EUF Position Summary on Basel III/CRD-IV re LCR & NSFR

The list of names of the key stakeholders to whom the letter has been sent:

European Commission:

Mr Michel Barnier
European Commissioner for Internal Market and Services
European Commission

Mr Olivier Guersent
Head of Cabinet of Commissioner Michel Barnier

Ms Paulina Dejmek-Hack
Member of Cabinet of Commissioner Michel Barnier

Mr Bertrand Dumont
Member of Cabinet of Commissioner Michel Barnier

Mr Jonathan Faull
Directorate General for Internal Market and Services (MARKT)

Ms Nadia Calviño
Deputy Director General for Internal Market and Services

Mr Mario Nava
Director for Financial Institutions for Internal Market and Services

European Banking Authority:

Mr Andrea Enria
Chairperson, EBA

Ms Isabelle Vaillant
Director of the Regulation Department, EBA

Mr Adam Farkas
Executive Director, EBA

The EU Federation for the Factoring and Commercial Finance Industry (EUF) is the Representative Body for the Factoring and Commercial Finance Industry in the EU. It is composed of national and international associations for the factoring and commercial finance industry that are active in the EU, representing over 97% of the industry turnover. It is in this role that the EUF notes that the availability of finance to businesses, particularly SMEs, may potentially be made more difficult and also costly as a result of the introduction of new measures within the Basel III/CRD IV framework.

Commercial finance and factoring are generic terms for a range of asset based finance services which include factoring, invoice discounting, international factoring, supplier finance/reverse factoring and asset based lending. All of these exist to provide working capital funding and financing solutions to businesses, particularly SMEs, and all have in common the idea that funding is offered based upon the accounts receivables created by the client company.

At the end of 2012, € 170 billion of working capital was being provided by the factoring and commercial finance industry to 160,000 principally SME businesses. Due to the short average collection period in factoring (an estimated average of 67 days in the EU in 2012), this results in permanent financing needs of less than 20% of the total factoring turnover. These figures do not only show that factoring companies accomplish a high volume of purchased receivables with a relatively small amount of liquidity, but they also highlight the vital role the industry plays in supporting commerce, growth and employment.

The EUF stresses the need for a thorough and well-founded analysis carried out by the EBA in order to assess the impact of applying the requirements of LCR and NSFR to factoring and commercial finance: Under the recent survey conducted by the EBA to draft the report on the impact of the LCR, only one out of the 350 banks interviewed acknowledged that they had factoring activities within their respective institutions. The EUF believes that the interviewees were not aware and did not have sufficient knowledge or experience in the factoring and commercial finance business, and hence could not give appropriate and well-founded insights into the impact of the LCR/NSFR implementation on the factoring and commercial finance industry. In that regard, the EUF believes the survey results to be flawed and certainly skewed towards predominantly traditional commercial banks, omitting the true impact this regulation could have on the factoring industry and in turn, on the SME sector in the EU, which drives our economy.

Moreover, it is vital that specificities of the European banking and financing industry are considered and upheld in the process of implementing the European CRD IV-framework. Particularities of certain special forms of financing, which are not based on the collection of deposits and which show a long history of low risks and very effective management of risks (such as factoring), need to be taken into consideration in this process, particularly as forms of financing such as factoring have neither created nor contributed but rather helped alleviate the burden caused by the recent credit crunch, thus playing a vital role for SMEs.

The EUF emphasizes the need for proportionate regulatory measures, which are suitable for all encompassed forms of financing. In summary, the EUF maintains that the framework for liquidity coverage is not consistent with the factoring activity and that corresponding exceptions or adapted rules are necessary: Both LCR and NSFR were conceived for banks and banking groups with a wide range of activities and financial services on offer and whose need for refinancing is a direct mirror of these activities, thereby making them vulnerable to shortfalls in liquidity supply. However, this description does not adequately fit factoring and commercial finance companies, which are rather a direct mirror of the real economy and therefore show more similarities to trade finance and can hence not be compared to and treated in the same way as traditional commercial banks. The regular activities of factoring companies neither encompass the collection of deposits nor do they foresee the holding of sovereign bonds and other HQLA, as required by the LCR. Factoring companies should not be required to carry out such speculative operations, which neither correspond to their license nor to their core business, thereby unnecessarily increasing the risk situation for factoring companies – a result diametrically opposed to the intended goal of lowering risks. Also, factoring companies could not meet the requirements of the NSFR without facing severe financial constraints.

Accordingly, the EUF advises that the EBA, in its role as architect of guidelines and reports on liquidity and regulatory harmonization in the EU, should urgently refine the Basel III/CRD IV and CRR rules and put in place appropriate relief and proportionate regulation to protect the financing of SMEs as wealth creators of the real economy.

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EUFederation
Factoring & Commercial Finance

Dear Ms or Mr,

The **EU Federation for the Factoring and Commercial Finance Industry (EUF)** is the **Representative Body for the Factoring and Commercial Finance Industry in the EU**. The EUF is composed of national and international associations for the factoring and commercial finance industry that are active in the EU. Its members represent **over 97% of the industry turnover** and include 14 national factoring and commercial finance associations (representing 15 EU-member states, namely [in alphabetic order] Austria, Belgium, the Czech Republic, Denmark, France, Germany, Greece, Ireland, Italy, the Netherlands, Poland, Portugal, Spain, Sweden and the UK) and two international factoring associations, who in turn represent 192 factoring and commercial finance companies. The EUF seeks to engage with Government and legislators to enhance the availability of finance to business, with a particular focus on the SME community. Furthermore, the EUF acts as a platform between the factoring and commercial finance industry, and key legislative decision makers across Europe, providing a source of reference and expertise on the factoring and commercial finance industry.

It is in this role that the EUF notes that the **availability of finance to businesses, particularly SMEs, may potentially be made more difficult and also costly as a result of the introduction of new measures within the Basel III/CRD IV framework**. With Basel III, the Basel Committee on Banking Supervision has devised a comprehensive set of reform measures which tighten the regulation, supervision and risk management of the banking sector. These measures are inter alia aimed at improving the banking sector's ability to absorb shocks arising from financial and economic stress – an aim which also the EUF generally welcomes, especially in the light of the still very recent credit crunch and financial crisis.

Under the recent banking survey conducted by the EBA to draft the report on the impact of the LCR, only one out of the 350 banks interviewed acknowledged that they had factoring activities within their respective institutions. However, approx. 90% of the factoring companies in the EU, which number over 540 companies, are considered to be bank subsidiaries. The other 10% are considered Non-Bank Financial Institutions (NBFIs). The EUF believes that the interviewees were not aware and did not have sufficient knowledge or experience in the factoring and commercial finance business, and hence could not give appropriate and well-founded insights into the impact the CRD-IV and the LCR/NSFR implementation could have on the factoring and commercial finance industry. In that regard, the **EUF believes the survey results to be flawed and certainly skewed towards predominantly traditional commercial banks, omitting the true impact this regulation could have on the factoring industry and in turn, on the SME sector in the EU, which drives our economy**.

Certain reformed measures in the new Basel III/CRD IV rules concerning the liquidity and capital requirements for various risk weighted assets have made some waves, particularly in the SME and commercial financing sector, including the factoring industry. It should be noted that these new provisions were mainly designed for deposit taking institutions as Basel III/CRD IV, which by definition does not cater to institutions that are not authorized to accept deposits. However, it must be outlined that many factoring companies are part of a banking group and, moreover, some Member States will also apply these provisions to non-deposit taking institutions such as factoring companies. **It is vital that specificities of the European banking and financing industry are considered and upheld in the process of transposing and implementing the global Basel III and the European CRD IV framework. Particularities of certain special forms of financing such as factoring need to be taken into consideration in the transposition process, particularly if they are as vital for SMEs as the factoring and commercial financing industry are today**.

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It is in this context that the **EUF wishes to explain some concepts and address certain issues** in relation to factoring and the CRD IV framework.

The concept of factoring and commercial finance:

Commercial finance and factoring are **generic terms** for a range of asset based finance services which include factoring, invoice discounting, international factoring, supplier finance/reverse factoring and asset based lending. There are many variations on each of these product sets and the precise nomenclature varies from market to market, but **all exist to provide working capital funding and financing solutions to businesses, particularly SMEs**. The exact content of the services provided by the commercial financier will vary according to the clients' particular requirements, but all of these solutions have in common the idea that **funding is offered based upon the accounts receivables created by the client company**: With a factoring solution, the factor agrees to pay an agreed percentage of approved debts as soon as the receivables are assigned or (in some jurisdictions) pledged to him. If credit protection is part of the factoring agreement, it is referred to as "non-recourse" factoring, while a factoring agreement where the credit risk on the debtor remains with the seller is called "with-recourse" factoring. The factor will often also undertake all credit management and collections work. There will normally be a charge for the collections service and, if it is required, for bad debt protection as well as a discount charge for finance provided in advance of collections.

Factoring is simply a unique blend of services designed to ease the traditional problems of selling on open account terms, mainly aimed towards SMEs. Typical services include investigating the creditworthiness of the seller's buyers/debtors, assuming credit risk on those debtors, and providing credit protection against the debtor's default and/or bankruptcy, prompt collection of accounts receivable, management of the receivables ledger, and provision of finance through immediate cash advances against outstanding receivables. The factoring industry has enjoyed a **long and rich history with a low record of credit losses** as a percentage of revenue. Factoring is one of the very few sectors within financial services whereby a financial institution purchases the asset from the client, in this case the account receivables (intangible assets which have a very tangible source of liquidity) and all underlying rights, including the right of payment by the debtor. This **strengthens the scenario that the factor will be paid** (as the seller's receivable is the source of liquidity of the advance made to the seller by the factor). And in the case where the seller files for bankruptcy protection, the factor generally will have redress in the courts due to its ownership stake in the receivables from the seller. Traditionally, the **receivables assigned to the factor are generally well diversified, are of short term duration, and are normally under a 90 day period**. Also, the **financing provided to the seller is contracted on a flexible basis**, often providing leeway for the factor to exit quickly in a deteriorating financial condition scenario, which in part explains the low loss record for the industry.

In general (and in contrast to the banking sector), **factoring margins are reflective of the risk being taken in the SME space** and are therefore quite adequate. Again, this in part stems from the strong credit metrics factors use, the benefit of management of the receivables by the factor, enhanced credit underwriting analysis on both seller and buyer, a robust technology platform to manage the risk, along with a strategy of receivables diversification, keeping credit losses to a minimum.

The factoring and commercial finance industry in the EU:

Data collated by the EUF for the year **2012** show that **factoring and commercial finance volumes amounted to € 1.2 trillion in the EU**, an increase of 5% in comparison to 2011 and thereby reaching a **GDP-penetration of 9.63%** in relation to the EU's GDP. Initial data for the first half of 2013 show a total turnover of € 552 billion and a GDP-penetration of 9.33%. **At the end of 2012, € 170 billion of working capital was being provided by the factoring and commercial finance industry to 160,000 principally SME businesses**. Due to the short average collection period in factoring, estimated to be on average of about 67 days in the EU (2012), this results in permanent accounts receivables and financing needs of less than 20% of the total factoring turnover. These figures do not only show that factoring companies accomplish a high volume of purchased receivables with a relatively small amount of liquidity, but more importantly, they also **highlight the vital role the industry plays in supporting commerce, growth and employment**, despite the continuing difficult economic environment and despite a reduction in traditional lending volumes.

From the standpoint of the industry's impact on SMEs and job creation in the EU, a recent study conducted by GE (cf. http://www.gecapital.eu/en/arfactor/reports/GE_report_EN.pdf) stated that the **factoring industry supports the creation of over 600,000 jobs from companies reliant on invoice finance located in the UK, France, Germany and Italy alone**. This suggests that overall, approximately 850,000 jobs have been created with the support of factoring in the 28 EU countries.

Liquidity Coverage Ratio and Net Stable Funding Ratio:

According to the BIS and the Basel Committee on Banking Supervision, the LCR is supposed to promote "*the short-term resilience of a bank's liquidity risk profile*" by "*ensuring that a bank has an adequate stock of unencumbered high-quality liquid assets (HQLA) that can be converted into cash easily and immediately … to meet its liquidity needs for a 30 calendar day liquidity stress scenario*". It is thought that "*shocks arising from financial and economic stress*" can thus be more easily absorbed, "*thus reducing the risk of spillover from the financial sector to the real economy*". **This is an understandable argument and goal, but the assumption or hypothesis behind it cannot be transferred and applied to factoring**. Literature on the argument is very recent and not numerous but yet able, when complemented by experiences of the industry operators, to highlight the substantial difference between the liquidity cycle in the factoring activity and the banking activity[1]: In a dynamic view of the operations management, one can observe that the financial outflows of the factor are substantially balanced by the inflows originated by the debtors' payments of the assigned debts coming to maturity at each different due date; the liquidity that may temporarily exceed is generally used by the factor to refund its own liabilities or, occasionally (having regard to the dynamic of the interest rates), it is left on the factor's current account. This approach appears to be accentuated in the current situation of uncertainty due to the crisis of the markets. In such a context, liquidity risks for the factor can be assimilated to extreme situations within the continuity of the business management that may become more frequent if the company is pursuing a strategy of expansion of its business. **The nature of the risk is almost exclusively related to the funding liquidity risk, mainly due to reasons and criteria that are external to the company management** and linked to e.g. restrictive interventions by the parent company in its granting of liquidity to the factoring company (in case of factors owned by banking groups) or e.g. to a liquidity crisis in the whole system (in case of independent factors), to changes or delays in the settlement of the supply relationship underlying the assignment, etc. **Potential liquidity risks related to internal factors are very scarce** and can originate from e.g. errors in the liquidity risk assessment of the factor's counterparties or from the provision of liquidity requirements to support the expansion of the business also in international markets.

The **Basel III/CRD IV liquidity requirements are based on stress hypotheses** which have been conceived to **tackle a situation of crisis occurring in the financial economy** and to prevent any risk of a "run" and spillover effects onto the real economy. **However, factoring companies only provide financing against the sale of receivables, thereby directly connecting their financing activity to the real economy in which goods and services are fluently traded**. A 50% weighting of inflows in factoring would de facto mean that 50% of the debtors in factoring are in default – if extrapolated to the whole real

[1] Schwizer, P (edited by), "Measurement and management of liquidity risk in factoring", Credifact, Discussion paper series 1/2013, January 2013 (abstract in English, text in Italian).

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economy, this would mean that (roughly speaking) half the real economy was in default or even already insolvent, thereby assuming a complete blockage of the economy. **Applying the levels of stress on which the LCR inter alia is based to factoring would therefore lead to assuming a scenario that the current exchange of goods and services would be stopped, thus leaving e.g. shops without goods and deliveries**.

Moreover, as **factoring and other forms of commercial finance do not involve the collection of deposits**, the **LCR cannot be applied by factoring and commercial finance companies which are not deposit-taking banks**. Neither is the holding of sovereign bonds and other HQLA, as required by the LCR, encompassed by or foreseen in the factoring companies' regular activities. The LCR has been drafted for banks and banking groups who have a wide range of activities and who are also familiar with e.g. the bond market. Factoring companies do not engage in these activities and would have to take up loans to buy the required sovereign bonds and other HQLA, let alone having to select the appropriate bonds and hedging instruments without the corresponding knowledge and experience. **All this would lead to factoring companies carrying out speculative operations, which neither correspond to their license nor to their core business, thereby unnecessarily increasing the risk situation for factoring companies – a result diametrically opposed to the intended goal of lowering risks**.

Similarly, **factoring companies could not meet the requirements of the NSFR without facing severe financial constraints**: The obligation to borrow at one year's maturity in order to be able to finance at three months's maturity or even less would not only lead to a reverse transformation, but also make hedging mechanisms for the risk of changes in the interest rate necessary, thereby creating additional and unnecessary financial and administrative costs.

Such evidences strengthen the consideration of the industry operators that the current framework for liquidity coverage, involving the LCR and the NSFR, appears to be too much bank-oriented to be applied "as-is" to the specialized factoring companies.

Factoring and Trade Finance:

From the EUF's viewpoint, **factoring and the underlying receivables** as the industry's source of repayment should be considered a **low risk asset class**. As you know, the Basel committee altered its original position on Trade Finance by reducing the regulatory burden on trade letters of credit as an asset class which provided relief to banks and their clients by reducing the capital allocation required under Basel III rules to 20%. The EUF believes that there are **more similarities between factoring and trade finance than between factoring and classical banking activities**. Hence, the **aim of the EUF is to refine the Basel III rules and the CRD-IV/CRR** in order to foster the development of the Factoring and Commercial Finance industry for the ultimate benefit of the SME. The EUF asserts that treating Factoring and Commercial Finance as a unique asset class to accurately reflect its low risk will help develop more domestic trade from the SME and ultimately create employment in the EU.

"Trade Finance" as a category of financing is carefully considered by the CRR due to its relevance in supporting trade and to the potential impacts of the liquidity risk management rules provided for the traditional banking activity. According to Art.4 para. 80 of the CRR, *'trade finance' means financing, including guarantees, connected to the exchange of goods and services through financial products of fixed short-term maturity, generally of less than one year, without automatic rollover*.

From this point of view, one can assume that in effect factoring:

- is clearly a form of financing;
- is connected to the exchange of goods and services, as it works on receivables arising from the business of the clients;

- works on fixed short term maturity, as trade receivables' duration is usually lower than 90 days;
- is a flexible form of financing to the SME, providing the factor a means to terminate or reduce its exposure quickly when the financial condition of the seller or its customers deteriorate.

In summary, the EUF will ultimately strive to demonstrate to the authorities that **factoring is a low risk asset class**, and therefore **should enjoy the same benefits of an exemption or at least a reduced regulatory burden on the factoring industry by altering the CRD-IV rules that adversely affect the source of liquidity SME sector in the EU**.

Awareness of the potential impacts of the rules on liquidity coverage:

The **potential detrimental impact on specific institutions** has been recognized in the CRR: Art. 509 states that the EBA will annually report to the Commission, assessing in particular the impact arising from *the provision of mechanisms restricting the value of liquidity inflows, in particular with a view to determining an appropriate inflow cap and the conditions for its application, taking into account different business models including pass through financing, factoring, leasing […] and the extent to which that cap should be amended or removed to cater for the specificities of specialized financing*.

This awareness is also clear with regard to the NSFR. Art. 510 requires the EBA to evaluate whether and how it would be appropriate to ensure that institutions use stable sources of funding and to assess the impact on the economy and on bank lending with a particular focus on lending to SMEs and on trade finance. According to the previous paragraph, **the EUF maintains that factoring should be considered as well in the analysis, taking into account the comments here expressed**.

The EUF believes that **the EBA's report should be founded on information, statements and evidence based on knowledge of and experience in the factoring business, so as to give the EBA appropriate and well-founded insights into the impact the CRD-IV and the LCR/NSFR implementation can have on the factoring and commercial finance industry**. Unfortunately, a sample of approximately 350 banks form the basis of the analysis, thereby **making the survey results skewed towards predominantly traditional commercial banks and omitting the true impact the LCR and NSFR could have on the factoring industry and in turn, on SMEs in the EU**.

Conclusion:

Both LCR and NSFR were conceived for banks and banking groups with a wide range of activities and financial services on offer and whose need for refinancing is a direct mirror of these activities, thereby making them vulnerable to shortfalls in liquidity supply. However, this description **does not adequately fit factoring and commercial finance companies** – these companies are rather a **direct mirror of the real economy and can therefore not be compared and treated in the same way as traditional commercial banks**.

Moreover, financing options such as **factoring and commercial finance** have proven to be a real and frequently used alternative to the classic bank loan and have **helped to alleviate much of the burden caused by the recent credit crunch, especially for SMEs**. It should also not be overlooked that the factoring industry **did not contribute in any way to the recent financial crisis**: When compared with other forms of financing which can be considered as contributing factors to the recent financial crisis, **factoring and commercial finance is a low-risk form of funding**, also thanks to its direct connection to the real economy via the purchase of receivables for delivered goods and rendered services.

The EUF therefore emphasizes the **need for proportionate regulatory measures**, especially regarding instruments to monitor, collateralize and hedge against liquidity risks: It should be **ensured that the new regulatory measures introduced by Basel III/CRD IV are suitable for all encompassed forms of**

financing, if necessary by creating specifically adapted rules or exceptions. In summary, the EUF maintains that the **framework for liquidity coverage is not consistent with the factoring activity and that corresponding exceptions or adapted rules are necessary**. The EUF therefore stresses the **need for a thorough and well-founded analysis carried out by the EBA** in order to assess to the impact of applying the requirements of LCR and NSFR to factoring and commercial finance and urges that the EBA takes the aforementioned arguments into account in its report to the European Commission. In fact, the **anomalous and wholly inappropriate imposition of LCR and NSFR on the non-deposit taking commercial finance industry** must be addressed. The EUF considers that these new rules potentially imperil and undermine the cost effective and flexible funding of €1.2 trillion to an estimated 150,000 SMEs whereby 850,000 jobs in the EU28 are supported. Economically and politically speaking, this is a **completely undesirable and unacceptable outcome**. Accordingly, we advise that the EBA, in its role as architect of guidelines and reports on liquidity and regulatory harmonization in the EU, should **urgently put in place appropriate relief and proportionate regulation to protect the financing of SMEs as wealth creators of the real economy**.

The EUF would be delighted to discuss the issues of the full application of LCR and NSFR to factoring more in detail in order to support the impact assessment by the EBA just as it would be happy to provide the EBA and any other competent EU policy- and decision-makers with more information about the factoring and commercial finance industry.

With kind regards,

John Gielen
Chairman – EUF

16 December 2013

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