‘Relevance of Factoring for Financing Small and Medium Enterprises (SMEs)’

SMEs are crucially important for sustained broad based output, employment and income generation. Development of SMEs is therefore considered as a key element for reaching double digit growth. SMEs of Bangladesh have already come out as a significant component of the manufacturing sector accounting for 50.9% of the establishments, 35.5 of employment and 47% of Gross value added (Bakht and Basher, 2015).

In spite of its economic importance, SMEs always face liquidity problem. SMEs suffer liquidity shortage because of: (a) most of the SMEs sale their products on a credit basis but a substantial part of their purchase is on cash basis (b) delayed payment of their receivables by large and medium sized firms as well as public sector enterprise and government departments (c) lack of expertise in financial management, in general, and credit management, in particular.

Banks are also generally reluctant to finance SMEs. Monetary policy statement, January –June 2018 shows that private sector credit grew by 18.1 percent in December 2017 whereas SME credit grew only around 3.78 per cent during the same period. Banks are unwilling to lend due to inability of SMEs to provide sufficient security, higher operating costs for lending small amount of loan, absence of proper accounting system in SMEs, incidence of high bad debt in SMEs, and slackening efforts of collecting book- debts after financing book debts by banks.To augment the contribution of SMEs to the economy, it is necessary to promote these enterprises through removal of financial impediments.

Like many countries, banks and financial institutions can offer domestic factoring to assist SMEs for financing against their accounts receivable and do credit management for local transaction. Under factoring, a bank or financial institution finances sellers immediate after submitting required documents namely invoice, VAT challan and transport documents which are commonly available with sellers after selling and transporting goods to buyers. Banks/ financial institutions will not hesitate to finance sellers without demanding any security as buyers give consent before shipment to pay banks / financial institutions in place of suppliers and most of the buyers of SMEs are big and reputed in the market. As cash flow and credit sales are positively correlated, in case of factoring more sales will generate more cash flow for suppliers without increasing leverage and giving security. Moreover, factoring is serviced by invoiced backed dedicated cash flow as opposed to consolidated cash flow of the borrower as in the case of conventional lending, it is inherently less risky from the credit point of view. However, reverse factoring may also be more suitable for a banker in financing working capital to a credit seller. Under reverse factoring, the factoring agreement is made between buyer and the factor and hence the client is the buyer as against the client being seller in case of normal factoring. Since here funds are released to suppliers after the buyer (client) duly accepts the invoices, the performance risk of the suppliers is obviated and the only risk is the credit worthiness of the buyer.

In factoring services, the other financial service is international factoring which is being used in place of Letter of Credit (L/C) for international trade. Both exporters and importers worldwide are gradually turning their back on L/C and accepting international factoring for their international trade. Exporters face increasing insistence by importers that trade be conducted on open accounts terms in place of L/C. For confirming L/C, importers have to provide required margin and sufficient security to their banks. Even for a successful importer, there comes a time when the growing requirements for L/C margin go beyond the importer's financing ability and L/ C coverage exceeds the security available to give to the bank. Moreover, importers need to approach banks for issuing L/C in each occasion of importing goods from abroad, which is really time consuming. L/C involves different parties namely issuing bank, confirming bank, negotiating bank, collecting bank, presenting bank, which increases formalities as well as aggregate charge for L/C.

An importer gets rid of these hassles under international factoring. It provides importers with opportunity for purchasing on convenient open account terms without opening L/C and blocking existing lines of credit. A factor also provides with 100 per cent protection to the exporter against the importer's inability to pay. International factoring' incurs less cost because it has only two parties, import factor and export factor.As importers of many countries are now demanding to use international factoring,suppliers must respond to the needs of importers for increasing exports.

With a view to achieving vision of reaching middle income status by 2021, Bangladesh needs to create more and better jobs for the 2.1 million youths entering the job market every year through supporting SMEs and export sector. Factoring can be a way out in this respect. Factoring has already received huge acceptability to SMEs around the world. The total volume of domestic and international factoring of Euro 1868.85 and 507.11 billion in 2016 indicates how SMEs utilize this financial service in financing their local business and international trade. In Bangladesh, domestic factoring is being offered by a number of banks and financial institutions. However, it is progressing sluggishly. On the other hand, two committees namely core and technical committee formed by Bangladesh Bank to see the nitty-gritty for launching international factoring are working on it. It is expected that both domestic and international factoring will be offered and used with full potential to facilitate SMEs and export sector of the country to reach desired level of development of the economy.

Reference

Bakht, Zaid and Abul Bashar (2015), ‘Strategy for Development of the SME Sector in Bangladesh’, *Bangladesh Institute of Development Studies*, Dhaka.