

## **Factoring: a Better Alternative of International Trade Payment methods**

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### **Abstract**

*The use of the letter of credit as a means of payment for international trade between countries is declining. Buyers and sellers are now choosing bills for collection or open account for settlement of their international trade transactions. Since there is a good growth of export and import of Bangladesh, the Bangladeshi business houses are currently using letter of credit at large for the settlement of their transactions. But the procedure of letter of credit is a very complex and time consuming one. The other methods available for the settlement are the open account, advance payment and documentary collection. But the businesses of Bangladesh do not use the other methods frequently due to their risk exposure and regulatory requirements. But currently a strong alternative called factoring is being used by the businesses of different parts of the world for the settlement of international trade transactions. Even some of the Asian countries are also using international factoring for that purpose. The study aims comparing the four international trade payment methods along with international factoring. It also tries to look into the legal basis of factoring, the recent trends as well as the problems and prospects of introducing international factoring from the Bangladeshi perspectives.*

### **1.0 Introduction**

The export from Bangladesh is becoming diverse and complex day by day. For sustainable export, getting payments against export from the foreign buyer on time is a prerequisite. Getting the payment on time is very much dependent on the method of payment used for a particular transaction. There are other factors that can also affect payment. Most important among them are the potential risk and cost that the exporters and the importers are willing to face or share between them. There are basically four methods of making payment for international transactions. these are i) cash in advance ii) open account iii) documentary collection and iv) documentary credit. Under cash in advance payment terms, the exporter receives payment before the ownership of goods is transferred. Wire transfers and credit cards are the most commonly used cash-in-advance options available to the exporters. An open account transaction is a sale where the goods are shipped and delivered before payment is due, which is made usually in 30 to 90 days. A documentary collection (D/C) is a transaction whereby the exporter entrusts the collection of a payment to the remitting bank (exporter's bank), which sends documents to a collecting bank (importer's bank), along with instructions for payment. Funds are received from the importer and remitted to the exporter through the banks involved in the collection in exchange of those documents. D/Cs involve using a draft that requires the importer to pay the face amount either at sight (document against payment) or on a specified date (document against acceptance). A Documentary Credit (L/C) is a commitment by a bank on behalf of the buyer that payment will be made to the exporter, provided that the terms and conditions stated in the L/C have been met, as verified through the presentation of all required documents. The buyer pays his or her bank to render this service.

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## 2. Objectives of the study

- 1) To understanding the international factoring as an alternative of the trade payment methods in Bangladesh.
- 2) To evaluate the international trade payment methods in terms of applicability, risks and costs.
- 3) To suggest some policy initiatives for introducing international factoring in Bangladesh.

## 3.0 Factoring basics

Actually there is no universal definition of factoring. In different parts of the world factoring has been defined in different ways. The conference of International Institute for Unification of private laws (UNIDROIT) on factoring held in May 1988 defines that factoring is an arrangement between a factor and his client which includes at least two of the services as (a) finance (b) maintenance of accounts, (c) collection of debts and (d) protection against credit risks. We can simply define it as a purchase of receivables by factor from its client and collect it during the maturity from the debtor. Usually the factor pays the client about 80% of the value of the receivable and remaining is paid by collecting from the debtor after the deduction of charges. Factoring can be classified as Domestic Factoring and International Factoring. The domestic factoring can be of two types on the basis of its practice such as (a) factoring without recourse and (b) factoring with recourse. In Bangladesh the most used type of factoring is the latter one. In addition to that domestic factoring can be (1) Bulk Factoring, (b) Maturity factoring, (c) Agency Factoring, (d) Invoice discounting and (e) Undisclosed factoring.

## 4.0 International factoring

The UNIDROIT convention defines international factoring as “an agreement between an exporter and factor whereby the factor purchases the trade debt from the exporter and provides the services such as finance, maintenance of sales ledger, collection of debts, and protection against credit risks”. There are various forms of international factoring. It basically depends on the exporters’ needs and cost bearing capacity, and security to the factors. These are “Two factor system”, “Direct export factoring”, Direct Import Factoring” and “Back to Back factoring”. Among these types the two factor system gives some added benefits.

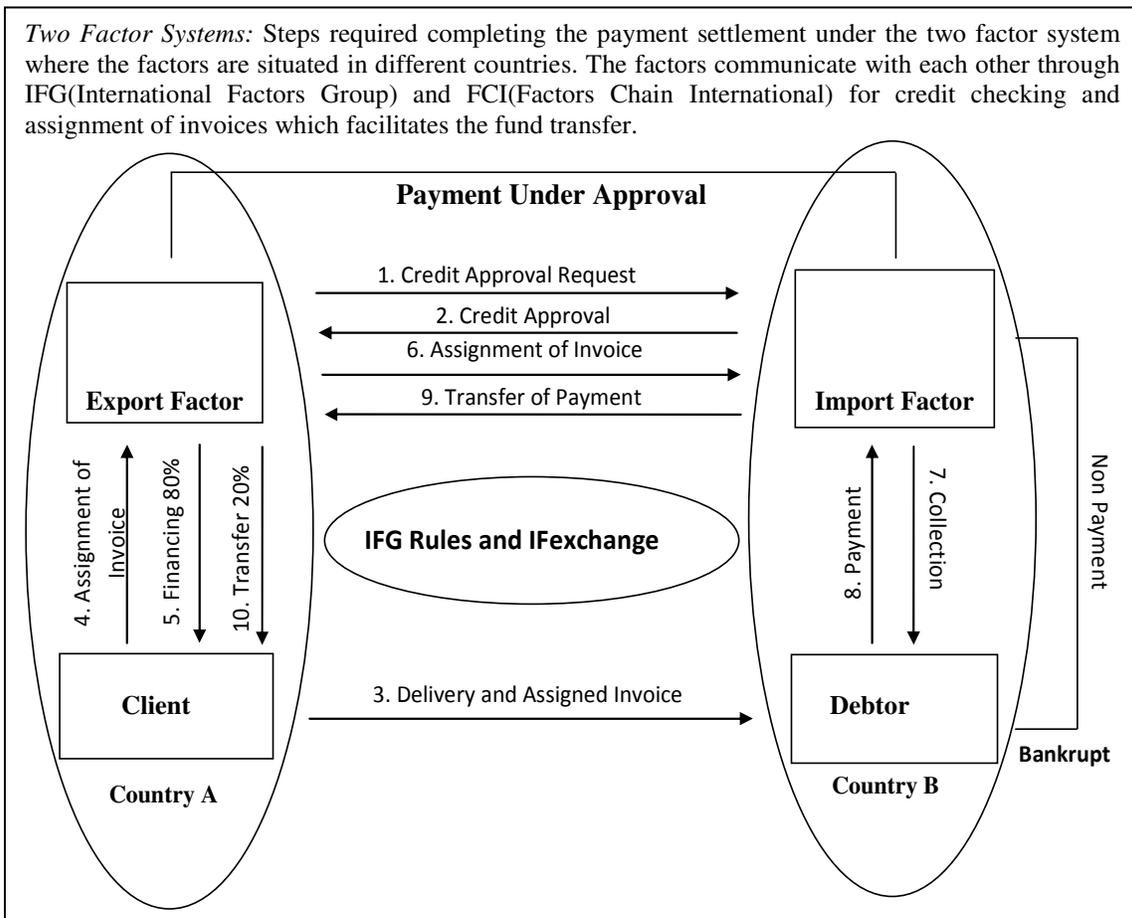
### 4.1 The two factor system

An international factoring transaction involves a number of elements that differentiate it from a domestic factoring transaction. Possibly the most important differentiations are the different languages of the parties to the sales contract and the difficulty in assessing the credit standing of a foreign party. As an answer to these considerations the two-factor system was developed. This entails the use of two factors, one in each country, dealing with the exporter and the importer respectively. The export factor on obtaining the information from the exporter on the type of his business and the proposed transaction, will contact the import factor designated by the importer and agree with the terms of the deal. The importer advances funds to the import factor who then transmits them to the export factor, minus his charges. In the two-factor system the import factor and the importer do not come into direct contact. The system involves three agreements, one between the exporter and the importer, one between the export factor and the exporter and one between the factors themselves. It is important to bear in mind that the import factor’s obligations are to the export factor alone and they include determining the importer’s credit rating and the actual collection of the debts. The import factor assumes the credit risk in relation to approved

debts and is responsible for the transfer of funds to the export factor. On the other hand, the export factor is responsible to the import factor for the acceptance of any recourse.

The two-factor system is supported by the existence of chains of correspondent factors. These are established for the purpose of facilitating the cooperation between the import and the export factors by the development of common rules and accounting procedures. There are members of factoring chains in most major trading nations. Some of them restrict their membership to one factor per country (Closed Chains), while others are open to the participation of multiple factors in the same country (Factors Chain International).

The two-factor system has various advantages. The main ones concentrate around efficiency and speed. The import factor is in a better situation to assess the credit capabilities of the importer and communicate effectively with him. He knows the legal and business environment in the country and is in a position to take swift action in case of any default. It facilitates the international trade by speeding up the circulation of funds. The speedier the flow of funds from the buyer to the seller, the smaller the risk of exchange rate fluctuations between the date of shipment and the date of payment. Finally, the use of this system can help in reducing the exchange risk involved in international trade transaction.



**Figure1: Two factor system (Source IFG)**

The use of the import factor alleviates the pressure on the export factor and streamlines the procedure. The same elements make the system preferable to the exporter who is sparing the inconvenience of dealing with a foreign factor. Further, there is the possibility of the client receiving lower discount charges if the import factor makes payments at the rate of discount charge in his country (if these are lower than the ones in the exporter's home jurisdiction).

#### **4.1.1 Organizations facilitating the “Two Factor System”**

There are different institutions currently working in the world to support the mechanism. Among those two organizations, the prominent ones are the IFG (International Factors Group) and the FCI (Factors Chain International). These are associations of factoring organizations or factors from all over the world.

The International Factors Group was founded in 1963 as the first international association of factoring companies. The original mission of IFG was to help factoring companies to conduct cross-border business acting as correspondents for each other. This is still the core activity of IFG today

FCI is a global network of leading factoring companies, whose common aim is to facilitate international trade through factoring and related financial services. FCI's mission is to become the worldwide standard for international factoring.

#### **4.2 Direct import and export factoring**

Direct import factoring connotes the situation where the exporter assigns debts to a factor in the country of the debtor. This is usually the case where there is a substantial volume of exports to a specific country. *This solution is a cheap and time efficient method of debt collection but it does not serve the aim of providing finance to the exporter.* The factor provides a debt collection service and does not enquire into the creditworthiness of the importer. Prepayments are not possible because that would expose the factor to high risks. Direct export factoring, on the other hand, does operate as an alternative to the two-factor system. In this situation, the factor is appointed in the exporter's own country and deals with all the aspects of the factoring arrangement including the provision of financing and the assessment of the financial position of the importer. This system is inexpensive and facilitates the communication between the exporter and the factor. However, all the advantages of the two factor system relating to the import factor's proximity to the importer and his jurisdiction, can be listed here as disadvantages. Communication problems with the debtor, credit risks and the occurrence of disputes are the most important problems.

#### **4.3 Back to back factoring**

Back to back factoring is an arrangement most suitable for debts owed by the exclusive distributors of products to their suppliers. The structure of the agreements is similar to the ones already considered with one material difference. The exporter enters into a factoring agreement with the export factor that contact with the import factor in the usual way. The difference lies in the existence of a separate factoring agreement between the import factor and the distributor.

Included in that arrangement is a right to set off credits arising from the domestic sales of the distributor with his debts to the supplier. The fact that the goods have already been sold to the third parties and thus the supplier cannot take a security interest over them to guarantee repayment of the debts.

#### **4.4 Disclosed and undisclosed factoring**

Disclosed factoring is the arrangement under which the exporter enters into a factoring agreement with the financial house and assigns the benefit of the debts created by the sale transaction to them. The importer is then notified and effects payment to the factor. The arrangement is usually on a non-recourse basis. This means that the factor cannot claim the assigned funds from the exporter if the importer fails to pay, in other words, he assumes the credit risk in the transaction. Those debts that are not approved by the factor are assigned on a recourse basis, so he can claim against the exporter in case of any default of the importer. Recourse factoring is more accurately described as invoice discounting. Factoring arrangements are usually made on a whole turnover basis. This arrangement connotes an obligation of the exporter to offer all his receivables to the factor who receives a commission undisclosed factoring, which is usually undertaken on a recourse basis and does not involve the importer. The agreement is made between the factor and the exporter and the importer remains bound to pay as agreed under the sales contract. In receipt of payment, the exporter holds the funds in a separate bank account as trustee for the factor.

#### **4.6 Advantages of international factoring**

In international factoring two other parties other than the buyer and the seller are the export factor and the import factor. This unique mechanism gives some advantages over the other methods used for settling the international trade transactions. That can be looked into as

- a) Flexible form of finance and with the help of factoring it is very easy to predict the cash flows. The factors immediately finance up to a certain percentage of the eligible export receivables. *The prepayment facility is available without letter of credit and in this case the strength of the invoices represents shipment of goods.*
- b) The factor checks information about the debtors in the importing country from its own database and if the information is absent in the database, the factor collects information about the factor with the help of their counterparts in the importing country. Thus the exporter knows about their clients in detail which helps the exporter to have a healthy portfolio.
- c) Factors use very efficient communications system and sometimes system customary to the importing country and thus have efficiency in ensuring prompt payment.
- d) Factors provide a multi-currency sales ledgering system and help the exporters to keep track of their portfolios of different currency.
- e) Factors use different hedge strategies to protect the clients from the risk of currency fluctuation.

## 5.0 Problems of factoring

The main disadvantage of the system is the expense involved. The increased cost of employing two factors makes the arrangement unsuitable for transactions of low value. Also there is the possibility of delays in the transmission of funds. In addition to that, duplication of some records is unavoidable. However, the use of chains of factors makes the transactions speedier through the use of a clearing system. Further, electronic forms of record transmission can help in alleviating the need for double record keeping.

## 6.0 Review of related literature

Factoring exists in almost every country in the world and it is gaining popularity due to the convenience in settling trades. In South Asia factoring services has come up in 1990 after its successful launching in India and Srilanka. In Bangladesh factoring is practiced by different NBFIs like IDLC, United Leasing, Lanka Bangla Finance and others at domestic level. In case of commercial banks the Eastern bank Ltd. and Trust bank Ltd. are practicing factoring at a very small scale. This has become possible in Bangladesh due to the publication of a guideline on domestic factoring by the central bank.

Moore (1959) has discussed elaborately the different aspects of factoring including the problems, accounting, and comparison with accounts receivable financing. Shay et al (1968) have examined banks moving into factoring because of the higher return by assuming higher risk. They have concluded that in time many banks will offer factoring, resulting in better service to high risk borrowers from both the banking and the financial establishments. Moberly (1979) notes that factoring is of great value to the growing companies. He has mentioned that a growing company often faces the problems associated with overtrading. The factor is usually in a position to finance 80% of the value of debts.

The Kalyanasundaram (1988) Committee set up by RBI (Reserve Bank of India) has examined the feasibility and mechanics of starting factoring organizations in India. The study has suggested that there is a sufficient scope for introduction of factoring in India which will be complementary to the services provided by the commercial banks. The study has concluded that an efficient financial system like factoring service could sustain itself on a viable basis only if a conducive environment is created and fostered. It has also suggested that if export factoring can be started it will facilitate the exporters of the country.

International Factoring is getting popularity in case of international trade instead of Letter of Credit (Banerjee, The Daily Financial Express April 2006). International Factoring Survey (1998), Khonstamm(1999) pointed that more and more countries are introducing international factoring and their exporters are turning their back to the letter of credit. Banerjee, (The Daily Financial Express, April 2006) mentioned that due to the security and margin requirements, the importers (even though bonafied) have to face serious time constraints and other problems for opening an L/C with the bank. Tarter (1997) mentioned that international factoring -- the sale of accounts receivable to international finance companies with the resources, expertise, and local presence to actively manage trade risk -- is providing a solid platform for success. Along with

that it provides a great opportunity of regional economic cooperation. Vydani (2003) pointed out that at present, the importance of international factoring as a modern approach to the financing of claims in foreign trade is increasing. International factoring is one of the important forms of financing receivables in international trade. Under international law, the Ottawa Convention of 1988 and the Convention on Assignment of Receivables in International Trade govern it, which is now ready for signature by the individual states. In addition Freddy (2007) pointed that “those engaged in international factoring or otherwise financing receivables across borders may well encounter difficulties if they do not recognise the marked differences in the laws of jurisdictions other than their own covering assignments and the rights and obligations of debtors in relation to assigned debts”.

## **7.0 Assessment of International Trade Payment Methods**

In international trade, both the buyer and the seller are concerned with the completion of the deal. Having contracted with the seller, the buyer wants to be sure that he receives the goods of the quantity and quality agreed. On the other hand, the seller is eager to receive payments on time and in the currency required once he has sent the goods. In order to meet these demands, various methods of payment have been developed: advance payment, documentary collection, open account and documentary credits.

### **7.1 Advance Payment**

This method is beneficial to the seller because he receives payment in advance, even before the goods are dispatched. As a result, he has money in his account even before parting with the goods and he can use it for arranging production and delivery of the goods. The seller, therefore, has the advantage and need not worry about receipt of the money.

This method is applicable for using in high-risk trade relationships or export markets, and ideal for internet-based businesses. The exporter is exposed to virtually no risk as the burden of risk is placed nearly completely on the importer. The main advantage of advance payment is that the payment takes place before shipment and thus eliminates risk of non-payment, on the other side it has some serious problems as well. For using this method the seller may lose its competitiveness and may lose customers. In addition to that there will be no additional earnings through financing.

Full or significant partial payment is required, usually through a credit card or a bank or wire transfer, before the ownership of the goods is transferred. Cash in advance, especially a wire transfer, is the most secure and favorable method of international trading for sellers and, consequently, the least secure and attractive method for buyers. However, both the credit risk and the competitive landscape must be considered. Insisting on cash-in-advance could, ultimately, cause exporters to lose customers to competitors who are willing to offer more favorable payment terms to foreign buyers. Creditworthy foreign buyers, who prefer greater security and better cash utilization, may find cash in advance unacceptable and simply walk away from the deal.

## 7.2 Documentary collection

While advance payment is more beneficial for the seller, bills for collection are more beneficial to the buyer. Using this method, a bank acts as an intermediary and hence the seller does not have to depend on the buyer only. But the bank's role is only in the process of routing the documents of transport/title along with other documents. (Collections can either be Clean or Documentary collections, which are covered by the Uniform Rules for Collection, ICC Document 522.)

The seller draws documents in terms of the contract it has entered into with the buyer, hands over those documents to the bank with clear instructions as to the mode of collection, i.e. whether goods are to be delivered against payment or against acceptance of documents (a bill of exchange). If that bill is not paid for some reason or other, the seller can take action against the buyer under the Negotiable Instruments Act to get payment.

Under this system, the buyer does not have to pay until he has received the documents providing transport of the goods from the seller. The seller has a reasonable expectation of getting paid for the goods. The documents will be handed over to the buyer only if one of the above two factors happens. The seller, however, has no guarantee of the bank assuring payments even if he has complied with the terms and conditions. From the seller's point of view, this is not a satisfactory system of payment - not only because he has no bank guarantee but also because he cannot negotiate these documents and get bank finance.

Bills for collection are becoming more and more popular because of the high cost of letters of credits - not just from the importer's point of view but also from the exporter's point of view. They are open to lack of security in obtaining payment.

This method of payment is very much useful in established trade relationships and in stable export markets. But it is riskier for the exporter, though D/C terms are more convenient and cheaper than an LC to the importer. One of the positives of the method is that it requires bank assistance in obtaining payment and the process is simple, fast, and less costly than LCs (Letter of Credits). On the other hand the method is not free from limitations. It may be that the banks' role is limited and they do not guarantee payment until they verify the accuracy of the documents.

There are some mentionable key points about the Documentary Collections. D/Cs are less complicated and less expensive than LCs. Under a D/C transaction, the buyer is not obligated to pay for goods before shipment, the seller retains the title to the goods until the buyer either pays the face amount at sight or accepts the draft to incur a legal obligation to pay at a specified later date. Although the title of the goods can be controlled under ocean shipments, it cannot be controlled under air and overland shipments, which allow the foreign buyer to receive the goods with or without payment. The remitting bank (seller's bank) and the collecting bank (buyer's bank) play an essential role in D/Cs. Here the banks control the flow of documents. They neither verify the documents nor take any risks. They can, however, influence the mutually satisfactory settlement of a D/C transaction.

### 7.3 Open Account

From the seller's point of view, an open account is the most risky payment system. Under this system, the buyer pays at the end of an agreed period. The seller consigns the goods directly to the buyer or to his order, and the documents pertaining to the goods are sent directly to the buyer enabling him to take delivery of the goods. Under this system, after sending the goods, the seller is at the mercy of the buyers. This type of payment is normal in trading arrangements requiring (i) a high degree or trust between the buyer and the seller and (ii) a regular and continuous business relationship between the two parties.

The benefit of this system is that since there is no bank involvement, there is less paper work and consequently lower costs. This system is more beneficial to a large number of exporters and importers and is based on full and undoubted trust between the two parties. Certainly, from the exporter's point of view, if you are going to release goods and also give your buyer documents to accompany them, you must have a high element of trust, otherwise, you would be out of business.

This method is recommended for use (i) in low-risk trading relationships or markets and (ii) in competitive markets to win customers with the use of one or more appropriate trade finance techniques. It can be a significant source of risk to the exporter because the buyer may default on payment obligation after shipment of the goods. It has some serious positives, e.g., this method boosts competitiveness in the global market and helps to establish and maintain a successful trade relationship. While using this method the exporter should be aware about the additional costs associated with risk mitigation measures. In case of open account, if the time of payment is not specified the general conditions of contract applies and requires the buyer to make the payment within thirty days of the date of invoice. The exporter should be absolutely confident that the importer will accept shipment and pay at the agreed time and that the importing country is commercially and politically secure. In addition to that the open account terms may help win customers in competitive markets and may be used with one or more of the appropriate trade finance techniques that mitigate the risk of non-payment.

### 7.4 Documentary credit

Letter of Credit (LCs) is one of the most secure instruments available to the international traders. An LC is a commitment by a bank on behalf of the buyer that payment will be made to the beneficiary (exporter) provided that the terms and conditions stated in the LC have been met, consisting of the presentation of specified documents. The buyer pays his bank to render this service. An LC is useful when reliable credit information about a foreign buyer is difficult to obtain, but the exporter is satisfied with the creditworthiness of the buyer's foreign bank. This method also protects the buyer since the documents required to trigger payment provide evidence that the goods have been shipped or delivered as promised. However, since LCs have many opportunities for discrepancies, the documents should be prepared by well-trained professionals or outsourced. The discrepant documents, literally not having an "*i* dotted and *t* crossed," can negate the bank's payment obligation. Letter of Credits are recommended for use in new or less-established trade relationships when the exporter is satisfied with the creditworthiness of the buyer's bank. The risk of documentary credit is evenly spread between the seller and the buyer,

provided that all terms and conditions are adhered to. This method suffers from some serious limitations. E.g., it is complex and labor-intensive process and relatively expensive method in terms of transaction costs.

An LC, also referred to as a documentary credit, is a contractual agreement whereby the issuing bank (importer's bank), acting on behalf of its customer (the buyer or importer), authorizes the nominated bank (exporter's bank), to make payment to the beneficiary or exporter against the receipt of stipulated documents. The LC is a separate contract from the sales contract on which it is based; therefore, the bank is not concerned whether each party fulfills the terms of the sales contract.

The bank's obligation to pay is solely conditioned upon the seller's compliance with the terms and conditions of the LC. In LC transactions, banks deal in documents only, not goods. LCs can be arranged easily for one-time deals. Unless the conditions of the LC state otherwise, it is always irrevocable, which means the document may not be changed or cancelled unless the seller agrees.

In Bangladesh the process of documentary credit settles most of the transactions. The use of the other methods is very negligible. As businesses in Bangladesh using letter of credit are to many, so we can look into some specific risk aspects related to letter of credit.

#### **7.4.1 Risks in the process of Documentary Credit**

The beneficiary of forged or falsified documents will obtain the payment for nonexistent or worthless merchandise against presentation. Credit itself may be forged. Sovereign and Regulatory Risks Performance of the Documentary Credit may be prevented by government action outside the control of the parties.

It is possible that performance of a Documentary Credit may be disturbed by legal action relating directly to the parties and their rights and obligations under the Documentary Credit. Like Force Majeure and Frustration of Contract, that is, the performance of a contract – including an obligation under a Documentary Credit relationship – is prevented by external factors such as natural disasters or armed conflicts.

In addition to that there are other risks factors available for the parties involved in the documentary credit process, e.g., the applicant may face the risk of non-delivery, short shipment, late shipment and failure of banks during the period of settlement. Although some of the risks can be minimized by having a well-formulated international sales and purchase contract, yet the issuing bank may face the insolvency of the applicant. In case of the reimbursing bank, it has no obligation to reimburse the claiming bank unless it has issued a reimbursement undertaking. The confirming Bank's main risk is that, once having paid the Beneficiary, it may not be able to obtain reimbursement from the Issuing Bank because of insolvency of the Issuing Bank or refusal of the Issuing Bank to reimburse because of a dispute as to whether or not payment should have been made under the Credit.

## 8.0 Scenario in Bangladesh

In the context of Bangladesh, letter of Documentary Credit is the most popular and widely used for making import payments from Bangladesh. Chowdhury and Habib in 2006 found that about 90% (both in terms of number of cases and amount) import payments from the country are made through letter of credit. The other two methods- cash in advance and documentary collection- the less used methods for international trade payment. In case of imports the open Account is absent. On the other hand, in case of exports, Chowdhury and Habib 2006 found that about 75% (in volume) of export payments are obtained through letter of credit and the other method, as documentary collection, accounted for about 32.50% and advance payments accounted for .5% which is very insignificant. Another method of open Account is absent in case of export as well. So it can be said that most of the export and import transactions of Bangladesh are dominantly settled by documentary credit. The result is that the businesses are paying high for their transaction settlement. As documentary credit has involvements of different parties namely the nominating bank, the reimbursing bank, the confirming bank etc. Some of them are involved only to ensure the creditworthiness of the issuing bank against a certain percentage of commission. Another reason could be that the sovereign rating is lower than that in some countries in LDC group. Although there is specific guidelines published by the International Chamber of Commerce (Such as UCP-600, ISP98), documentary credit is an inefficient process in terms of time. As a result the businesses of our country are losing their advantage over those of some countries under the class of developing countries.

## 9.0 Special considerations for international factoring

In course of the previous analysis we have touched upon the particular characteristics that differentiate international factoring from international trade payment methods. Language and communication problems stemming from different commercial traditions are the most obvious ones but usually those are the least severe of the problems that an export factor may face. Exchange rate fluctuations and political risks represent the most potent dangers. International receivables financing requires a much greater deal of caution than domestic factoring, because an assessment of normal commercial risks may not be enough to guarantee a profitable transaction. The most serious complication however is the need to create valid assignments under foreign jurisdictions. It is imperative for the operation of any factoring agreement that the rights vis-à-vis the debtors and the third parties are adequately recognized and protected under the jurisdiction of both the exporter and the importer.

Generally debts are considered to situate in the country where the debtor has his place of business, because that is where they can be enforced. However, this general rule is liable to be altered by the contractual provisions that gave rise to the debt. The questions of the validity of the assignment will be determined by the law of the factoring agreement as chosen by the parties. Compliance with the contractually stipulated law, however, may not guarantee enforcement in another jurisdiction, which has its own mandatory rules for assignment of receivables.

The factor will have to grapple with the different registration requirements and the peculiarities of different legal systems, because these types of assignment valid in one country may be unavailable in another.

## **10.0 The UNIDROIT Convention on International Factoring**

In recognition of the importance of international factoring as a source of funds for the purposes of international trade, the Rome Institute for the Unification of Private International Law (UNIDROIT) in May 1988 produced a Convention on International Factoring in Ottawa, Canada. The convention aims to help overcome the difficulties outlined through this work, and make the international assignment of receivables a more accessible form of finance. As of 7/2/2001, 14 states, including most major industrialized states like the UK, the US, Germany, Italy and France, have signed the convention. So far it has been ratified by 4 states. Another 2 have acceded to the convention. The convention applies to international factoring transactions. A transaction is international when the parties have their place of business in different states.

A factoring contract is one which involves the assignment of receivables arising from commercial (excluding transactions with ultimate consumers) sales of goods transactions and under which the factor provides finance, ledgering, collection of receivables and protection against the debtor's default. The convention may be adopted or rejected as a whole by the parties. As far as the substantive provisions are concerned, the convention specifies that the debtor is under an obligation to pay the factor (in the absence of knowledge of superior rights) for identified receivables arising out of contracts of sale concluded at or before the time of written notice of the assignment to the debtor. An issue of controversy in English law is the question of whether the debtor can recover sums paid to the factor if the contract between the supplier and the debtor (the buyer) is not performed. The solution adopted by the convention is that there is no liability on the factor for defaults under the primary contract between the seller and the buyer, unless, the factor has not advanced the funds to the supplier, or he has done so with knowledge of the Also known as the Ottawa Convention on International Factoring.

The convention is characterized as a move in the right direction in making international factoring more accessible as a means of obtaining finance for international trade. The fact that it has entered into force means that at least some states recognize its potential. Further, there is not any suggestion of a conflict of rule of laws that could serve as a guideline for dealing with such problems. Additionally, the convention is limited in its application and does not cover domestic factoring and the relations between the factors and their clients. Some see this as a disadvantage. Finally, the compromise reached in Article 6 over the effects of prohibitions on assignment may limit its effectiveness and discourage factors especially when dealing with small exporters.

The convention aims to encourage the practice of international receivables financing as a method of facilitating international trade. Its main goal is to reduce the cost of transactions such as international factoring, project financing and securitization (among others) through the use of uniform rules. The current situation as described above is seen as a disincentive for the widespread use of receivables financing as a method of raising finance for trade. The divergence of national laws and the multiplicity of often-contradictory criteria for the assignment of receivables are at the root of the problem. The convention specifically addresses the questions regarding the validity of assignments made in foreign jurisdictions and the vital issue of priorities

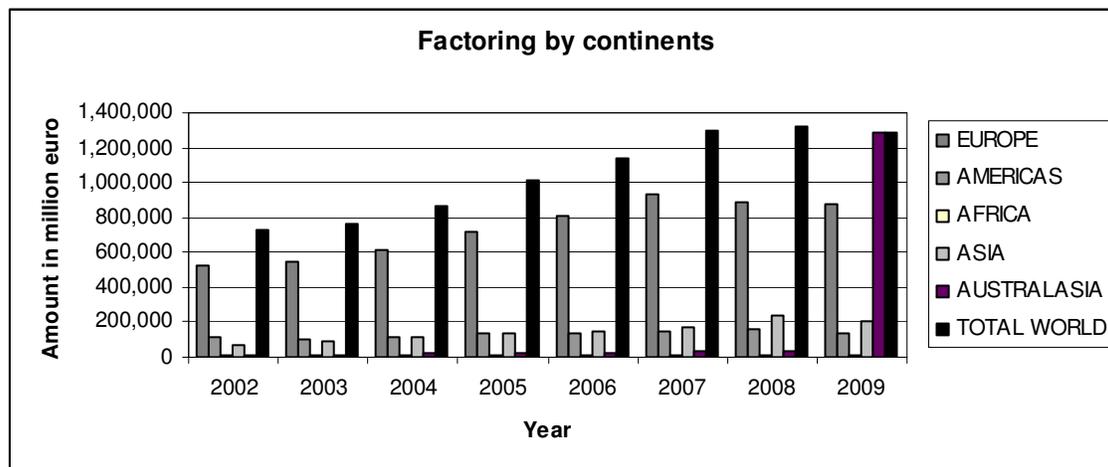
in the event of insolvency of the debtor. The convention prevails over the UNIDROIT Convention on International Factoring except where it does not apply to the rights and obligations of a debtor which the Ottawa Convention does. However, the convention has been very recently adopted and it has not as yet come into force, while the Ottawa Convention is currently in operation. Nevertheless, the adoption of the convention is a major development for the practice of international factoring. Thus, the convention encompasses a wide range of transactions, such as factoring, forfaiting, securitization, assignments of future income streams in project finance and refinancing transactions including the transfer of tort receivables, insurance policies and deposit accounts. The convention applies to assignments with some international element. This may relate to the assignment or to the receivable. At this point the convention differs from the Ottawa Convention where internationality only relates to the receivables. Thus, assignments, whether domestic or international, of international receivables and international assignments of domestic receivables are included within the scope of the convention.

### 11.0 Current situation of international factoring in the world:

**Table 1: Amount of International Factoring (Figures in Million euros)**

	2002	2003	2004	2005	2006	2007	2008	2009
EUROPE	522,851	546,935	612,504	715,486	806,983	932,269	888,533	876,649
AMERICAS	115,301	104,542	110,094	135,630	140,944	150,219	154,450	142,013
AFRICA	6,203	5,840	7,586	6,237	8,513	10,705	13,263	14,796
ASIA	69,849	89,095	111,614	135,813	149,945	174,617	235,619	209,991
AUSTRALASIA	9,992	13,979	18,417	23,380	27,853	33,780	33,246	128,355
TOTAL WORLD	724,196	760,391	860,215	1,016,546	1,134,238	1,301,590	1,325,111	1,283,559

Source: factor chain international



If we look into the above figures and table we can easily observe that the use of factoring in the settlements of international trade transaction is increasing rapidly. Among the continents Europe has the highest amount of factoring and Australasian has the lowest. If the number of companies across the continents is analyzed, it is clearly visible that America is dominating the factoring business of the world.

Continent	No. of companies
Europe	624
Americas	961
Africa	17
Asia	139
Australasia	27

*Source: Factor Chain International*



## 12.0 Asian scenario

If we look into the following table, it is very easy to indicate that India our neighboring country, has already eight factoring companies and during the year 2008 they settled payments of 450 million of euros of international trade. That indicates that they are doing well. In the South Asia the other country, Sri Lanka, has five factoring companies and they are doing basically domestic factoring.

**Table3: Factoring business in Asia in 2008(Figures in million euros)**

No. of Companies	Country	Domestic In mn euro	International In mn euro	Total In mn euro
3	Armenia	6	1	7
16	China	30,000	25,000	55,000
11	Hong Kong	4,000	4,500	8,500
8	India	4,750	450	5,200
7	Israel	1,100	300	1,400
13	Japan	105,000	1,500	106,500
1	Lebanon	325	75	400
5	Malaysia	540	10	550
10	Singapore	3,300	700	4,000
2	South Korea	0	900	900
5	Sri Lanka	100	0	100
24	Taiwan	32,750	16,000	48,750
21	Thailand	2,250	117	2,367
5	United Arab Emirates	1,700	160	1,860
8	Vietnam	80	5	85
139	Total	185,901	49,718	235,619

Source: *Factors Chain International*

### 13.0 Factoring scenario in Bangladesh

In Bangladesh the factoring is in the infant stage. There is no legal scope of using factoring as a method for the settlement of international trade transactions. Although Bangladesh Bank with the help of SEDF (South Asia Enterprise Development Facilities) has developed a guideline for the banks and non-bank financial institutions for domestic factoring, yet it is currently working on the guideline for international factoring. There are leading non-bank financial institutions (IDLC, LBFL, ULC,) and banks (EBL, TRUST) which are currently offering factoring services for their domestic clients. But the weight of factoring in their product portfolio is very negligible although the enterprises of Bangladesh need a lot of short term funds.

#### 13.1 Why Bangladesh should use factoring

About 90% (Shamsul, 2006) of the business enterprises of Bangladesh consists of Small and Medium Enterprises. One of the greatest problems of these enterprises is the lack of working capital or the large cash conversion cycle. The SMEs of the country contribute about 25 % (Financial Express, December 3, 2010) of the GDP of the country. If Bangladesh wants to ensure higher economic growth, growth in SMEs is a must. So to ensure the growth of the economy and solve the problem of lack of working capital, factoring is a better option. Collection of debt by the businesses is another problem for these enterprises. Involvement of a factor can reduce the problems related to collection of receivables. A factor can provide credit administration services to its clients which will help the businesses in focusing production, marketing and technological innovations. By using factoring it is possible to enhance the exporting activities from Bangladesh.

Because the factors can provide credit checking services as well for the importers which is impossible by the commercial banks, which are currently providing services to the exporters. In addition to that, the factoring services will create business opportunities for the banks and enhance the profit as well. Along with those, there will be higher possibility of cross selling. The factoring services can provide better support to both the service providers and the clients in liquidity, profitability and capital management. The Garment manufacturers can use factoring for reducing their cash conversion cycle, which will improve their management fund.

#### **14.0 Problems of factoring in Bangladesh**

There are serious problems in Bangladesh regarding factoring. Some of the problems could be viewed as follows

- 1) The financial institutions are reluctant to adopt factoring as a part of their portfolio because they are earning good profit through practicing conventional functions.
- 2) Lack of legal and institutional support for the implementation of factoring.
- 3) Lack of knowledge and misconception among the entrepreneurs regarding factoring
- 4) Passive role of the central bank to adopt factoring as an alternative of documentary credit.

#### **15.0 Recommendations**

To eliminate the problems of factoring and to adopt it as a mechanism for the settlements of international trade transactions, we recommend the following:

- 1) Bangladesh has to adopt UNIDROIT (International Institute for the Unification of Private Law) Convention for international factoring to provide legal basis for it.
- 2) The government in collaboration with Bangladesh bank and other financial institutions can initiate training programs for both entrepreneurs and officers of different financial institutions to create awareness and to eliminate misconceptions about factoring.
- 3) Bangladesh has to become member of the international chains like FCI (Factors Chain International).
- 4) Some of the FERA (Foreign Exchange Regulation Act) 1947 and Bangladesh Bank Guidelines for Foreign Exchange Transactions may require to be changed.
- 5) A few other acts as Stamp Act and Transfer of Property Act may be amended for proper functioning of the International Factoring.

## 16.0 Conclusion

International factoring is a method of obtaining finance and enhancing liquidity with great potential. The use of factors to provide prepayments for the sale of goods and services in an international context is necessary to increase the volume of international trade. Further, what factoring does in essence is to introduce intermediaries between the buyer and the seller where the communication between them may be difficult due to language, culture or different trading practices. The factor can facilitate trade in such situations and undertake the burdensome obligations of debt collection across national borders. Thus, international factoring can be used to effectively finance and facilitate international trade. Despite this fact, however, factoring is still to a great extent an infant industry.

The reason for this possibly rests on the problems of creating assignments that are valid in more than one jurisdiction. The uncertainty of enforcing claims in foreign states and the lack of any clear priority rules to determine the rights of the assignee vis-à-vis third parties may account for the reluctant expansion of factoring in international trade. The operation of the UNIDROIT Convention and the adoption of the UN Convention will help overcome these difficulties and create an environment of certainty of legal framework. Receivables financing in general and international factoring in particular have too great a potential to be overlooked as methods of financing cross border transactions. Bhattacharya (1997) and Choudhury et al (1995) have suggested that factoring services both domestic and international should be implemented in Bangladesh to enhance economic growth and to establish financial discipline.

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