CHAPTER - 5

REVIEW OF LITERATURE:

POLICY AND STRATEGIC ISSUES

5.1 Introduction

In this chapter, an attempt is made to review the existing literature in respect of policy and strategic issues involved in factoring particularly international factoring. A detailed review regarding global developments of factoring has been discussed in Chapter 3. But there are many conceptual aspects of international factoring that need to be analysed for which a review of literature is necessary. In this chapter, the relevant matter is discussed.

5.2 Integrated Approach

Factoring, receivables financing and invoice discounting are facilities with a common theme. Unfortunately, in the absence of unified legal framework, factoring in different countries has been defined in different ways. Moreover, there is an additional risk in resorting to factoring agreements when there are transactions across the national boundaries in view of different laws in respect of the activity. With a view to minimising risk in such arrangements, there is, thus, a need for harmonisation of factoring laws. The book on **International Factoring** written by two authors (Cox and Mackenzie, 1986) is the first compendium on international factoring wherein there is substantial deliberation.
on the various legal and operational aspects involved in international factoring. The researcher has relied heavily on the deliberations contained in the said book.

5.3 Benefits of Factoring

The available literature talks about benefits that may accrue to the exporters in case they resort to factoring compared with other traditional modes of financing (Pilcher 1989, Saxena 1989, Bajaj 1991). The benefits largely relate to the areas of expeditious and flexible finance coupled with relief from choosing the importers. Debt insurance facility is the added attraction. Factoring can also help ease the seller's cash flow problems (Seetha, 1990). An interesting dimension has also been added in as much as to allay the fear that resort to factoring will impair the financial discipline. Rather, it has been argued (Dandekar, 1991) that factoring will go a long way to help the borrowers to improve their financial discipline and serve as a catalyst for expansion and growth of industrial and business units.

5.4 Banker-Factor Relationship

Sometimes, the factoring and banking community are erroneously viewed as competitors. In reality, a bank and a factor complement each other's efforts. A factor fills a different niche than a bank does. When the bank provides an alternative for customers they have to turn down, the customer gets these financing needed, while the bank is still attending his needs and the factor provides assistance that was not available through traditional financing (Hart, 1991). The above view has been supported by many
other researchers (Rao 1990, Shankar 1990). Rao further argues that factoring can even be of advantage to the banks in more than one ways. It will not only enhance the turnover of the working funds, but in all probability, bring down the magnitude of funds and commitments in individual cases. Moreover, the banks would be in a better position to maintain adequate control over accounts by securing timely information as well as documents.

5.5 Future of Factoring

Matthesen T (1991) in his Kuper award winning article on factoring has raised certain vital issues facing the industry in the changing scenario of 1990s. These issues are:

(i) Can we be profitable in the face of increasing credit losses and the ongoing problem with Leveraged Buy Outs (LBOs)?

(ii) Can we provide sufficient credit coverage for our clients as we grow?

(iii) Where will the new business come from? Can we expand into new client industries?

(iv) Has increased skepticism about financial institutions in general eroded consumer confidence in our business?

(v) Are we technologically competent in today’s ever changing environment?

While doing a thorough introspection, he has concluded that factors have continued to survive regardless of the economic cycles in which they operate. By offering
maximum value in the execution of service, factors should be able to continue their successful track record. However, success dare not breed complacency. Factors will have to thrive on creativity in serving their clients’ growing and diversified needs while balancing the need for prudent credit and receivables management. This successful balance can alone be the way for a future in factoring that is as bright as its past.

5.6 Legal Aspects

The legal relationship of the parties involved in a factoring transaction is determined to a large extent by the agreement between the factor and the client (Joubert, 1991). In his dissertation, Joubert argues that the factoring involves execution of two agreements. Firstly, there should be an obligatory agreement in terms of which the factor is, in general, obliged to provide certain services and to pay certain amounts of money to the client while the client, on the other hand, is bound to cede his book debts to the factor. But, in certain countries of the world like Germany and South Africa, this obligatory agreement alone does not lead to the book debts being transferred to the factor. For such a transfer to take place, a further real agreement is necessary.

5.7 Factoring in India

Report of the Study Group (Kalyanasundaram Committee, 1988) for examining introduction of factoring services in India was made available in December, 1988. Subsequently, it was attempted to examine its applicability and relevance. For instance, the researcher in his project report (1990) submitted to Indian Institute of Bankers,
Bombay, under Lord Aldington Banking Research Fellowship has discussed the various issues relating to introduction of factoring services in India. Drawing experiences from abroad, the various issues for consideration before the product is actually launched, according to him, are:

(i) Rationale of zonal bifurcation of the factoring activities as recommended by Kalyanasundaram Committee,

(ii) Deciding the specific criteria for selection of the clients (i.e. the sellers),

(iii) Problems of ancillary small scale industrial units,

(iv) Types of services to be provided that is, debate regarding with and without recourse services,

(v) Dilemma of relationship between the parent bank and the subsidiary company undertaking factoring business,

(vi) Problems of resource mobilisation by the factoring organisations,

(vii) Considerations for pricing the services,

(viii) Automation of operations, and

(ix) Various legal issues, especially those relating to enactment of a full-fledged factoring law, assignment of debts, stamping of documents, ban on assignments and retention of title.
The other suggestion put forward by the author was that export factoring should also be launched in the country on selective basis by joint ventures of selected banks and Export Credit Guarantee Corporation of India Ltd.

The various benefits that can accrue to the Indian financial system as a result of introduction of factoring have been discussed by various authors (Rao 1989, Shankar 1990, Sriram 1990, Mistry 1991). Rao argues that an efficient financial system such as factoring service can sustain itself on a viable basis only if a conducive environment is created and fostered. The government should, therefore, take expeditious steps to promote the required legislation as also to make amendment to the existing laws to subserve the objective of promoting factoring. Sriram describes the introduction of factoring services as the beginning of a new culture. He argues that the appreciable determination of the Reserve Bank of India to actualise the recommendations of the Vaghul group for development of factoring services in India is amply manifested through the formation of the Kalyanasundaram Committee, acceptance of its major recommendations and initiation of talks with premier nationalised banks to float factoring subsidiaries. Shankar summarises by saying that the industry's response to factoring has been positive. But permitting only banks to offer this service has come in for criticism from some trade quarters which enquire whether banks have the required expertise and mechanism to recover the debts of their clients when their own debts are proving to be irrecoverable. However, the author opines that once the teething troubles are taken care of, the future
of factoring is bright. Banks in India are on the threshold of developmental changes and willing to experiment with bold and innovative schemes. Factoring would definitely be a new profit-oriented venture for the Indian banks. The special benefits that may accrue to the units in small and medium sector as a consequence of introduction of factoring in India have been stressed by Joshi (1991). He has argued that factoring for SSI units would be mutually beneficial to both the factors and SSI units. The latter would benefit from the wide range and flexibility of factoring services, while factors would have a readily available substantial business from this sector.

However, the introduction of factoring in the Indian context needs a cautious approach (Sen Gupta, 1990). The observations of the author are that besides the normal constraints narrated in the literature, factoring at the initial stage may have its own teething problems arising from lack of professionalism and competence, under-developed expertise, resistance to change, etc coupled with the tendency on part of some of the clients to perpetrate fraud by way of fictitious invoicing, pre-invoicing or duplicate invoicing. Since funds in factoring are available in unlimited quantum depending upon growth propensity, it may also result in over-trading.

A totally different view arguing against the introduction of factoring in India has sometimes been expressed (Bhusnurmath, 1991). The argument has been that, in spite of several steps taken by the Reserve Bank of India to promote bills culture, it has failed to take off. The single most important reason for the same can be traced to non-availability
of eligible bills because of the reluctance of the large buyers to submit to the bills-discipline. Therefore, the problem can easily be encountered by introducing the simple concept of invoice discounting rather than starting a new financial product by means of factoring services. The rationale for introducing invoice discounting in India has also been stressed by Sen Gupta (1990). However, he has considered this service not as a substitute but as a complementary product to factoring business.

5.8 Findings of Research Projects

A detailed research project was undertaken at National Institute of Bank Management (NIBM), Pune (Sen Gupta and Kuvalekar, 1990), to look into the various aspects of launching domestic factoring services in India. The broad objectives of the study were to:

(i) Understand the perception of the users mainly the small scale sector with reference to the utility and acceptance of the service.

(ii) Develop broad structural framework and policy guidelines relating to operational aspects of factoring.

(iii) Examine legal and other issues connected with domestic factoring business.

Primary data formed the major source of the study in absence of sufficient secondary data. Selected sample consisted of (i) 30 industrial units (Small Scale Sector)
in and around Pune under the category of sellers, (ii) 5 buyers comprising of large industrial houses and (iii) identified legal experts and bank executives.

A number of suggestions have been offered encompassing all facets of domestic factoring, the most important amidst them relate to:

(i) Organisational framework,
(ii) Types of services,
(iii) Pricing of services,
(iv) Resource mobilisation,
(v) Selection of clientele,
(vi) Credit information system,
(vii) Legal issues,
(viii) Control mechanism, and
(ix) Marketing consciousness.

Very little efforts have been made in the world to analyse the effect of factoring on the portfolio of the sellers either in financial terms or from the perspective of customer-satisfaction. Therefore, very scanty literature is available in this regard. In the UK, a recent survey conducted by the Association of British Factors (ABF) has revealed that the average client is a satisfied person; nearly 82 per cent of the users have described their experiences of factors as either excellent or very good. Recently in 1992, Canara Bank on request from Canbank Factors, its subsidiary, carried out an evaluation study to
determine the impact of their services, benefits accruing to their clients and the experiences of the clients. The other dimension was to analyse the perception of the bankers of the factoring service. The sample size was restricted to 12 units out of a total population of 38 organisations availing factoring facilities from Canbank Factors, situated in and around Bangalore. As regards bank branches, response could be obtained from 4 branches of Canara Bank situated in Bangalore. The methodology adopted was structured interview.

The main findings of the evaluation study are:

(i) Customers who had several inhibitions regarding factoring before availing of the service and also during the initial stage, are very satisfied about its operation now.

(ii) Marketing consciousness needs to be created both among the clients and bankers about factoring services.

(iii) All the clients are very enthusiastic about full factoring (which is not existent in India as on date) indicating that there is a good scope for it. But factors need to weigh this against costs and may broaden their client base as a preliminary step to expand the scope of their operations.

(iv) There is a need to open more branches of factoring companies.

(v) As the system of accounting and follow-up is fully mechanised, staff strength is less and over-heads lower compared to those of banks. The
cost/financial charges may, therefore, either be reduced or justified by providing an improved package of facilities within the limited scope of the services rendered by the factors.

(vi) Efforts are needed to attract large scale establishments into the fold of factors.

The specific issues relating to launching of international factoring services in India have been detailed at length by Sen Gupta A K (1990,1992). Besides discussing the conceptual framework, the author has argued in favour of international factoring being introduced in the Indian context primarily as an export promotion measure. The author has argued that international factoring has an immense role to play in harmonising the world trade with emphasis on open account transactions. While international factoring may not replace business backed by letters of credit, it is likely to be viewed as an alternate source of financing to documentary credit. The author concludes that the time has ripened when on an experimental basis, a few banks may be allowed to start export factoring with or without collaboration with Export Credit Guarantee Corporation of India Ltd.

5.9 Conference Deliberations

During 1992 (October 30-31), a Conference of Top Management of Banks in India was organised at National Institute of Bank Management (NIBM), Pune to discuss threadbare the various issues confronting the factoring industry. Seven different papers were presented covering all aspects of factoring, both domestic and international, besides
bringing out the vital issues concerning banker-factor relationship. The papers also included the achievements of the two factoring organisations during their first year of operation. The major issues that the Conference addressed were:

(i) Strengthening marketing consciousness.
(ii) Closer co-operation between the banker and the factor.
(iii) Problems in obtaining letter of disclaimer/waiver from the financing bank.
(iv) Effect of factoring on maximum permissible bank finance (MPBF).
(v) Need to start factoring in remaining two zones of the country namely, eastern and northern.
(vi) Need for development of non-fund based factoring concept.
(vii) Launching separate factoring company for small scale sector.
(viii) Diversification of factoring activities into without recourse factoring and other related areas like collection, data base, etc.
(ix) Implications of Shah Committee’s recommendations.
(x) Rate of interest on bank borrowings availed by factoring companies.
(xi) Introduction of full fledged legal framework for factoring.
(xii) Stamp duty exemptions.
(xiii) Notification of factor’s charge on book debts of the company.
(xiv) Ban on Assignment clauses in the purchase agreements.
Strategies for launching international factoring.

Future of factoring in India.

One of the important viewpoints came from Shri J V Shetty, Chairman and Managing Director, Canara Bank during the valedictory address wherein he urged Export Credit Guarantee Corporation of India Ltd. which has been contemplating to start international factoring in India, to join hands with existing factoring companies instead of going alone. He argued that similar approach has been adopted by Small Industries Development Bank of India (SIDBI) which has collaborated with the existing two factoring companies by way of equity participation.

5.10 Conclusion

The review of literature thus described above encompasses the various dimensions of factoring services. Nevertheless, factoring being a new concept, there is substantial gap in academic work relating to establishing the efficacy of the same as an effective financial product. However, it can safely be concluded that factoring as an alternate instrument has opened a new vista towards financing trade receivables in addition to traditional modes of bank financing.
References


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