Appendix A – A Brief Overview of the FCI Two-Factor System

1. Why Have Two Factors?

The problem

A factoring company intending to serve exporting sellers needs to provide services in a wide range of countries. It needs to offer an efficient service to the seller, while managing the factoring risk. It is impractical for a single factoring company to set up its own operation in each country to which the factor's clients wish to export. The costs are high and the factor would need considerable local knowledge which he can only develop over time.

Two-factor solution

This problem is FCI's main focus. One solution is to co-operate with factors in the buyer's country and this is known as the *two-factor system*. The factor in the seller's country (the Export Factor or EF) establishes a relationship with a correspondent factor in the buyer's country (the Import Factor or IF). Each factor has relevant local knowledge and expertise and can operate in the way most appropriate for that home market. A sound operational system, especially for communications between the two factors, ensures that the relationship works efficiently for the good of the client.

The aim

The service elements of international factoring include sales finance, buyer credit protection and collection of invoices. The aim of the two-factor system is to combine the strengths of the EF and IF to provide these services internationally in a way that is reliable, safe and competitive.

2. Roles and Responsibilities

Who are the parties involved?

In addition to banks and sellers' agents, there are four main parties involved in the two-factor system:

Seller

Sells goods or services to the buyer in another country.

Receives a factoring service from the EF.

Often called *supplier*, *client* or *exporter* but FCI adopts the standardised term *seller*.

EF in the seller's country

Has responsibility to the seller to whom he provides a service.

Has responsibility to the IF for the seller's performance.

IF in the buyer's country

Has responsibility for the buyer from whom he collects payment and whose payments he guarantees.

Has responsibility to the EF.

Buyer

Receives goods or services from the seller.

Pays the IF for the invoice from the seller.

Functions of international factoring

The basic functions of international factoring are the same as for domestic full-service factoring:

- ✓ Financing the seller
- ✓ Credit cover
- ✓ Accounts receivable (A/R) administration
- ✓ Collection of outstanding invoices.

Who is responsible for what?

The EF and IF divide these functions between them on the basis that:

- ✓ The EF has responsibility for the seller. He finances the seller and provides the A/R administration.

The EF is best placed to monitor and handle the communication with the seller. He has the contract with the seller in his own country and he may also factor the seller's domestic sales.

- ✓ The IF has responsibility for the buyer. He provides credit covers to the EF and collects the outstanding invoices.

The IF is based in the buyer's country and is best placed to undertake credit assessments and communications in his home market.

- ✓ The EF and IF have responsibilities to each other.

An Interfactor Agreement regulates their respective responsibilities. It does so by binding the EF and the IF to abide by the GRIF, the Rules of Arbitration and the edifactoring.com Rules.

3. How the Two-Factor System Works

Flow of transactions

The flow of basic transactions between the parties in the two-factor system is described by the following fourteen steps.

1 The EF and IF agree to work together.

2 The seller identifies a prospective buyer.

3 The seller approaches the EF about factoring services, signs a contract and asks for credit covers.

4 The EF asks the IF to assess the buyer for credit-worthiness.

5 If the buyer is credit-worthy, the IF gives a credit cover.

6 If the buyer agrees to buy the goods or service, the seller despatches the goods or provides the service. The seller also sends the buyer the invoices. Each of these has a notice printed on it, assigning it to the IF.

7 The seller assigns the invoices to the EF and sends copies of the invoices.

8 The EF assigns the invoices to the IF and sends invoice details.

9 The EF finances the seller for part of the invoice value.

10 On the due date of the invoice, the buyer pays the IF who transfers funds to the EF.

11 If the buyer does not pay on time, the IF starts his collection procedures.

12 If the buyer does not pay within 90 days of the due date, the IF must pay under approval .

13 The EF transfers the payment for the invoice to the seller, after deducting the pre-financed amount.

14 The buyer may raise a dispute that can only be resolved with the seller. Both factors help to achieve this.

Credit risk protection

This is one of the most important aspects of the service the two-factor system provides. The EF offers the seller protection for credit risk in case the buyer does not pay invoices within 90 days of the due date:

- ✓ The EF covers himself against the credit risk by obtaining credit cover from the IF.
- ✓ The EF gives the seller the same credit cover for the buyer.
- ✓ Ultimately the IF therefore carries the credit risk of the buyer.
- ✓ The EF carries a risk on the IF.

Seller exports to more than one country

The seller has only one export factoring contract with one EF. However, the seller will usually sell to more than one buyer and to more than one country. The EF therefore chooses one or more correspondent IFs for each country to which the seller wants to export. In some cases, one IF may cover more than one country. Each IF correspondent takes care of all the buyers that he agreed to cover in his country or countries.

4. Advantages

Seller

The two-factor system has many advantages for the seller:

- ✓ One export factoring agreement covers the credit risk of his sales to several buyers in several countries.
- ✓ He can deal with the EF in his own language.
- ✓ The factors sort out any payment problems with the buyer, leaving the seller free to preserve a good business relationship with his customers. However, the seller will need to be involved if there is a dispute.
- ✓ He does not need a detailed knowledge of the law or trade customs in the buyer's country.
- ✓ Through the EF and IF, he can obtain valuable information on the standing of foreign buyers, on trade customs and market potential.
- ✓ He can deal on open account terms and avoid the cost of letters of credit.

Buyer

Dealing with a factor in his home country offers three major benefits for the buyer:

- ✓ All communication is in his own language.
- ✓ He can pay invoices locally in the most convenient way. He chooses the option that gives cleared funds, for that particular currency, most quickly and cheaply.
- ✓ He can deal on open account terms and avoid the cost of letters of credit.

EF

The two-factor system offers benefits to the EF:

- ✓ He is able to offer his sellers an export factoring service in a large number of countries without setting up an operation there himself.
- ✓ The IF takes on the credit risk of the buyers in the destination country.
- ✓ The IF takes care to collect payments from the buyers and, if necessary, to take legal action against them.

IF

The two-factor system is an excellent way for the IF to generate new business and increase his portfolio of buyers, thus spreading the credit risk.

5. Disadvantages

Risks

The strengths of the two-factor system are also the source of its weaknesses, namely:

- ✓ The reliance the IF must place on the EF's ability to identify suitable sellers.
- ✓ The reliance the EF must place on the IF's dealings with the buyers.
- ✓ Co-operation between the EF and IF.

An EF may have a seller who exports to 20 countries. If the IF in just one of those countries gives poor service, then the EF could lose the export factoring contract. This results in loss of business for the EF and all his corresponding IFs.

Similarly, poor co-operation between EF and IF or failure to follow the FCI interfactor communication procedures can result in the loss of business.

There is also a credit exposure on the IF which the EF must assess and manage.