

## **Unit 4**

# **Factoring, Forfeiting & Securitization of**

## Factoring

### Introduction

- Factoring is a financial transaction whereby a business sells its accounts receivables i.e invoices to a third party called a factor at a discount in exchange for immediate money.
- Factoring involves a seller/client and a buyer/customer and a factor.
- Vaghul committee on money market recommended development of factoring business to benefit SSIs through banks and banking financial institutions.
- Kalyanasundaram committee of 1988 recommended 3 - 5% commission in a zone to start this service through subsidiaries.
- In 1991 SBI and Canara Bank set up factoring services through their 2 subsidiaries in the western and southern region.
- Awareness about factoring services is still very low in India. Proper marketing efforts needs to be put in this direction.

**Meaning :** Latin term ‘factor’ which means ‘doer’.

“Factor is one who lends money to producers and dealers on the basis of accounts receivables”

- Factoring is a financial transaction whereby a business sells its accounts receivables to a third party at a discount in exchange for cash or money.
- Factor is a financial institution which manages the collection of accounts receivables of the companies on their behalf and bears the risk associated with those accounts.

## **Mechanism**

- The customer places an order for goods on credit, client delivers goods and sends credit invoice.
- Client sends invoice to factor
- Factor makes pre-payment upto 80 per cent to client
- Factor starts managing debt with the buyer.
- Customer pays the factor
- Factor pays balance 20 per cent to the client, after deducting commission

## Characteristics of factoring

- It is a mode of financing as well as a financial service provided by the specialist companies called factors
- It is a contractual service arising out of the agreement between a business firm and the factors
- Continuous arrangement between the factor and the client
- It enables the conversion of outstanding receivables into cash
- It involves an outright sale of book debts to the factor by the client
- Factor makes an advance payment (80% to 90%) against the invoice factored by the client's firm
- Factor may assume the credit risk or may not assume the credit risk arising from the collection of receivables
- Factor undertakes the services of credit collection, sales promotion, maintenance etc



## Functions of Factoring

- **Finance:** Acts as a source of short term funds. The factor pays up to 80% of the outstanding and pays the balance minus commission on maturity.
- **Debt administration:** The factor maintains sales showing outstanding position. He sends monthly statements to the client.
- **Credit risk:** The factor will advise the client about the worthiness of different buyers and help them in credit protection. Without recourse factoring also helps in credit protection to the clients.
- **Advisory services:** Factor provides clients advisory services in finance, buyer management, credit sales and also handles issues related to sales and finance management.



## Types of Factoring

- **Recourse factoring:** Factor purchases trade debtors and purchases receivables. But in case of default factor takes recourse. Therefore this kind of factoring has no bad debt protection in developing countries.
- **Non-recourse factoring:** If the trade debtor fails to pay, the factor can recover the money from the client. This gives bad debts protection to the client and therefore is bit expensive. Famous in developed countries.
- **Advance factoring:** The factor pays only a specified advance, say 90% of the receivables in advance and the balance is paid on collection of debt. A drawing limit is opened as soon as the advance is raised. Client has to pay interest on the factored amount from the date of payment to the date of actual collection.
- **Bank participation factoring:** Is a modification over advance factoring where a bank provides a part of the factor reserve. Factor reserves receivables less advance given by the factor. If factor advances reserve is 25% and bank would pay say 50% of that reserve to support 87.5%.
- **Maturing factoring/Collection factoring:** No advance payment to the factor. But payment is done on the date of collection or payment date which is usually a few days after due date of invoice.

**Notified and Undisclosed factoring:** In notified factoring the customer is informed about assignment of debt to the factoring agent and is required to pay to the factor instead of the firm. In a non-notified or confidential factoring arrangement the factoring arrangement is not disclosed to the customer but the customer is required to pay to the new party.

**Full factoring:** This provides all the services involved in factoring including credit collection, credit protection, sales ledger protection and sales finance. It is also called old line factoring.

**Invoice factoring:** The debt due to the client is purchased by the factor, providing liquidity but it doesn't provide the service element of factoring.

**Buyer based, seller based and selective factoring:** In a buyer based factoring the factor would maintain a list of buyers whose receivables would be factored without recourse to the seller. In a seller based factoring system, the factoring agent keeps a list of seller who would like to factor with or without recourse. In selective factoring the seller is restricted to sell to the approved buyer.

**Export factoring:** Also known as international or cross-border factoring. Deals in export sale and provides financial service, collection service, advisor service and services pertaining to legal formalities of export.



## Factoring charges

**Finance charges:** are levied based on pre-paid amount outstanding in clients accounts on a regular basis. It is only for the money lent and is similar to interest charged by banks on a cash credit account.

**Service fee:** This is to cover the services provided such as collection, sales ledger management, periodical reports. It is charged on a monthly basis based on sales volume, number of customers, number of invoices, and the level of credit risk posed by the buyers.

Both these charges compare favourably with interest charged by banks for short term borrowings.



## Forfeiting

- Forfeit means “relinquish or give up a right”
- It refers to exporter giving up his right to a receivable future date in favour of immediate cash, at an discount from a forfeiter, thereby passing all collection to the forfeiter.
- It refers to factoring without recourse to the exporter
- Evolved in 1960s in Switzerland to help German export to the eastern block countries.
- It mushroomed in Switzerland and now it is concentrated in London.
- RBI approved forfeiting as a mode of export finance
- Exim bank was the first institution to get approved un

## Characteristics of Forfeiting

It is a pure financial arrangement

- It is related to credit sales of more than 90 days (long receivables)
- Forfeiter discounts entire value of the bill thereby providing finance to the exporter.
- Availing bank provides unconditional and irrevocable guarantee, which is a critical element of this arrangement
- Usually a forfeiter finances long term deferred payment for years
- Forfeiter bears credit risk and exchange risk as well.
- A forfeiter may hold the bills till maturity or sell them in secondary market
- Forfeiting agreement can be flexible and can be structured around various needs like interest rates, duration, etc
- Usually suitable for high value items like capital goods, consumer durables, projects exports etc.

## Forfeiting Mechanism

- Forfeiter gives a commitment to the exporter about foreign exchange at the time of shipment
- Exporter and importer sign a commercial contract
- A forfeiting certificate issued by the AD is attached to the contract and sent to importer along with commercial documents
- The importers bank gives guarantee at the request of the importer.
- The guarantee is forwarded by the importer to the exporter
- The exporter then assigns the guarantee in favour of the forfeiter
- Forfeiter pays the exporter on a non-recourse basis
- On maturity the forfeiter presents the documents to the importers bank
- Importer pays the guaranteeing bank
- Guaranteeing bank pays the forfeiter

## Forfeiting charge

- **Discount fees:** Cost of interest for the credit period on the discounted amount.
- **Option fee:** Charged for right to withdraw unilaterally from a forfeiting contract
- **Collection cost:** Cost of collection charged to the exporter
- **Commitment fee:** Commitment fee charged by the forfeitor for the period between signing of agreement and the actual collection to the exporter. It is a percentage on the total sum of the commitment period.

## Securitization of Debt

- Securitisation means to convert an asset, specifically a loan into marketable security for the purpose of raising cash or funds.
- It can also be used for financial assets such as mortgage loans, automobile loans, receivables, credit card receivables etc
- Illiquid receivable is converted into securities, hence the name debt or asset securitisation
- It may involve pooling of assets and selling them to investors through a specialized intermediary for the purpose.





## **Features of Securitization of Debt**

- Marketability
- Merchantable quality
- Wide distribution
- Homogeneity
- Commoditisation
- Integration and differentiation (pooling separation of assets)
- De-construction of claims to various cash flow rearrange them into various buckets and sell to different investors

## Parties involved in securitization of debt

- Originator or seller: whose receivables portfolio forms the basis for asset backed security (ABS)
- Special purpose vehicle (SPV): formed to carry out a specific activity. Can be trusts, corporations, limited partnerships, etc. this helps distancing of the instrument from the originator and mediates between the originator and the investor.
- Investors: individuals or institutional investors who invest and receive interest and principal as per agreed norms
- Other parties
  - Obligor: originator's debtor or borrower of the original loan
  - Trustee: investors representative to safeguard their interest
  - Credit rating agency
  - Regulators
  - Service providers
  - Specialists like legal, accounts, pool auditors

## **Benefits of Securitization of Debt**

### **1. Benefits to issuers / originator**

- Diversification and reduced cost of funding
- Management of regulatory capital
- Generation of servicing fee income
- Management of interest rate volatility

### **2. Benefits to Investors**

### **3. Benefits to borrowers**

## **Issues in securitization of debt**

- Debility (incapability) to central bank
- Heightened volatility
- Pressure on profitability
- Eroding capital base

## **Link for you tube video**

<https://www.youtube.com/watch?v=r55fXJsRwvA>

## Special Purpose vehicle

- SPV is created to carry-out a specific business purpose activity.
- SPVs are frequently used in structured finance transactions such as in asset securitizations, joint ventures, or to isolate certain company asset or operations. SPVs can be created through a variety of entities, such as trusts, corporations, limited partnerships, and limited liability corporations.
- SPV are used by many companies for an array of different purposes.
- SPV which acts as the issuer of the ABS ensures the distancing of the instrument from the originator.
- The entity that intermediates between the originator's receivables and the end-investors is known as 'Special Purpose Vehicle'.

## **Securities issued by SPV**

- Mortgage-Backed Securities (MBS), which are backed by mortgages
- Asset-Backed Securities (ABS), which are mostly backed by consumer debt
- Collateralized Debt Obligations (CDO), which are mostly backed by corporate bonds or other corporate debt.

## **Reasons for creating SPV**

- Securitization
- Risk Sharing
- Finance
- Assets Transfer
- Financial Engineering
- Regulatory Reasons