

## Unit I

### Introduction to Traditional Financial Services

#### Concept of financial services

In general, all types of activities which are of financial nature may be regarded as financial services. In a broad sense, the term financial services means mobilization and allocation of savings. Thus, it includes all activities involved in the transformation of savings into investment. Financial services refer to services provided by the finance industry. The finance industry consists of a broad range of organisations that deal with the management of money. These organisations include banks, credit card companies, insurance companies, consumer finance companies, stock brokers, investment funds and some government sponsored enterprises.

Financial services may be defined as the products and services offered by financial institutions for the facilitation of various financial transactions and other related activities. Financial services can also be called financial intermediation. Financial intermediation is a process by which funds are mobilized from a large number of savers and made available to all those who are in need of it and particularly to corporate customers. There are various institutions which render financial services. Some of the institutions are banks, investment companies, accounting firms, financial institutions, merchant banks, leasing companies, venture capital companies, factoring companies, mutual funds etc. These institutions provide a variety of services to corporate enterprises. Such services are called financial services. Thus, services rendered by financial service organisations to industrial enterprises and to ultimate consumer markets are called financial services. These are the services and facilities required for the smooth operation of the financial markets. In short, services provided by financial intermediaries are called financial services.

#### Functions of financial services:

1. **Economic growth:** The financial service industry mobilizes the savings of the people, and channels them into productive investments by providing various services to

people in general and corporate enterprises in particular. In short, the economic growth of any country depends upon these savings and investments.

2. **Promotion of savings:** The financial service industry mobilizes the savings of the people by providing transformation services. It provides liability, asset and size transformation service by providing huge loans from small deposits collected from a large number of people. In this way financial service industry promotes savings.

3. **Capital formation:** Financial service industry facilitates capital formation by rendering various capital market intermediary services. Capital formation is the very basis for economic growth.

4. **Creation of employment opportunities:** The financial service industry creates and provides employment opportunities to millions of people all over the world.

5. **Contribution to GNP:** Recently, the contribution of financial services to GNP has been increasing year after year in almost all countries.

6. **Provision of liquidity:** The financial service industry promotes liquidity in the financial system by allocating and reallocating savings and investment into various avenues of economic activity. It facilitates easy conversion of financial assets into liquid cash.

### **Characteristics of financial services:**

1. **Intangibility:** Financial services are intangible. Therefore, they cannot be standardized or reproduced in the same form. The institutions supplying the financial services should have a better image and confidence of the customers. Otherwise, they may not succeed. They have to focus on quality and innovation of their services. Then only they can build credibility and gain the trust of the customers.

2. **Inseparability:** Both production and supply of financial services have to be performed simultaneously. Hence, there should be perfect understanding between the financial service institutions and its customers.

3. **Perishability:** Like other services, financial services also require a match between demand and supply. Services cannot be stored. They have to be supplied when customers need them.

4. **Variability:** In order to cater a variety of financial and related needs of different

customers in different areas, financial service organisations have to offer a wide range of products and services. This means the financial services have to be tailor-made to the requirements of customers. The service institutions differentiate their services to develop their individual identity.

5. **Dominance of human element:** Financial services are dominated by human element. Thus, financial services are labour intensive. It requires competent and skilled personnel to market the quality financial products.

6. **Information-based:** Financial service industry is an information-based industry. It involves creation, dissemination and use of information. Information is an essential component in the production of financial services.

### **Financial services market:**

The market for the exchange of financial products and instruments through a wide variety of players, each one offering a unique type of service, may be designated as “financial services market”. Financial services market constitutes an important component of the financial system. Financial services market serves the needs of individuals, institutions and corporates through a network of elements. Prior to economic liberalization, the Indian Financial Service Sector was characterized by so many factors which retarded its growth. Financial services market covers a wide range of activities and they can be broadly classified into traditional activities and modern activities. In the changed economic scenario, many financial intermediaries have started expanding their activities in the financial services market by offering a variety of new products. The financial service sector has thus emerged as the fastest growing sunrise industry. However, the financial service market has to face many challenges in its attempt to fulfill the ever growing financial demands of the economy.

### **Financial services market — constituents:**

**Market Players:** Financial services are offered by a host of institutions and agencies that understand and meet the requirements of a wide spectrum of customers. The

players include banks, financing institutions, mutual funds, merchant bankers, stock brokers, consultants, underwriters, market makers, etc.

1. **Instruments:** Financial instruments constitute an important part of the financial services market. The instruments include equity instruments, debt instruments, hybrid instruments, etc. It is a feature of a financial services market that a number of innovative instruments such as zero coupon bonds, etc. are floated on a continual basis.
2. **Specialized Institutions:** These include acceptance houses, discount houses, factors, depositories, credit rating agencies, venture capital institutions, etc.
3. **Regulatory Bodies:** The financial services market is regulated by a host of institutions and agencies. The regulatory bodies include the Department of Banking and Insurance of the Central Government, RBI, SEBI, BIFR, etc.

## **Growth of financial services in India:**

1. **Merchant Banking Era:** the period between 1960 and 1980 may be called “merchant banking era”. During this period, financial services such as merchant banking, insurance and leasing services began to grow. Merchant bankers carried out the following functions: (a) Helping clients in identification and analysis of projects. (b) Conducting marketing, managerial, technical, financial analysis on behalf of clients. (c) Assisting in designing apt capital structure.  
(d) Bridging the gap between capital market and fund-seeking institutions. (e) Underwriting. (f) Assisting in getting issues listed in the stock exchange. (g) Arranging syndication loans, etc.
2. **Investment Companies Era:** This era marked the setting up of various investment institutions and banks. The investment companies include Unit Trust of India, which is the largest public sector mutual fund company in the world, LIC and general insurance companies. The leasing business started emerging at the end of 1970s. These leasing companies broadened their scope of functioning from equipment leasing to operational and financial lease.
3. **Modern Service Era:** This stage marked the launch of a variety of financial products and services during 1980s. These services included over the counter services,

share transfers, pledging of shares, mutual funds, factoring and discounting. Varieties of innovative range of products were introduced by these firms. Yet another important landmark in this era was formation of credit rating agencies and development of venture capital firms.

4. **Depository Era:** In order to integrate the Indian financial sector with the global financial services industry, depository services were set up. The depository system was introduced with a view to promote the concept of paperless trading through dematerialization of shares and bonds. Book building was another step forward in direction of building string financial service sector in India. Online trading platforms at BSE and NSE were duly introduced during this era.

5. **Legislative Era:** Several new laws were enacted or some previous laws were amended for strengthening the financial services industry. For instance, FERA was replaced by FEMA. For safe and orderly trading changes were introduced in the Income Tax Act and the Indian Companies Act. There was enactment of separate law to regulate the internet trading of securities.

6. **FII's Era:** The economic reform measures initiated by the government necessitated greater free play for various participants. Divestment guidelines have been issued by the SEBI in recent times, whereby FIIS are permitted to operate in the Indian capital market. This is initiated so as to attract more and more FIIs into the Indian capital market.

### **Problems in financial services sector:**

1. Lack of Expertise
2. Inadequate Accommodation
3. Inadequate Technology
4. Inadequate Quality Services
5. Restricted Scope of Operations
6. Limited Innovation

7. Lack of Sound Institutional Mechanism
8. Lack of investor awareness
9. Lack of transparency
10. Lack of specialization
11. Lack of recent data
12. Lack of efficient risk management system

### **1. Eliminating Data Breaches**

Financial service firms are prime targets for cybercrime. Because of the sensitive data they carry, they are more likely to be targeted. In fact, financial service firms were hit 300 times more than other businesses. In 2018 financial service firms were hit 819 times, an increase from 69 incidents reported in 2017. The total number of cyber-attacks won't be known until well into 2022, but there have already been many data breaches this year.

On March 22-23, a hacker gained access to Capital One's consumer and small business credit card applications from as early as 2005. According to Capital One, approximately 140,000 social security numbers and 80,000 linked bank account numbers were exposed in the U.S. Also, about 1 million Canadian social insurance numbers were breached. Other financial service firms faced data breaches as well.

First American Financial Corp had a breach that exposed about 885 million personal and financial records related to real estate transactions dating as far back as 2003. Canadian credit union Desjardins Group had about 2.7 million of its member's information exposed. This breach exposed sensitive data like its member's home addresses, names, email addresses, and social security numbers. A cyber attack on Westpac/PayID exposed the banking information of 98,000 customers. Each attack is costing financial service firms millions of dollars. They need to continue coming up with innovative solutions to stay ahead of these cybercriminals.

## 2. Keeping Up with Regulations

Regulations in the financial service industry continue to increase. Banks are spending a large part of their income on making sure they're compliant. They have to make sure there are systems to keep up with ever-changing regulations and industry standards.

Traditional banks have to constantly evaluate and improve their operations to keep up with fast-changing consumer and shareholder expectations, technology, and industry regulations.

According to KPMG, there are 10 key regulatory challenges financial service firms will face in 2022. They include:

- Geopolitical change: Companies must expect business change and disruption
- Divergent regulation: Must anticipate continued differences in state, federal, and global regulations among protectionist and localized public policy agendas in the U.S. and overseas.
- Data protection and governance: Protect your data at all costs
- Operational resilience: Plan for the unexpected. It will happen
- Credit quality: Firms must apply what they've learned from past credit cycles
- Capital and liquidity shifts: Even though there may be an easing of regulatory capital and liquidity requirements, firms should not weaken risk management
- Compliance agility: Must have a solution for agile and streamlined compliance
- Financial crime: It's OK to be innovative but don't do too much at the cost of increased risk for financial crime.
- Customer trust: Firms must maintain the trust of the customers
- Ethical conduct: Do the right thing no matter what

Financial service companies need to create a strategy to innovate and stay in compliance.

## 3. Exceeding Consumer Expectations

Consumers continue to expect a lot from their financial institutions. Many want more personalized services from their financial providers.

According to the 2019 Accenture Global Financial Services Consumer Study, one in two consumers wants personalized banking advice based on their personal circumstances. They want an analysis of their spending habits and advice on how to handle money. 64% of the participants are interested in insurance premiums tied to their behavior, such as having a good driving record.

Half the survey respondents say they still want an in-person banking experience along with a digital one.

#### **4. Surpassing the Competition**

Competition within the financial services industry is still robust. As mentioned earlier, consumers want more personalized service. They also want more automated services with easier access to them. Institutions that provide all these services will dominate their share of the market.

Today, consumers are less concerned with brand loyalty and identity. They want what they want. Institutions that provide those services will keep their customers.

#### **5. Keeping Up with Technology**

Business growth is very important for financial firms, but they must spend money updating their technology to grow. According to a report from Protiviti, financial service firms must continue to invest in technology such as robotics and other workflow automation tools to increase their efficiency and reduce the costs associated with operational, risk management, and compliance.

Firms must also modernize their technology platforms and data storage to enable big data solutions such as AI-supported digital customer support assistants. Financial firms must also consider consolidating platforms and provide a more efficient, customer-friendly experience across internet, mobile and physical locations.

#### **6. Incorporating AI into Their Firms**

According to a study from Deloitte, major financial service firms are achieving a 19% growth in revenue. Deloitte found that 30% of financial service firms they describe as frontrunners are more adept at utilizing AI, helping them increase revenue faster than their competitors.

These frontrunner firms are also twelve times more likely to notice the importance of AI to their businesses than late adopters. Frontrunners are quicker to recognize the importance of AI and are motivated to implement it. At the same time, other firms may recognize the importance of AI but are more hesitant to use it.

Deloitte's study also discovered that 45% of frontrunner firms invest 5 million dollars in AI initiatives. That's 3 times the rate of late adopters. 25% of frontrunner firms spend 10 million dollars or more on AI. 70% of these firms plan to increase their spending by 10% during the next fiscal year. 60% of frontrunner firms define success by increased revenue, and 47% say customer experience has improved. Frontrunners whose businesses have increased revenue, improved customer experiences, and reduced costs are the most effective in finding and funding more diverse business opportunities.

AI is definitely the future in financial services. Companies that want to thrive need to incorporate it as soon as possible.

## **7. Organizing Big Data**

Big data is a necessity but also an obstacle for financial service firms. Big data is getting bigger because a lot of data is being created by several sources. This new data is structured and unstructured, and these legacy data systems can't handle the volume of data coming in.

The various types of data coming in is one of the biggest challenges facing financial service companies. According to a study from EMC, there will be 44 zettabytes of digital data by 2022. That's 44 trillion gigabytes. The challenge for financial service companies is to sort through all their data and determine what is useful and what isn't.

## **8. Effective Financial Digital Marketing Strategy**

The effective use of digital channels to drive leads and customers are two of the primary digital transformation challenges the financial industry faces. Many financing companies and banks are having difficulty being efficient, effective, and measuring the impact of their marketing channels such as paid media, enterprise SEO, Local SEO, content strategy, or social media. one of the

primary challenges these companies have is their digital experience, website design, and presentation of their brand.

## **Banking and non-banking finance companies:**

### **Banks**

Banks are the financial institution, authorized by the government to conduct banking activity like accepting deposits, granting credit, managing withdrawals, pay interest, clearing cheques and providing general utility services to the customers. Banks are the apex organisation, which dominates the entire financial system of the country. It acts as a financial intermediary, between the depositors and borrowers that ensures smooth functioning of the economy. Banks can be public sector banks, private sector banks or foreign banks. They are responsible for making loans, creating credit, mobilization of deposits, safe and time bound transfer of money and providing public utility services. Ownership of a commercial bank lies with the shareholder and they are operated with the profit motive.

### **NBFCs**

NBFC expands to Non-Banking Financial Company is a company registered under the Companies Act, 1956 and regulated by the Central Bank i.e. Reserve Bank of India under the RBI Act, 1934. These entities are not banks, but they are engaged in lending and other activities, akin to that of the banks like providing loans and advances, credit facility, savings and investment products, trading in the money market, managing portfolios of stocks, transfer of money and so on. It is indulged in the activities of hire purchasing, leasing, infrastructure finance, venture capital finance, housing finance, etc. An NBFC accepts deposits, but only term deposits and deposits repayable on demand are not accepted by it. In India, these companies emerged in the mid-1980s. Kotak Mahindra Finance, SBI Factors, Sundaram Finance, ICICI Ventures are examples of popular NBFCs.

NBFCs are divided into three categories, which are: ■ Asset Companies ■ Loan Companies ■ Investment Companies

### **Key Differences between an NBFC and a Bank:**

The difference between an NBFC and a bank can be drawn clearly on the following grounds:

1. **Meaning:** A government authorized financial intermediary that aims at providing banking services to the general public is called a bank. An NBFC is a company that provides banking services to people without holding a bank license.
2. **Incorporation:** An NBFC is incorporated under the Indian Companies Act, 1956 whereas a bank is registered under the Banking Regulation Act, 1949.
3. **Acceptance of Deposits:** NBFCs are not allowed to accept such deposits which are repayable on demand, unlike banks, which accept demand deposits.
4. **Foreign Investments:** Foreign Investments up to 100% is allowed in NBFCs. On the other hand, only banks of the private sector are eligible for foreign investment, and that would not be more than 74%.
5. **Payment and Settlement Cycle:** Banks are an integral part of payment and settlement cycle while NBFCs are not a part of the system.
6. **Reserve Ratios:** It is mandatory for banks to maintain reserve ratios like CRR or SLR. As opposed to NBFC, which does not require to maintain reserve ratios.
7. **Deposit Insurance Facility:** The deposit insurance facility is allowed to the depositors of banks by Deposit Insurance and Credit Guarantee Corporation (DICGC). Such facility is unavailable in the case of NBFC.

### **Regulatory framework:**

#### **Need for Regulatory Framework**

1. **Economic Growth:** For the process of smooth financial intermediation and disintermediation, proper regulatory framework is a must. This is an essential requisite for the economy to grow and function smoothly.

2. **Promoting Savings and Investments:** The financial services industry besides channeling savings into productive investments, helps economic activities to take place without much difficulty.
3. **Efficient Financial Services:** Regulations are also essential to carry out the financial services smoothly. Regulations make the participants follow all the norms, strengthening the efficiency of financial services.
4. **Investor Protection:** Without proper enactment of laws, rules and procedures, investors perhaps lose their confidence while participating in the markets. Regulatory framework is necessary to boost the investor confidence and protect their interest

#### **Types of Regulatory Framework:**

Regulation	Nature	Objective
Institutional Regulations	Setting up of Regulatory institutions like SEBI, RBI, IRDA, etc.	To promote healthy competition among players
Prudential regulations	Internal management of financial institutions and financial service organizations regarding capital adequacy, liquidity and solvency.	To prevent the entry of Firms without adequate resources. E.g. Fixing up of net worth requirement for financial service firms by the SEBI.
Investor regulations	Designed to protect the interest of the investors	To promote healthy trading and promoting confidence among investors.
Legislative regulations	Contained in the legislative measures brought out by the government	To supervise and monitor the functioning of financial services firms in such a way that firms which manipulate can be punished or penalized.

Self-Regulations	Additional regulatory Framework	To strengthen the efficiency of financial service firms. E.g. Foreign Exchange Dealers have their own self-regulations.
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**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 of a recent origin in the Indian context. In 1988, the Reserve Bank of India (RBI) constituted a High Powered Committee to examine the scope for offering factoring services in the country. In 1989, the committee submitted its report strongly recommending the case for setting up factoring subsidiaries. Following the announcement of the guidelines, the State Bank of India and Canara Bank have set-up their factoring subsidiaries – SBI Factors & Commercial Services Limited and Canbank Factors Limited.

**Concept:**

We can define factoring as the sale of book debts by a firm to a financial intermediary called the factor on the understanding that the factor will pay for the debts as and when they are collected or on a guaranteed payment date. Usually the factor makes a part payment immediately after the debts are purchased thereby providing immediate liquidity to the client.

- Client concludes a credit sale with the customer.
- Client sells the customer’s account to the factor and notifies the customer.

- Factor makes a part payment (advance) against the account purchased after adjusting for commission and interest on the advance.
- Factor maintains the customer's account and follows up for payment.
- Customer remits the amount due to the factor.
- Factor makes the final payment to the client when the account is collected or on a guaranteed payment date.

### **Functions of the Factor:**

- 1) To provide finance against book debts, say up to 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

For rendering the services of collection and maintenance of sales ledger, the factor charges commission expressed as a flat percentage of the value of debts purchased and collects this commission upfront (at the time of purchasing the debts). For making an immediate part payment against the debts purchased (which is of course an advance), the factor charges interest at a rate which is marginally higher than the rate of interest charged by banks on working capital advance. The interest charge is calculated for the period between the date of advance payment and the date of collection or the guaranteed payment date. If the interest charge is collected upfront, it is referred to as the discount charge

### **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.

### **Mechanism of Factoring:**

Factoring business is generated by credit sales in the normal course business. The main function of factor is realization of sales. Once the transaction takes place, the role of factor step in to realize the sales/collect receivables. Thus, factor act as an intermediary between the seller and till and sometimes along with the seller's bank together. The mechanism of factoring is summed up as below:

- An agreement is entered into between the selling firm and the firm. The agreement provides the basis and the scope understanding reached between the two for rendering factor service.
- The sales documents should contain the instructions to make payment directly to the factor who is assigned the job of collection of receivables.
- When the payment is received by the factor, the account of the firm is credited by the factor after deducting its fees, charges, interest etc. as agreed.
- The factor may provide advance finance to the selling firm conditions of the agreement so require.

### **Forms of factoring:**

- **Recourse Factoring:** The factor purchases the receivables on the condition that the

loss arising on account of irrecoverable receivables will be borne by the client. For example, assume that a factor has advanced an amount of Rs.2.4 lakh against a receivable of Rs.3 lakh which turns out to be irrecoverable. Under a recourse factoring arrangement, the factor can recover the sum of Rs.2.4 lakh from the client. Put differently, under a recourse factoring arrangement, the factor has recourse to the client if the debt purchased turns out to be irrecoverable.

- **Non-Recourse Factoring:** As the name implies, the factor has no recourse to the client if the debt purchased turns out to be irrecoverable. Since the factor bears the losses arising on account of irrecoverable debts (receivables), the factor charges a higher commission (the additional commission is called the del credere commission). Also, the factor participates actively in the credit-granting process and decides/approves the credit lines extended to the customers of the client. While non-recourse factoring is the most common form of factoring in countries like the USA and the UK, in the Indian context, factoring is done with recourse to the client.

**Maturity Factoring:** Under this type of factoring arrangement, the factor does not make any advance payment. The factor pays the client either on a guaranteed payment date or on the date of collection. The guaranteed payment date is usually fixed taking into account the previous ledger experience of the client and a period for slow collection after the due date of the invoice.

- **Advance Factoring:** Under this arrangement, the factor provides an advance varying between 75-85 percent of the value of receivables factored. The balance is paid upon collection or on the guaranteed payment date. As we have already seen, the factor charges interest from the date on which advance payment is made to the date of actual collection or the guaranteed payment date. The rate of interest is usually determined depending upon (i) the prevailing short-term rate of interest; and (ii) the client's financial standing and (iii) volume of turnover.

- **Invoice Discounting:** In such type of arrangement, only finance is provided, and, hence, no other services are offered in respect of receivables.
- **Full Factoring:** A factoring arrangement which combines the features of non-recourse and advance factoring arrangements is called Full Factoring or Old Line Factoring. Put differently, full factoring provides the entire spectrum of services – collection, credit protection, sales-ledger administration and short-term finance
- **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

### **Factoring Cost:**

The factor provides various services at some charge in the form of a commission expressed as a value of debt purchased. It is collected in advance. The commission is in the form of interest charged for the period between the date of advance payment and date of collection/guarantee payment date for short term financing as advance part payment. It is also known as discount charge. The cost of factoring services primarily comprises of the following two components:

1. **Administrative charges /factoring fees:** This is charged towards providing various services to the clients namely (a) sales ledger administration (b) credit control including processing, operational overheads and collection of debts (c) providing, protection against bad debts. This charge is usually some percent of the projected sales turnover of the client for the next twelve months. It varies between 1 to 2.5 percent of the projected turnover. The quantum of charged depends upon the following factors. a. Type of industry b. Financial strength of the client as well as of the debtors c. Volume of sales d. Average invoice value e. Terms of trade f. Type(s) of service(s) offered g. Required profit

margin to the factor h. Extent of competition i. Security to the factor etc.

2. **Discount charges:** This is levied towards providing instant credit to the client by way of prepayment. This is normally linked with the base rate of the parent company or the bank

from which the factoring institution is borrowing money, say, 1 to 2.5 percent above the said rate.

## **Advantages of Factoring**

### **1. Immediate Cash Inflow**

This type of finance shortens the cash collection cycle. It provides swift realization of cash by selling the receivables to a factor. Availability of liquid cash sometimes becomes a deciding factor for grabbing an opportunity or losing it. The cash boost provided by factoring is readily available for capital expenditures, securing a new order or meeting an unforeseen condition.

### **2. Attention towards Business Operations and Growth**

By selling off invoices, business managers can feel stress-free of the task of collection from the customers. Resources employed in the receivables department can be directed towards business operations, financial planning, and future growth.

### **3. Evasion of Bad Debts**

Factoring is of two types – with recourse and without recourse. Under without recourse factoring, in case of bad debts, the loss is borne by the factor. Hence, the seller is under no obligation to the factor once it sells off its receivables.

#### **4. Speedy Arrangement of Finance**

Factors provide funds more rapidly than banking companies. Factoring companies offer quicker application, lesser documentation and swifter realization of funds as compared to other financial institutions.

#### **5. No Requirement of Collateral**

The advances are extended on the basis of the strength of accounts receivables and their credit healthiness. Unlike cash credit & overdraft, factors do not require any collateral security to be pledged/hypothecated. New businesses, startups can easily avail the advances provided they have strong receivables.

#### **6. Sale Not Loan**

Factoring transaction is a transaction of sale, not a loan. Unlike other types of finances, factoring does not result in an increase in liabilities of the business. Hence, there are no adverse impacts on the financial ratios as well. It just involves the conversion of book debts into liquid cash.

#### **7. Customer Analysis**

Factors provide valuable advice and insights to the seller regarding the credit strength of the party from whom receivables are pending. It helps in negotiating better terms between the parties in future contracts.

### **Disadvantages of Factoring**

#### **1. Reduction of Profit**

The factor deducts a certain discount from the value of accounts receivable as fees for the services offered. Moreover, in certain cases, the factor also charges interest on the advance made. Consequently, profit of an entity is reduced by a significant margin.

## **2. Reliability of Customer's Credit**

The factor assesses and evaluates credit wellness of the party who owes bills receivables. This is a critical factor which is outside the control of the seller. A factor may refuse to extend advances due to poor credit ratings of the concerned party.

## **3. Exhausting of Collateral Security**

Factoring exhaust bills receivables of an entity as the entity is no longer entitled to receive payments from them. The seller is no longer holding any control over the book debts. Hence, they can not be provided as collateral security while obtaining any other type of finance.

## **4. Presence of Contingent Liability**

The liability of the seller is not completely waived in case of with recourse factoring. If a party fails to pay its debts to the factor, the factor is legally entitled to recover it from the seller. Thus, the seller is contingently liable to the factor for paying the debts in future in case of default. This situation would impact business operations and financial plans which are under execution.

## **5. Higher Finance Charges**

Factors usually deduct 2% to 4% of the total amount involved as their fees for the duration of 45-60 days. Computing it annually, the cost of finance turns out to be around 18% to 24% p.a. which is very higher than other sources of finance.

## **6. Loss of Personal Touch**

The buyer may not be willing to deal with a factor because of their professional nature and stringent methods. Factoring agencies even send notices at regular intervals to the buyer as a reminder of the debt. The buyer may develop a negative image of the seller through factoring. Loss of personal touch may lead him to consider switching vendors.

**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

**Factoring v/s Forfaiting:**

<b>BASIS FOR COMPARISON</b>	<b>FACTORING</b>	<b>FORFAITING</b>
Meaning	Factoring is an arrangement that converts your receivables into ready cash and you don't need to wait for the payment of receivables at a future date.	Forfaiting implies a transaction in which the forfaiter purchases claims from the exporter in return for cash payment.

Maturity of receivables	Involves account receivables of short maturities.	Involves account receivables of medium to long term maturities.
Goods	Trade receivables on ordinary goods.	Trade receivables on capital goods.
Finance up to	80-90%	100%
Type	Recourse or Non-recourse	Non-recourse
Cost	Cost of factoring borne by the seller (client).	Cost of forfaiting borne by the overseas buyer.
Negotiable Instrument	Does not deals in negotiable instrument.	Involves dealing in negotiable instrument.
Secondary market	No	Yes

### **Factoring 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. Recognizing the utility of factoring services for small and medium size industrial and commercial enterprises in India, for the first time the Vague 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 Kalyana sundaram 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. and 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 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

### **Forfeiting:**

Forfeiting is the purchase of receivables along with availed 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, Forfeiting is a source of trade finance which enables exporters to get funds from the institution called forfeiter on transferring the right to recover the debts from the importer. The debt instrument is purchased by the forfeiter 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 Forfeiting arrangement. Now-a-days, in many developed countries, a forfeiter provides a finance even in respect of commodity exports wherein the credit period is up to 180 to 360 days. (It is estimated that about 15 to 20 per cent of Forfeiting market worldwide is represented by transactions involving commodity exports up to 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 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

### **Costs involved in a transaction of Forfaiting:**

A transaction of forfaiting involves different types of fees and charges. The fee charged by the forfaiter depends on the relationship with the exporter, volume of trade and above all the cost of funds of the forfaiter.

The fees that come into play during a transaction of forfaiting fall into three broad categories.

**Commitment Fees:** A commitment fee is payable to the forfaiter by the exporter in consideration of the commitment made by the forfaiter to execute a particular transaction of forfaiting at a particular discount rate and within a specific time. The commitment fees range between 0.5-1.5 per annum. It is always calculated on the unutilized amount of the forfaiting transaction. Irrespective of the execution of the export contract, the commitment fees are required to be paid.

**Discount Fees:** It is the cost payable on the credit promised under the factoring deal for the total period of credit under consideration. It is payable by the exporter to the forfaiter. Instead of charging the same separately, the forfaiter deducts it from the amount it owes to the exporter against the promissory note or bills of exchange, as the case may be. Discount rate is arrived at based on the London Inter-Bank Offered Rate (LIBOR) for the period under consideration. The forfaiter pays the exporter the money almost instantly, but it has to wait quite some time to recover the same from the importer. During the intervening period, the adverse movements in the international currency market may wipe out the profits of the forfaiter. So this also includes the

possible loss/gain that can be expected due to changes in the exchange rates in the intervening period.

**Documentation Fees:** Documentation fees are generally charged for transactions involving elaborate legal formalities and complexities and they may not be charged when the legal procedures and the documentation required are low.

**The major parties around whom, a transaction of Forfaiting revolves are:**

An exporter, an importer, a domestic bank, a foreign bank and a primary forfaiter.

A primary forfaiter is a financial entity or an individual who does a contract of forfaiting with the exporter and sells the payments of the importer. There is also a secondary forfaiter too, who is a person or an intermediary who purchases the securities from the primary forfaiter and sells them in the secondary market. The act of the secondary forfaiter helps in the growth of the secondary market activities of the documents involved in a typical forfaiting transaction.

The process of forfaiting gets underway the moment an exporter asks for quotations from the overseas buyer on the issues of price, delivery, interest structure, currency involved etc. Once the exporter is satisfied with the data received/quotation he approaches the EXIM Bank, furnishes the name of the overseas party, name of the country, description of the goods, order details, base price, payback period and the details of the export agency who will facilitate the transaction for the exporter. To make a complete transaction of forfaiting, the forfaiter asks for the details of the banker of the overseas importer. The overseas banker accepts and validates the documents of the transaction. This is known as the banker's co-acceptance. The Co-acceptance serves as a yardstick for the forfaiter as to the credit quality and the marketability of the instruments accepted.

EXIM Bank then collects from the overseas forfaiting agencies the representative quotes on rates of discount, documentation charges and the commitment charges and informs the same to the exporter. If the terms are acceptable for the exporter, he requests the EXIM Bank to obtain a firm quote from the forfaiter. The exporter initiates a contract with the help of EXIM Bank with the overseas forfaiting agency. On execution of the deal, EXIM Bank issues a formal certificate to the party in India. Subsequently, the exporter ships the goods as per the specification.

With the shipment, the exporter's bank in India sends the relevant documents to the importer's bank. The importer's bank supplies them to the importer when the importer produces the avallized promissory notes to the bank. In this context let us discuss what avallization is all about. Bill of exchanges in forfaiting transactions are backed by the Co-acceptance of the banker of the foreign country, or in other words the banker of the importer. The Co-acceptance is also known as availization. After the submission of the documents they are sent to the exporter by the bank. The Indian exporter has to endorse the note with "Without Recourse" clause. Without recourse debt is a kind of debt instruments on which the right of recourse (or, reverting in case of a difficulty in collection back to the originator) has been surrendered by the buyer. These without recourse notes are sent back to the forfaiting agency by the EXIM

Bank. On receipt of these papers the forfaiting agency, after verifying the signature of the avail releases payments at a discounted value in consultation with the EXIM Bank. After the overseas bank receives the proceeds, it transfers them to the exporter. All these are performed at the instructions given by the EXIM Bank. Immediately after the inward remittance of the funds, the exporter is issued a Certificate of foreign inward remittance.

On maturity of the Bills of Exchange or the Promissory notes, the forfaiting agency presents certain documents to the Co-acceptor for payments. The documents, which are presented at this time, are commercial contract between the foreign buyer and the domestic exporter, evidence of delivery of goods by the exporter to the overseas buyer, endorsement of debt instruments without recourse in favor of the forfaiter etc.

### **Advantages and Disadvantages of Forfeiting:**

1. It provides immediate funds to the exporter who is saved from the risk of the defaulting importer.
2. It is an earning to commercial banks who by taking the bills of highly valued currencies can gain on the appreciation of currencies.
3. The forfaiter can also discount these bills in the foreign market to meet more demands of the exporters.
4. There is very little risk for the forfaiter as both importer's bank and exporter's banks are involved.
5. Letter of Credit plays a major role for the forfaiter. Moreover, he enters into an agreement with the exporter on his terms and conditions and covers his risks by separate charges.
6. As forfaiting provides 100% finance to exporter against his exports, he can concentrate on his other exports.

### **Disadvantages or Drawbacks of Forfaiting**

The following are some of the disadvantages of forfaiting.

1. Forfaiting is not available for deferred payments especially while exporting capital goods for which payment will be made on a deferred basis by the importer.
2. There is discrimination between Western countries and the countries in the Southern Hemisphere which are mostly underdeveloped (countries in South Asia, Africa and Latin America).
3. There is no International Credit Agency which can guarantee for forfaiting companies which affects long-term forfaiting.

4. Only selected currencies are taken for forfaiting as they alone enjoy international liquidity.

#### Forfaiting in India

For a long time, Forfaiting was unknown to India. Export Credit Guarantee Corporation was guaranteeing commercial banks against their export finance. However, with the setting up of export-import banks, since 1994 forfaiting is available on liberalized basis.

The exim bank undertakes forfaiting for a minimum value of Rs. 5 lakhs. For this purpose, the exporter has to execute a special Pronote in favor of the exim bank. The exporter will first enter into an agreement with the importer as per the quotation given to him by the exim bank. The exim bank on its part, gets quotation from the forfaiting agency abroad. Thus, the entire forfaiting process is completed by exporter agreeing to the terms of the exim bank and signing the Pronote.

Forfaiting business in India will pick up only when there is trading of foreign bills in international currencies in India for which the value of domestic currency has to be strengthened. This would be possible only with increasing exports. At present, India's share stands at 1.7 percent in the world exports. Perhaps, this will bring a push to the forfaiting market.

#### **Bill Discounting**

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 (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:**

- The drawer (seller of the goods) who draws the bill, who ensures that the bill is accepted and paid according to its tenor and promises to compensate the holder or any endorser of the bill if it is dishonored.
- 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.
- The Payee: The person to whom or to whose order the bill is payable.
- The Endorser: 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

For example: You have sold goods to Mr. X, he has given you letter of credit from bank of 30 days, if you want to get money from bank before 30 days, the bank will charge some interest rate from you, which in return will be called as discount for the seller. Let's assume if the amount

which you were supposed to get was Rs. 1 lakh on or after 30 days, by bank's discount or interest rate of Rs. 50,000 you now get Rs. 95,000 in return from the bank. The buyer will anyhow deposit Rs. 1 lakh to the respective bank on 30th day only.

This trading or financial process is termed as bill discounting or invoice discounting.

Bills that come under bill discounting are termed as 'bills of exchange'. Bill discounting feature can be used to avail loans up to approximately 90% of the raised invoices. The credit period majorly depends on the buyer's creditworthiness. Once the bank is convinced, it provides discount on the amount that is required to be paid at the end of credit period.

### **Process of Bill/Invoice Discounting**

- Invoices are being raised when the seller sells the goods on credit
- Accepting the invoice means, that the buyer has acknowledged on paying the amount on due date
- For discounting purposes, seller approaches the financial institution
- As per the creditworthiness of the buyer and legitimacy of the bill, the bank or NBFC is assured
- Bank or NBFC disburses the fund to the seller post deducting the fee, discount and appropriate margin which is already defined
- Furthermore, the seller receives the funds which can be used for other business purposes

Bill discounting or invoice discounting has always been considered as a beneficial financial instrument that has helped sellers in providing working capital finance.

**Bill discounting v/s factoring:**

Basis	Bill discounting	Factoring
Meaning	Bill discounting means to trade bill before it becomes due for payment at par value.	Factoring means to sell its bool debt to the financial transaction to the factoring company at a discount.
Existence	Bill discounting comes under the Negotiable instrument act, 1881.	There is no such specific law for factoring.

Settlement of finance	In bill discounting, the bill is discounted and paid when the transaction takes place.	In factoring, the financier gives a maximum amount as an advance when a transaction takes place the remaining amount at the time of settlement.
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Parties involved	In bill discounting there is a drawer, drawee, and a payee.	In factoring, there is a factoring company, debtor and a customer.
Fees	A financier charges fees in the form of discounting charges or interest.	Financier gets fees in the form of interest for the financial services and commission for extra services facilitate.

### **Bill Market in India**

Bill Market refers to the market for short-term bills generally of three months maturity. A bill is a promise to pay a specified amount by the borrower (drawer) to the creditor (drawee).

Bills are of three types-

- (a) Bills of exchange or commercial bills used to finance trade;
- (b) Finance bills or promissory notes; and
- (c) Treasury bills used to meet temporary financial needs to the government.

These bills may be bought and sold in the discount market which consists of commercial banks, discount houses and other institutions.

The bill market plays an important role in the banking and monetary system of the country because of the following reasons:

- (a) It helps to meet the short-term financial requirements of individuals, companies and the government.
- (b) The commercial banks which have surplus funds can invest them profitably in these bills,
- (c) The commercial bank can dispose of these bills easily or can get them rediscounted by the Reserve Bank of India whenever they require cash.

## **Types of Bill Market Scheme**

### **I. Old Bill Market Scheme:**

The bill market scheme was introduced by the Reserve Bank of India in January 1952. Under this scheme, the Reserve Bank undertook to advance loans to commercial banks against their demand promissory notes supported by the security of usance bills of their constituents or customers. According to the bill market scheme, a bank can grant loans to its customers against their promissory notes and can further use the same promissory notes to borrow from the Reserve Bank. All that the bank is required is to convert these promissory notes into usance promissory notes maturing within 90 days.

Thus the bill market scheme aimed at widening the loan window of the Reserve Bank for the banks by allowing them to borrow even against their ordinary commercial credit after its conversion into eligible bills

### **New Bill Market Scheme:**

Dissatisfied with the old bill market scheme, in February 1970, the Reserve Bank of India constituted a Study Group under the chairmanship of Sh Narasimhan to go into the question of enlarging the use of bills of exchange as an instrument of credit and the creation of genuine bill market in India.

On the recommendations of the report of the study group, the Reserve Bank introduced the New Bill Market Scheme in November 1970 under Section 17 (2) of the Reserve Bank of India Act.

### **The main features of the New Bill Market Scheme:**

- (i) All licensed scheduled commercial banks including the public sector banks will be eligible to offer bills of exchange to the Reserve Bank for rediscounting.
- (ii) The bills covered under the scheme must be genuine trade bills relating to the sale or dispatch of goods.
- (iii) The Reserve Bank rediscounts these bills. That is why the scheme is also called 'Bills

Rediscounting Scheme'. The rediscounting facility should be available at the Reserve Bank's offices at Bombay, Calcutta, Madras and New Delhi. To avoid rediscounting of large number of small bills, such bills should be given in bunches.

(iv) The bill should be drawn on and accepted by the purchaser's bank. If the purchaser's bank is not a licensed scheduled bank, the bill should in addition bear the signatures of a licensed scheduled bank.

(v) The bills should have maximum usance of 90 days.

(vi) The bills should bear at least two good signatures.

(vii) The scheme does not cover the bills of exchange relating to the sale of goods to the government departments and quasi-government bodies as well as to statutory corporations to the sale of such commodities which are indicated by the Reserve Bank from time to time.

(viii) According to the modification of the scheme in 1971, the bills of exchange relating to the sale of goods to government departments and quasi government bodies as well as to statutory corporations have also been covered by the scheme.

(ix) With effect from April 1972, the bills of exchange drawn and accepted by the Industrial Credit and Investment Corporation of India (ICICI) were also made eligible for discount under the scheme