ramco

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Concept Paper

Factoring

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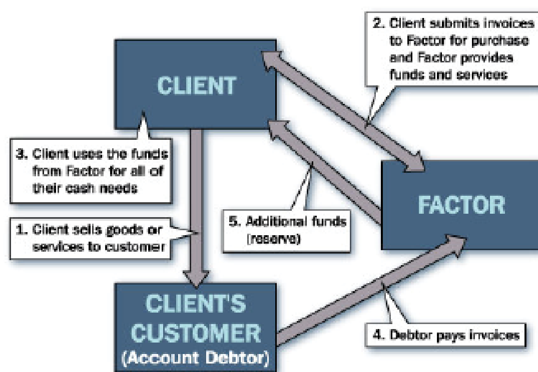
1. Introduction

Factoring is a financing option for businesses. With factoring, the business, i.e. the Client, sells accounts receivable to the Factor, in exchange for funding. The Factor typically advances 75 to 80% of the face amount of the accounts, to the Client. The Factor then collects the accounts from the Client's customers (the Account Debtors) and upon collection, remits to the Client the remaining 20 to 25% of the accounts, less a fee. In addition, the Factor provides various accounts receivable management, collection and credit services to the Client.

The in-depth analysis of factoring is provided elsewhere in this document. For an initial overview the following diagram illustrates the factoring process:



Organizations utilize the services of the Factors for covering their short-term funds gap.

Organizations that have good sales volumes, but are running on credit terms, are typical candidates to utilize factoring services.

The main benefit of factoring is the increase in working capital, with availability of cash on a regular basis. This ultimately improves the profitability of the business, maintains good credit ratings for the business, allows the business to take advantage of discounts for purchases, avoids interests and penalties, funds expansion and growth plans of the business and allows the business to spend more time, specializing in its area of business.

1.1 Trade Transaction

Factoring revolves around trade transactions. Factoring, in simple terms, is financing of account receivables, generated for trade transactions. A brief note on trade transaction is presented below for better understanding.

A trade transaction has two parties to it, the Seller and Buyer. The seller and the buyer enter into a sale agreement that lays down the boundaries of the sale. There could be multiple options through which the sale of goods and realization of proceeds could happen.

The sale and the payment could happen immediately, termed as Sight Transactions or the sale could happen immediately and the Payment at a future date, termed as Usance transactions.

In case of usance transactions, the buyer is given "Time" after the sale is effected, to pay for the goods/services that are being purchased/consumed. Extending credit period to buyers could be due to business needs but at the same time the seller's money is blocked till the payment is realized. In such situations, the seller is faced with a gap in the funds and would prefer to get immediate money for the invoices he has raised.

The alternative available to the seller is to borrow money against the invoices he has raised (the receivables). This amounts to borrowing against receivables. Financers or Lenders provide for such activities in the market. When these transactions occur with a Corporate, involving big volumes, they approach Finance companies that would be willing to loan them money against their invoices, but for a fixed charge. Such a charge would include the Financiers' risk, taken for the Credit period he has to wait to recover the loaned funds.

In the above situation, the activity is called Discounting. The seller discounts his invoices (payable at a fixed future date) with a Finance company. Charges levied by the finance company (Discounter) is termed Interest. Any other charges to be deducted from the total payable value are termed handling charges.

The above situation can occur both in International as well as Domestic trade situation. When it occurs in an international scenario, it comes under the purview of Trade Services where more documentation and prior seller-buyer-banker agreements are involved. When this occurs with simple sales/services contracts, involving just Sales invoices and Promissory notes that are duly acknowledged and accepted by the buyer, it is treated as a Normal Discounting or Factoring transaction.

1.2 Discounting Vs. Factoring

The fundamental difference between factoring and confidential invoice discounting is that the factor's involvement is disclosed to the buyers and the factor takes responsibility for collecting the value of outstanding invoices on the seller's behalf.

Also, normal discounting applies to the full value of invoices while factoring means only a certain part of the invoice value presented is Financed and the balance, paid on receipt of full funds from the buyer. A normal discounting deal is always at the seller's risk i.e. in case the buyer does not pay on due date, the financier can recover the money/funds from the seller. In case of factoring, it can be treated in 2 ways i.e. at Seller's risk or Bank's risk.

When the risk is passed to the seller, it is termed as 'With Recourse' and when it is on the bank, it is 'Without Recourse'. **In normal discounting terms the lender is called Financier while in factoring the lender is referred as Factor.**

As regards post financing work, under normal discounting, the financier does not own responsibility to recover the funds and it is for the seller to follow-up with the buyer and ensure payment. Under factoring, however, the factor may or may not take the responsibility of tracking for funds. But he will do a certain amount of tracking.

2. Factoring

The various dimensions of factoring are discussed below

2.1 Parties in Factoring

The factoring transaction involves three parties:

1. The Seller, who has produced the goods/services and raised the invoice
2. The Buyer, the consumer of goods/services and the party to pay
3. The Factor, the financial institution that advances the portion of funds to the seller

2.2 Factoring Process

The steps involved in factoring is listed below:

- The seller interacts with the funding specialist/broker and explains the funding needs.
- The broker prepares a preliminary client profile form and submits to the appropriate funder for consideration.
- Once both parties agree that factoring is possible, the broker puts the seller in direct contact with the funder to ask/answer any additional questions and to negotiate a customized factoring agreement, which will meet the needs of all concerned.
- At this point, the seller may be asked to remit a fee with formal application to cover the legal research costs, which will be incurred during "due diligence". This is the process by which the buyer's credit worthiness is evaluated through background checks, using national database services.
- During the next several days, the funder completes the "due diligence" process on the seller, further verifies invoices and acknowledges any liens, UCC filings, judgments or other recorded encumbrances on the seller's accounts receivables.
- The seller is advised of the facility and is asked to advise the buyers of the Factor by letter and submit an acknowledged copy of the same to the Factor for records.
- A detailed sanction letter is given to the seller and their acceptance on the same taken, with the required signatories. (Authorized signatories would be mentioned in the "Signing Authorities" section of the Proposal presented by seller).

Sanction terms must contain the following.

- All Facilities covered under the sanction.
- The period for which the sanction is valid
- When the Facility comes into effect e.g. (if Facility is dated 1/12/'04, it can state that invoices raised from or after 15/12 only would be Factored).
- Who the authorized signatories are for signing invoices for factoring.
- The limits.
- The seller has to advise the buyer of the Factoring agreement.
- Copy of such advice acknowledged by the buyer should be submitted to the Factor. Buyer's consent is not required to decide on the Factor.

- The discounting rates, charges fixed.
- In case of discounts given by the seller to the buyer, which value would be financed by the factor (since the factored amt should NEVER exceed the amount actually payable by buyer).
- Usually within 7 to 10 days of the initial contact with the factor, agreements are signed, customers are notified, UCC forms filed and the first advance is forwarded to the company. This advance can vary between 70 - 80% of the face value of the invoices being factored. In the construction industry, the advances may be in the range of 60 - 70%. The remaining amount is called the "reserve" which is held by the factor until the invoices are paid. The factor then deducts his fee and returns the remaining funds to the seller.
- Once the factoring agreement is in place, subsequent transaction becomes simple
- The seller performs services or delivers products, thus creating an invoice
- The seller sends or faxes a copy of the invoice directly to the factor
- The funder verifies the invoice and the advance is sent to the seller as per the agreement with the factor. In certain cases, the funder wires the funds to the seller's account for an additional fee.
- The buyer pays the factor
- The factor then returns any remaining reserve, minus the fee, which has been predetermined in the negotiated agreement

2.3 Types of Factoring

When an agreement has been reached between the seller and the factor, the factor determines whether to use recourse, non-recourse or a modified version of recourse factoring, based on the credit worthiness of the buyer and the volume of invoices to be factored.

Non-recourse factoring is when the factor takes full responsibility for the invoice, regardless of whether he is able to collect the debt. Most factoring arrangements are non-recourse if the buyers have favorable credit ratings through public reporting agencies, such as Dunn & Bradstreet, TRW, etc.

Recourse factoring is when the factor reserves the right to seek payment from the seller, if the buyers fail to pay their invoices for some reason.

Modified recourse factoring is a combination of the two, providing advantages to the seller and decreased risk for the factor. This arrangement can often translate into lower costs and higher advances for the accounts being factored.

Cost of Factoring

Factoring fees are more expensive than loan interest charged by a banking institution. The reason is the cost of money. Factors borrow short-term money to service their clients as opposed to the banks, which work with the depositors' funds on a long-term basis.

The percentage of fee charged by a factor is actually a transactional cost, based on how long it takes for the buyers to pay the volume of invoices factored and the credit worthiness of the buyers. The fee charged varies from factor to factor. Very large yet less complicated invoices usually receive preferred rates tied to "prime". The rates for smaller transactions, on an average are 4% to 5% per month. The rates on factoring international invoices may be slightly higher, if the accounts are not already insured or guaranteed by a recognized institution.

Advantages for the seller

- Seller gets funds immediately after the sale is effected and on presentation of accepted sales invoices and Promissory notes
- Major part of paper work and correspondence is taken care of by the factor.
- Follow-up, for recovery of funds, is done mainly by the factor.
- Interest rates are not as high as normal discounting.
- Increased cash flow to meet payroll
- Immediate funding arrangements
- No additional debt is incurred on balance sheet
- Other assets are not encumbered
- Approval is not based on seller's credit rating

3.0 Ramco's Offering

3.1 Factoring Functions

Four major functions are being envisaged as executing the factoring transaction, the **sales function**, the responsibilities of which include:

- Business development
- Prospecting
- Product structuring
- Relationship Management
- Negotiations
- Finalizing the master factoring agreement

The **services function**, the responsibilities of which include:

- Creation of Products
- Liaison with clients
- Process factoring transaction life cycle
- Monitoring Transactions
- Initiating loss booking with underwriting

The **underwriting function**, the responsibilities of which include:

- Analyzing the sellers and buyers
- Taking credit decisions
- Performing reference checks
- Analyzing and recommending facility renewals
- Monitoring and analyzing asset quality

The **portfolio management function**, the responsibilities of which include:

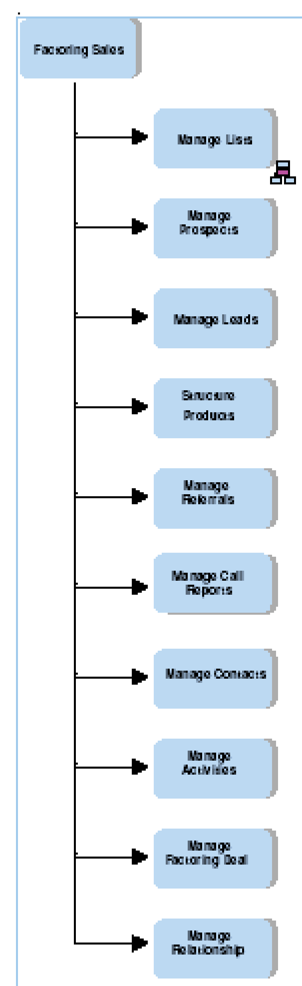
- Managing the portfolio with covenants and condition checks
- Setting and monitoring ticklers

Other functions include factoring administration, managing templates and reporting

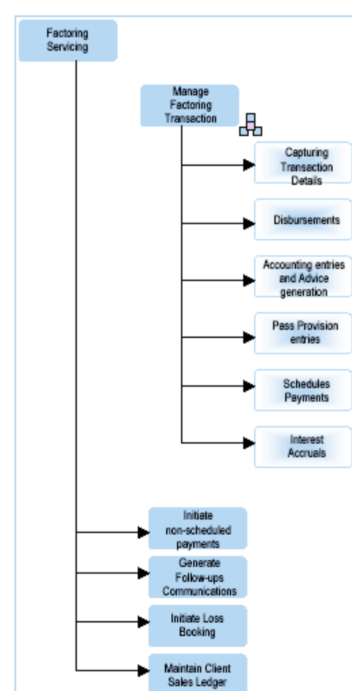
3.2 Factoring ARIS Function Tree

The ARIS function tree for major functions are given below,

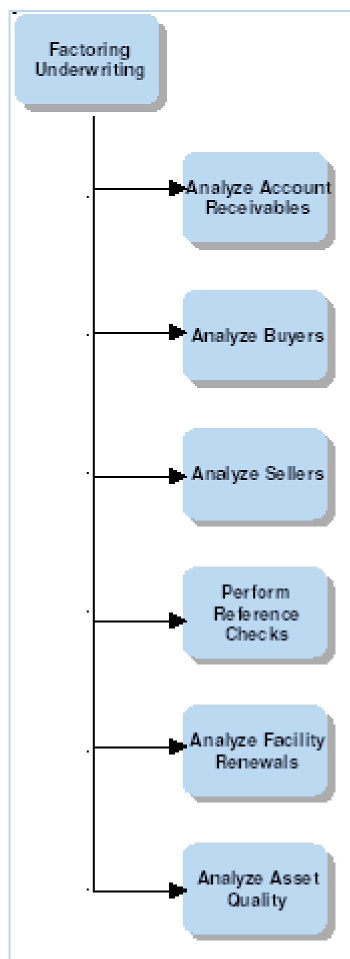
3.2.1 Factoring Sales



3.2.2 Factoring Services



3.2.3 Factoring Underwriting



3.2.4 Portfolio Management