CHAPTER - 1
INTRODUCTION

1.1 Backdrop

Exports constitute the edifice of citadel of a sound economy more particularly for a developing nation like India, which is often faced with a chronic balance of payment crisis. Many models for export promotion, marketing and subsidised finance have been initiated from time to time towards growth of this sector. Notwithstanding the progress achieved, much desires to be done with an innovative approach for export promotion.

Exporters are not any special breed of sellers. They include hundreds of enterprises, large and small, which sell their finished goods/services overseas as well as in the home market. Selling in the international market is an irresistible challenge for many companies. Markets are larger, customers numerous, and opportunities greater. Electronic communications can enable the sellers and buyers to settle a transaction in no time.

Notwithstanding the physical contraction in global business arena, the international market is still fragmented. Different countries of the world are distinct entities in terms of language, custom, culture, methods of payment and currency system. Tariffs and preferences, restrictions of import and restrictive laws for outflow of foreign exchange are some additional impediments in the process of trade harmonisation. Exchange risk contributes to further complexity of the situation.
1.2 Export Finance

One of the major contributing factors for promotion of export trade is the availability of special finance both at pre and post-shipment stages. An exporter has not only to arrange for procurement of raw materials for processing the same in finished goods for boarding them on ship/air, but also has to often allow credit terms to an overseas buyer. Delivery period in international trade transactions is normally longer compared to the domestic counterpart and correspondingly the lead time for getting payment from the overseas buyer(s) is more. Thus, the exporter has to be extra-cautious to ensure that the buyer is a reliable one and the payment for the goods sold will be received expeditiously.

This feeling of risk and uncertainty involved in the international trade transactions has resulted in various methods of payment like Advance Payment, Cash With Order, Bills of Exchange backed by Letters of Credit and so on. All these mechanisms tend to be biased heavily in favour of the exporter so that his rights relating to receipt of payment are fully protected. Consequently, up to the last decade or so, the mechanism of financing of international trade has mainly been backed by letters of credit. However, the global trend reveals that this approach is gradually loosing its momentum primarily on account of doctrine of strict compliance besides high cost and time involved. In the words of Joroen Kohnstamm, Secretary General of Factors Chain International, the largest coordinating body in international factoring in the world, "The seriousness of this problem
has been amply demonstrated in a recent survey of United Kingdom where it was shown that more than 50 per cent of documents failed to comply with terms of Letters of Credit in first presentations to the banks".\(^1\)

In view of the above constraints, there has been a visible shift towards "open account" transactions in international trade wherein there is a direct agreement between the exporter and the importer(s) to complete the deal including the payment of dues at a pre-determined future date usually 60 to 90 days from the date of the invoice. The goods and the shipping documents are sent directly to the importer/s so that he/they can take delivery of the goods.

The essential condition of an open account business is that the exporter should have:

(i) Complete faith in the credit standing not only of the importer but also of his country so that the proceeds of the goods can be realised within the agreed period.

(ii) An efficient sales ledger administration often in multi currencies coupled with credit control mechanism involving sound knowledge of trade practices, laws and language of the importer’s country.

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(iii) Sufficient liquidity to grant competitive credit terms to the importer(s).

(iv) Guaranteed payment in case of insolvency/bankruptcy of any of the importers.

But the seller may lack to fulfil all the above requirements. Thus, to facilitate him to fulfil the same, international factoring is suggested. International factoring can play a very effective role in such a situation as the factor would provide, in an open account transaction, not only liberal credit but also aforementioned package of services to cater to the needs of the exporter.

1.3 International Factoring Defined

The diplomatic conference of International Institute for Unification of Private Laws (UNIDROIT), held in 1988 at Ottawa, Canada, defined international factoring as an agreement between an exporter and a factor (an agency to undertake factoring services), whereby the factor having purchased the trade debts from the exporter, would provide the services, such as finance, maintenance of sales ledger, collection of debts, protection against credit risks, etc. Thus, the factor besides providing finance against trade debts, would offer the advisory and administrative services. Consequently, the exporter can concentrate on the production with a view to improving the profitability of his enterprise leaving the job of credit management to an outsider-professional that is, the factor. It will also lead to improvement in the overall productivity of the firm as a result of quicker realisation of trade-receivables.
1.4 Development of International Factoring

Though factoring in the modern and organised form started in USA as early as in 1920s, in real terms, the development thereof has taken place only since 1980. The performance since then has been remarkable - the total factoring turnover as at the end of 1993 stood at $260,844 million, business being transacted by 755 factoring companies across the world.\(^2\) This includes international factoring business amounting to $14,556 million.\(^3\)

Over the years, international factoring has taken various forms for operational convenience, the most prominent amongst them being:

(i) Two factor system,
(ii) Single factor system,
(iii) Direct export factoring,
(iv) Direct import factoring, and
(v) Back to back factoring.

These different types of factoring have evolved, due to varying needs of the exporters, security to the factors besides the price bearing capacity of the former. A detailed discussion in this regard is given subsequently (chapter 2). Factoring in India has taken some shape as outlined below.

\(^3\) ibid.
1.5 Factoring in India

The study group on factoring (Kalyanasundaram Committee) was appointed by the Reserve Bank of India in 1988, to look into the various aspects of introducing factoring services in India. One of the terms of reference of the above group was to consider the feasibility of extension of factoring services to the exporters. The committee observed that, during 1986-87, only 38 per cent of the country's exports were on LC terms, meaning thereby that, if international factoring was introduced, it might evoke favourable response from the exporting community. It, therefore, recommended for the introduction of international factoring in India.

1.6 Need for the Study

Despite the recommendations of Kalyanasundaram Committee which were accepted by the RBI, international factoring is yet to be introduced in India. Further, it is felt that a number of issues are to be resolved before this activity is launched in our country. Domestic factoring though introduced in the country in 1991, is still in the nascent stage. The performance of the factoring companies offering the domestic business needs to be evaluated with a view to judging their operating efficiency. Besides, there are many issues relating to policy, strategic, legal and structural aspects, that need to be examined before extending this activity to the export-sector. It is also appropriate to study the perceptions of the likely users, namely the exporters as regards the utility and acceptance of the services. Opinions of the bankers who, at present, are providing the export finance
both at pre and post-shipment stages and are likely to start international factoring activities, are also vital for the study. Similarly, views of the existing factoring companies that would eventually diversify in international services also need a study.

It is, in the above backdrop, that the research is undertaken to look into the various policy, strategic, legal and operational issues involved in international factoring business in India and offer suggestions to resolve them.

1.7 Hypothesis

Thusfar, no study on factoring has been undertaken in India. Therefore, the present study may be termed as an exploratory one. But formulation of specific research-hypothesis is difficult in such a study. Nevertheless, based on the theoretical framework of international factoring, there appears to be a relationship between;

(A) International factoring, and

(B) (i) Exports of the country,

(ii) Realisation of export receivables (collection period), and

(iii) Profits of the exporting units.

With the introduction of international factoring services in India, other variables remaining the same, (i)exports of the country, and (ii)profits of the exporting enterprises, are expected to increase and (iii) realisation of export receivables is likely to be quicker. Reverse is the case when international factoring is not there.
To test the above hypothesis, the required data (quantitative) are not presently available as international factoring services are yet to be introduced in the country. Nevertheless, broad indication through qualitative analysis of relationship as stated above, has been examined, by interacting with the exporters and other related parties namely, the banks and existing factoring companies.

However, it may be reiterated that this is a formulative research study and not a hypothesis testing research work.

1.8 Scope

The scope of the study is restricted to international factoring that is, where factoring involves two contracting parties namely, an exporter and an importer, located in two different countries.

1.9 Objectives

The broad objectives of the study are:

(i) To analyse the conceptual framework of international factoring,

(ii) to study the perceptions of the potential users and providers of the service namely, the exporters and bankers and existing factoring companies respectively, with reference to introduction, utility and acceptability,

(iii) To assess the prospects of international factoring business in India, and

(iv) To examine the legal, policy, strategic and organisational issues connected with introduction of international factoring in India.
1.10 Methodology

1.10.1 Data Requirement

To achieve the objectives mentioned above, the following data were needed:

(i) Conceptual framework and mechanism of international factoring as per the prevalent practices in the world,

(ii) Perceptions of the potential users of the service namely, the exporting community, about the possible acceptance and utility of international factoring services,

(iii) Views of the experts including bankers, and existing factoring companies regarding their perceptions of the services and various problem areas connected thereto,

(iv) Projected exports of the country during next 5-10 years, and

(v) Legal, policy, strategic and organisational issues in international factoring business.

1.10.2 Data Collection

I. Primary Data

(i) Sources

(a) Exporting enterprises (both manufacturing and trading).

(b) Banks.

(c) Existing factoring organisations.
(d) Consultants and experts in the area.

(ii) Sampling Design

(a) For exporting enterprises, the universe chosen is the units located in and around Bombay and Pune. For budgetary and time constraints, the universe is restricted to the captioned size only. However, since Maharashtra is one of the largest industrial states of the country with heavy concentration of exporting units, it can be considered quite representative of the population.

The sampling frame is drawn from the list of exporting units (both manufacturing and trading) maintained at Maharatha Chamber of Commerce, Pune and the Head Offices/Zonal Offices of different banks in Bombay/ Pune.

The size of the sample, because of budgetary and time constraints, is restricted to 250. The sampling units are drawn from:

1. Manufacturing units,
2. Trading units,
3. 100 per cent export oriented units,
4. Export houses,
5. Trading houses,
6. Star trading houses,
7. Units in free trade zones, and
8. Units in export processing zones.

From the source list mentioned above, the sample is drawn on a random basis.

(b) For banks, the entire population of public sector banks is chosen. This is because their number was small, during the survey, at only 28 (State Bank of India, 7 Associate Banks of SBI and 20 Nationalised Banks). Since this group of banks controls more than 85 per cent of the total banks' exposure to export credit, other units of the banking system, namely private sector banks and foreign banks have not been chosen as sample.

Besides, many senior executives in the banking system come to National Institute of Bank Management, Pune to participate in the various training programmes/seminars/conferences. During 1991-92 and 1992-93, 4 programmes were organised by the Institute in the areas of international finance and banking. During the same period, the Institute also organised 4 general management programmes such as Bank management programme, management education programme, etc. By application of the technique of accidental sampling, 85 participants of these programmes were also chosen as the sample respondents for the study.

(c) The two existing factoring organisations in the country namely, SBI Factors and Commercial Services Pvt. Ltd. (subsidiary of State Bank of India) and Canbank Factors Ltd. (subsidiary of Canara Bank) were also
considered as respondents for two reasons. Firstly, they have on-hand experience of running factoring business (only domestic factoring) and secondly, in the process of diversification they are contemplating to launch international factoring activities.

(d) A few (5 in number) management consultants and experts in the area of factoring were considered on random basis. They include two previous Managing Directors of existing factoring companies, a chartered accountant, a management consultant and a practising lawyer. These are drawn from Pune, Bombay and Bangalore.

(iii) Methodology for Data Collection

(a) For exporters, data was collected both through a structured questionnaire and interviews. Firstly, the questionnaires were sent to a sample of 250 exporters. The questionnaires were addressed to the chief executives of the concerned enterprises. Correct responses were received from 68 firms. 12 of the respondents were subsequently interviewed. The purpose of these interviews was primarily to get clarifications on the responses they offered in the questionnaire. This was done in view of the fact that the very concept of factoring is new in India and therefore, some of the exporters may not be well versed with the same. Therefore, personal interviews were aimed at reinforcing the validity of the statements given in the
response to the questionnaire. However, as a matter of abundant precaution, a note explaining the conceptual aspects of international factoring was sent to the exporters alongwith the questionnaire.

(b) For banks, data was collected through a structured questionnaire followed by interviews with 6 respondents. For 28 public sector banks, the questionnaires were sent to the concerned General Managers (International Banking). Subsequent interviews, however, were conducted either with the General Manager (International Banking) or in his absence, the next senior executive i.e Assistant General Manager, Chief Officer, etc. For the respondents chosen from accidental sample of the participants who attended the training programmes at NIBM, the methodology of data collection was through a structured questionnaire followed by open discussion in the group.

(c) For the existing factoring organisations, the response was collected through a structured questionnaire.

(d) Responses of experts were collected through personal unstructured interviews.

(e) Questionnaires sent to exporters (alongwith the explanatory note), banks and factoring companies are given in the Appendices I, II and III respectively.
II. Secondary Data

(i) Sources

(a) Relevant books, articles and research papers were referred from libraries in India as well as from different sources outside India primarily from Factors Chain International, Amsterdam.

(b) Report of the Study Group on Factoring appointed by the Reserve Bank of India.

(c) International publications on factoring including annual reports and business statistics of global scenario published by Factors Chain International, Amsterdam.

1.10.3 Data Analysis and Interpretation

I. Primary Data

(a) Data collected through the questionnaire and interviews with the exporters was analysed to find out:

(i) Experience with the present systems of export credit backed by letters of credit and the problems associated therewith,

(ii) Experience with the Export Credit Guarantee Corporation (ECGC) of India Ltd.

(iii) Awareness regarding international factoring,

(iv) Acceptance and perceived utility from availing this service,
(v) Types of facilities required,
(vi) Pricing of the services,
(vii) Structural framework of factoring organisation, etc.

Through frequency distribution of responses to various open-ended questions, the major views/opinions of the exporters regarding the following issues were brought out:

(i) Reasons for not being satisfied with existing system of export finance backed by letters of credit,
(ii) Nature of problems regarding realisation of export trade debts,
(iii) Nature of problems with the functioning of the ECGC.

(b) Data collected through questionnaire and interviews with the executives of the banks was analysed to find out:

(i) Perceptions regarding utility of the factoring services,
(ii) Possible extent of effect of introduction of international factoring in India on letters of credit backed export-finance.
(iii) Willingness or otherwise of the bank executives to launch international factoring services.

However, majority of the questions meant for banks were open-ended ones seeking their views on a number of issues. These responses were deliberately kept open-ended with a view to obtaining their free and frank opinion on a number of topics. These include:
(i) Future prospects of international factoring in India,

(ii) Possible problems while introducing this service in India, and suggestions to overcome the same,

(iii) Nature and extent of competition between an international factoring agency and a bank providing export finance,

(iv) Possible areas of cooperation between a banker and a factor,

(v) Organisational preparedness necessary on the part of the banks to launch international factoring services.

(c) Data collected from the factoring companies and the experts was analysed qualitatively with a view to understand the following aspects:

(i) Strategies to launch international factoring,

(ii) Perceptions regarding prospects of international factoring, and

(iii) Likely problems envisaged and strategies to overcome the same.

II. Secondary Data

(a) The various reports and statistical data collected from Factors Chain International were analysed to trace out the global developments of international factoring during the last 10 years or so.

(b) Papers submitted at the UNIDROIT (International Institute for Unification of Private Laws) Convention on International Factoring in Ottawa, 1988
were looked into critically to bring out the legal issues in international factoring.

(c) The experiences of the existing domestic factoring organisations in India were studied to examine policy and operational issues involved in international factoring and develop a structural framework for effective launching of international factoring in India.

(d) Loglinear regression equations were computed to ascertain the relationship between exports and export credit in India and to estimate the demand for export credit up to 1999-2000 both at pre and post-shipment stages under three different scenarios anticipating 15, 20 and 25 per cent growth rate in exports. This data has been used to estimate the likely demand of export factoring in India up to 1999-2000.

1.11 Chapterisation

The dissertation has been divided into eleven chapters including the current one. The conceptual design of international factoring including the types of services, advantages and the legal framework thereof is discussed in the chapter 2. The discussions on review of literature are given in two separate chapters namely, chapters 3 and 5. While chapter 3 deals exhaustively with the growth and development of international factoring in different parts of the world, a broad review of research work done across the globe in the area of factoring is contained in chapter 5. Status report of factoring in
India is given in the chapter 4. This chapter analyses the performance of the two factoring companies in India in the area of domestic factoring. The detailed analysis of the primary data collected through the process of survey is furnished in the chapter 6. The discussions in this chapter are bifurcated under three heads namely, (a) views of the exporters, (b) views of the bankers and (c) views of the existing factoring companies. Chapter 7 deals with the prospects of international factoring in India. The next three chapters refer to the various issues relating to introduction of international factoring services in the country. The sequencing of the discussions in this regard is as follows:

Chapter - 8: Legal aspects,

Chapter - 9: Policy and strategic dimensions, and

Chapter - 10: Structural and organisational issues.

Chapter 11 is the concluding one containing the broad recommendations, based on the findings of the study, to make the international factoring experiment a success in India.

1.12 Limitations

The major limitation of the study has been the absence of secondary data in respect of international factoring in India. Therefore, the prime approach has been on perceptions of the various parties namely, exporters, bankers, existing factoring organisations, etc. who will be directly or indirectly involved with this service.
1.13 Utility of the Study

This is a pioneering research work undertaken in the area of international factoring in a developing country like India. It is thus expected that the output of the research work may be quite useful in providing a total package of conceptual, policy, strategic and operational guidelines to those interested in launching international factoring services in India. Some of the findings may be of strategic interest to the policy makers including the Reserve Bank of India. Finally, this document contributes to the existing fund of knowledge on the subject by sharing experience of India.