European Commission
DG FISMA
Unit D1 – Bank regulation and supervision
SPA2 04/008
1049 Brussels

Kraainem, 7th of October 2015

Ref: EUF/ES/15-013

Re: EU Commission (DG FISMA) consultation paper on the possible impact of the CRR and CRD IV on bank financing of the economy

To whom it may concern:

We would like to thank you for giving us the opportunity to respond to the EU Commission consultation (DG FISMA) on the possible impact of the CRR and CRD IV on bank financing of the economy. We would like to answer some of the specific questions contained in the consultation paper on the possible impact of the CRR and CRD IV on bank financing of the economy, and specifically look at the capital reduction factor for SME financing, the so called Supporting Factor (SF), introduced in the CRR to determine if this specific measure has resulted in enhanced lending to SMEs.

The EUF would like to point out the nearly simultaneous launch of both the EBA's and Commission's consultations on very similar topics. We understand that the EBA has been commissioned by you to analyse the impact the SF has had on SME lending while at the same time you have also launched this consultation on a very similar topic. In this context, the EUF recommends that the Commission considers the EBA's findings in its assessment of the possible impact of the CRR and CRD IV on bank financing of the economy. Due to the close connection of the two consultations in terms of content, we also wish to draw your attention to the EUF's response to the aforementioned EBA's consultation at http://euf.eu.com/.

Who is the EU Federation for Factoring & Commercial Finance (EUF)?

The EUF is the industry body and voice for the European factoring industry. The EUF's members consist of 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 over

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400 factoring and commercial finance companies. The EUF is a European wide association of associations, acting as one voice for the Receivables Finance and Factoring Industry in the EU. In 2014, the Receivables Finance Industry in the EU provided over €185 billion of working capital financing to over 160,000 businesses, mostly SMEs. This amount of working capital has to be seen in relation to the total factoring turnover in the EU, which in 2014 exceeded € 1.3 trillion. If you consider that the total EU GDP was approximately € 13 Trillion that same year, businesses supported by these types of finance accounted for approximately 10% of GDP, a figure representing the "real economy" in the EU. This is not too far from the EBA's analysis:

"SMEs in the EU remain largely reliant on bank financing. But of the remaining forms of finance available, trade credit is used by 10.3% of SMEs, factoring by 6.3% and non-bank loans by 6.9%."

The EUF represents an industry that is one of the leading drivers of financing for SMEs in the EU. Factoring companies in particular have been one of the leading drivers of growth for SMEs, as they provide a means to provide working capital through a highly effective operating platform that reduces the risk of default and supports the flow of finance downstream, supporting supply chains in the real economy. Traditionally, a factoring company provides liquidity to an SME based on the eligible receivables assigned to it. The factoring company may provide a form of credit protection against the default risk of the client's customers as well, providing additional capital to their end buyers, many of whom are SMEs themselves, ultimately offering liquidity in the supply chain that normally would be challenged otherwise. Hence, you can say that factoring is a unique blend of services designed to ease the traditional problems of selling on open account terms, mainly aimed towards SMEs.

As the EBA recently reported in the aforementioned consultation document (p. 5), *"following the financial crisis, SME bank lending has suffered a significant backdrop in volumes, from a peak of EUR 95 billion in mid-2008 to approximately EUR 54 billion in 2013/2014", a more than 40% decrease. However, if you look at the factoring industry in Europe during about this same period, factoring volume increased from 827 billion Euros in 2009 to 1,37 trillion in 2014, a 66% increase. This confirms again that factoring was continuously used to provide working capital solutions to SMEs while access to bank lending plummeted during this period.*

Factoring's Role in the Financial Crisis

The financial crisis placed the stability of the financial system at risk in part due to the significant amounts of leverage that were never adequately revealed. However, the factoring community had no direct correlation to the weak credit practices experienced during this period, and most importantly, the factoring community did not contribute to the stress of the banking system. On the contrary: Factoring helped alleviate the effects of the credit crunch when many banks withdrew from the market.

In the EU, a very large majority of factoring companies are owned by banks or part of a banking group. However, factors themselves are traditionally not deposit-taking, but rather institutions that finance companies on a short term basis. Neither are they taking on excessive leverage (factors only finance up to the value of the "eligible receivables balance" that has been assigned by their clients). Factoring is a straightforward and quite simple form of financing based on a receivable/invoice originated by the SME and hence directly linked to the real economy.

In fact, when assessing the role of factoring companies, it has to be taken into account that factoring and commercial finance has proven to be a real and frequently used alternative to the classic bank loan and has helped to alleviate much of the burden caused by the recent credit crunch in Europe, especially for SMEs. For example, in countries such as France and Germany, the number of factoring clients increased by approximately 11% and 60% respectively from 2008 to 2009 (France: 28,800 clients in 2008 to 32,200 in 2009; Germany: 5,400 clients in 2008 to 8,840 clients in 2009). Also, the total factoring turnover in the EU decreased only very slightly from 2008 to 2009 (by -2,9%), only to increase substantially in 2010 (by nearly +18% in comparison to 2009). This shows that the financial crisis did not affect the factoring industry negatively. Moreover, the fact that the factoring industry did not contribute to the causes of the recent financial crisis should not be overlooked: Factoring is considered a low-risk form of financing, also thanks to its direct connection to the real economy via the purchase or transfer of receivables for delivered goods and rendered services.

Factoring's Low Record of Credit Losses

The factoring industry has enjoyed a long history with a low record of credit losses and continuous and stable growth. As an alternative form to traditional trade finance, Factoring is one of the very few mechanisms within the wider financial services industry whereby a financial institution purchases the assets from the client, in this case the account receivables and all their underlying rights, including the right of payment by the debtor. This element strengthens the scenario that the factor will be repaid.

The receivables assigned to the factoring company are generally well diversified and of a short term duration (normally under a 90 day period). In addition, the financing provided to the seller is contracted on a flexible basis, often providing leeway for the factoring company to exit quickly in a deteriorating financial condition scenario, whether it be stemming from the debtor(s) or the seller itself, which in part explains the low loss record for the industry.

Moreover, factoring companies use strong credit metrics, they become secure not only from the assignment of the receivable but also from the intricate management system supporting the process, a robust technology platform that ledgers the receivable, supports the credit underwriting on both the seller and their buyer(s), and has the capacity to alert the factor in such areas as a rise in dilution or concentration risk, keeping credit losses to a minimum.

Also, the flow of funds to a factor does not come from the seller but rather from the clients' customers, as they make payment directly to an account controlled by the factor, increasing the likelihood of repayment. Lastly, factors can finance companies in all sectors, but mostly related to consumer products/services, business to business or service industries.

Questions raised in the European Commission Consultation Document

The aforementioned EBA consultation document focuses on the impact of the Supporting Factor. In brief, the SME supporting factor (SF) allows the entity to multiply an exposure to a SME by a factor of 0.7619, thus aiming to reduce the impact on the capital requirement. Your consultation document, however, has a more general approach as it addresses the possible impact of the CRR and CRD IV on bank financing of the economy.

Regarding the list of questions in your Consultation Form, we wish to point out the following: As our members are factoring associations and neither the EUF nor our member associations interact directly with SMEs as factoring clients, the EUF can only respond to some of these questions, but we have promoted that you (as well as the EBA) receive responses directly from individual factoring companies. However, we wanted to include below some observations on the consultation:

SME Supporting Factor

In its consultation document, the EBA states that by applying the SME Supporting Factor of 0.7619 to capital requirement, credit institutions will be able to increase lending to SMEs in the current economic context. This reduction came into effect in January 2014 quite recently to have a strong impact, <u>but may be reviewed by the Commission in 2016</u>. For the record, the EUF is strongly supportive of continuing this practice, as again many of factoring companies who are members of the national factoring associations (who again are our members) are regulated banks or subsidiaries of banks or parts of a banking group. Eliminating or reducing the size of the SF would have an adverse impact on the costs when financing SMEs in the EU, resulting perhaps in the consideration to fund them altogether. The EBA states in their consultation document the following (p. 42), which is in our view part of the reason not only to keep the SF in place but also to improve on it:

Estimates and researches "find that a 2 percentage point reduction in capital requirements was associated with an increase in aggregate corporate lending by 1.5% and a rise of aggregate investment by 0.5%".

Hence, the SF is a form of relief, ultimately reducing the burden that would obviously be passed on to the SME due to the increased capital reserve requirement. Therefore, the EUF defends the SF's continued presence.

Moreover, we would like to stress the fact that factoring is a self-liquidating exposure where the default risk of the client is mitigated and subordinated to the risk of dilution and/or default of the assigned debtor. Factoring is widely used by the SMEs, usually assigning or selling receivables against their larger and more creditworthy debtors/customers, in order to effectively reduce the risk of the operation for the financier. It is also useful to notice that the value of receivables, as security, is not linked to the market value of the asset, and is always equal to 100% of the nominal value except in case of dilution or debtor default (which the factor has already taken into consideration by establishing an appropriate buffer/reserve based on the companies past dilution history), thus allowing the factor to grant higher level of advance than for example other asset-based lending solutions and, in particular, to recover most of the defaulted exposures having possibility to chase the assets of the assigned debtors and, in recourse operations, the client.

Considering the aforementioned features of factoring, the EUF would extend to the Commission the suggestion, already proposed to the BCBS in the occasion of the consultation on the update of the Basel Standard Approach (cf. the EUF's response to the BCBS of April 2015 at http://euf.eu.com/news/newsflash/003-euf-response-to-bcbs-position-paper-on-revisions-to-the-sa-on-credit-risk-2015-03-25.html), to consider also the introduction of a specific approach for factoring exposures in order to further support the SMEs, and in particular:

<u>a) to allow the possibility to weight the factoring exposure to a client accordingly to the risk weight of the assigned debtor(s).</u>

Within the IRB approach, the Basel II framework already provided (§365) for exposures to purchased receivables, different approaches to determine the capital requirements (bottom-up / top-down) that considers the assigned debtor as risk counterparty of the factor. Moreover, the IRB approach allows the bank to consider purchased receivables, subject to some conditions, as collateral for the exposure to the client.

Furthermore, factors consider dilution risk when determining the appropriate advance rate to make available to the client, so that the residual unexpected dilution risk can be anticipated.

According to the proportionality principle and to the features of factoring, the EUF believes that, in the view of the alignment to the IRB approach, the Commission may consider to provide also in the Standardized Approach (SA) the possibility to weight the exposure with the risk of the assigned debtor instead of the risk weight of the client/seller even in recourse

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operations, subject to the same conditions required in the IRB approach to consider the receivables as a collateral. Such approach is already in place in Italy (only for supervised financial intermediaries) and appears as a good way to recognize the unique aspect of the factoring service.

b) <u>to provide a lower, specific risk weight for factoring exposures, by way of a cap or a cutoff on the applicable risk weight</u>

As already mentioned, factors usually register recovery rates higher than other kind of asset-based facilities due to the security offered by the assigned (or purchased) receivables. Therefore, the risk weight applicable to corporates should recognize the lower risk of factoring and be re-calibrated taking into account the lower LGD and calculating specific risk weight applicable to factoring, by way of:

i) a cap on the applicable risk weight (i.e. factoring exposures are weighted up to 50%), or

ii) a reduction of the applicable risk weight (i.e. factoring exposures are weighted 50% less than the applicable risk weight).

The EUF is currently collecting figures about credit losses in factoring and will be happy to share and discuss the results with the Commission to support these proposals.

Liability Cap of EUR 1.5 Million

The EBA states that the total amount owed to the lending institution, its parent and subsidiary undertakings (including exposures in default, but excluding the claims secured on residential property) shall not exceed EUR 1.5 million. This is actually a very low threshold in certain cases and can hence represent a significant impediment for SMEs. , as some factoring companies will provide financing starting at an amount of EUR 500,000 but up to amounts in the EUR 20 plus Million range. This restriction could also be a significant impediment, especially when looking at the impact. When applying this liability cap to an exemplary case where the outstanding balance is EUR 1.5 Million (in terms of exposure), and assuming the receivables have credit terms less than 90 days, that means the company SME could only be financed through factoring to up to four times its balance, or in this case EUR 6.0 Million in revenue. Considering that SMEs (just like other companies) use a balanced mix of different forms of financing, which may well originate from different institutions within one banking group, the liability cap can result in restricted financing offers for SMEs. The other drawback with this liability limitation is that not all factoring clients may be eligible for the SF in the first place. Many of the factoring companies offer their services to companies whose receivables balance far exceeds the EUR 1.5 Million threshold, thereby possibly rendering the SF irrelevant, even though these companies are SMEs. In summary, the liability limitation is far below the EBA's designated expectation of an SME's needs based on the annual turnover of EUR 50 Million or less as stated in the Commission Recommendation 2003/361/EC to which art. 501 para. 2 of the CRR refers.

Commission (DG FISMA) Consultation paper and questionnaire

Q1: What role has been played by the CRR and CRD IV requirements in the recapitalization process, in terms of the timing and overall effect on the levels and quality of capital held by banks? How have market, supervisory and regulatory capitalization demands interacted to make banks adjust the level of capital they hold to the current level? Whilst these three factors may be interlinked, is it possible to identify which has/have played the most important role?

Supervisory and regulatory demands on banks' capitalization have had a notable impact, not only because banks have made adjustments to their internal organization and processes (both on a solo as well as on a group level; on a group level, this also affects non-bank-members of a group which often rely on the group's credit institution for refinancing and also independent non-bank finance providers that receive wholesale funding from banks), but also because a tendency to decline financing/funding to especially smaller companies has been noted since CRD IV/CRR. Such clients then look for alternative forms of funding, e.g. factoring. Although unfortunately, the EUF currently has no detailed statistical data to prove this, we believe that some of the data contained in the aforementioned EBA's consultation document (cf. pp. 29 ff., especially the rejection rate on p. 32 and data on partial funding p. 37 and the data on p. 42) can be seen as backing up this impression.*Q2. If you consider that capital levels go significantly beyond what is necessary in light of the level of risk incurred and posed by banking activities in certain areas, please specify those areas and back up with evidence:*

Although the EUF is not in a position to comment directly, we can say that the reduction in the capital reserve is certainly welcome when it pertains to retail and corporate risk. Having an exclusion just based on these parameters is helpful and reduces the costs of financing by lowering the capital levels, but whether this is enough in each single case is a question that needs to be addressed directly by the affected institutions, including factoring companies.

As a general observation, however, the CRR/CRDIV framework as a whole is insufficiently sensitive and responsive to the levels of risk in specific areas of banking activity, as well as to the specialised systems and practices that have evolved to successfully manage those risks.

Q4**:** *Have increased capital requirements influenced the overall capacity of banks to lend? Which factors, including demand-side factors, regulatory changes and other supply-side* *factors (such as the volatility of interbank and capital markets), contributed most significantly to the change in the volume of loans? How do you think bank lending would have developed had regulatory changes to capital requirements not been introduced?*

Alternative forms of financing (such as factoring) have become more popular over the last years, as can be seen from the aforementioned increasing turnover figures. This development is partly due to the “credit crunch”, which forced especially SMEs to diversify their sources of financing, but it is also a consequence of the (more strict) capital requirements introduced by CRD IV/CRR which made banks look for and turn to more “capital-efficient” businesses (i.e. low risk/low capital requirements such as factoring). It can also be noted that the level of transparency for certain credit/financing decisions has decreased, at least from the perspective of SMEs which are not familiar with the complex details of CRD IV/CRR.

The EUF would also suggest that demand-side factors are also having a persistent effect on the volume of lending to smaller SMEs in particular. There remains an enduring lack of confidence on the part of small businesses to invest and grow and this is coupled with a lack of understanding of the funding options available.

Q13: *Should the provisions contained in the CRR allow for more differentiation in how they are applied to banks of different sizes or with different risk-profiles? How can they do this without compromising the objective of achieving financial stability and creating a level playing field within the single banking market? Are there any provisions that could potentially be applied with greater differentiation? If so, what are these provisions? Provided application on a differentiated basis is desirable, what considerations could be relevant to make such a differentiated application? Are any concrete changes desirable in this context? If so, what are these changes and the associated costs and benefits?*

Banks have developed differently in different EU countries, both for historical/cultural reasons as well as for market reasons: the client base can differ from country to country, as can the demand for certain forms of funding. These differences have not been taken into account sufficiently in the CRR itself, so that a large, multinational bank is generally treated in the same way as one of the smaller, mainly regionally active ones, when the businesses they are supporting and the risks they are managing may be very different.

This creates deficits in relation to the proportionality principle which also helps to maintain a diverse financing environment for SMEs. Also, it has not been sufficiently considered that some banks have specialized in certain forms of financing, e.g. factoring, which means that they have a different risk scenario. The LCR and the NSFR are examples for rules which were devised for certain banks, but not for highly specialized banks or banking groups, thereby making adjustments e.g. the LCR delegated act in Commission Delegated Regulation (EU) 2015/61 necessary.

Q14: *Which areas of the CRR could be simplified without compromising the Regulation's objective of ensuring prudence, legal certainty and a level playing field? Are there areas that could be simplified, but only for specific types of bank or business models? Would it be useful to consider an approach where banks that are capitalized well above minimum requirements or that are less exposed to certain risks could be subject to simplified obligations? What would be the risks with such an approach?*

The EUF welcomes simplification, not only with regard to the CRR, but with regard to the financial supervisory/regulatory regime as a whole. Especially smaller and highly specialized credit institutions and financial entities which are part of a banking group consider having to check new rules and standards for requirements which might apply to them, even though they are not aimed primarily at them, as an administrative burden and also as a source of risks. The number of new rules and requirements is ever increasing, the sources of these and their relation to each other are also sometimes unclear and the implementation periods are short, especially from the perspective of financial service providers with limited resources. More specialized, but better adapted and lastly simplified rules would of course also require more specialized knowledge in EU institutions such as the EBA and the Commission. The EUF would gladly do its best to contribute to this specialized knowledge.

Conclusion

The financial crisis has taught all of us many lessons, and one of them is to ensure the continued liquidity infusion of SMEs during their peak periods. Even though the SF may not necessarily be directly linked to an increase of capital to SMEs, the situation we experienced during the credit crunch only a few years ago should be avoided at all costs, not only by implementing constant reviews and impact analysis of financial supervisory regulations, but also by providing rules that can act as a "buffer, air bag, or derogation" for SMEs should a similar situation arise once again, thereby ensuring that a sound mix of financing options remain available to them. However, this objective should not be achieved at the cost of stable, low-risk forms of financing which have served especially the SME-community well over many decades.

The EUF believes that paying more attention to important basic principles such as the proportionality principle on the one hand, as well as to low-risk and well-established specialized forms of financing on the other hand while drafting regulatory requirements for credit institutions and banking groups is the only sustainable way forward, also to ensure that a sound financing mix continues to be available for SMEs.

Please do not hesitate to contact us should you require more information about the factoring industry in Europe.

With kind regards

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