# EUF Opinion on default risk for purchased receivables

March, 17th 2021

**Executive summary**

- Trade receivables are very different from loans in many respects: trade receivables (typically represented by invoices) follow the fulfilment of trade agreements, in other words real-world and freely established economic transactions between economic agents (supply of goods or services), and all debtors need to perform, implicitly or explicitly, a lot of checks before approving the payment of an invoice. Such checks are aimed to assure the goods or services supplied and the invoice are compliant with the contract.
- In purchased receivables a past due invoice represents a true default risk only if the approval process is completed, or the debtor doesn't raise any claim regarding the goods or the invoices received. When the payment of an invoice is delayed because of a (still) ongoing approval process, in the opinion of the EUF it represents a "dilution risk" and not a "default risk". In fact, in that case the reason behind the delay is operational and not financial. The invoice approval process has a binary outcome: authorization or dispute. In the latter case, the delay does not lead to default of the obligor according to par. 29 of the GL. In the former case, the invoice is either paid if funds are available or not paid otherwise.
- A suspension of the counting of days past due might be considered when i) the debtor claims dilution events (including procedures to approve invoices) as a reason for the delay and when ii) the factor can suppose a dilution risk for the invoices past due when there are elements that point out a non-financial reason of the delay.
- Dilution risk can be assumed when there are no possible indications of unlikeliness to pay, the obligor has a high credit standing (measurable by internal or external ratings), the dimension of the business suggests significant complexity of the internal procure-to-pay processes, and/or there are no exposures past due (other than invoices).
- Nevertheless, the factor should actively manage the position of the debtor, pick up the due invoices promptly and activate any action required to gather precise information from the obligor about any dispute or dilution risk source on those invoices. A safe way to avoid any potential delay in the recognition of defaults could be to fix, in the factor's internal policies, a reasonable amount of time in which such information should be gathered (e.g. 90 days).
- In all cases, the debtor is not at all aware of the fact that there is a prudential rule in the banking sector, NDoD, that will lead to a financial default (contagion rule).

## Context

1. The new EBA Definition of Default ("DoD") is applicable since 1st January 2021. The DoD implements the definition of default under Article 178 of the CRR, with the purpose to harmonize the way the exposures are classified to default across Europe and consists in the following regulatory items:

    - Draft Regulatory Technical Standards on the materiality threshold for credit obligations past due under article 178 of Regulation (EU) No 575/2013, that define the materiality of an obligation past due when the sum of the credit obligation past due exceed both:
        - An absolute threshold (100€ for retail exposures, 500€ for exposures other than retail), and
        - A relative threshold (1% of the total exposure).
    - Guidelines on the application of the definition of default under Article 178 of regulation (EU) 575/2013 ("GL"), that provide instructions on how to apply the definition of default, also with reference to specific businesses such as factoring, to which the GL dedicate a whole paragraph.

2. According to the CRR, an obligor should be considered defaulted whenever:

    (a) the obligor is unlikely to pay its credit obligations the parent undertaking or any of its subsidiaries in full, without recourse by the institution to actions such as the enforcement of any collateral or security;

    (b) the obligor is past due more than 90 consecutive days on any material credit obligation.

3. Factoring is mostly impacted by the DoD in relation to the counting methodology of 90 days past due exposures (2.(b)) for receivables purchased without recourse, and in particular when risks and rewards of the receivables have been fully transferred to the factor and accounted in the balance sheets of the factor as an exposure towards the buyer (account debtor). Hereafter, with the wording "exposures to purchased receivables" we will refer only to this kind of exposures, excluding the exposures to the factor's client (the assignor of the receivables and the seller of the goods or services invoiced) that are referred to as recourse factoring.

4. The present note provides the outcomes of the discussions within the Prudential Risk Committee and within the Excom of the EUF on the matter. Its objective is to provide further elements for analysis by individual members and in no way can it be considered a recommendation from the Federation to its members.

## The difference between loans and purchased receivables in the perspective of default risk

5. Preliminarily, it is useful to recall that trade receivables are very different from loans in many respects such as:

    a. The payment is made by the buyer and not by the client (except in some situations, that will be addressed in the following);

    b. The buyer, who has to pay the factor for the assigned receivables, doesn't have any financial agreement with the factor and is completely unaware of the assignment in the case of not notification.

c. The buyer has signed a purchase agreement with the assignor (the client of the factor), that sets specific conditions to which the payment of the invoices is subject. Such conditions normally refer to the quantity, quality and price of the goods (services) to be sold, to the delivery time, to the ability and terms to issue the invoice, to the payment terms, to particular price adjustment such as premia, discounts, and so on…

d. In bank loans, the payment has to be done at the due date because it is unconditional, and in fact it is normal practice to debit directly the current account of the client at the due date, without any input from the obligor.

e. In purchased receivables the payment is instead subject also to the above-mentioned conditions, as the buyer wants to verify carefully that the supply and the invoice are compliant with the contract before paying. The payment of an invoice is normally made by initiative of the obligor by way of a credit transfer.

**Fig. 1 – Loans vs trade receivables**

| | Loans | Purchased Trade Receivables (without recourse) |
|---|---|---|
| Risk counterparty | Client | Account Debtor (Buyer) |
| Reason why money is owed | Financial agreement | Purchase of goods or services |
| Collectability of the payment | Subject to payment terms | Subject to payment terms<br>AND<br>Conditions set by purchase agreement, practices or law |
| Normal payment method | Direct debit<br>(automatically at due date) | Credit transfer<br>(initiative of the payer) |
| Meaning of a past due payment | Technical past due<br>Lack of funds | Technical past due<br>Payables approval processes<br>Disputes / Dilution<br>Lack of funds |
| Consequences of classification to default | Borne by the debtor | Borne by the debtor's suppliers |

6. While, in banking lending, the repayment of a loan is exclusively in charge of the financial department of the obligor and, consequently, the approval process is very fast, the payment of an invoice needs a longer process starting with the operations department and ending with the accounting department. The "life cycle" of trade payables involves a series of actions from the seller and the buyer that starts with the issuance of the invoice, then a series of actions from the buyer including and especially the payment of the invoice as a last step, triggered by the regular development of the previous other important steps.

7. Not all debtors have strictly formalized procurement and payment policies, yet all debtors perform, implicitly or explicitly, a number of checks before approving the payment of an invoice. Such checks are aimed to assure the supply and the invoice are compliant with the contract. In the most complex organizations, when a large number of invoices are assigned to a Factor, the payment might even be subject to the matching of the ledgers. The duration of the whole process is then a function of the complexity of the buyer's organization and frequently exceeds the due date of the invoice.

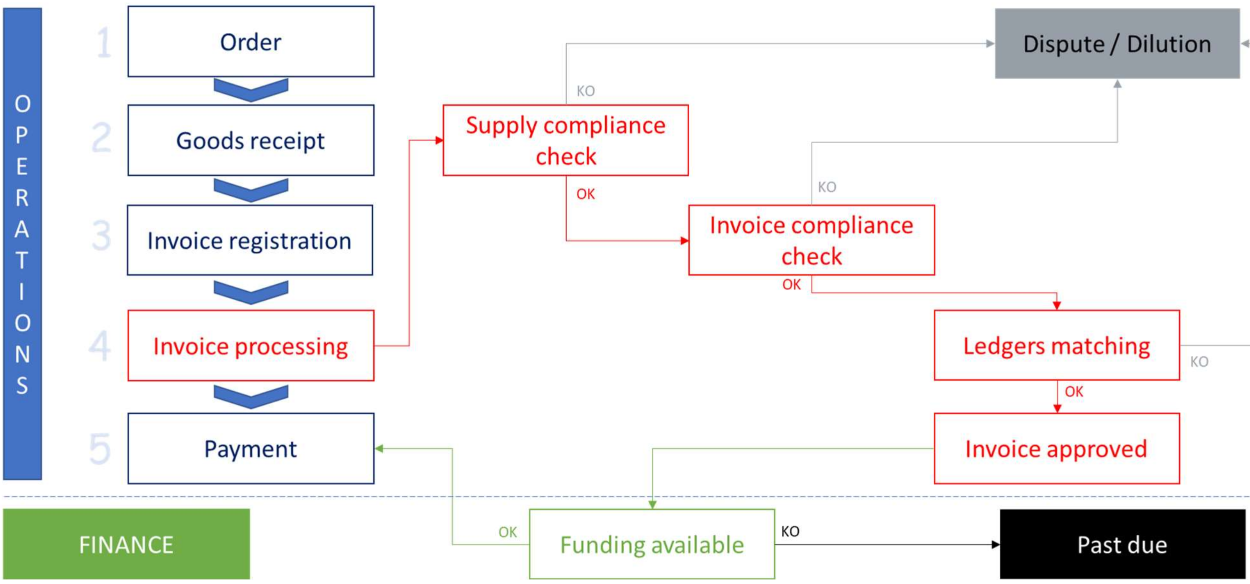
8. It is very important to note, however, that a delay in the payment of an invoice cannot be considered in the same way as a delay in the payment of an obligation raising from a financial agreement. While the latter is normally due to the lack of funding to pay back the loan received, the former might be due to administrative reasons that have nothing to do with the financial capability of the buyer. In fact, it is common that late payments regard the large enterprises and the very best debtors in terms of credit standing and financial robustness, that have a more complex and formalized approval process to authorize the payment of the invoices of any supply.

9. It is useful to notice that the output of the process to approve the invoice is binary: the invoice is either approved or disputed. According to the FCI GRIF (Art. 27) "A dispute occurs whenever a debtor fails to accept the goods or the invoice or raises a defence, counterclaim or set-off including (but not limited to) any defence arising from a claim to the proceeds of the receivable by any third party."

10. A dispute may end with the dilution of the assigned invoice value. Dilution risk is not covered by non recourse factoring, so that the purchase price paid in advance for the receivables, in the case of dilution, represents a credit obligation of the client (the seller) and not of the buyer.

11. Only once the invoice is approved, the finance/administrative office of the buyer can make the payment, obviously if there are funds available on the current account: so a past due invoice should be considered similar to a past due loan only if and when all the other conditions set for the payment are fulfilled. In other words, in purchased receivables a past due invoice represents a true default risk only if the approval process is completed, or the debtor doesn't raise any claim regarding the goods or the invoices received. In all the other cases, it actually represents a dilution risk on the invoice.

**Fig. 2 – The "life cycle" of trade payables**




12. The factor cannot prosecute a buyer/debtor before the payment terms are expired. Therefore, a dispute on the invoices is normally found out by the Factor after the due date of the invoice, during the dunning process (it is useful to remind that this is part of the factor's job). It normally takes up to 60 days to gather

further information regarding the dispute. This time-period allows all the parties to determine if the non payment of the invoice is related to a commercial dispute or actually to a default.

13. This distinction is particularly important in risk modelling for factoring and purchased receivables. As already highlighted, late payments in trade receivables are often a consequence of ongoing approval procedures or in some cases a sign of a possible dispute, and as such are more frequent in the largest and strongest businesses. If past due invoices are considered similar to past due credit obligation, it might trigger an unnecessary "default" under the CRR, with many consequences on the relationship with the buyer as well as on the reliability of the risk model, due to the large amount of "II type errors" in classification to default (the invoice, even if late, will be paid) that can affect the estimates of the PD and LGD parameters.

14. When assessing the default risk of the client, dilution risk (in a broad sense) can therefore be considered as the "missing link" between trade receivables and loans.

**Default of exposures to purchased receivables under the DoD**

15. In the case of factoring and purchased trade receivables, the GL provides (par. 28) that "the counting of days past due should commence when the payment for a single receivable becomes due". This principle has been reinforced in the feedback statement, where the EBA declares that "In accordance with general principles the calculation of days past due should always refer to the dates of contractual obligations. In the case of a purchased receivable the date of contractual obligation is the due date of the receivable."

16. However, the EBA recognizes some specificity of purchased trade receivables and in particular a number of events that could affect the collectability of the invoices. Several exemptions are then provided from the above-mentioned general principle:

    a. Technical past due situations (par. 23);

    b. Events related to dilution risk (par. 29);

    c. Formal disputes between the obligor and the institution over the existence or amount of the credit obligation (par. 19);

    d. Payment flexibility provided in the credit arrangement (par. 17);

    e. Legal restrictions to the payment (par. 18).

17. As explained in the previous paragraphs of the present note, considering as "past due" the purchased invoices during the ongoing approval process for the payment or that could be disputed, leads to an unnecessary trigger of the counting of days past due that, in relation to the periodicity of the invoice assignments and the usual repetitiveness of the delay (that are generated by the complexity of the business), could easily exceed the 90 days period and force to classify the whole position of the obligor as default (including the other exposures of that obligor, if any, across the whole bank or group).

18. Although the factor can always refer to the 30 days technical past due for purchased receivables, as provided in the guidelines, this period alone is actually too short to give any substantial relief to the issue, as the practice demonstrates that the time lag between the due date of the invoice and the moment in which the factor can gather the information from the debtor about the status of the invoice is normally longer, considering that the factor i) cannot prosecute the debtor before the due date, ii) needs time to allocate the payments to the right invoices and detect unpaid receivables, iii) needs to activate a dialogue

with the debtor and iv) the debtor needs time to take the request of the factor on board, processes it and reply. According to experience of the factoring companies, this process may require from 60 to 90 days after the due date.

19. Regarding dilution risk, the GL provide the following (par. 29): "Where the institution recognises events related to dilution risk of purchased receivables as defined in point (53) of Article 4(1) of Regulation (EU) No 575/2013, these events should not be considered as leading to the default of the obligor. Where the amount of receivable has been reduced as a result of events related to dilution risk such as discounts, deductions, netting or credit notes issued by the seller the reduced amount of receivable should be included in the calculation of days past due. Where there is a dispute between the obligor and the seller and such event is recognised as related to dilution risk the counting of days past due should be suspended until the dispute is resolved".

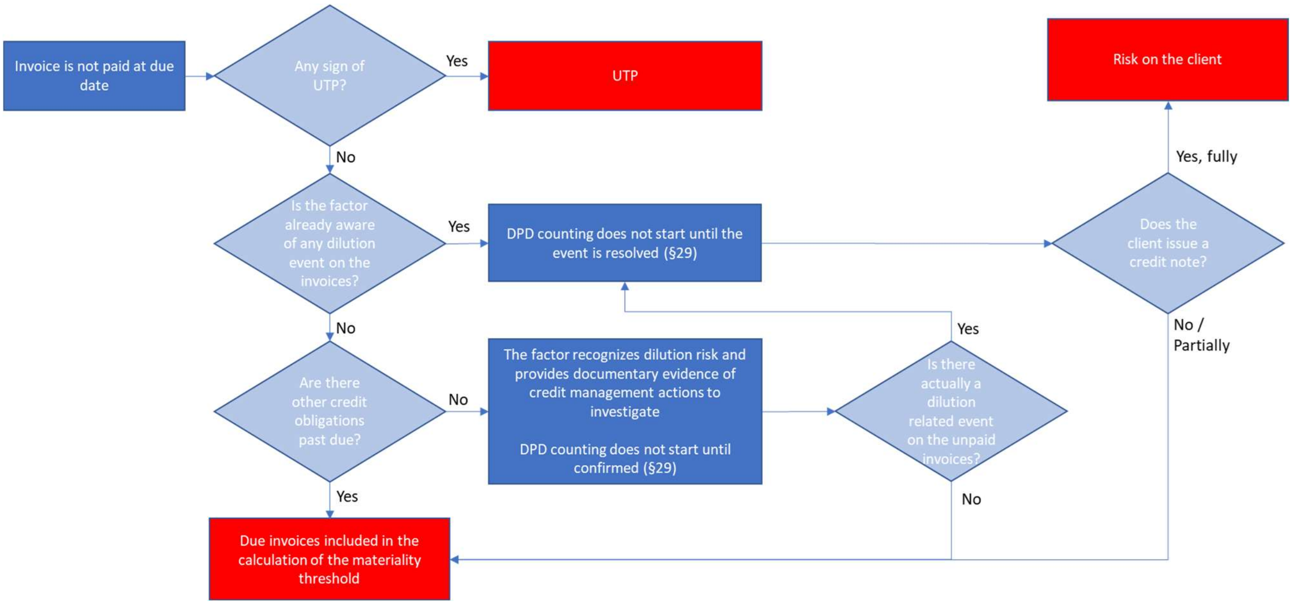
20. In the opinion of the EUF, the case in which the payment of an invoice is in delay because of a (still) ongoing approval process, represents a "dilution risk" and not a "default risk". In fact, in that case the reason behind the delay is operational and not financial. The invoice approval process has a binary outcome, approval or dispute. In the latter case, the delay does not lead to default of the obligor according to par. 29 of the GL. In the former case, the invoice is either paid if funds are available or not paid otherwise. It is in this final situation that the counting of days past due should start.

21. Therefore, the EUF believes that the invoices that are past due because of an ongoing compliance verification process regarding the supply or the invoice or of an ongoing ledger matching process engaged by the obligor are related to dilution risk and therefore should not lead to default and should not be included in the calculation of days past due.

22. As a practical approach, in order to avoid triggering the counting unnecessarily, a suspension of the counting of days past due (i.e. not treating the invoices as past due) could be considered when i) the debtor claims dilution events (including procedures to approve invoices) as a reason for the delay and when ii) the factor can suppose a dilution risk for the invoices past due when there are elements that indicate a non-financial reason of the delay. Dilution risk can be assumed when there are no possible indications of unlikeliness to pay, the obligor has a high credit standing (measurable by internal or external ratings), the dimension of the business suggests significant complexity of the internal procure-to-pay processes, and/or there are no exposures past due (other than invoices).

**23.** Nevertheless, and even if the purpose of the prudential rule NDoD is not to avoid late payments, the factor should consider to actively manage the position of the debtor, pick up the due invoices promptly and activate any action required to gather precise information from the obligor about any dispute or dilution risk source on those invoices. A safe way to avoid any potential delay in the recognition of defaults could be to fix, in the factor's internal policies, a reasonable amount of time in which such information should be gathered (e.g. 90 days). Within this period, the factor could gather proper evidence of the presence of one of the technical situations that allows to suspend or modify the counting of days past due as listed in §15 (letter a to e). After this period, the factor would be in the position to either suspend the due date if it recognizes one of those technical events or include the invoices in the counting of days past due.

**Fig. 3 – A practical approach to separate dilution risk from default risk: decision tree**




24.The EUF considers that the approach explained in this note is a proper way to separate dilution risk from default risk and avoid the insurgence of a significant number of unnecessary default exposures triggered by late payments of trade receivables that are related to operational reasons (and possible dilution risk) rather than to financial reasons (and possible default risk). The EUF deems such approach as compliant with the GL, as it exploits the measures already provided.

25.The EUF recommends that the EBA considers improving the fitness of the GL to purchased receivables and reduce any potential discretion by way of an increase of the number of days that are considered as "technical past due" under par. 23.d of the GL from 30 to 90 days.