Factoring Regulation Act: No small change for India

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Effective management of working capital is critical to any business enterprise. By receiving funds advanced against invoices, factoring enables a business to free up capital without the need to offer any collateral. Factors also provide other value-added services, such as managing collection of invoices and credit rating of customers, thereby enabling clients to focus on their core activity.

New dawn?

Factoring in India is still at a nascent stage as compared to global volumes. Although, in the past couple of decades, the government in tandem with the Reserve Bank of India (RBI) had sought to encourage this practice by giving it some degree of recognition under the existing statutory framework, the absence of a comprehensive law was still felt. The industry was beset with barriers to entry such as lack of requisite credit information, low profit margins and a high incidence of stamp duty for assignment of receivables.

The above lacunae were sought to be addressed by the Factoring Regulation Act, 2011, notified in late January 2012, in a bid to give an impetus to factoring activity, especially in the micro, small and medium-sized enterprises (MSME) sector.

Salient features

The act regulates the assignment of receivables to a factor, including transactions involving foreign debtors or assignors. Notable exclusions from the act's scope include securitization transactions, facilities provided in the course of ordinary banking business, mergers and acquisitions, contracts based on netting agreements, and any assignment of loan receivables by a bank or non-banking financial company (NBFC) to another bank or NBFC.

Rights, obligations and liabilities of the factor, assignor and debtor have been clearly enunciated. Where the assignor is an MSME, delay in payments will attract liability to pay interest along with the principal amount as stated by the MSME Development Act, 2006.

The statute also grants the RBI regulatory oversight over factors, which will enjoy the status of a credit institution under the Credit Information Companies (Regulation) Act, 2005, thereby enabling them to resolve credit information deficits.

Notice to debtors

From the commencement of the act, factors are to obtain a certificate of registration from the RBI without which they cannot carry out factoring activity. The criteria for obtaining this certificate are the same as those specified for NBFCs in the Reserve Bank of India Act, 1934. Requirements of net owned fund, maintenance of requisite percentage of assets, creation of reserve fund, and other stipulations imposed by Chapter III-B of the RBI Act on NBFCs will apply equally to factors.

The scheme of the act envisages notice of assignment, to be given by either the assignor or the factor to the debtor, failing which the factor cannot institute proceedings solely by itself to recover money from the debtor. This is a departure from the position under India's property laws, which freely permit assignment and recovery, irrespective of issuance of such notice.

On receipt of notice, the debtor must discharge its contractual obligations to the assignee and any payment made to the assignor is required to be held in trust by the assignor for the factor.

To ensure transparency and accessibility of information, details of every transaction are required to be registered, within 30 days from the date of assignment, with the Central Registry created under India's securitization laws. While these details are open to public scrutiny, this is not deemed to constitute adequate notice to debtors. Further, the imposition of a penalty of ₹5,000 (US$100) per day of default seems a tad harsh considering the sheer volume of transactions due to their short tenor and the revolving nature of assignments.

While demand for a specialized forum for recovery of amounts due has not been heeded, India's civil code has been amended to enable cases pertaining to recovery of receivables by an assignee to be tried as a summary suit, thereby facilitating speedy relief for factors.

Hands-off approach

While there was much talk of fixing a cap on the discount chargeable by factors, legislators wisely decided to let market forces dictate the rates, thereby encouraging competition and efficiency.

But perhaps the best piece of news for this industry is that documents for assignment of receivables will not attract stamp duty. This idea was originally mooted as far back as 1988 by the Kalyanasundaram Committee, which was appointed by the RBI to advance the embryonic factoring trade. With this finally being implemented in 2012, it is hoped that factoring will begin to find favour with both financiers and businesses and play a decisive role in augmenting India's economic development.

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