring services to exporters in India, notwithstanding the fact that they are currently being extended credit at concessional rates by banks and ECGC provides the cover for the risks involved (paragraph 7.2).

10.27 Among the various organisations which have been dealing with exporters, banks and ECGC appear to be more eminently suitable for handling export factoring. The Group is of the view that besides bank(s) sponsored Factors, ECGC or an organisation sponsored by it, may be permitted to undertake export factoring. Any such organisation, however will have to seek approval of RBI to undertake business c. export/import factoring (paragraph 7.6).

10.28 For ensuring that the exporters continue to receive finance and credit protection without any additional cost and, at the same time, avail of other services provided by Factors, there could be suitable linkages between the concerned agencies. In one such model, ECGC would provide all services expected from an Export Factor, except the financing service, which would be provided by bank(s), while under the other model the bank(s) sponsored Factor would provide all the services, including credit protection, the finance being provided by bank(s) (paragraph 7.7).

10.29 ECGC has represented that if banks (or their subsidiaries/associates) are also asked to undertake full scale export factoring, it will have an adverse impact on the risk portfolio of ECGC; besides, it would disturb the present insurance arrangement in terms of reasonableness of cost, flexibility and range of insurance protection. It has, therefore, suggested that ECGC alone may provide credit protection (to the extent of 100%) and other services excluding finance, which may continue to be provided by bank(s). However, the Group believes that an element of competition is absolutely necessary for ensuring satisfactory services to the exporters and they should have the opportunity to make their own choice and decision regarding the Factor whose services they will avail of (paragraphs 7.8 and 7.9).

10.30 In view of its experience, data bank it has built up and relationship with agencies/affiliates abroad, ECGC could start factoring business within a short period, while banks will take a fairly long time before they commence export factoring. This position gives ECGC an edge over banks. Besides, being familiar with ECGC and its services, exporters too, would feel confident of approaching ECGC. It, therefore, need not apprehend any threat or challenge from banks, which would be later entrants (paragraph 7.10).

10.31 With the expected growth in international trade, exporters, particularly the smaller ones, are likely to find services of export factoring attractive. As such, steps should be taken for introduction of export factoring services concurrently with the extension of such services for domestic credit sales (paragraph 7.12).

Legal Framework

10.32 Government of India may consider introducing legislation requiring Government agencies, public sector undertakings and others to pay interest for delays (beyond a specific period) in payment for supplies made to them, on the lines of legal frame-work in some of the countries abroad and such legislation may also cover factored debts (paragraph 8.5).

10.33 Indian law does not, at present, comprehensively deal with various aspects involved in factoring business. As such, it would be necessary to promote special legislation to support the establishment and operations of efficient and viable factoring organisations (paragraphs 9.3 and 9.11).

10.34 To enable a Factor to be in a position to collect the debts in its own right, it must take an assignment of book debts of clients. Existing provisions of section 130 of the Transfer of Property Act, 1882, are quite adequate to protect the interests of the Factor (paragraph 9.12).

10.35 To make factoring economically viable, it is essential that assignment of book debts in favour of a Factor are exempted from stamp duty. Various States should, therefore, be requested to remit the stamp duty; since no factoring business is being done currently in the country, remission would not result in any loss of existing revenue to the States. If, however, complete remission of stamp duty is not acceptable, assignments upto specified amount or sales from specific sectors, may be exempted from such duty (paragraphs 9.13 and 9.15).

10.36 Notice of assignment becomes necessary to prevent the debtor paying the debt to the client or a subsequent assignee and also enable the Factor to claim the payment of debt in its own right. If stamp duties on assignment are waived, notice of assignment can be given by the Factor as soon as it 'approves' the debt for factoring; for this purpose, no further statutory support is necessary (paragraph 9.16).

10.37 As regards priority between successive assignments, it must be provided through specific legislation that subsequent assignments shall, in no event, have priority over the first assignment in favour of the Factor. A system of filing notice of the agreement between the Factor and its client in a central register, to be maintained by an appropriate statutory authorit may also be provided (paragraph 9.16).

10.38 An influential buyer could insist that the contract with the supplier should contain a stipulation to the effect that the supplier cannot assign the debts due by the buyer. Hence, it may be provided, through legislation, that any such stipulation shall be of no effect (paragraph 9.17).

10.39 To direct development of factoring on healthy lines, there is a need for a system of regulating the entry of entrepreneurs who would be keen on starting factoring business, prescribing norms about their minimum capital requirements and extent of deposits which could be raised by them from the public and for monitoring their operations. In the Group's view, RBI would be the appropriate authority for framing and implementation of the relevant regulations (paragraph 9.21).

10.40 The Civil Procedure Code may be amended to clarify that the factored debts can be recovered by resort to summary procedure under Order 37 of the Code in terms of which the defendant is not entitled, as of right, to defend the suit, which he can do in the case of ordinary suits (paragraphs 9.18 and 9.19).

10.41 As financing by Factors will attract the provisions of the legislation on money lending in various States, it will be necessary to persuade the concerned Governments to grant necessary exemptions therefrom to factoring organisations (paragraph 9.20).

10.42 An efficient financial system, like factoring service, can sustain itself on a viable basis only if a conducive environment is created and fostered. The Study Group, therefore, urges that expeditious steps may be taken by Government of India to promote legislation, as also to grant appropriate exemptions from and make amendments to the existing Laws, to subserve the objective of promoting factoring (paragraph 9.22).

ANNEXURES

ANNEXURE - I

RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY

NOTIFICATION

Constitution of a Study Group for examining introduction of 'factoring services' in India

The difficulties experienced by industrial units, particularly those in the small scale sector, in collecting payment for the supplies made by them to various purchasers from both the public and private sectors are well-known. In this regard, suggestions have been made to the effect that to partially alleviate the problems of suppliers, one or more 'factoring' organisations may be set up in the country so that the 'factors' would purchase the book-debts of the suppliers and thereby ensure that they get timely payment for their supplies. As this matter requires to be considered from various angles in depth, it has been decided to constitute a Study Group to examine the feasibility and mechanics of starting 'factoring' organisation/s in the country and making recommendations regarding its/their constitution, organisational set-up, scope of activities and other related matters.

2. The Study Group will be headed by Shri C.S. Kalyanasundaram, former Managing Director, State Bank of

India and will have the following members*:

1. Shri P.S.Gopalakrishnan,
Chairman,
Indian Overseas Bank.

2. Shri V.Mahadevan,
Deputy Managing Director,
State Bank of India.

3. Dr.A.C.Shah,
Executive Director,
Bank of Baroda.

4. Shri J.V.Shetty,
Executive Director,
United Bank of India.

5. Shri S.A.Kamath,
General Manager,
Union Bank of India.

6. Prof. Sampat P.Singh,
Member of Faculty,
National Institute of Bank Management.

7. Shri M.C.Satyawadi,
Joint Secretary,
Ministry of Finance.

8. Shri G.P.Gupta,
General Manager,
Industrial Development Bank of India.

9. Shri R.Vijayakrishnan,
Assistant General Manager,
Export Credit Guarantee Corporation of India.

10. Shri R.Srinivasan,
Legal Adviser,
Reserve Bank of India.

11. Shri O.P.Sodhani,
Controller,
Exchange Control Department,
Reserve Bank of India.

12. Shri T.K.K. Bhagavat, CONVENER
Chief Officer,
Industrial & Export Credit Department,
Reserve Bank of India.

3. The terms of reference for the Study Group will be as under:

(a) To consider whether in the Indian financial system there is need and scope for one or more factoring organisations to effectively alleviate the problems faced by suppliers of goods and services in receiving payments therefor within a reasonable period.

(b) If there is scope for such organisations, to examine approximately how many of them need to be established and what should be their constitution?

(c) To suggest whether these organisations should be in public or private or joint sector or in all these sectors?

(d) To examine whether any changes need to be made in the present legal framework to promote factoring business; if yes, on what lines?

(e) To consider the feasibility of extension of factoring services to exporters.

(f) To make recommendations in respect of any other matter directly related to the issue of introduction of factoring services.

4. The Secretariat of the Study Group will be in the Reserve Bank. The Group should endeavour to submit its report within a period of six months.

Sd/-
R.N. MALHOTRA
GOVERNOR
20th January 1988

*(Note: Shri N.Raghunathan, Additional Secretary and Development Commissioner (SSI), Ministry of Industry, Government of India, joined the Group as from 29.2.1988)

ANNEXURE - II

Names of members of the Committees of the Study Group

(a) Demand Assessment Committee

1. Dr.A.C.Shah, Executive Director, Bank of Baroda, Bombay.	Chairman
2. Shri V.Mahadevan, Deputy Managing Director, State Bank of India, Bombay.	Member
3. Prof. Sampat P.Singh, Member of Faculty, National Institute of Bank Management, Pune.	"
4. Shri S.A.Kamath, General Manager, Union Bank of India, Bombay.	"

(b) Legal Committee

1. Shri R.Srinivasan, Legal Adviser, Legal Department, Reserve Bank of India, Bombay.	Chairman
2. Shri S.A.Kamath, General Manager, Union Bank of India, Bombay.	Member
3. Shri J.Radhakrishnan,* Chief Law Officer, State Bank of India, Bombay	"

(c) Committee on Export Factoring

1.	Shri O.P.Sodhani, Controller, Exchange Control Department, Bombay.	Chairman
2.	Shri R.Vijayakrishnan, Assistant General Manager, Export Credit Guarantee Corporation of India Ltd., Bombay.	Member
3.	Shri A.R.Barve,* General Manager, State Bank of India, Bombay.	"
4.	Shri V.Ananthkrishnan,* Chief Executive, Foreign Exchange Dealers Association of India, Bombay.	"
5.	Shri S.Bhattacharya,* Deputy Manager, Export-Import Bank of India, Bombay.	"
6.	Shri G.P.Muniappan,* Joint Controller, Exchange Control Department, Reserve Bank of India, Bombay.	"
7.	Shri R.C.Rai,* Joint Chief Officer, Industrial & Export Credit Department, Reserve Bank of India, Bombay.	"

* Members who were co-opted to the Committees.

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ANNEXURE - III

Questionnaire

A. For banks, trade/industry bodies and other organisations

I. EXPERIENCE:

There are serious problems with regard to collection of book debts. In the light of your experience, what type of problems in this area are actually faced by industrial units, particularly in the Small Scale Sector, which make it difficult for them to operate successfully?

Can you substantiate your observations with specific cases or instances? Kindly furnish one or two cases or instances.

II. FINANCE-EXISTING SET-UP:

We can divide the management of book debts into the following three broad areas:

a) Financing of book debts.
b) Collection of book debts.
c) Losses arising out of bad debt write-offs following defaults.

From your experience, knowledge and perception, please indicate what are the problems in the following areas:

- Availability of adequate finance for book debts.
- Ability to collect book debts in a reasonable time, say 30 days, or such credit period as is agreed to be extended.
- Necessity for write-offs and their extent as a percentage of the sales value.

Kindly also let us know in rough percentage terms the relative weightage you would like to assign to these three problems areas. In other words, how effectively and efficiently are credit departments of units organised to cope with the probl they may face.

III. FACTORING:

Do you think provision of a new financial service in the form of Factoring in our country would help solve this problem? In this connection,

* Would you like this service to be mainly in the form of Financing or Collection Agency or an Insurance Cover against book debts or any combination of these three services?

* Insofar as collection of book debts is concerned, would you like this Agency to take over collection of book debts either 'with recourse' or 'without recourse' to the principal?

* At present, we can think of four possible agencies to offer this service:

  1) Do you think a financial institution like IDBI will be best suited to provide this service to the Indian business and industry?

  2) Do you think the major commercial banks of the country could provide this service through their branches under the present set up?

  3) Do you think the banks should do this job but through a separate subsidiary?

  4) Do you think that it will be best to open this field only to the private sector and new companies could be promoted to provide this financial service as well as a few other related services?

Do you think introduction of Factoring would mean additional cost to business and industry?

Do you think that the additional cost will be more than justified by additional benefits accruing to the corporate sector?

What, in your judgement, would be a reasonable rate of charge at which a Factor should take over book debt collection of 'A' class company on the basis of 'without recourse'?

. DEMAND

There may be various types of companies dealing with ifferent types of customers and working under different conomic as well as industry conditions. Keeping this in mind, ould you specify what type of companies would like to avail f this service immediately?

hat type of companies you think may later on like to avail f this service after it gets going?

n your estimate, how much is likely to be roughly the demand or such a service in our country in the immediate feature?

(Please elaborate by way of a detailed note)

ould you kindly give a rough figure for the total volume f book debts coming to the Factoring Agency/Agencies.

. STRATEGY:

o you think it will be advisable to think in terms of mmediately providing Factoring service to the corporate ector on an ambitious scale with a view to covering almost very industry?

Or, would you suggest that such a service should first be introduced and prove its efficacy in specific industries/ trade or should be confined to one or two services, before being extended to other areas, build-up more of business based on its success and promotion of further new service?

Do you think it would be advisable to provide some incentives to encourage the promotion of this service in the country? If so, please elaborate.

VI. <u>LINKAGE WITH PRESENT BANKING FACILITY</u>:

Factoring service may include or exclude financing of book-debts. This means, the banking system would not provide finance against book debts if the Factor provides the same.

Do you think the banks could tie-up with the Factoring Agency and indirectly provide finance through them? Please specify what type of relationship would serve best to link the present banking system to the proposed Factoring Agency?

VII. What legal difficulties or constraints do you anticipate in operating an efficient and viable factoring organisation in India today?

What changes, if any would you consider necessary in the existing legal frame work for the purpose?

VIII. Should Factoring services be extended to exports also? If so, what type of services would be expected by exporters?

For individual trading/
<u>industrial units</u>

How do you assess the credit worthiness of your customer?

What relative information do you seek and from what source? How do you up-date this information?

Do you fix any monetary credit limits for each customer? How often do you review these?

Do you follow a formal system or you go about assessing your customer's credit-worthiness on the basis of trial and error?

What proportion of your total turn-over is on credit terms? What are generally the credit terms? Is it determined in relation to each customer or is there a pattern of credit terms in your trade? If so, can you elucidate?

Do you draw Bills of Exchange on your customer or you sell on open account? What proportion of your customers accept bills? Are these DA or DP bills? If both, what is the share of each?

What is your experience of payment of bills on due date?

What proportion of your credit sales are bad debts? How do you provide for the bad debts? Do you think you should have an insurance-cover against debt defaults? How much cost of such insurance-cover you will be willing to bear if such a cover is available to you?

Do you think your credit-sales-management could improve if you were to avail of the services of an outside agency for this? Do you think your debt-collection could also improve if you avail services of an outside agency? How much cost for such services are you prepared to pay?

As a percentage to credit sales, can you quantify the cost of your in-house credit-administration and losses on account of bad debts?

How do you, at present, finance your credit sales? Do you build in your price the interest element for the credit period? How do you cope up on this count when the debt is not paid on the due date?

12. Do you see delayed payments by your debtors as a major problem in your business? What incentives are offered to minimise debt-defaults?

13. Do you think a factoring organisation can solve the problems in this area? Can you reason out your response? What price would you be prepared to pay if the factoring organisation could offer you prepayment of your trade debts?

ANNEXURE - IV

Particulars of meetings held by the Study Group members with invitees

Date	Venue	Participants
15.4.1988 Morning	Reserve Bank of India, Bombay	Representatives of public sector banks/all-India financial institutions from Western India
Evening	"	Representatives of major foreign banks
21.4.1988 Morning	"	Representatives of bodies representing trade/industry and state level financial institutions from Western India.
Evening	"	Eminent individuals in the field of economics, financial management, banking, etc.
29.4.1988 Morning	State Bank of India, Local Head Office, New Delhi	Representatives of public sector banks/all-India financial institutions from Northern India
Evening	"	Representatives of bodies representing trade/industry from Northern India
6.5.1988 Morning	United Bank of India, Head Office, Calcutta	Representatives of public sector banks/all-India financial institutions from Eastern India
Evening	"	Representatives of bodies representing trade/industry and certain organisations from Eastern India
10.5.1988 Morning	Indian Overseas Bank, Madras	Representatives of banks from Tamil Nadu and Kerala
Evening	"	Representatives of bodies representing trade/industry and certain organisations from Tamil Nadu and Kerala

11.5.1988 Morning	State Bank of India, Local Head Office, Bangalore	Representatives of banks/ state level financial institutions from Karnataka and Andhra Pradesh
Evening	"	Representatives of bodies representing trade/industry from Karnataka and Andhra-Pradesh

ANNEXURE - V

Summary of discussions held abroad by the sub-group of the Study Group

A sub-group consisting of Shri C.S. Kalyanasundaram, Chairman of the Group, Shri O.P. Sodhani, Member and Chairman of the Committee on Export Factoring and Shri T.K.K. Bhagavat, Convener of the Group visited a few foreign centres and had an interface with the organisations directly handling factoring business and those which are indirectly associated with it. A list of organisations with whom meetings were held is enclosed to this note. In the following paragraphs, a gist of the issues raised and responses at these meetings is furnished.

Issue No.1

Whether the factoring organisation(s) should be bank sponsored organisation(s) or can also be independent of any such linkage ?

Response

Factoring in Western countries evolved over a period to meet the felt needs of the market operators. The predominent characteristics, therefore, assumed different shapes in different countries, though in basic form it retained the characteristic of being an instrument of service support and financial intermediation. Factors' ability to gather adequate information about the clients and their customers, as also the industry, was a critical element in the growth of factoring. While in the U.S.A., the growth of factoring business was industry specific, in the U.K. and Europe, factoring grew as an information-based service system.

During this evolutionary process, a number of small operators came in the market but business volumes handled by each of them were not very large. The real growth of factoring business came about essentially when commercial banks came into the field during 1950-60. A large number of these small operators could not make a mark and were either taken over by the banks or merged with the factoring organisations set up by the banks. For example, Ifitalia, the biggest factoring organisation in Italy, has controlling interests in over 50 factoring organisations which operate as separate entities but have the backing of Banca Nationale Del Lavoro (BNL), the largest commercial bank of Italy. The process of mergers with and acquisitions by the banks in the U.K. and the U.S.A. has given banks strong factoring arms, which have grown in size and coverage with the support of the parent banks during the last quarter century or so.

There are a few distinct advantages for all concerned where a Factor is supported by a bank :

(i) Banks could make available to their factoring arms funds at the same cost as to their own branches. The Factor, thereby, is freed from the problems of raising funds. With the parent bank's support, Factors are able to offer financial services to the clients at a cost which is at par with the financial services offered by the bank.

(ii) The parent bank's image helps the Factor in building business credibility and connections.

(iii) Credit information is readily shared to the mutual advantage of the parent bank and the Factor.

For factoring services, the concerned staff should have an orientation quite different from the banks but as the basic skills required are, by and large, the same, there is an advantage in being a bank's associate.

Rosenthall & Rosenthall, a U.S.A. based factoring organisation, is an exception to the general pattern. It has maintained its ownership status totally independent of any bank and, yet, has grown impressively through the years. Its strength is its versatility.

Issue No.2

What services does a Factor offer ?

Response

In what is known as 'old line' factoring or 'full factoring', the Factor -

(a) runs the sales ledger for the clients,
(b) takes responsibility for the collection of debt,
(c) provides the cover against debt default and
(d) provides funds for the debts assigned to it.

While a Factor should offer full range of services to the clients, there are, generally, clients who do not need full factoring. A cash-rich client does not need funding services. A client selling to buyers of high standing may not need 'without-recourse' factoring. A large client organisation may have its own highly efficient collection set-up and, therefore, may not need the collection services but may be in need of improving its cash flows. It is of essence that the Factor should identify the needs of the client and evolve its package of services which may include all or only some of the services listed above, such that factoring is perceived by the client as relevant to his business.

In the U.S.A., Factors perceive their role much beyond full factoring as described above. As Rosenthall and Rosenthall put it, they 'live with the client'. While the major area of operation is trade receivables' financing, through full factoring or a variant thereof, according to the needs of the clients, the Factors are also willing to provide facilities for opening L/Cs by the clients against their confirmation. They also provide to the client information on prospective buyers to facilitate market thrust. In certain circumstances, finance for acquiring inventories is also made available, i.e., financial assistance is provided even before a receivable is generated. Financial counselling is another important service that the Factors provide. In the U.K., however, the line between factoring and banking services are clearly drawn but with in-house association with the banks, it is rarely that the client is left to fend for himself. While nowhere Factors perceive their role as providers of rehabilitation assistance, a client with the support of a Factor, is generally able to secure a more efficient management of his working capital which, in turn, helps in prevention of sickness.

In the U.S.A., even though information base on the buyers is strong, Factors still operate in a very narrow product range (essentially textiles, wearing apparel, leather products, etc.), though they are now slowly moving to other lines also. In the U.K., the product range covered is much wider and essentially all growth oriented product lines are covered. In Italy, also, the spectrum of products covered is very wide.

If the Factor is able to get adequate data on its clients and customers and if it also has the grasp of their line of business, it is much better placed to take the risks. Its ability to approve the credit limits enhances with the information base. The importance of building information base was recognised by the Factors in the U.K. and Europe very early, which enabled them to take up commitments in other lines of business, besides the traditional lines of textiles and wearing apparel. It must be emphasised that the Factor builds the information base not only on clients/customers but, through intimate dealings, also builds a useful data bank and industry profile. This gives it the clout in financial fields which it uses to its advantage as also to the advantage of its clients. It is pertinent to note that the computer and telecommunication facilities available in these countries are of great help to Factors.

Issue No.3

In setting up a factoring organisation, should one first build a strong set up in domestic factoring before venturing into international factoring ?

Response

Generally, Factors have earned their business experience in domestic factoring which they have usefully and effectively utilised in the international field. Thereafter, like in all other business areas, market compulsions prevailed. In the U.S.A., imports constitute a very significant part of the total trading turnover; for example, Manufacturers Hannover Trust, started its factoring operations as an Import Factor. In international trade, importers and exporters are located at long distances. If the information available on the importer or the importing country is not adequate, a Factor's ability to assess the risk is restricted. It, therefore, essentially depends on the Factor as to how effectively the information base is organised. If a Factor can build a strong organisation and establish effective linkages with foreign markets, it can and should take up international factoring with the same ease as domestic factoring. A Factor cannot for long remain as an Export/Import Factor alone, as any Factor abroad collaborating with it, would do so in the expectation of receiving reciprocal business. All the same, a newly set up factoring organisation will be well advised to gain some experience and organise itself on sound lines before commencing international factoring.

With the technological improvements in the area of telecommunications, the world has become a small market place and, therefore, gathering of information is comparatively much easier. Even then, the type of business with which factoring business should be started would essentially depend upon -

(a) the felt needs of the market,

(b) assessment of the Factor and the priorities set by it,

(c) the Factor's ability to organise and mobilise the sources of information on the clients/customers and

(d) the Factor's grasp of the lines of business of its clients, its organisational strengths, its linkages with the parent body, etc.

Issue No.4

How is the eligibility of clients and customers determined? What is the screening process ?

Response

Factors generally base their assessment of the value of the prospective client's business on the following criteria :

(a) credit standing,
(b) sales turnover,
(c) average size of invoice, and
(d) debt collection experience.

Factors look for large volumes of business so that the costs and risks are widely spread. In fact, even if a Factor does not feel comfortable with the risks vis-a-vis the customer, it can still provide to the client debt collection and sales ledger management services which are essentially fee-based. They even provide with-recourse factoring or invoice discounting. In these areas, Factors are generally able to operate with greater flexibility than the commercial banks. In handling with-recourse factoring or invoice discounting, the Factor would have to make an assessment of risks vis-a-vis the client,on the same basis as a bank would do vis-a-vis the borrower. It may, therefore, be necessary for a Factor to insist on an acceptable security in such situations.

For screening the customers, Factors predominently rely on the published financial data. Besides, they meet the prospective customers and interview them to assess their strengths and weaknesses. Services of credit information agencies are also availed of but, since the data gathered through such agencies is generally structured, Factors do collect additional information on the customers from banks. Market reports on major buyers' record of invoice payments is also obtained. Where the amounts involved are not very large, the screening processes are faster and simpler compared to cases where high-value commitments are involved, where the screening process is generally more elaborate. While the Factors are generally liberal in fixing the credit limits for the customers (as they base their judgement not only on the basis of their financial strengths but also on their invoice-payment record), Factors are generally selective in choosing their clients. Suppliers of goods with established names attract buyers who would not like to default or delay the payment of invoices in the interest of maintaining supply lines free from irritations. This is the Factors' best insurance against losses. Factors, being specialists in debt collection, generally maintain close contact with the customers. Unless they are alert, they may not be able to pick up signals in time.

Issue No.5

What are the aspects taken into account while quoting the price for different services ?

Response

The Factors take into account the following :

(a) Risk involved (assessed on the basis of information).
(b) Volume of business.
(c) Average size of client's portfolio.
(d) Number of invoices.
(e) Value of each invoice.
(f) Cost of funds.

The prices quoted, however, differ from client to client.

Issue No.6

What risks do the Factors cover ?

Response

Factors cover only the risk of debt default arising out of buyers' insolvency or financial inability to pay, 100% cover is provided where the Factoring is on notification basis. Where the customer is notified of debt assignment, 100% cover is provided, but where it is on non-notification basis, cover is provided only upto 80%. Defaults occuring on account of commercial disputes between the parties are not covered by Factors.

While factoring business is done predominantly on without-recourse basis, with-recourse factoring is not uncommon. In this connection, two situations may be highlighted. If the buyer of goods and services is an eminent party, with a good record of prompt payments, the supplier would generally be unwilling to bear the cost of without-recourse factoring. He may, all-the-same, need the debt collection and sales ledger management services, as also financial support to improve his cash flow. Factors, in such situations, offer with-recourse service. The other situation involves buyers with poor record of payments. In either case, the Factor makes the pre-payment of the invoices to the supplier. It, therefore, assumes the same risk vis-a-vis the client that a lending banker takes vis-a-vis the borrower. In such situations, it is not unusual for a Factor to ask for security by way of charge on assets (other than book debts) belonging to the clients and even personal guarantees. With-recourse factoring also assumes the form of discounting of invoices, drawn on the buyers by a Factor. In this situation also, the Factor assesses the standing of the supplier of goods and the security that he offers.
In case the invoices discounted are not paid when due, recourse is made to the supplier. Financial services so provided are thus

on the same footing as those provided by banks, with the difference that the Factor also provides the additional service of debt collection and sales ledger management, which the banks do not provide.

In international factoring, political risk assumes importance. The Factors Chain International, an international Group for co-ordinating factoring activities, have evolved a scheme to provide such cover to their members. Factors can also cover this risk through organisations like the Export Credit Guarantee Organisation in the U.K.

It is by exception that Factors obtain reinsurance cover through insurance companies. One shape of such cover generally obtained by Factors is to cover the losses beyond a certain amount.

Issue No.7

What documents are obtained for factoring business ?

Response

A master-agreement to assign the present and future book-debts, followed by notification of each assignment to the customer, is generally obtained. In the West, stamp duty has been abolished practically everywhere except in the U.K., where transactions upto a certain amount are exempt. Documentation, therefore, is generally in the form of assignment deeds which involve complete transfer of the ownership of book debts to the Factor.

In the U.S.A., the Uniform Commercial Code provides for a separate mechanism for filing of charges and assignments. With the assignment being registered, every successive assignee of the same book debt takes the assignment, subject to the rights of his predecessor. Competing claims of more than one assignee or third parties can, therefore, be settled with comparative ease. In the U.K., in settling the competing claims, reliance is essentially placed on the notice of assignment to the debtor. In most countries the law of assignment is generally on the lines as it obtains in the U.K. with minor variations, but generally registration of assignment is not prescribed. The usages in different countries differ so widely in this respect that Unidroit has not been able to prescribe any unified approach in their convention. One has, therefore, to be guided in this aspect by the laws of the relative country.

Central Banking authorities in the West do not exercise any direct supervision on the Factors. But where the factoring organisation is sponsored by a commercial bank, statements of affairs of the factoring-arm are also required to be submitted to the supervisory authority. Through this process, indirect supervision is exercised. A view was expressed in many quarters that, if the Factor is not an associate of a commercial bank, there was a case for direct supervision by the Central Banking authorities. This is because Factors are financial intermediates, who deal with public funds and their scale and style of operations can have far reaching impact and implications on the business climate and public morale. However, no restrictions on starting of factoring business are contemplated in any quarter.

In the West, factoring has taken roots as an additional financial and service intermediation. In a sense, therefore, factoring business is complementary to banking business, facilitating more efficient working capital management. Absence of stamp duty or negligible stamp duty has made assignment of debts very convenient. Besides, the legal systems of most Western countries provide for quick and efficient delivery of judgements, making it possible for Factors to resort to legal measures. These legal support systems have significantly contributed to the growth of factoring.

Issue No.8

What procedures are followed by Factors for collection of debts and effecting recoveries ?

Response

Factors, generally, ask the clients to prepare the invoices with a notice printed thereon, indicating the assignment of the invoice to the Factor. These invoices are sent on a daily or weekly basis to the Factor, who accounts for them in the customers' ledger accounts and mails them to the customers. This ensures that all the invoices assigned to the Factor are accounted for. A few days before the maturity date, a reminder is sent to the customer. If any invoice is not paid on the due date, a reminder is sent within a week and a second reminder within a fortnight, if necessary. In the third week after the due date, a telephone call is made. By this time, if the customer does not respond and the invoice remains outstanding, the matter is handed over to a lawyer, who sends legal notice. Some debt collecting agencies/Factors send their debt collectors to the customers to collect the debts and, in extreme cases, even employ strong arm tactics. Majority of the customers pay up by this time but if they have any problems,they are communicated to the Factor. If any customer is in genuine financial difficulties, the Factor discusses the problems with him and provides him the support if it is considered necessary. However, where it is appropriate, suits are filed in county-courts or the courts of summary cases for civil action.

In certain circumstances, Factors do insist on the security of tangible assets and third party guarantees (from the Directors/promoters of corporate entities). This procedure is followed where the Factor's obligation is with recourse. This is also done where the Factor has provided funds before the book debts are created or where it extends, to the customer, financial support to enable him to pay past due invoices. Although this is strictly not a Factor's function, in providing such help to the client it extrapolates its role to that of a financier.

Factoring is generally perceived as a high risk business. This is because even a relatively small percentage of bad debts can erode the margin of profit, which is already narrow. Even marginal delays in collection of debts beyond the due dates can add to the costs. Factors, therefore, keep a tight control on collection procedures.

The administrative services provided by Factors are unique in their nature and range inasmuch as no other intermediary offers such services. The Factor has, however, to keep the prices for these services low, as it has to contend always with comparative cost-effectiveness of such services being organised in-house by clients. A client derives many advantages through availing of these services from a Factor in view of their cost-effectiveness. In these circumstances, it is only appropriate that the Factor looks for high volumes so that the risks are widely spread and, in absolute terms, the fee income is substantial.

In rendering financial intermediation service, the Factor has to compete with banks, though its own cost of funds may not be the same. If the Factor is an associate of a bank, it is possible that the funds support is not only adequate but also at the same cost as to the branches of a bank. This certainly helps the Factor in maintaining a reasonable level of profit. If, however, a factoring organisation is privately owned and has to raise funds in the market, the profit margins would be very low. Survival of a Factor with such low margins would be difficult. In the West, in the initial years of evolution, Factors faced such situations. They had to make many adjustments in order to survive the onslaught of competition. Merger of most of the privately owned factoring organisations with those sponsored by the banks or their take-over by the banks was the result of this process of adjustment for survival.

Issue No.9

What is the relevance of Unidroit to international factoring ?

Response

The International Institute for the Unification of Private Law (Unidroit) was set up at Rome, under the auspices of the League of Nations, with the object of promoting harmonisation of Commercial Laws. In 1974, the Council of the Institute included, within its programme, certain aspects of international factoring, in view of the increasing importance which factoring is assuming as a means of financing small to medium sized business. In many countries, factoring is obliged to operate in the context of a complex legal framework, because of its comparatively recent origin. Factoring essentially has to rely, in most countries, on adaptation of existing laws which most closely relate to its business, as opposed to operating under legislation created to meet its specific needs. Draft rules and conventions drawn by Unidroit are aimed to define the law on factoring in clearer terms and are being increasingly adopted by various nations. Unidroit Convention, adopted in Ottawa in May 1988, covers various aspects viz.,

(a) Notice of assignment.
(b) Discharge of indebtedness by the debtor.
(c) Validity of assignment.
(d) Transfer of rights of the supplier to the Factor and vice versa.
(e) Right of set-off.
(f) Recovery of payments made to the Factor and/or suppliers.
(g) Third party liability.
(h) Transfer of title to receivables between Factors.

It will be a useful exercise to draw on these rules and conventions to redefine in clearer terms the law on assignments and other related areas in India, as well.

Issue No.10

What role is played by Factors Chain International (FCI) and such other bodies ?

Response

In the area of international factoring, the two Factor system is most prevalent. Under this arrangement, the exporter enters into a contract with a Factor in his country and assigns the export related debts to the Export Factor. The Export Factor, in turn, enters into contract with a Factor in the importer's country who is called the Import Factor. The Import Factor obtains the sub-assignment in his favour from the Export Factor and handles these debts in his own right. In order to facilitate the dealings between the two Factors located in two different countries where the local laws and usages and practices may be different, a need for an organisation was felt which could set appropriate business standards for bilateral dealings. FCI, with its head-quarters in Amsterdam (Netherlands), is one such organisation which, has about 90 members operating in over 30 countries. This is a non-exclusive organisation open, in principle, to any company which is providing factoring services. The constitution of FCI lays down the basic requirements for membership and rules of conduct. One basic requirement is that the factoring organisation should be sponsored by a commercial bank and that it should have a minimum equity of US $ 1 million. Members are required to have an active interest in international factoring operations outside their domestic sphere. The main objectives of FCI are -

(a) To set business standards such that the members co-operate bilaterally in export/import factoring transactions.

(b) To assist the members in their efforts to simplify and rationalise the work and routine connected with international factoring business.

(c) To be perceived as a professional association to bring together Factors which do not necessarily compete with each other.

FCI, however, does not itself handle factoring transactions.

International Factors Group is another such chain with a comparatively smaller number of members. This chain also operates, by and large, on the same pattern as FCI. Hellers Group, controlled by Heller Overseas Corporation of U.S.A., is the third important chain operating on similar lines. But the Hellers Group also handles factoring business per se and, therefore, the membership is rather restricted to the associates of the Group. In international factoring business, it adds to the efficacy if a Factor operates through a chain which facilitates correspondent business relationship.

Issue No.11

How can Factors effectively compete with existing agencies dealing with receivables ?

Response

The Factor must organise its package of services such that it can render to its clients services better than any other intermediate. Its survival will, therefore, depend on -

(a) adoption of flexible business philosophies so that the Factor can innovate and provide solutions to the felt needs of individual clients and customers, and

(b) effective use of technological changes which are taking place continually.

Thus, besides the services in the area of credit- sales administration and facilities of pre-payments and credit-cover, the Factor should also be willing to play the role of a friend, philosopher and guide. The Factor is generally the repository of vital information on the financial strengths and weaknesses of the buyers, their payments culture and of data on varied business lines. This information base is its strength, which it can use to the advantage of all concerned. Collecting, collating, storing, retrieving and transmitting this information is crucial to the role of a Factor. A modern day Factor can ill-afford to lag behind in these areas.

Enclosure to Annexure-V

List of organisations abroad with whom discussions were held

Sr. No.	Name of the Organisation	Name(s) of the Executives
1.	International Institute for the Unification of Private Law (UNIDROIT), 00184 Rome, Via Panisperna 28, Italy.	1. Mr. Micardo Monaco - President 2. Mr. Walter Rodino - Secretary General 3. Madam Frederica Mastre - Executive Officer
2.	Ifitalia, Via V.Veneto, Rome - 00187, Italy	1. Mr. De Martino - General Manager
3.	Factors Chain International, Kaizergracht - 559, 1017, Dr., Amsterdam, Netherlands.	1. Mr. Jeroen Kohnstamm - Secretary General
4.	B.V. De Factorij, Factorbedrijf van de Algemene Bank Naderland, Kaizergracht, 641-645, Amsterdam, Netherlands.	1. Mr.P.F.L.Ruijters - Managing Director 2. Mr.J.N.Korse - Assistant Manager
5.	London Forfaiting Co. PLC., International House, 1, St.Katharine's Way, London E1 9UN.	1. Mr.R.Preteceille - Associate Director 2. Mr.David Lilley - Associate Director
6.	Griffin Factors, 70, Pall Mall, London SW17 5EZ.	1. Mr. David A.Barbour - Development Manager
7.	National Westminster Bank, International Banking Division, National Westminster Tower, 25, Old Broad Street, London EC2N 1HQ	1. Mr.A.Derric Plummer T.D. - Regional General Manager 2. Mr. Michael L.Preece - Regional Manager 3. Mr. Derek J.Wilkins - Regional Manager 4. Mr. David A.P.Cooper - Head of Forfaiting Unit

8. Credit Factoring International Ltd., Smith House, P.O.Box 50, Elmwood Avenue, Feltham, Middlesex T13 7QD, U.K.	1. Mr.Robert J.Smith - International Director
9. Barclays Bank PLC P.O. Box No. 259, Fleetway House, 25, Farringdon Street, London EC4A 4LT	1. Mr.G.S.Bedi - Manager, Export Finance 2. Mr.Martin Aspinall - Manager, Forfaiting Unit
10. Barclays Commercial Services Ltd., Arbuthnot House, Breeds Place, Hastings, East Sussex TN34 3DG, U.K.	1. Mr.Philip T. Black - Managing Director
11. Midland Bank Aval Ltd., 135-141 Cannon Street, London EC4N 5AY.	1. Mr. D. Ian Guild - Chief Executive 2. Mr.Andrew T.M. Freeman - Associate Director 3. Ms. Janine R.Barber - Executive Director 4. Mr. Alison J. Elliot - Manager 5. Mr. Simon J. Lay - Manager
12. Lloyds Bank, PLC P.O. Box 19, Hay's Lane House, 1, Hay's Lane, London SE1 2HA	1. Mr. Michael Bendit - Regional Chief Manager
13. Lloyds Bank Export Finance Ltd., 40-66, Queen Victoria Street, London EC4P 4EL	1. Mr. David E. Wills - Director & Chief Manager 2. Mr.T.J.P. Everitt - Assistant Director

14. Alex Lawrie, Beaumont House, Beaumont Road, Banbury, Oxfordshire OX16 7RN U.K.	1. Mr. Barric P. Birch, - Sales Director
15. Midland Bank PLC, International Division 110, Cannon Street, London EC4N 6AA.	1. Mr. Graham Penny - Regional Manager 2. Mr. Brian W.Richards - Manager 3. Mr. Trevor Deave - Manager Global Trade Services
16. Bankers Trust Factors Co., Bankers Trust Company, 1775, Broadway, New York - NY 10019	1. Mr. Fred Hoffman - Assistant Vice President
17. Irving Commercial Corpn., 1290, Ave of the Americas, New York - NY 10104	1. Mr. John D. Cummings - Vice President & Director Marketing 2. Mr. Richard C. Mermer - Assistant Vice President
18. Nixon Hargrave Devan & Doyle, Attorneys at Law, 30, Rockefeller Plaza, New Yorn NY - 10112.	1. Mr. Rajiv Khanna - Attorney at Law and his colleagues
19. Citizens and Southern Commercial Corporation, Factoring Division, 110, East, 59th Street, New York NY - 10022	1. Mr. Michael Bogin - Assistant Vice President 2. Ms. Denise Arbesu, - Factoring Officer
20. Bancboston Financial Co., 2, Pennsylvania Plaza, New York NY - 10121	1. Mr. Lawrence W. Frohnhoefer - Vice President
21. CIT Factoring Group of MHT Co.	1. Mr. Donglas Peckhomar
22. Rosenthal & Rosenthal Inc., 1451, Broadway, New York NY 10036.	1. Mr. Michael J. Rosenberg - Executive Vice President 2. Mr. William G. Smith - Vice President

ANNEXURE - VI

Part I - Names of individuals/organisations which conveyed their views to the Study Group

A. INDIVIDUALS

1. Prof. G.L.Abhyanakar, University of Bombay, Bombay.
2. Shri Jai Arya, Irving Trust, U.S.A.
3. Shri T.A.S.Balagopal, Director(Exports), TELCO, Bombay.
4. Shri M.L.Bagri, Member, SIDF Advisory Board, IDBI, Bombay.
5. Shri R.S.Bhatt, State Bank of India, Consultant, Bombay.
6. Shri Girish Vasudev, Chief Executive, 'Consultaire', Bombay.
7. Shri K.M.Goel, President, Indian Institute of Directors, Calcutta.
8. Shri K.Gopalakrishnan, Data Scan(Pvt.)Ltd., Madras.
9. Shri N.S.Nagarkatti, NICCO, Calcutta.
10. Dr.(Kum.) Kala S.Pant, Consultant, Bombay.
11. Shri B.L.Paranjpe, Senior Adviser, Midland Bank p.l.c., Bombay.
12. Shri Ravi Poddar, IRIDA, Calcutta.
13. Kum. I.T.Vaz, General Manager, DICGC, Bombay.

B. BANKS/FINANCIAL INSTITUTIONS

1. Allahabad Bank, Calcutta.
2. Andhra Bank, Hyderabad.
3. American Express Bank Ltd., Bombay.
4. Bank of America National Trust and Savings Association, Bombay.
5. Bank of Baroda, Bombay.
6. Bank of India, Bombay.
7. Bank of Madura Ltd., Madura.
8. Bank of Maharashtra, Pune.
9. Bank of Tokyo, Bombay.
10. Canara Bank, Bangalore.

11. Central Bank of India, Bombay.
12. Chartered Bank, Bombay.
13. Citi Bank, Bombay.
14. Corporation Bank, Mangalore.
15. Dena Bank, Bombay.
16. Export Credit Guarantee Corporation of India Ltd., Bombay.
17. Export-Import Bank of India, Bombay.
18. Federal Bank Ltd., Alwaye, Kerala.
19. Grindlays Bank p.l.c., Bombay
20. Haryana Financial Corporation, Chandigarh.
21. Indian Bank, Madras.
22. Indian Overseas Bank, Madras.
23. Industrial Credit and Investment Corporation of India Ltd., Bombay.
24. Industrial Development Bank of India, Bombay.
25. Industrial Finance Corporation of India, New Delhi.
26. Industrial Reconstruction Bank of India, Calcutta.
27. Karnataka State Financial Corporation, Bangalore.
28. Maharashtra State Financial Corporation, Bombay.
29. New Bank of India, New Delhi.
30. Oriental Bank of Commerce, New Delhi.
31. Punjab & Sind Bank, New Delhi.
32. Punjab National Bank, New Delhi.
33. State Bank of Bikaner and Jaipur, Jaipur.
34. State Bank of Hyderabad, Hyderabad.
35. State Bank of India, Bombay.
36. State Bank of Mysore, Bangalore.
37. State Bank of Travancore, Trivandrum.
38. State Industrial and Investment Corporation of Maharashtra, Bombay.
39. Syndicate Bank, Manipal.
40. Tamil Nadu Industrial Development Corporation Ltd., Madras.

41. UCO Bank, Calcutta.
42. Unit Trust of India, Bombay.
43. Union Bank of India, Bombay.
44. United Bank of India, Calcutta.
45. Vijaya Bank, Bangalore.
46. Vysya Bank, Bangalore.

C. ASSOCIATIONS REPRESENTING TRADE/INDUSTRY

1. Ahmedabad Textiles Mills' Association, Ahmedabad.
2. All India Manufacturers' Organisation, Bombay.
3. Assam Entrepreneurs' Association, Guwahati.
4. Associated Chambers of Commerce & Industry, New Delhi.
5. Bengal Chamber of Commerce, Calcutta.
6. Bengal National Chamber of Commerce & Industry, Calcutta.
7. Bombay Chamber of Commerce and Industry, Bombay.
8. Calcutta Chamber of Commerce, Calcutta.
9. Confederation of Engineering Industries, New Delhi and Calcutta.
10. Council for Leather Exports, Madras.
11. Engineering Export Promotion Council, New Delhi and Calcutta.
12. Faridabad Small Industries Association, Faridabad.
13. Federation of Association of Small Industries of India, New Delhi.
14. Federation of Indian Chambers of Commerce and Industry, New Delhi.
15. Fertiliser Association of India, New Delhi.
16. Gujarat Chamber of Commerce and Industry, Ahmedabad.
17. Gujarat State Small Industries Federation, Ahmedabad.
18. Greater Mysore Chamber of Commerce and Industry, Bangalore.
19. Indian Cotton Mills' Federation, Bombay.
20. Indian Council of Small Industries, Calcutta.

21. Indian Jute Mills Association, Calcutta.
22. Indian Merchants' Chamber, Bombay.
23. Madras Chamber of Commerce and Industry, Madras.
24. Maharatta Chamber of Commerce and Industries, Pune.
25. Merchants Chamber of Commerce, Calcutta.
26. National Alliance of Young Entrepreneurs, New Delhi.
27. PHD Chamber of Commerce and Industry, New Delhi.
28. Tamil Nadu Small Scale Industries Association, Madras.
29. The Gem and Jewellery Export Promotion Council, Bombay.
30. World Assembly of Small and Medium Enterprises, New Delhi.

D. OTHER ORGANISATIONS

1. Bankers Training College, Bombay.
2. Bureau of Public Enterprises, New Delhi.
3. Cement Corporation of India, Bombay.
4. Cotton Corporation of India Ltd., Bombay
5. Fertiliser Corporation of India Ltd., New Delhi.
6. First Leasing Co. of India Ltd., Madras.
7. Heavy Engineering Corporation Ltd., Ranchi, Bihar.
8. Housing and Urban Development Corporation, New Delhi.
9. National Institute of Bank Management, Pune.
10. Overseas Sanmar Leasing Ltd., Madras.
11. Peerless General Finance & Investment Co.Ltd., Calcutta.
12. Reserve Bank Staff College, Madras.
13. Sundaram Finance Ltd., Madras.
14. Tannery and Footwear Corporation of India Ltd., Kanpur.
15. The Motor and General Finance Ltd., New Delhi.
16. 20th Century Leasing Ltd., Bombay.

ırt II - Names of Individuals/Organisations which did not respond to the questionnaire/ invitation of the Study Group

INDIVIDUALS

Dr.S.K.Chakraborty, Indian Institute of Management, Calcutta.

Prof. O.P.Chawla, NIBM, Pune.

Dr.B.D. Ghonasgi, Department of Commerce, University of Bombay. Bombay.

Dr.R.M.Honavar, Institute of Financial Management and Research, Madras.

Dr.I.G.Kannan, Administrative Staff College of India, Hyderabad.

Shri S.C.Kuchhal, International Management Institute India, New Delhi.

Prof.I.M.Pandey, Indian Institute of Management, Ahmedabad.

Dr.J.C.Sandesara, Department of Economics, University of Bombay, Bombay.

BANKS/FINANCIAL INSTITUTIONS

Andhra Pradesh State Financial Corporation, Hyderabad.

Bank of Rajasthan Ltd., Jaipur.

Delhi Financial Corporation, New Delhi.

Gujarat State Financial Corporation, Ahmedabad.

Hong-Kong & Shanghai Banking Corporation, Bombay.

Kerala State Financial Corporation, Trivandrum.

Mercantile Credit Corporation Ltd., Madras.

Pradeshiya Industrial and Investment Corporation of Uttar Pradesh Ltd., Lucknow.

Rajasthan State Industrial Development and Investment Corporation Ltd., Jaipur.

Societe Generale, the French and International Bank, Bombay.

Tamil Nadu Industrial and Investment Corporation Ltd., Madras.

West Bengal Financial Corporation, Calcutta.

C. ASSOCIATIONS REPRESENTING TRADE/INDUSTRY

1. Andhra Pradesh Small Scale Industries Association, Vijaywada.
2. Apparel Export Promotion Council, Bombay.
3. Association of Indian Automobile Manufacturers, Bombay.
4. Association of Industries, Madhya Pradesh, Indore.
5. Bihar Chamber of Commerce, Patna.
6. Bihar State Small Industries Association, Patna.
7. Cement Manufacturers' Association, New Delhi.
8. Chemical and Allied Products Export Promotion Council, Bombay.
9. Cotton Textiles Export Promotion Council, Bombay.
10. Export Promotion Council for Handicrafts, New Delhi.
11. Federation of Andhra Pradesh Chambers of Commerce and Industry, Hyderabad.
12. Federation of Association of Small Scale Industries of Rajasthan, Jaipur.
13. Federation of Karnataka Chambers of Commerce and Industry, Bangalore.
14. Federation of Punjab Small Industries Association, Ludhiana.
15. Himachal Pradesh Small Industries Association, Solan.
16. Indian Drug Manufacturers' Association, Bombay.
17. Indo-American Chamber of Commerce, Bombay.
18. Indo-German Chamber of Commerce, Bombay.
19. Karnataka Small Scale Industries Association, Bangalore.
20. Kerala State Small Industries Association, Ernakulam.
21. Meghalaya Small Industries Association, Shillong.
22. Mill Owners' Association, Bombay.
23. Mizoram Small Industries Association, Mizoram.
24. Orissa Small Scale Industries Association, Cuttack.
25. Plastics and Linolium Export Promotion Council, Bombay.
26. Silk and Rayon Textiles Export Promotion Council, Bombay.
27. Southern India Chamber of Commerce and Industry, Madras.
28. Upper India Chamber of Commerce, Kanpur.
29. Wool and Woollen Export Promotion Council, Bombay.

D. <u>OTHER ORGANISATIONS</u>

1. Indian Institute of Management, Ahmedabad.

2. Indian Institute of Management, Calcutta.

3. Jay Bharat Credit and Investment Co.Ltd., Bombay.

ANNEXURE - ~~VII~~ I

Evolution of Factoring

The term 'Factor' has its origin from the Latin word 'facere' meaning 'to make or do,' i.e., to get things done. The dictionary defines a Factor as an agent, particularly a mercantile agent. Factoring has a long and fascinating history which traces back through several centuries. In the early stages, Factors were itinerant merchants who were entrusted with merchandise belonging to others. They were the 'middlemen' between countries which had fairly advanced economies and the countries which were still in the early stages of development. It is interesting to note that factoring in one form or other was involved in much of the world's commerce.

The growth of factoring, in a fairly recognisable form, took place in the fifteenth and sixteenth centuries, with the advent of the period of exploration and colonization by Great Britain, France and Spain. When the mother countries started shipping goods, in ever increasing quantities, to the settlements under their control in foreign lands, the Factors arranged for the sale and distribution of these goods and became the local representatives of the manufacturers and merchants from the mother country. Initially, they maintained extensive storage facilities for the merchandise received by them from abroad and made arrangements for the cartage of such merchandise to customers throughout their respective territories; the Factors' principal function then was to sell such merchandise on the best terms. The Factors did not own the merchandise but were responsible for its safekeeping, as well as for the proceeds they received upon its sale. In course of time, the Factors prospered and grew in economic strength. To the earlier services rendered to their foreign principals, they added the practice of making advance payments to their principals against the security of the merchandise in their possession. The Factors also obtained information relating to local customers (which could not be transmitted in good time to the principals abroad) and assumed the risk of losses, in case they were unable to collect the amounts owing from such customers. Thus, the Factor substituted itself as a debtor of high credit standing for the individual customers of uncertain credit worthiness, from whom the principal, otherwise, would have had to collect the amounts due, individually.

During the later years of the nineteenth century and the early years of the present century, the storage, selling and general merchandising functions performed by the Factors were gradually replaced by financing, credit and collection functions which were found to be of greater value by their various clients.

Around the turn of the last century, factoring was also extended to domestic sales; at the same time, the role of Factors in international trade became less prominent. Those Factors who offered financial services came to be known as 'del credere' Factors. Their services involved advancing money on the security of accounts receivable, collecting the debts, and assuming the credit risk. As the Factors shed the role of merchandise agents and took on 'del credere' responsibilities, the relationship between the Factors and the parties with whom they dealt also changed inasmuch as it was no longer one of principal and agent but one of an independent financial organisation offering services to manufacturing concerns which were known as 'clients'.

Factoring, as practiced currently, involves such a relationship and, although there is little resemblance between the manner in which factoring is conducted today and the activities of the general Factors a few centuries ago, an impressive link with the past does exist.

Factors in the U.S.A. have traditionally operated in textile industry and have gradually extended to apparel industry, as also some consumer goods industries. The Factors there rely on their in-depth knowledge of the practices and position of the concerned industries and have been slow to move into new fields. They have also built-up, over a period, comprehensive information about credit-worthiness, uptodate financial position, record of dealings, etc., of thousands of sellers/buyers in these industries, which forms the basis for approval of credit limits of various parties. Services rendered by a Factor are tailored to suit the clients' requirements. To some of the clients, the Factors provide only such services as management of sales ledgers, collection of debts and protection against bad debts, without providing any finance.

Factoring is undertaken by banks, bank sponsored organisations, as well as other private organisations but it is the former group which is dominant. In the U.K., factoring services are mainly handled by subsidiaries of banks or divisions/departments of banks. The factoring organisations rely almost entirely on the specialised agencies for credit information on parties of all sizes, instead of developing a vast independent information system of their own. In the early stages of development, Factors were generally confining to certain limited industry sectors but over a period they have diversified their exposure tc a wider range of industries.

ANNEXURE - ~~VIII~~ XI

Definitions of Factoring

1. It is the outright purchase of credit approved accounts receivables, with the Factor assuming bad debt losses.

2. Factoring is a sales accounting service with important additional benefits of use of finance and protection against bad debts.

3. Factoring is a process of invoice discounting by which an external Financing/Leasing/Capital market agency purchases all trade debts, offers additional resources to the corporate account and, in turn, takes upon the recovery of trade dues.

4. Factoring is a continuing legal relationship between a financial institution (the'Factor') and a business concern (the 'client') selling goods or providing services to trade customers (the 'customers') on open account basis whereby the Factor purchases the client's book debts (accounts receivables), either with or without recourse to the client and in relation thereto controls the credit extended to customers and administers the sales ledgers.

5. The Unidroit Convention on International Factoring held in Ottawa, Canada, in May 1988, has defined 'Factoring' as a contract concluded between one party (the supplier) and another party (the Factor) pursuant to which :

(i) the supplier may or will assign, to the Factor, receivables arising from contracts of sales of goods made between the supplier and its customers (debtors) other than those for the sale of goods bought primarily for their personal, family or household use;

(ii) the Factor is to perform at least two of the following functions :

a) finance for the supplier, including loans and advance payments;

b) maintenance of accounts (ledgering relating to the receivables);

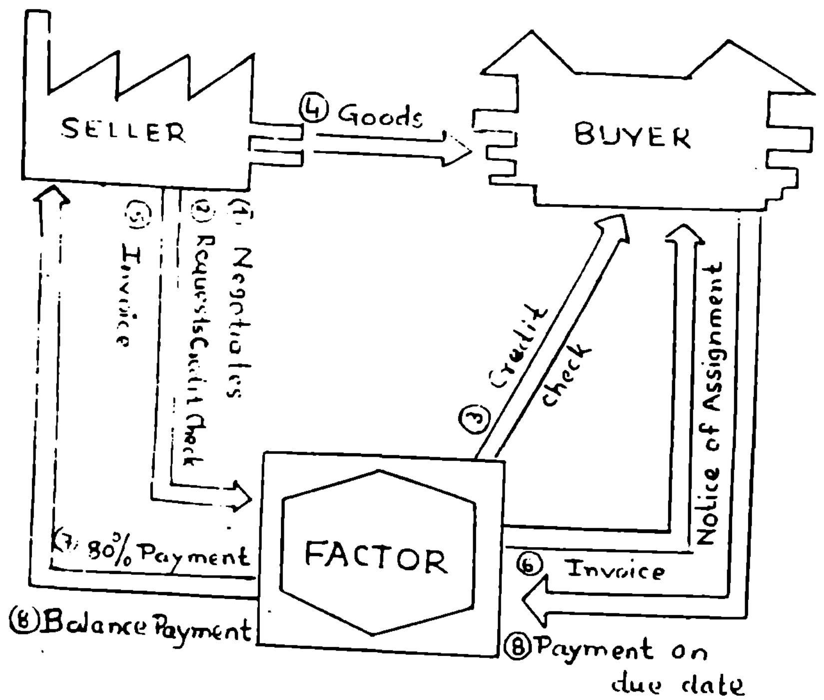
c) collection of receivables and

d) protection against default in payment by debtors;

(iii) notice of the assignment of the receivables is to be given to debtors.

ANNEXURE-~~II~~ I

Mechanics of domestic factoring



(1) Seller (client) negotiates with the Factor for establishing factoring relationship.

(2) Request by seller for credit check on the buyer (customer) whose name and address are furnished to the Factor.

(3) Factor checks the credit credentials and approves the buyer. For each approved buyer, a credit limit ~~is fixed~~ and the period upto which credit can be given, are fixed.

(4) Seller sells the goods to the buyer.

(5) Seller sends the invoice to the Factor. The invoice is accounted for in the buyers' account in the Factor's sales ledger.

(6) Factor sends the notice of assignment/copy of invoice to the buyer.

(7) Factor advises the amount to which seller is entitled after retaining a margin, say, of 20%, the residual amount being paid later.

(8) On the expiry of the agreed credit period, buyer makes the payment of the invoice to the Factor. At this point, the Factor pays to the seller margin money retained as per (7) above. If, however, the buyer defaults to pay the Factor, it would still make the final payment to the seller in the case of without recourse factoring.

ANNEXURE - ~~X~~ IV

Illustration of how an Export Factor Works

An exporter (client) submits to the Export Factor (EF) a buyers' (customers') list indicating their names and street addresses, and his credit line needs.

The Import Factor (IF) selected by EF rates the buyers' list. The results are reported to the exporter.

The exporter enters into an export factoring agreement with EF. All export receivables are assigned to EF, who in turn assigns them to IF.

Export orders are credit approved. The approval of credit lines usually takes between 48 hours and two weeks, depending on how easily credit information about the buyers can be obtained.

The exporter ships merchandise to approved foreign buyers. Each invoice is made payable to a specific Factor in the buyer's country. Copies of invoices and shipping documents are sent through EF to IF.

IF follows up, if receivables are not paid on the invoice due date. It collects in accordance with local practices and assists in resolving disputes. It holds receivables on its books for 60 days after receiving notice of a dispute, thus allowing the parties time to resolve it.

IF remits payments received from buyers to EF immediately. EF converts foreign currency remittances and makes weekly funds transfers of all proceeds to the exporter.

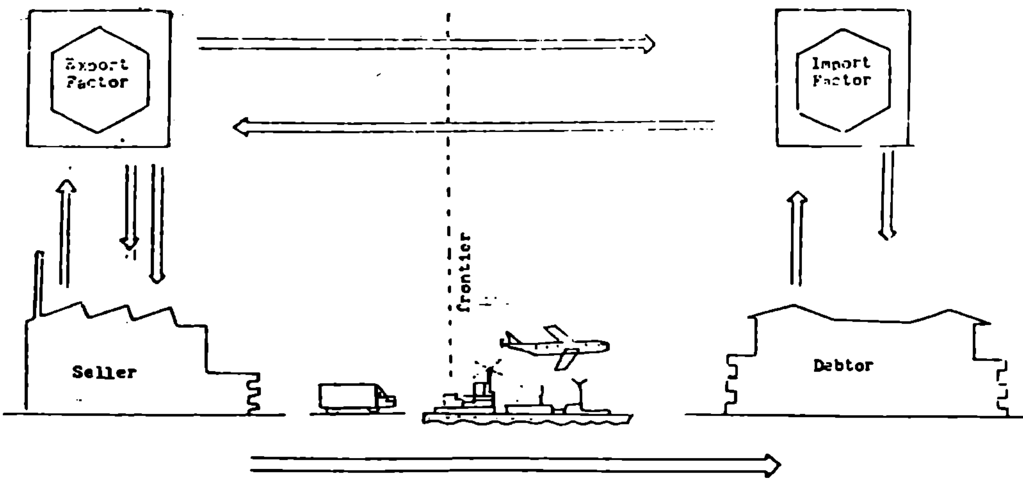
If an approved buyer is financially unable to pay, IF pays the receivables to EF 100 days after the due date and the funds are included in the next weekly payment to the exporter.

EF provides the exporter with a monthly report showing the status of each receivable.

EF also makes advances to an exporter against approved export receivables.

ANNEXURE - ~~XI~~ I

Mechanics of Two - Factor System



1. The seller delivers goods to his debtors.

2. The seller assigns his accounts receivab' through EF to IF, who assumes the credit risk, · ed this had been agreed to beforehand.

3. EF pays the agreed advances to the '

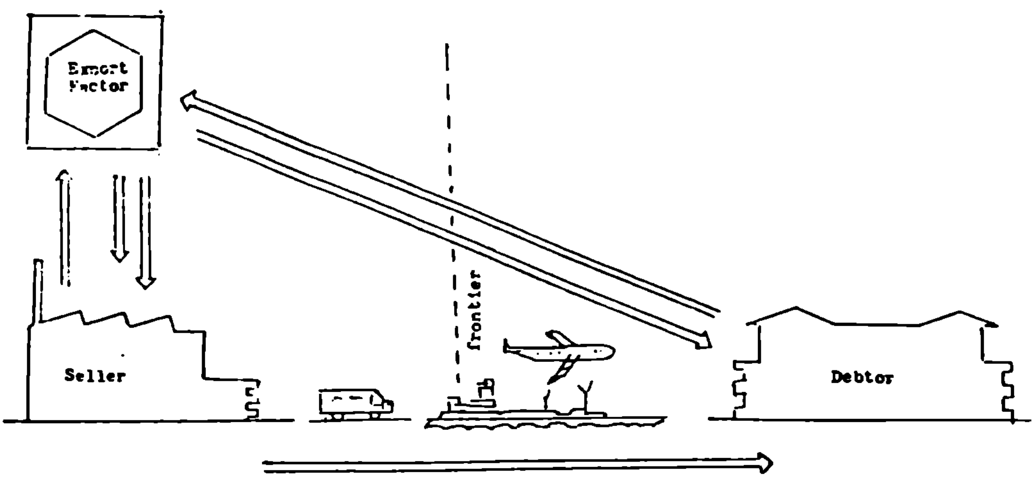
4. IF deals with the accounts receiv with the sales contract existinr and the debtor.

5. The debtor pays on the due d the amount to EF.

6. EF settles the advance t' and remits the balance

ANNEXURE ~~XII~~ VI

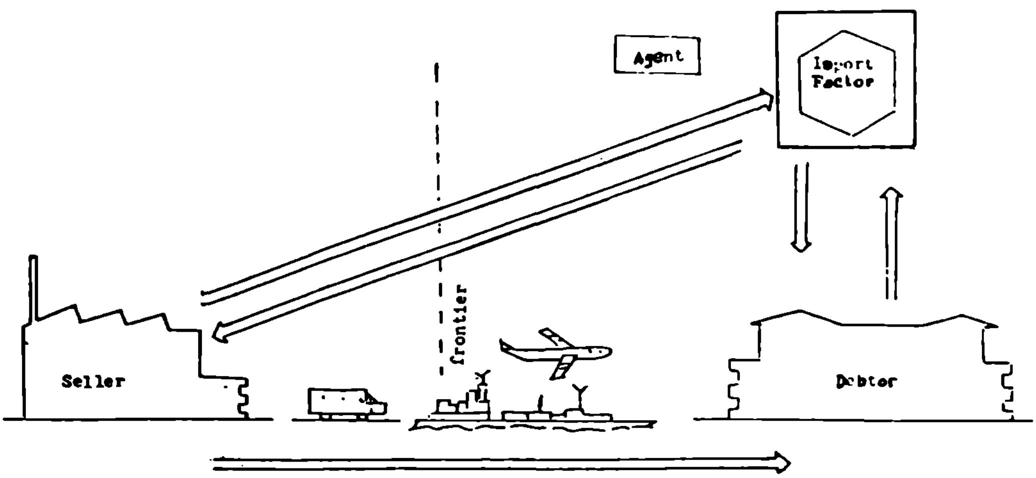
Machanics of Direct Export Factoring



1. The seller ships the goods to his debtor.
2. The seller assigns his invoices to EF.
3. EF pays the seller the agreed advance.
4. EF handles the accounts receivables in accordance with the sales contract between the seller and the debtor.
5. The debtor pays on the due date to EF.
6. EF settles the advance with the funds received and forwards the balance to the seller.

ANNEXURE-~~XIII~~ VII

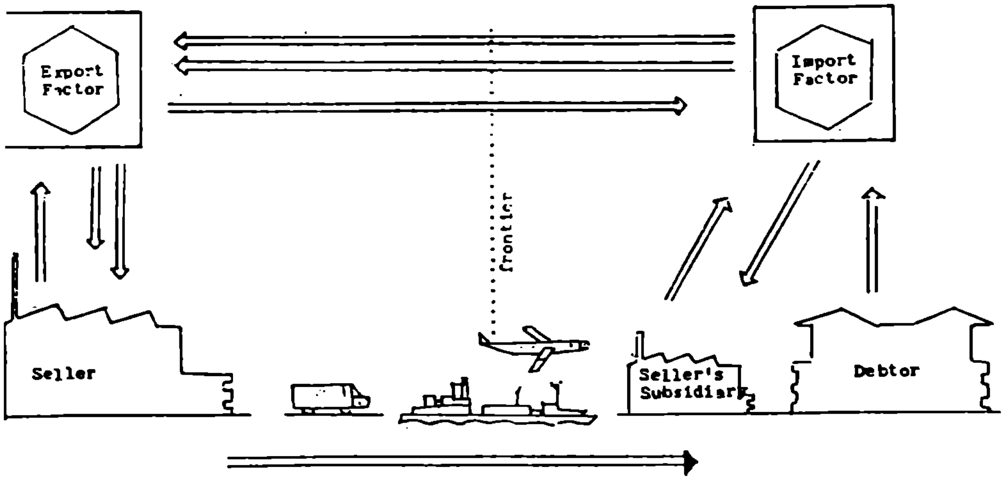
Mechanics of Direct Import Factoring



1. The seller ships the goods to his debtor.
2. The seller assigns his invoices to IF, who assumes the credit risk,provided this has been agreed to beforehand.
3. IF handles the accounts receivables in accordance with the sales contract between the seller and the debtor.
4. The debtor pays IF on the due date.
5. IF forwards the payment to the seller, possibly deducting the agent's commission.

ANNEXURE - ~~XIV~~ VII

Mechanics of Back-to-Back Factoring



1. The parent company ships goods to its subsidiary which sells and ships the goods to the debtors in IF's country.

2. The seller assigns his invoices on the subsidiary via EF to IF.

3. The subsidiary assigns its receivables to IF with or without credit risk coverage.

4. EF pays the parent company the agreed advances.

5. The subsidiary's debtors pay IF.

6. IF distributes the funds according to instructions from EF.

7. EF settles the balance with the seller.

ANNEXURE - ~~XV~~ X

Statement showing particulars of annual exports from India and proportion of outstandings to total exports. *

Year April-March	Annual exports (Rs. in crores)	Outstandings as on 31st December Rs. in crores	% of outstanding over annual exports
1979-80	6418	221.39	3.45
1980-81	6711	227.38	3.39
1981-82	7806	227.73	2.92
1982-83	8803	327.33	3.72
1983-84	9771	374.69	3.83
1984-85	11855	402.19	3.39
1985-86	11012	440.11 £	4.00
1986-87	12551	666.66 @	5.31

* Source : RBI Bulletin, January 1988 issue; Table No.31

£ As on 30th June 1986

@ As on 30th June 1987

ANNEXURE - XVI

Unidroit Convention on International Factoring

THE STATES PARTIES TO THIS CONVENTION,

CONSCIOUS of the fact that international factoring has a significant role to play in the development of international trade,

RECOGNISING therefore the importance of adopting uniform rules to provide a legal framework that will facilitate international factoring, while maintaining a fair balance of interests between the different parties involved in factoring transactions,

HAVE AGREED as follows :

CHAPTER I - SPHERE OF APPLICATION AND GENERAL PROVISIONS

Article 1

1.- This Convention governs factoring contracts and assignments of receivables as described in this Chapter.

2.- For the purposes of this Convention, "factoring contract" means a contract concluded between one party (the supplier) and another party (the factor) pursuant to which:

a) the supplier may or will assign to the factor receivables arising from contracts of sale of goods made between the supplier and its customers (debtors) other than those for the sale of goods bought primarily for their personal, family or household use;

b) the factor is to perform at least two of the following functions :

- finance for the supplier, including loans and advance payments;
- maintenance of accounts (ledgering) relating to the receivables;
- collection of receivables;
- protection against default in payment by debtors;

c) notice of the assignment of the receivables is to be given to debtors.

3.- In this Convention references to "goods" and 'sale of goods" shall include services and the supply of services.

4.- For the purposes of this Convention :

a) a notice in writing need not be signed but must identify the person by whom or in whose name it is given ;

b) "notice in writing" includes, but is not limited to, telegrams, telex and any other telecommunication capable of being reproduced in tangible form;

c) a notice in writing is given when it is received by the addressee.

Article 2

1.- This Convention applies whenever the receivables assigned pursuant to a factoring contract arise from a contract of sale of goods between a supplier and a debtor whose places of business are in different States and :

a) those States and the State in which the factor has its place of business are Contracting States; or

b) both the contract of sale of goods and the factoring contract are governed by the law of a Contracting State.

2.- A reference in this Convention to a party's place of business shall, if it has more than one place of business, mean the place of business which has the closest relationship to the relevant contract and its performance, having regard to the circumstances known to or contemplated by the parties at any time before or at the conclusion of that contract.

Article 3

1.- The application of this Convention may be excluded :

a) by the parties to the factoring contract; or

b) by the parties to the contract of sale of goods, as regards receivables arising at or after the time when the factor has been given notice in writing of such exclusion.

2.- Where the application of this Convention is excluded in accordance with the previous paragraph, such exclusion may be made only as regards the Convention as a whole.

Article 4

1.- In the interpretation of this Convention, regard is to be had to its object and purpose as set forth in the preamble, to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.

2.- Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law.

CHAPTER II - RIGHTS AND DUTIES OF THE PARTIES

Article 5

As between the parties to the factoring contract :

a) a provision in the factoring contract for the assignment of existing or future receivables shall not be rendered invalid by the fact that the contract does not specify them individually, if at the time of conclusion of the contract or when they come into existence they can be identified to the contract;

b) a provision in the factoring contract by which future receivables are assigned operates to transfer the receivables to the factor when they come into existence without the need for any new act of transfer.

Article 6

1.- The assignment of a receivable by the supplier to the factor shall be effective notwithstanding any agreement between the supplier and the debtor prohibiting such assignment.

2.- However, such assignment shall not be effective against the debtor when, at the time of conclusion of the contract of sale of goods, it has its place of business in a Contracting State which has made a declaration under Article 18 of this Convention.

3.- Nothing in paragraph 1 shall affect any obligation of good faith owed by the supplier to the debtor or any liability of the supplier to the debtor in respect of an assignment made in breach of the terms of the contract of sale of goods.

Article 7

A factoring contract may validly provide as between the parties thereto for the transfer, with or without a new act of transfer, of all or any of the supplier's rights deriving from the contract of sale of goods, including the benefit of any provision in the contract of sale of goods reserving to the supplier title to the goods or creating any security interest.

Article 8

1.- The debtor is under a duty to pay the factor if, and only if, the debtor does not have knowledge of any other person's superior right to payment and notice in writing of the assignment :

a) is given to the debtor by the supplier or by the factor with the supplier's authority;

b) reasonably identifies the receivables which have been assigned and the factor to whom or for whose account the debtor is required to make payment; and

c) relates to receivables arising under a contract of sale of goods made at or before the time the notice is given.

2.- Irrespective of any other ground on which payment by the debtor to the factor discharges the debtor from liability, payment shall be effective for this purpose if made in accordance with the previous paragraph.

Article 9

1.- In a claim by the factor against the debtor for payment of a receivable arising under a contract of sale of goods the debtor may set up against the factor all defences arising under that contract of which the debtor could have availed itself if such claim had been made by the supplier.

2.- The debtor may also assert against the factor any right of set-off in respect of claims existing against the supplier in whose favour the receivable arose and available to the debtor at the time a notice in writing of assignment conforming to Article 8(1) was given to the debtor.

Article 10

1.- Without prejudice to the debtor's rights under Article 9, non-performance or defective or late performance of the contract of sale of goods shall not by itself entitle the debtor to recover a sum paid by the debtor to the factor if the debtor has a right to recover that sum from the supplier.

2.- The debtor who has such a right to recover from the supplier a sum paid to the factor in respect of a receivable shall nevertheless be entitled to recover that sum from the factor to the extent that :

a) the factor has not discharged an obligation to make payment to the supplier in respect of that receivable; or

b) the factor made such payment at a time when it knew of the supplier's non-performance or defective or late performance as regards the goods to which the debtor's payment relates.

CHAPTER III - SUBSEQUENT ASSIGNMENTS

Article 11

1.- Where a receivable is assigned by a supplier to a factor pursuant to a factoring contract governed by this Convention:

a) the rules set out in Articles 5 to 10 shall, subject to sub-paragraph (b) of this paragraph, apply to any subsequent assignment of the receivable by the factor or by a subsequent assignee;

b) the provisions of Articles 8 to 10 shall apply as if the subsequent assignee were the factor.

2.- For the purposes of this Convention, notice to the debtor of the subsequent assignment also constitutes notice of the assignment to the factor.

Article 12

This Convention shall not apply to a subsequent assignment which is prohibited by the terms of the factoring contract.

CHAPTER IV - FINAL PROVISIONS

Article 13

1.- This Convention is open for signature at the concluding meeting of the Diplomatic Conference for the Adoption of the Draft Unidroit Conventions on International Factoring and International Financial Leasing and will remain open for signature by all States at Ottawa until 31 December 1990.

2.- This Convention is subject to ratification, acceptance or approval by States which have signed it.

3.- This Convention is open for accession by all States which are not signatory States as from the date it is open for signature.

4.- Ratification, acceptance, approval or accession is effected by the deposit of a formal instrument to that effect with the depositary.

Article 14

1.- This Convention enters into force on the first day of the month following the expiration of six months after the date of deposit of the third instrument of ratification, acceptance, approval or accession.

2.- For each State that ratifies, accepts, approves, or accedes to this Convention after the deposit of the third instrument of ratification, acceptance, approval or accession, this Convention enters into force in respect of that State on the first day of the month following the expiration of six months after the date of the deposit of its instrument of ratification, acceptance, approval or accession.

Article 15

This Convention does not prevail over any treaty which has already been or may be entered into.

Article 16

1.- If a Contracting State has two or more territorial units in which different systems of law are applicable in relation to the matters dealt with in this Convention, it may, at the time of signature, ratification, acceptance, approval or accession, declare that this Convention is to extend to all its territorial units or only to one or more of them, and may substitute its declaration by another declaration at any time.

2.- These declarations are to be notified to the depositary and are to state expressly the territorial units to which the Convention extends.

3.- If, by virtue of a declaration under this article, this Convention extends to one or more but not all of the territorial units of a Contracting State, and if the place of business of a party is located in that State, this place of business, for the purposes of this Convention, is considered not to be in a Contracting State, unless it is in a territorial unit to which the Convention extends.

4.- If a Contracting State makes no declaration under paragraph 1, the Convention is to extend to all territorial units of that State.

Article 17

1.- Two or more Contracting States which have the same or closely related legal rules on matters governed by this Convention may at any time declare that the Convention is not to apply where the supplier, the factor and the debtor have their places of business in those States. Such declarations may be made jointly or by reciprocal unilateral declarations.

2.- A Contracting State which has the same or closely related legal rules on matters governed by this Convention as one or more non-Contracting States may at any time declare that the Convention is not to apply where the supplier, the factor and the debtor have their places of business in those States.

3.- If a State which is the object of a declaration under the previous paragraph subsequently becomes a Contracting State, the declaration made will, as from the date on which the Convention enters into force in respect of the new Contracting State, have the effect of a declaration made under paragraph 1, provided that the new Contracting State joins in such declaration or makes a reciprocal unilateral declaration.

Article 18

A Contracting State may at any time make a declaration in accordance with Article 6(2) that an assignment under Article 6(1) shall not be effective against the debtor when, at the time of conclusion of the contract of sale of goods, it has its place of business in that State.

Article 19

1.- Declarations made under this Convention at the time of signature are subject to confirmation upon ratification, acceptance or approval.

2.- Declarations and confirmations of declarations are to be in writing and to be formally notified to the depositary.

3.- A declaration takes effect simultaneously with the entry into force of this Convention in respect of the State concerned. However, a declaration of which the depositary receives formal notification after such entry into force takes effect on the first day of the month following the expiration of six months after the date of its receipt by the depositary. Reciprocal unilateral declarations under Article 17 take effect on the first day of the month following the expiration of six months after the receipt of the latest declaration by the depositary.

4.- Any State which makes a declaration under this Convention may withdraw it at any time by a formal notification in writing addressed to the depositary. Such withdrawal is to take effect on the first day of the month following the expiration of six months after the date of the receipt of the notification by the depositary.

5.- A withdrawal of a declaration made under Article 17 renders inoperative in relation to the withdrawing State, as from the date on which the withdrawal takes effect, any joint or reciprocal unilateral declaration made by another State under that article.

Article 20

No reservations are permitted except those expressly authorised in this Convention

Article 21

This Convention applies when receivables assigned pursuaht to a factoring contract arise from a contract of sale of goods concluded on or after the date on which the Convention enters into force in respect of the Contracting States referred to in Article 2 (1) (a), or the Contracting State or States referred to in paragraph 1(b) of that article, provided that:

a) the factoring contract is concluded on or after that date; or

b) the parties to the factoring contract have agreed that the Convention shall apply.

Article 22

1.- This Convention may be denounced by any Contracting State at any time after the date on which it enters into force for that State.

2.- Denunciation is effected by the deposit of an instrument to that effect with the depositary.

3.- A denunciation takes effect on the first day of the month following the expiration of six months after the deposit of the instrument of denunciation with the depositary. Where a longer period for the denunciation to take effect is specified in the instrument of denunciation it takes effect upon the expiration of such longer period after its deposit with the depositary.

Article 23

1.- This Convention shall be deposited with the Government of Canada.

2.- The Government of Canada shall:

a) inform all States which have signed or acceded to this Convention and the President of the International Institute for the Unification of Private Law (Unidroit) of:

i) each new signature or deposit of an instrument of ratification, acceptance, approval or accession, together with the date thereof;

ii) each declaration made under Articles 16, 17 and 18;

iii) the withdrawal of any declaration made under Article 19(4);

iv) the date of entry into force of this Convention;

v) the deposit of an instrument of denunciation of this Convention together with the date of its deposit and the date on which it takes effect;

b) transmit certified true copies of this Convention to all signatory States, to all States acceding to the Convention and to the President of the International Institute for the Unification of Private Law (Unidroit).

IN WITNESS WHEREOF the undersigned plenipotentiaries, being duly authorised by their respective Governments, have signed this Convention.

DONE at Ottawa, this twenty-eighth day of May, one thousand nine hundred and eighty-eight, in a single original, of which the English and French texts are equally authentic.