FACTORING

MEANING OF FACTORING

Factoring is a financial service in which the business entity sells its bill receivables to a third party at a discount in order to raise funds. It differs from invoice discounting. The concept of invoice discounting involves, getting the invoice discounted at a certain rate to get the funds, whereas the concept of factoring is broader. Factoring involves the selling of all the accounts receivable to an outside agency. Such an agency is called a factor.

CONCEPT OF FACTORING

The seller makes the sale of goods or services and generates invoices for the same. The business then sells all its invoices to a third party called the factor. The factor pays the seller, after deducting some discount on the invoice value. The rate of discount in factoring ranges from 2 to 6 percent. However, the factor does not make the payment of all invoices immediately to the seller. Rather, it pays only up to 75 to 80 percent of the invoice value after deducting the discount. The remaining 20 to 25 percent of the invoice value is paid after the factor receives the payments from the seller's customers. It is called factor reserve.

SALIENT FEATURES OF FACTORING:

(i) Credit Cover:

The factor takes over the risk burden of the client and thereby the client's credit is covered through advances.

(ii) Case advances:

The factor makes cash advances to the client within 24 hours of receiving the documents.

(iii) Sales ledgering:

As many documents are exchanged, all details pertaining to the transaction are automatically computerized and stored.

(iv) Collection Service:

The factor, buys the receivables from the client, they become the factor's debts and the collection of cheques and other follow-up procedures are done by the factor in its own interest.

(v)Provide Valuable advice:

The factors also provide valuable advice on country-wise and customer-wise risks. This is because the factor is in a position to know the companies of its country better than the exporter clients.

MECHANISM OF FACTORING:

The mechanism of factoring is summed tip as below:

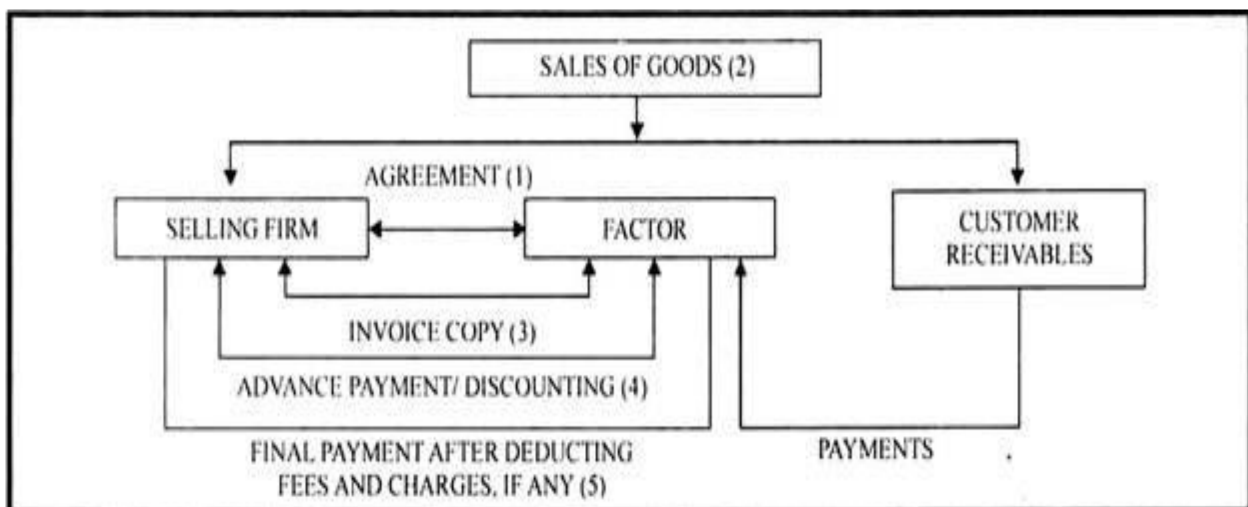
(i) An agreement is entered into between the selling firm and the factor firm. The agreement provides the basis and the scope of the understanding reached between the two for rendering factor services.

(ii) The sales documents should contain the instructions to make payments directly to the factor who is assigned the job of collection of receivables.

(iii) When the payment is received by the factor, the account of the selling firm is credited by the factor after deducting its fees, charges, interest etc. as agreed.

(iv)The factor may provide advance finance to the selling firm if the conditions of the agreement so require.

The mechanism of factoring has been shown in the following figure:



PARTIES TO THE FACTORING

There are basically three parties involved in a factoring transaction.

1. The buyer of the goods.

2. The seller of the goods

3. The factor i.e. financial institution.

The three parties interact with each other during the purchase/ sale of goods. The possible procedure that may be followed is summarized below

The Buyer.

1. The buyer enters into an agreement with the seller and negotiates the terms and conditions for the purchase of goods on credit.
2. He takes the delivery of goods along with the invoice bill and instructions from the seller to make payment to the factor on due date.
3. Buyer will make the payment to the factor in time or ask for extension of time. In case of default in payment on due date, he faces legal action at the hands of factor.

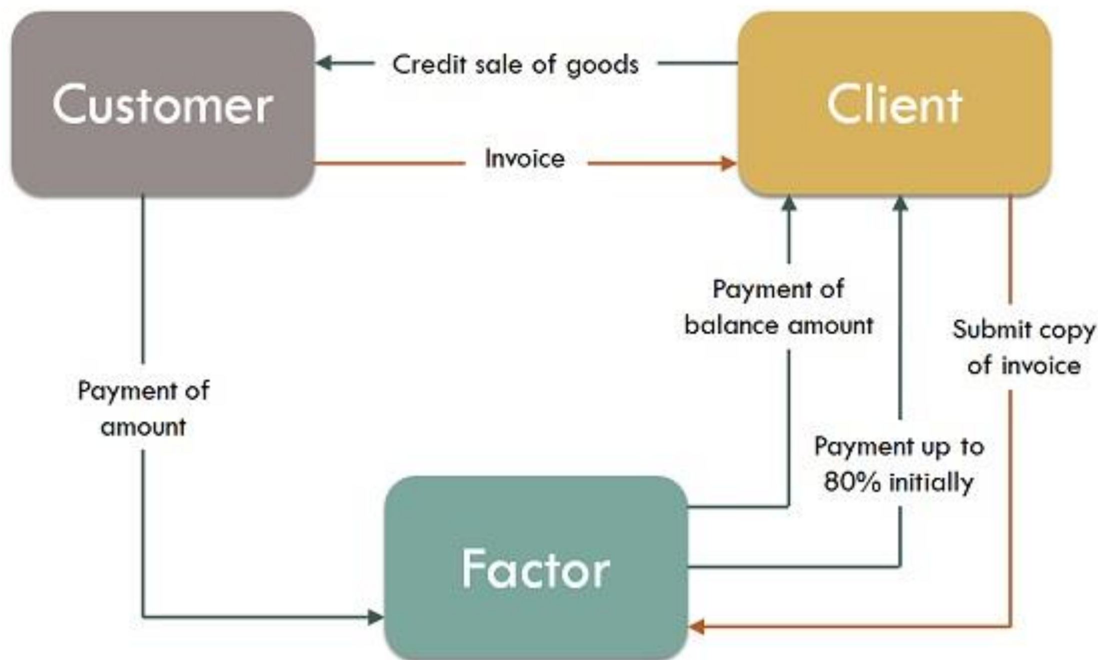
The Seller

1. The seller enters into contract for the sale of goods on credit as per the purchase order sent by the buyer stating various terms and conditions.
2. Sells goods to the buyer as per the contract.
3. Sends copies of invoice, delivery challan along with the goods to the buyer and gives instructions to the buyer to make payment on due date.
4. The seller sells the receivables received from the buyer to a factor and receives 80% or more payment in advance.
5. The seller receives the balance payment from the factor after paying the service charges.

The Factor

1. The factor enters into an agreement with the seller for rendering factor services i.e. collection of receivables/debts.
2. The factor pays 80% or more of the amount of receivables copies of sale documents.

3. The factor receives payments from the buyer on due dates and pays the balance money to the seller after deducting the service charges.



Functions of Factor:

A factor performs a number of functions for his client.

These functions are:

*1. **MAINTENANCE OF SALES LEDGER**:*

A factor maintains sales ledger for his client firm. An invoice is sent by the client to the customer, a copy of which is marked to the factor. The client need not maintain individual sales ledgers for his customers.

On the basis of the sales ledger, the factor reports to the client about the current status of his receivables, as also receipt of payments from the customers and as part of a package, may generate other useful information. With the help of these reports, the client firm can review its credit and collection policies more effectively.

*2. **COLLECTION OF ACCOUNTS RECEIVABLES:***

Under factoring arrangement, a factor undertakes the responsibility of collecting the receivables for his client. Thus, the client firm is relieved of the rigours of collecting debts and is thereby

enabled to concentrate on improving the purchase, production, marketing and other managerial aspects of the business.

With the help of trained manpower backed by infrastructural facilities a factor systematically undertakes follow up measure and makes timely demand in the debtors to pay amounts. Normally, debtors are more responsive to demands or reminders from a factor as they would not like to go down in the esteem of credit institution as a factor.

*3. **CREDIT CONTROL AND CREDIT PROTECTION:***

Another useful service rendered by a factor is credit control and protection. As a factor maintains extensive information records (generally computerized) about the financial standing and credit rating of individual customers and their track record of payments, he is able to advise its client on whether to extend credit to a buyer or not and if it is to be extended the amount of the credit and the period there-for.

Further, the factor establishes credit limits for individual customers indicating the extent to which he is prepared to accept the client's receivables on such customers without recourse to the client. This specialized service of a factor assists clients to handle a far greater volume of business with confidence than would have been possible otherwise.

In addition, factor provides credit protection to his client by purchasing without recourse to him every debt of approved customers (within the stipulated credit limit) and assumes the risk of default in payment by customers only in case of customers' financial inability to pay.

*4. **ADVISORY FUNCTIONS:***

At times, factors render certain advisory services to their clients. Thus, as a credit specialist a factor undertakes comprehensive studies of economic conditions and trends and thus is in a position to advise its clients of impending developments in their respective industries.

Many factors employ individuals with extensive manufacturing experience who can even advise on work load analysis, machinery replacement programs and other technical aspects of a client's business.

Factors also help their clients in choosing suitable sales agents/seasoned personnel because of their close relationship with various individuals and non-factored organizations.

Thus, as a financial system combining all the related services, factoring offers a distinct solution to the problems posed by working capital tied in trade debts.

TYPES OF FACTORING

A. Domestic Factoring

Factoring can be both domestic and for exports. In domestic Factoring, the client sells goods and services to the customer and delivers the invoices, order, etc., to the Factor and informs the customer of the same.

In return, the Factor makes a cash advance and forwards a statement to the client. The Factor then sends a copy of all the statements of accounts, remittances, receipts, etc., to the customer. On receiving them the customer sends the **payment to the Factor.**

Different types of Domestic Factoring are as follows:

1. Full Factoring

This is also known as "Without Recourse Factoring ". It is the most comprehensive type of facility offering all types of services namely finance sales ledger administration, collection, debt protection and customer information.

2. Recourse Factoring

The Factoring provides all types of facilities except debt protection. This type of service is offered in India. As discussed earlier, under Recourse Factoring, the client's liability to Factor is not discharged until the customer pays in full.

3. Maturity Factoring

It is also known as "Collection Factoring ". Under this arrangement, except providing finance, all other basic characteristics of Factoring are present. The payment is effected to the client at the end of collection period or the day of collecting accounts whichever is earlier.

4. Advance Factoring

This could be with or without recourse. Under this arrangement, the Factor provides advance at an agreed rate of interest to the client on uncollected and non-due receivables. This is only a pre-payment and not an advance.

Under this method, the customer is not notified about the arrangement between the client and the Factor. Hence the buyer is unaware of factoring arrangement. Debt collection is organized by the client who makes payment of each invoice to the Factor, if advance payment had been received earlier.

6. Invoice Discounting

In this arrangement, the only facility provided by the Factor is finance. In this method the client is a reputed company who would like to deal with its customers directly, including collection, and keep this Factoring arrangement confidential.

The client collects payments from customer and hands it over to Factor. The risk involved in invoice discounting is much higher than in any other methods.

The Factor has liberty to convert the facility by notifying all the clients to protect his interest. This service is becoming quite popular in Europe and nearly one third of Factoring business comprises this facility.

7. Bulk Factoring

It is a modified version of Involve discounting wherein notification of assignment of debts is given to the customers. However, the client is subject to full recourse and he carries out his own administration and collection.

8. Agency Factoring

Under this arrangement, the facilities of finance and protection against bad debts are provided by the Factor whereas the sales ledger administration and collection of debts are carried out by the client.

9. Supplier Guarantee Factoring

Supplier Guarantee Factoring is also known as 'drop shipment factoring'. This happens when the client is a mediator between supplier and customer. When the client is a distributor, the factor guarantees the supplier against the invoices raised by the supplier upon the client and the goods may be delivered to the customer. The client thereafter raises bills on the customer and assigns

them to the factor. The factor thus enables the client to make a gross profit with no financial involvement at all.

10. Bank participation factoring

In bank participation factoring the bank takes a floating charge on the client's equity i.e., the amount payable by the factor to the client in .respect of his receivables. On this basis, the bank lends to the client and enables him to have double financing.

11. Disclosed and Undisclosed Factoring: The factoring in which the factor's name is indicated in the invoice by the supplier of the goods or services asking the purchaser to pay the factor, is called disclosed factoring. Conversely, the form of factoring in which the name of the factor is not mentioned in the invoice issued by the manufacturer. In such a case, the factor maintains sales ledger of the client and the debt is realized in the name of the firm. However, the control is in the hands of the factor.

12. Buyer-Based Factoring*:*

Buyer-based factoring involves factoring of all the buyer's payables. Thus, the factor would maintain a list of 'approved buyers' and any claims on such buyers (by any seller) would be factored without recourse to the seller.

B. International Factoring

Traditionally international trade is based on Letters of Credit. When the exporter knows the importer well with repetitive transactions, he may be willing to export on 'Open Account 'basis. On open account the exporter ships the goods without letter of credit or advance payment.

Hence, it is credit risky for exporter. If credit is extended (say 90 days since), the exporter will be quite reluctant as he encounters a credit risk and hence invariably insists on L/C.

In advanced countries bankers do not make much of a distinction between fund-based and non-fund based facilities and hence if they have to open L/C's it may be at the cost of a reduced overdraft or bills limit for the importer.

The system of L/C's operates on the "Doctrine of Strict Compliance" which means the Letter of Credit opening bank will pay money to the exporter only when all the conditions listed in the Letter of Credit document are satisfied by the exporter/shipper of goods.

In many cases, the documents fail to pass the grade which means the exporter has simply lost the security available to him under the L/C. Further, now-a-days, goods move very fast and hence if documents are held up in banks for processing, it causes delay and inconvenience to the importer.

In the light of the above, international trade has slowly started moving from cash to credit, and from L/C's to open account sales. International Factoring is a service which helps the exporter and importer to trade on open account terms.

Types of International Factoring

The following are the important types of International Factoring. The client can choose any type of international factoring depending upon exporter – client needs and his price bearing capacity.

Two Factor Systems

This is the most common system of international factoring and involves four parties i.e., Exporter, Importer, Export Factor in exporter's country and Import Factor in Importer's country.

The functions of the export Factor are:

i. Assessment of the financial strength of the exporter

ii. Prepayment to the exporter

iii. Follow-up with the Import Factor

iv. Sharing of commission with the import Factor

The functions of the Import Factor are:

i. Maintaining the books of the exporter in respect of sales to the debtors in his country

ii. Collection of debts from the importer and remitting the proceeds to the exporter's Factor

iii. Providing credit protection in case of financial inability on the part of any of the debtors

1. Single / Direct Factoring System

In this system, a special agreement is signed between two Factoring companies for single Factoring. Whereas in Two Factor System, credit is provided by import Factor and pre-payment, book keeping and collection responsibilities remain with export Factor.

For this system to be effective there should be strong co-ordination and co-operation between two Factoring companies. Pricing is lower when compared to Two Factor System.

2. Direct Export Factoring

Here only one Factoring company is involved, i.e., export Factor, which provides all services including finance to the exporter.

3. Direct Import Factoring

Under this system, the seller chooses to work directly with Factor of the importing country. The Factoring agreement is executed between the exporter and the import Factor. The import Factor is responsible for sales ledger administration, collection of debts and providing bad debt protection up to the agreed level of risk cover.

4. Back to Back Factoring

It is a very specialized form of International Factoring, used when suppliers are selling large volumes to a few debtors for which it is difficult to cover the credit risk in International Factoring.

In this case, International Factor can sign a domestic Factoring agreement with the debtor whereby it will be getting the receivables as security for the credit risk taken in favour of Export Factor.

ADVANTAGES OF FACTORING

IMMEDIATE CASH INFLOW

This type of finance shortens the cash collection cycle. It provides swift realization of cash by selling the receivables to a factor. Availability of liquid cash sometimes becomes a deciding factor for grabbing an opportunity or losing it. The cash boost provided by factoring is readily available for capital expenditures, securing a new order or meeting an unforeseen condition.

ATTENTION TOWARDS BUSINESS OPERATIONS AND GROWTH

By selling off invoices, business managers can feel stress-free of the task of collection from the customers. Resources employed in the receivables department can be directed towards business operations, financial planning, and future growth.

EVASION OF BAD DEBTS

Factoring is of two types – with recourse and without recourse. Under without recourse factoring, in case of bad debts, the loss is borne by the factor. Hence, the seller is under no obligation to the factor once it sells off its receivables.

SPEEDY ARRANGEMENT OF FINANCE

Factors provide funds more rapidly than banking companies. Factoring companies offer quicker application, lesser documentation and swifter realization of funds as compared to other financial institutions.

NO REQUIREMENT OF COLLATERAL

The advances are extended on the basis of the strength of accounts receivables and their credit healthiness. Unlike cash credit & overdraft, factors do not require any collateral security to be pledged/hypothecated. New businesses, startups can easily avail the advances provided they have strong receivables.

SALE NOT LOAN

Factoring transaction is a transaction of sale, not a loan. Unlike other types of finances, factoring does not result in an increase in liabilities of the business. Hence, there are no adverse impacts on the financial ratios as well. It just involves the conversion of book debts into liquid cash.

CUSTOMER ANALYSIS

Factors provide valuable advice and insights to the seller regarding the credit strength of the party from whom receivables are pending. It helps in negotiating better terms between the parties in future contracts.

REDUCED CURRENT LIABILITIES

The amount received from the factoring is used to pay off the bank borrowing and other current liabilities comprising trade creditors. As a result, current liabilities are considerably reduced. The liquidity position of the firm is strengthened further.

OFF-BALANCE SHEET FINANCE

When the factor purchases the clients' debts, the finance is provided off the balance sheet. In recourse factoring, the finance appears in the client's balance sheet only as a contingent liability. In recourse factoring, if the customer defaults in payment, the client has to make good the loss incurred by the factor. The factor is entitled to recover from the client the amount paid in advance.

But in case of non-recourse factoring, the finance provided does not appear anywhere in the financial statements of the borrower. The factor does not have the right of recourse.

HIGHER CREDIT STANDING

With increased cash flows to the client, he is able to meet his liabilities promptly as and when they arise. The factor's acceptance of the client's receivables itself is the mark of high quality of the receivables factored. The problem of bad debts does not arise.

DISADVANTAGES OF FACTORING

REDUCTION OF PROFIT

The factor deducts a certain discount from the value of accounts receivable as fees for the services offered. Moreover, in certain cases, the factor also charges interest on the advance made. Consequently, profit of an entity is reduced by a significant margin.

RELIABILITY OF CUSTOMER'S CREDIT

The factor assesses and evaluates credit wellness of the party who owes bills receivables. This is a critical factor which is outside the control of the seller. A factor may refuse to extend advances due to poor credit ratings of the concerned party.

EXHAUSTING OF COLLATERAL SECURITY

Factoring exhaust bills receivables of an entity as the entity is no longer entitled to receive payments from them. The seller is no longer holding any control over the book debts. Hence, they can not be provided as collateral security while obtaining any other type of finance.

PRESENCE OF CONTINGENT LIABILITY

The liability of the seller is not completely waived in case of with recourse factoring. If a party fails to pay its debts to the factor, the factor is legally entitled to recover it from the seller. Thus,

the seller is contingently liable to the factor for paying the debts in future in case of default. This situation would impact business operations and financial plans which are under execution.

HIGHER FINANCE CHARGES

Factors usually deduct 2% to 4% of the total amount involved as their fees for the duration of 45-60 days. Computing it annually, the cost of finance turns out to be around 18% to 24% p.a. which is very higher than other sources of finance.

LOSS OF PERSONAL TOUCH

The buyer may not be willing to deal with a factor because of their professional nature and stringent methods. Factoring agencies even send notices at regular intervals to the buyer as a reminder of the debt. The buyer may develop a negative image of the seller through factoring. Loss of personal touch may lead him to consider switching vendors.

COMMON PROBLEMS WITH FACTORING INVOICES

1. The customer is not creditworthy

This is the most common problem when trying to factor receivables. If the customer is not creditworthy, the invoice isn't factorable. Unfortunately, there is little that can be done about this since the creditworthiness of the customers is the cornerstone of factoring.

2. The invoice exceeds the credit line

This common problem occurs when the total amount of the invoices that the client want to factor exceeds the credit line that the provider has assigned to the customer. It's always a good idea to review and manage the status of the line proactively so that one can anticipate this problem. The solution is to try to negotiate a credit line increase.

3. The invoice can't be verified

Most factoring companies will verify invoices prior to funding. This step allows them to verify that the work has been completed satisfactorily – or that the product has been delivered in accordance with the purchase order. It also helps you ensure that the clients are happy. However, customers can refuse to verify an invoice at their discretion. And if they do, the provider may not factor that invoice.

4. The customer refuses to submit payment to the factoring company

As part of the financing process, the customer must submit the invoice payment directly to the factoring company. This process is usually outlined in the notice of assignment letter that is sent to them. For whatever reason, the customer could refuse to send the payment to the factor. This situation can be very problematic and could prevent factor from financing the invoices associated with that customer.

5. The work is not complete / the product is not delivered

This is the most common problem when factoring invoices. Usually the client tries to factor an invoice for which the service has not been completed or the product has not been fully delivered. This invoice will be un-factorable until the work is completed or the product is delivered. Factoring companies can only purchase invoice for completed services.

KEY DIFFERENCES BETWEEN BILL DISCOUNTING AND FACTORING

The following are the major differences between bill discounting and factoring:

- Selling of bills at a discount to the bank, before its maturity is known as Bill Discounting. Selling of the debtors to a financial institution at a discount is Factoring.
- The bill is discounted, and the whole amount is paid to the borrower at the time of the transaction. Conversely, the maximum part of the amount is provided as an advance, and the rest of the amount is given as balance when the dues are realized.
- The parties to bill discounting are a drawer, drawee, and payee whereas the parties to factoring are the factor, debtor, and borrower.
- The bill discounting is always recourse, i.e. if the customer defaults in payment of debt, then the payment is made by the borrower. On the other hand, the factoring can be recourse and nonrecourse.
- The Negotiable Instrument Act, 1881 contains the rules relating to bills discounting. In contrast to factoring which is not covered under any act.
- In bill discounting the financier gets the discounting charges for financial services, but in the case of factoring the factor gets interest and commission.
- In factoring, the debts are assigned which is not done in bill discounting.

FACTORING IN INDIA

Factoring service in India is of recent origin. It owes its genesis to the recommendations of the Kalyanasundaram Study Group appointed by the RBI in 1989. Pursuant to the acceptance of these recommendations, the RBI issued guidelines for factoring services in 1990. The first factoring company – SBI Factors and Commercial Ltd (SBI FACS) started operation in April 1991. This article highlights the important aspects of the factoring services in India.

The business of factoring in India is regulated by the Factoring Regulation Act, 2011. Section 2(j) of the Factoring Regulation Act, 2011 defines factoring business as

"factoring business" means the business of acquisition of receivables of assignor by accepting assignment of such receivables or financing, whether by way of making loans or advances or otherwise against the security interest over any receivables but does not include—
i) credit facilities provided by a bank in its ordinary course of business against security of receivables;
ii) any activity as commission agent or otherwise for sale of agricultural produce or goods of any kind whatsoever or any activity relating to the production, storage, supply, distribution, acquisition or control of such produce or goods or provision of any services."

At present, the factoring business can be carried out by either banks or NBFCs. The Reserve Bank of India (RBI) is the regulatory body supervising the factoring business. Banks can undertake factoring business without the prior approval of RBI. However, NBFCs intending to carry out factoring business as their principal business are required to obtain a prior approval from RBI.

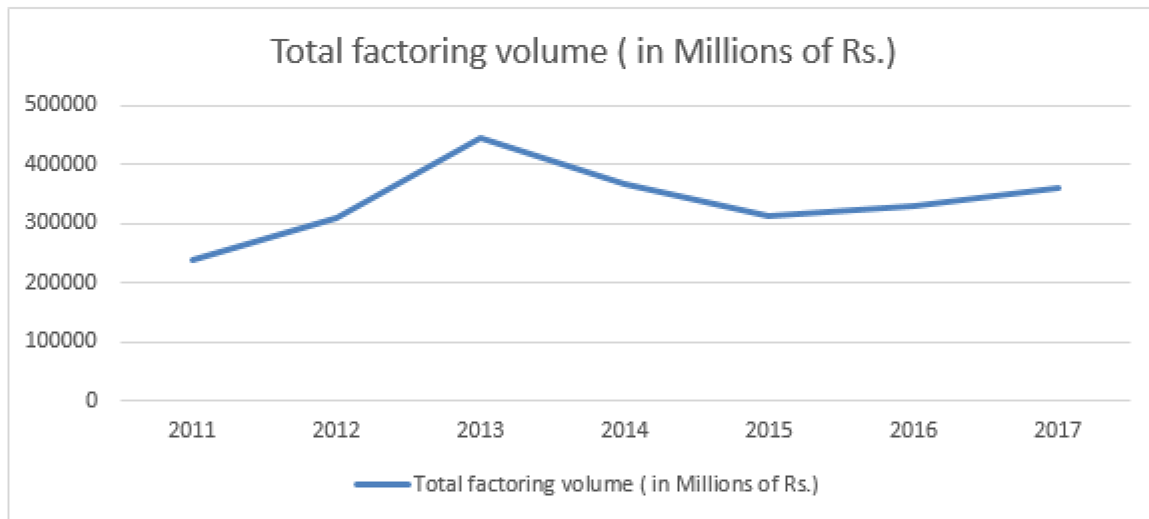
Further, the Factoring Regulation Act, 2011, states that the NBFCs which intend to engage itself in the factoring business have to fulfill the principality test. To determine whether the principal business of the NBFC is factoring, it needs to fulfill the following conditions

"(a) if its financial assets in the factoring business are more than fifty per cent of its total assets or such per cent as may be stipulated by the Reserve Bank; and
(b) if its income from factoring business is more than fifty per cent of the gross income or such per cent as may be stipulated by the Reserve Bank."

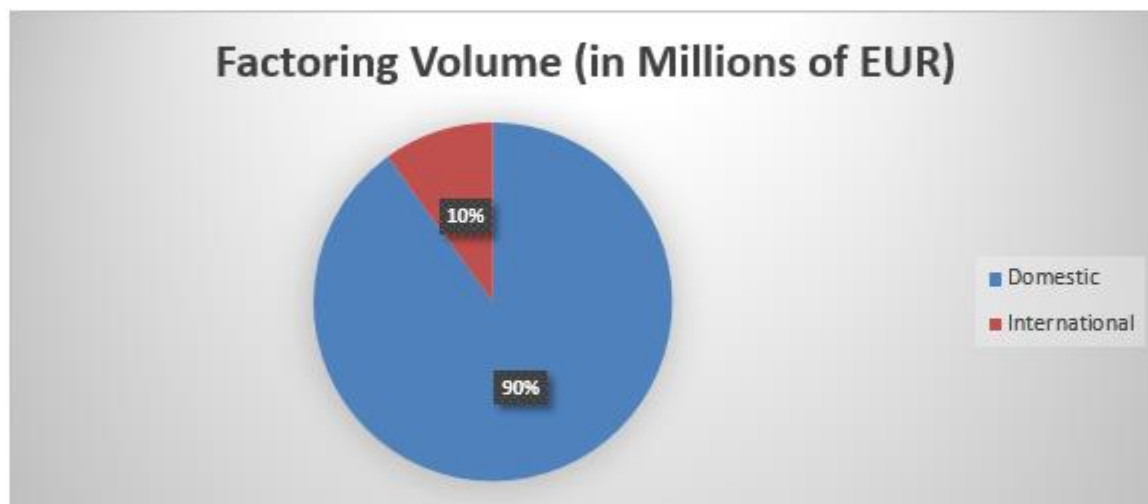
Market for factoring in India

SBI Factors and Commercials Limited was the first factoring company to start its operation in India in April, 1991. Since then a number of companies have started factoring business in India. At present, there are only 7 NBFC factors registered with RBI.

Since its inception, factoring business has made a significant progress in India. The total factoring volume has increased in the past 7 years. The factoring volume was highest in 2013 and subsequently decreased till 2015. In the years 2016 and 2017, there was again a rise in the volume. The following graph depicts this increase:



In the year 2017, the total volume of factoring was Rs. 361811 million[2] (4269 in million EUR[3]). Out of this, the major contribution was from the domestic sector. The domestic sector contributed Rs. 325622 million (3842 in million EUR) and the international sector Rs. 36189.60 million (427 in million EUR). The following pie chart shows the percentage contributed by the domestic and international sectors in the total factoring volume in the year 2017.



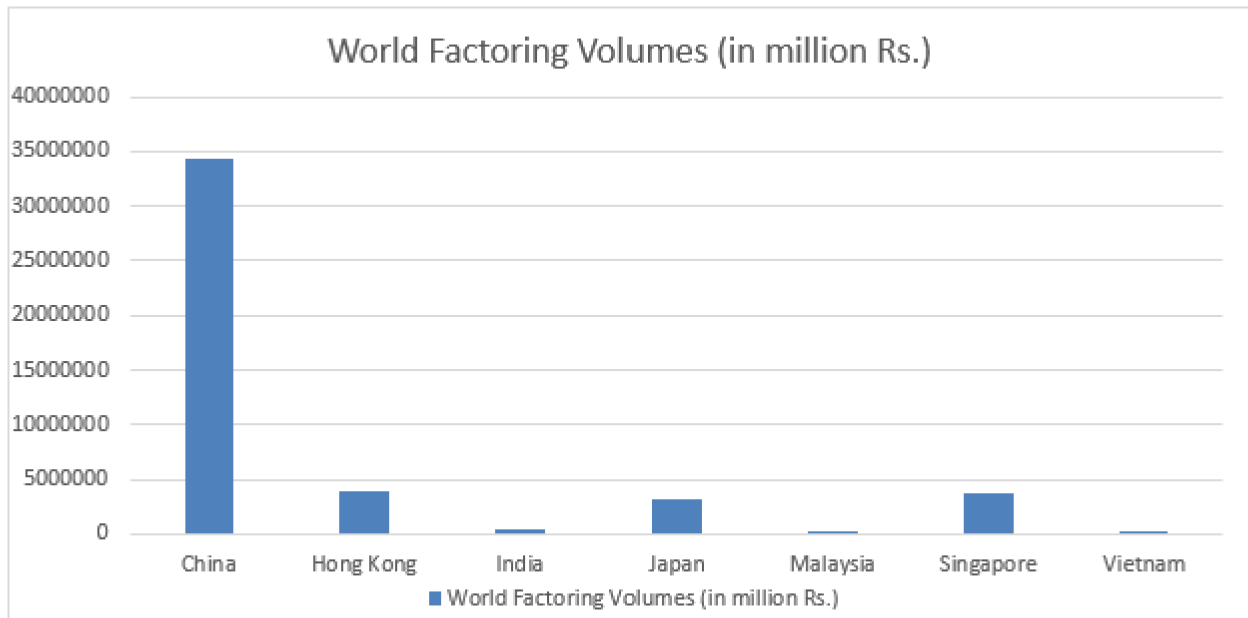
Several factors such as lack of awareness, a perception of high interest rates and cumbersome documentation processes, have prevented the growth of factoring services in India.

Global Scenario

Factoring business is becoming popular over the world on account of various services offered by the factors. The world factoring statistics indicate that the factoring industry volume have shown a significant growth. The total volume estimated for 2017 amounts to Rs. 209510 billion (2,472 billion EUR).

Though the Asian market for factoring has declined by 4% in 2017 but Indian market for factoring has increased by 10% in 2017 as compared to 2016.

However, the contribution of India in the global factoring market is way too less than the other Asian countries. The factoring volume in India in 2017 is Rs. 361811 million (4269 in million EUR) as compared to other Asian countries like Rs. 34370500 million (405537 in million EUR) in China, Rs. 3978650 million (46944 in million EUR) in Hong Kong, Rs. 3159940 million (37284 in million EUR) in Japan and Rs. 3729140 million (44000 in million EUR) in Singapore. The following chart shows a comparison of Indian factoring market with other Asian countries factoring market.



EXPORT FACTORING

Export factoring services are offered to the exporters (clients) who sell their products or services to the importers (customers) in other countries on open account tern having a credit period ranging from 60 to 180 days. Before the goods are shipped to the customer, export factor is expected to investigate the customer's creditworthiness and assume responsibility for collecting all amounts owed as well as affording credit protection. Export factor can offer benefits of export factoring both to the exporters as well as to the importers. The mechanism of export factoring is similar to that of domestic factoring, the exception being the exporter and importer belong to two different countries.

Four different types of arrangements are possible for export factoring:

a) Two Factor System

b) Single (Direct) Factoring System

c) Direct Export Factoring

d) Direct Import Factoring

The main function of the export factor relate to :

Assessment of the financial strength of the exporter.

Prepayment to the exporter after proper documentation, regular audit and post

sanction control.

Follow-up with the import factor.

Sharing of commission with the import factor.

The main functions of the import factor are as under:

Maintenance of books of the exporter in respect of sales to the debtors of his country. Collection of book debts from importers and remitting proceeds of the same to the export factor. Providing credit protection under non-recourse factoring arrangement in case of financial inability on part of any of the debtors of his country.

Need for Export Factoring

Many exporters find it difficult to evaluate creditworthiness of potential importers due to lack of'information and data. Further, on account of various reasons, they also experience difficulties to recover dues from import customers on maturity dates. This poses the problem of credit risk. All these problems in respect of export trade can be solved by offering export factoring services to the exporters. Use of such services will help exporters to sell goods or offer services in abroad on open account terms and eliminate credit risk as well. Such facilities will help exporters to expand the business with the existing customers and search new markets for the business.

FORFAITING

Forfaiting is a means of financing that enables exporters to receive immediate cash by selling their medium and long-term receivables—the amount an importer owes the exporter—at a discount through an intermediary. The exporter eliminates risk by making the sale without recourse. It has no liability regarding the importer's possible default on the receivables. A forfaiter is typically a bank or a financial firm that specializes in export financing.

Definition of Forfaiting

Forfaiting is a mechanism, in which an exporter surrenders his rights to receive payment against the goods delivered or services rendered to the importer, in exchange for the instant cash payment from a forfaiter. In this way, an exporter can easily turn a credit sale into cash sale, without recourse to him or his forfaiter.

FEATURES OF A FORFAITING ARRANGEMENT

1) It is a specific form of export trade finance.
2) Export receivables are discounted at a specific but fixed discount rate.
3) Debt instruments most commonly used in Forfaiting arrangement are a bill of exchange and a promissory note.
4) Payment in respect of export receivables which is further evidenced by bill of exchange or promissory notes, must be guaranteed by the importers' bank. The most usual form of guarantee attached to a Forfaiting agreement.
5) It is always without recourse to the seller (viz. Exporter).
6) Full value of export receivables i.e. 100 per cent of the contract value is taken into account.
7) Normally the export receivables carrying medium to long term maturities are considered.

COST OF FORFAITING SERVICES:

A Forfaiting service is subjected to various costs such as commitment fee, discount rate and documentation fee. Of these, discount rate, which is fixed, forms a larger portion of cost of Forfaiting service.

The discount rate charged by the forfaiter is based on the following elements:

1. A charge for the credit extended or finance provided. This is the main element and is roughly equivalent to the forfaiter's own costs of raising the money.
2. A charge based on the risk of interest rate and exchange rate movements in the currency in which the credit is extended.
3. A charge based on the sovereign risk, political risk and transfer risk e.g. the probability of a change of government and imposition of exchange controls preventing the discharge of the debt.
4. A charge based on the credit risk attached to the importer as well as avalor.

DIFFERENCE BETWEEN FORFAITING AND EXPORT FACTORING

Forfaiting differs from export factoring in the following three ways:

- Factors usually want access to all or a large percentage of an exporter´s business, while forfaiters will work on a transaction-by-transaction basis.
- Forfaiters usually work with medium and long term receivables, while factors work with short term receivables. Since payment terms usually reflect the types of products involved.
- Forfaiters usually work with sales of capital goods (machinery), commodities and large projects, while factors work mostly with sales of consumer goods.
- Most factors do not have strong capabilities with developing countries where legal and financial frameworks are inadequate and credit information is rarely available through affiliate factor. However, most forfaiters are willing to work with sales to such countries because they usually required bank or sovereign guarantees.

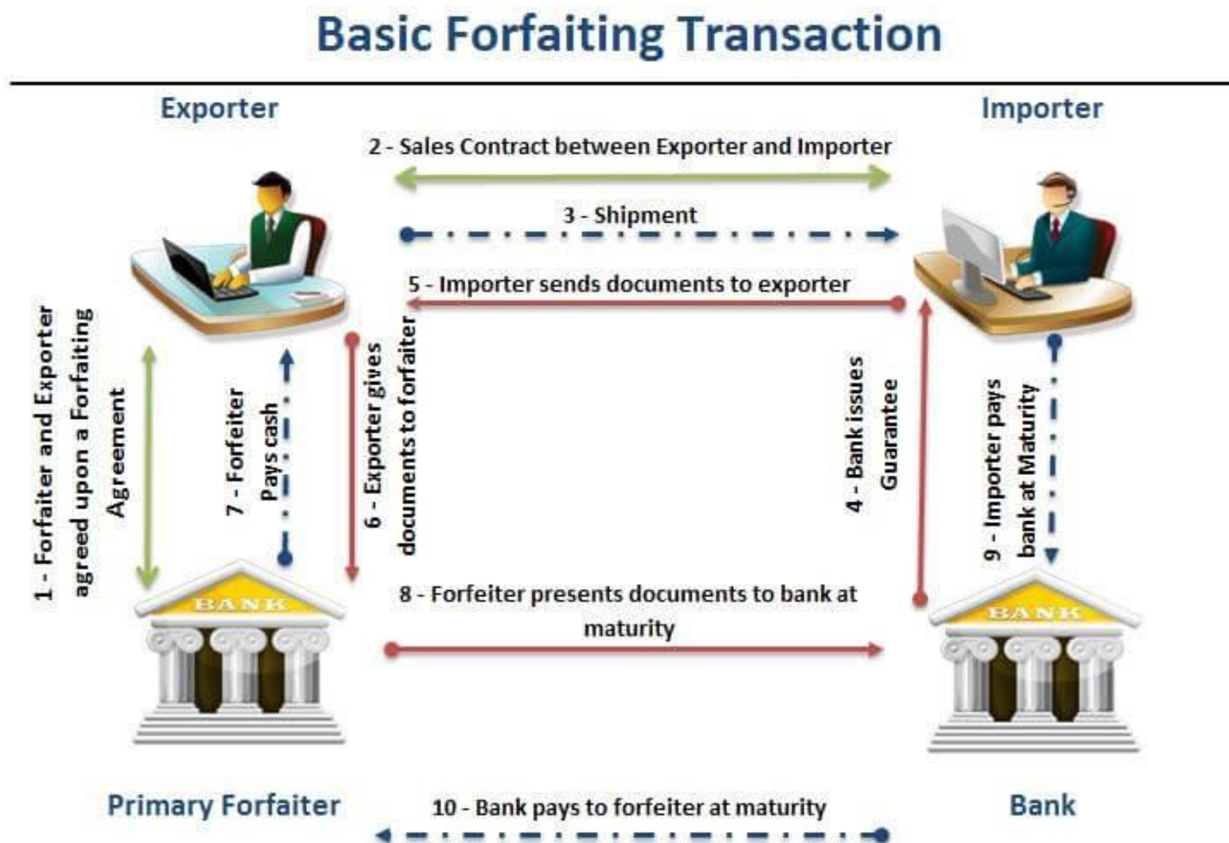
KEY DIFFERENCES BETWEEN FACTORING AND FORFAITING

The major differences between factoring and forfaiting are described below:

1. Factoring refers to a financial arrangement whereby the business sells its trade receivables to the factor (bank) and receives the cash payment. Forfaiting is a form of export financing in which the exporter sells the claim of trade receivables to the forfaiter and gets an immediate cash payment.
2. Factoring deals in the receivable that falls due within 90 days. On the other hand, Forfaiting deals in the accounts receivables whose maturity ranges from medium to long term.
3. Factoring involves the sale of receivables on ordinary goods. Conversely, the sale of receivables on capital goods are made in forfaiting.
4. Factoring provides 80-90% finance while forfaiting provides 100% financing of the value of export.
5. Factoring can be recourse or non-recourse. On the other hand, forfaiting is always non-recourse.
6. Factoring cost is incurred by the seller or client. Forfaiting cost is incurred by the overseas buyer.
7. Forfaiting involves dealing with negotiable instruments like bills of exchange and promissory note which is not in the case of Factoring.

8. In factoring, there is no secondary market, whereas in the forfaiting secondary market exists, which increases the liquidity in forfaiting.

PROCESS OF FORFAITING



The forfaiter is a financial intermediary that provides assistance in international trade. It is evidenced by negotiable instruments i.e. bills of exchange and promissory notes. It is a financial transaction, helps to finance contracts of medium to long term for the sale of receivables on capital goods. However, at present forfaiting involves receivables of short maturities and large amounts.

1. Before resorting to forfaiting, the exporter approaches the forfaiting company with the details of his export and the details of the importer and the importing country.

2. On approval by the forfaiter, along with the terms and conditions, a sale contract is entered into between the exporter and importer.
3. On execution of the export, the exporter submits the bill to the forfaiter and obtains payment. In this way, the three parties involved in the forfaiting process are the exporter, the importer and the forfaiter.
4. If the exports are done against Document Acceptance Bill, it has to be signed by the importer and since the importer's bank has guaranteed through the Letter of credit, it will be easy for the forfaiter to collect payment.
5. All the trade documents, connected with exports, are handed over by the exporter to his bank which in turn hands over the documents to the importer's bank.
6. The proof of all these documents will be submitted by the exporter to the forfaiter who will make payment for the export.
7. The cost of forfaiting is included in the bill. The exporter may not lose much as the interest will be included in the invoice and recovered from the importer. However, the forfaiter is exposed to the risk of fluctuations in the exchange rate, interest rate and commercial risk, and to cover these risks, he charges suitably.

ADVANTAGES OF FORFAITING

The following are some of the advantages of forfaiting.

1. It provides immediate funds to the exporter who is saved from the risk of the defaulting importer.
2. It is an earning to commercial banks who by taking the bills of highly valued currencies can gain on the appreciation of currencies.
3. The forfaiter can also discount these bills in the foreign market to meet more demands of the exporters.
4. There is very little risk for the forfaiter as both importer's bank and exporter's banks are involved.
5. Letter of Credit plays a major role for the forfaiter. Moreover, he enters into an agreement with the exporter on his terms and conditions and covers his risks by separate charges.
6. As forfaiting provides 100% finance to exporter against his exports, he can concentrate on his other exports.

DISADVANTAGES OR DRAWBACKS OF FORFAITING

The following are some of the disadvantages of forfaiting.

1. Forfaiting is not available for deferred payments especially while exporting capital goods for which payment will be made on a deferred basis by the importer.
2. There is discrimination between Western countries and the countries in the Southern Hemisphere which are mostly underdeveloped (countries in South Asia, Africa and Latin America).
3. There is no International Credit Agency which can guarantee for forfaiting companies which affects long-term forfaiting.
4. Only selected currencies are taken for forfaiting as they alone enjoy international liquidity.

FORFAITING IN INDIA

Recognizing the utility of Forfaiting services to Indian exporters, the RBI decided to make available such services to the exporters. At the beginning the RBI authorized I EXIM Bank in 1992 to offer Forfaiting services. The role of the EXIM Bank has been that of a facilitator between the Indian exporter and the overseas Forfaiting agency. Scheduled commercial banks have also been permitted to offer Forfaiting services by acting as an agent or a facilitator between Indian exporter and the Forfaiting agency operating in some other country. That means in other words, scheduled commercial banks can undertake Forfaiting services as a part of fee has &financial services. A subsidiary of EXIM bank namely; Global Trade Financial Services Private Ltd. has been engaged in prclviding Forfaiting services to the exporters in India. As per the RBI's A D Circular No. 3 Dated February 13, 1992, discount fee, documentation fee and any other costs levied by a forfaiter must be transferred to the overseas buyer.

In view of this, the exporter, who intends to avail Forfaiting facility, should finalise the export contract in a manner which ensures that the amount received in foreign exchange by him after payment of Forfaiting discount and other fees is equivalent to the price which he would obtain if goods were sold on cash payment terns. If the banks are able to act as an agent to structure Forfaith deals keeping in view the requirements of our Indian exporters, then there will be demand for such product. For this, commercial banks and others may have to introduce a lot of flexibility while acting as an agent or a facilitator in this regard. Fa example, the minimum value of the

Forfaiting transaction may be required to be kept at a reasonable level. Instead of acting simply as an agent, with the permission from the RBI, banks and financial institutions in India must explore the possibility of taking up Forfaiting activity as a fund based activity. With the dissemination of knowledge about Forfaiting among Indian exporters, it may be possible to create awareness about it and subsequently demand for the same.

For a long time, Forfaiting was unknown to India. Export Credit Guarantee Corporation was guaranteeing commercial banks against their export finance. However, with the setting up of export-import banks, since 1994 forfaiting is available on liberalized basis.
The **Exim bank** undertakes forfaiting for a minimum value of Rs. 5 lakhs. For this purpose, the exporter has to execute a special Pronote in favor of the Exim bank. The exporter will first enter into an agreement with the importer as per the quotation given to him by the Exim bank. The Exim bank on its part, gets quotation from the forfaiting agency abroad. Thus, the entire forfaiting process is completed by exporter agreeing to the terms of the Exim bank and signing the Pronote. Forfaiting business in India will pick up only when there is trading of foreign bills in international currencies in India for which the value of domestic currency has to be strengthened. This would be possible only with increasing exports. At present, India’s share stands at 1.7 percent in the world exports. Perhaps, this will bring a push to the forfaiting market.