Exploring the value of factoring as a finance option for small enterprises in emerging economies

A Tanzanian case study

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Abstract**:** *Using Tanzania as a case study, this paper explores the value of factoring as a finance option for small enterprises in emerging economies. Based on identified challenges, the paper develops a policy framework that could facilitate the growth of the factoring industry in Tanzania. Within the boundaries of the developed framework, the paper concludes that there is a need for the Tanzanian government to create a favourable legal and regulatory environment, foster economic growth, support the formation of factoring associations, strengthen credit information infrastructure, and create an overall favourable tax structure that is supportive of the factoring industry. Furthermore, the paper argues that the ongoing global growth in factoring provides a unique opportunity for fostering the growth of factoring finance in emerging economies through cross-border factoring.*

Keywords**:** *factoring; small enterprise; emerging economies; Tanzania*

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Small enterprises, which represent a significant proportion of local communities' businesses, experience many problems and market challenges in their efforts to develop and grow (Storey, 1994). Of the several difficulties that affect the growth of these enterprises, financial problems in the form of credit rationing and finance gaps are among the major ones (Stiglitz and Weiss, 1981). While access to finance presents problems to many small enterprises in general, this paper addresses only one of these financing problems, namely the management of working capital. In particular, it focuses on the difficulty small enterprises face in financing their production cycle, since after goods are delivered most buyers stipulate payment in 30 to 90 days.

Around the world there has been a rapid growth in the use of factoring as a means of mitigating this problem. Factoring is a form of asset-based finance in which the credit extended is based on the value of the borrower's accounts receivable. Unlike the other main form of asset-based finance, asset-based lending, receivables are purchased by the factor rather than used as collateral for a loan.

Factoring therefore offers an additional option to small enterprises in addressing problems of access to and management of working capital. Although little systematic work has actually been undertaken to establish whether this is the case, from the supply side it might be expected that these enterprises could contribute a significant market for the sale of factoring and invoice discounting services. This paper, using a Tanzanian case study, explores the value of factoring as a finance option for small enterprises in emerging economies, and identifies the challenges that possibly hinder the growth of this industry. Based on the challenges identified, the paper develops a policy framework that could facilitate the growth of this industry. Furthermore, the paper explores the potential of the global growth of the factoring industry in fostering the growth of this industry in Tanzania through cross-border factoring.

This paper is organized in eight sections. A theoretical and empirical review of small enterprise financing gaps is presented in the next section. This is followed by a discussion of the role and benefits of factoring as a finance option for small enterprises in section three. Section four presents an overview of the global growth in factoring, followed by a review of the factoring industry in Tanzania in section five. Section six discusses the challenges identified for the factoring industry in Tanzania. The policy framework developed for facilitating the growth of the factoring industry in Tanzania follows in section seven. The paper concludes in section eight.

Theoretical and empirical review of financing gaps

Although many difficulties face the small enterprise sector, financial problems in the form of credit rationing and finance gaps seem to overshadow the other barriers that hinder this sector's survival and growth. Small enterprises in developing economies in particular continue to experience difficulties in accessing external financing. The existence of these difficulties directs many enterprises to seek different financing alternatives for their operations.

The notion that small enterprises face credit rationing and finance gaps in their relationship with financial institutions has been popular for decades. Many researchers over the years have covered the theoretical and empirical debate pertaining to the existence of credit rationing and finance gaps for small enterprises (Storey, 1994; Mason and Harrison, 1993; Binks and Ennew, 1996). The available evidence indicates that the theoretical debate hinges upon the principal and agent theory and asymmetric information, with the resultant potential for adverse selection and moral hazard (Stiglitz and Weiss, 1981; De Meza and Webb, 1987; Cressy, 1996). Similarly, empirical evidence has been collected from a wide variety of surveys. In Tanzania for example, these difficulties mainly seem to confront small enterprises (Satta, 2003).

Difficulties in accessing external finance to a large extent has a negative effect on small enterprises' growth, since, with the exception of trade credit, most external financing to these enterprises is extended by financial intermediaries. Private debt markets usually offer highly structured, complex contracts to informationally opaque small enterprises. The severity of financing gap problems partly depends on the magnitude of information opacity in small enterprises and on the strengths of lending technologies to mitigate these problems. Many small enterprises are therefore likely to confront problems when attempting to gain access to external finance because of the natural difficulties that financial institutions face in producing consistently reliable risk assessment processes. Equally significant for the severity of financing gap problems is the lack of collateral owned by most small enterprises for obtaining bank financing. In an attempt to alleviate such problems, many enterprises have sought to pledge and finance an important element in their working capital, that of accounts receivable, through factoring.

While small enterprises report problems in terms of access to external finance, delayed payment, management of working capital, and cash flow control, it is the underlying causes of these difficulties and the most appropriate strategies for their alleviation that are the subject of vigorous debate. Although access to finance and financial control present problems to many small enterprises, the debate underlying causality is not relevant for the purpose of this paper. This paper rather attempts to answer the question: *What are the key policy issues that may strengthen factoring as a finance option for small enterprises in Tanzania?* The answer to this question is particularly relevant in developing economies whose private sectors are young and continuing to develop and expand.

The role and benefits of factoring in financing small enterprises

Factoring involves a process in which a specialized firm assumes the responsibility of the administration and collection of the account receivables for its clients. It is a form of short-term commercial financing based on the sale of trade debts at a discount, or for a prescribed fee plus interest.

The factoring process involves the interaction of three economic agents (Figure 1). These are the *client firm*, which provides its customers with goods or services, the *customer firm*, which buys goods and services from the supplier (*client firm)*, and the *factoring firm*, which substitutes cash for accounts receivable to/from the *client firm*. Specifically, factoring is a form of asset-based finance in which the credit extended is based on the value of the borrower's accounts receivable. This value is the payment owed by the borrower's customers.

Under asset-based finance, the credit provided by a

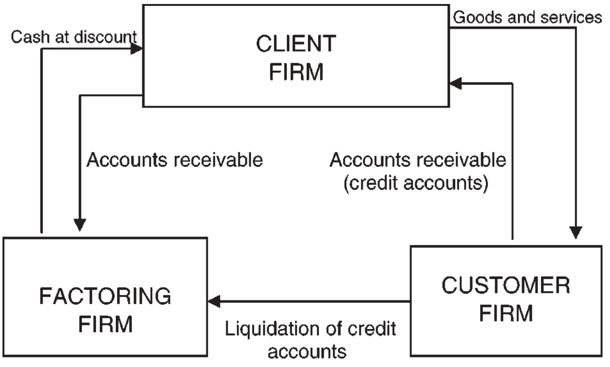

Figure 1. The factoring process.

Table 1. Factoring turnover of emerging economies: 2000–03 (million Euro).

Countries	Factoring turnover	Factoring as a percentage of GDP	3-year growth rate (%) of factoring turnover (2000–2003)
Chile	2,247.80	3.19	32.08
Czech Republic	876.10	1.43	87.06
India	549.30	0.11	243.62
Slovakia	188.60	0.83	140.00
Slovenia	48.10	0.22	161.54
Thailand	1,136.40	0.83	12.38
Tunisia	120.17	0.56	250.00

Source: extracted from Klapper (2006).

lender is explicitly linked on a formula basis to the value of a borrower's overall creditworthiness. This explicit link is continuously managed so that the value of the underlying assets always exceeds the amount of the credit. Unlike the other main form of asset-based finance in asset-based lending, the receivables are purchased by the factor rather than used as collateral in a loan. In this case, the title and ownership of the receivables shifts from the seller to the factor.

Relative to other lending products such as financial statement lending, relationship lending, asset-based lending, credit-scored lending and trade credit, factoring has several advantages over other types of lending. In a factoring relationship for example, the credit is primarily based on the quality of the underlying accounts and not on the quality of borrower. Furthermore, factoring involves more than just financing, as it generally includes two other services: credit and collections. The bundling of services is one of the advantages of factoring over other types of lending, particularly for small enterprises that do not have the expertise or resources to manage their credit and collection activities. Factoring, as a finance option for small enterprises, also affords businesses access to finance based on their growth in sales, as compared with bank loans and overdrafts, which are normally available against an accumulation of tangible assets.

Another equally important benefit of factoring over other types of lending is that it is useful for providing financing to high-risk, informationally opaque borrowers, because underwriting is not based on the risk of the borrower. In other words, factoring allows high-risk enterprises to transfer their credit risk to their high-quality buyers.

Global growth in factoring and its potential in emerging economies

Although the importance of factoring varies considerably around the world, it occurs in most countries and is growing especially quickly in many emerging economies. Around the world, factoring is the dominant form of asset-based finance and an important source of external financing for small and large enterprises. Specifically, Bakker *et al* (2004) note that in recent years factoring has experienced phenomenal growth and has become an important source of financing, particularly for short-term working capital for small, medium and large enterprises. In 2004, for example, the global volume of factoring was over US$860 billion, representing an increase of 88% over 1998 (Klapper, 2006). Table 1 demonstrates the increasing role factoring is playing as a finance option for small enterprises in emerging economies. This rapid growth provides a unique opportunity for international factoring companies to venture into countries where factoring industries are underdeveloped. Similarly, recent evidence, which indicates an increase in the use of trade credit in countries where greater barriers to small enterprise financing exist, further strengthens the potential of factoring as a finance option for small enterprises in emerging economies (van Horen, 2004).

The factoring industry in Tanzania

While there has been a significant shift in bank lending from the public sector to the private sector in Tanzania during the last decade (Figure 2), most of this shift seems to be going to medium and large enterprises. This suggests a significant finance gap and the potential for factoring to fill it. Although in developed countries, equity markets play a significant role, in Tanzania this is not the case due to the financial sector being banking-oriented (Satta, 2004). For the moment, intermediated finance still dominates capital market financing even for large enterprises in Tanzania. Given the fact that bank credit is insufficiently available to small enterprises in Tanzania, factoring could be an important source of finance for these enterprises.

While there has been global growth in the factoring

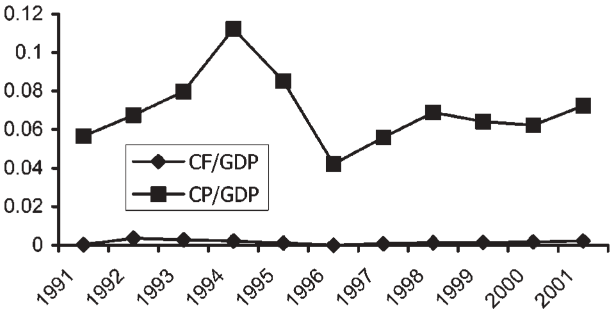

Figure 2. Growth comparison between C_f*/GDP* and C_p*/GDP*.
Notes: C_f*/GDP* = share of claims by the banking sector on small enterprises to GDP; C_p*/GDP* = share of claims by the banking sector on the private sector to GDP.
Source: Satta, 2006.

industry of developed countries, this has not been the case for Tanzania. A recent study by Klapper (2006) on the role of factoring for financing small and medium-sized enterprises covering 48 countries around the world found that there had been no significant growth of the factoring industry. This was not only the case in Tanzania, but also in several other developing economies. Available evidence further casts doubt on the level of informal factoring services in Tanzania due to a lack of mutual trust among small enterprises (ILO, 2001). Facilitating the growth of the factoring industry in Tanzania in order to expand the sources of finance to small enterprises therefore seems to be a logical step. One way of achieving this is the creation of a favourable factoring environment that will allow entry to international factoring companies as well as foster the growth of domestic factoring companies.

Challenges facing the growth of the factoring industry in Tanzania

The growth of the factoring industry in Tanzania is dependent, among other things, on the presence of a favourable environment. Key issues that have an influence on the factoring environment include taxes (VAT); regulations (supervisory authority, cross-border factoring regulations, factoring licences, laws on initial capital, etc); legal code, security laws permitting lenders to collateralize working capital assets such as accounts receivable; a recording system to register liens on accounts receivable; and general barriers to factoring growth.

Tax treatment of factoring transactions often makes factoring prohibitively expensive. In some countries, interest payments to banks are tax-deductible, but the same does not apply to the interest on factoring arrangements. Although the service fee associated with factoring should typically be subject to value added tax (VAT), the financing (if taxed) removes the presence of a level playing field between factors and other lenders. Similarly, tax treatment for factors making provision for bad debts/receivables is equally important as for other lenders (eg banks). In most emerging economies, however, they are not recognized as formal financial institutions and not treated as such (Bakker *et al*, 2004).

A supportive legal and regulatory environment is also likely to encourage the growth of the industry. A factoring act or any reference in law (civil code) that legally recognizes factoring as a financial service is important as this legitimizes the factoring industry.

Weak information infrastructure such as lack of credit information bureaux that provide general data on payment performance similarly pose another challenge for the growth of the factoring industry in Tanzania. Bakker *et al* (2004) argue that access to credit information increases not only the provision of bank credit, but greater access to financing from non-bank sources as well.

Existing empirical evidence also indicates that factoring is significantly larger in countries with greater economic development as measured by per capita GDP (Klapper, 2006). In a recent study, using a sample of factoring turnover as a percentage of GDP for 48 countries around the world, Klapper (2006) found that factoring was more common when the economy was growing and sales – and subsequently the amount of trade credit extended and receivable recorded – was larger. This evidence provides support for the theory that enterprises will have larger sales and a greater volume of receivables to factor when the economy is healthy and growing. The evidence that greater economic development is strongly linked to the growth of the factoring industry possibly poses one of the greatest challenges to Tanzania.

Policy framework for improving the factoring environment

Based on the challenges identified for the growth of the factoring industry in Tanzania, this paper develops a policy framework that addresses these challenges in an effort to create a favourable environment. As in any other emerging economy, a favourable small-enterprise financing environment in Tanzania may play a crucial role in determining the mix of available financing products and the importance of factoring in that mix. Given the importance (and newness) of factoring as a source of small enterprise financing, a number of policy measures (Figure 3) are necessary to create a favourable environment that will facilitate the gradual establishment of local factoring companies in Tanzania and allow the

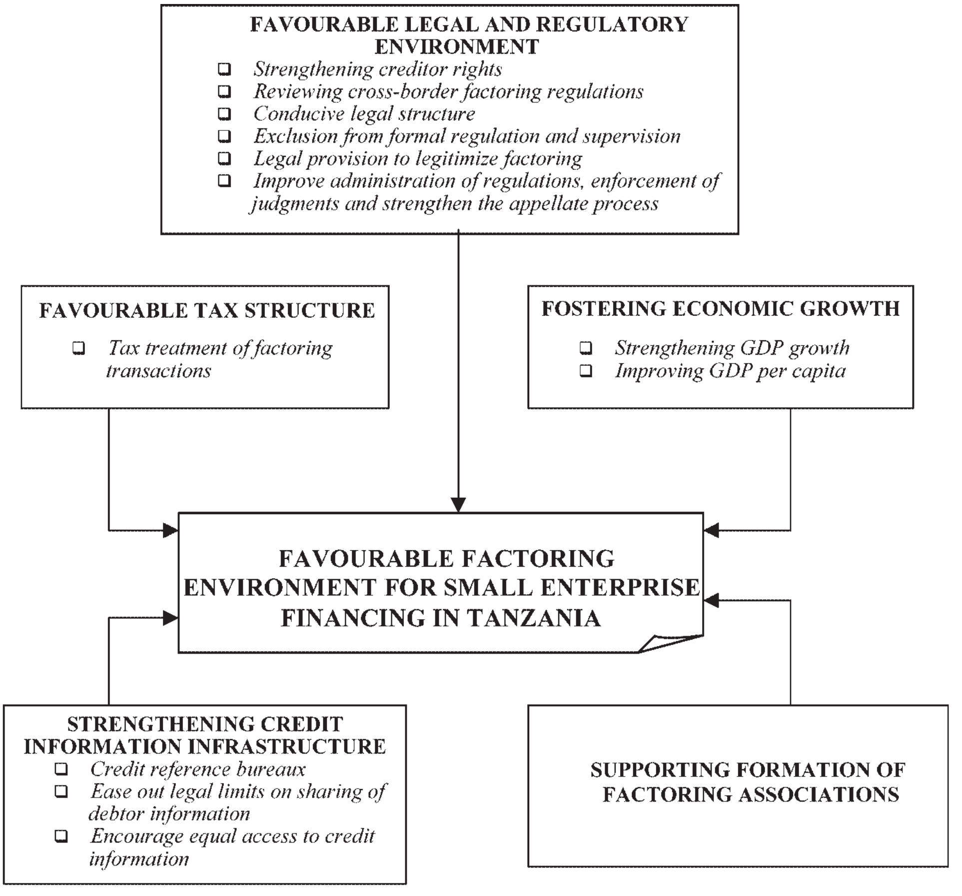

Figure 3. Policy framework for creating a favourable factoring environment in Tanzania.

entry of international factoring companies. The policy measures that make up this policy framework are discussed below.

Improving the legal and regulatory environment

This policy measure covers several relevant issues. There is a need for the government to strengthen creditor rights by upgrading/reviewing existing bankruptcy and collateral legislation and infrastructure to meet international best practice. A review of cross-border factoring regulations is also important. All these measures are necessary to allow for participation of international factoring companies. Furthermore, a factoring act or any reference in law (civil code) that legally recognizes factoring as a financial service in Tanzania is important, as this will legitimize the factoring industry. Such a legal reference is likely to boost the confidence of factoring companies.

The strength of a country's rule of law affects the level of mutual trust in transactions among ordinary citizens and enterprises. Existing empirical evidence shows that the level of trust influences the terms on which banks lend to small enterprises (Harhoff and Körting, 1998). Recent findings in Eastern Europe similarly indicate that there is a positive association between the rule of law and the level of trust (Bakker *et al*, 2004).

Although progress has been made in Tanzania in resolving commercial and financial cases by establishing a commercial division of the high court, there are still a number of deficiencies (Finnegan, 2001; ILO, 2001). The establishment of the Commercial Court in Tanzania, which occurred a few years ago, is but one part of a broader legal system reform initiative. Further progress is necessary in areas such as government administration of regulations, enforcement of judgments, and appellate review, which need to be implemented in an efficient manner if the legal environment is to become favourable for factoring companies. Furthermore, no matter how strong a country's commercial law, lien registration and bankruptcy law, they will have limited impact on credit availability if they are not enforced in a timely, predictable and uniform manner. Progress, therefore, is also required on this front if a favourable environment for factoring services is to be created in Tanzania.

Since factoring companies do not take deposits, it is also appropriate for the government in Tanzania not to subject them to government regulation and supervision. The government could instead refer factoring to any relevant legislation, civil or commercial code so that factoring companies are recognized as legitimate financial service providers on a par with banks and leasing companies. Consequently this could make factoring companies more visible in financial circles.

Need for a favourable tax structure

A positive consideration by tax authorities is required, particularly at this stage while factoring is still in its infancy. Equally important is the need for factoring companies to be allowed to make tax-deductible provision for bad debts/receivables. This is necessary if the playing field is to be levelled between factoring to be provided by bank subsidiaries or independent factors, and bank credit and factoring to be provided directly by banks.

Fostering economic growth

One of the basic conditions for facilitating the growth of the factoring industry is continued economic development, as measured by per capita GDP and GDP growth. While Tanzania has recorded a steady growth in its economy from 3.6% in 1995 to almost 6% in 2005, minimal growth has been recorded in terms of per capita GDP, which currently stands at US$330. Fostering the growth of the factoring industry requires additional efforts in terms of improving per capita GDP as well as GDP growth in general.

Strengthening credit information infrastructure

The strengthening of credit information infrastructure could partly be achieved by facilitating the development of commercial credit information bureaux. Another avenue for achieving this policy measure is by easing out the legal limits on the sharing of debtor information and by encouraging equal access to credit information by suppliers of credit. As the Tanzania Bankers Association has recently established a credit reference bureau, such initiatives, if supported by the appropriate national authorities, could have a significant impact on credit information infrastructure.

Formation of factoring associations

Once the factoring industry has picked up, the government may have to encourage and support the formation of domestic factoring associations. This is likely to give the industry a collective voice in discussions with government authorities on policy issues that hinder the growth of the industry.

Conclusion

This paper, using Tanzania as a case study, has examined the environment surrounding the factoring industry in emerging economies with a view to facilitating a favourable factoring environment for small enterprise financing. The key argument that emerges from this paper is that the growth of the factoring industry in Tanzania is partly dependent on the presence of a favourable environment. Based on identified challenges, the paper develops a policy framework that could facilitate the growth of the Tanzanian factoring industry. This framework covers a number of relevant policy measures: namely, the need for a conducive legal and regulatory environment, strengthening credit information infrastructure, fostering economic growth, the need for a favourable tax structure, and supporting the creation of factoring associations. The paper further argues that the ongoing growth of the factoring industry at the global level provides a unique opportunity for fostering the growth of factoring industries in emerging economies through cross-border factoring.

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