CHAPTER - I

INTRODUCTION AND DESIGN OF THE STUDY

◊ INTRODUCTION 1
◊ STATEMENT OF THE PROBLEM 10
◊ SCOPE OF THE STUDY 13
◊ OBJECTIVES OF THE STUDY 14
◊ HYPOTHESES 15
◊ METHODOLOGY 16
◊ FRAMEWORK OF ANALYSIS 21
◊ LIMITATIONS OF THE STUDY 23
◊ ORGANISATION OF THE STUDY 23
CHAPTER - I

INTRODUCTION AND DESIGN OF THE STUDY

INTRODUCTION

The Indian financial market has undergone dynamic transformation with many new financial products and delivery system being experimented with. Besides catering to the capital and money market, some of the innovative products are aimed at providing an alternative avenue towards meeting the financial needs of a specific clientele for their working capital. Lack of access to financial as well as escalating costs are the major areas of concern for the small and the medium sector too. The way to success in business, be big or small depends largely on liquidity.

With the growing industrialization and consequential growth in the volume of industrial production and sales, timely collection and efficient management of receivables has assumed importance. Commercial banks normally provide working capital finance to the trade and industry. This takes the form of cash credit facility against inventory and bills finance.
against receivables. As no business can survive without ensuring liquidity, therefore, for catering to this requirement an innovation in services called “factoring” has shown its face in India in the 1990s. Factoring is a complete financial package that combines working capital financing, credit risk protection, accounts receivables book – keeping and collection services. A growing number of companies offer factoring services. Factoring has become well established in developing countries, in particular in those that are highly industrialized. Factoring is now universally accepted as vital to the financial needs of small and medium – sized businesses.

**ORIGIN OF FACTORING**

The working group on money market (Vaghul Committee) commissioned by the Reserve Bank of India (RBI) observed that introduction of factoring service could to a great extent, solve the financial problem of the small scale suppliers. The RBI thus perceived factoring as one of the measures, which could assist suppliers with timely finance and expedite collection of dues. A committee headed by C.S. Kalyanasundaram, Former Managing Director of SBI, was set up by the RBI to examine the need and scope for factoring organization in India.
The committee, which submitted its report in December 1988, recommended introduction of factoring services in India. Factoring involves provision of specialized services relating to credit investigation, sales ledger management, purchase and collection of debts, credit protection as well as provision of finance against receivables. The Kalyanasundaram Committee concluded that there is sufficient scope for introduction factoring services in India. The RBI has accepted the recommendations of the Committee. The idea of introducing factoring services in India was also suggested subsequently by the Vaghual Committee on Money Market. The Government of India has since declared “factoring” as an activity which could be undertaken by banking companies under the Banking Regulation Act, 1949. RBI has directed banks to take up factoring activity through a subsidiary.

CONCEPT OF FACTORING

"Factoring is a method of converting the non-productive, inactive assets (book debts) into productive assets (cash) by transferring the book debts to the company that specializes in collection and administration". In simple words, factoring is the process of delegating the collection of book debts of a company to an agent (called the factor) who takes charge
of the collection process and the risk associated with it (bad debts), thus enabling the company to have a better liquidity. The cost that the company incurs for this delegation is the commission paid to the factor. Factoring is a powerful financial instrument to meet the post sales working capital of the industry, trade and service sector. The service is rendered by specialized agencies who assume the responsibility of credit risk for which service charge is taken. The fee is charged on the face value of the receivable factored. Normally this fee vary from 1% to 3%. Factoring is also named as “Account Receivable Financing” by the way of processing and converting the receivables into instant cash.

**MECHANISM OF FACTORING**

Factoring is simply a unique package of services designed to ease the traditional problems of selling on open account. Typical services include investigating the creditworthiness of buyers, assuming credit risk and giving 100% protection against write-offs, collection and management of receivables and provision of finance through immediate cash advances against outstanding receivables.

Under the factoring arrangement, the seller does not maintain a credit or collection department. The job, instead is handed over to a
specialised agency, called the “factor”. After each sale, a copy of the invoice and delivery challan, the agreement and other related papers are handed over to the factor. The factor, in turn, receives payment from the buyer on the due date as agreed, whereby the buyer is reminded of the due date payment account for collection. The factor remits the money collected to the seller after deducting and adjusting its own service charges at the agreed rate. Thereafter, the seller closes all transaction with the factor. The seller passes on the papers to the factor for recovery of the amount.

1. Customer places an Order on the Client.
2. Factoring company fixes customer sub-limit.
3. Client delivered the goods and invoices to the customer with a notice to pay the factor.
4. Client sends a copy of the invoice to the factor.
5. Factor makes a prepayment of 80% of the invoice total to the client.
6. Factor sends the monthly statements to the customers.
7. Factor follow-up, for any unpaid dues.
8. Customers make payment to the factor.
9. Factor releases the balance 20% to the client.
REGULATORY FRAMEWORK

Barring the guidelines issued to banks that factoring is a permissible banking activity and that this activity should be carried on through separate subsidiaries, no other restrictions are imposed by the RBI. They have, however, instructed banks to undertake inland factoring only. RBI appears to be keen that the factoring organizations start on a firm footing and they are allowed free play to achieve the role expected of them. There is, however, some anxiety in the minds of the clients as also banks as to how to go about in the area of existing bank limits and computation of eligible bank finance. In case where a client is opting for factoring, there has to be necessarily a discussion between the bank and the Factor. When a client opts for full factoring where all the book debts are to be assigned to the factor, the bill limit, if any, with the bank has to be cancelled and the bank will give letter of waiver after all the existing debts are paid, if these are not taken over immediately by the factor as a pre-arrangement. Wherever invoice factoring is opted, because of large volume or as per convenience, where invoices of few customers alone are factored, care is to be exercised to ensure that the invoices factored are not taken as security for bill finance made available by the bank. In such cases, the factor can send a copy of monthly statement of factored debts
to the bank and also make all payments to client through the bank by issuing cheques favouring the bank for the credit of the account of the client.

LEGAL ASPECTS OF FACTORING

The legal relationship between a factor and the client is governed by the provisions of the factoring agreement. Some of the salient features of the agreement are as follows:

1. The client gives an undertaking to sell its receivables and the factor agrees to purchase the same subject to the terms and conditions mentioned in the agreement.

2. The client warranties that the debts are valid, enforceable, undisputed and recoverable. The client also undertakes to settle problems of dispute, damage and deductions relating to the bills assigned to the factor.

3. The client agrees that the bills purchased by the factor on a non-recourse basis (called approved bills) will arise only from transactions specifically approved by the factors or those falling within the credit limits authorized by the factor.
4. The client agrees to serve a notice of assignment in the prescribed form to all customers whose receivables have been factored.

5. The client agrees to provide copies of all invoices, credit notes, etc., relating to the factored accounts to the factor and to remit money received by the client against the factored invoices to the client.

6. The factor acquires the power of attorney to assign the debts further and to draw negotiable instruments in respect of such debts.

7. The time frame for the agreement and the mode of termination are specified.

**FACTORING TYPES**

Depending upon the features built into the factoring transaction, there can be different forms of factoring arrangements. They are as follows:

a) Recourse Factoring

b) Non-recourse factoring

c) Maturity factoring

d) Advance factoring
e) Full factoring
f) Bank participation factoring
g) Supplier guarantee factoring
h) Cross-border factoring

SERVICES OF FACTORS

The services of factors are sales ledger administration, collection integrated with credit management and protection against bad debts, together with a financial facility that expands directly in line with sales.

Factors undertake responsibility for clients' sales ledgers, despatch of statements promptly, communicating firmly with slow-paying customers and solving any queries or difficulties that may arise in normal course of action. The client is kept apprised of developments at all times.

Through delegating these tasks to a factor, trading and manufacturing organizations not only eliminate the dangers inherent in poor sales accounting, but also save the cost of maintaining in-house sales accounting administration.
STATEMENT OF THE PROBLEM

The predominant among the service sector are the financial services that are growing leaps and bounds. The Indian industrial scenario has undergone a significant change as there are many small and medium sized companies who have started competing with large companies and services like factoring are more important to these companies as their capital base is low. Factoring is a flexible alternative to traditional forms of funding.

The State Bank of India and Canara Bank have set up their factoring subsidiaries – SBI factors and Commercial Services Limited and Canbank Factors Limited keeping in view the perennial problems of interminable delays in collection of dues and working capital inadequacies that dogged medium and small scale manufacturers. The then RBI governor at the time of launching of these factoring institutions had urged that the banking industry should look into the ways for expanding factoring services in the country.

Factoring is now universally accepted as vital to the financial needs of small and medium- sizes businesses. A growing number of
companies now offer factoring services and are competing each other. Banks also consider factoring institutions as their competitors.

The core area of factoring is to convert credit sales into immediate cash with a limited obligation. The total book debt will be taken over by the factors with a greater risk. The judgement may also fail, if there is underestimation or change in the market scenario. Factor benefits client, customer and factor, if the settlement is viable. Proper prediction about the markets, buyer's potential for repayment and regular follow up leads to a safe voyage. It wipes out the company's insolvency to solvency. But, the present trend for a factoring company is that it has to face vigorous competition in the financial service sector.

With a view to attaining a balanced dispersal of risks, factors should offer their services to all industries and all sectors of the economy. Factors should attempt a mix from among the various sources of funds to keep the cost of funds as low as possible so that a reasonable spread is available. Since factors will be competing with banks in financing receivables, they will have to charge their clients at a rate not higher than that charged by banks. Factoring companies fund their receivables portfolio primarily through equity which is not an optimal funding alternative given the cost of equity.
To pursue growth objectives, the manufacturers and the suppliers create a plenty of book debt. Realization of outstanding dues is increasingly becoming a complicated and tedious exercise. Delayed payments by customers may hamper future production and sale. These people take shelter of factoring services to ensure smooth running of their businesses. Factoring seeks to address this problem by helping creditors to realize their dues. Through factoring, business community has got not only financial support but also management support. But factoring would not be a complete solution for delays and defaults in payments. Commercial banks provide bill finance against receivable but do not provide management support. Hence efforts are needed to determine how clients view factoring as compared to other financing options.

The market for factoring in India has been growing at substantial rates. SBI factors and Canbank factors are actively involved in providing services to their clients spread over various parts of the country.

But little research on the factoring market currently exists and hence this study seeks to make an indepth analysis of the performance of SBI factors and Canbank factors and the satisfaction of the clients of these two factoring institutions. In this process the following questions arise.
(i) How do the SBI factors and Canbank factors fund their receivables portfolio?

(ii) Are these factoring institutions keeping their cost of funds low to have a reasonable spread?

(iii) Is there adequate growth in respect of various growth indicators?

(iv) Are the clients of SBI factors and Canbank factors satisfied with the services provided to them?

SCOPE OF THE STUDY

This study focuses on the performance of SBI factors and Canbank factors and client satisfaction of these two factoring institutions. Comparison of SBI and Canbank factors have been made in respect of growth, funds position and operational efficiency. Measurement of clients satisfaction and evaluation of factoring from the point of view of the clients have also been made in the study.
OBJECTIVES OF THE STUDY

The objectives of the study are

1. To understand the trends in growth of SBI factors in comparison with Canbank factors.
2. To forecast the future growth of SBI factors and Canbank factors.
3. To make a comparative analysis of the funds position of SBI and Canbank factors.
4. To study the operational efficiency of SBI factors in comparison with that of Canbank factors.
5. To identify the determinants of profitability of both SBI and Canbank factors.
6. To present the prudential risk distribution strategy of SBI and Canbank factors.
7. To measure the satisfaction of clients of SBI and Canbank factors and analyse the influencing factors.
8. To study clients’ evaluation of factoring as a financing option.
HYPOTHESES

To fulfil objective seven of the study, the following null hypotheses have been formulated and tested.

1. The mean satisfactions scores of clients of the factoring institutions do not differ significantly according to the difference in the type of their organisation.

2. There are no significant differences in the mean satisfaction scores of clients differing in the nature of their business.

3. The mean satisfaction scores of clients of different locations do not have significant differences.

4. Mean satisfaction score of the clients with differing periods of existence do not differ significantly.

5. Mean satisfaction scores of the clients do not differ significantly according to the difference in the scale of their operations.

6. Mean satisfaction scores of the clients do not differ significantly according to the difference in their period of clientship.
7. Mean satisfaction scores of the clients with different types of factoring agreements do not have significant differences.

8. Satisfaction scores of clients do not differ significantly according to the difference in the credit period availed.

9. Mean satisfaction scores of clients do not differ significantly according to the difference in the amount of credit sales.

10. Mean satisfaction scores of the clients of SBI factors and Canbank factors do not have significant differences.

**METHODOLOGY**

The following methodology has been followed for the collection and analysis of data.

**Period of Study**

The data collected for the study pertain to a period of sixteen years from 1991-92 to 2006-07. The period has been taken as sixteen years to include the entire period from the year of commencement of operations of the SBI and Canbank factors.
Sample Design

1. Selection of Factoring Institutions

Eight factoring institutions are operating in India presently. The SBI factors and Canbank factors have been selected out of these eight because, these two factoring institutions are operating for a long period and have similar periods of operation which makes meaningful comparisons possible. The remaining factoring institutions such as The Hongkong and Shanghai Banking Corporation Limited, Foremost Factors Limited, Global Trade Finance Limited, Export Credit Guarantee Corporation of India Limited, Citibank India and Small Industries Development Bank of India had less than five years of operation as on 31st March 2007 due to which meaningful conclusions cannot be drawn from the analysis and hence excluded from the study.

2. Selection of Sample Clients

Multi-stage sampling has been used in this study for the selection of the clients of the factoring institutions.

In the first stage southern region of India where SBI factors and Canbank factors have their offices, comprising of the states of Andhra Pradesh, Karnataka and Tamil Nadu have been selected.
In the second stage, the researcher has identified the number of offices of SBI and Canbank factors situated in the selected states, which are given in Table 1.1.

**TABLE 1.1**

**NUMBER OF OFFICES OF SBI AND CANBANK FACTORS IN SOUTH INDIA AS ON 31ST MARCH 2006**

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Name of Factors</th>
<th>No.of Offices</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>SBI Factors and Commercial Services Private Limited</td>
<td>4</td>
</tr>
<tr>
<td>2</td>
<td>Canbank Factors Limited</td>
<td>5</td>
</tr>
</tbody>
</table>

Source: Annual Reports of SBI & Canbank factors, 2005-06

These 9 offices constituted the sample frame for the selection of clients.

In the third stage, the number of clients of the select 9 offices were identified. SBI factors had 323 clients and Canbank factors had 154 clients as on 31st March 2006. Postal addresses of the clients were obtained from the 9 offices. Twenty per cent of the clients of SBI factors were selected which came to 64. This was rounded off to 60. In the case of Canbank factors, since the number of clients were smaller, 25 per cent
were taken which came to 38 which was rounded off to 40. Thus a total of 100 clients were selected comprising of 60 clients of SBI factors and 40 clients of Canbank factors. While selecting the sample clients care was taken to include clients differing in type of organization, nature of industry, location, period of existence, scale of operations, period of clientship, type of factoring agreement, credit period, amount of credit sales and factoring institution.

**Data Source**

The study was based on both secondary and primary data. The secondary data related to the operations of the factors have been collected from the Annual reports of SBI and Canbank factors. Primary data pertaining to the clients of SBI factors and Canbank factors have been collected through questionnaire.

**Pilot Study and Pre-testing**

A pilot study was conducted on 12 clients of SBI factors and 8 clients of Canbank factors in order to check the validity of the questions included in the questionnaire. On the basis of the pilot study, the questionnaire was redesigned with suitable modifications.
Survey, Data Collection and Processing of Data

The researcher conducted mail survey during the period from September 2006 to March 2007. A structured questionnaire was constructed to derive the necessary data from the clients. The select clients were sent the questionnaire by post. The data thus collected were posted in the master table to facilitate further processing. Statistical analyses of the data were done through computers.

QUANTIFICATION AND MEASUREMENT OF VARIABLES AND CONSTRUCTION OF SCALES

The objectives of the study include measuring the clients' satisfaction and the factors influencing their satisfaction level. In order to measure the level of satisfaction a five-point scale on the Likert Model has been constructed. The scores awarded to the responses of each component are Highly Satisfied – 5, Satisfied – 4, Neutral – 3, Dissatisfied – 2 and Highly Dissatisfied – 1.

The total scores of seven components constitute the satisfaction score of the clients. Further mean satisfaction scores of the clients have ascertained and standard deviation have been computed to classify satisfaction level into low, moderate and high. The scores below mean
minus standard deviation have been grouped as low, scores above mean
plus standard deviation as high and scores in between two limits under
moderate satisfaction.

In order to study clients’ evaluation of factoring services as a
financing option a three point scale was constructed. Seven statements
were included in the scale. The scores awarded to the responses for the
various statements were, extremely – 3, moderately – 2 and slightly – 1.
The total scores for the seven statements constituted the evaluation score
for each respondent.

FRAMEWORK OF ANALYSIS

The analysis and tabulation of results were performed by the use of
Statistical Package for Social Science (SPSS). Statistical tools such as
Trend Percentages, Annual Compound Growth Rate, Co-efficient of
Variation, Correlation, Multiple Regression, Discriminant Function
Analysis and Factor Analysis were used in the study.

In order to fulfil the first objective i.e., the trends in growth, Trend
Percentages, Annual Compound Growth Rate, Co-efficient of Variation
and Standard Deviation have been applied. To forecast the future growth
of SBI and Canbank factors Polynomial Regression technique was incorporated.

For the purpose of third and fourth objectives, the tools of analysis used were Mean, Co-efficient of Variation and Standard Deviation. Correlation analysis has been used to find the degree of relationship between profitability of the factoring institutions with the selected independent variables. Multiple regression analysis has been used to identify the determinants of profitability. Multiple regression technique was also used to study clients’ evaluation of factoring as a financing option. Discriminant function analysis has been used to identify the variables which significantly discriminate the high and low profitability periods of the select factoring institutions.

As regards the seventh objective i.e. measuring clients’ satisfaction and to identify the influencing factors Analysis of Variance (ANOVA) has been used. Factor Analysis has been employed to assign the order of importance to the independent variables and to determine the percentage variance contributed by them towards clients’ satisfaction.
LIMITATIONS OF THE STUDY

This study is subject to the following limitations:

1. This study is based on the published data and also on the clients’ responses of the select factoring institutions. Hence the study carries all the limitations inherent in both secondary and primary data.

2. Financial information related to the factoring institutions under the study have been rounded off to the nearest crores of rupees which has led to minor variations in the ratios.

3. The risk industry-wise exposure of SBI and Canbank factors were available only for the periods from 1992-93 to 2001-02.

ORGANISATION OF THE STUDY

Organisation of the study is as follows:

The first chapter gives an “Introduction and Design of the study” which includes, introduction, statement of the problem, scope of the study and objectives of the study, research methodology, limitations and chapter scheme.
The second chapter “Reviews the concept and the literature” of the previous studies relevant to the present study.

The third chapter focuses on “The Profile of SBI Factors and Commercial Services Pvt. Ltd. and Canbank Factors Ltd.

Statistical analyses and interpretations relating to growth, funds position, operational efficiency of SBI and Canbank factors, satisfaction level of clients and client’s evaluation of factoring services are given in the fourth chapter.

The fifth chapter recapitulates the key findings of the study and offers suitable suggestions.