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E-mail: info@amicusservices.in
Website: www.amicusservices.in

Amicus Alert: Factoring Regulation Amendment Bill, 2020 – A game changer

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The Factoring Regulation Act, 2011 (herein referred to as the "**Act**") regulates, inter alia, the assignment of receivables, the registration of factors carrying on the factoring business and the rights and obligations of parties to the contract for assignment of receivables. The Act requires registration by a non-banking financial company (herein referred to as the "**NBFC**") /Company intending to undertake factoring business. The principal issue with the registration of NBFC/Company as a Factor, under the Act, has been the requirement of having factoring as the principal business of the NBFC/Company (pun intended). Further, while Trade Receivable Discounting System (herein referred to as "**TReDS**") has been a game changer, with respect to, invoice discounting for Micro, Small and Medium enterprises (herein referred to as "**MSME's**"), it has not been able to substantially scale up factoring credit as Non-Factor NBFC's have, so far, been prohibited from participating in TReDS, due to restrictions under the Act. To resolve these issues and to fulfil the objective of expanding the application of the Act vis-à-vis helping MSME's to avail new credit avenues, the Factories Regulation Amendment Bill, 2020 (herein referred to as "**Amendment**") was tabled before the Lok Sabha and passed on 26th July 2020.

I. Key Changes in definitions:

(i) **Factoring business:** Under the Act, 'factoring business' is defined as the business of acquisition of receivables of an assignor by accepting assignment of such receivables, or financing against the security interests of any receivables through loans or advances[1]. The Amendment amends this to define factoring business as (i) acquisition of receivables of an assignor by assignment for a consideration, for the purpose of the collection of such receivables or (b) for financing, whether by way making loans or advances or otherwise. Therefore, the assignment of receivables shall be undertaken as a factoring business, only if the acquisition of receivables has been for consideration and for the purpose of undertaking collection of such receivables. Further, in the case of assignment against financing, the reference to creation of a security interest has been correctly removed. Since an assignment in itself is a transfer of the receivables of the borrower to the creditor, factoring credit does not require creation of security interest on such receivables.

In the definition of "Factoring Business", under the Act, a specific exclusion was created for credit facilities provided by banks, in its ordinary course of business, against the security of receivables which was contrary to definition of "Assignment"[2] which provided that undivided interest of any assignor in any receivable shall not include creation of rights in receivables as security for loans and advances or other obligations by a bank or a financial institution. The Amendment now has also excluded from the definition of "Factoring Business" credit facilities provided by either banks or NBFC's, in its ordinary course of business against the security of receivables, thereby, providing much needed clarity.

(ii) **Receivables:** The definition of the Receivables[3], under the Act, does not provide clarity as to what exactly would constitute receivables. Hence, the Amendment has simplified the language, considerably, to simply state that Receivables mean any money owed by a debtor and not yet paid to the assignor for goods and services and includes payment requited to be paid for toll or for the use of any facility or services.

II. Expanding the scope to Non-factor NBFCs and removal of the Principality threshold

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[1] Section 2 (j) of Factoring Regulation Act, 2011: "Factoring busines" means the business of acquisition of receivables of assignor by accepting assignment of such receivables or financing, whether by way of making loans or advances or otherwise against the security interest over any receivables but does not include;-

(i) credit facilities provided by a bank in its ordinary course of business against security of receivables;

(ii) any activity as commission agent or otherwise for sale of agricultural produce or goods of any kind whatsoever or any activity relating to the production, storage, supply, distribution, acquisition or control of such produce or goods or provision of any services.

Explanation.—For the purposes of this clause—

(i) the expression "agricultural produce" shall have the meaning assigned to it under clause (a) of section 2 of the Agricultural Produce (Grading and Marking) Act, 1937 (1 of 1937); and

(ii) the expressions "goods" and "commission agent" shall have the meanings assigned to them respectively under clause (d) and Explanation (ii) of clause (i) of section 2 of the Forward Contracts (Regulation) Act, 1952 (74 of 1952);

[2] Section 2 (a) of Factoring Regulation Act, 2011 :"Assignment" means transfer by agreement, of undivided interest of any assignor in any receivable due from any debtor in favour of a factor and includes an assignment where either the assignor or the debtor, are situated or established outside India. Explanation.—For the purposes of this clause, undivided interest of any assignor in any receivable shall not include creation of rights in receivables as security for loans and advances or other obligations by a bank or a financial institution;

[3] Section 2 (p) of Factoring Regulation Act, 2011: "Receivables" mean all or part of or undivided interest in any right of any person under a contract including an international contract where either the assignor or the debtor or the assignee is situated or established in a State outside India; to payment of a monetary sum whether such right is existing, future, accruing, conditional or contingent arising from and includes, any arrangement requiring payment of told or any other sum, by whatever name called, for the use of any infrastructure facility or services;

According to the Act, "Factor"[4] meant non-banking financial company, as defined in clause (f) of section 45-I of the Reserve Bank of India Act, 1934, which has been granted a certificate of registration under sub-section (1) of section 3 of the Act, or any body corporate established under an Act of Parliament or any State Legislature or any Bank or any company registered under the Companies Act, 1956 engaged in the factoring business. Therefore, while Banks are deemed to be a "Factor", an NBFC is required to be registered under section 3 of the Act to be a "Factor". Furthermore, under the Act, any NBFC which intends to register as a "Factor", have to fulfill the principality test to determine whether the principal business of the NBFC is factoring or not. Some key conditions that are required to be fulfilled by NBFC's are:

"(a) if its financial assets in the factoring business are more than fifty per cent of its total assets or such per cent. as may be stipulated by the Reserve Bank; and

(b) if its income from factoring business is more than fifty per cent of the gross income or such per cent as may be stipulated by the Reserve Bank."[5]

The Amendment does away with the requirement of NBFC's having their principal business as factoring and now allows any NBFC to register as a "Factor". Further, RBI has also been granted the authority to issue a certificate of registration in such manner as may be specified in the Regulation. Thereby, NBFCs can now participate in TReDs, even if their principal business is not factoring.

III. TReDS

The Amendment has introduced the definition of Trade Receivable Discounting System (herein referred to as "**TReDS**"), as a payment mechanism authorized by the RBI, under the Payment and Settlement Act, 2007, to facilitate the financing of trade receivables. TReDS has been established mainly to address the problems of delay in payments and market liquidity faced by all enterprises, including MSME's.

The introduction of an online mechanism for financing trade receivables, through the TReDS, has been an enabler for the rise of factoring volume in the Indian market. Previously, only NBFC-Factor and banks could undertake the assignment of receivables in TReDS and other NBFC's/companies were not allowed to undertake invoice discounting through TReDS. The new simplified registration process, as per the Amendment, allows financers and NBFCs, to discount invoices through TReDS. Moreover, the Amendment has also permitted the TReDS to act as agents of financiers for filing registration of charges with the Central Registry, which would ultimately help in bringing more operational efficiency and ensure avoidance of double assignments by MSMEs.

IV. Power of RBI to make regulations

A new section 31A has been inserted to empower the Reserve Bank of India to make regulations concerning the factoring business. Any such regulations made by the RBI may include all or any of the following:

(i) The procedure for granting registration certificate to the factor.
(ii) The procedure of submitting transaction details with the Central Registry related to transactions done via TReDS.
(iii) Any other related concerns.

[4] Section 2 (i) of the Factoring Regulation Act, 2011
[5] Section 3 of Factoring Regulation Act, 2011

In addition to the aforementioned, the powers of RBI would also include laying down rules with respect to the time period, form, and manner for registration of invoice and satisfaction of charge.

Conclusion

The Standing Committee on Finance (2020-2021), in their 24th Report[6], while finalizing this Amendment, had highlighted that "*The factoring credit contributes only 2.6% of total formal MSME credit in India versus 11.2% in China. It is estimated that only 10% of the total receivable market is presently covered under formal bill discounting mechanism in the financial system, while the rest is covered under conventional cash credit/overdraft arrangements with banks. As one of the principal instruments of working capital and trade finance, bill discounting and factoring remains underutilized*."

MSME's have often struggled to purchase stock for their business due to delays in receipt of payments from the purchasers. Hence, TReDS has definitely helped in covering ground to a certain extent by providing a platform to the MSMEs to avail credit facilities against their pending invoices. Currently, 7 NBFCs, called NBFC-Factors do the majority of factoring through the 'principal business' condition and they are namely the Canbank Factors, India Factoring and Finance, SBI Global Factors, Siemens Factoring, Bibby Financial Services, IFCI Factors and Pinnacle Capital Solutions. Thus, clearly, there is a dearth of financers in this space which is largely due to the restrictions imposed on registration as a "Factor". The key changes proposed by this Amendment are a necessary and a much-needed effort in maintaining the economic and financial stability in the sector. Thereby, while the factoring business in India is a long way from achieving the status of a perfect market, the Amendment is without doubt promising.

- ***Ms. Joyeeta Banerjee (Associate Partner); Ms. Mahima Sharma (Trainee Associate) and Ms. Preetika Bharti (Intern)***

[6] STANDING COMMITTEE REPORT, Seventeenth Lok Sabha , Report on the Factoring Regulation (Amendment) Bill, 2020, Twenty-fourth report, 03.02.2021 (2020-2021), available at <http://164.100.47.193/lsscommittee/Finance/17_Finance_24.pdf>