CHAPTER - 9
POLICY AND STRATEGIC DIMENSIONS
OF INTERNATIONAL FACTORING

9.1 Introduction

International factoring services are expected to be launched in India in the near future. As stated in the earlier chapters, both SBI Factors and Commercial Services Pvt. Ltd. (subsidiary of State Bank of India) and Canbank Factors Ltd. (subsidiary of Canara Bank) are inclined to start this activity. Some of the leading investment and financial houses may also enter into this area of activity either individually or in collaboration with some factoring houses abroad. In the decade to come, a few factoring companies are likely to emerge in the financial services market of the country, to be engaged in international factoring services. Notwithstanding the enthusiasm and exuberance exhibited towards starting this innovative product, a number of issues relating to policy and strategic dimensions need to be resolved, if the experiment is not to fail in its nascent stage itself. Some of these basic issues which have vital bearing on the success or otherwise of this innovative experiment in the country are discussed in the following paragraphs.

9.2 Types of Services

Many variations of factoring are prevalent throughout the world, the predominant amongst them being full service factoring (without recourse), with recourse factoring,
maturity factoring, invoice discounting, bulk factoring, agency factoring, etc. However, the debate is only in respect of one vital aspect - whether both "recourse" and "without recourse" factoring services should be launched in India, as has been recommended by Kalyanasundaram Committee. This issue has to be seen from a different perspective in as much as whether factoring in India is to be launched on two factor system or otherwise. This is because in a two-factor system (explained in chapter 2), the importer credit risk is born by the import factor located in the importer's country; thus for all practical purposes, the facility becomes without recourse facility. But, in a single factoring model (direct export factoring or direct import factoring), the Indian factor has to take upon itself both exporter-risk and importer-risk. Further, if the factoring company does not take upon the responsibility of debt-insurance against the commercial and political risks, the facility itself becomes truncated and unattractive to the exporters. Additionally, when a factoring company in India is acting as import factor, he has necessarily to provide credit limits on the importer in India. Otherwise, the service practically looses its attraction.

Therefore, it is felt that if international factoring (more so the export factoring) is to become a meaningful and useful alternate instrument compared to the existing bank-schemes of financing exports, the facility must have the characteristics of without-recourse. To make it practically operative, it is better that Indian factors must operate on a two-factor system so that risk in the operations gets minimised.
Alternatively, the factors may have arrangements with Export Credit Guarantee Corporation (ECGC) of India Ltd., whereby the latter would provide the cover to the exporters and guarantee to the factors, as available in the existing banks’ export credit schemes. Therefore, it is appropriate to start slowly and cautiously so that the initial experimentation does not get a set back.

The other pertinent question is whether factoring companies in India should also start import factoring services. There are primarily two views in this regard. One view has emanated from the analysis of the primary data contained in chapter 6 (views of bank-executives), that to start with, import factoring may not be started on a big scale. This is primarily due to lack of both credit information system and adequate spread of the network of the factoring companies. However, the fact cannot be overlooked that export factor has necessarily to act as import factor in cases of import of goods/services into the country. Further, this activity is quite a remunerative one especially when the imports are done by large public sector undertakings/private houses / multi national companies (MNCs) as the risk of debt insurance is minimal. Risk involved in such cases is only limited to follow-up as chances of bankruptcy are remote.

9.3 Resource Mobilisation and Pricing of Services

These two are interlinked issues; the pricing strategy has to be decided keeping in view both the fixed and variable cost structure coupled with profit margin and based on the same, the cost of funds of resources to be mobilised, is to be fixed. It has then to be
ensured whether it is feasible to raise the resources at the maximum level of cost already
decided. The pricing of factoring services primarily comprises of two components:

(a) **Administrative Charge:**

This is levied towards providing sales ledger administration of the exporter
including credit control, collection of debts and providing protection against bad debts.
This charge is computed with reference to the projected export-turnover of the exporter,
being a per cent of the same. Since the importer-risk is taken care of by the import
factor, this charge is shared between the export factor and import factor. There are no
specific guidelines regarding sharing of the commission. It depends on the inter-factor
agreement executed between the two factoring companies.

(b) **Discount Charge:**

This is charged towards providing instant credit to the exporter by way of
prepayment. This is normally linked with the base interest rate of the parent company or
the bank from which the factoring company is borrowing money.

There are two dimensions to the above issue. Firstly, whether factoring can
succeed in spite of the fact that it is a costly alternative. Secondly, whether the factoring
companies would be in a position to mobilise resources to offer discounting charges at par
with bank credit. The first question cannot be answered with conviction. But, the fact
remains that international factoring would open up an alternative window to the exporters
not only for finance but also for all the allied specialised services that would be provided
under a "Single Window" approach. Many of the problems faced by the exporters today like delay in obtaining buyerwise limits from ECGC, settlement of claims (by ECGC) in cases of insolvency of the importers, inappropriate maintenance of sales ledger, etc. would be taken care of by the factor. Besides, finance at the post-shipment stage would be available on flexible terms, may be more quickly than what is existing today in respect of bank finance, though on slightly costlier terms. At least this has been the experience in respect of domestic factoring organisations. The second issue as regards mobilisation of resources is probably more important from the view point of successful operations of the factoring companies. This is particularly true when we consider the fact that existing export credit by banks is available on subsidised terms. On an average, banks' exposure to export credit as a proportion to total gross credit is around 10 per cent (target fixed by the RBI) and therefore, they are in a position to resort to transfer price mechanism through their deployment of resources to other sectors with a view to off-set the losses. However, the situation is totally different for an export factor. While its major, if not total, deployment of funds would be in export sector, its pricing will have to be somewhat compatible with that of bank-credit.

With the above background, let us have a look at the various options available for resource mobilisation by a factoring organisation. These sources could be (besides own funds):
(i) Line of credit from the parent bank (in case of bank sponsored subsidiary),

(ii) Loan from banks,

(iii) Public deposits,

(iv) Market borrowings,

(v) Capital raised from the public, and

(vi) Rediscounting / refinance from the RBI / Small Industries Development Bank of India (SIDBI).

The first option is practically ruled out as the base rate at which the subsidiary is in a position to avail of the line of credit from the parent bank would be minimum 18-19 per cent p.a. (1-2% above the minimum lending rate). Similar is the case with loans raised from other banks. Rather charges in these cases may even be more. Raising resources through public deposits will not be an easy task for a new factoring company. The modalities regarding rediscounting/refinance from the various institutions are yet to be worked out. However, in respect of domestic factoring services, rediscounting facility from Small Industries Development Bank of India in respect of deployment to small scale sector is available charges in respect of which amount to around 17 per cent. This option is also, therefore, costly. The only other options left to a factoring company for raising resources are market borrowings and equity/ preference capital from the public/promoters themselves, with an intelligent mix of the two. This is in the light of the above that the suggestion has come from existing factoring companies (Chapter 6) that free access to
flexible resource by borrowings from shareholder-bank/inter-bank market should be allowed to them to facilitate continuous availability of cheap resources.

9.4 Relationship Dilemma

As in the case domestic factoring, international factoring services, at least to start with, are likely to be launched by subsidiaries of commercial banks. This situation is likely to result in some relationship dilemma between:

(i) Parent bank and the subsidiary,
(ii) Subsidiary and the other banks.

An apprehension always exists that the factoring companies may be looked upon as a threat by the banking system. This is logically so as a part of export financing business at post-shipment stage will be taken over by the factoring organisations. Some of the banks may even like to shed off the existing sticky accounts to a factor as a problem solving mechanism for reduction of overdues whereas the factor would like to have in its portfolio the best of exporters, creating disharmony in the existing financial system. Further, the factor may not cater to the needs of the exporters of the other banks (other than the sponsorer ones). Thus, the factoring experiment may increase the hegemony of the big banks by floatation of yet another product on the existing concept of "financial supermarket".

The above issue can be approached in many ways. Firstly, the big banks alone should not be allowed to start the activity. Even the smaller banks should be permitted
by the RBI to undertake the factoring services. The smaller banks may be persuaded to
join hands with the bigger ones to launch international factoring on a consortium basis.
The general permission granted by the RBI allowing the banks to start factoring activities
departmentally (Chapter 4) is a welcome step.

There is an alternative approach towards tackling the above problem. Providing
finance is only an incidental activity of a factor. The main function is to provide the
package of administrative services, related to credit management functions. This being
the approach, even non-fund based international factoring can be thought of meaning
thereby that the factor will provide services alone, whereas finance (both at pre and
post-shipment stages) will continue to be offered by the banks. This mechanism has three
distinct advantages:

(a) Additional security to the financing bank by way of guarantee to be given
by the factor,

(b) Existing relationship between the exporters and the banks not being
disturbed, and

(c) Problems of resource mobilisation by the factoring companies being
obviated.
9.5 Evaluation of Factoring Proposals

No doubt, international factoring services would open up an alternative window for the exporters/importers of the country. But, at the same time, all the proposals emanating from them may not be factorable proposition.

The edifice of sound factoring decision comprises of the following three facets:

(i) Financial, operational and managerial competence of the exporter,

(ii) Collectibility of debts, that is strength of the importer and importer’s country, and

(iii) Continued profitability of the exporting units.

The assessment of the risk of the exporter is of vital importance to the factor. This would primarily depend on the general economic environment, the government policies, rules and regulations, incentives, etc. applicable to the exporting units, the managerial competence of the exporter, the nature of products, the financial strength of the unit, past performance, and so on. Besides, some of the industries may not, at all, be considered for factoring ab initio. Few instances of the above are given hereunder:

(a) Companies having a high concentration on a few importers,

(b) Companies with speculative business,

(c) Units manufacturing and selling highly specialised items,

(d) Units manufacturing volatile items susceptible to changes very quickly like high-fashion garments, etc., and

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(e) Companies engaged in construction or similar activities where part/progress payment systems are in vogue.

Similarly, there should be a minimum economic size for an exporting unit to resort to factoring as for a very small exporter, the cost of factoring may be disproportionately high and uneconomic. This means that some financial as well as non-financial criteria may have to be evolved by the factoring company, for the exporter to be eligible for entering into a factoring contract though it may result in some contraction in the operating market.

9.6 Credit Information System

The other important issue in this regard is the need of development of credit information system within or outside the factoring organisation. This is of vital essence in respect of import factoring services as the import factor in India will be expected to set-up a buyer-wise limit (both amount and period-wise) on the importer(s) in India. The factor in such cases should be fully equipped to assess the debtor-risk. Unfortunately in India, we do not have any comprehensive credit rating agency which furnishes the full credit report on a company. The rating agencies in India are primarily engaged in rating debt-instruments of the companies who are entering the capital market. Therefore, in such circumstances the issue is whether import factoring should be launched in India in absence of such credit information agency. It is, however, more or less agreed proposition that the factoring companies may themselves have to develop credit rating divisions within
themselves. No doubt, this is a long drawn process and it may take a long time to build up the systems and data-base. Close cooperation among the various factoring organisations with a view to disseminating knowledge about the parties dealing with them, will to a certain extent improve the situation. This also calls for close cooperation between the banker and the factor so as to enable the latter to obtain credit references from the former about the importers dealing with them.

9.7 Automation of Operations

For a few years to come, international factoring business will definitely be a seller's market. Number of operators in the market will be few. With the strict financial/non-financial criteria stipulated, the number of exporters and importers for each factoring during first few years, will be relatively small, say not more than 50-60. This number has been assumed based on the experience of the domestic factoring companies. Assuming the number of importers per exporter to be around 8-10, each factoring organisation will have in its portfolio a minimum of around 400-600 importer accounts. Number of invoices outstanding on each importer may be more than one. All these invoices being the assets of the factoring company, require close monitoring and follow-up. Besides, the work relating to sending of statement of account, extract of ledger account, details of unpaid invoices, etc. to the exporter has also to be undertaken by the factor. Importers in India also need close follow-up for the purpose of recovery. It is extremely difficult to carry on these activities manually. Therefore, in view of the above,
there is no other option for a factoring company except to go in for full automated operations. Further, if Indian factors opt to become members of international factoring chains, they have to link themselves with other factoring companies through the common net-working system. For instance, it is obligatory on the part of all the factoring companies belonging to Factors Chain International (FCI) to have the "intelligent" communication system known as FACT which is operated by GEISCO - Mark III Satellite System. Therefore, the computerisation of operations is a vital issue which should be taken care of by a factoring company before the services of international factoring are launched.

9.8 Marketing of Service

For marketing any financial product, the four most important considerations are:

(a) Product,

(b) Place,

(c) Price, and

(d) Promotion.

Though the core product of factoring (especially international factoring) is in an enviable position in India today, there are certain problems which need a closer look. The concept is not popular among exporters, importers and even bank executives (chapter 6). Factoring, as happened in other parts of the world at the initial stage, is sometimes construed as a mere debt protection agency. The bankers consider the factoring
organisations as their competitors. Thus a marketing consciousness needs to be generated through organising a number of seminars and conferences bringing out the positive impact this concept can have on the economy as a whole through promotion of exports.

Pricing is yet another important consideration. Factoring eventually is costlier than conventional export credit provided by the banks (because of additional service charges). Nevertheless, the efficacy of the performance of an export factor in the Indian context, would be judged in the context of reduction of historic debt turn, through quick collection services offered. In case of import factoring, the efficiency would be judged by how quickly the Indian factor can offer buyer-wise limits followed by quickness in debt collection. Therefore, efficiency needs to be of high order if the factor is to survive.

Promotion of factoring product is of vital essence to a factor for his survival. Here comes the role of the business development department that has the responsibility of procuring business from new exporters/importers of the desired quality on the most profitable terms. The total process involved in the parlance of factoring consists of several stages:

(a) Canvassing new business and contacting the people,
(b) Visit to their business premises,
(c) Getting business proposals,
(d) Discussions with the exporters/importers,
At each of the stages, the role of marketing or business development manager is vital. Thorough professionalism coupled with courtesy and gentle politeness will bring in the required confidence and mutual trust eventually generating new and good business.

The other important issue is the presence of competition, though to a limited extent, from the banking system. The word "to a limited extent" is specifically applicable in the Indian context as in many other countries, various possible substitute products are available to satisfy the same needs. Table 9.1 shows the extent of availability of substitute products in the UK.

However, entry of substitute products may also render the factoring business in India competitive in future. Therefore, organising market research on an ongoing basis may become the imperative necessity in days to come. By doing so, some of the interesting questions can be answered:

(a) Which industries are providing the most growth especially in export markets?

(b) Which industries provide the most secure exporters?

(c) Which industries have a bias towards certain types of service?, and

(d) Which industries have an inherent need for debtor based finance, and so on.?
By careful evaluation of all the facts, the marketing efforts may then be coordinated to ensure that maximum results are obtained from the promotional expenditure.

The role of advertising and publicity in canvassing new business by factoring organisations cannot be undermined. However, extravagant means like publicising through TV/Radios, etc. may have to be discouraged at the initial stage to keep the overheads to the minimum. The main sources of organising advertisement campaign may be:

(a) Printed literature,
(b) Publicity campaign/articles in business magazines/books,
(c) Branch managers of sponsoring banks,
(d) Existing exporters/importer customers, and
(e) Practising professionals like chartered accountants/auditors/solicitors, etc.

The one mode of canvassing new business in financial service industry including factoring services all over the world, which is gaining popularity, is "direct mailing". It can be used not only as a lead generator but also as an educator of the professional intermediaries. Broadly speaking, direct mail activity can fall into one of the two categories:
Blanket Coverage  Where all companies within specific industries and within specific turnover ranges are mailed without further detailed selection as to their financial means or their potential needs.

Selective Mailshot  Where information is sent only to those companies on which detailed research has been undertaken ascertaining that there is a very strong possibility that factoring would meet their financial and administrative needs.

Direct mail has the advantage that it is a very flexible system, but it is essential to have the capacity to follow-up promptly and energetically if success is to be achieved.

9.9  Formulation of Schemes

In the beginning of this chapter, discussions have been made regarding the types of services that can be initiated by an international factor. The main two services identified in this regard have been export factoring and import factoring. However, some specific schemes in this regard which are in vogue in different countries of the world are as under:

9.9.1 Full Service Factoring

This is the most standard and comprehensive of all the packages wherein all the ingredients of factoring services are present, namely

1. Providing finance,
2. Sales ledger administration,
3. Credit control and collect of debts,
4. Bad debt protection, and
5. Consultancy services.

Facilities at items 1, 2 and 5 are provided by the export factor whereas 3, 4 are taken care of by the import factor.

9.9.2 Maturity Factoring

The alternative name given to this arrangement is "collection factoring". In such an arrangement no prepayment is accorded to the exporter at the initial stage at the time of assignment of invoice. The entire amount less the factoring fees (including the amount payable to import factor) is paid to the exporter as and when the dues are collected from the importers. The responsibilities relating to sales ledger administration, asset management, credit control including collection of debts and debt protection, however, remain vested with the factor.

9.9.3 Invoice Discounting

This involves simple financing against invoices without assumption of any other risk or responsibility on part of the export-factor. All other responsibilities namely, sales ledger administration, accounting and collection of debts remain vested with the exporter himself. The exporter after collecting the debts himself passes on the same to the factor. The peculiar characteristic of such arrangement is that it is totally confidential in nature and the importers are not aware of the financing arrangement. Therefore, the popular name of this facility is "confidential invoice discounting" or "undisclosed factoring". As
can be seen from the mechanics of operation, this facility is high risk in nature and normally, therefore, no credit protection facility is available. Therefore, under such a factoring arrangement, there is no need for an import factor in the importer’s country.

9.9.4 Import Comprehensive Factoring

This is an exclusive facility for the importers, which is comprehensive in nature comprising of the following services:

1. Providing limits (amount and period-wise) for the importer,
2. Offering debt protection guarantee to the export factor/exporter, and
3. Providing or arranging import financing to the importer.

9.9.5 Overview

There is a combination of various issues which determine the type of the scheme applicable to a particular transaction. Some of these are:

1. Nature of exporter’s/importer’s business,
2. Volume of exporter’s/importer’s business,
3. Cost of service acceptable to all the parties, and
4. Factor’s security.

Nevertheless, for smaller growing companies in a competitive environment, full service factoring and import comprehensive factoring can offer the best and comprehensive package. However, if an exporter is used to sell to credit worthy importers and has had no bad debt experience in the past, probably he may not require
protection against bad debt facility, which will push down the pricing structure substantially. A very sound cash-rich company not needing financial assistance but in requirement of other services, may go in for maturity factoring. Similarly, a sound company with computerised and well managed sales ledger administration selling to a number of good importers may like to avail of only invoice discounting facility. This may serve two purposes, namely uninterrupted and predictable cash-flow and an "ego" satisfaction of demonstration of running business with his own funds to outside world as notification of debt is not there.

Therefore, a factoring company has to be very meticulous while devising the schemes within the broad framework of factoring concept and also marketing the same depending on the need and price bearing capacity of an individual client (exporter or importer).

9.10 Conclusion

The above are some of the vital policy and strategic issues involved, that must be looked into carefully before international factoring is launched in the country. However, many more problems may emerge as the experiment starts. These have to be tackled prudently as and when they arise.
Table 9.1
Benefits of Factoring Services and Possible Substitute Products in UK

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<th>Sr. No.</th>
<th>Benefit</th>
<th>Need</th>
<th>Possible Substitute Products</th>
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<tbody>
<tr>
<td>1</td>
<td>Increased Profits/ Faster Growth</td>
<td>More Working Capital</td>
<td>Overdraft</td>
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<td>Reduced Debt Turn</td>
<td>2nd Mortgage</td>
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<td>Reduced Bad Debt</td>
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<td>Lower Administration Costs</td>
<td>Sales Ledger Bureau</td>
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<td>2</td>
<td>Reduced Executive Hours</td>
<td>Sales Ledger Administration Credit Control Collection</td>
<td>More/Better Staff</td>
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<td></td>
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<td>Collection Agency Sales Ledger Bureau</td>
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<td>No Bad Debts Additional Funding Facility</td>
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<td>Reduced Exchange Risks</td>
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