

Banks and Factoring? What Can They Be Thinking?

In the past ten years, numerous banks have gotten in and out of the factoring industry in one form or another. With the advent of several companies that sold "their concept of factoring" to banks, the industry has changed dramatically. Rates have been driven down to half of what they were twenty years ago and yet, in many cases, the risk has risen.

Banks have primarily concentrated on balance sheets and cash flow. They look at the credit history of the client company to determine if they can reasonably expect the client to service the debt so that their money will return to them with an interest percentage that is connected to prime or LIBOR. As collateral goes, they are most comfortable with a hard asset such as real estate or machinery and equipment. This is their mindset; it is what they have been taught to do.

Then, you have the factoring company. This is an entirely different mindset. They want to know the history and character of the principals of the client they are factoring, but their primary focus is the quality of the commercial accounts receivable. Their credit criteria are the strength and concentration of the account debtors, the opportunity for dilution and several other considerations which are necessary to consider every

day, on every piece of business. They understand that the reason they are being used is because a company's balance sheet does not meet the criteria of a bank's credit culture. They know and understand the risk involved and further understand that monitoring is the key to successfully getting their money returned to them.

So, how do these two cultures reconcile their different mindsets? Banks have been sold a false

concept (and many have paid a high price for the learning experience) by companies that promise them the high return on their money without fully explaining their risk, nor giving them the proper training and tools to properly carry out the daily duties and responsibilities of the factoring company. These companies have very derisively been called "factor in a box" by the factoring companies that know the truth and the high risk that is involved. Banks have been sold on this false concept of "Just use this software and you too can be getting 24%-36% APR on your money, just like those factoring companies are getting." Just use our software and training program and we will generate business for you and then our software and systems will protect you. Then the banks happily put a teller, or an up and coming junior bank officer in charge of the portfolio. Three months, six months, or a year later a deal goes south and the bank wonders what happened. The high returns have evaporated in the loss and they have a bad taste for the factoring industry.

In order for a factoring entity to survive and be successful, it must have three elements; #1 is capital, #2 is a method of sourcing companies for their product and most importantly, #3 is a proven method of getting their money back along with a reasonable fee for their efforts. Fail in the first area and you will prevent growth as having money available is the product, fail in the second area and your product (your money) sits on the shelf and you realize no gain, but fail in the third area and your company is doomed. .

For a bank to be successful in the factoring industry, they have to change their mindset and understand these basic principals. They already have the first element, capital and they have it at a much cheaper rate than most factoring companies. They usually have leverage on assets of 12.5 to 1 and their cost of funds is much cheaper. The second

element is, in most cases, right in their bank. They have a built in referral system which allows them to draw on their customer base to loan money when the commercial lending arm is just not able to justify the lending of money based on balance sheets. The third element is what gets them in trouble. Portfolio monitoring is critical and it is not an easy task. So much of the daily decision making process of advance rates, when or should you loan on an invoice is based on experience in the industry. Collateral must be monitored on a daily basis. The very reason that the balance sheet does not justify loaning money is why the monitoring is so critical. It requires a conscious effort on the part of the back room operation on a daily basis to ensure that the invoices are correct and valid; the debtors are properly notified and are of sufficient credit strength to justify an advance. Someone who does not have experience in the industry is going to lose money. There are just too many snares and traps which can and will trip you up, take your money and take it fast. Factoring is not rocket science but it does take experience and the education process can cost more than 8 years at Harvard Business School. Even the most experienced people will occasionally take a hit in their portfolio but the entire concept is to lessen the risk. The banks that understand this vital third element of success in the factoring industry have flourished, while the ones that have bought into the false theory of a software monitoring package and little or no controls have taken massive hits.

Another point that banks should take into consideration is the rate on return. The very fact of having bank rate funds is a very lucrative position to hold in commercial finance. The inherent costs of the backroom must be taken into account, but also the concept of "Risk versus Return". So often, with the strong competition that the industry is experiencing, rates are lowered and lowered significantly. Sometimes in the heat of competition for a deal, rates are dropped even further until it is way past the concept of "risk vs return". This industry sells a product and if you do not realize the return on the product, the industry as a whole suffers. Banks in the industry or entering the industry would do well to keep in mind that comparing the normal rate of return on a commercial loan to a factoring proposal is not the proper way to set your rates. Take all of the other costs in consideration of properly monitoring the loan and the risk of the proposal. Take advantage of the competitive edge that having the high leverage and the low cost of funds allows but cutting rates to the point of not being able to hold the proper amount in loan loss reserves is damaging to the industry as a whole and certainly will come back to haunt the institution that practices wholesale rate cutting.

So, as in most industries, the key to success in factoring is experience and following good solid industry practices. If banks can change their paradigm of thought, they can be successful, however if they buy the concept that has been sold by these "factor in a box" companies, they will continue to suffer losses and do damage to the factoring industry.

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