WORLD BANK GROUP
Finance, Competitiveness & Innovation

Product Card & Credit Infrastructure Requirements

Traditional Factoring

What is Traditional Factoring?

Factoring is a financing product, which consists of a financial company providing liquidity to a customer through the purchase of accounts receivable or invoices ("receivables"). Factoring can be targeted to all types of companies (agricultural, manufacturing, service, distributors, etc.). Factoring can provide liquidity to firms of all sizes, since the financier ("factor") relies on the creditworthiness of the payor of the receivable, rather than on the beneficiary thereof.

How is Traditional Factoring structured?

The customer provides the factor with a list of its debtors (end customers), with a breakdown of the sales and accounts receivable balances of each debtor. The factor then selects the debtor(s) which comply with established eligibility criteria. For those that comply, the factor may purchase such debtor's receivables. In Factoring operations, the Factor provides an initial advance rate (typically 75 to 85%) of the face value of the account receivable to the customer, and the debtor is instructed to pay the account(s) receivable(s) to the factor. When the debtor pays the full amount of the account receivable to the factor, the factor then applies payment to the outstanding balance of the advance or facility provided to the customer. Any remainder exceeding the advance provided (after covering any pending interest or fees) is forwarded to the customer. [Note: The present product card refers to domestic factoring exclusively.]

- Availability: The factor performs a financial analysis of the customer consisting of: i) the debtors which meet the factor's eligibility criteria for purchasing receivables; ii) the customer's credit worthiness including sales (and sales history and actual time to receive payment) to each debtor; and, iii) the compliance (including historical and timely payment) of receivables by the debtor as well as overconcentration. Based on this analysis, the factor establishes credit limits for each debtor, with the overall facility calculated based on the maximum term of receivables eligible for purchase.

- Traditional Factoring payments: In the majority of factoring arrangements, the account debtor(s) must pay the amount due under the receivable directly to the factor. In some cases, the account debtor may pay to the customer account (or lockbox) held or controlled by the factor. In even fewer cases (limited generally to customers with very good credit standing), the factor may allow the debtor to pay the customer, with the customer then obliged to send payments as received to the factor ("delegated collection"). Generally, delegated collection also requires recourse to the customer and other controls.

- Traditional Factoring Notification: In any factoring arrangement it is necessary to ensure that the debtor is only deemed free of its payment obligation when it pays the factor (not when it pays its supplier). As a result, the factor must notify the debtor that the specific receivable in question has been purchased. Once said notice takes place, if the debtor pays the customer (its supplier), then such payment is not valid, and debtor could be required to pay factor independently of payment made to its supplier.

- Traditional Factoring Options: Factoring can operate in two ways: i) Recourse Factoring for cases in which obligated debtor(s) fail to pay the receivable, the Factor is able to require payment from the customer; and, ii) Non-Recourse Factoring for cases in which the factor purchases in full the receivables and, in case of non-payment by the debtor, the factor has no right to demand payment from customer. The risk profile is different for recourse ad non-recourse factoring, which may be manifested in the financing or discounting charge on the receivables.

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- Credit Information Systems:

  Traditional factoring relies on the credit worthiness of the end account debtors, so having a credit bureau in the country can help the factor decide from which of its client's account debtors to purchase receivables. As a result, counting with a credit information system is highly desirable. Some factoring can take place without this requirement, so long as factor purchases receivables only from account debtors they know as creditworthy though other means or methods.

- Secured Transactions Laws:

  Since traditional factoring is a purchase of receivables from a customer in which the factor subrogates to the collection rights of the customer, it is not necessary to have a secured transactions law in place but having it could give more legal clarity. Additionally, having a factoring law in place is also highly desirable to ensure the debtor is obligated to pay factor and so that debtor cannot contest the assignment of the receivable.

- Collateral Registry:

  Traditional factoring is considered a functional equivalent of secured transactions, as a result, a collateral registry is necessary for traditional factoring, providing transparency to third parties and eliminating secret liens. Many markets accommodate factoring products without a registry but risk the creation of competing interests over the asset, making factoring more risky and costly.

- Extrajudicial Enforcement:

  Since the factor is subrogating the collection rights of the customer, traditional factoring requires to have extra judicial ways to enforce the collection right. This ability can be deemed as a method of collection method, rather than as a method of enforcement.

- Secondary Market:

  For traditional factoring to operate properly and based on the fact that the credit analysis of the product and its exit strategy rely on the credit worthiness of the account debtor(s), it is not necessary to have a secondary market (for purchased invoices). There could be a credit insurance in case account debtors default on their payment obligations.

- Banking Regulation:

  Having favorable Banking regulation, which takes into account the credit risk profile of the account debtor and the historical payment performance of the receivables, rather than only the credit worthiness of the customer, is desirable for traditional factoring. If it is not in place, traditional factoring can still be done, but with increased pricing.

- Technological Infrastructure:

  Technology platforms are desirable for factoring, first, to determine the validity of the receivable, second to provide notice to the account debtor that the assignment has taken place and of its new obligation to pay the factor instead assignor, and third to leverage efficiency and volume of transactions.

- Risk Mitigants:

  Credit insurance and/or risk-sharing facilities are important risk mitigants necessary to compensate for cases in which the local framework does not provide all credit and technology infrastructure requirements