UNIT 19 FACTORING, FORFAITING AND BILL DISCOUNTING

Objectives

After reading this unit, you will be able to :

- explain the meaning and scope of Factoring, Forfaiting and Bill Discounting Services;
- appreciate operations in respect of Factoring and Forfaiting Services;
- distinguish between Factoring and Forfaiting Services;
- appreciate various aspects of Discounting and Rediscounting of Commercial Bills;
- understand the reasons for Growth of Factoring and Forfaiting Business in Indian market; and
- understand developments in Commercial Bill Market in India.

Structure

19.1 Introduction
19.2 Factoring Services
19.3 Types of Factoring Services
19.4 Terms and Conditions of Factoring Contract
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19.6 Mechanism of Factoring
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19.1 INTRODUCTION

We have seen in the previous unit how venture capitalists come to the rescue of entrepreneurs by providing risk bearing capital known as venture capital. It is usually a long term investment either in the form of equity, conventional loans, conditional loans and convertible loans. Venture capital has potential for significant growth and financial returns. In the present unit we will be discussing in detail three services used for financing short-term, trade, i.e. factoring, Forfaiting, and bill discouting.

Factoring services have become quite popular all over the world now, with more than 900 companies offering these services. Factoring is a contract like any other sale-purchase agreement regulated under the law of contract.

Eorfaiting is a source of trade finance which enables exporters to get funds from the institution called forfaitee on transferring the right to recover the debts from the importer.

Another source of short-term trade financing known as bill discouting where one party accepts the liabilities of trade towards the third party.

Let us now discuss about all these three services in the subsequent sub sections of this unit.

19.2 FACTORING SERVICES

Factoring services started in the United States of America in the 1920s and were introduced to the other parts of the world in the 1960s. Today there are more than 900 companies offering factoring services in more than 50 countries. Factoring services have become quiet popular all over the world.

Factoring is a financial service covering the financing and collection of accounts receivables in domestic as well as in international trade. Basically factoring is an arrangement in which receivables on account of sale of goods or services are sold to the factor at a certain discount. As the factor gets title to the receivables on account of the factoring contract, he becomes responsible for all credit control, sales ledger administration and debt collection from the customers.

Functions of the Factor

Broadly speaking the main functions of the Factor are as under :

1) To provide finance against book debts, say upto 90 per cent of the invoice value immediately. Thus the client gets funds immediately for his working capital.
2) To collect cash against receivables on due date from the customers of the clients and furnish reports to the client.
3) To undertake sales ledger administration (i.e. accounting work) for the client in respect of client's transactions with its customers.
4) Under the non-recourse factoring arrangement, if the customer become financially insolvent and cannot pay up, the Factor provides protection to the client against bad debts on all approved invoices. Thus the Factor provides debt insurance facility to the client against possible losses arising from insolvency or bankruptcy of the customer.
5) Factor also provides other information such as sales analysis and overdue invoice analysis which enable the client to run the business more effectively. Besides, the Factor also provides relevant expertise in the areas of marketing, finance, etc., to the client.

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Parties to Factoring Contract

There are three parties involved generally in a factoring contract, viz.,

1) ***Buyer of goods (i.e. customer)*** who has purchased goods or services on credit and as such has to pay for the same once the credit period gets over.
2) ***Seller of goods (i.e. client)*** who has supplied goods or provided services to the customers on credit terms.
3) ***'Factor'*** who purchase the invoices (receivable) from seller of goods and collect the money from the customers of his clients.

19.3 TYPES OF FACTORING SERVICES

The various types of factoring arrangements can be classified into the following categories.

1) ***Full Servicing Factoring:*** This is also known as without recourse factoring service. It is the most comprehensive type of factoring arrangement offering all types of services, namely: (a) Finance, (b) Sales ledger administration, (c) Collection, (d) Debt protection, and (e) Advisory services. The most important characteristic of this type of factoring service is that it gives protection against bad debts to the client. In other words, in case the customer fails to pay, the factor will absorb the losses arising from insolvency or bankruptcy of the client's customers.

2) ***Recourse Factoring:*** In such a type of factoring arrangement, the factor provides all types of facilities except debt protection. That means, in other words, the client is responsible for any bad debts arising from insolvency of the client's customers.

3) ***Maturity Factoring:*** Under this type of factoring arrangement, except for providing finance, all other facilities are provided to the client. As far as finance is concerned, the client is paid at the end of a predetermined date or maturity date whether or not the customers have settled their dues in respect of credit sales.

4) ***Invoice Discounting:*** In such type of arrangement, only finance is provided, and, hence, no other services are offered in respect of receivables.

5) ***Agency Discounting:*** Under this arrangement, the facilities of finance and protection against bad debt are provided by the factor. As against this, the sales ledger administration and collection of book debts are carried out by the client himself.

The aforesaid classification of various factoring arrangements along with the type of services provided under each classification is shown in the Chart 19.1.

Chart 19.1: Types of Services Provided By Factors

Types of Factoring Accounts	*Finance*	*Collection of Arrangement*	*Sales Ledger Administration*	*Credit Protection*
1. Full factoring (without recourse)	Yes	Yes	Yes	Yes
2 With recourse factoring	Yes	Yes	Yes	No
3. Maturity factoring	No	Yes	Yes	Yes
4. Invoice discounting	Yes	No	No	No
5. Agency factor	Yes	No	No	Yes
6. Terms and Conditions of Factoring Contract				

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19.4 TERMS AND CONDITIONS OF FACTORING CONTRACT

Factoring contract is like any other sale purchase agreement regulated under the law of contract. The terms and conditions on which factor agrees to purchase the debts from seller are mutually settled keeping in view the business connections and customs. Nevertheless, some of the important aspects which are supposed to be born in mind and incorporated in factoring agreements are as follows :

1) Offer to sell debts from time to time arising out of business transactions, on such terms and conditions as are stipulated in the agreement. The offer shall specifically mention about the invoices relating to each debt as an evidence of the delivery of goods or rendering of services to the customer.
2) Acceptance of the offer shall be comprehensive, covering all interests in the purchased debts, with all remedies for enforcing the debts and rights of unpaid seller being vested in the factor.
3) Condition to have no recourse to the supplier by the factor in the case of non-recourse factoring contract on the failure of the customer to pay the dues.
4) Power of attorney from the firm to the factor so as to empower the factor to the factor.
5) Payment of purchase price of debts.
6) Notice of sale of assignment of debt be endorsed on invoices sent to customer to entitle the factor to recover their dues and issue discharge receipt of the customers.
7) Non-collection of dues by the firm : Firm (client) not to collect dues from customers assigned to the factors.
8) Notice of credit allowed to customer to be given to the factor.
9) Warranties and covenants.
10) Factoring commission, charge, fees and mode of payment.
11) Durations of agreement.
12) Notice of termination.
13) Jurisdiction of court to entertain dispute between the parties.

The above conditions may be elaborated in view of the business practices and incorporated in the letter of confirmation to be issued by the factor of the client and be accepted by the client through a Board Resolution. It is always safe to enter into formal agreement between the parties so as to cover all assignment of debts and powers to affect recovery thereof in legal way.

19.5 FACTORING: ADVANTAGES AND DISADVANTAGES

Benefits of Factoring to Clients

1) Under the factoring arrangement the client receives prepayment upto 80-90 per cent of the invoice value immediately and the balance amount after the maturity period. This helps the client to improve cash flow position which enables him to have better flexibility in managing working capital funds in an efficient and effective manner. Besides this, such arrangement also improves the ability of the client to develop sales to credit worthy customers.

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2) If the client avails the services of the factor in respect of sales ledger administration and collection of receivables, he need not have'any administrative set up for this purpose. Naturally this will result into a substantial saving in time and cost of maintaining own sales ledger administration and collecting receivables from the customer. Thus, it will reduce administrative cost and time. As a result of this, the client can spare substantial time for improving the quality of produ'ction and tapping new business opportunities.

3) When without recourse factoring arrangement is made, the client can eliminate the losses on account of bad debts. This will help him to concentrate more on maximizing production and sales. Thus, it will result in increase in sales, increase in business and increase in profit.

4) The client can avail advisory services from the factor by virtue of his expertise and experience in the areas of finance and marketing. This will help the client to improve efficiency and productivity of his organization. Besides this, with the help of data base, the factor can readily provide information regarding product design/mix, prices, market conditions etc., to the client which could be useful to him for business decisions.

   The above mentioned benefits will accrue to the client provided he develops a better business relationship with the factor and both of them have mutual trust in each other.

Disadvantages of Factoring

1) Image of the client may suffer as engaging a factoring agency is not considered a good sign of efficient management.
2) Factoring may not be of much use where companies or agents have one time sales with the customers.
3) Factoring increases cost of finance and thus cost of running the business.
4) If the client has cheaper means of finance and credit (where goods are sold against advance payment), factoring may not be useful.

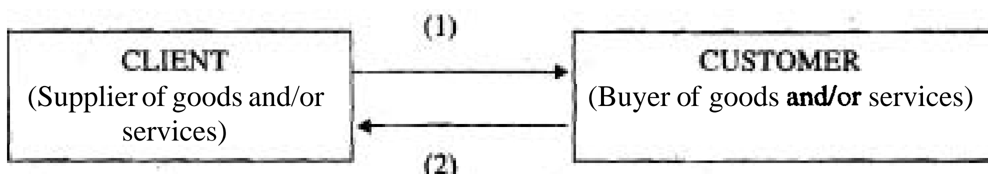
19.6 MECHANISM OF FACTORING

Operation of Factoring Services

There are three parties to a domestic factoring arrangement:

1) The client who is supplier or seller of goods and services.
2) The customer who is a debtor or buyer of goods and services provided by the client.
3) The factor who is a financial institution or intermediary between client and customer who provides the factoring services.

In normal business, the client sells the goods to the customer on credit. He sends invoices to the customer directly and also collects payment directly from the customer as shown in the following diagram.



1) Goods are sent on credit along with invoices to the customer.
2) Payment is made by the customer to the client on due date.

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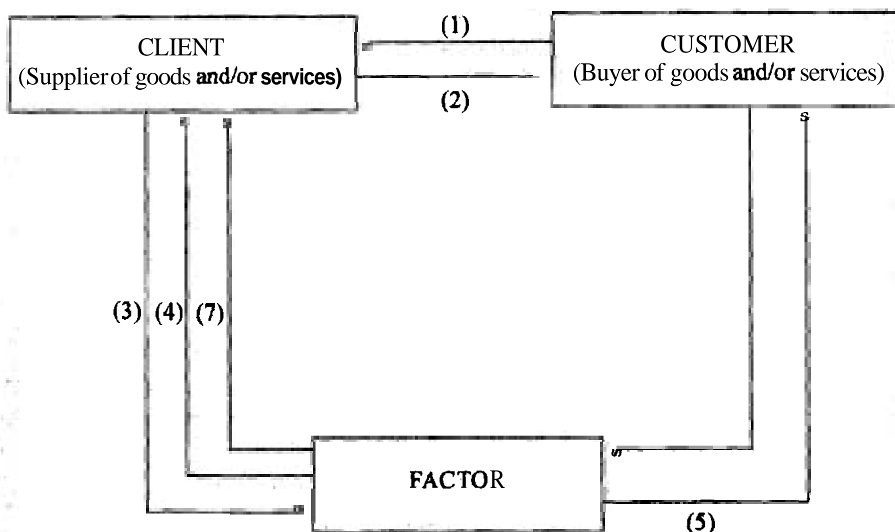
When a client enters into an agreement with a factor then a third party namely the factor is also introduced and their relationship can be shown here as under :



1) Customer places an order with the client for goods and/or services on credit.
2) Client Delivers the goods and invoice with a notice to pay to the factor.
3) Client sends of invoice to the factor.
4) Factor provides finance (pre-payment) to the client say 80-90 per cent of the invoice value on the production of a copy of invoice.
5) Monthly statement of accounts are sent to the customer and follow-up if invoke remains unpaid by due date.
6) Customer pays money to the factor on due date (i.e. collects book debts).
7) Factor makes the balance payment of the invoice value to the client.

Once the goods or services are delivered or supplied to the customer by the client, he sends invoices to the customer in the normal way. However, all the invoices must bear the notification that the invoices have been assigned in favour of the factor and accordingly payment must be made to the factor. After the client has sent the invoices to the customer, he offers to sell to the factor, the book debts on standard form, supported by copies of invoices and delivery orders.

The factors buys the book debts and immediately makes the agreed upon advance payment (Normally upto 80-90 per cent of the invoice value) to the client. The remaining balance (i.e. 10-20 percent of the invoice value) will paid to the client after the factor has been paid by the customer on maturity date depending on the type of factoring arrangement.

Using the invoices submitted, the factor maintains the sales ledger for the client and statements of accounts are sent to the customer on a monthly basis. The factor takes over the collection of book debts, and reminders are sent when the invoices are overdue. Client is kept informed of all the factoring transactions through monthly and weekly reports provided by the factor.

Cost of Factoring

These are two types of costs in factoring services

1) Service Fee or Charges
2) Discount Charges

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1) ***Service Fee:*** Service fee is levied for the work involved in administering the sales ledger as well as protection against bad debts, It is calculated as a percentage of gross value of the invoices factored and is assessed on the following criteria:

   a) Gross annual sales volume;

   b) Number of customers;

   c) Number of invoices and credit notes; and

   d) Degree of risk represented by the customer.

The service fee for domestic factoring ranges from 0.30 per cent to 0.75 per cent and it would be higher when non-recourse arrangements are made.

2) ***Discount Charge (interest charge):*** The discount charge is levied on the advance provided by the factor and is computed on the basis of prime lending rate of banks plus premiums for credit risk basis. It is calculated on a day-today basis on the advances outstanding and ranges from 1 to 3 per cent above the reference bank's prime lending rate.

19.7 MAIN CHARACTERISTICS OF FACTORING SERVICES

The main characteristics of factoring are noted below :

1) Factoring is a money market instrument.
2) Book debts represented by invoices are assigned in favour of a factor.
3) Since, factoring is not a negotiable instrument, customer's consent is required about the factoring arrangement under which he will make a repayment directly to the factor but not to the client.
4) Dual pricing structure comprising discount charges and services charges is followed.
5) Under without recourse factoring credit insurance facility is offered to the client. In view of this cost of factoring services is more under without.recourse factoring as against with recourse factoring.
6) Margin is kept in the range of 5 per cent to 20 per cent. In other words, usually about 80 to 95% of the invoice value is provided as pre-finance by the factor to the supplier which is known as prepayment.
7) Remaining amount of the value of invoice is paid to the client after collection of money from the customer and after deducting his own charges.

Activity 1

State whether the following statements are True or False

i) Factoring service is considered only in respect of receivables arising on account of credit sales. True/False

ii) Factoring services can be offered with recourse only. True/False

iii) Maturing factoring does not involve finance True/False

iv) Factoring involves assignment of book debt by client in favour of the factor. True/False

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19.8 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 terms 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

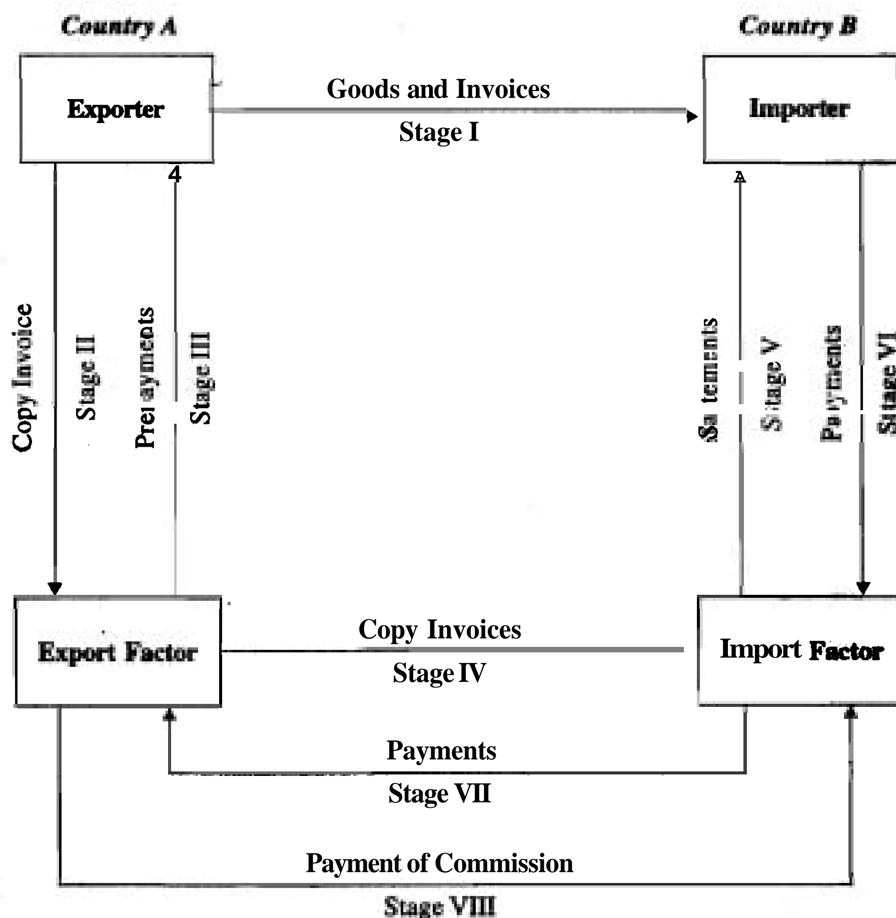
c) Direct Export Factoring

d) Direct Import Factoring

Under the two factor system, which is more in vogue in international factoring, both the export factor in the exporter's country and the import factor in the importer's country will be involved in providing international factoring services to the clients (exporters). Since both are integral part to the two factor system, naturally the functions of the factors will be divided between the export factor and import factor.

The mechanism of the two-factor system in international factoring alongwith the functions of export and import factor are illustrated in Figure 19.1.

Figure 19.1: Mechanism of two Factor System



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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.

Precautions to be taken by the Export Factor

If at all any institution intends to launch export factoring services, it must take, among others, following precautions:

1) In view of the availability of export finance by banks at concessional rate to the exporters, export factor has to provide prepayment facility against purchase of export receivables under factoring services at competitive rates. For this purpose, factors have to mobilise funds at most affordable cost.
2) Most of exporters may demand export factoring with without recourse facility. Therefore, a factor must be in a position to offer this facility alongwith other services as a part of factoring services package. For this, he can take help of factoring company operating in importers countries (known as import factor) for absorbing credit risk.
3) Factors may require to become a member of any one of the international chains like Amsterdam based Factors Chain International (FCI). FCI facilitates dealings between the two factors in different countries (where the local laws and usages and practices may be different) by setting up of appropriate business standards for bilateral dealings between Export Factor and Import Factor. In view of this, export factor will require to follow uniform rules to operate in the international market.

RBI Guidelines for Factoring Services

The RBI has issued guidelines subject to which banks can undertake factoring services through departmentally. These guidelines are as under :

1) Banks should frame an appropriate policy on factoring services with the approval of their Boards.

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2) As activities like factoring services requires skilled personnel and adequate infrastructure facilities, it should be undertaken only by certain select branches of banks. This will have to be suitably published for the benefit of banks customers.

3) The activities like factoring services shall be treated on par with loans and advances and therefore should accordingly be given the risk weight of 100% for calculation of capital to risk asset ratio. Further the guidelines on income. recognition, asset classification and provisioning norms would also be applicable to the portfolio of factoring.

4) The facilities extended by the prepayment under the factoring services would be covered within the exposure selling fixed upto 25% of bank's capital funds to an individual borrower and 50% of bank's capital funds to a group of borrowers.

5) Banks shall maintain a balanced portfolio of financing receivables under factoring services vis-a-viz the aggregate credit portfolio. The exposure towards prepayment in respect of purchase of receivables under factoring services should not exceed 10% of total gross advances as on the date of previous balance sheet.

19.9 FACTORING SERVICES IN INDIA

Though factoring services have been introduced since 1991 in India still it is quite new in the sense that factoring product is not widely known in many parts of the country. Recognising the utility of factoring services for small and medium size industrial and commercial enterprises in India, for the first time the Vaghul Committee which submitted its report on the Money Market, recommended the development of a system of factoring of open account sales particularly for the small scale industrial units. This committee further observed that both banks and non-bank financial institutions in the private sector should be encouraged to set up institutions for providing factoring services. Later, the Kalyanasundaram Committee, which was appointed by the Reserve Bank of India (RBI) in 1988 specifically for exploring the possibilities of launching factoring services in India, found an abundant scope for such services and hence strongly advocated for the introduction of factoring services in India. This committee also observed that banks were ideally suited for providing factoring services to the industries in the economy. However, the said Committee expressed the view that to begin with only four or five banks either individually or jointly should be allowed on zonal basis to undertake factoring services. The recommendations of Kalyanasundaram Committee were accepted by the RBI. Subsequently a suitable amendment was made in the Banking Regulation Act 1949, so as to allow banks to set up subsidiary company for undertaking factoring services.

To begin with, the RBI permitted both the State Bank of India and Canara Bank to start factoring services through their own subsidiaries. Accordingly, two factoring companies in India, i.e. SBI Factors and Commercial Services Ltd. arid Canbank Factors Ltd; sponsored by the State Bank of India and Canara Bank respectively, commenced operations in 1991. In the beginning they were allowed to operate in Western and Southern Zone of India respectively. However, later on, the RBI lifted these area restrictions on their operations and accordingly, both these companies were given permission to expand and operate their business in other parts of the country. In view of this, they can operate on all-India basis. In 1993 the RBI allowed all the scheduled commercial banks to introduce factoring services either departmentally or through a subsidiary set-up. Besides SBI Factors and Commercial Services and Canbank Factors Ltd., there are a few non-banking finance companies such as Formost Factors Ltd., Global Trade Finance Pvt. Ltd. (a subsidiary of EXIM

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Bank) and Integrated Financial Services Ltd., which are also in the business of domestic factoring in India. Of these, Global Trade Finance Pvt. Ltd. and Formost Factors Ltd. have undertaken the business of export factoring also. Besides these non-banking finance companies, Small Industries Development Bank of India (SIDBI), Hongkong and Shanghai Banking Corporation have been offering factoring services to their clients. Almost all of them have been providing factoring services to the SSI and non-SSI units.

Activity 2

Identify the reasons for the need of an Import Factor.

....

....

....

....

....

19.10 FORFAITING: AN INTRODUCTION

Forfaiting is the purchase of receivables alongwith avalised negotiable instruments like promissory note or bills of exchange (without recourse to any previous holder of the instruments) due on a specific date to be matured in future and arising from the exports of goods on credit. Thus, Forfaiting is a source of trade finance which enables exporters to get funds from the institution called forfaiter on transferring the right to recover the debts from the importer. The debt instrument is purchased by the forfaiter at an appropriate discount. This facility is always provided with non-recourse feature. Normally all exports of capital goods and other goods made on medium to long term credit are considered for providing finance through Forfaiting arrangement. Now-a-days, in many developed countries, a forfaiter provides a finance even in respect of commodity exports wherein the credit period is upto 180 to 360 days. (It is estimated that about 15 to 20 per cent of Forfaiting market worldwide is represented by transactions involving commodity exports upto 180 to 360 days).

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 is an aval.
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

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portion of cost of Forfaiting service. The discount rate charged by the forfaiter is based on the following elements :

- 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.
- A charge based on the risk of interest rate and exchange rate movements in the currency in which the credit is extended.
- 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.
- A charge based on the credit risk attached to the importer as well as avalor.

19.11 BENEFITS OF FORFAITING SERVICES

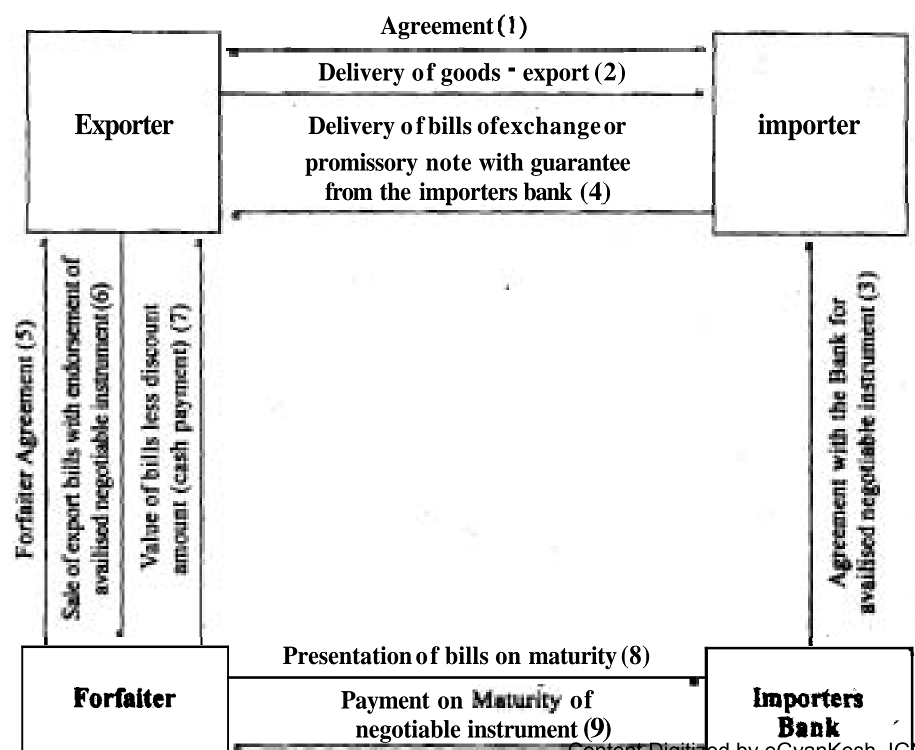
The benefits accruing to the exporter are numerous. Few of these benefits are stated below:

1) Exporter can convert export transaction under deferred payment arrangement into a cash transaction. Thus he can improve his own liquidity position.
2) Since the forfaiter takes all risks, naturally exporter is relieved of the risks arising out of the default by the buyer (importer) as also the political and exchange risk.
3) Since the Forfaiting is a fixed rate contract, the exporter is hedged against interest rate risk and exchange rate risk.
4) Exporter gets finance upto 100 per cent of the contract value (which is to be reduced to the extent of Forfaiting cost).
5) Exporter is freed from credit administration and collection problems.

19.12 MECHANISM OF FORFAITING SERVICES

The communication channels and module of transactions in Forfaiting are shown in the Figure 19.2.

Figure 19.2: Mechanism of Forfaiting



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Details are as under :

1) Commercial contract between exporter and importer.
2) Delivery of goods by exporter to importer on credit.
3) Contract between importer and his bank to have guarantees which will be given in respect of payment against negotiable instrument on due date.
4) Delivery of availised negotiable instrument either bill of exchange or promissory note to the exporter.

5 & 6) Forfaiting contract between exporter and forfaiter under which availised negotiable instrument will be endorsed without recourse in favour of the forfaiter.

7) Cash payment of discounted availised negotiable instrument by forfaiter to exporter (face value of bill less discount amount).
8) Presentation of availised negotiable instrument to the importer's bank.
9) Payment on presentation of availised negotiable instrument on maturity.

Activity 3

Complete the following statements:

i) Factoring does not involve the use of any negotiable instrument whereas ....
....
ii) Farfaiting services involve cost such as ....
iii) In factoring usually 80-90 per cent of the invoice value is paid to the client whereas in Forfaiting ....

19.13 MARKET GROWTH

During the period 1970-1980, both the primary and secondary markets in and for non-recourse trade paper increased considerably. Specialist banks in addition to traditional deposit and clearing banks developed Forfaiting departments, usually within their trade finance departments.

Later, specialist Forfait Houses were set up and there was a perceptible geographic growth and shift of the market from Switzerland/Northern Italy to Western Germany and more markedly to London. In 1984 London Forfaiting Company PLC, the only publicly owned and U.K. Stock market quoted specialist Forfaiting Company, was set up.

The primary forfait market has developed along side state backed credit export schemes, sometimes as a competition and sometimes as an adjunct to the state credit export schemes. Between market professionals a secondary market also evolved in forfait paper, which in effect securities these exporter receivables. During the period 1980-90 an increasing awareness of the forfait market was developed in many developed countries among business community.

19.14 FORFAITING SERVICES IN INDIA

Recognising the utility of Forfaiting services to Indian exporters, the RBI decided to make available such services to the exporters. At the beginning the RBI authorised 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,

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scheduled commercial banks can undertake Forfaiting services as a part of fee based financial services. A subsidiary of EXIM bank namely; Global Trade Financial Services Private Ltd. has been engaged in providing 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 terms. If the banks are able to act as an agent to structure Forfaiting 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. For 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.

19.15 DIFFERENCES BETWEEN FACTORING AND FORFAITING SERVICES

1) Factoring services is mainly meant for financing and collecting of receivables arising from short term credit transactions say upto 180 days. As against this, Forfaiting is meant for financing credit transactions of having deferred credit period of more than 1 year.
2) Factoring arrangement can be with recourse or without recourse depending on the terms of factoring contract between a client and a factor. As against this, Forfaiting transaction is always without recourse where forfeiter absorbs credit risk also.
3) Factoring services can be considered either for domestic transaction or for export transaction. As against this Forfaiting transaction is always considered for export transactions only.
4) Factoring is done on the strength of sales invoices only. Whereas Forfaiting involves use of availised negotiable instruments like bill of exchange or promissory note.
5) In a factoring arrangement, a margin of 5 to 20 per cent is kept. In other words, finance is provided immediate on the purchase of invoice to the extent 80 to 95 per cent of invoice value. As against this; a forfaiter discounts the entire sale value of the export transaction without keeping any margin.
6) Factoring services include sales ledger, administration, collection of receivables and other advisory services. On the other hand, Forfaiting is a pure financial arrangement.
7) Factoring is done on whole turnover basis, whereas, Forfaiting can be done on transaction basis.

19.16 BILL DISCOUNTING: AN INTRODUCTION

Bill financing is considered to be an appropriate form of financing trade and business Under this form of financing, seller of the goods draw a bill of exchange on the buyer

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(who accepts and returns the same to the drawer). Subsequently seller of the goods discounts the bill of exchange with bank or finance company and avail the finance accordingly. Only those bills which arise out of genuine trade transactions are considered by the banks and finance companies for discounting purpose.

Parties to a Bill of Exchange

Parties to a bill of exchange are as follows :

A) **The drawer** (seller of the goods)

- Who draws the bill.
- Who ensures that the bill is accepted and paid according to its tenor.
- Who promises to compensate the holder or any endorser of the bill if it is dishonoured.

B) **The drawee** (buyer of the goods)

- The person on whom the bill is drawn.
- Who has shown assent by signing across the bill for payment at maturity (thus becoming the acceptor)
- The person who assumes legal obligation to pay the bill.

C) **The Payee**

The person to whom or to whose order the bill is payable.

D) **The Endorser**

- The payee or any endorsee who signs the bill on negotiation.
- If the bill is negotiated to several persons who signs it in turn becomes an endorser.
- The endorser is liable as a party to the bill.

If the bill of exchange is not endorsed then drawer and payee will be the same person.

19.17 BENEFITS OF FINANCE THROUGH BILL DISCOUNTING

Following are the benefits of bill discounting for the drawer :

Cheaper form of Credit: Banks usually discount bills at a rate lower than the rate charged for cash credit. In view of this, drawer of the bill can reduce its cost of funds by raising the funds through discounting of bills with banks.

Better Funds Management: Bills seems to have certainty of payment on due dates and this helps to have efficient working capital management, It also leads to greater financial discipline as bills are discounted only against genuine trade transactions as compared with bank overdraft facilities which may be utilised for any other purpose.

Following are the benefits of providing finance against bills for the banker.

No Risk in Lending: By providing finance against bill, the bank can ensure safety of funds lent. As a bill is a legal negotiable instrument with the signatures of two concerned parties, enforcement of a claim is easier. Further, with recourse to two parties, it implies a lower credit risk. In other words, if the acceptor of the bill fails to make payment on the due date the bank can claim the whole amount form the drawer of the bill.

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Greater Liquidity: A banker who is in need of funds can rediscount bills with various financial institutions as approved by the RBI. Thus bank can raise the funds easily and quickly against the bills which are discounted.

No change in the value of the bill: As a security, the value of a bill is not subject to fluctuations which are found in case of values of tangible goods and financial securities. The amount payable on account of a bill is fixed and the acceptor is liable for the whole amount.

Precautions for Bill Discounting

Before approving a bill for discounting the following should be ensured by the banker :

- The signature as well as credit limit of the bank's borrowers have been verified. (Need to ensure that limit for bill discounting has been sanctioned by the credit manager).
- The nature of the transaction is mentioned on the bill and all invoice details are provided. There is a need to verify and ensure that bill is drawn against a genuine trade transaction. (i.e. bill covers only sale of goods transactions).
- The original tenor of the bill does not exceed 120 days if Bill Discounting Facility is to be availed of.
- The payment instructions and maturity date are clearly mentioned on the bill. The bill is drawn in favour of or endorsed to the discounting bank.
- All material alterations have been authenticated.
- Notice of dishonour and presentment have been waived.

19.18 SCHEME OF REDISCOUNTING OF BILLS

In order to make commercial bill an active instrument in the secondary money market, the RBI introduced bill rediscounting scheme in November 1970 and the same was revised from time to time. The features of revised rediscounting scheme are as under :

1) The bank, which originally discounts the usance bill, will have to issue an instrument known as "Derivative Usance Promissory Note" in favour of the bank or other approved financial institution with which it is rediscounting the bills. Such usance promissory note should be payable not more than 90 days from the date of rediscounting. (Government has exempted stamp duty on derivative usance promissory note).
2) The usance promissory note should be backed by unencumbered usance bills of exchange arising out of genuine commercial transactions evidencing sale of goods.
3) The negotiation of the usance promissory note shall be restricted to the participants in the Bills Rediscounting scheme as approved by the RBI.
4) Rediscounting of bills must be for a minimum period of 15 days.

19.19 DEVELOPMENTS IN COMMERCIAL BILL MARKET IN INDIA

Even though the role of commercial bill market as an important segment of money market was recognised as early as in 1930s, deliberate efforts were not made to ensure development of commercial bill market till 1952.

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Bill Market Scheme of 1952

In January 1952, the Reserve Bank of India (RBI) introduced a Bill Market Scheme under section 17(4)(C) of the RBI Act, 1934. This scheme was introduced with the objective of providing liquidity to banks in the form of demand loans against the security of usance promissory notes or bills drawn on and payable in India of their constituents provided they arose out of bonafide commercial or trade transactions. In order to avail refinance under the above section, the scheduled banks were required to convert a portion of the demand promissory notes obtained by them from their constituents in respect of loans, overdrafts and cash credit granted to them into usance promissory notes maturing within 90 days. The accommodation which was initially restricted to licensed scheduled commercial banks having deposits of Rs. 10 crore or more, was later extended to all the licensed scheduled commercial banks irrespective of size of deposits. The scheme however, did not develop into a genuine bill market as it was primarily intended for providing accommodation from RBI to banks.

Bill Market Scheme for Exporters

In 1958, the RBI extended the Bill Market Scheme to export bills also to encourage banks to extend credit facilities to exporters on a more liberal basis. The banks, however, could not avail of these facilities as exporters were reluctant to draw usance promissory notes as required by the RBI, after having tendered to banks for purposes of negotiation, documentary usance export bills which the banks sent abroad for acceptance and collection.

In 1963, the RBI introduced a new Export Bills credit scheme whereby advances could be made by the RBI to scheduled banks against their promissory notes only and upon their declaration of holdings of eligible usance export bills drawn in foreign currencies or Indian rupees and discounted or negotiated by them.

New Bill Market Scheme

The next significant measure taken by the RBI for promotion of a bill market was in November 1970 when on the recommendation of a Study Group chaired by M. Narasimham, it introduced the New Bill Market Scheme (NBMs). This schemes was an improvement over the earlier scheme in that only genuine trade bilk, maturing within 90 days, arising out of bonafide commercial or trade transactions involving sale or despatch of goods were made eligible for rediscounting with the RBI by all licensed scheduled commercial banks.

19.20 REASONS FOR NON-DEVELOPMENT OF BILL MARKET IN INDIA

Despite various measures taken by the RBI to activate bill market, the same is yet to be fully developed in India. The various reasons can be identified in this regard. Few of these reasons are given below :

1) Reluctance of industry as well as trade and Government undertakings as well as departments to move towards bill financing since it does require observance of strict financial discipline. In other words, industries and Government departments are not prepared to subject themselves to the strict commitment to honour financial obligations on the agreed date.
2) The procedural delay involved in the creditor getting a prompt legal remedy in case of dishonoured bills.

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3) With the era of globalisation and reforms in the economy, the domestic market has become highly competitive and has turned into a buyer's market. As a result, sellers of goods are not able to bring around the buyers to accept bill of exchange for sale of goods on credit. From the buyer's point of view, they would like to retain the character of the transaction as a pure credit transaction with simple debtor-creditor relationship rather than elevate it to a negotiable instrument.

4) Operational and procedural constraints in the discounting and rediscounting of bills.

   - Lack of uniformity in the documents to be submitted for availing bill discounting facility.
   - Wide geographical spread of the buyers
   - Delay on the part of drawers bank in sending the bills for presentation/ acceptance
   - Delay on the part of drawee in accepting the bills within a reasonable time frame.
   - Delay in remittance of proceeds by the bank at the drawee's end.
   - Delay in the approval of new customers (drawees) in the absence of reliable credit information especially in respect of small and medium size enterprises as well as unlisted and unincorporated entities.

5) Cost of availing credit through bill discounting is perceived to be high compared to cost of cash credit facility. In addition to the discounting charges, collection and handling charges are also levied. In view of this, effective cost of bill discounting turns out to be rather high especially in case of bills of smaller amount.

19.21 REVITALISING BILL MARKET IN INDIA

Since the introduction of the New Bill market scheme, the RBI has introduced several measures to encourage use of commercial bills and thus widen the commercial bill market in India. Few of these measures are stated below :

- Simplification of the rediscounting procedures by dispensing with the actual lodgement of bills in respect of bills below the face value of Rs. 10 lacs and replacing it with derivative bills. The minimum amount of bill at Rs. 5000/- prescribed under the scheme was also done away with.
- Promotion of Drawee Bills Scheme, by making it mandatory for banks to extend atleast 25 per cent of the cash credit limit to borrowers in the form of bills and requiring banks to ensure that their corporate borrowers financed their domestic credit purchases from SSI units, atleast to the extent of 25 per cent, by way of acceptance bills drawn on them by their suppliers, and advising banks to monitor the compliance of this requirement through a suitable monitoring system *(These* mandatory stipulations were subsequently withdrawn with effect from 2nd November, 1999)..
- Remission of Stamp duty by the Government of India on bills of exchange drawn on or made by or in favour of a commercial bank or a co-operative bank and payable not more than three months after date or sight.
- The licensed scheduled commercial banks have been allowed to rediscount bills with a few financial institutions such as Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC) and its subsidiaries and Unit Trust of India (UTI) and such other financial institutions, incorporated in

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India, as may be approved by the RBI on a reference made to it. (In fact the RBI has enlarged the list of approved institutions for rediscounting bills).

- In 1981, in addition to all India financial institutions, RBI allowed Mutual Funds to participate in Bill Rediscounting market thus augmenting the supply of funds in the secondary market.
- The Discount and Finance House of India Ltd. (DFHI) was set-up by the RBI jointly with public sector banks and All India Financial Institutions to develop secondary market for commercial bill.
- To simplify the procedure for rediscounting of billsby banks and to enable multiple rediscounting of bills, the RBI has introduced a revised procedure under which derivative usance promissory notes drawn by banks for suitable maturities upto 90 days on the strength of underlying bills discounted by the banks' respective branches can be rediscounted with other banks, approved financial institutions and primary dealers. The Government of India has exempted the payment of stamp duty on these usance promissory notes.
- Delinking interest rates applicable on discounting of bills from the prime lending rates of banks thus giving commercial banks the freedom to charge market determined interest rate on bills.

19.22 SUMMARY

In this unit we have discussed the financial services namely Factoring, Forfaiting and bill discounting. Factoring involves financing and collection of accounts receivables in domestic as well as international trade. This service is rendered by the factor who provides finance against book debts, collects cash against receivables, undertakes sales ledger administration, provides protection against bad debts, etc. There are three parties to a factoring contract: buyer of goods, who has to pay for goods bought on credit terms, seller of goods, who has to realize credit sales from buyer. and the factor, who acts as an agent and realizes the sales from the buyuer.

Forfaiting is a source of trade finance which enables exporters to get funds from the forfaiter on transferring the right to recover the debts from the importer. It denotes the purchase of trade bills or promissory notes by a bank or financial institution, without recourse to seller. Bill discouting is a source of short-term trade finance. It is known as acceptance credit, where on party accepts liability of trade towards third party.

19.23 KEY WORDS

Factoring: is a financial service covering the financing and collection of accounts receivables in domestic as well as international trade.

Factor: acts as agent in realising credit sales from buyer and passes on the realised sum to seller after deducting his commission.

Forfaiting: denotes the purchase of trade bills or promissory notes by a bank or a financial institution without recourse to seller.

19.24 SELF ASSESSMENT QUESTIONS

1) What do you mean by factor and factoring services?
2) What do you mean by without recourse and maturity factoring?
3) Explain the benefits and disadvantages of factoring services.

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4) Explain the mechanism of factoring services.
5) Explain the various types of export factoring arrangement.
6) Define Forfaiting services?
7) What are the differences between factoring and Forfaiting services?
8) Comment on factoring and Forfaiting services in India.
9) Explain the benefits of finance through bill discounting.
10) (i) What do you mean by rediscounting of bills?
    (ii) Explain in brief RBI's scheme of rediscounting of bills
11) Write short notes on :
    (1) Bill Market Scheme of 1952
    (2) New Bill Market Scheme of 1970.
12) "Despite various measures taken by the RBI, the commercial bill market is not developed in India". Comment on this and give the reasons for the same.

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