To: The European Banking Authority

Kraainem, 21 January 2016

Réf: EUF/16-01

Re: EBA CONSULTATION PAPER ON THE APPLICATION OF THE DEFINITION OF DEFAULT

Dear Madam or Sir,

The EU Federation for the Factoring and Commercial Finance Industry (EUF) is a trade association based in Brussels representing the interests of the European factoring and commercial finance (FCF) industry. Our members comprise 14 national European Factoring associations as well as two (recently merged) international associations, thereby accounting for 97.5% of the total European factoring market. Our association's members comprise of both regulated and non-regulated factoring companies. Over three quarters of the factored volume conducted within the EU is generated by factoring companies that are part of consolidated banking groups, which fall under the umbrella of regulatory oversight. As you know, factoring is a means of finance which is widely used especially by SMEs as it is a method of providing working capital finance to a supplier of goods and services. The factor will provide a range of services to its clients, including providing capital against the assignment of their receivables, accepting the risk of bad debts and collecting on past due accounts. Factoring has been considered a stable financing alternative by many companies, particularly during the financial crisis. Many SMEs that were unable to obtain traditional bank funding turned to factoring as an alternative means of financing. Hence, the factoring industry thrived during the financial crisis, helping hundreds of thousands of SMEs throughout the EU.

The EUF appreciates the efforts made by the Authority to provide general rules to harmonize the treatment of factoring exposures under the Basel framework. The treatment for the factoring exposures as proposed in the Consultation Paper is in line with the outcomes of the preliminary discussions between EBA and EUF and EUF is delighted to provide its contribution and insight on the contents of the Consultation Paper.

Please find below a summary of the EUF proposals, that are more thoroughly explain in the following.

With regard to the guidelines for the QIS on the GL on the definition of default. § 3.3.1 Materiality threshold, the EUF strongly advises a second thought about the approach and in particular suggests:

- to compare the absolute threshold with the amount past due over 90 days and the relative threshold with the ratio between the amount past due over 90 days and the total exposures on the same subject and trigger the default only when both absolute and relative thresholds are breached, or in alternative
- to keep the approach proposed in the QIS guidelines but providing, for an exposure to a debtor within a factoring agreement, that no default can be identified on the debtor in the absence of at least one invoice consecutively due for all the 90 days counting period;

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- in any case, to increase the value of the relative limit to at least 5% and the value of the absolute limit to 10.000€, for factoring and invoice financing;
- that the trigger for retail exposures should be aligned with the trigger for the other exposures, by requiring the breach of both the thresholds.

With regard to the specific treatment for factoring:

- to change §23 as follows "[...] the counting of the days past due should commence when the payment for a single receivables becomes due and the factor has concluded the activities for the reconciliation of the collected amounts. When the assignment is not disclosed to the debtor(s) or when the assignor acts as agent for the collection, the counting of the days past due should commence when the reimburse by the assignor of the collected amounts to the factor becomes due";
- to clarify that the approach for factoring proposed in §22 and §23 is valid for institutions adopting the standardized approach and adopting the IRB approach, unless the latter have implemented their internal rating systems adopting the above-mentioned derogation for purchased receivables as allowed by CRR;
- to add new paragraph, e.g., §23bis and §23ter stating as follows:
    - "23bis. In the case of the exposures referred to in paragraph 23, paragraphs 17 and 18 apply also to the agreements between the suppliers and the buyers underlying the ceded receivables;
    - 23ter. Disputed invoices shall not be considered past due until the dispute has been settled between the counterparties. Nevertheless if the institutions suspect opportunistic behavior of the debtor, they should assess the possible indications of unlikeliness to pay, in accordance with Articles 178(1) and (3) of Regulation (EU) No 575/2013 and Section 5 of these guidelines";
- to clarify that the application of the default definition as for retail exposures to purchased receivables, where the requirements of the above-mentioned Article 154(4) or 153(6) of the CRR are met, is available for institutions that use the Standardised Approach as well;
- to consider that a default on trade debts of PA debtors can be detected only when a crisis procedure has been activated on the single public entity or, at least, one of the following reliefs:
    - i) the introduction of a waiver that would allow the institution to suspend the counting of past due days if the debtor (being a public administration) makes a payment on at least one of its past due exposures, or
    - ii) to provide for the start of counting of the days past due for receivables to public entities to be from the date when the payment is actually expected, according to the factor's experience or to reliable information pooled among institutions where available, rather than from the due date of the invoice;
- to synchronise the entry into force of the new definition of default with the IFRS 9 standard;
- to allow the possibility to calculate days past due on a monthly basis and at the end of the month only.

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The specificities of factoring and the reasons for a specific treatment

It is beneficial to first set out the features that make Factoring a low risk financial product: Factoring is a flexible form of finance which is secured by way of assignment or purchase of receivables. Consequently 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. Moreover, in non- recourse factoring, the factor also provides credit coverage on the debtor exposure, so that (depending on the agreement) the default risk of the debtor(s) may be actually and completely transferred from the client to the factor.

Factoring is widely used by SMEs, usually assigning or selling receivables against their larger and more creditworthy debtors/customers, thus effectively reducing the risk to the financier.

The decision by the Factor about the sum to advance to the client follows the assessment of the value of the sales ledger and takes into account the level of debtor disputes that might cause dilution, as well as setting funding limits of the debtor balance in order to assure a proper diversification of the assigned portfolio of receivables.

In particular, notification to the debtor of the Factor's interest in its debts is a key element in assuring a lower risk to Factoring, as it allows the Factor to directly manage the sales ledger of the client and channel the payments by the debtor into its own bank account. In addition, through the collection services offered, the Factor is able to intercept promptly any non-recoverable invoices and to adjust accordingly the level of finance made available to the client, usually up to 80% of the approved debts, the balance (minus the factoring costs) being paid out to the factoring client later, mostly (and at the latest) when the debtor pays.. Also, it is useful to highlight 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 advances than for example other asset-based lending solutions and, in particular, to recover most of the defaulted exposures having the ability to chase the assets of the assigned debtors and, in recourse operations, the client.

The low risk and real loss nature of factoring is further highlighted when the performance is compared with that of traditional bank lending. The following table (Source: EUF White Paper on Factoring and Commercial Finance, forthcoming) shows data relating to European bank loans according to the Annual Data published by the European Central Bank (ECB) and that of SNL Financial separately published by the ECB, in comparison to samples from the FCF industry collated by the EUF.

	Bank loan impairment rates: Low Risk Countries:	Bank loan impairment rates: High Risk Countries:	Overall EU Bank loan impairment rates:	EUF Sample FCF Provision Rates: Low risk countries:	EUF Sample FCF Provision Rates: High risk countries:	Overall EUF FCF Sample
2012	0.46%*	2.12%*	1.22%^			
2013	0.40%*	1.72%*	0.96%^			
2014	0.32%*	1.60%*		0.09%	0.43%	0.26%
2015 h1	0.19%*	1.20%*				

*https://www.ecb.europa.eu/pub/pdf/other/financialstabilityreview201511.en.pdf?24cc5509b94b997f161b841fa57d5eca page 70, chart 3.6 SNL Financial

^ https://www.ecb.europa.eu/stats/money/consolidated/html/index.en.html (reference period end 2013/2012, impairment loans and receivables inc. FL as a % of total loans and receivables inc. FL)

Comments on the QIS on the GL on the definition of default. § 3.3.1 Materiality threshold

Regarding the approach, some technical issues still remain to be settled, that will be discussed further below. However, as an initial point, although we understand that Factoring is outside the scope of this QIS, the EUF would like to express its serious concerns about the policy option the EBA is testing within the QIS regarding the materiality threshold.

In particular, whilst the new option recognizes some comments proposed, among others, also by the EUF, namely the increase in both the absolute and relative limits and the trigger as both the limits are exceeded cumulatively, yet it provides a slight but significant change in the approach stating that the counting of the 90 days should start as soon as the amount past due exceeds the two components of the threshold.

We understand that the final decision about the policy has not yet been set and the EBA is considering alternatives to this approach, but we need to underline now that this change in the approach could be tremendously detrimental to the Factoring industry and hence to the thousands of SMEs supported by it , in particular when referred to the exposures to debtors raising from Factoring agreements where the risks and benefits related with the ceded receivables are fully transferred to the Factor under a non recourse agreement.

The EUF must once again emphasize the fact that these kinds of exposures refer to the trade receivables purchased by or assigned to the factor, i.e. the amount of the exposure to a certain debtor at a certain date is the sum of the amount of the single invoices outstanding at such date as a consequence of the supply relationship between the supplier (the actual client of the factor) and its buyer (the debtor, which is the actual obligor in this case).

The peculiar nature of this kind of exposures encompasses some differences from the exposures rising from traditional finance products such as loans, that can be summarized as follows:

i. the Factoring agreement is between the Factor and the client, i.e. the supplier, while the debtor generally does not enter in any contractual relationship with the Factor;
ii. while traditional lending is subject only to terms, the credit raised from trade receivables is subject to terms and conditions: that means that the due date of the invoice cannot be considered as fully mandatory in itself for the debtor, as there may be events connected to the trade relationship that reduce the reliability of the due date (we will focus more on this issue in the following),
iii. payment of trade debts by the debtor is subject to the so-called "payment behavior" of the debtor, that - roughly speaking - expresses the habits of a buyer to pay its commercial payables with a certain delay on the due date. This is usually connected to the working capital management policy of the buyer rather than to its actual financial situation. Factoring itself is often used by the supplier in order to manage these longer periods that are usually well known and accepted by commercial practice, in particular in some Countries around Europe (estimates for Italy, for example, suggest that the outstanding past due debts represent on average about 30% of the total).

These specifics imply that a certain delay is innate in the exposure to debtors within a Factoring agreement with a client. This is also due to technical reasons: indeed, the debtor may be or may not be informed about the factor's interest on the ceded receivables. In the former case, the debtor pays directly to the factor's account, and the factor requires some days for reconciliation of the amount collected with the client's account. In the other case if (by mistake or on purpose) the debtor pays to the bank account of its supplier, i.e. the factor's client, it may be that the latter requires some days to transfer the collected amount to the factor.

For all the above-mentioned reasons, a certain delay in the payment of invoices occurs almost every time, so that debtors usually show a certain part of its outstanding debts that are past due for some (sometimes many) days.

We believe that the new policy option, that provides a trigger for the counting of days past due when both absolute and relative thresholds are exceeded (at least for non retail exposures), may bring the unintended result that most if not all the debtors will be considered as past due over 90 days, as due to the abovementioned factoring characteristics, a certain amount of past due debts, most probably exceeding both limits, is always present and innate in the operation.

Moreover, we also stress that the debtor may be, at the same time, both a client of the factor itself and of other banks within the banking group, thus implying that the whole exposure of the group on such subject may fall into the non performing class due to reasons other than its actual financial situation.

To avoid this unwanted and unreasonable situation, **the EUF strongly advises:**

Option (a)**:** a step back to the former policy option on materiality threshold but keeping the trigger of default when both limits are breached cumulatively, i.e. to **compare the absolute threshold with the amount past due over 90 days and the relative threshold with the ratio between the amount past due over 90 days and the total exposures on the same subject and trigger the default only when both absolute and relative thresholds are breached**,

or in alternative

Option (b): to keep **the approach proposed in the QIS guidelines but providing**, for an exposure to a debtor within a factoring agreement, **that no default can be identified on the debtor in the absence of at least one invoice consecutively due for all the 90 days counting period**. This solution would appear more in line with art. 178 of the CRR, that reads: "*A default shall be considered to have occurred with regard to a particular obligor when [...]the obligor is past due more than 90 days on any material credit obligation to the institution*". We understand that, considering the particular nature of the underlying exposures (that cannot be compared with installments of a financial contract), the requisite of continuity in past due is not fulfilled unless at least the oldest due invoice has been "past due" consecutively for at least 90 days.

In any case, considering the fact that late payments in trade receivables are a common practice in the trade relationships of the businesses, the EUF also reaffirms its suggestion, as already stated within the relative consultation process, **to increase the value of the relative limit to at least 5% and the value of the absolute limit to 10.000€**, for factoring and invoice financing. Moreover, the trigger for retail exposures should be aligned with the trigger for the other exposures, by requiring the breach of both the thresholds.

Answers to EBA's questions

Question 1: Do you agree with the proposed definition of technical defaults? Do you believe that other situations should be included in this definition? If yes, please provide detailed proposals on how to address further possible solutions.

The EUF takes note that under the EBA's draft guidelines "*A so called 'technical default' should only be considered to have occurred in either of the following case:*

(a) where an institution identifies that the defaulted status was a result of data or system error, including manual errors of standardised processes but excluding wrong credit decisions;

(b) where due to the nature of the transaction there is a time lag between the receipt of the payment by an institution and the allocation of that payment to the relevant account, so that the payment was made before the 90 days and the crediting in the client's account took place after the 90 days past due."

In principle, we do not share the view in paragraph 20 that the classification of the obligor as in a defaulted status should not be subject to additional expert judgment. Expert judgment has an important place within credit risk management and should continue to be used. Situations may occur that will result in past due exposure of more than 90 days, however not due to a credit deterioration of the counterparty. This restrictive definition is likely to strongly increase the default rate and consequently, the provision for credit loss (cost of risk) of the bank at constant perimeter in terms of activity and risk profile. Linked to this, another risk of this too restrictive definition is to force an increase of the level of cured defaults when based on a purely automated approach, to decrease the accuracy of internal models and to reduce the incentive of the use tests.

In Factoring operations, due to the nature of the underlying purchased receivables and to the practicalities of the industry, this is even more greatly exacerbated.

As stated above, payments by debtors are made on the Factor's own account and therefore are always subject to reconciliation with the client's and the debtor's account. This process requires a variable number of days that depends on the features of the payment, namely:

a) when the assignment or purchase of receivables has been disclosed to the debtor, on whether the payment: i) refers to a single invoice or many, ii) refers to a single supplier or many, iii) includes information on the invoices paid and such information is processable,

b) when the assignment or purchase of receivables has not been disclosed to the debtor or when the factoring client acts as collection agent for the factor, on the days the client may take to collect the payments and transfer the collected amount to the factor, and on whether the factor agrees that the client transfers the collected amounts at certain dates rather than one by one.

This situation does not actually stem from errors in the processes but it's just the way Factoring is carried out and may occur at the threshold of the 90 days past due or at the due date.

In the former case, where a payment has been made before the 90th day of delay but reconciliation occurred after such day, we believe this situation does fit with the case in sub (b) of §20 and represents a true 'technical default'.

In the latter case, where a payment occurs at the invoice due date but reconciliation occurred after such day, according to the new policy option regarding materiality thresholds, such delayed payments would however trigger the comparison with the thresholds and the counting of the 90 days past due, with the consequences of continuously 'start and stop' the counter due to merely practical reasons.

Other examples of "technical default" or "technical past due" in factoring can be categorised as follows:

- the seller has not dispatched the invoice to the buyer;
- extension of payment terms granted to the debtor but not yet registered on the Factor's system;
- discounts, deductions, netting or other credit invoices issued by the seller but not promptly communicated to the factor or not directly linked to the invoices;
- wrong payments by the debtor to the supplier;
- delay in the transfer of information about the collected receivables by the seller in non notification factoring agreements or when the client acts as agent for the collection;
- delay in the registration of the collected amounts in non notification factoring agreements or when the client acts as agent for the collection;
- payments by the buyer without indication of the paid invoices.

A practical solution to avoid most of the above mentioned issues, that would require a change in the technical default definition would be to change §23 as follows "[...] *the counting of the days past due should commence when the payment for a single receivables becomes due* ***and the factor has concluded the activities for the reconciliation of the collected amounts****.* ***When the assignment is not disclosed to the debtor(s) or when the assignor acts as agent for the collection, the counting of the days past due should commence when the reimburse by the assignor of the collected amounts to the factor becomes due***".

The number of days required for the reconciliation of collected payments may be formalized within the internal policies and practices of the institution, accordingly to Article 178(2) of Regulation (EU) No 575/2013 that states that: "*Institutions shall have documented policies in respect of the counting of days past due [...].These policies shall be applied consistently over time, and shall be in line with the internal risk management and decision processes of the institution.*".

We assume that the other above-listed cases actually fall under the current proposal of technical past due definition.

Question 2: Do you consider the requirements on the treatment of factoring arrangements as appropriate and sufficiently clear? If not, please provide proposals for additional clarifications.

The EUF believes that the approach regarding the treatment of factoring arrangements requires further clarification.

In particular, it is important to remember that according to the IAS/IFRS framework the balance sheets of the factors express two kind of risk:

- the risk on the client, represented by the amounts advanced by the factor against the outstanding assigned receivables within factoring agreements with recourse or without recourse where risks and benefits are fully transferred to the factor;
- the risk on the debtors, represented by the invoices purchased within factoring agreements where risks and benefits are fully transferred to the factor.

So it is useful to split comments between those risk categories.

Nevertheless, it is useful to note that in some countries IAS principles do not apply at individual level, so that factors, for any type of factoring, always account the purchased receivables among the assets, and the retentions, reserves, deposits of guarantees among the liabilities; the difference between the global amounts of purchased receivables and retention, reserves, deposits of guarantees indicate the amount of the funding granted by the factor – which is not as such written in the balance sheet.

Notwithstanding the accounting representation, when assessing the risk of a given factoring agreement, factors usually combine both client and debtor risks to take into account the above-mentioned specificities of factoring.

Client side

On the client side, the financing facility is usually considered as one and limited to a percentage of the amount of the outstanding receivables.

The EUF reckons that taking into consideration the agreed percentage of advance, as proposed by the EBA in the Consultation Paper, may represent a proper way to treat factoring.

Indeed, the actual amount of funds available to the client on a certain day is calculated taking into consideration such agreed percentage of the invoices that are considered suitable for finance.

Thereafter, the availability is increased by:

- receiving invoices form the client, and
- receiving payments from the debtors or reimbursed by the client or by the insurance company,

while it is decreased by:

- any prepayment made to the client,
- credit notes, and
- the financier's fees and charges.

However, the practical implementation of such an automatic approach requires some clarifications.

We appreciate that the approach is consistent with art. 166 of the CRR ('Exposure value'), that clearly states that '*Unless noted otherwise, the exposure value of on-balance sheet exposures shall be the accounting value measured without taking into account any credit risk adjustments made*.' However, it is also necessary to clarify explicitly that the specific derogations already provided by the CRR for the treatment of purchased receivables under the IRB approach still hold. In particular, provided that some conditions and requirements about the purchased receivables are met and that such representation is consistent with the internal credit risk management policy:

i. the institution may be authorized to allocate the exposure to the assigned receivables (or, under different conditions, on the pool of assigned receivables), when some operational requirements (art. 184) are fulfilled. The risk parameters are calculated on the debtor side, although the institution may consider a personal guarantee by the assignor when it has full recourse on the latter;
ii. the institution may be authorized to allocate the exposure on the client, the exposure being the advance, and consider the assigned receivables as a collateral for the exposure to the client when some requisites about legal certainty and risk management are met (art. 209). The risk parameters are calculated on the client side and a deduction on the LGD is provided when the advance does not exceed 80% of the ceded receivables (35% instead of 45%, art. 230).

Therefore, we assume that **the approach proposed in §22 and §23 is valid for institutions adopting the standardized approach and adopting the IRB approach, unless the latter have implemented their internal rating systems adopting the above-mentioned derogation for purchased receivables as allowed by CRR**. A clarification in the text of the guidelines would be welcomed.

From a technical point of view, the factor may provide different credit lines to the client: in these cases, the total amount that is 'in debit' (i.e. the amount that exceeds the agreed percentage) for the purposes of §22 should be represented by the sum of the amounts that are in debit for each single factoring credit line.

There are cases where the factor does not inform the client about such percentage: in those cases, the factor manages the position of the client according to its internal limits and implicitly considers that it is liable up to the total amount of the outstanding debts (i.e. the agreed percentage is equal to 100%).

Debtor side

As already mentioned above, the risk taken on the debtor (i.e. the client's buyer) within a non recourse factoring facility has a peculiar nature as the underlying debt is an account payable, subject to conditions and not only to payment terms like financial debts. These conditions are not always explicit in the agreement but may be - and usually are - implicit in the supply relationship.

Moreover, the payment is also subject to the so-called "payment behavior" or "payment habits" of the buyer, a certain delay in the payment of the payables that is usually an expression of the nature of the supply, of the relative strength of the buyer within the supply relation, of the customs of the sector of activity and of the payment policies of the buyer. For example, a buyer may decide, for its own internal policy on working capital management, that all payments on trade debts are concentrated at the end of the month, regardless of the actual due date of the invoices. This practice is quite common and easily accepted by the supplier, and does not require any formal or written agreement.

Therefore, as stated above, in principle we are not in line with the view in §20 that the classification of the obligor to a defaulted status should not be subject to additional expert judgment and believe that, in principle, a judgmental assessment of the situation of the debtor or a **rebuttable presumption** that the debtor that presents trade payables past due over 90 days is defaulted, that allows the institution to 'flag' inconsistent defaults of creditworthy debtors when in the presence of these events linked to the trade relationship **would avoid unnecessary classification in default and the consequent effect on the whole group position of such debtor due to the contagion criteria**. The EUF understands that the EBA may feel that it is not in its power to introduce waivers on such automatic approach provided by the CRR, but this advice will be shared also with any other competent Authorities in order to integrate it in the regulation and assure a proper regulation for factoring operations.

Taking this last reflection into consideration, as a practical alternative, the EUF suggests that **a recognition of the trade events** that may reduce the reliability of the due date of the invoice as a mandatory payment date for the debtor or postpone the actual payment terms for the buyer according to some conditions **under the reliefs proposed in §17 and §18 would represent at least a partially positive fall back**.

Although the exposure to the debtor does not stem from a "credit arrangement" between the factor and the obligor (as we said, there is no contractual relationship between the factor and the debtor, which may also be not even aware of the transfer of its debts to the factor), **we assume these reliefs are valid also for this kind of exposures** and the words "credit arrangement" might be extended to the original supply contract between the supplier and its debtor, that the factor can only acknowledge. A clarification on the text would be welcomed.

We appreciate that §17 and §18 already state as follows:

17. Where the credit arrangement explicitly allows the obligor to change the schedule, suspend or postpone the payments under certain conditions and the obligor acts within the rights granted in the contract, the changed, suspended or postponed installments should not be considered past due, but the counting of days past due should be based on the new schedule once it is specified. Nevertheless if the obligor changes the schedule, suspends or postpones the payments, the institutions should analyse the reasons for such a change and assess the possible indications of unlikeliness to pay, in accordance with Articles 178(1) and (3) of Regulation (EU) No 575/2013 and Section 5 of these guidelines.

18. Where the repayment of the obligation is suspended because of a law allowing this option or other legal restrictions, the counting of days past due should also be suspended during that period. Nevertheless, in such situations, institutions should analyse, where possible, the reasons for exercising the option for such a suspension and should assess the possible indications of unlikeliness to pay, in accordance with Articles 178(1) and (3) of Regulation (EU) No 575/2013 and Section 5 of these guidelines.

Hence we present a list, obviously not exhaustive, of examples of the trade events that we assume fall under the definition of technical default (§20) or under the provisions of §17 and §18.

N.	Event	Applicable treatment
1	Contractual agreements that allow flexibility of payment or extensions of the payment terms to the buyer	§17
2	Payments related to subcontracts where the subcontractor agrees to receive the payments for its work conditional on the collection of the payments by the first contractor	§17
3	Payments conditional on the consent to pay by the buyer (e.g. after verification of the supply)	§17
4	Share of the due amount kept by the buyer as guarantee of completion of work or quality control	§17
5	Agreement between the factor and the client that allows the latter to transfer the collected amount, under a non notification factoring agreement or when the client acts as agent for the collection, at certain agreed dates rather than one by one	§17
6	Extension of payment terms granted to the buyer by the seller in non notification factoring agreements, not necessarily in written form	§17
7	Incomplete verification and liquidation process by PA buyers	§18
8	Payments conditional on the elaboration of final expenditure documents by public health debtors, where the law provides that the payments over the planned amount are suspended until the final expenditure is settled	§18
9	Laws preventing payments over the planned amount by PA debtors or allowing the PA debtors to delay the payment by way of a hindrance to the enforcement or other mechanism	§18

In particular, the EUF believes that disputes must be considered thoroughly.

From a risk perspective, **the disputes, as well as discounts, deductions, rebates, bonuses and netting or in general credit notes issued by the seller are not in the field of default risk but rather in the field of dilution risk**. Please note that dilution will only lead to a loss for a factor if the diluted invoice amount cannot be replaced by invoices in the reserve already kept by the factor (availability, non-advanced invoices, ineligible invoices). In other words a loss for the factor only qualifies in case of a so-called double default. This is also recognized by the CRR: under the IRB approach, dilution risk is subject to a separate requirement, unless it is considered irrelevant.

When the buyer disputes a receivable (e.g. receivables not existing at all or just partially existing, commercial supply not regular or different to the agreements, etc.), the amount or even the very existence of the invoice may be challenged. It is very uncommon that disputes are brought to a court. Whilst disputing parties usually try to settle the dispute outside the court, the process can nevertheless be time-consuming and exceed the 90 days. These events should be classified within client risk, since they are not covered by credit insurance (and consequently do not represent debtor risk) and since, if they occur, the corresponding amounts are debited from the client account and finally generate client default if they are not reimbursed before 90 days. Therefore, dilution risk should be treated according to art. 230 of the GL10 and definitely not as representing a source of default risk on the debtor. The EUF considers that **these cases should be excluded from the definition of default as they refer to a different kind of risk and proposes that, until the dispute has been settled between**

the counterparties (seller and buyer) the unpaid invoice should not be considered past due, whether or not the dispute has been put forward to a court.

We therefore propose to add new paragraph, e.g., §23bis and §23ter stating as follows:

"***23bis. In the case of the exposures referred to in paragraph 23, paragraphs 17 and 18 apply also to the agreements between the suppliers and the buyers underlying the ceded receivables.***

23ter. Disputed invoices shall not be considered past due until the dispute has been settled between the counterparties. Nevertheless if the institutions suspect opportunistic behavior of the debtor, they should assess the possible indications of unlikeliness to pay, in accordance with Articles 178(1) and (3) of Regulation (EU) No 575/2013 and Section 5 of these guidelines."

The EUF also believes that a clarification is needed regarding §23, where the consultation paper reads as follows: *"[...] for institutions that use the IRB Approach, by virtue of the fact that the ceded receivables are purchased receivables, where they meet the requirements of 154(4) of Regulation (EU) No 575/2013 or in the case of purchased corporate receivables the requirements of Article 153(6) of Regulation (EU) No 575/2013, the default definition may be applied as for retail exposures in accordance with Section 9 of these guidelines"*.

According to this wording, **the EUF suggests the EBA clarify that the application of the default definition as for retail exposures to purchased receivables, where the requirements of the above-mentioned Article 154(4) or 153(6) of the CRR are met, is available for institutions that use the Standardised Approach as well**.

PA Debtors

Although some cases are already treated in the above, we believe that low thresholds as proposed by EBA give rise to concerns about the exposures of institutions to public administration and government institutions.

During the public hearing, EBA has indicated that it will be proposing a specific treatment for public institutions on the evaluation of unlikeliness to pay. We believe a similar exceptional treatment must be introduced for the past due trigger for default: such exceptional treatment would be justified given the specificities of the trade debts of public administrations, where payment habits vary amongst Member States. In some, the average past due date exceeds 180 days while the actual risk of losses is very limited if any, considering that intervention by Central Governments may eventually occur in the worse cases such as in the form of outstanding trade debts payment programmes (i.e. Spain and Italy). The EUF therefore suggests the EBA carefully analyzes the actual risk of these public trade debts and proposes a proper specific treatment. From a risk perspective, PA trade debts are not really a source of credit risk but actually a source of liquidity risk, as the real risk is not losing money but rather getting the money back later than expected; therefore, an approach to credit risk capital requirements identifying defaulted exposures to PA debtors by way of the application of automatic procedures relying on the delay of payment of trade debts is not consistent to the reality of facts or to the actual risk of the operation.

The EUF understands that the CRR may pose limits on the competence of the EBA on this matter. Yet, the issue is crucial to the factoring industry and therefore we emphasise the need to overcome the risk that a significant number (if not all) of the PA entities in some countries will be identified as defaulted, thus preventing factoring institutions from continuing to provide support to the PA's suppliers and drying out a vital source of liquidity to SMEs.

Due to the peculiar nature of PA debtors and in particular of PA trade debts, we suggest the EBA considers that **a default on trade debts of PA debtors can be detected only when a crisis procedure has been activated on the single public entity** or, at least, one of the following reliefs:

i) the introduction of a waiver that would allow the institution **to suspend the counting of past due days if the debtor (being a public administration) makes a payment on at least one of its past due exposures**, or

ii) **to provide for the start of counting of the days past due for receivables to public entities to be from the date when the payment is actually expected**, according to the factor's experience or to reliable information pooled among institutions where available, rather than from the due date of the invoice.

Question 7: What probation periods before the return from default to non-defaulted status would you consider appropriate for different exposure classes and for distressed restructuring and all other indications of default?

In general, the EUF believes that **no probation period should apply to automatically identified default**, i.e. when the default raises from the past due over 90 days criterion. Article 178(5) of the CRR indeed endorses a judgmental approach, as it reads as follows: "*If the institution considers that a previously defaulted exposure is such that no trigger of default continues to apply, the institution shall rate the obligor or facility as they would for a non-defaulted exposure. [...]*"

In particular for factoring exposures, and focusing on the debtor side, the probation period concept does not seem to be appropriate: in the case where the factor takes the full debtor risk, one time a debtor has repaid its invoice, be it in full, or partially following a recognised technical default (dispute, discussion, etc…) , the corresponding outstanding disappears, meaning that the past due exposures actually no longer exist. By the way, as already mentioned many times throughout this paper, the existence of past due invoices is not a proper signal of financial difficulties, as the reasons for payment delay may lie in trade related decisions taken by the debtor itself or in agreement with its supplier. Therefore, there is no real need for a probation period in this case: as a matter of fact, imposing a (minimum) three months duration does not fit with any reality encountered on the debtor's side. Moreover, a probation period would have a double negative effect on the factor's debtor portfolio given the expected high volatility of defaults driven by the 90 days past due principle, in particular if the counting has to be performed on a daily basis.

We therefore propose to **drop the three months minimum probation period for default identified through the past due over 90 days criterion, or at least for the exposures to debtors**, stating that when the past due invoices are repaid, the debtor can be thought as back to normal.

Other comments

Time needed for implementation

The impact of the proposed definitions on financial institutions will vary depending on the extent to which the current approaches deviate from the proposals.

However, given the envisaged significant impact on substantial numbers of institutions, we would like to stress that sufficient time needs to be granted to change all the different operative procedures and to enable banks' customers to become used to the new rules, which are sometimes very strict compared to the current ones. In addition to the previous remarks, common to all banks, the IRB banks need to have sufficient time to enable the recalibrations of models and banks' internal systems and also to factor in the time required for obtaining supervisory approval of the banks' internal models.

In order to minimize the operative impact **it is important to synchronise the entry into force of the new definition with the IFRS 9 standard**. The new rules on the definition of default should therefore not enter into force before the mandatory application date of IFRS9.

Daily basis counting past due

In §19 and §91 it is stated that the past due count must be performed on a daily basis. This type of count gives a potential high volatility to the results and, for factoring in particular, it can generate a relevant IT burden to account correctly exposures on clients / debtors. The negative effects of such volatility could also be exacerbated by the provision of a probation period (see answer to Question 7).

We would instead recommend to allow that where it would be unduly burdensome for an institution doing factoring to perform the counting of days past due on a daily basis, the institution has **the possibility to calculate on a monthly basis and at the end of the month only**.

With kind regards,

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