

To: Secretariat of the Basel Committee on Banking  
Supervision

Bank for International Settlements

CH-4002 Basel Switzerland

Kraainem, 24 June 2016

**Re: Response to the Consultative Document on Reducing variation in credit risk-weighted assets - constraints on the use of internal model approaches**

To whom it may concern:

We are writing in response to your request for feedback on your consultative document on the proposed changes to the IRB approaches. The EU Federation for the Factoring and Commercial Finance Industry (EUF) is the industry body and voice for the European factoring industry. The EUF's members consist of 14 national factoring and commercial finance associations (representing 15 EU-member states, namely [in alphabetic order] Austria, Belgium, the Czech Republic, Denmark, France, Germany, Greece, Ireland, Italy, the Netherlands, Poland, Portugal, Spain, Sweden and the UK) and the international factoring chain FCI+IFG. In 2015, the Receivables Finance industry in the EU provided over €168 billion of working capital financing to over 171,000 businesses, about 85% of which are SMEs. This amount of working capital has to be seen in relation to the total factoring turnover, which in 2015 was over € 1.47 trillion. If you consider that the total GDP of Europe exceeded € 13 Trillion, this figure represents a significant portion of the real economy within the EU. Our members account for 97% of the total European factoring market, and comprise of both regulated and non-regulated factoring companies. Over half of the factored volume conducted within the EU is generated by factoring companies that are banks or part of consolidated banking groups, which fall under the umbrella of regulatory oversight.

As you may know, factoring is a means of finance which is widely used, especially by SMEs, as a method of providing working capital finance to a supplier of goods and services. This is achieved by the supplier assigning and selling its accounts receivable to a factoring company. The factor will provide a range of services to its clients, including providing working capital against the assignment of their receivables, accepting the risk of bad debts and collecting on past due accounts. The factor will usually charge an administration fee for these services and a discount charge for the advancement of funds against eligible assigned invoices. Factoring has

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been accepted as a stable financing alternative by many companies, particularly during the financial crisis over the last five years. Many SMEs that were unable to obtain traditional bank funding were able to obtain funding under factoring facilities, offered by bank owned and independent factoring companies. Hence, the factoring industry thrived during the financial crisis, helping hundreds of thousands of SMEs throughout the EU to obtain working capital. You could say that factoring companies are a direct mirror of the real economy.

The EUF, in its role of representative body of the European factoring and commercial finance industry, is pleased to share with this Committee its comments about the proposed changes. In particular, the Committee is proposing:

1. to remove the IRB approaches for some portfolios, which as a result will be subject to the standardised approach to credit risk: such portfolios being banks and other financial institutions and large corporates (defined as corporates belonging to consolidated groups with total assets exceeding EUR50bn), and to remove the option to use the A-IRB approach for exposures to corporates that are part of consolidated groups that have annual revenues greater than EUR200m;
2. within the F-IRB scheme, to introduce a lower regulatory LGD estimate for exposures collateralized by purchased receivables (20% instead of 35%) but with a higher haircut on the value of the outstanding receivables (50% instead of 20%);
3. to introduce floor on parameter estimation;
4. to introduce a definition of "commitment".

#### 1. Criticism of The removal of the IRB approaches for certain portfolios

The BCBS is proposing to remove the option to use the IRB approaches for certain exposures, where it is judged that the model parameters cannot be estimated sufficiently reliably for regulatory capital purposes. Although the EUF fully understands the need for a reliable and comparable measure of risk even where default events are historically few and infrequent, the proposal to exclude the IRB option give raise to some criticism and unwanted consequences, and so seems inappropriate.

Firstly, we do not understand which considerations have led the Committee to assign a differentiated treatment (and much punishing) to large corporates with consolidated assets greater than EUR 50bn vis-à-vis all those large corporates belonging to groups with revenues greater than EUR 200mn which can use F-IRB. Thus we would suggest that **at least the F-IRB is envisaged for both categories of firms** (those with revenues greater than EUR 200mn and those with consolidated assets greater than EUR 50bn). This approach would also offset possible distortions in pricing that could arise for those large corporates with total assets higher than EUR 50bn (in particular for those investment grade, considering that the risk weight under the SA are extremely conservative) versus Mid-corporates (TA < EUR 50bn), with the latter potentially benefiting of more competitive pricing given the on average lower cost of capital.

Secondly, the more punitive treatment assigned to large corporates with consolidated assets greater than EUR 50bn seems illogic considering that the largest exposures are indeed the ones for which more public disclosure is available which allow banks to perform a deeper assessment of counterparty creditworthiness.

Moreover, the standardized approach is particularly penalizing for unrated counterparties and given the not negligible share of European corporates which is not externally rated, the proposal to abolish the internal model to a certain extent risks severely hindering the revamp of the economy.

Besides such conceptual issues, we also would like to underline that such differentiated approach would nonetheless increase significantly operational costs for the institutions, as they would have to manage different treatments and also detect the situation of all corporate clients, that may change (more or less frequently) from one class to another thus increasing also fluctuations in the RWA.

We consider most appropriate for these portfolios to preserve the use of the IRB Approach (with the possibility - where necessary on the basis of shared and simple criteria - of data pooling in particular for LGD and CCF). Where the approach should remain Standardized is required to Supervisor to explicitly allow the mechanic extension of the external rating of the mother company to all corporates belonging to a consolidated groups even in the absence of explicit form of support, consistently to the objective "...to not significantly increase overall capital requirements...": most of such companies are indeed without external rating.

Moreover, if the decision was taken to remove the IRB option for certain exposure, i.e. large corporates, makes even more necessary, under a wider perspective, that also the Standardized Approach recognizes the purchased receivables approach where eligible (i.e. option to use the risk weight applicable to the debtor or to adopt a "top down" approach as described in the Basel framework and recognized also in Art. 153.6 of the CRR 575/2013 in the Advanced approach framework) as well as a specific and more favorable risk weight for exposures collateralized by purchased receivables (i.e. 50%) in order to avoid a counterintuitive penalization of the larger clients, for whom the IRB approaches won't be available, with respect to the smaller ones. Moreover, a proper scheme for the treatment of credit insurance on purchased receivables should be adopted<sup>1</sup>.

## 2. Fixed supervisory parameters for F-IRB

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<sup>1</sup> For further details about the EUF proposals re. the treatment of exposures to factoring and purchased receivables and about a possible scheme for recognizing the mitigation of credit insurance, please refer to the EUF position paper Re: Revisions to the Standardised Approach for credit risk - second consultative document of 2016, 11th March.

Par. 4.2.2 provides decreasing values in fixed LGD parameters for eligible non-financial collateral under the F-IRB approach. In particular, the proposed new value of LGD for exposures secured by receivables is lower (20%) than the current one (35%), but at the same time the haircut is increasing from 20% to 50%.

The EUF appreciates that a 20% LGD parameter for such collateral type appears to be appropriate, having regard to the track record of factoring operations, and consistent with the proposals submitted by the Federation during the consultation on the revision of the Standardized Approach. Yet, we believe that a 50% haircut would be too conservative and far from the actual practice, that consist in a financing facility that usually ranges from 60 to 80% of the outstanding amount of the receivables. Moreover, it could bring to unwanted consequences, pushing the institutions to reduce the amount of finance provided to the client in order to benefit most from the reduced LGD parameter. That could result in a counterintuitive shift towards riskier overdraft-like products.

Therefore, we would suggest that the haircut for receivables should remain at the same 20% level.

Under F-IRB, the Committee does not propose to change the fixed maturity parameter (2.5 year). We believe this fixed parameter could frustrate institutions specialized in short term finance such as factoring and invoice finance, discouraging the investment in internal models for "standardized" institutions and at the same time unduly penalizing those that already adopted A-IRB by way of the proposed removal of the option to use estimates stemming from their advanced models for certain exposure classes. We therefore strongly advise to provide, under the F-IRB approach, the following buckets of regulatory fixed values for the parameter M:

- M = the purchased receivables exposure weighted average maturity, at least 90 days like allowed in the current IRB framework (see also Art. 162.2.e) of the CRR 575/2013 for the Advanced approach, as far as the purchased receivables are concerned,
- M = 1 year for other exposures with duration up to one year,
- M = 2.5 year for the rest.

### 3. The introduction of model-parameter floors

The BCBS is proposing to adopt exposure-level, model-parameter floors to ensure a minimum level of conservatism for portfolios where the IRB approaches remains available.

The EUF does not agree with the idea of setting floors, in principle, the floor on LGD for exposures secured by receivables (15%) appears to be extremely too conservative when the underlying portfolio or receivables is of high quality. A-IRB institution specialized in factoring and invoice finance will be highly penalized and will see significant changes in their risk appetite, especially in jurisdictions with a very good history of trade debt payments. Furthermore, such a high floor would be too close to the regulatory fixed parameter provided

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for the F-IRB approach and would then reduce the appeal of the advanced (and expensive) models for specialized institutions. We therefore suggest to reduce significantly the floor, not over 5%.

#### 4. The Credit Conversion Factor

As previously quoted, we remind our answer of the Revisions of the Standardised Approach for Credit Risk (of March 11<sup>th</sup>, 2016 – hereby enclosed), where our request was to keep the CCF to 0% for factoring (according to the discretion allowed to the factor in purchasing receivables) and in any case not to exceed a the 20% level, as the underlying instrument features (the invoices) are close to those handled by the Trade Letters of Credit (that intrinsically encompass the invoice in the requested documentation).

#### 5. The proposed definition of "commitment"

The EUF understands and appreciate the effort of the BCBS to uniform and clarify the definition of "commitment". Yet, we advise the Committee to carefully consider the potential unwanted effects of providing such a common definition on the compliance with other banking regulation that may apply in certain jurisdictions. Effects might transcend the "prudential" level and hit also contractual and accounting profiles, not to speak of other specific regulatory pieces like usury (where applicable).

However, reading the proposed definition, we understand that internal limits determined by the institution, of which the customer can (or not) be aware (without having been nor "offered" nor "accepted" by the client, to be used for internal reference by the institution) is not included in the perimeter of "commitments" under the proposed definition. Concretely, this represents the limits set on receivable purchases, from the factor unilateral point of view.

Thank you in advance for your attention. We look forward to hearing back from you. In the meantime, if you have any questions or want additional information and details about the above mentioned position of the EUF, please do not hesitate to contact Diego Tavecchia, Chairman of the Prudential Risk Committee of the EUF (contact details below).

With kind regards,



Erik Timmermans, Chairman, EUF



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To:

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

Kraainem, 11th of March 2016

Re: Revisions to the Standardised Approach for credit risk - second consultative document

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 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 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 that some of the comments submitted to the Consultation regarding the first consultative document on the revisions to the Standardized Approach for credit risk have been taken into consideration by the Committee while drafting this second consultative document (SCD), while some other observations on very important issues were not.

We are therefore delighted to provide our contribution, as a Federation representing the institutions specialized in factoring and invoice finance, to the work of the BCBS by submitting the following comments on each particular item affecting our industry.

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**Summary of comments to the second consultative document on Revisions to the Standardised Approach for credit risk**

The EUF would propose the following comments, that are more thoroughly explained in the following paragraphs:

- i. A specific approach for Sovereign exposures should be separately provided.
- ii. Due diligence on exposures to corporates should also enable lower risk weight and not only higher.
- iii. The lower SMEs risk weight should be confirmed and maybe reduced further.
- iv. The role of purchased receivables as mitigants should be recognized as already provided in the IRB approaches, extending to the SA:
  - a. the possibility to apply the risk weight of the assigned debtor when operational requirements are met;
  - b. the possibility to apply the facility level approach to purchased receivables;
  - c. the possibility to apply a lower risk weight (i.e. 50%) in accordance to the lower LGD of the operation (i.e. 35% like in the Foundation-IRBA) when the relative requirements are met.
- v. In addition, recognition of the lower LGD for exposures to purchased receivables assisted by a credit insurance scheme should be provided by way of a reduced risk weight (50%) or of a supporting factor (0.5).
- vi. The current rule that provides a relief in the RW applicable (100% instead of 150%) to past due loans where provisions exceed 20% of the exposure value, that has been dropped in this consultative document, should be confirmed.
- vii. Purchased receivables should be considered as being past due only once the expected payment date has passed, unless there is evidence that the delay of the payment is due to commercial reasons other than financial difficulties of the buyer (i.e. disputes, dilution, payment flexibility, reconciliation processes, verification procedures etc...);
- viii. Credit Conversion Factor for exposures to factoring client should be kept to 0% and, in any case, must not exceed the one proposed for short-term self-liquidating trade letters of credit (20%)

### 1. Sovereign exposures

The EUF agrees that sovereign risk deserves a separate discussion once the CRSA is finalised. However, some important items regarding exposures to PA entities stemming from purchased receivables should be part of the revision of the definition of past due (see paragraph 5 below).

### 2. Exposures to corporates

The EUF welcomes the removal of the approach proposed in the previous version of the document that removed all references to external credit ratings and assigned risk weights based on a limited number of alternative risk drivers and the recognition of external ratings. However, with regard to the due diligence process, it is stated that the analysis performed cannot ever result in lower risk weights than the ones assigned as 'base' risk weights with the external ratings. While we appreciate the value adding nature of the due diligence, which reduce the mechanistic reliance on external ratings, this provision basically frustrates any risk management effort made by banks to carry out an objective and accurate analysis. A prudent way to incentivise due diligence and avoid abuse of positive overriding of the base rating could be to limit to one "bucket" the potential decrease in the risk weight, providing as follows: a) in case of negative overriding, to assign a risk weight at least one "bucket" higher than the "base" risk weight determined by the published external rating (as proposed in the SCD), while b) in case of positive overriding to assign the risk weight one "bucket" lower than the "base" risk weight determined by the published external rating .

The EUF strongly recommends to allow the due diligence process to enable a decrease of the applicable risk weight by way of assigning the risk weight applicable to one "bucket" lower than the 'base' risk weight.

The EUF appreciates that within the new revised approach a risk weight of 85% for unrated exposures to corporate SMEs has been proposed. This reduces the 'cliff effect' that the former approach is likely to entail in the case of SME exposures falling out of the retail portfolio. We strongly support maintaining this reduced RW and also suggest to consider an even lower RW, i.e. [75%-80%] to reflect the actual risk of such exposures in consideration of the fact that they typically provide more physical collateral than other large corporates. Such treatment, however, must remain separated from the below-mentioned specific approach for purchased receivables.

### 3 . Purchased receivables

The EUF noted that the comments submitted to the first consultation on the revisions to the Standardized Approach referring to the extension, to the SA, of the special treatment already provided by the Basel framework for purchased receivables within the IRB foundation approach have not been recognised in the second consultative document.

As already mentioned in the previous EUF position paper, factoring and invoice discounting operations, and in general operations based upon purchased receivables, show a level of risk that is much lower than traditional lending. The lower risk is based upon the following profiles of the operation:

a) the nature of the purchased receivables as collateral: the value of receivables 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),

b) the effectiveness of the assignment / purchase of receivables as form of security and the tools applied to assure control of the payment inflows: even if different countries have different regulations on how to make the assignment / purchase of receivables effective against third party rights, the factors' practicalities usually involves the satisfaction of all the requirements and / or additional guarantees in order to assure that the factor is in control of the future payments referring to the assigned receivables, by way of notification to the debtor (that allows to channel all payments directly to the current account of the factor) or, in non-notification agreements, by way of trust accounts or pledge on current account, usually along with irrevocable payment orders to immediately transfer to the factor the amount paid on the account of the seller.

The self-liquidating nature of purchased receivables within a factoring programme, therefore, is broken only in the case of:

- debtor default,
- dilution,
- invalid or voided assignment / purchase,
- fraud (fresh air invoices).

These characteristics of purchased receivables are the basis of the low LGD experienced by the factoring industry. Unfortunately, there still is not any pooled data on the LGD of exposures to purchased receivables. In the near future, sector studies will be activated to collect and analyse loss figures and provide reliable measures of the sector LGD. For the time being, considering also that only few specialized institutions have implemented their own internal rating system (also due to the fact that the commercial finance industry is not regulated in many EU Countries), we can only rely on internal measures and estimates provided by single companies. Such estimates, however, clearly confirm the expectation of a lower LGD than the regulatory measure (45%) applied in the foundation IRB approach: if we look to factoring operations with recourse, some Italian major factoring companies estimate a LGD that ranges from 22% to 27%, well below the regulatory FIRB level.

Figures from the EUF White Paper 2015 (attached) also confirm this expectation, showing that the loan loss provisions in factoring are significantly lower than in bank lending as a whole and are almost irrelevant.

The following table 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.

Table 1. Loan loss provisions comparison between whole bank lending and factoring<sup>1</sup>

	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)

With this premise and also considering that such lower risks have been already recognized by the BCBS within the IRB approach (see the 'bottom up' and 'top down' approaches and the possibility to apply a 35% LGD instead of 45% in the FIRB approach), the EUF believes there is no actual reason why such approaches should not be extended to the SA. Recognition of the lower risk of purchased receivables is consistent with the aim to make the SA a valid and effective alternative to the IRB, and also to the aim to avoid adverse selection that may push to riskier financial alternative in the absence of a correct calibration of the risk weights for exposures related to purchased receivables. Therefore, the EUF strongly advises that the Basel Committee recognizes the value of purchased receivables as credit risk mitigants also under the Standardised Approach, introducing, perhaps in a separate and ad hoc 'portfolio':

- a) **the possibility to apply the risk weight of the debtor, even in the case where the agreement provides partial or full recourse to the client, when operational requirements for purchased receivables are met** (see §493 and following of the International Convergence of Capital Measurement and Capital

<sup>1</sup> EUF, Factoring and Commercial Finance: A White Paper, 2016.

Standards paper by the BCBS and art. 184 of the CRR), accordingly to the 'top down' and 'bottom up' approaches (recourse to the client may be considered as a personal guarantee);

- b) **the possibility to apply the facility level approach for default detection in purchased receivables** as well, extending the application of §76 of the current consultation paper as follows: "For retail exposures and purchased receivables, the definition of default can be applied at the level of a particular credit obligation, rather than at the level of the borrower. In the case of purchased receivables, every invoice is considered as a single credit obligation."
- c) **the possibility to consider purchased receivables as additional eligible guarantee**, already provided for the IRB Foundation approach (§289 of the International Convergence of Capital Measurement and Capital Standards paper by the BCBS), when the relative requirements are fulfilled (§511-520). The application of the 35% LGD instead of the regulatory 45% measure to a sub-investment grade portfolio would bring to an actual risk weight of 50%. We suggest that a risk weight of 50% is provided for exposures to corporate, that are guaranteed by purchased receivables.

The EUF believes there is no actual innovation in the above-mentioned proposals, as they refer only to the extension of methods already provided by the Basel Committee for the IRB approaches and just represent a measure to apply fair rules to all institutions, according to the proportionality principle in the context of a real level playing field.

#### 4. Credit insurance

Credit insurance is a very common and effective way to mitigate the risk of losses in exposures to purchase receivables, largely used in the industry to limit the risk in particular in agreements without recourse to the client. There are many examples, within the industry, of factoring companies that actually subordinate the granting to a client of non-recourse limits on a certain purchased receivables portfolio to the 'plafond' or ceiling granted by the insurance company on that same portfolio.

Although this kind of insurance is highly relevant from a business perspective, and particularly successful in reducing actual losses of the institution, it does not find recognition in the regulatory perspective, as it is not included in the scope of eligible CRM tools, with the exception of the AIRB approach, where LGD estimates are internal and can consider the effects of credit insurance: credit insurance indeed can show positive effects on the registered loss by way of the reimbursement but also by way of the debt collection activity that is usually associated with the insurance.

Empirical evidences on the Italian case show that, with regard to insured receivables portfolio:

1. LGD weighted for EAD are always lower than non weighted LGD, informing that losses on the biggest exposures are lower;
2. LGD estimated considering different discounting rates (from 3% to 13%) show differences that range from  $\pm 4\%$  (when all reimbursements and collection inflows are considered) to  $\pm 7\%$  (when only recoveries from post reimbursement collection are considered);

3. considering also the contribution of debt collection activity, such LGDs range [31-37%] and therefore drop about 900 basis point in each case;
4. however, even if one considers only the reimbursement, the less favorable case to the insured institution, the LGDs are always lower than the regulatory level of 45%, except the case of a 13% discount rate.

Results of such forthcoming research are summarized in the following tables<sup>2</sup>:

**Table 2. Synoptic table of mean LGD in insured receivables**

Discount Rate	LGD at claim date				LGD at default date (estimate)			
	3%	5%	8%	13%	3%	5%	8%	13%
<i>Valid</i>	81406	81406	81406	81406	81406	81406	81406	81406
<i>Missing</i>	0	0	0	0	0	0	0	0
Mean reimbursement	0.39	0.39	0.40	0.42	0.40	0.41	0.43	0.46
Mean reimbursement and post collection	0.36	0.37	0.38	0.40	0.37	0.39	0.41	0.44
Mean reimbursement and pre collection	0.32	0.33	0.34	0.36	0.33	0.34	0.36	0.39
Mean reimbursement and pre/post collection	0.30	0.31	0.32	0.34	0.31	0.32	0.34	0.37

**Table 3. Synoptic table of mean LGD weighted for EAD in insured receivables**

Discount Rate	LGD at claim date EAD-weighted				LGD at default date (estimate) EAD-weighted			
	3%	5%	8%	13%	3%	5%	8%	13%
<i>Valid</i>	81406	81406	81406	81406	81406	81406	81406	81406
<i>Missing</i>	0	0	0	0	0	0	0	0
Mean reimbursement	0.37	0.38	0.39	0.41	0.38	0.39	0.41	0.44
Mean reimbursement and post collection	0.35	0.36	0.37	0.39	0.36	0.37	0.39	0.42
Mean reimbursement and pre collection	0.30	0.31	0.32	0.34	0.31	0.32	0.34	0.37
Mean reimbursement and pre/post collection	0.28	0.29	0.30	0.32	0.29	0.30	0.32	0.36

<sup>2</sup> G. De Laurentis, R. Pisani, R. Trinca Colonel, "L'utilizzo delle polizze di assicurazione nella gestione del rischio di credito da parte delle banche", SDA Bocconi Research Report, forthcoming.

The EUF understands that CRM techniques are subject to strict requirements in order to be considered eligible and that the existing credit insurance contracts usually do not fulfill such requirements. Yet again, it also believes it is in the interest of the Basel Committee to encourage practices that can reduce the risk borne by the banking and financial industry. It therefore strongly advises the BCBS to take in consideration to provide, for exposures to debtors arising from purchased receivables that are assisted by a credit insurance contract and included in the 'plafond' (i.e. the maximum liability) agreed by the insurer, a lower risk weight under the Standardized Approach.

This takes into account that a 35% LGD regulatory measure would be much more consistent with the empirical evidence on historical LGD for insured receivables (and even conservative, depending on the applied discount rate), i.e. by applying a 50% risk weight to exposures to purchased receivables to unrated corporates when included in the 'plafond' of credit insurance or in alternative a reduction factor of, for example, [0.5], to the applicable risk weight.

#### **5. Defaulted exposures**

The EUF completely disagrees with the proposed change to remove the 100% risk weight for past due exposures where provisions are above 20% of the nominal value.

In principle, the IRB capital requirement formula is based on a very important premise: The capital requirements reflect the unexpected loss through the deduction of the expected losses from the VaR estimate (with a confidence level of 99,9%). Based on that, and starting on a specific inflexion point, when the PD increases the capital requirements start to decrease as the expected loss is already high, "leaving" less space for substantial unexpected losses.

For defaulted or quasi-defaulted exposures (higher PD), the capital requirements are reduced as they represent unexpected losses that, from a specific point, start to decrease as the expected losses increase. However, although the need to align both frameworks is acknowledged by BCBS in page 17 ("From past due to defaulted exposures"), the proposed exclusion of the provisions as a driver for the standard RW will create an inconsistency between SA and IRB frameworks.

Moreover, such change will frustrate the institutions that are more careful in provisioning their riskier exposures, reducing incentives to an appropriate provisioning policy. Such a counterintuitive outcome would also be in contradiction to the recent invitation of the European Authorities to increase the level of provisioning.

In order to avoid unfair and unwished outcomes, the EUF strongly supports maintaining the current rule that provides a relief in the RW applicable (100% instead of 150%) to past due loans where provisions exceed 20% of the exposure value.

Regarding past due loans, the EUF also wishes to stimulate a discussion about the definition of past due loans in purchased receivables when the exposure is actually assigned to the debtor (i.e., in IAS/IFRS

framework, when recourse to the client is excluded and risk and benefits of the receivables are substantially transferred to the assignee).

In this case, the risk taken on the debtor (i.e. the client's buyer) within a non recourse factoring facility has a particular 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.

A list, obviously not exhaustive, of examples of the trade events that are not linked to a decrease in the creditworthiness of the debtor may include:

- Contractual agreements that allow flexibility of payment or extensions of the payment terms to the buyer
- 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
- Payments conditional on the consent to pay by the buyer (e.g. after verification of the supply)
- Share of the due amount kept by the buyer as guarantee of completion of work or quality control
- 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
- Extension of payment terms granted to the buyer by the seller in non-notification factoring agreements, not necessarily in written form
- Incomplete verification and liquidation process by PA buyers
- 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
- 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.

A judgmental assessment of the situation of the debtor in order to detect inconsistent defaults of creditworthy debtors when in the presence of these events linked to the trade relationship would avoid unnecessary classification in default.

In particular, the EUF believes that disputes (and dilution in general) must be considered thoroughly.

From a risk perspective, the disputes, as well as discounts, deductions, netting-off 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). 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. 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.

The EUF is also convinced that a specific approach for past due Sovereign and Public Sector Entities should be included. In some Countries, late payments by PA debtors are very common while the actual risk of losses is very low, 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). This results, in those jurisdiction, in a high share of past due loans to such entities that do not present material losses tracks. Figures from Assifact suggest that trade debts of the Italian public sector, purchased by banks and financial companies and outstanding at December, 31<sup>st</sup> 2015 are largely past due (27%), with a significant share (17%) that is overdue by more than one year. A survey from the Bank of Italy<sup>3</sup> show that, in the last two years, average payment delay of PAs' payables have reduced from 145 days to 110 days, still a very high level. In this contexts, however, bad debts and losses are substantially immaterial and related only to situation of declared crisis of the public body. The latest figures available on the sector<sup>4</sup> suggest that bad debts on public sector debtors held by Italian factoring companies are limited to 0.51% of the total amount.

In this situation, the delay of payments itself is not a good indicator of a deteriorating creditworthiness. A possible remedy to this issue would be to introduce a longer period before the detection of past due (180 days instead of 90). Another solution can be drawn from the Italian national regulation, that currently

<sup>3</sup> [https://www.bancaditalia.it/pubblicazioni/qef/2015-0295/QEF\\_295\\_15.pdf](https://www.bancaditalia.it/pubblicazioni/qef/2015-0295/QEF_295_15.pdf)

<sup>4</sup> Assifact, Indagine sui crediti verso la pubblica amministrazione, 2011.

allows institutions to interrupt the counting of past due days as the (public) debtor make a payment on at least one of its exposures past due over 90 days. Such waiver is very effective in limiting the amount of past due loans against PAs to those that actually show a situation where liquidity of the public body is drying up and the risk of the declaration a state of crisis increases. Therefore, the EUF strongly advises to integrate such waiver in the Standardized approach, in order to allow a better and more risk sensitive detection of past due loans to the public sector.

In conclusion, according to the above-mentioned comments, we propose to amend §75 adding the following to the first bullet point: "Any material credit obligation is past due more than 90 days or 180 days for purchased receivables to Sovereign and Public Sector Entities. Overdrafts will be considered as being past due once the customer has breached an advised limit or been advised of a limit smaller than current outstandings. Purchased receivables will be considered as being past due once the expected payment date has passed, unless there is evidence that the delay of the payment is due to commercial reasons other than financial difficulties of the buyer (i.e. disputes, payment flexibility, reconciliation processes, verification procedures etc...);

and to add another paragraph:

"XX. For exposures to Sovereign and Public Sector Entities, the count of the days past due is interrupted when the debtor makes a payment for at least one of its exposures that are past due by more than 180 days."

## 6. Unconditionally Cancellable Commitments

In general, the EUF believes that the proposed treatment for off-balance sheet items contradicts the Basel Committee's message that "increasing overall capital requirements under the standardised approach is not an objective". The proposal to increase the CCF (from 0% to [10-20%] for retail exposures and from 0% to [50-75%] for other exposures) unduly penalises the SA institutions and provide a different treatment between corporate and retail UCC that in the view of the EUF is not justified.

In particular, for exposures to factoring and invoice discounting clients, the EUF would like to stress that often the client is not informed about the amount of the commitment granted by the institution (in this case, it only has internal relevance) and, in any case, the actual usability of the commitment is always and in any case conditioned and subordinated to the acceptance, by the factor, of the receivables proposed by the client. That means that, in the absence of commitments to purchase from the client up to a certain amount of receivables, the factor can always prevent the conversion to credit of its commitment to a certain client by simply not purchasing any more receivables. That, added to the fact that institutions specialised in factoring are often able to intercept problematic situations more promptly (due to the monitoring and management of the receivables purchased), puts the factor in a very good situation to manage the risk of credit conversion.

Therefore, the EUF states that **Credit Conversion Factor** for exposures to factoring client should be kept to 0%. In any case, we believe that the CCF must not exceed the one proposed for short-term self-liquidating trade letters of credit (20%) as factoring and receivables finance have a short term and self-liquidating nature and can be assimilated, to a certain extent, to trade finance, as acknowledge by the Basel Committee itself<sup>5</sup>.

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

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<sup>5</sup> Cfr. Appendix 2 del CGFS Papers No 50: Trade finance: developments and issues.

# Factoring and Commercial Finance

## A Whitepaper

The EU Federation for the Factoring  
and Commercial Finance Industry



January 2016

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## Executive Summary

The European Factoring and Commercial Finance (FCF) Industry is a success story.

It provides working capital to support businesses that drive the real economy in Europe.

Yet it is an industry that presently is not always fully known or wholly understood at a regulatory and legislative level.

This Whitepaper is designed to build knowledge and change perceptions.

It demonstrates from existing and new research undertaken on behalf of the EU Federation for the Factoring Industry (EUFI) that it:

- Is growing rapidly, the FCF industry now supports businesses that have a combined turnover that represents 10% of EU GDP
- Provides funding of €170Bn to around 164,000 businesses, large, medium and small which together have a combined turnover of €1.37Tn
- Principally enables businesses in the Manufacturing, Services and Distribution sectors
- Is, in risk terminology, a low Loss Given Default (LGD) solution, providing opportunity for safe, secure funding in an increasingly risk aware regulatory environment
- Offers a unique combination of meeting user, provider and regulator stakeholder needs simultaneously; a real and unique win win in business finance

## **Part One: The European Factoring and Commercial Finance Industry - A Background**

### **Introduction**

The European Factoring and Commercial Finance Industry is a success story in supporting the real economy, growth and employment through the provision of working capital finance.

Factoring and Commercial Finance (FCF) holds perhaps a unique position in the provision of funding for business in that it can fairly claim to be a real win:win for users and providers.

Funding is made against the trade receivables (otherwise known as the debtors or sales invoices outstanding) of the user business, so there is no need for that business to be large, established and strong; the credit risk is distributed amongst the business' debtors. This makes the form of funding especially useful within the SME sector, although in recent years, larger scale organisations have also increasingly been taking advantage of the opportunities this form of funding can provide.

For a given level of receivables, FCF can provide a user with proportionately more funding than other sources, whilst for the provider the advance is more secure than the alternatives of traditional lending.

And yet despite this symbiotic advantage the EU Federation for the Factoring Industry (EUF) believes the solutions are still not used to anything like their full potential. We believe that amongst stakeholders, awareness of the unique character and contribution that FCF can provide is far from complete.

This White Paper is designed to provide a step towards opening up the industry for all to view, to show its success, its opportunity and to start to address some of the challenges it faces to reach its true potential.

We hope that you find it illuminating and inspiring.

John Gielen, Independent Chairman

On behalf of The EUF Executive Committee

## Industry Development

The early origins of Factoring and Commercial Finance (FCF) are open to some considerable debate; for example, some suggest they lie in the trade of the Roman empire, others the importation of tea from the UK colonial empire.

However, without doubt the modern movement originated at the end of the 19<sup>th</sup> century in the U.S. textile industry and this developed version migrated to Europe and started growing here significantly from the early 1960s.

What links all these historic stories are the core elements of an FCF relationship; the requirement of businesses for capital and the devolution of the expertise in management and control of customer relationships.

Whatever the origins, it is quite apparent that after around one hundred years of development, FCF has become a significant element within many countries' business finance systems.

It has established itself as a major source of finance and credit management for a growing number of companies, especially but not exclusively for Small and Medium Enterprises (SMEs).

Globally it is currently found in around ninety countries and is spreading continuously as its benefits and opportunities become more widely understood. In the year 2000, global volume was estimated to be in the order of €600 Billion; by 2014, the combined client turnover had grown exponentially to around €2.3 Trillion, which represents around 4% of global GDP.

Whilst volumes are in general growing rapidly across the planet, Europe for now remains the heart of the industry with around 60% of global turnover domiciled here. That's around €1.37 trillion euros, or 10% of European GDP.

## What is Factoring and Commercial Finance?

FCF is a method of providing working capital to business and it occupies a unique place in the world of finance. Let's look at the drivers that have led to this position.

The global crisis of 2008, followed by the subsequent overall lacklustre and challenged state of European economies resulted in many companies, particularly SMEs, experiencing greater difficulty in obtaining traditional bank funding than ever before.

FCF providers however are generally experiencing increasing levels of new business enquiries and are continuing to write more new business than ever before.

The finance that FCF provide is principally secured by the underlying receivables. With a much reduced emphasis on the balance sheet, an FCF provider is able to offer significantly higher

levels of finance to companies experiencing strong growth or requiring support through change and restructuring.

In seeking to define FCF, it has to be understood that the industry and its products are diverse and varied; it is wide in scope and approach. There are variations depending on market development, user needs and significantly based on the varying legal and regulatory environments that pertain in the individual countries where it is found.

Language and terminology can also be divergent, although the EUF has recognised this challenge and has created a glossary of commonly used terms and a tool to translate these between five major European languages.

Accordingly, there is no one, simple universal definition; more realistically we have a family of products and solutions with common features and approach.

This diversity is also a result of innovation and continuous improvement, adaptation to local environment and adoption of latest technological advances.

But whilst acknowledging the variations, there are overriding common themes and attributes which closely link the range together in a coherent and effective manner.

Based on the UNIDROIT Convention, FCF can be defined as:

An agreement between the assignor (the client using the services) and the FCF provider (offering the services) in which the former assigns/sells its receivables (debtor sales invoices) to the FCF provider, which delivers to the assignor a combination of one or more of the following services:

- A Finance Function: payment in advance (depending on circumstances typically between 80% and 90%) of the total sales invoices offered for FCF (credit facility function). The balance, less the FCF provider's charges, is usually paid when the invoice(s) is/are paid by the debtor.
- A Ledger Management Function: receivables collection and management including the gathering of credit information about debtors, collecting debts, accounting, and the management of non-performing advances.
- A Credit Protection Function: bad debt protection, i.e. the FCF providers' assumption of the responsibility for a debtor's financial inability to pay.

The relative levels of provision and utilisation of these various functions will be considered later in the report. Broadly speaking, the most universally utilised and sought after element is the provision of finance.

## **EU Federation for the Factoring Industry (EUF)**

The EUF is the Representative Body for the Factoring and Commercial Finance Industry in the European Union (EU). It comprises fourteen national industry associations (representing fifteen countries) that are active in the region, together with the recently combined Factors Chain International and International Factors Group. Its members account for around 97% of the EU Industry turnover.

The EUF seeks to engage with Government, regulators and legislators to enhance the availability of finance to business, with a particular emphasis on the SME community, as businesses in this sector are the heartland of growth. The EUF acts as a platform between the Factoring and Commercial Finance Industry and key legislative decision makers across Europe bringing together national experts to speak with one voice.

Its aim is to provide these bodies with vital industry information to inform, influence and assist with the direction of existing and future finance legislation. It seeks to ensure the continued provision of prudent, well-structured and reasonably priced finance to businesses across the EU.

The FCF Industry has a valuable role to play in the EU economy and the EUF will work to engage in debate with all relevant stakeholders to ensure they are fully aware of the benefits that the Industry has to offer.

The EUF's aims are to:

- represent the Industry with EU policy makers and to promote harmonisation in the EU legal, fiscal and regulation environment
- promote an understanding of the benefits of Factoring and Commercial Finance as a first choice flexible form of growth finance for companies
- gather information and publish papers and statistics on industry related subjects
- observe legal and EU Policy initiatives affecting the Industry and to lobby in favour of policies that can support the growth and effectiveness of the Industry or lobby against initiatives that would create barriers for the Industry's growth or negatively influence the provision of this effective and efficient form of finance for business.
- encourage the establishment of Factoring and Commercial Finance activities in EU countries

More information on the EUF and its activities can be found at [www.euf.eu.com](http://www.euf.eu.com)

## EUF Members

Name	Country	Website
The Asset Based Finance Association (ABFA)	UK & Ireland	<a href="http://www.abfa.org.uk">www.abfa.org.uk</a>
Asociacion Española de Factoring (AEF)	Spain	<a href="http://www.factoringasociacion.com">www.factoringasociacion.com</a>
Association Professionnelle Belge des Sociétés de Factoring (APBF-BBF)	Belgium	<a href="http://www.febelfin.be">www.febelfin.be</a>
l'Association Française des Sociétés financières (ASF)	France	<a href="http://www.asf-france.com">www.asf-france.com</a>
Associazione Italiana per il Factoring (ASSIFACT)	Italy	<a href="http://www.assifact.it">www.assifact.it</a>
Czech Leasing and Finance Association (CLFA)	Czech Republic	<a href="http://www.cfla.cz">www.cfla.cz</a>
Deutscher Factoring-Verband (DFV)	Germany	<a href="http://www.factoring.de">www.factoring.de</a>
Factoring & Asset Based Financing Association Netherlands (FAAN)	Netherlands	<a href="http://www.factoringnederland.nl">www.factoringnederland.nl</a>
Factors Chain International (FCI+FG)	EU countries	<a href="http://www.fci.nl">www.fci.nl</a>
Finans og Leasing (FL)	Denmark	<a href="http://www.finansogleasing.dk">www.finansogleasing.dk</a>
The Hellenic Factors Association (HFA)	Greece	<a href="http://www.hellenicfactors.gr">www.hellenicfactors.gr</a>
Österreichischer Factoring- Verband (OFV)	Austria	
Swedish Bankers Association (SBA)	Sweden	<a href="http://www.swedishbankers.se">www.swedishbankers.se</a>
<u>Associação Portuguesa de Leasing, Factoring e Renting (FLA)</u>	Portugal	<a href="http://www.alf.pt">www.alf.pt</a>
Polski Związek Faktorów (PZF)	Poland	<a href="http://www.factoring.pl">www.factoring.pl</a>

## Part Two:

### Our understanding of the Industry based on EUF Research in 2015

#### Introduction:

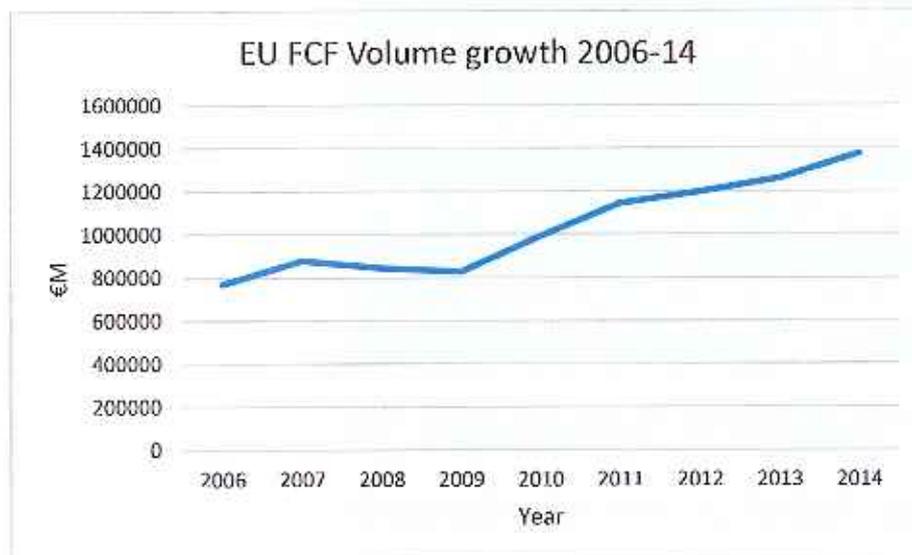
The EUF was instigated in 2009 and in its relatively short history has developed (inter alia) a reputation for the delivery of credible centralised data on the Industry. Driven by the Economics and Statistics Committee (ESC) under its Chairman, Diego Tavecchia of Assifact, the EUF now regularly collates numeric data which describe the shape, distribution and growth of the Industry.

In order to bring this information to the widest audience possible, this Whitepaper focuses on the key findings of the research that has been undertaken by the ESC in 2015 in Part Two.

It then introduces the separate results of the EUF's latest cross European Survey in Part Three.

#### FCF development

The Industry has grown dramatically in recent years. The effects of the Financial Crisis, whilst visible on the trajectory, has had limited effect and certainly minimal compared with mainstream banking where lending (especially to SMEs) has remained increasingly constrained. The development demonstrated between 2006 and 2014 represents a 7.5% compound annual growth rate. From 2009 the equivalent figure is 10.7%.



Source: EUF data

Of course this figure is an overall view and inevitably masks different performances and rates of progress in the individual constituent countries whose respective positions vary both in economic performance but also in the relative development and performance of the embedded industries.

## FCF Volumes

The following table demonstrates the variations between the volumes and market penetration by EU Member country; it clearly reflects the individual economic environments whilst combining to create an overall picture of growth which massively outstrips the growth in EU GDP in the same period.

Country	Turnover (€M) 2014	% Change on previous year	GDP penetration	EU Market Share
Austria*	16458	16.64	5.00	1.20
Belgium*	55374	16.13	13.77	4.03
Bulgaria 1	1728	1.65	4.11	0.13
Croatia 1	2498	-20.25	5.80	0.18
Cyprus	2671	-5.38	15.26	0.19
Czech Republic* 1	5912	12.77	3.82	0.43
Denmark* 1	10463	16.36	4.07	0.76
Estonia	2010	5.85	10.29	0.15
Finland	20554	16.13	10.07	1.50
France*	226598	13.02	10.58	16.49
Germany*	189880	10.85	6.54	13.82
Greece*	13017	7.62	7.27	0.95
Hungary 1	2827	12.85	2.74	0.21
Ireland*	25476	20.14	13.74	1.85
Italy*	183004	2.81	11.32	13.32
Latvia	680	14.86	2.83	0.05
Lithuania	5550	100.87	15.29	0.40
Luxemburg	339	-16.71	0.73	0.02
Malta	296	66.29	3.72	0.02
Netherlands*	57378	8.46	8.78	4.18
Poland* 1	33497	8.99	8.13	2.44
Portugal*	21404	-4.03	12.27	1.56
Romania 1	2700	-0.22	1.79	0.20
Slovakia	1036	-3.00	1.38	0.08
Slovenia	536	-14.38	1.44	0.04
Spain*	112976	-3.06	10.67	8.22
Sweden* 1	28290	-1.83	6.59	2.06
United Kingdom* 1,2	350622	6.19	15.81	25.52
EU Total Turnover	1373774	7.43	9.87	100.00
EU Members (*) 1,2	1330349	7.23	10.14	96.84

\*EU Member

1: % variation adjusted to avoid biases due to exchange rate fluctuations

2: Figures for previous year amended

Source: EUF ESC Committee, EUF Members, IFG, FCI

## Factoring and Commercial Finance characteristics

FCF is both a domestic and a cross border funding solution; the majority of business however is intranational domestic based. Cross border business is transacted either directly by the provider on its own (or through its own corporate international network), or through a specialist network of linked business providers in the recently merged FCI and IFG.

A majority of the business is conducted on what is described within the industry as on a "recourse" basis. This means that the credit risk remains with the seller client. Alternatively, the user can choose a "non-recourse" basis, where credit default insurance is a feature of the transactions. Of course the decision as to which approach to use is driven by the individual circumstances of the FCF arrangement and the client user's particular needs.

Increasingly within Europe, ownership of FCF providers is dominated by banks and banking groups, with delivery either through dedicated departments or specialist subsidiaries. The independent sector however continues to play an important role delivering specialist and bespoke solutions for particular client situations. It is also important in driving innovation in new solutions.

2014	EU Total	% of EU Total	Sample % of Turnover
Total Turnover	1,373,774	100	100
- Domestic	1,121,238	81.62	100
- International	252,535	18.38	100
Recourse	808,048	58.82	78
Non-Recourse	565,725	41.18	78
Bank owned	1,269,056	92.38	79
Non-Bank owned	104,718	7.62	79

Source: EUF ESC Committee, EUF Members, IFG, FCI

## Part Three: The Latest Research

### Introduction

The research undertaken to date by the EUF and described in the previous section has shown the large scale picture of turnover, advances and product types. This new research goes beyond this overview and creates the opportunity to understand better the make-up and characteristics of the market, to appreciate the impact, effectiveness and potential for FCF in Europe.

### Aims

The purpose of this latest research is to try to understand better the full picture of the user demographics:

- The sectoral distributions of users: In which sectors do they operate?
- The type and size of user: What is the profile of the user group?
- Critically, and for the first time, it seeks to dispassionately assess the (well understood within the industry) premise that FCF is a low Loss Given Default (LGD) product for the providers. Until now this “knowledge” has been based on anecdotal and personal perceptions and has not been supported by any independent survey or analysis.

### The survey

The survey was designed by roundwindow Consultancy Services in conjunction with the ESC and the Executive Committee of the EUF.

The sample population was drawn from the membership of the EUF’s members. Fourteen National Associations representing fifteen countries were requested to take part.

The survey was launched in September 2015 and data collection completed by mid-December. roundwindow would like to thank the National Associations for their critical role in supporting the survey and encouraging their members to participate in this important information gathering process.

Data received was a mixture of individual companies’ responses and collated information provided by National Associations where available.

Critical to the success of this exercise has been the fact that Survey responses were received and depersonalised by an external independent agency Euralia to ensure that the data to be analysed by roundwindow was fully anonymised and not traceable to an individual company. The EUF gratefully acknowledges the vital support given by Euralia in this regard.

### Participation: Sample sizes, distribution and significance

Responses relating to 80 different companies were received. Sample sizes varied according to the sensitivity and detail required of the question and the participants' individual ability to provide the relevant level of information.

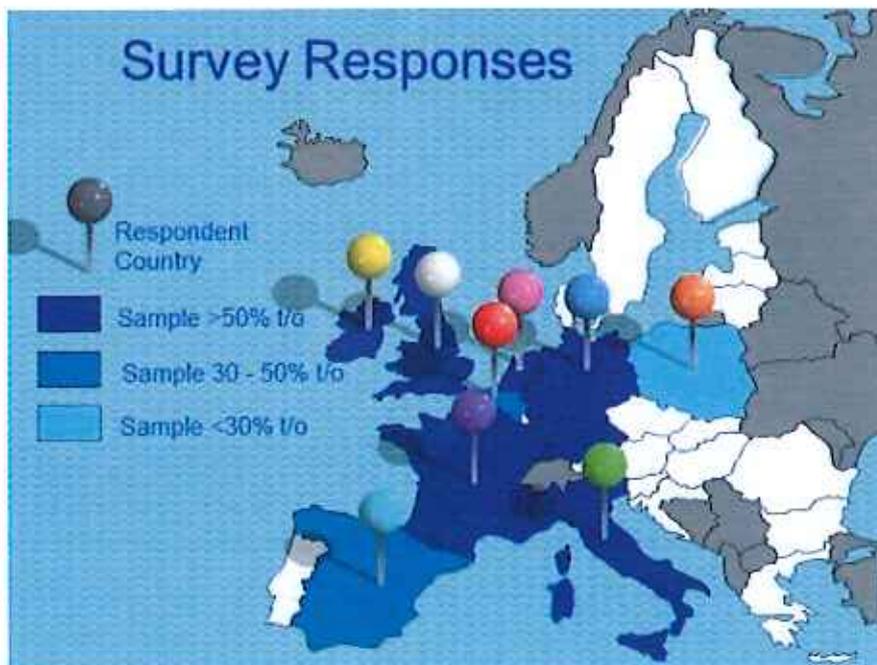
The input received therefore varied according to the particular elements of the questions asked. Samples (n) equating to between 40 and 71 sources within the 80 participants were achieved. This is a very high response level from an overall potential European scale provider population of around 200 (N).

From a statistical perspective, this means that these are all large samples in respect to their population and (depending on question) the combined turnover of the respondents represents between 40% and 62% of that of the total EU industry.

Responses were received from nine countries and these country sample sizes varied between 12% and 100% of their local turnover.

In just two survey response cases where cross border business within EU was noted but not location defined, the whole turnover was assumed as being based in the principal country of business.

Detailed information on the sample size and its significance is given question by question in the full analysis.



### **Participation: Competition and Data**

The majority of National Association members of EUF were active in seeking to persuade their respective individual members to participate or by collating data on a country level basis.

Three National Association members advised that they would be unable to participate because of their particular concerns or especial sensitivity regarding potential conflict with any relevant competition and anti-trust regulations.

One National Association believed that its members would not be in a position to collate the necessary data.

It is important to note that all the active participants' data analysed is both historic and anonymised.

Significant elements of the data are already available in the public domain through respective individual audited accounts.

## Survey Results

### User Sector Distribution

#### Purpose

This element of the research was designed to analyse the sectoral distributions of users: In which sectors do they operate?

#### Methodology

The survey asked respondents to provide data regarding the Industrial sectors in which FCF users operate.

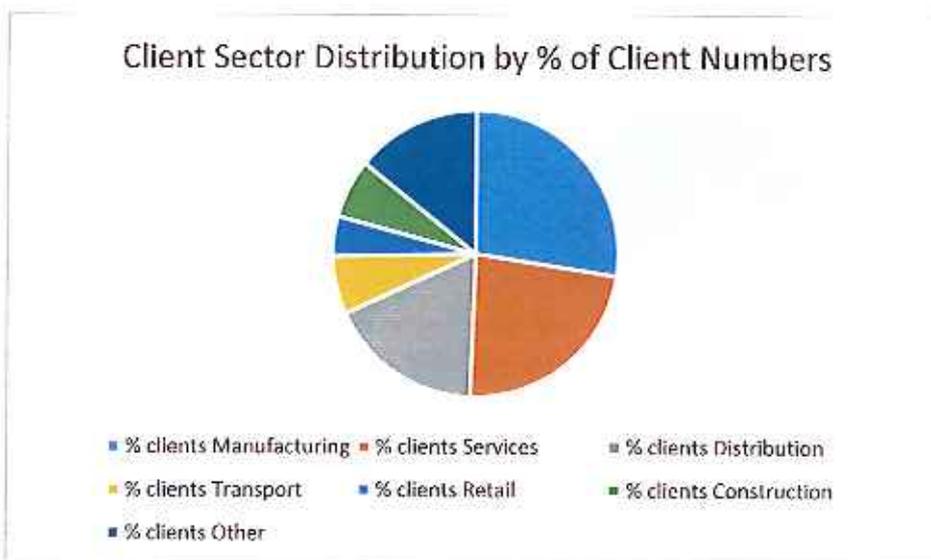
Respondents were asked to allocate according to the following categories (which were selected on the basis of the anticipated types of likely users):

- Manufacturing
- Distribution
- Services
- Transport
- Retail
- Construction
- Other

The question was posed from three perspectives;

- What proportion numerically of clients are there in each sector?
- What proportion of client turnover vests in each sector?
- What proportion of advances (utilisation of funding) does each sector represent?

**What proportion numerically of clients are there in each sector?**



Sample size: n=49

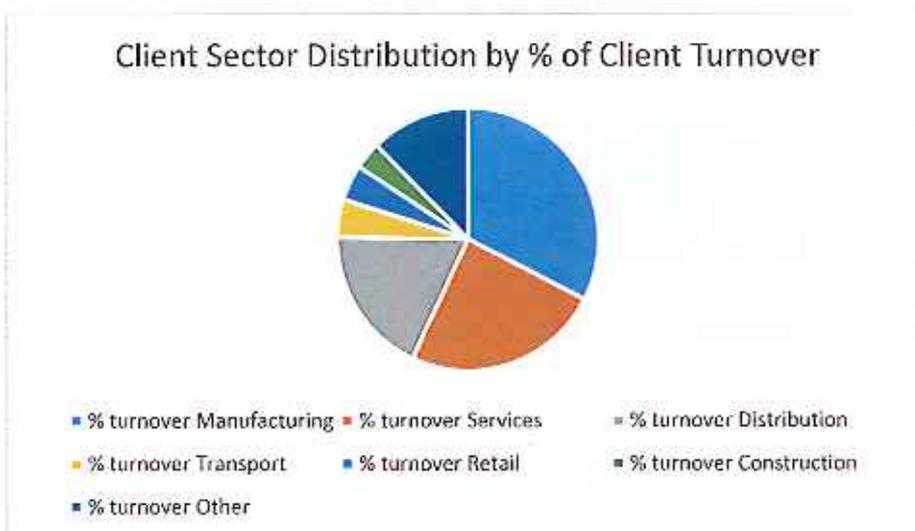
Looking from the perspective of client numbers, the three top three sectors are Manufacturing (26.9%), Services (22.5%), Distribution (17.3%), Together they represent two thirds of the total and clearly dominate utilisation of the FCF solutions. This focus within a key range of activities within the economic spectrum reinforces the value of this form of funding for everyday “real world” business.

### Extrapolation for the entire European Population

A statistical analytical approach to this data provides some further insight. Using the sample’s standard deviation and standard error of mean, a spread of the expected proportions can be predicted for the entire European user population. For example, with some approximation, the table below indicates that for Manufacturing clients, with a 95% probability, the percentage of the number of clients in that sector is 26.9% +/- 3.5%. That is to say, analysis of the data suggests there is a one in twenty chance that the percentage figure for the entire population will lie outside the range 23.4% to 30.4%.

Client Numbers by Sector	%	% +/-
Manufacturing	26.9	3.5
Services	22.5	3.9
Distribution	17.3	3.4
Transport	6.7	1.3
Retail	4.5	2.1
Construction	6.7	1.9
Other	15.5	5.9

What proportion of client turnover vests in each sector?



Sample size n=72

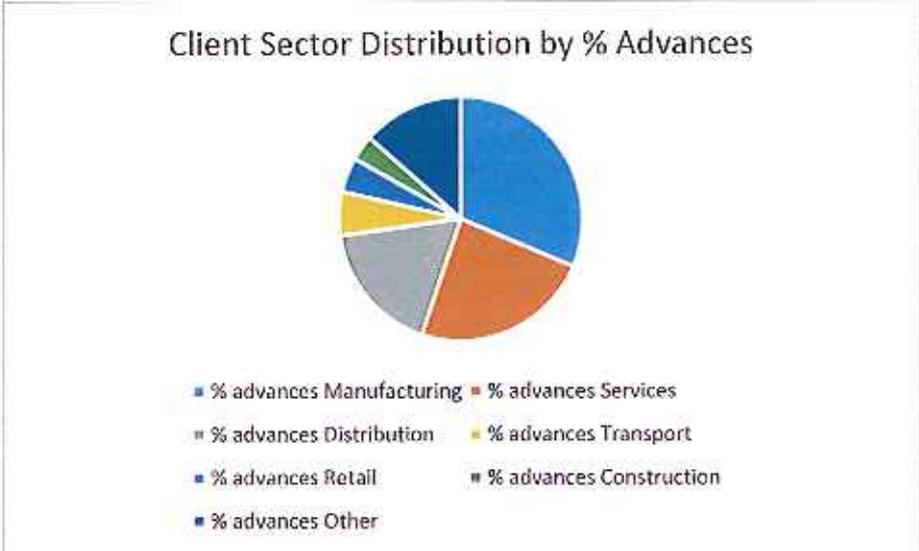
Looking at Turnover distribution, the top three sectors are the same as for client numbers. Manufacturing (32.5%) takes the lead, followed by Services (24.4%) and Distribution (18.2%). The top three combination represents a slightly higher level of concentration at 75.1% of the total.

**Extrapolation for the entire European Population**

The statistical analytical approach to this data described above again provides the following likely ranges for the entire population

Client Turnover by Sector	%	%=-/
Manufacturing	32.5	3.8
Services	24.4	3.8
Distribution	18.2	3.1
Transport	4.6	0.9
Retail	4.4	2.0
Construction	3.3	0.9
Other	12.3	3.8

What proportion of advances (utilisation of funding) does each sector represent?



Sample size n=71

Advances, the measure of how much funding is being utilised by FCF users, followed very closely the pattern of turnover. Here the same three top sectors followed the same sequence and penetration levels were broadly similar, with Manufacturing 31.3% Distribution 23.8% and Services 17.5%

#### Extrapolation for the entire European Population

Predictions for the range of the whole population are as follows:

Advances by Sector	%	%=-
Manufacturing	31.3	4.4
Services	23.8	4.0
Distribution	17.5	3.6
Transport	5.8	1.5
Retail	4.6	2.4
Construction	3.3	1.1
Other	13.5	4.4

#### Key Findings and Implications:

- Anecdotally, it had been well understood that usage is focused in the three key economic sectors of Manufacturing, Service and Distribution; the responses reinforce and amplify this understanding.
- The responses clearly confirm that FCF is a vehicle for funding of the real economy providing financing support in key productive sectors of European industry.
- Manufacturing is the single largest sector supported by any of the three measures of client numbers, turnover and advances.
- Within the sample (n=71), Manufacturing penetration was highest in Germany at 52% (n=25) by measure of turnover, closely followed by Belgium 48% (n=2) and France 45% (n=4).
- Within the sample(n=71), Distribution penetration in the Netherlands was notably the highest by measure of turnover at 54% (n=5).

## **User Size and Funding Utilisation Distribution**

### **Purpose**

This element of the research was designed to analyse the type and size of user: What is the profile of the user group?

### **Methodology**

The survey asked respondents to provide data regarding the numbers, sizes, turnovers and advances.

Respondents were asked to report client numbers, their turnover and the advances by the categories of:

- Small Business defined (using EU Criteria) as a business with turnover less than €10M per annum,
- Medium with turnover between €10M and €50M, and
- Large with turnover >€50M

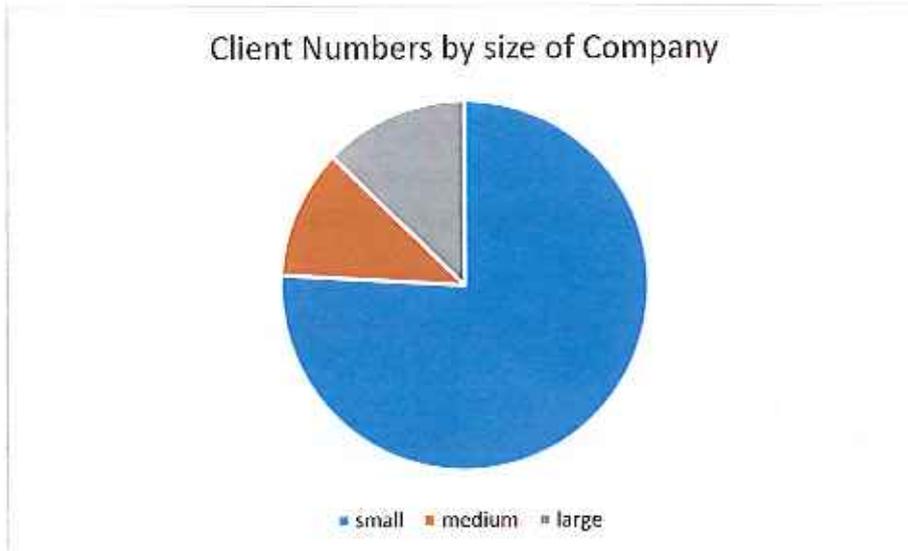
The question was posed from three perspectives:

- What proportion numerically of clients are there in each size band?
- What proportion of client turnover vests in each size band?
- What proportion of advances (utilisation of funding) does each band represent?

Data was received in this section from 69 respondents; the sample sizes below are smaller, reflecting different levels of ability in the respondents to sub categorise data into numbers, turnover and advances by client scale ranges.

**Responses:**

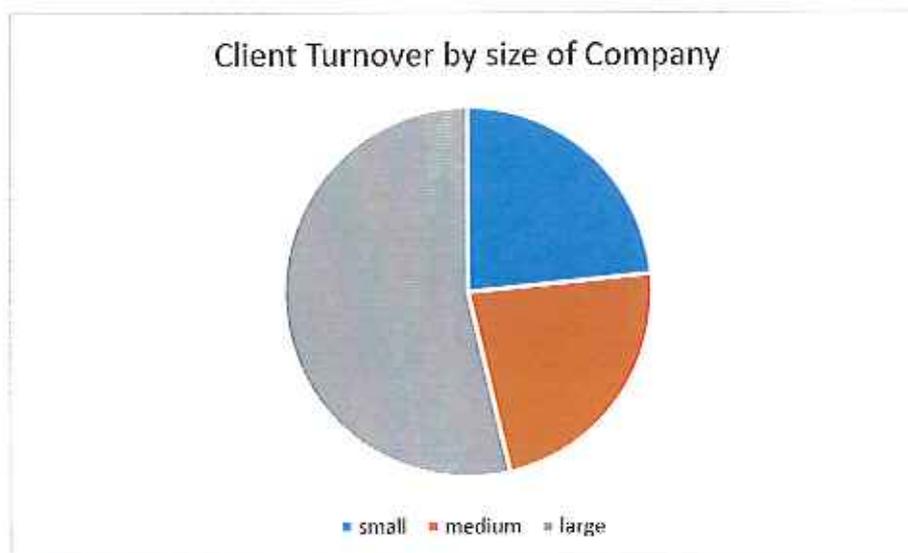
**What proportion numerically of clients are there in each size band?**



Sample size n= 67

Confirming the long held industry view that the majority of users by number are SME businesses, Small represented 76% of numbers, Medium 11% and Large 13%. This measure reflects the focus of the industry on SMEs as a seedbed for economic growth, and as a group which may find sourcing traditional lending more challenging.

**What proportion of client turnover vests in each size band?**

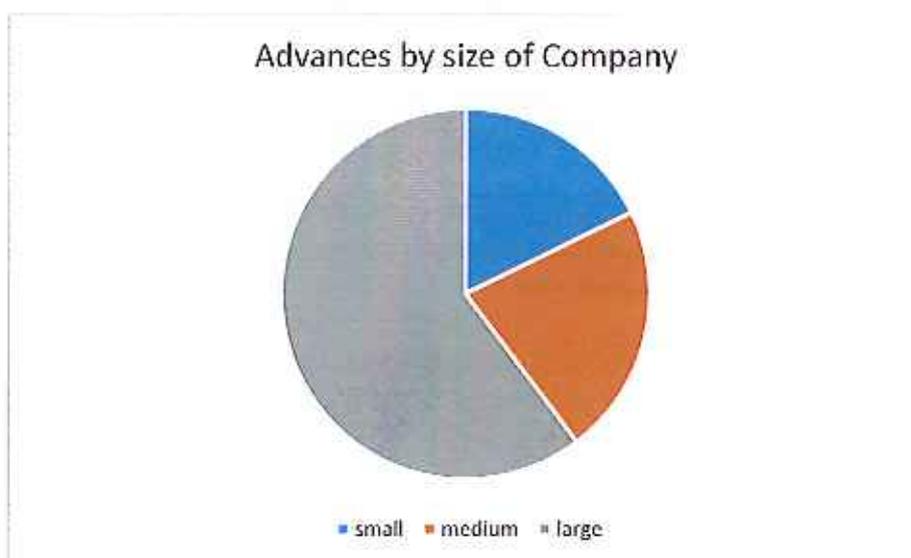


Sample size N= 62

Turnover however indicates a diametrically opposed position with the roles reversed; small businesses, although the large majority by sheer numbers as demonstrated above, only

represented 23% of turnover. Medium size users also represented 23% and Large 54%. Here the position demonstrates that whilst numbers favour the small scale end of the market, volume is focused more in the larger end.

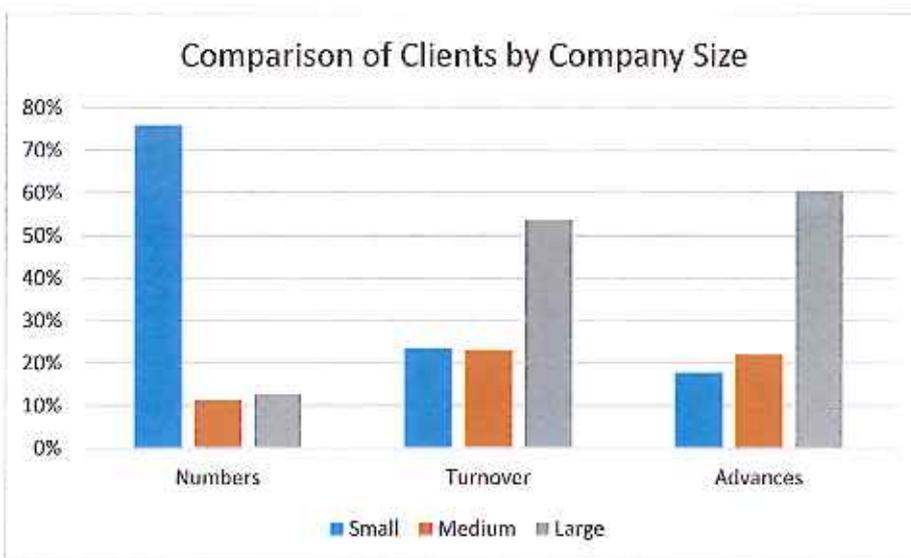
**What proportion of advances (utilisation of funding) does each band represent?**



Sample size n = 42

The role reversal effect is even more accentuated if we look at funding utilisation by user size. Here, small companies utilise only 18% of the funding provided, Medium 22% and Large 60%. This demonstrates almost a reverse 80/20 Pareto effect in the small sector when compared to actual client numbers.

The difference between proportions of client numbers, turnovers and advances is made more apparent in the following graphic:



### **Key Findings and Implications:**

Historically FCF has very much been perceived as an SME oriented funding solution;

- This element of the survey confirms that by number SME users predominate
- The focal role of FCF in supporting the development of SMEs is made clear
- It also brings to attention that by the measure of Turnover, Large scale users are the approximate equivalent of Small and Medium sized combined
- By advances, or funding utilisation, Large Companies clearly dominate the stage. The implication of this is that, contrary perhaps to some previously held perceptions, FCF is a funding vehicle for businesses of all sizes
- Indeed, according to Eurostat over 99% of businesses in Europe are SMEs; by implication this means that the sector penetration of FCF is actually higher in the Large Corporate population than it is within SMEs

## **Losses and Provisions Analysis**

### **Purpose**

Critically, and for the first time, the survey seeks dispassionately and scientifically to assess the (well understood but untested within the industry) premise that FCF is a low Loss Given Default product for the providers.

Until now this “knowledge” has been based on anecdotal, personal perceptions and experience. This survey is a ground breaking exercise in assessing these perceptions.

For respondents, this data is often considered to be highly sensitive for commercial, operational and reputational reasons. Understandably, there has often historically been a distinct reluctance to share this information.

Crucially, the design of this project, which involved the anonymization of data through an independent third party has given many respondents the confidence to share this (what can be otherwise) very private information.

The results are illuminating.

### **Methodology**

Respondents were asked to report on the credit performance of their portfolios: Their “at risk balances”, their provisions made and reserves held for the year 2014 (or the period of their latest audited accounts if the data was not separately available).

If available, such data was to be analysed by client turnover band in order to allocate to small, medium or large enterprise.

### **Responses**

This element of the survey, perhaps because of its sensitivity and its novelty produced the lowest numerical sample size with data relating to N=40 respondents.

Nonetheless, the sample respondents’ turnover represents approximately €738Bn or 54% of the European Industry turnover and their “at risk balances” of €72Bn represent around 42% of the estimated total European EU 28 figure of €170Bn. This sample is still considered to be large in the context of the overall EU population; the respective provider members of the EUF National Associations number around 200 and between them represent around 97% of the EU industry turnover.

The responses therefore have good statistical significance as a large sample of a small population, although the caveat must be made that this responding element of the population was partially self-selecting. There is a possibility that a proportion of those who responded might tend to have had “better” performances than those who chose not to participate and this potential bias cannot entirely be eliminated. However, even with this

proviso, the results offer a very clear endorsement of the view that FCF is a low loss form of funding.

**Provisions made:**

Provisions made in 2014	Lowest "Best" Individual Performance Reported by %	Highest "Worst" Individual Performance Reported by %	Average Provision made	Median Provision made
Absolute value €M	-3.061M <sup>~</sup>	11.995M	€5.72M	€0.440M
% of risk balance	-0.069% <sup>~</sup>	1.896%	0.26% <sup>*</sup>	0.09% <sup>^</sup>

Sample n= 40

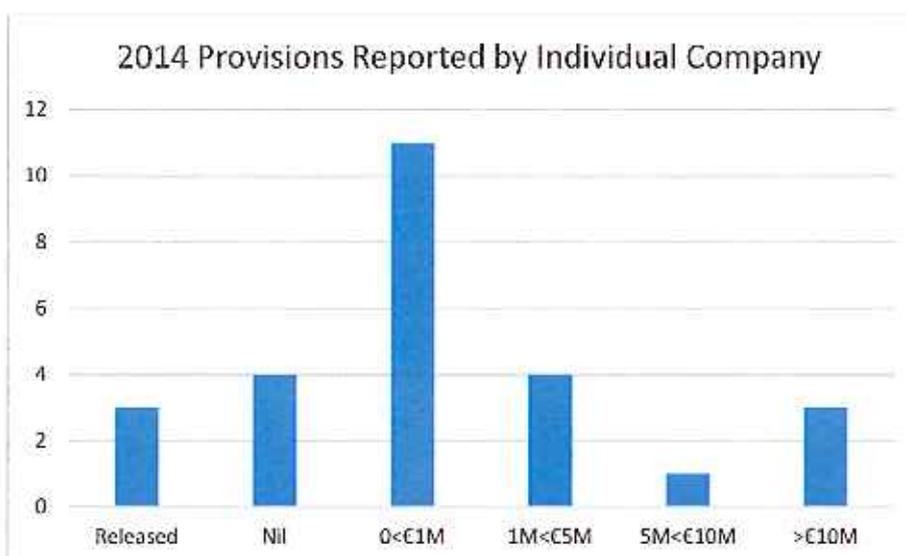
\* Total sample provisions as % of total sample risk balance

<sup>^</sup> Median provision as a % of median risk balance

<sup>~</sup> Provision written back/recovered

This data demonstrates for the first time - and very effectively - that loss rates in the Industry are, at an absolute level, very low. Even allowing for the possibility that this is a "rose-tinted" view with 26 of the 40 respondents being self-selecting, the implication of low loss is clear. Further research with a larger sample will help to clarify the indicated position.

The distribution of provisions according to this group also show that (as demonstrated by the median figure in the previous table) clustered in the sub-million Euro scale.



Sample n=26

Of the three individual reported provisions greater than ten million Euro, these represented 1.90%, 0.31% and 0.21% of their respective companies' risk balances.

Indeed, the provisions as a proportion of client turnover are vanishingly small:

Provisions made in 2014	Sample Average
% of Client Turnover	0.042%

Sample n=40

In the survey, the "at risk" figure is defined as total exposure to FCF according to the balance sheet - if appropriate according to IAS - which may be total advances in a recourse environment or total advances plus credit risk in a non-recourse.

The reported "at risk" figure €86.5Bn at year end represented 15.8% of the Client Turnover for the year of €548Bn. This figure is in line with expectations and previous data.

### Comparison with Traditional Bank Lending in the EU

The low loss nature of FCF is further highlighted when the performance is compared with that of traditional bank lending. The following table 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.

	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 EU 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)

Data for the overall EU banking sector for 2014 is not yet available but a simple trend analysis of the above ECB figures for 2013 and 2012 compared with the SNL analysis suggests that the figure may reasonably be expected to be in order 0.8%. The actual figure will be awaited with interest.

Although the data periods are not contiguous, the dramatic difference in risk levels is clearly apparent.

What is emphatically demonstrated by the data is clearly that traditional lending methods are not as secure as FCF as exemplified by the large sample analysed in the survey.

**Key Findings and Implications:**

- A large sample of respondents demonstrates that the industry's belief that FCF is a low loss solution is well justified
- The loss levels reported are very low in absolute terms
- They are significantly lower in comparison to other comparable forms of lending in the EU
- From a provider's perspective this implies a portfolio based capital allocation approach should favour this form of funding
- From a regulator's perspective this implies that this form of funding offers a lower risk and should accordingly be associated with a lower risk weighting and a lower cost of capital

## Summary and Conclusion

The survey reinforces The EUF's view that the European Factoring and Commercial Finance (FCF) Industry is a continuing success story. It serves to provide working capital to support real businesses in the real economy in Europe, providing funding, employment and growth opportunities.

The Industry is, at this stage in its development, not always fully known or wholly understood at a regulatory and legislative level and this paper has been designed to try to help to build knowledge and change perceptions.

It demonstrates clearly, both from the perspectives of existing and new research that the industry is growing rapidly and is now supporting businesses that have a combined turnover that represents 10% of EU GDP.

In doing so it provides funding of €170Bn to around 164,000 European businesses of all sizes, large, medium and small, in arrange of industrial sectors but principally in Manufacturing, Services and Distribution. The responses clearly confirm that FCF is a vehicle for funding of the real economy providing financing support in these key productive sectors of European industry.

For the first time it also confirms that the solution is a low loss given default source of finance, providing safe secure funding in an environment where the focus on financial risk is becoming increasingly important.

Whilst historically FCF has been very much perceived as an SME oriented funding solution, the survey confirms that by number SME users predominate, it also brings to attention that by the measure of turnover, Large scale users are the approximate equivalent of Small and Medium sized combined. Indeed, by the measure of advances, or funding utilisation, Large Companies clearly dominate the stage. The implication of this is that, contrary perhaps to some previously held perceptions, FCF is a funding vehicle for businesses of all sizes.

Given that according to Eurostat over 99% of businesses in Europe are SMEs this implies that the sector penetration of FCF is actually higher in the Large Corporate population than it is within SMEs. In other words, this is an important solution for all scales of business.

The survey demonstrates effectively that, as was anticipated by the received wisdom of the Industry, FCF is a low loss solution with very low absolute and proportional loss levels.

This reinforces the perspective that banks and other financial institutions should take advantage of the opportunity to fund safely whilst regulators should recognise and take account of the low risk approach.

Finally, this combination of satisfying the working capital and operational needs of users, meeting the expectations of funding providers and achieving all this in a low risk environment truly is a win win in the world of finance.

