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Exploring the Viability of Invoice Factoring within Islamic Finance Frameworks

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Abstract: This study investigates the feasibility and viability of integrating invoice factoring into Islamic finance frameworks. With Islamic finance principles emphasizing ethical and Sharia-compliant practices, the study aims to assess whether invoice factoring, a widely utilized financial tool in conventional finance can be adapted to align with Islamic financial principles This process provides the business with immediate cash flow instead of waiting for customers to pay their invoices with the intermediation of the factor.

Through the study, we found that there is a Disagreement between Islamic Sharia scholars regarding the use of invoice financing, and this is what made a group of countries refrain from dealing with it, and another group has adapted it according to Sharia law to benefit from the advantages of this financial technique.

Keywords: Invoice factoring; Islamic finance; Sharia-compliant.

1. Introduction

The creation of the enterprise at the beginning of its life with the aim of achieving profit, but with the passage of time and entry into the market, the enterprise faces many difficulties and challenges that make its goal to continue and not go bankrupt. Among these difficulties the management of the treasury in terms of the necessity of agreeing on the creditors and debits in maturity dates in order to obtain liquidity, Enhance cash-flows when needed to cover obligations necessary to complete the production process, To meet operating expenses.

In these circumstances, invoice factoring appears to be an ideal solution because it eliminates the need to borrow from banks especially for short term.

1.1. Research Problematic

from this we ask the principal question:

Is there Viability of Invoice Factoring within Islamic Finance Frameworks?

1.2. Hypotheses

- Businesses that utilize invoice factoring experience a significant improvement in cash flow compared to those that rely solely on traditional bank loans.

- Higher costs associated with invoice factoring deter businesses from using this financing method compared to traditional loans.
- The invoice factoring is not permitted in Islamic finance.

1.3. Research Aims

- Enhance the understanding of the factoring and its different techniques.
- Rise the awareness about the alternative financing
- Show the new tools of Treasury management
- Have an overview on this industry in the world, size development
- Know the advantages and disadvantages of the factoring
- The role of technology to develop factoring
- Know the point of view of islam about this tool
- paving the way for future studies.

1.4. Methodology

We used the descriptive methodology to introduce the concept of invoice factoring and all related notions. The analytic methodology was used to explain the graphic representations and to Draw a conclusion from the arguments for and against the adoption of invoice factoring by Islamic finance.

2. the invoice factoring

2.1. Definition of invoice financing

a financial service called factoring, in which a business sells its accounts receivable –or invoices- to a third party and receives it cash immediately in exchange for a charge or fee.

Factoring belongs to the most popular business financing methods, along with bank loans and leasing. It is a financial transaction, where a specialized company (a bank or a debt-buying firm as a rule) buys the invoice issuer’s trade receivables. The idea behind factoring is to collect cash sooner than the contracted invoice due date falls. A short-term monetary trade receivable is purchased before the payment term expires. There are three parties to the transaction here:
• the factor, i.e. a specialised entity that offers factoring services and buys receivables from the goods/services seller’s invoices;
• the factorer, i.e. a company that sells its products/services, issues invoices and is entitled to claim payment for the goods offered;
• the debtor, i.e. the recipient of goods/services supplied by the factorer and committed to pay the factorer the amount due.

The rules of transaction are specified in the factoring contract. Until recently, factoring has been perceived as a service for major businesses only, although now it is targeting smaller companies, too, while invoice discounting is typical of smaller businesses, SMEs and micro-businesses. Factoring is a combination of services: financial liquidity management services, accounts receivables monitoring, insurance, etc (Dziuba, 2018).
Factoring is a financial transaction whereby a business sells its accounts receivable (i.e., invoices) at a discount. The factor usually charges the seller a service charge, which is interest based, depending on how long the factor must wait to receive payments from the

debtor.
Factoring differs from a bank loan in three main ways:
− First, the emphasis is on the value of the receivables (essentially a financial asset), not the firm's credit worthiness.
− Secondly, factoring is not a loan - it is the purchase of a financial asset (the receivable).
− Finally, a bank loan involves two parties whereas factoring involves three (Vasilescu, 2010).

2.2. Invoice discounting

Invoice discounting, is a different financial service. Its sole purpose is to finance a business through buying out invoices, without any other additional services. The factor purchases non-overdue and undisputable accounts receivable before their due date. The factorer sells their accounts receivable with a deferred payment date to the factor, who pays an advance rate of e.g. up to 90% of the invoice, reduced by a discount commission; the remaining part of the receivables is transferred to the factorer once the invoice is paid by the debtor. Invoice discounting is characterised by the reduced waiting time for payments and the ability to improve companies' financial liquidity, which is so crucial in the competitive business environment. Payment backlogs are eliminated. Simplified procedures translate into lower costs (as compared to factoring). The invoice discounting method (contrary to factoring) enables companies to fully control their finance. The "traditional" invoice trading market is a sizeable one: globally it reaches 3 trillion US dollars8.The segment consists mainly of factoring systems and, to a lesser extent, the accounts receivable discounting. Alternative systems – the subject of our considerations – are relatively new to the market (Dziuba, 2018).

- Recourse and non-recourse factoring agreements.
- Agreements for factoring with or without disclosure to debtors.
- Agreements for factoring with direct collection by the factor or collection by the client on behalf on the factor.
- Agreements which include or do not include the availability of finance by way of early payment by the factor.
- Agreements whereby the factor pays for each purchased debt (less any earlier payments) on a fixed maturity date or when payment is received from the debtor.
- Agreements which themselves provide the assignments of the debts or which merely provide for each debt to be offered to the factor.

as many factoring agreements combine features of some or all of these differences, there are a large number of combination s and permutations in the form of factoring offered by practitioners (Salinger, 2006).

2.3. History of invoice financing

There is no beginning date of this kind of deals but it has been developed in parallel with the trade as Allison Dunhum said it is not surprising that a code containing rules regulating the distribution of goods should also contain some rules Concerning rights and duties of debtors and creditors and persons who deal with them. Born from English practice and introduced in the 1960s in France.

The complex situation arising out of the insistence of some buyers that they must use and control goods before payment and the conflicting demand of the seller or lender that he must be able to assert a claim in the goods payment pending. Since possession in the lender until payment is incompatible with the borrowers requirement's, some credit device is needed which permits the buyer to have possession before payment and yet, at the same time, gives the lender a claim to the goods which he can assert if he is not paid (Dunhum, 1948).

2.4. The law framework of invoice factoring

Regarding the legal framework for regulating the domestic invoice factoring process and ensuring the rights of all participating parties, it varies from one country to another.

Factoring defined in ministerial decree in 1973 finds its legal foundations in pre-existing legal notions in French law: payment by subrogation and the assignment of debt, central operations of factoring. these notions are widely developed by case law (www.e-affacturage.fr, 2024).

the Algerian legislator adopted factoring by decree 93/08 and the national economic council referred to international factoring in 2000, however it has remained throughout the years a financial instrument that no one talks about in Algeria (Henni, 2009).

the Unidroit International Institute worked for the Unification of Private Law Unified rules regarding the process of transferring international invoices in order to subject the parties to the process.The work of the Institute led to the adoption of the "Ottawa" Agreement on 05/28/1988, which It aims to encourage international trade agents to resort to this technique by simplifying The legal system related to it(2016 ،ليلى) .

2.5. E-invoincing

The benefits of e-invoicing have been documented extensively by various organisations, ranging from the European Commission 'Expert Group on E-Invoicing' to independent research organisations. The focus of much of the research, however, is limited to the replacement of paper invoices with electronic documents. While paperless invoicing does drive near-term cost savings, there are often further benefits to be gained through more ambitious accounts payable (AP) automation projects. The introduction of electronic invoices into a financial supply chain can be a key enabler to other projects, such as evaluated receipts settlement, supply chain finance and category spend management, each of which can have even greater impacts on a company's income statement or balance sheet.

These broader AP automation projects, however, often require new approaches to financial supply chain management, such as reversing the flow of invoices from buyer to seller or eliminating invoices altogether. Corporations considering e-invoicing initiatives should think holistically about the financial supply chain benefits that can be achieved from related projects. Much can be learned from the experiences of large organisations in North America, Europe and Asia which are already implementing many of these approaches. (Keifer, 2011).

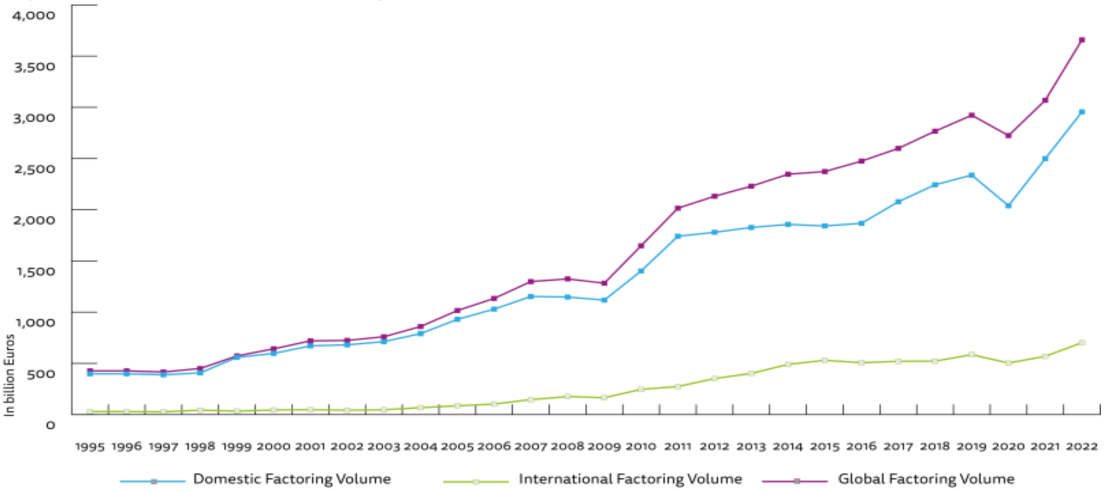
Invoice financing platforms: The focus of considerations here is a particular type of electronic platforms, which has been drawing much interest over the recent years, namely invoice and other corporate debt trading systems. They are referred to as P2P (peer-to-peer) invoice financing, or invoice trading platforms.They are usually auction-based and operate in the Internet environment. The systems subject to this analysis enable businesses to raise funding (working capital) in an alternative manner (Dziuba, 2018).

2.6. Invoice Factoring Market Size, Share & Growth

The global invoice factoring market was valued at USD 3.57 Trillion in 2022 and is poised to grow from 3.90 Trillion in 2023 to 7.88 Trillion, at a 9.2% during the forecast period (2024-2031) (https://www.skyquestt.com, 2024). The demand for alternate forms of finance for micro, small and medium-sized businesses contributes to the market expansion.

Machine learning (ML), natural language processing (NLP), and artificial intelligence (AI) are being used by many organizations, and they are predicted to create profitable growth opportunities for factoring during the projected period. With banks and Supply Chain Finance (SCFs) cooperating to benefit the client ecosystems, the COVID-19 pandemic was believed to bring a more cooperative approach.

Fig.1.Evolution of Global Factoring Volume (in Euro billions)



Source: https://fci.nl/en/industry-statistics

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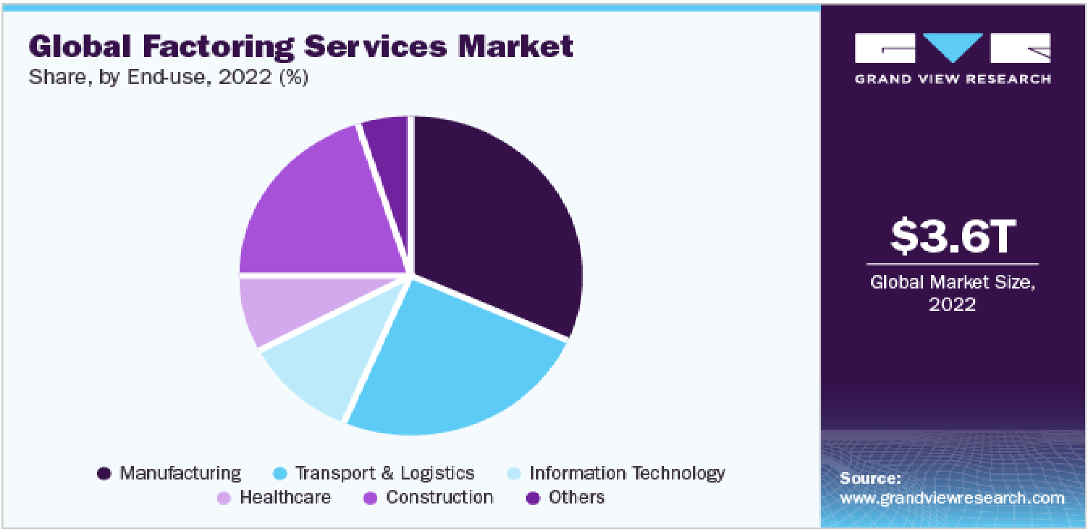
Through the graphical representation, we can notice the significant development in the volume of invoice factoring over the period studied. It has doubled 6 times in 30 years, noting that factoring was at the local level due to the absence of international law in this field. in 2003-2004 Where did operations begin at the international level after the Ottawa Agreement. After that The pace of increase has become greater, with a decrease noted as a result of the 2009 financial crisis and the Covid crisis in 2020-2021.

Fig.2.the global factoring by sectors



Source: https://fci.nl/en/industry-statistics

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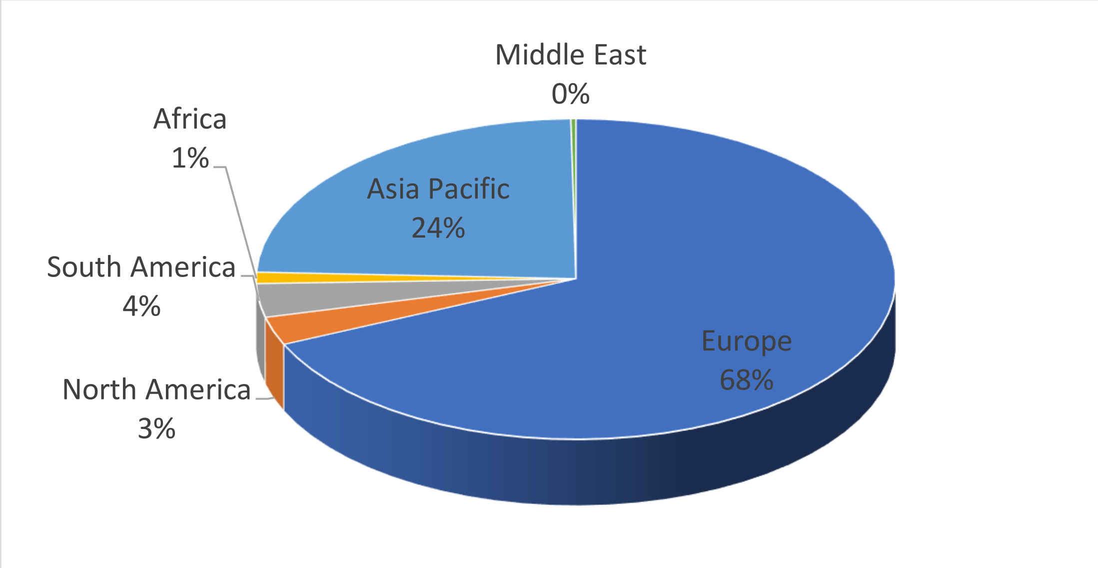
The beginning of factoring was in the manufacturing sector and it still the largest sector followed by transport and logistics, construction, information technology, healthcare and the other sectors.

Fig.3.the global factoring by regions



Source: Done by researcher based on: https://fci.nl/en/industry-statistics

We can observe that Europe dominate the factoring industry by 68%when France is number one with 421 500 million euro, Asia pacific has the quarter of the market 24% and China is the leader with 576 885 M€ , far come South America where Chile is number one with 41 000 M€, north America with USA 100 800 M€, Africa with South Africa in the head with 37 392 M€, followed by Morocco 2532 M€ and Egypt 1181 M€ ,Tunisia 378 M€. the last one is the midle east where the leader of the region is UAE with 1500 M€. then ze conclude that the leader of the global factoring market is China (FCI Annual Review 2023, 2024).

2.7. Advantages of factoring

- Factoring services can be adapted to each client's specific demands in order to meet those needs. These services, in contrast to bank loans, are based on the present value of the sales ledger rather than historical management data. Additionally, because they are sales transactions rather than loans, they do not lead to an increase in liabilities. As a result, businesses are increasingly choosing them (www.maximizemarketresearch.com, 2024)
- factoring offers more than simply finance: through matching finance with professional credit management services, and in some cases credit protection, factoring stands out as unique from the other competing sources of external finance
- Being a simple financing technique, based on invoices, not being necessary the collaterals, with the immediate payment, the SMEs can use factoring in order to improve their cash-flow, without increasing the debt level. Besides, in the condition of financial crisis, the restrictive conditions imposed by the banks and the low level of liquidities on the market makes the factoring an important financing alternative for the SMEs. (Vasilescu, 2010).
- The process of converting invoices is a method of transferring short-term rights that is

increasingly used in international trade, as it allows small productive enterprises to obtain Immediate payment of her rights abroad (KLEIN, 1983)

- reduced administrative burden

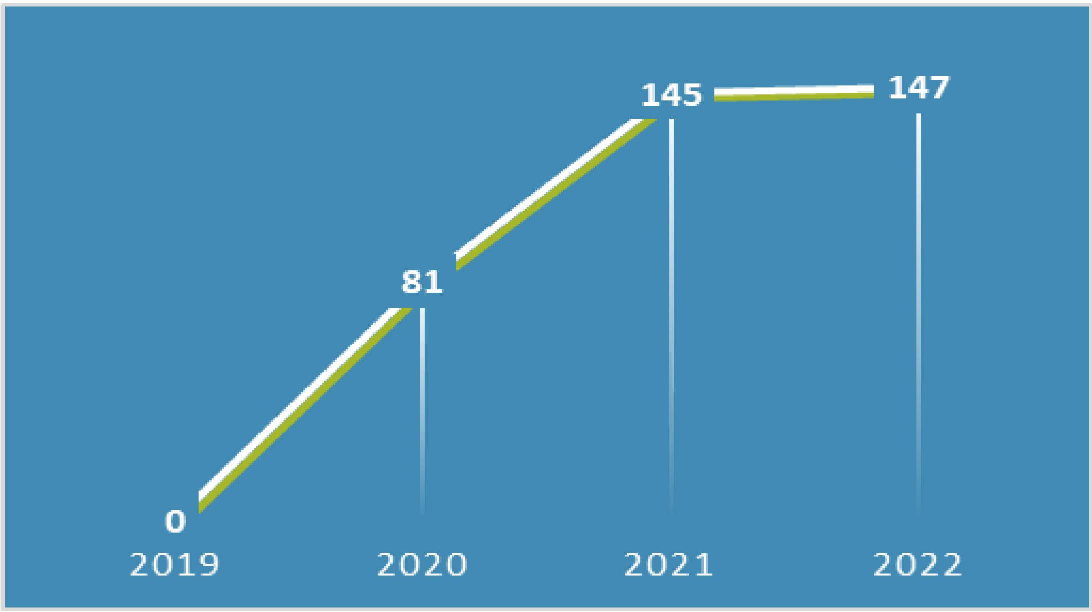
2.8. Disadvantages of factoring

- Factoring is diversely used in EU and it is limited accessible for SMEs. That factoring is not widely used by SMEs can be explained by the fact that it has a relatively high risk and information intensive transactions.
- the factoring is often considered as an expensive financing alternative, due to the high transaction cost. This not make it feasible for healthy SMEs to choose for factoring as a means of gaining liquidity. (Pieper)
- The process of invoice factoring is more important at the international level, as it doubles commercial risks are greater compared to internal sales, as the supplier only has there is little information regarding the solvency and solvency of his foreign contractors due to Their residence outside his country, and it is also difficult for him to obtain his rights abroad on his own because It is in the face of different legal systems, customs and traditions (BOURDEAUX, 1998)

3. the invoice factoring suitability to islamic rules

In Islamic finance, the perspective on factoring and invoice financing is influenced by the principles of Shariah (Islamic law), which prohibit certain elements such as riba (interest), gharar (excessive uncertainty), and maisir (gambling). However, Islamic finance also aims to promote economic development and facilitate business activities in a manner consistent with Islamic ethical principles.

Fig.4.the Islamic factoring volume (Million€)



source: fci annual review 2023

The development of Islamic factoring is very weak, starting in 2019 and recording 147 M€ in 2022 which represent 0.004% from the world total factoring.

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3.1. Arguments for and against invoice factoring

Overall, while there may not be a specific ruling on factoring and invoice financing in traditional Islamic jurisprudence, Islamic finance scholars and practitioners work to develop structures and mechanisms that align with Shariah principles while meeting the financing needs of businesses in accordance with Islamic ethical guidelines.

3.2. against invoice factoring

It was stated in Sharia Standard No. 16 of AAOIFI that It is permissible to deal with commercial papers in condition that this does not result in a legal violation, for example Usury or postponement prohibited by Sharia law.

It is not permissible to discount commercial papers, and it is permissible to pay for less than their value To the first beneficiary (creditor) before its due date.

It is not permissible to sell the deferred deferred commercial paper for the same amount (usury on credit).

Not more than that (usury of credit, credit, credit)

literally, dayn is financial liability resulting from a loan and exchanged contact. technically, bay el dayn is a sale of debt in exchange for cash, debt or commodity to the debtor or a third party other than the debtor, on a spot basis or on a deferred payment basis.

In general, the majority of Islamic jurists allow the sale of debt to the debtor. However, they hold different views about the sale of debt to a third party. Muslim jurists also agree on the prohibition of exchanging one delayed contervalue for another delayed contervalue "bay el kali bi kali" sale of debt for another debt.

hence, it can be said that the legality of bay el dayn depends on its type, which is determined by:

- The number of parties involved (whether two or three)
- The party of whom the debt is sold (whether the debtor or a non-debtor)
- The modes of delivery (on a spot basis or credit basis) (INCEIF, 2023)

Reducing debt in exchange for time is usury. Sharia forbids usury on credit because it is in exchange for a term, and meeting the term with dirhams is not permissible. They cited as evidence the hadith of Al-Miqdad ibn Al-Aswad, who said: "I lent a man one hundred dinars, then my share went out in a mission sent by the Messenger, may God bless him and grant him peace, and I said to him: Hurry for me ninety dinars." And give ten dinars, and he said: Yes. He mentioned that to the Messenger of God, and he said: You have consumed usury, O Miqdad, and you have fed him(غيث، 2010) .

3.3. With the invoice factoring

Islamic Finance assets are growing faster than conventional financial ones. Future expectations are for a growth rate of more than 10% per year. FCI has developed Islamic International Factoring facility to open a new door to this system. Undoubtedly, FCI reverse transactions also will be available by the implementation of a Supplemental Agreement for Islamic FCI reverse in a very short time. Islamic International factoring will be a new and fruitful horizon for both Islamic and non-Muslim members of FCI, creating ever higher trade finance volumes.

In countries like UAE, Malaysia and Turkey factoring has been used a sharia compliant financial instrument, on the basis of commodity Murabaha, Bay al dayn, Murabaha respectively in domestic market.

From an Islamic perspective, factoring and invoice financing can be structured in ways that comply with Shariah principles. Here are some key considerations:

-Avoidance of Interest (Riba): Islamic finance prohibits the charging or receiving of interest. In the context of factoring and invoice financing, Islamic financial institutions would typically structure transactions as purchases of goods or services rather than loans with interest charges. For example, instead of lending money at interest, an Islamic financier may purchase an invoice at a discount and then collect the full invoice amount from the debtor.

-Transparency and Fairness: Islamic finance emphasizes transparency and fairness in all transactions. Therefore, factoring agreements should clearly outline the terms and conditions, including any fees or charges involved. The pricing and terms should be fair and equitable to all parties involved.

-Avoidance of Excessive Uncertainty (Gharar): Islamic finance discourages transactions that involve excessive uncertainty or ambiguity. Factoring agreements should be based on tangible assets or services, with clear specifications regarding the underlying goods or services being financed. Any uncertainties should be minimized through proper documentation and due diligence.

-Risk-sharing and Profit-sharing: Islamic finance encourages risk-sharing and profit-sharing arrangements between parties. In the context of factoring, Islamic financiers may share in the risks and rewards associated with the financed invoices. For example, profits could be shared between the financier and the business selling the invoices based on agreed-upon profit-sharing ratios.

-Ethical Considerations: Islamic finance places emphasis on ethical considerations and the avoidance of activities that are deemed harmful or unethical. Therefore, factoring and invoice financing transactions should comply with Shariah principles and should not involve transactions related to prohibited industries or activities such as alcohol, gambling, or other unethical businesses.

There are only few differences between General Rules of International Factoring (GRIF) and Islamic finance principals. Consequently, the supplemental agreement for islamic international factoring has only three important deviations from the GRIF:

- As interest is prohibited in islam, any late payments by the export or the import factors will be subjected to "late payment amount" to be agreed on by the parties, not to interest.
- As trade of some goods and services are prohibited in islam, the product or service related to the receivable must be approved by the other party before the first assignment by the export factoring.
- Transactions with prohibition of assignment are not acceptable.

The islamic international factoring works on the basis of tamleek, exactly like the assignment in normal international factoring….

If the export factor is an islamic one, the Import factor may sometimes receive an order approval request instead of a credit line, depending on which islamic financial instrument is used as a basis for factoring (www.online.fliphtml5.com, 2024).

3.4. Exemple of Islamic factoring in Indonesia

the factoring based on the fatwa of National Sharia Council-Indonesian Ulama Council (NSC-IUC) No. 67, 2008 employs wakalah bil ujrah and hiwalah contract corresponding to Bank Indonesia Circular Letter (BICL) No. 10/14/DPbS. There are similarities between the fatwa of NSC-IUC and the formulation of BICL. They form the aspects, objects, other types, forms of agreement to provide bailouts (qardh) and get ujrah/costs, and the phase in the Civil Code is cassie and subrogation. Simultaneously, the differences in debt transfer and receivables transfer, assignors, related agencies, objects of transactions, and contrasts with Hiwalah Muqayyadah do not provide bailouts and ujrah, as well as dispute resolution.(Siradjuddin, 2021)

4.Conclusion

invoice factoring is a financial practice wherein businesses sell their accounts receivable to a third-party factor at a discount in exchange for immediate cash flow. This practice serves as a valuable tool for businesses seeking to improve their working capital management and liquidity.

The advantages of invoice factoring are evident, However, along with its advantages, invoice factoring also presents certain disadvantages. These include higher costs compared to traditional bank loans, potential strain on customer relationships due to involvement of a third-party factor, and the risk of recourse in case of non-payment by customers.

Despite its widespread adoption in conventional finance, the integration of invoice factoring into Islamic finance frameworks has sparked controversy within Islamic Sharia principles. Critics argue that traditional invoice factoring arrangements may involve elements of riba and gharar, as they often entail the charging of interest and transfer of ownership of debts.

To address these concerns, scholars and practitioners have developed alternative Islamic invoice financing models that adhere to Sharia principles. These models include Murabaha, Wakala, and Tawarruq structures, among others, which aim to provide Sharia-compliant alternatives to conventional invoice factoring. However, the development and adoption of these Islamic invoice financing models are still evolving, and debates persist regarding their compliance with Sharia principles and practical applicability.

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