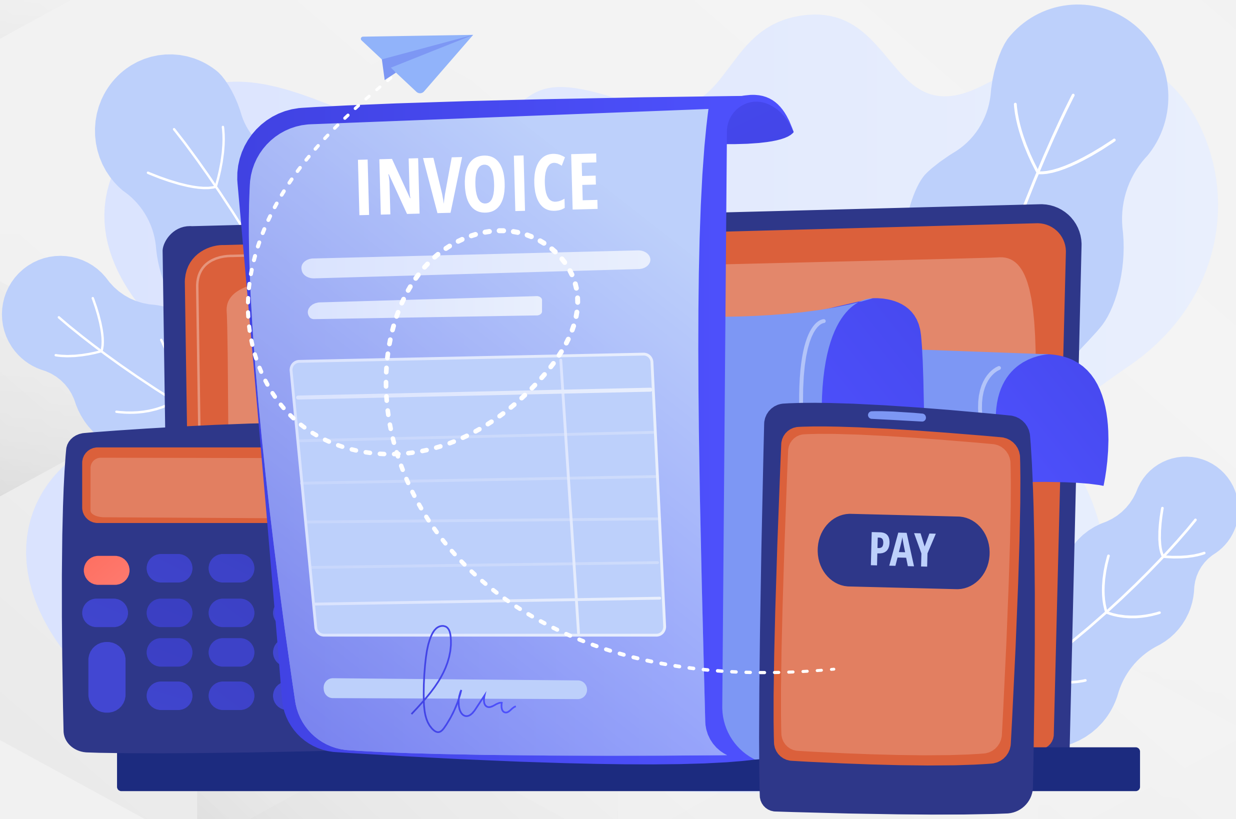
Ambitions Unleashed

Understanding Factoring Solution

Part-1



Introduction

Factoring is a financial arrangement in which a company (seller) sells its receivables to a factor (financial institution) for advance payment to meet its short-term liquidity needs. Depending on the agreement terms, the factor pays an upfront amount to the company, which is usually a percentage of the invoice amount, less discounting fee. The factor will make the balance payment (if any), after deducting the commission fee to the company (seller) after the end customer settles the invoice. It is an off-balance sheet transaction, and the ownership of receivables is transferred to the factor.

The factoring is an ideal debt solution for mid-market enterprises across a diverse range of industries looking to improve balance sheet structure and seeking immediate access to working capital. They should generally have a debtor payment cycle of 30, 60 to over 90 days.

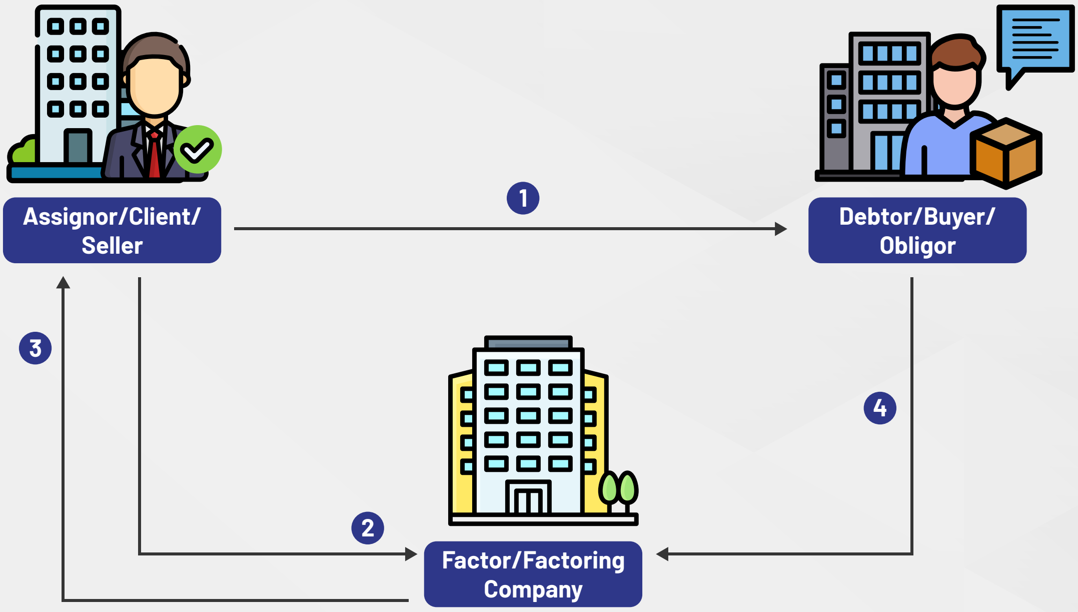
Key Parties Involved in Factoring

The Factor: The factoring company is a financial institution, which can be a non-banking financial company (NBFC) or a commercial bank.

The Seller/Client: The company that sells its outstanding invoices in exchange for a cash consideration.

The Debtor: The buyer or the customer, who is responsible for paying the invoice. Depending on the nature of the arrangement, the debtor, in most cases, pays the invoice amount directly to the factor.

How Does Factoring Work?



1. The seller/client company sells goods/services to the buyer on credit and raises invoices.
2. In order to meet its short-term liquidity needs, the seller assigns its receivables to the factor and the ownership of receivables is transferred to the factor.
3. The factor makes the payment to the client at a discounted rate pre-determined in the agreement.
4. At the end of the credit period, the debtor will pay all the dues to the factor.

Note: This is an example of traditional factoring transaction and there are various other forms of factoring arrangements basis the business needs.

Factoring Landscape in India

The onset of domestic factoring services dates back to 1988, when RBI set up the Kalyanasundaram Study Group to monitor the possibility of starting factoring organisations in India. In 1991, the Banking Regulations Act 1949 was amended to add factoring as a banking service wherein RBI announced rules for banks and its subsidiaries to engage in factoring business.

The enactment of the Factoring Act, 2011 in February 2012 provided the legal framework for governing the factoring industry in India. The act stated that any organisation doing factoring business must register as an NBFC with RBI by applying for a factoring license, while banks, government organisations, and corporations created by the act of parliament engaging in factoring business were excluded from the need of registering.

In addition, RBI introduced TReDS (Trade Receivables Discounting System) in 2014 and launched it in 2017 to address the working capital gap faced by small and medium enterprises (MSMEs). TReDS is a secured electronic platform that enables MSMEs to discount their invoices digitally with multiple financiers fostering visibility and financial ease.

The Factoring Regulation (Amendment) Bill, 2021, was presented in Lok Sabha to ease the rules and make the provisions of the act more flexible while ensuring robust regulatory oversight. The amendment also aimed to widen the scope of entities engaged in factoring business and to attract more NBFCs to participate in factoring, in an effort to boost the growth of the factoring industry. Furthermore, the Insurance Regulatory and Development Authority of India (IRDAI) introduced the Trade Credit Insurance Guidelines, 2021 to safeguard businesses against the risk of non-payment from the debtors.