

# FACTORING



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# FACTORING

## DEFINITION:

- Factoring is defined as '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'.



# Explanation

- It is the outright purchase of credit approved accounts receivables with the factor assuming bad debt losses.
- Factoring provides sales accounting service, use of finance and protection against bad debts.
- Factoring is a process of invoice discounting by which a capital market agency purchases all trade debts and offers resources against them.




# Evolution of factoring

- The term factor has its origin from the Latin word, 'Facere' meaning to get things done. The dictionary defines a factor as an agent particularly a mercantile agent. Factoring has a long fascinating history which traces back through several centuries.
- In the early stages factors were itinerant merchants who were entrusted with merchandise belonging to others.



# Different kinds of factoring services

## **DEBT ADMINISTRATION:**

- The factor manages the sales ledger of the client company. The client will be saved of the administrative cost of book keeping, invoicing, credit control and debt collection. The factor uses his computer system to render the sales ledger administration services.
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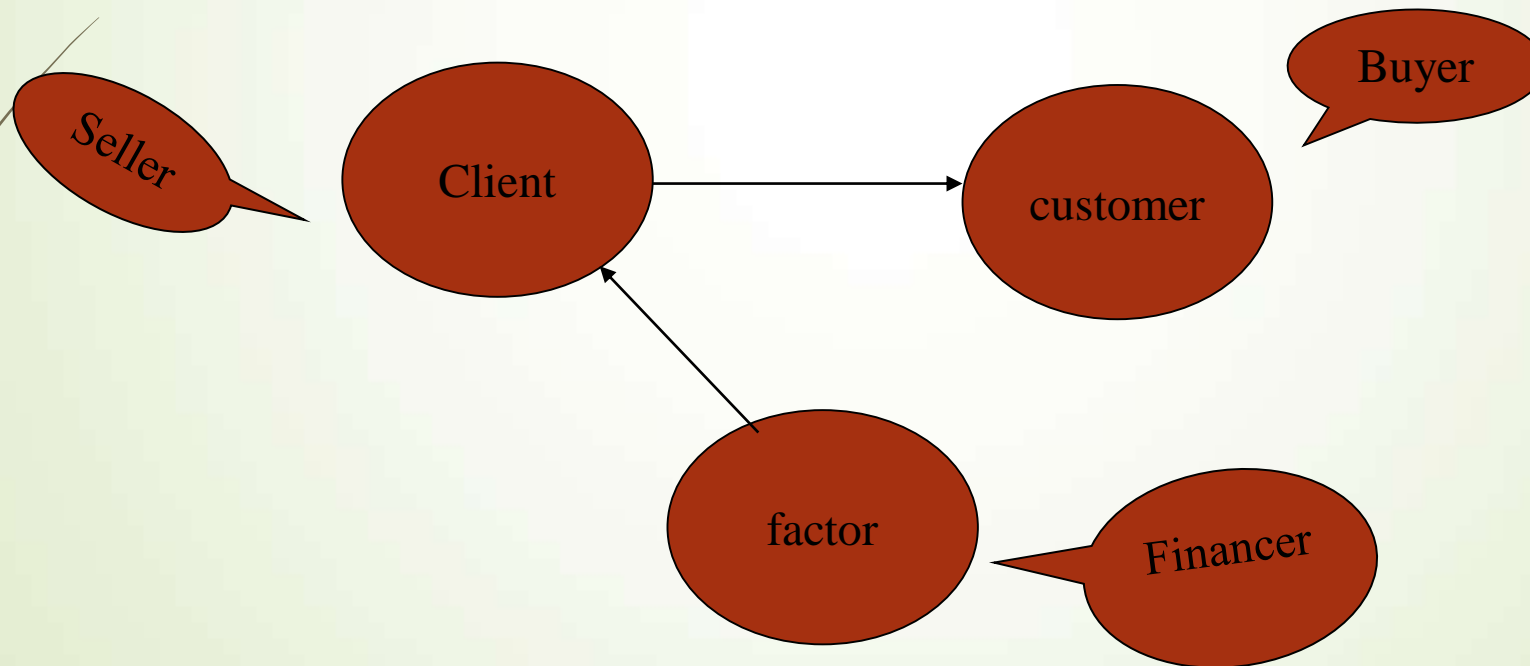


# Different kinds of factoring services

- **Credit Information:** Factors provide credit intelligence to their client and supply periodic information with various customer-wise analysis.
- **Credit Protection:** Some factors also insure against bad debts and provide without recourse financing.
- **Invoice Discounting or Financing :** Factors advance 75% to 80% against the invoice of their clients. The clients mark a copy of the invoice to the factors as and when they raise the invoice on their customers.


# Different kinds of factoring services

- Basically there are three parties to the factoring services as depicted below:






# Services rendered by factor

- Factor evaluated creditworthiness of the customer (buyer of goods)
  - Factor fixes limits for the client (seller) which is an aggregation of the limits fixed for each of the customer (buyer).
  - Client sells goods/services.
  - Client assigns the debt in favour of the factor
  - Client notifies on the invoice a direction to the customer to pay the invoice value of the factor.
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# Services rendered by factor

- Client forwards invoice/copy to factor along with receipted delivery challans.
  - Factor provides credit to client to the extent of 80% of the invoice value and also notifies to the customer
  - Factor periodically follows with the customer
  - When the customer pays the amount of the invoice the balance of 20% of the invoice value is passed to the client recovering necessary interest and other charges.
  - If the customer does not pay, the factor takes recourse to the client.
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# Benefits of factoring

- The client will be relieved of the work relating to sales ledger administration and debt collection
- The client can therefore concentrate more on planning production and sales.
- The charges paid to a factor which will be marginally high at 1 to 1.5% than the bank charges will be more than compensated by reductions in administrative expenditure.
- This will also improve the current ratio of the client and consequently his credit rating.



# Benefits of factoring

- The subsidiaries of the various banks have been rendering the factoring services.
  - The factoring service is more comprehensive in nature than the book debt or receivable financing by the bankers.
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# Forfaiting

- ▶ The forfaiting owes its origin to a French term 'forfait' which means to forfeit (or surrender) one's rights on something to some one else.
  - ▶ Under this mode of export finance, then exporter forfaits his rights to the future receivables and the forfaiter loses recourse to the exporter in the event of non-payment by the importer.
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# Methodology

- It is a trade finance extended by a forfaiter to an exporter/seller for an export/sale transaction involving deferred payment terms over a long period at a firm rate of discount.
- Forfaiting is generally extended for export of capital goods, commodities and services where the importer insists on supplies on credit terms.

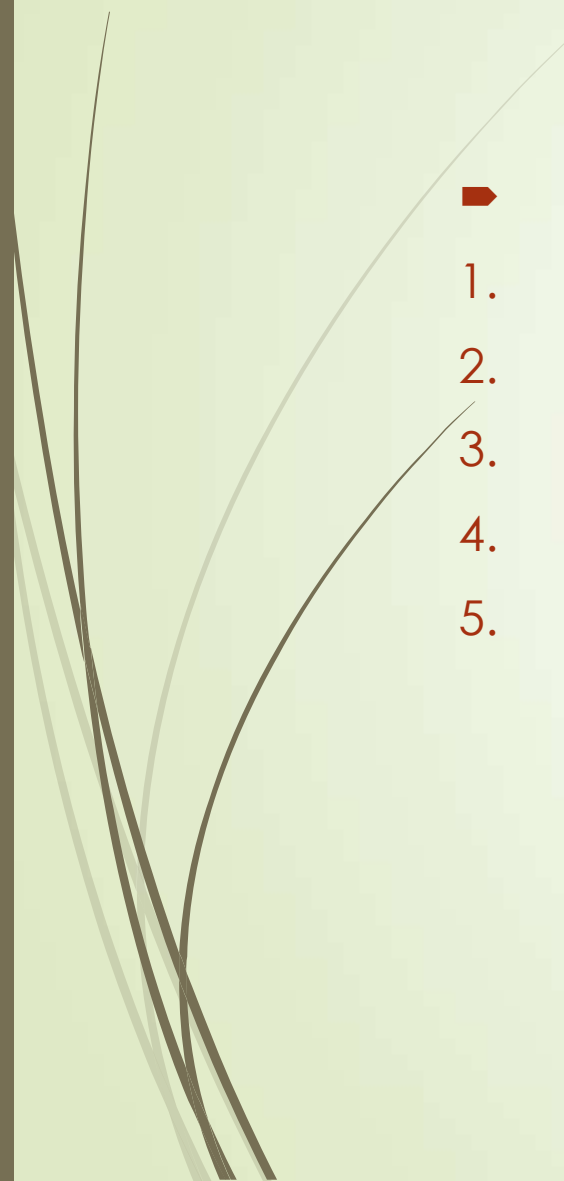


# Methodology

- The exporter has recourse to forfeiting usually in cases where the credit is extended for long durations but there is no prohibition for extending the facility where the credits are maturing in periods less than one year.
- Credits for commodities or consumer goods is generally for shorter duration within one year. Forfeiting services are extended in such cases as well.




# Mechanism

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- There are five parties in a transaction of forfaiting. These are :
    1. Exporter
    2. Exporter's bank
    3. Importer
    4. Importer's bank and
    5. Forfaiter



# Mechanism

- The exporter and importer negotiate the proposed export sale contract. These are the preliminary discussions.
  - Based on these discussions the exporter approaches the forfaiter to ascertain the terms for forfeiting.
  - The forfaiter collects from exporter all the relevant details of the proposed transaction, viz., details about the importer, supply and credit terms, documentation, etc., in order to ascertain the country risk and credit risk involved in the transaction..
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# Mechanism

- Depending upon the nature and extent of these risks the forfaiter quotes the discount rate.
- The exporter has now to take care that the discount rate is reasonable and would be acceptable to his buyer.
- He will then quote a contract price to the overseas buyer by loading the discount rate, commitment fee, etc., on the sale price of the goods to be exported.
- If the deals go through, the exporter and forfaiter sign a contract.



# Mechanism

- Export takes place against documents guaranteed by the importer's bank.
  - The exporter discounts the bill with the forfaiter and the forfaiter presents the same to the importer for payment on due date or even can sell it in secondary market.
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# Documentation and cost

- Forfaiting transaction is usually covered either by a promissory note or bill of exchange. In either case it has to be guaranteed by a bank or, bill of exchange may be 'avaled' by the importer's bank.
- The 'Aval' is an endorsement made on bill of exchange or promissory note by the guaranteeing bank by writing 'per aval' on these documents under proper authentication.
- The forfeiting cost for a transaction will be in the form of 'commitment fee', 'discount fee' and 'documentation fee'.



# Mechanism- a case

- Export-Import Bank of India, (EXIM Bank) has started with a scheme to the Indian exporters by working out an intermediary between the exporter and the forfaiter.
- The scheme takes place in the following stages:
  1. Negotiations being between exporter and importer with regard to contract price, period of credit, rate of interest, etc.
  2. Exporter approaches EXIM Bank with all the relevant details for an indicative discount quote.
  3. EXIM Bank approaches an overseas forfaiter, obtain the quote and gets back to exporter with the offer.



## Mechanism- a case

4. Exporter and importer finalise the term of contract. All costs levied by a forfaiter are to be transferred to the overseas buyer. As such discount and other charges are loaded in the basic contract value.
5. Exporter approaches EXIM Bank and it in turn the forfaiter for the firm quote. The exporter confirm the acceptance of the arrangement.
6. Export takes place — shipping documents along with bill of exchange, promissory note have to be in the prescribed format.



## Mechanism- a case

7. Importer's bank delivers shipping documents to importer against acceptance of bill of exchange or on receipt of promissory note from the importer as the case may be and send these to exporter's bank with its guarantee.
8. Exporter's bank gets bill of exchange/promissory note endorsed with the words 'Without Recourse' from the exporter and present the document(s) to EXIM Bank who in turn send it to the forfaiter.



## Mechanism- a case

9. Forfaiter discounts the documents at the pre-determined rate and passes on funds to EXIM Bank for onward disbursement to exporter's bank nostro account of exporter's bank.
10. Exporter's bank credits the amount to the exporter.
11. Forfaiter presents the documents on due date to the importer's bank and receives the dues.
12. Exporter's bank recovers the amount from the importer.



# DIFFERENCE BETWEEN FACTORING AND FORFAITING

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| <ol style="list-style-type: none"><li>1. Suitable for ongoing open account sales, not backed by LC or accepted bills or exchange.</li><li>2. Usually provides financing for short-term credit period of upto 180 days.</li></ol> | <ol style="list-style-type: none"><li>1. Oriented towards single transactions backed by LC or bank guarantee.</li><li>2. Financing is usually for medium to long-term credit periods from 180 days upto 7 years though shortterm credit of 30–180 days is also available for large transactions.</li></ol> |
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# DIFFERENCE BETWEEN FACTORING AND FORFAITING

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| 3. Requires continuous arrangements between factor and client, whereby all sales are routed through the factor. | a | 3. Seller need not route or commit other business to the forfaiter. Deals are concluded transaction-wise.                |
| 4. Factor assumes responsibility for collection, helps client to reduce his own overheads.                      |   | 4. Forfaiter's responsibility extends to collection of forfeited debt only. Existing financing lines remains unaffected. |



# DIFFERENCE BETWEEN FACTORING AND FORFAITING

5. Separate charges are applied for

- financing
- collection
- administration
- credit protection and

— provision of information.

5. Single discount charges is applied which depend on

- guaranteeing bank and country risk,
- credit period involved and
- currency of debt.

Only additional charges is commitment fee, if firm commitment is required prior to draw down during delivery period.



# DIFFERENCE BETWEEN FACTORING AND FORFAITING

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| 6. Service is available for domestic and export receivables.   | 6. Usually available for export receivables only denominated in any freely convertible currency. |
| 7. Financing can be with or without recourse; the credit protection collection and administration services may also be provided without financing. | 7. It is always 'without recourse' and essentially a financing product.                          |



# DIFFERENCE BETWEEN FACTORING AND FORFAITING

- 8. Usually no restriction on minimum size of transactions that can be covered by factoring .
- 9. Factor can assist with completing import formalities in the buyer's country and provide ongoing contract with buyers.
- 8. Transactions should be of a minimum value of USD 250,000.
- 9. Forfaiting will accept only clean documentation in conformity with all regulations in the exporting/importing countries