Unit 4

Factoring, Forfeiting & Securitization of

Factoring

Introduction

- Factoring is a financial transaction whereby a business accounts receivables i.e invoices to a third party called a a discount in exchange for immediate money.
- Factoring involves a seller/client and a buyer/custome factor.
- Vaghul committee on money market recommended deve of factoring business to benefit SSIs through banks banking financial institutions.
- Kalyanasundaram committee of 1988 recommended 3 – in a zone to start this service through subsidiaries.
- In 1991 SBI and Canara Bank set up factoring services their 2 subsidiaries in the western and southern region.
- Awareness about factoring services is still very low 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 tl of accounts receivables"

- Factoring is a financial transaction whereby a business sells it receivables to a third party at a discount in exchange for money.

- Factor is a financial institution which manages the collection receivables of the companies on their behalf and bears the associated with those accounts.

Mechanism

- The customer places an order for goods on credit, client d 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 co

Characteristics of factoring

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

Functions of Factoring

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

Types of Factoring

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

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

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

Invoice factoring: The debt due to the client is purchased by
providing liquidity but it doesn't provide the service element o

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

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

Factoring charges

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

Service fee: This is to cover the services provid collection, sales ledger management, periodical rep is charged on a monthly basis based on sales number of customers, number of invoices, and the of credit risk posed by the buyers.

Both these charges compare favourably with intere 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 exp the eastern block countries.
- It mushroomed in Switzerland and now it is concen London.
- RBI approved forfeiting as a mode of export finance
- ~~Exim bank was the first institution to get approved~~ ur

Characteristics of Forfeiting

It is a pure financial arrangement

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

Forfeiting Mechanism

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

Forfeiting charge

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

Securitization of Debt

- Securitisation means to convert an asset, spec loan into marketable security for the purp raising cash or funds.
- It can also be used for financial asset mortgage loans, automobile loans, receivables, credit card receivables etc
- Illiquid receivable is converted into securiti hence the name debt or asset securitisation
- It may involve pooling of assets and selling t 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 th different investors

Parties involved in securitization of debt

- Originator or seller: whose receivables portfolio forms t for asset backed security (ABS)
- Special purpose vehicle (SPV): formed to carryout a activity. Can be trusts, corporations, limited partnership this helps distancing of the instrument from the origi mediates between the originator and the investor.
- Investors: individuals or institutional investors who inv 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 pu
  activity.
- SPVs are frequently used in structured finance tran
  such as in asset securitizations, joint ventures, or t
  certain company asset or operations. SPVs can be
  through a variety of entities, such as trusts, corp
  limited partnerships, and limited liability corporation
- SPV are used by many companies for an array of f
  purposes.
- SPV which as the issuer of the ABS ensures
  distancing of the instrument from the originator.
- The entity that intermediates between the originato
  receivables and the end-investors is known as
  Purpose Vehicle'.

Securities issued by SPV

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

Reasons for creating SPV

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