EUFederation
Factoring & Commercial Finance

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Ref.: EBA's report and opinion on perimeter of credit institutions (27 November 2014)

Dear Madam, Dear Sirs,

The EU Federation for Factoring and Commercial Finance (EUF) is the representative body for the factoring and commercial finance industry in the EU. It is composed of national and international industry associations that are active in the EU and represent 97.5% of the industry turnover. The EUF seeks to engage with Government and legislators to enhance the availability of finance to business, with a particular emphasis on the SME community. The EUF wishes to act as a platform between the factoring and commercial finance industry, and key legislative decision makers across Europe. Therefore, the EUF offers itself as a source of reference and expertise on the factoring and commercial finance industry in order to assist with the direction of existing and future finance legislation with a view to ensuring the continued provision of prudent, well structured and reasonably priced finance to businesses, SMEs in particular, across the EU.

Against this background, the EUF has closely followed the ongoing discussions regarding the creation of new regulatory requirements for what is commonly referred to as “shadow banking” as well as the revision of already existing regulations with a view to e.g. widening scopes of application and altering definitions. In this context, the EUF’s attention was drawn to the EBA’s report and opinion on matters relating to the perimeter of credit institutions which was published in late November 2014 (cf. https://www.eba.europa.eu/-/eba-publishes-an-opinion-on-the-perimeter-of-credit-institutions). As the aforementioned report and opinion of the EBA also mention and make reference to factoring, the EUF wishes to comment on these documents and provide some background information on factoring in order to provide a clearer picture of what factoring and commercial finance means and entails.

The EBA’s report and opinion mention factoring several times and also include factoring companies among the entities which the EBA considers as “genuinely in the shadows” (cf. p. 2 of the EBA-report) but it seems as if neither the differences between factoring and other financial services nor the fact that factoring companies are often banks or subsidiaries of banks that are already supervised (on a solo or consolidated level) were considered when composing the report and the opinion.

In the attempt to identify key terms and parts of the definition of the term “credit institution” which possibly should be reviewed in order to limit the “degree of variation between the Member States as to the interpretation of the term ‘credit institution’” (cf. p. 4 of the EBA-report), the EBA’s classifies factoring companies as entities that “carry on bank-like activities within the scope of credit intermediation” (cf. p. 2 of the EBA-report) and it suggests to include factoring in the list of examples for the (granting of) “credit” (cf. p. 11 of the EBA-report).

It is in this context of trying to create a new definition for the term “credit institution” which can be applied homogenously that the question arises of how to then delineate the concepts “granting credit”, “factoring” and “trade/supplier’s credit”. In most Member States, factoring is effected through the purchase/assignment of trade accounts receivables: In return for providing the seller/factoring client with liquidity through the payment of the purchase price for the receivables, the buyer/factoring company acquires the receivables and therefore becomes the new creditor of these receivables. With a trade/supplier’s credit, the supplier grants his customers certain accommodations for payment, generally by granting longer terms of payment or by agreeing to a trade discount if customers pay within a certain timeframe. Moreover, this is generally done with a large number of, if not even all customers. Therefore, criteria of frequency and of paying interest or fees are not suited to delineate receivable or commercial financing from trade/supplier’s credit. As the assignment or transfer of the trade accounts receivables does not alter their legal classification as pecuniary claims based on trade contracts, the EUF wishes to point out that there is no material difference between the receivables in the case of factoring and in the case of trade/supplier’s credit. This needs to be taken into account should the definitions of terms such as “credit institution” be reviewed, also with a view to the so-called “shadow banking industry”.

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 as well as historical developments of and legal frameworks for national factoring markets, 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 sold,

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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.

The national factoring industries in the EU member states therefore have quite a few traits in common, but there are also differences and specificities, mainly due to different historical developments and varying legal backgrounds. Such diversity and national particularities should not be ignored when considering the revision of existing or the creation of new regulations.

In its report, the EBA includes findings regarding the solo prudential requirements for factoring companies in different Member States' legislations. With a view to the proportionality principle and identifying (national) qualitative and risk-sensitive approaches from which to draw conclusions for possible European solutions, this is to be commended. However, the EBA report lacks some specificities of the single national factoring market. As an example, the information on Germany contained in the report (cf. pp. 17/18 of the EBA-report) is not completely correct for factoring companies: factoring companies in Germany are subject to solo prudential requirements under the German Banking Act (e.g. regarding licensing, risk management, reporting, qualification of managers and directors). Moreover, on p. 17/18 of the report, the EBA states that in the Netherlands, inter alia factoring companies are not subject to solo prudential requirements, but in the following paragraph, the EBA goes on to say clearly that the Netherlands is among those Member States which "apply the provisions of the CRR as though the entities concerned were 'credit institutions' within the meaning of the CRD IV/CRR".

Considering that the EBA suggests a review and changes to the definition of the term "credit institution" and also bearing in mind that the EBA explicitly states in its report that it is contributing to the workstreams of the ECB and the ESRB with regard to shadow banking, such information needs to be clarified and completed in order to avoid any inaccurate and moreover unnecessary legislation and supervisory requirements, which (in the case of factoring) would ultimately have a very negative effect on SMEs, who are the main beneficiaries of factoring.

The features of factoring strengthen 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. Although a complete analysis of the industry is not available, a small survey on the balance sheet of 15 main factors operating in different Countries among the EU shows that for the year 2013 the average cost of risk in factoring is estimable to 0.6-0.7%, while the average cost of risk in banking is 1.90%, according to the EBA key risk indicators. This confirms the statement of the academic literature that factoring is a very low risk financial service, thanks to the assignment of the receivables coming from the business activity of the client that allows the factor to rely on two counterparties and mitigate the risk of the operation and also thanks to the close relationship that the factor establishes with its client, thus reducing asymmetrical information, particularly suitable for emerging economies or in periods of crisis.

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This is confirmed by the figures available for the EU factoring market: during the last 6 years of crisis, the industry turnover grew from 830 billion € in 2009 to over 1.36 trillion € in 2014, reaching a penetration of more than 10% of the total EU GDP. Latest figures available (2013) suggest that more than € 162 billion of working capital was being provided by the factoring and commercial finance industry to over 165,000 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 study conducted by GE in 2011 (cf. http://www.gecapital.eu/en/arfactor/reports/GE_report_EN.pdf) states 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.

It is against this background that the EUF wishes to point out that the EBA and other standard setting bodies should consider a more tangible application of the proportionality principle as well as qualitative (instead of quantitative) and risk-sensitive approaches to financial supervision and regulation, as well as aspects of comparability and of "creating a level playing field".

When preparing new financial supervisory legislation and regulations, especially when considering the broadening of the scope of application of an existing sets of rules, the risk history as well as risk potential and the systemic relevance of classes of businesses or sectors to be included into this scope have to be taken into consideration. The EUF emphasizes the need for proportionate regulatory measures, which are suitable for and adapted to all encompassed forms of financing. Therefore, the EUF wishes to stress that before suggesting any reviews and changes of fundamental terms such as "credit institution", further research needs to be done and in particular, more thorough information and data from within the affected industries should be gathered and taken into account.

Please do not hesitate to contact us should you have any queries regarding the aforementioned viewpoints or require more information on the factoring industry in Europe.

With kind regards,

John Gielen
Chairman - EUF