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UNDERSTANDING FACTORING & TRADE CREDIT

Understanding Factoring and Trade Credit

WATERLOW PUBLISHERS

Foreword

I am delighted to welcome a further positive contribution to the spread of knowledge of factoring and its related services and trade credit.

The use of trade credit has been well established for centuries as an essential ingredient in trading, both within the domestic market and internationally. Offering credit to buyers brings with it a management responsibility which has perhaps not received proper recognition in the United Kingdom until recent years.

Factoring, introduced into the United Kingdom some twenty-five years ago, provides a means whereby many of the basic requirements involved in administering, protecting and funding the debtor asset are provided from one specialist organisation – the factor. Factoring and its related financial services are now widely used by a growing number of organisations varying from small to large companies.

The volume of factoring business in the United Kingdom has grown at a compound rate of 20% plus per annum over the last few years. This success has attracted many new institutional investors into factoring, with many new factoring companies emerging. The major requirement now is for a wider availability of the skills and expertise needed within the factoring industry, and it is in this context that I welcome this book.

Michael A. Maberly
Managing Director
Credit Factoring International Ltd

Introduction

In every decade there is a change in the fortunes of one or more of the different types of industrial and commercial finance. In the 1950s, the demand for finance for expansion of British industry was met largely by the banks through overdrafts and by the Stock Exchange through equity participation. In the 1960s the finance companies led the way with the growth of industrial hire-purchase for productive equipment. In the 1970s the leasing companies were spectacularly successful. Throughout the whole of the last thirty years there is one group of financiers who have grown quietly and steadily – the factoring companies.

For a variety of reasons, all of which are explored in our book, we feel that the last part of the 1980s will see the explosion of factoring as the fastest growing financial facility. It has all the qualities associated with a facility which industry needs: it provides a convenient service, by relieving the industrial companies of the burden of their sales ledgers and chasing overdue accounts, leaving them free to concentrate on production and distribution of their products; factoring provides cash advances on the book debts, without encumbering other assets of the company, and once the facility has been agreed, it expands automatically to cope with the client's growth. Along the way, factoring provides expertise in credit assessment and access to export information. All in all, a service which has been undersold and under-estimated in the past. Factoring has grown without artificial inducements. It has developed steadily over nearly thirty years and therefore has an inherent stability which we find attractive. The industry itself is well-organised and well able to cope with what we expect to be rapid growth in the next decade.

During the next few years, we expect the facility to receive the recognition which it deserves. In 1984, questions about factoring were included in the examinations of the Institute of Bankers, the Institute of Credit Management and the Finance Houses Association. The

Association of British Factors runs an annual Diploma course for people within the factoring industry and it is abundantly clear that the whole of the financial sector now recognises the potential of factoring. As its importance increases, so will the need for expert personnel increase and we hope that this book will make a substantial contribution to that training need. We see it as likely too that accountants within industry and commerce will be asked with increasing frequency to evaluate factoring as opposed to continuing the old-fashioned process of running an in-house sales ledger and collection department. Lawyers will be asked to examine the legal position and, as we point out, the last review of the relevant law was in 1873. We hope that this book will help them too by describing the background and the current position so that the way forward can be more accurately charted.

In preparing the text we have been encouraged by the members of the Association of British Factors and the Association of Invoice Factors who have assisted us throughout by allowing us to visit their offices, interview their staff and obtain material which would otherwise not have been available to us. We are grateful to all of them. Some people assisted us in a dual capacity, both as officials of the Association of British Factors and as executives of their own companies. We are particularly grateful to Roger Pilcher and Malcolm Smith, former Chairmen of the Association and Chief Executives of Credit Factoring International and Alex Lawrie respectively and to Michael Burke, Secretary of the ABF.

Several people helped us exceptionally, including Peter Johnson and his staff at Griffin Factors/Forward Trust Group, Michael Maberley and his staff at Credit Factoring International especially Tricia Wheldal, and many people at Alex Lawrie, including Judy Williams, A. J. Browne, H. Bartlett, Steven Gibben, C. G. Roebuck, W. Roach, Roger Riley, who helped on the accountancy aspects of factoring, H. J. Betts of International Factors, and L. M. Bland and Peter Webb of Century Factors. We would like to thank John Chesterfield, Chairman of the ABF's Education Committee for what turned out to be splendid guidance on the shape of the book and for his assistance in relation to the ABF's Diploma.

We wish to acknowledge not only the practical help provided by all of these persons but also the friendly and co-operative way in which they handled what to them must have been basic questions. We hope that they like the book.

In addition, thanks are due to our friends in the academic world, particularly Professor Cyril Tomkins, Head of the School of Management at Bath University and Professor J. R. S. Revell, Director of the Institute of European Finance at University College of North Wales, Professor Tony Guest of Kings College, University of London and Professor Roy Goode, OBE, of Queen Mary College, University of London, for their help and guidance over many years.

Finally, our long-suffering spouses, Trevor and Muriel, deserve recognition for their patience and understanding and for their help in proof reading.

Whilst we have had enormous help from all of these persons in preparing the book, any errors which still remain are of course entirely our fault.

Susan Crichton and Charles Ferrier

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1 History and Background

> "Factor: An agent, particularly a mercantile agent; one of several elements which contribute to a result."

This is the dictionary definition found between "Factitive" (. . . describing an action which produces a new condition in the object) and "Factorage" (the Factor's fees or commission). According to the same dictionary, a factory is an establishment where Factors in foreign countries reside to transact business for their employers and factorship is the business of a Factor. Confused? We hope you won't be by the time you have completed your study of this work.

At various times in the past there have been false dawns in the development of factoring. Many people expected factoring to take off in the 1950s but, quite unjustly, it got the reputation for being expensive. That was overcome in the 1960s and 1970s, when higher interest rates generally made factoring look positively attractive. In the 1970s the growth of leasing as the main type of industrial finance of equipment drew attention away from factoring. But attention is likely to be focussed firmly on factoring during the next decade and its value to the economy will increase accordingly.

The first of the myths about factoring was that any company which employed a Factor must be at death's door. That has patently proved to be untrue, otherwise the factoring companies themselves would by now be dead. In fact, factoring companies are best able to help young growing industries which have the greatest potential and which need the service element of factoring as much as the financing element. A company which did not look as though it would survive would be very unlikely to get a Factor to take it on. It is expensive for a Factor to evaluate a sales ledger and they will not waste time doing so on a company which will not be using their service for many years ahead.

In forecasting the future, the best starting point is the past. And so we hope that readers will find the following historical notes of interest.

BACKGROUND

Trade credit has been granted by merchants for almost as long as there have been merchants. Evidence exists that in Babylon, Egypt and Assyria over 3,000 years ago there was credit from merchants to buyers to stimulate trade. That trade credit is a 'good thing' is not in doubt. Without it, the volume of trade which would be possible would be substantially lower than it is. And it is stimulated by the availability of factoring services, which reduce the risk to industry and lay greater responsibility on the financial sector. In many ways, factoring is the most worthy of all financial facilities. More than any other it is linked directly to increasing the volume of trade which can take place and its importance should not be under-estimated. The availability of factoring and invoice discounting does not only stimulate trade in general. It tends to be of greatest value to small and medium-sized companies which are seeking to expand and it therefore makes a direct and immediate contribution to the well-being of the economy by assisting traders to maximise their potential through not being constrained in their provision of reasonable credit terms.

The several elements of service provided by factoring companies did not all suddenly come together. They developed separately in different ways and were brought together in the 1950s and 1960s in one complete package. It is instructive to examine the histories of each separately.

Trade Credit

Trade credit itself has been in being for many thousands of years. It is a system whereby buyers of goods are given time in which to make payments. In some cases, the goods can be sold to retail buyers and the cash received from them before the merchant's term of credit expires. In that way, the transaction can be 'self-liquidating'. It is the way many retailers operate today. They take credit from their suppliers but insist on cash (or near-cash) from customers. They very often then have a cash surplus for a time before the merchant or manufacturer has to be paid. Although it is outside the scope of this book, it is worth mentioning in passing that retailers are a major source of finance to the money markets, and so, in a roundabout sort of way, their placing of money on deposit helps the manufacturing industry, who are major borrowers from the markets.

In any consideration of trade credit and factoring, it is important to

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means that people will buy more clothes, and the tailor will receive more and more orders. So the whole process has the effect of increasing the wealth of the nation – and all through starting with a period of credit. Of course, once this period is established it has to be kept in being, otherwise the level of activity would fall. There could, for example, be a credit squeeze, during which a government reduces the amount of money in the economy. When that happens, either prices have to fall or the level of business declines.

Factoring companies contribute in two main ways: expertise and funds. By providing a specialist service, greater expertise can be brought to bear. The tailor is released to get on with making clothes. The financial experts do what they are best at – collecting money. The factoring companies also provide finance to the tailor more quickly than he would have received otherwise, at more or less the same cost as he would incur dealing with a bank. So the tailor is relieved also of the worry associated with customers perhaps not being able to pay. And he has adequate funds to pay his own suppliers – for cloth and other materials, distribution expenses and so on – and, of course, the wages of his staff.

The four main elements in a factoring service are ledger and collection service, finance, insurance of debt and advice.

Historically, the expertise of ledger and collecting services have been gained through the banking system, linked with the experience of credit managers in industry and commerce. The business of managing credit is highly specialist and requires many attributes not always associated with credit. The main skill needed is that of being able to assess people, particularly their ability to pay and also their willingness to pay. Many credit managers have fallen foul of the debtor who has convincing reasons for delaying payment and the reaction of some is to take a tough line with all debtors. That does not work, of course, and is where factoring companies can in particular ease the wheels of business. They persuade debtors to pay in a tactful way. After all, they cannot afford to upset their clients' debtors. They would soon have no clients. So expertise has to be gained over many years.

The ability to provide finance is a major pre-requisite of a factoring company, of course, but it is not nowadays necessarily the main attraction. What the client needs more than finance is the expertise of the factoring company in handling customers. But the major factoring companies do employ specialist bankers who look after their own finances, and their expertise dates back to the days of the goldsmiths in London coffee houses.

Insurance

The days of credit insurance for all debts may be fast approaching. The leading insurance companies for many years stayed out of this area, mainly because they did not have the necessary specialist knowledge. Now, however, the credit insurance and factoring companies together have a major bank of knowledge upon which the insurers can draw. It is difficult to research the early days of debt insurance because there are few records. Certainly, it must go back at least to Roman times, when it was not uncommon to pass debt notes from one person to another, at a discount. That was virtually the beginning of invoice discounting as we know it, though there may also have been some element of recourse (that is, if the debtor does not pay, the person giving the note will) at that time. Historically the nearest to true modern invoice discounting may be the bill of exchange, a banking instrument used extensively in the early eighteenth century to finance major purchases and to provide evidence of major debts. The discounting of bills of exchange was a major part of the work of banks and other financial institutions in the eighteenth century – though of course if one debtor in the chain defaults, the holder of the bill can sue any of the previous holders (subject to the rules in the Bills of Exchange Act 1882). Thus there was additional protection not available (usually) to today's Factors and credit insurers.

Debt Collection Agencies

It is difficult to trace the early history of debt collection agencies. No doubt there were agencies in the very early periods of trading, which would undertake the following main functions of such agencies :

writing to debtors
providing legal advice
tracing debtors who have absconded
providing credit information
providing training courses for credit management staff

However, these agencies have little or nothing in common with the way that Factors operate, and the nearest historical equivalent we have found are the *del credere* agents who operated in many markets in the 17th and 18th centuries. Broadly, a *del credere* agent gets a higher commission than other agents by not only finding customers for a company's goods or services but for guaranteeing that, if they do not pay, the agent will meet the bill. This was an important stimulus to