Factoring in the fast lane

PETER MULROY demonstrates how banks have been playing a crucial role in this rapidly-growing form of trade finance now that most international factoring companies are bank owned

The rebound that has followed the global financial crisis, led mostly by emerging market economies, marked a significant milestone for trade in general and trade finance in particular.

Throughout the past decade, new, non-traditional forms of trade finance have shifted on capturing new trade flows in open account transactions. Increased take-up of credit insurance and supply chain finance programmes by importers have changed the trade finance landscape.

During this period, international factoring has experienced rapid growth compared with other trade-related products and services, and has become a legitimate alternative to trade letters of credit (LCs). One consequence is the development of Factors Chain International (FCI), the trade network of independent and bank-related factoring companies as a barometer of the global factoring market.

Growth of factoring

Overall global industry growth

The global factoring industry has been growing at nearly 14% per annum over the past 15 years (see Figure 1). This includes both domestic and international crossborder factoring volumes. Three major forces have underpinned this growth:

- emerging markets have adopted the service as a major source of credit protection and liquidity for small and medium-sized enterprises (SMEs) and large corporates, led by China;
- Europe has seen the most significant growth during the past 15-year period, and still accounts for nearly two-thirds of the global factoring volumes; and
- international crossborder factoring volume has grown much faster than domestic factoring.

Since the 2009 recession, the industry has added nearly EUR1trn in factoring volume globally (see Figure 2); almost doubling in size in the three-year period. This significant increase has been driven by a systematic growth in factoring throughout most of the developed and developing world. Predominantly led by commercial bank-owned factoring companies, this demand is partly down to the increased perceived risk stemming from the recession, but also the shift from overdraft and unsecured credit facilities to receivables-based factoring and invoice-discounted portfolios. Similar growth can be seen in the asset-backed securities and asset-based lending portfolios of most asset-based lenders in the developed world.

This shift to more secured lending demanded by risk management from most financial institutions is also enhanced by the introduction of Basel III rules impacting capital requirements (see page 10 of this issue).

Crossborder factoring growth

Taking the period of 2009 to 2012, once the international crossborder factoring statistics are isolated from the overall world factoring growth volumes shown in Figure 3, international factoring volumes have grown more rapidly than domestic ones and have been the primary driver in world factoring growth.

Again, three major changes have brought this about:

- The increase in usage of open account as a trade term, especially from suppliers in the developing world, and pushed by the major retailers and importers in the developed world;
- the impact of the global recession and shift from unsecured to secured asset-based funding; and
- the rise of greater China as a factoring market.

Figure 4 demonstrates how the crossborder international factoring volume growth rate outstrips the growth rate in world exports (3.5 times higher), credit insured exports

(2.2 times higher), trade LCs issued (16 times higher), and even world factoring volumes (1.5 times higher). All figures above, excluding crossborder factoring, include domestic business, as it accounts for the vast majority of trade transactions in all categories.

In summary, LCs are still today the dominant form of financing of international trade, but the product is a mature instrument, with little growth over the past decade. However, the growth in open account trade has accelerated the take up of credit insurance and international crossborder factoring in particular.

Factors Chain International

Founded in 1968, Factors Chain International (FCI) is a global network of leading factoring companies, whose common aim is to facilitate international trade through factoring and related financial services. Headquartered in Amsterdam, Netherlands, FCI has over 260 members in 73 countries, and is the world's largest factoring network, with member transactions representing 90% of the world's international crossborder factoring volume. FCI focuses on growing international factoring through its four pillars:

1. an integrated factoring communications system;
2. a sound and tested legal infrastructure;
3. an extensive education platform to enhance service quality; and
4. promotion through global awareness

FCI has changed enormously over the past 20 years. In the early 1990s, the majority of the members of the organisation were independent factoring companies. But the sea change in the industry now means that more than 80% of the members of FCI are now bank owned or divisions of banks.

FCI market growth

FCI's two-factor volume of crossborder business increased 36% in 2012 to EUR23bn (see Figure 5 for a definition of two-factoring). Its top three two-factor export markets were:

- China – which has doubled to almost EUR8bn, reflecting China's inter-Asian business growth;
- Turkey – up 20% to EUR3.5bn; and
- Hong Kong – increased by 70% to more than EUR3bn.

Turning to import factoring, the top three markets were:

- the US – up 50% to EUR7.5bn;
- France – increased 33% to EUR2.7bn; and
- China – surged 160% to EUR2.4bn.

International Factors Group comparisons

The International Factors Group (IFG) is also a trade network, but has evolved as more of a trade association servicing the factoring and asset-based lending industry. IFG includes non-factoring companies, including third parties such as IT vendors, accounting and law firms.

Today nearly 90% of the global two-factor volume is generated from FCI's members, however IFG has championed important industry initiatives such as improving the regulatory landscape for the factoring sector, education, and industry promotion.

General rules of international factoring

FCI also provides a legal foundation to conduct crossborder factoring. The General Rules of International Factoring (GRIF) form the legal basis under which nearly all crossborder two-factor business transactions are conducted, and this legal framework has been accepted by nearly every international factoring company around the world.

Similar to the International Chamber of Commerce (ICC), FCI is a rule-making body, and has been promulgating the rules of international factoring over its 45-year history. FCI members also use a proprietary communication system called Edifactoring.com.

Like the SWIFT messaging system, edifactoring.com allows members to:

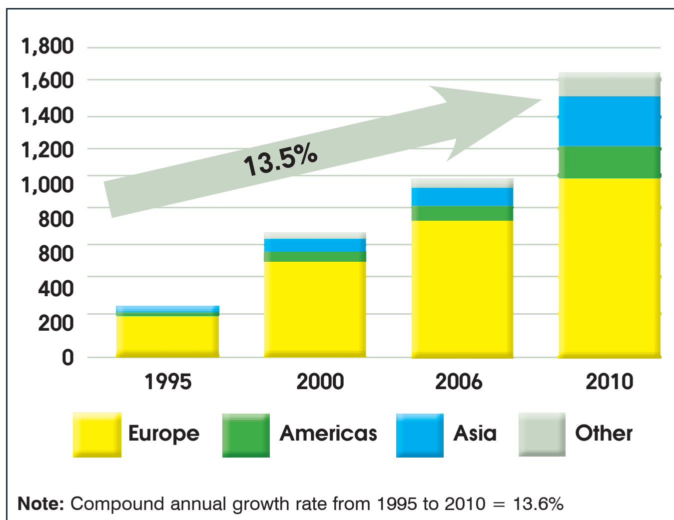
- issue factor guarantees;
- send invoice data;
- issue dispute notices; and
- provide payment advice.

Definitions

There is nothing complex about factoring. It is simply a unique blend of services designed to ease the traditional problems of selling on open account terms. Suppliers turn to factoring for two main reasons:

- protection against bad debt losses (credit protection); and
- advances against their own accounts receivables to increase liquidity.

Figure 1: Global factoring industry grows 13.6% in 15 years (EURbn)



Note: Compound annual growth rate from 1995 to 2010 = 13.6%

> **"When there is uncertainty in retail, for example during an economic downturn, there is always a spike in demand for factoring"**

Figure 2: Total world factoring volume 2009-2012 (EURbn)

2009	2010	2011	2012	CAGR
1,283	1,648	2,015	2,134	18.5%

Figure 3: Total international crossborder factoring volumes 2009-2012 (EURm)

2009	2010	2011	2012	CAGR
165,459	245,898	247,276	354,84	29%

Typical services include:

- investigating the creditworthiness of buyers;
- assuming credit risk via factor guarantees;
- providing 100% credit protection against customer write-offs;
- collection and management of receivables; and
- provision of finance through immediate cash advances against outstanding receivables.

Export factoring procedures

Export factoring normally involves a six-stage process. This is set out in Figure 5.

Not only is each stage designed to ensure risk-free export sales, it lets the exporter offer more attractive terms to overseas customers on open account terms. The credit protection and factoring services provide the supplier with the reassurance that their end customer – for example, a retailer – is creditworthy.

Once a credit line is established on the debtor (buyer), the seller will submit invoices to the factor for approval and receive an advance of funds from the factor, subject to a reserve or cushion established by the factor in case of a dispute between the exporter and importer.

When the invoice becomes due, the buyer will be required to pay the factor directly, and if not, the factor can commence collection procedures against the buyer. All of the activities are recorded in the factor's receivables-based system. This process not only allows the seller to receive working capital early, but also protects them from potential bad debts as the factor is normally on the hook for the potential loss in case of default or a buyer bankruptcy – the risk of which is heightened in crossborder trade.

Given the sophistication of the back office systems and IT enhancements within the factoring industry – which have also played their part in driving the growth of factoring – it would be very difficult for the average importer or manufacturer to build a credit and collection department that can replicate it.

Factors have professionally-trained credit officers who analyse the creditworthiness of buyers globally, or they sign a contract with a domestic credit insurer who is willing to take a good portion of the debtor risk on behalf of the export factor for a fee.

This analysis is stored online and supplemented by the company's market intelligence based on the pay history developed over time. In addition, many factors are directly linked via an EDI interface connecting the major retail chains to speed up the flow of funds and information. Access to online accounts receivable information at any given time, including an 'app' service where a client can download their receivables balances and cash position over their handheld device, is another reason for factoring's growing popularity.

When there is uncertainty in retail, for example during an economic downturn, there is always a spike in demand for factoring (also called credit protection). But this is rather like buying flood insurance after a river has burst its banks and flooded your home. Ideally, you should have some type of credit protection in place before the damage occurs. Another reason for the increased demand for factoring is the added liquidity it may afford clients. In many cases members will lend against the value of the eligible accounts receivable balance outstanding at any given time. This gives the supplier a measure of liquidity that grows as their receivables grow.

Emerging market challenges

A recent FCI visit to Dhaka, Bangladesh, to introduce international factoring to the financial services sector revealed some typical emerging market developments. Despite this rather archaic and rudimentary means of financing domestic trade – characterised, for instance, by the presence of unregulated financial institutions and the absence of a receivables registry – there is at least a hybrid form of factoring and an infrastructure. This can evolve into something more regulated and robust.

Non-bank financial institutions

Only non-bank financial institutions (NBFI) perform a form of factoring in the local market. These NBFIs are unregulated, hence there are no limitations as to what they can charge their clients for financing, and most can demand what they like in terms of collateral – in other words receivables.

This can lead to excessive charges – in Bangladesh rates of 20% or higher for borrowing costs under both leasing and factoring arrangements were not uncommon. They perform what is called

Figure 4: Factoring, LC and credit insurance comparisons with world exports 2008-2012 (EURm)

	2008	2009	2010	2011	2012	CAGR
Crossborder factoring	176,168	165,459	245,370	264,108	354,843	19.1%
World factoring	1,325,111	1,283,559	1,645,524	2,015,007	2,134.247	12.7%
Credit insurance	987,075	945,324	1,034,091	1,275,602	1,377,650	8.7%
Letters of credit (LC) issued	2,735,092	2,635,125	2,700,700	2,806,965	2,863,104	1.2%
Total world exports	11,597,377	8,705,400	11,430,175	14,108,509	14,461,222	5.6%

Sources:

- Factoring figures from FCI.
- Credit insurance figures from Berne Union (2012 estimated).
- The LC figures are from ICC/SWIFT study. SWIFT does not release LC issuance data, but in December 2010 its board agreed to carry out a 'trade snapshot', releasing the number of MT700 commercial, standby and guarantee messages issued, including average invoice size, so the 2011 LC figures estimated are based on actual data. The 2012 figures are estimates (data not yet released), and the 2010 figures are based on the number of MT700 messages issued in the year and the average invoice size for the month of December only. The 2008 and 2009 figures calculated based on the % change in the number of MT700 messages created year on year.
- The world export figures are from the WTO (converted from US$ to euros (EUR).

Figure 5: The six-stage factoring process

1. The exporter signs a factoring contract assigning all agreed receivables to an export factor. The factor then becomes responsible for all aspects of the factoring operation.
2. The export factor chooses a factoring correspondent to serve as an import factor in the country where goods are to be shipped. This is known as two-factoring
3. The import factor investigates the credit standing of the buyer of the exporter's goods and establishes lines of credit. This allows the buyer to place an order on open account terms without opening letters of credit.
4. Once the goods have been shipped, the export factor may advance up to 80% of the invoice value to the exporter.
5. When the sale has been communicated to the import factor, the import factor collects the full invoice value at maturity and is responsible for the transmission of funds to the export factor who then pays the exporter the outstanding balance.
6. If after 90 days past the due date an approved invoice remains unpaid, the import factor will pay 100% of the invoice value under guarantee.

"checkering" which is not really true factoring.

Factoring is defined by the UNCITRAL whereby two of three services occur:

1. sale of a receivable to a factor;
2. financing against the receivable; and
3. collection of the proceeds of the receivable.

Under a "checkering" scenario, the factor is not purchasing a receivable but finances the seller against a post-dated cheque. This is due mainly to the excessive cost of stamp duty tax, a levy against the purchase of the receivable imposed and assessed by the Bangladeshi government.

The risk here is that in many cases, if the cheque is not honored because of insufficient funds, the legal process of securing justice is too daunting and more unorthodox methods of securing payment are deployed. Hence, the concept (as is known in other markets) of a "heavy hand" could come into play, physically forcing the party to come up with the funds.

While this is not a routine occurrence, it is not, however, uncommon in emerging economies.

Need for a receivables registry

In successful factoring markets, normally the country has some form of receivables registry enabling the factor or lender to ensure that that have a first lien position on the account (as title holder of the receivable).

This protects that lender from being in the position where another financial institution has already financed the seller against the same receivable(s).

The lack of this kind of registry is very apparent in most developing markets and establishing them is something the World Bank and the IFC have also identified as important so that factors and lenders can safely finance the SME against intangible assets.

SME business

Furthermore, the laws in Bangladesh only allow for banks to handle foreign currency transactions, in other words, participate in international factoring, NBFIs are not permitted to handle or receive foreign currency from the client's foreign buyers. This makes it very difficult for these factors to finance Bangladeshi exporters – especially SMEs. Equally important, these NBFIs are capturing the SME business that the banks are not targeting.

"Growth in open account trade has accelerated the take up of credit insurance and international crossborder factoring in particular"

Engagement of commercial banks in emerging market factoring

Commercial banks in Bangladesh indicated their interest in establishing a factoring initiative (either as a wholly-owned subsidiary or within the trade finance division of their banks). Most of these banks have never financed open account trade on a factoring basis (most are only accustomed to financing against trade LCs). In fact, in Bangladesh, most exporters use the LCs issued by buyers in the US, for example as collateral to offer their banks in order to issue import LCs to source raw material from Asia.

This back-to-back method is frequently used there, but the process leaves out many of the SMEs, especially those wanting to conduct trade on open account, so the right infrastructure is very much needed to develop import and export factoring in such an emerging market.

Seven pillars of factoring wisdom

A World Bank study [1] states that weak contract enforcement, tax, and regulatory impediments will hamper the growth of factoring in most developing markets. But based on my own experience having served on the board of FCI over the past decade, and seeing first-hand how

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factoring companies can be impeded from forces outside their making, the reason why a market fails to flourish both from a domestic and international factoring standpoint can be summed up in what I refer to as the "seven pillars of factoring" (see Figure 6).

Figure 6: The seven pillars of factoring growth

1. **Weak legal infrastructure.** A sound legal system that allows for the legal assignment of the receivable to a third party. The assignment must be legally enforceable, normally legal notification to the debtor (buyer) should be required, and all rights of the receivable must be absolute.
2. **Strict tax impediments**. Elimination of the stamp duty tax system, put in place by the British common law system during the rise of the British empire, holds back the growth of factoring in many emerging market
3. **Lack of a central registry or mechanism to prevent fraud.** Most developing markets do not have the legal process in place to register the receivables they purchase, hence the increase in the likelihood of financing invoices already financed by a third party.
4. **Strict foreign currency controls.** NBFIs need permission to receive and manage foreign currency on behalf of their clients. This means eliminating foreign currency controls where importers and exporters are forbidden to source or export on an open account basis.
5. **Floating charge on the assets.** Many factors run into the problem of being unable to "carve out" a portion of the accounts from the bank which has taken a fixed charge on the assets of the company (encumbrance of the receivables), making them un-factorable.
6. **Unregulated markets lead to loan sharking.** Where factoring is permitted by the local authorities but is unregulated, or without any guidelines, this leads to aggressive loan sharking and ultimately a bad reputation of the product due to its exorbitant costs.
7. **Lack of an open account culture.** Most markets are stuck in the past and the central bankers will only support the financing of trade on an LC basis. Development of an open account culture is a must – where not only the traders, but also financial institutions are allowed to finance exports on open account terms.

FCI policy developments

Purchase order management (POM)

FCI launched the POM system in 2012. It allows for the financing of a company's purchase orders for a period of no more than 90 days and requires that once the goods are shipped and the invoice is raised, the goods must be converted into a factoring advance.

Supply chain finance programmes such as the POM are not necessarily new, and some factors within FCI have been doing forms of it for years. Most programmes offered by large banks today are set up for strong, investment-rated buyers, but the POM offers a number of opportunities within the SME sector as well. The POM offers an opportunity for FCI members to finance the raw material and production stage of an exporter, converting the pre-shipment loan into a factorable receivable advance, ultimately being paid down from the collection of the proceeds from the buyer under the account.

International Chamber of Commerce (ICC)

In August 2010, FCI began talks with the ICC Banking Commission about the concept of having the ICC endorse the GRIF rules as the legal foundation for open account trade finance. The ICC has over 600 members today, and SWIFT has nearly 10,000 members, many of which use the UCP600 rules on LCs to transact crossborder business. Talks are progressing well and we anticipate entering into a final endorsement phase shortly.

Further information on the ICC as a rule-making body can be found at: www.tfreview.com/node/8450.

International Finance Corporation

Over the years FCI has had many interactions with the International Finance Corporation (IFC), a member of the World Bank,. The IFC has invested capital in a number of FCI member financial institutions. FCI representatives met with the IFC trade finance division in Washington DC in January 2010 and again in July 2012, to investigate the launch of a guarantee programme for factoring.

This would be based on the IFC's Global Trade Finance Programme (GTFP), which extends and complements the capacity of banks to deliver trade financing by providing risk mitigation in new or challenging markets where trade lines may be constrained.

GTFP offers confirming banks partial or full guarantees covering payment risk on banks in the emerging markets for trade-related transactions.

Further details are available in the GTFP section of www1.ifc.org.

FCI is exploring with the IFC how to replicate this programme for FCI members doing business with import factors in emerging markets. This would allow export factors, previously unwilling to factor receivables approved by import factors in higher-risk emerging markets to take this risk through the backing of the IFC.

Where next

Factoring is at an interesting crossroads – international factoring in particular. The product has doubled in volume in the past decade, adding nearly EUR1trn in the past three years, yet maintaining stability in its role as a global network. This is set to continue as a result of bank regulatory changes and enhanced perceptions of crossborder transaction risk.

Central bankers around the world have looked at this growth story and have come to appreciate the product as a safe and secure method of financing trade. In fact, the economic crisis has resulted in a much more positive attitude towards factoring. Last but not least, governments have come to appreciate the invaluable role factors play in financing SMEs, those small engines of future growth in most economies. TFR

References:

1.Although published in 2004 this study provides useful additional background global factoring market: http://www1.worldbank.org/finance/assets/images/3342.pdf

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