EUFederation
Factoring & Commercial Finance

To:
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Kraainem, 26 March 2015

Réf: EUF/MP/15-003

Re: Consultative Document - Revisions to the Standardized Approach for credit risk

Dear Madam/Sirs

We are writing in response to your request for feedback to your Consultative Document on the Revisions to the Standardized Approach for Credit Risk. 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 industry. Our members comprise 14 national European Factoring associations as well as two 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 falls 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 wishes to underline that the factoring and commercial finance industry is looking with growing concern at the evolution of the proposed regulation issued by the EBA and the BCBS, which are both currently in consultation, and the adverse impact the recommended changes to the standardized approach on credit risk might have on the industry. The EBA proposal on materiality threshold of credit obligation past due under Article 178 of Regulation

(EU) 575/2013 in our opinion provides a restrictive approach to identify past due exposures and the above mentioned BCBS proposal on revisions to Standardized Approach provides a very likely increase in the risk weight applicable (in particular) to exposures to corporates. Together, we fear they might be extremely detrimental for the commercial banks and financial companies operating in the factoring sector being subject to exposures that during their life become more easily "past due" because of their link with the trade relationships and payment behaviors between the supplier and its client but with an actual very low chance of actual loss.

Exposures to corporates

The EUF believes that the current proposals are too penalizing with respect to the previous regime. High-rated, large corporate companies will be weighted with a Risk Weight (RW) which is 3 times the previous one (60% vs 20%); non-rated, smaller businesses will be weighted not below 100% and up to 130%; companies with negative equity will be weighted with a flat weight of 300%. This will definitely bring a significant increase of the capital requirements for the whole banking system. Furthermore, the EUF also believes that the spread between the best weight (60%) and the worst (300%) is too high and would penalize in particular those countries (e.g. Italy) where there are a certain number of enterprises that have a low level of equity but their exposures are adequately collateralized.

Moreover, the use of only two risk drivers (revenue and leverage) appears too simplified, too reliant on absolute measures and not really risk sensitive. The EUF maintains that more risk sensitive drivers would be the ones that allow the industry to assess the capability of the enterprise to generate enough cash flow to repay its debt (e.g. charges for interest/EBITDA or Financial Debts/EBITDA and so on).

External Ratings

Even if the EUF agrees that overreliance on external ratings is not desirable, it underlines that most of the problems with external ratings that brought to the current situation of crisis was caused by an incorrect assessment of the risk underlying ABS facilities and Sovereign debt, while the ratings assigned by the rating agencies to corporate companies on the contrary came out to be more consistent with the actual risk of the assessed counterparties. Nevertheless, even if the EUF appreciates the fact that only a small part of the corporate counterparties is rated, it wishes to point out that the rating agencies carry out an assessment process on the client which is both quantitative and qualitative, and at the end very thorough and inevitably more risk sensitive than an approach based only on the combination of (two) quantitative measures, without any possibility to correct the risk weight on the basis of elements raising from the qualitative assessment made by the bank.

Finally, the proposed approach is very likely to impose a heavier operational burden on the banks, without any benefit (but with a certain worsening) on the capital requirements side. Indeed, the requirement to collect, structure and manage information about revenue and ledger will definitely increase the cost of the relationship with the client.

Therefore, the EUF advocates for:

i. the rejection of the proposed approach and the confirmation of the current one based on external ratings when existent and a flat (perhaps revisited) risk weight for non rated businesses or, subordinately,
ii. a mixed approach where external ratings keep being used when appropriate, linked to the current and less penalizing risk weights, while the risk drivers combination will be used only for exposures to non-rated businesses. In this case, however, we recommend a re-calibration of the risk weights aimed to reduce the spread between the best weight (60%) and the worst (300%). The latter should not be higher than 130% (the risk weight applicable to the riskier class provided in the table).

Cliff effect

Enterprises currently included in the retail portfolio may be excessively impacted by the subsequent transfer to the corporate portfolio after the loss of one or more of the requirements for being considered as retail. The applicable risk weight may increase from 75% up to 130%, according to the leverage, or even to 300% in case of negative equity. The requirements for identifying retail exposures are not yet well defined in the consultative paper and for this reason the EUF urges the BCBS to propose a more stable approach in order to avoid the fluctuation of risk weights applicable to a counterparty driven by for example the fact that its exposure fluctuates up and down a threshold.

Past due loans

With regards to the Past due loans, the consultation document is still too restrictive. The EUF believes that the current approach is already well suited to address the risk of insufficient provisioning for higher unexpected loss, by way of the flat risk weight of 150%, potentially reduced when appropriate specific provisions are made. Therefore and consistently with the above-mentioned comments on the proposals to review the risk weights applicable to corporate exposures, the EUF deems the 150% flat risk weight for past due loans appropriate and does not see any need for a change , also considering that the EBA has recently issued (and is about to issue) many technical standards that will eventually increase by far the amount of past due loans and therefore will definitely improve the attention paid by the banking industry on non performing and past due exposures.

A different approach, based on add-ons to the applicable risk weight, must vary as a function of the amount of the provisions and should be graduated on the bad exposure.

The specificities of factoring and the reasons for a specific treatment under the Standardized Approach

It appears useful to spend some words in order to explain 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 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.

The decision about the amount to advance to the client follows the assessment of the value of the sales ledger and takes into account the assessment of the level of debtor disputes that may bring to a dilution, as well as 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 on its debts is the key to assure a lower risk for factoring, as it allows the factor to directly manage the sales ledger of the client and channel the payments by the debtor on its own accounts. By the way, through the collection services offered, the factor is able to intercept promptly non-recoverable invoices and to adjust accordingly the level of finance made available to the client, usually up to 80% of the approved debts. Besides, it is 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. This entails that the Loss Given Default (LGD) ratio in factoring is lower than the 45% level assumed in the Standardized Approach to determine risk weights.

The available estimates suggest indeed that the average LGD for debtor default in factoring is about 21% in Italy and 12% in Germany[1]. Such a lower LGD is also due to the fact that the factor, during the relationship, can monitor the trend of the payments by the debtor and intercept earlier than other financiers any signal of decay in credit quality (as the factor is the first to determine whether the debtor is able to pay on time). The average Expected Loss Ratio for factoring exposures in those Countries is very low and estimated to be approximately 0.58% in Italy and 0.06% in Germany. Figures published by the ACPR (Autorités de Contrôle Prudentielles) on provisions and purchased invoices outstanding by the French factoring companies suggest an average ratio of 0.11% in 2013.

A comparison between these figures and the ratio between provisions and loans in these Countries suggests that the actual losses in factoring is less than a half of the actually risk borne by the banks (see Table 1).

Table 1. Estimates of credit losses

	Credit Losses Factoring	Credit Losses Banks
France	0.11%	0.34%
Germany	0.06%*	0.38%
Italy	0.58%*	1.93%

* Estimates of the Expected Loss Ratio
Source: elaboration on data provided by Assifact, Autorités de Contrôle Prudentielles, Banca d'Italia, Bundesbank, DFV.

Therefore, the EUF urges the BCBS to consider the introduction of a specific approach for factoring exposures, and in particular:

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

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.

[1] Estimates for Italy (provided by Assifact) already include dilution risk, while in Germany the LGD for dilution risk is below 60%, including first and foremost the risk of fraud (estimates provided by DFV).

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Furthermore, as mentioned previously, 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 above-mentioned features of factoring, the EUF believes that, in the view of the alignment to the IRB approach, the BCBS should 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 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) to provide a lower, specific risk weight for factoring exposures, by way of a cap or a cutoff on the applicable risk weight

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 amount of retention on the risk weight for factoring reflects the lower risk as proved above.

Credit Conversion Factor

As far as the product is concerned, factoring exposures linked to invoice financing can be considered, to some extent, as equivalent to “Short-term self-liquidating trade letters of credit arising from the movement of goods”.

The arguments are as follows:

- the invoices processes follows a similar logic as those applied for the trade letters of credits,
- they represents the formalization of an economic transaction,

- they bear a self liquidating character as the repayment source is independent from the client,
- no drawing on any credit line can be done, without having purchased beforehand adequate assets,
- meaning that any drawing is constrained like in the trade letters of credit.

Next to that, as a matter of evidence, when a company is nearing the default point, the turnover is going down, and the number and amounts of invoices sold to the factor are decreasing. Out of the experience evidenced in the application files, the factoring outstanding at the date of default are in most of the cases lower at the time of default than at the time of observation, meaning that the use of the committed part of the financing line bears a credit conversion factor nearing 0%. The usage of any credit line is de facto limited to the maximum of the amount of the invoices remitted. Additional drawing without any invoice are therefore not possible as opposed to the classical overdraft product.

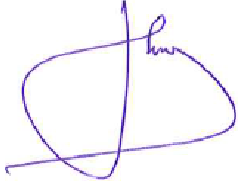
The EUF proposes therefore to include the factoring product as a category similar to the self-liquidating trade letters of credit: as a consequence, the same treatment as for the trade credit letter should apply, namely a Credit Conversion Factor of 20%, to keep a conservative margin.

Conclusion

There are many unique aspects to the factoring and commercial finance industry that your study unfortunately does not take into account when considering changes to the standardized approach methodology. It especially does not consider the importance the industry plays in providing the necessary working capital financing to SMEs, the real driver of economic growth in the EU. Your report states indeed that the “risk weights on SMEs is more than double the average risk weight on other corporates”. And indeed, the leverage of SMEs is normally higher than those larger corporates. However, the factoring industry has a proven track record of low losses financing SMEs mainly due to its unique systematic approach to control the risk through the management of the cash flow from their end customers, the incorporation of prudent measures to control the dilution risk, and spreading the risk away from one single seller to a basket of risk as defined through their customer base. It is this unique structure that is at risk by the changes proposed in your consultative document, which would create an undue burden by establishing increased capital reserves, in some cases tripling them, which would ultimately restrict capital to the very companies that need financing the most, the SMEs! We hope that you will take this into consideration and not proceed with your current proposals, and instead provide some form of derogation to the factoring and commercial finance industry by avoiding the implementation of such a restrictive methodology to assess

credit risk, or alleviating the burden by allowing a mixed approach, as we have suggested in our aforementioned recommendations.

With kind regards,



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