Regulatory Hotline

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NBFC INVESTMENT AND CREDIT COMPANY – CAN NOW FACTOR

In a move that endeavors to foster growth and development in the startup sector by way of extending credit facilities to small enterprises, the Central Government has provided relaxation for undertaking the factoring business governed by the Factoring Regulation Act, 2011 (“**the Act**”). The Central Government by way of the Registration of Factors (Reserve Bank) Regulations, 2022 (“**Factor Registration Regulations**”) and the Registration of Assignment of Receivables (Reserve Bank) Regulations, 2022 (“**Assignment Registration Regulations**”) (collectively referred to as the “**Amending Regulations**”) has provided necessary impetus to small enterprises for lining up credit.

The Amending Regulations came into effect on January 17, 2022 and strive to (i) broaden the ambit of companies that can carry out the business of factoring; and (ii) introduce administrative efficacy in the process of assigning receivables as governed by the Act.

Prior to the Amending Regulations, the entities which could undertake the business of factoring were very few. In fact, the number of Non-Banking Financial Companies (“**NBFCs**”) eligible to conduct factoring business post the implementation of the Factor Registration Regulations has increased exponentially from 7 (seven) to 182 (one hundred and eighty two).[1] The primary objective of the Amending Regulations is to establish an efficient framework governing the provision of working capital and credit facilities to micro, small and medium enterprises (“**MSMEs**”) in order to proliferate their growth.

BACKGROUND

The system of factoring was introduced in India to address the primary obstacle faced by start-ups, which is the lack of access to adequate capital. Trade receivables factoring is a form of financing that permits business to convert their outstanding invoices into working capital which they can then utilize for their business operations. This is typically done by way of assignment of trade receivables of the assignor to the factor/NBFC for monetary consideration.

While the Act was introduced with the intention of augmenting the working capital available to MSMEs through trade receivables factoring, as of last year, factoring comprises of only 2.6% of the total MSME credit in India[2]. The primary reason for this low percentage is the ineligibility of several NBFCs to participate as factors under the Act. It is estimated that only 10% of the receivable market in India is covered under the Act while the rest of the receivable financing market falls within the purview of conventional cash credit overdraft arrangements.

The Government sought to reduce the regulatory compliance governing factoring transactions and broaden the scope of NBFCs permitted to function as factors under the Act. Accordingly, the Amending Regulations were introduced, and the implementation of such regulations are of utmost importance given the severe hit taken by the start-up sector as investments in Indian start-ups witnessed a severe decline by 81% from 2019 to 2020 due to the repercussions of the COVID-19 pandemic[3]. We identify some of the key takeaways from the Amending Regulations:

KEY TAKEAWAYS

1. **Non-Banking Financial Company – Factor**

   The Factor Registration Regulations has introduced two separate categorizations of NBFCs which can undertake the business of factoring as envisaged under the Act. The first classification is that of the Non-Banking Financial Company – Factor (“**NBFC-Factor**”). The NBFC-Factor has been defined under the Factor Registration Regulations as a non-banking financial company which undertakes factoring as its principal business and has been granted a certificate of registration from the Reserve Bank of India (“**RBI**”).[4] The Factor Registration Regulations establishes certain eligibility criteria which will need to be satisfied in order for a NBFC to be classified as a NBFC-Factor.

   Every NBFC which seeks to operate as a NBFC-Factor should (i) not accept or hold public deposits[5]; (ii) maintain total assets of at least INR 10,00,00,00,000 (Indian Rupees Ten Thousand Crores) crores as per its last audited balance sheet[6]; (iii) maintain a minimum net owned fund of INR 5,00,00,000 (Indian Rupees Five Crores) subject to change at the discretion of the RBI[7]; and (d) ensure regulatory compliance[8].

   Upon satisfaction of the aforementioned criterion, a NBFC seeking to function as a NBFC-Factor may apply to the RBI for registration as a NBFC-Factor[9]. After receipt of the certificate of registration, every NBFC-Factor will need adhere to certain minimum thresholds in order to maintain its title as a NBFC-Factor under the Act. Firstly, the NBFC-Factor must maintain its minimum net owned fund of at least INR 5,00,00,000 (Indian Rupees Five Crores).

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The second threshold which needs to be met is that the financial assets of the NBFC-Factor must comprise at least 50% (fifty percent) of its total assets and the income attained from its factoring business should comprise at least 50% (fifty percent) of its gross income[10].

A NBFC-Factor will be permitted to start its factoring business within 6 (six) month of receipt of its certificate of registration from the RBI[11].

2. **Non-Banking Financial Company – Investment and Credit Company**

   In the event that a NBFC does not satisfy the eligibility criterion to operate as a NBFC-Factor, it will still have the option at its disposal to undertake the business of factoring as a Non-Banking Financial Company – Investment and Credit Company ("**NBFC-ICC**"). A NBFC-ICC has been defined under the Factor Registration Regulations as "*any company which is a financial institution carrying on as its principal business – asset finance, the providing of finance whether by making loans or advances or otherwise for any activity other than its own and the acquisition of securities, and granted a certificate of registration under Section 45IA of the Reserve Bank of India Act, 1934; and is not any other category of NBFCs as defined by the RBI*."[12]

   Accordingly, a NBFC-ICC can apply to the RBI for conversion from a NBFC-ICC to a NBFC-Factor as long as it ensures that its financial assets comprises at least 50% (fifty percent) of its total assets and the income attained from its factoring business comprises at least 50% (fifty percent) of its gross income.

   Therefore, the Factor Registration Regulations has broadened the scope of eligible NBFCs which can undertake the factoring business by implementation of the dual categorization framework. This will provide MSMEs with easier accessibility to working capital which can assist in accelerating their growth.

3. **Registration of Assignment of Receivable Transactions**

   In tandem with the Factor Registration Regulations, the Government of India has also introduced the Assignment Registration Regulations which seeks to establish a timeline for registering and recording transactions pertaining to the assignment of receivables between a factor and an assignor.

   Under the newly implemented Assignment Registration Regulations, any trade receivables which have been funded through the trade receivables discounting system ("**TReDS**") will need to be filed in the prescribed form with the Central Registry within 10 (ten) days of assignment of such receivables[13].

   Whilst the Factoring Regulation (Amendment) Act, 2021 ("**Previous Amendment**") had already introduced the framework for registration of such receivable transactions with the Central Registry, the Previous Amendment did not stipulate any specific timeline within which such registration was to be completed. Accordingly, the Assignment Registration Regulations have been implemented to deter any backlog or delay in the registration of any trade receivables which have been financed through TReDS.

ANALYSIS & CONCLUSION

The pivotal objective behind the Amending Regulations is to boost the start-up sector by enhancing the access of working capital to MSMEs. However, the extent to which the Amending Regulations will assist in realizing this objective is yet to be established.

The primary issue with the Amending Regulations is that it imposes more stringent regulations for the operation of eligible NBFCs. Accordingly, while the Factor Registration Regulations have broadened the scope of eligible NBFCs by including NBFC-ICC, such a NBFC-ICC will not be eligible to continue to undertake the business of factoring unless it undertakes factoring of trade receivables as its primary business (i.e. at least 50% of its gross income should be derived from the factoring of trade receivables).

In a similar vein, the eligibility criterion for NBFC-Factors under the Factor Registration Regulations have tightened. For instance, any NBFC seeking to operate as a NBFC-Factor must have total assets worth at least INR 10,000 crores – a threshold which serves more to inhibit rather than invite NBFCs to undertake such factoring business.

At the moment, the Central Government has rightly acknowledged that change is required in the regulatory framework governing factoring of trade receivables. However, whether the implementation of the Amending Regulations will bring about such change is yet to be seen.

– Aarathi Das & Basava Rao

You can direct your queries or comments to the authors

[1] https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=53131.

[2] https://economictimes.indiatimes.com/small-biz/money/why-factoring-failed-to-address-delayed-payments-for-msmes-and-how-recent-amendments-can-help/articleshow/85708448.cms?from=mdr.

[3] https://www.thehindubusinessline.com/companies/investments-in-indian-start-ups-crash-nearly-81-in-march-y-o-y/article31218813.ece.

[4] Regulation 2(4), Registration of Factors (Reserve Bank) Regulations, 2022, https://rbi.org.in/Scripts/NotificationUser.aspx?Id=12222&Mode=0.

[5] Regulation 5(2)(a), Registration of Factors (Reserve Bank) Regulations, 2022, https://rbi.org.in/Scripts/NotificationUser.aspx?Id=12222&Mode=0.

[6] Regulation 5(2)(b), Registration of Factors (Reserve Bank) Regulations, 2022, https://rbi.org.in/Scripts/NotificationUser.aspx?Id=12222&Mode=0.

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[7] Regulation 3, Registration of Factors (Reserve Bank) Regulations, 2022,

https://rbi.org.in/Scripts/NotificationUser.aspx?Id=12222&Mode=0.

[8] Regulation 5(2)(d), Registration of Factors (Reserve Bank) Regulations, 2022,

https://rbi.org.in/Scripts/NotificationUser.aspx?Id=12222&Mode=0.

[9] Regulation 5, Registration of Factors (Reserve Bank) Regulations, 2022,

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[10] Regulation 4, Registration of Factors (Reserve Bank) Regulations, 2022,

https://rbi.org.in/Scripts/NotificationUser.aspx?Id=12222&Mode=0.

[11] Regulation 5(6), Registration of Factors (Reserve Bank) Regulations, 2022,

https://rbi.org.in/Scripts/NotificationUser.aspx?Id=12222&Mode=0.

[12] Regulation 2(5), Registration of Factors (Reserve Bank) Regulations, 2022,

https://rbi.org.in/Scripts/NotificationUser.aspx?Id=12222&Mode=0.

[13] Regulation 3(1), Registration of Assignment of Receivables (Reserve Bank) Regulations, 2022,

https://rbi.org.in/Scripts/NotificationUser.aspx?Id=12223&Mode=0.