CONTRIBUTION FROM THE ITALIAN FACTORING INDUSTRY

TO THE

CEBS QUESTIONNAIRE ON THE SURVEY OF MARKET PRACTICES ON LARGE EXPOSURES

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Introduction

This document presents the views of the Italian factoring industry on the topic of large exposures and concentration risk. Specifically, Assifact, the Italian Factoring Association, has here summarised the observations of its financial intermediary members in response to the "Questionnaire on Large Exposure" submitted by the Committee of European Banking Supervisors (CEBS) with the aim of providing the European Commission with information and proposals on the topic of Large Exposures, based on surveys of current market practices on the measurement and management of concentration risk.

General approach to concentration risk

In general, financial intermediaries working in factoring sector adopt approaches to the measurement and management of risk that closely follow the current national regulation on prudential supervision (definition of "large risks" exposure, individual limit and overall limit) in parallel with or supplemented by internal approaches specialised according to the type of activity performed.

The regulation on concentration risk issued by the Bank of Italy define large exposure as risk positions amounting to 15% or more of the regulatory capital. Intermediaries are asked to contain the total amount of large exposures to within the limit of eight times the regulatory capital (overall limit) and exposure to individual clients or connected groups of clients within a maximum of 60% of the regulatory capital (single name limit).
Containment of the concentration risk is also monitored by the Supervisory Authority by checking on the monitoring reports that financial intermediaries are obliged to submit quarterly.

Internal approaches to risk measurement follow directly from specialisation of the activities performed. The peculiarity of factoring activities derives from the fact that it is based on purchase of portfolios of trade receivables, generally short term, from the client, on the basis of contract relationships that are typically long term, with the provision, generally in combination, of management and financial services. In exchange for transfer from a single transferor, one acquires a portfolio of receivables composed of a large number of claims transferred.
The purchase of these receivables takes place through a complex and structured procedure, which is also reflected in the forms of organisational structure adopted by the intermediaries, of evaluation of the two risk counterparties (transferring creditor, debtor transferred), typically present in the factoring operation, of evaluation of the relationship between the two counterparties in terms of analysis of the underlying supply contracts and the usual behaviour of the parties in the relationship and in the context of other relationships (regularity of payment, requests for delays, disputes over supplies made etc) and compliance with procedures for credit approval and decisions on creditworthiness of the risk counterparties taken by the competent management bodies.

The portfolios of purchased receivables are diversified by geographic location, sector of economic activity (SAE) or type of goods traded (RAE), by the type of supply, size of the customers, and in other ways.
The internal approaches to risk measurement and management are thus also based on the specific evaluations performed, based on the level of risk of the individual homogeneous segments identified in the portfolio of trade receivables purchased, on monitoring of the homogeneous credit pools and on the possible setting of limits of exposure and credit in relation to the described pools.

Nature of concentration risk / Counterparties / Measurement of exposures
The concentration risk derives from the high exposure of the financial intermediary compared with its own regulatory capital, in relation to individual clients or groups of variably interconnected clients.

The connection between clients may arise from the power of one client to control another ("juridical connection") or from connections of an economic nature such as to involve an adverse effect on the economic or financial status of the connected client in the event of the principal clients suffering financial stress ("economic connection"). Thus, even when the clients are many, they may constitute a single unit from the point of view of credit risk (single name exposure).

In the Italian factoring industry, one may find high levels of risk concentration in terms of assignors, but marked fragmentation in terms of the assigned debtors, considered the main risk counterparties in the operation.

As stated previously, lack of diversification of risk exposure in the factoring industry may also be related to specific factors such a geographic concentration, the sector of economic activity (SAE) or branch of business (RAE) of the counterparties, and so on. The aim of concentration risk measurement and management systems is to ensure a sufficient degree of diversification of exposure and to monitor its course.
In national regulations on concentration risk, such systems are principally aimed at checking the positions of individual clients or groups of connected clients as described above.

The internal approaches adopted by the factoring industry, more sophisticated and developed in relation to the nature of the activities performed, aim to achieve a better diversification of exposure, including on the basis of segmentation of commercial receivables into homogeneous pools and, by monitoring trends in these homogeneous receivables segments, to make it possible to modify the composition of the assets purchased.
Notwithstanding the fact that the concentration of factors' portfolios is structurally rather higher than that of financial intermediaries whose assets portfolio is largely made up of financial credits, one finds that risk levels are modest, noticeably lower than for a traditional loan portfolio, even when the probability of default is the same. This is because exposure is monitored differently.
Factors, in fact, operate with substantial information assets, thanks to the analyses performed on the relationship between the two risk counterparties and the information that is obtained

from management of the trade receivables to which they have title (transfer of the credit; Law 52/91 and civil code articles 1260 and following). These information assets can be used to forecast crises of the counterparty and is substantially increased by the possibility of being able to observe it in numerous commercial relationships. A debtor's concentration does not influence the solidity or stability of the financial intermediary. In contrast with non fulfilment of financial obligations, failure to pay a trade debt does not presuppose default on all other commercial exposures. In fact the default may have its origins in the underlying supply relationship, with the creditworthiness of the debtor remaining unchanged.

The amount of the exposure is currently given as the sum of the risk assets taken on in relation to the subject, weighted to take account of any lesser risk deriving from the nature of the debtor counterparty and from any guarantees (real or personal). The progressive move to the IRB method should permit a measurement of risk more in line with the specific features of the factoring operation.
In general, the principal risk counterparty in the factoring operation, typically self liquidating, is the debtor transferred, by which the factoring company expects the exposure to be liquidated. In *non recourse* factoring operations, the credit risk can be attributed to the transferor.

Monitoring and management of risk / Governance and reporting
In general, one finds that the monitoring and management of concentration risk is carried out both on the basis of current regulations with the modalities provided for therein, and also using internal tools and processes for constant monitoring of exposure at both single position and segment levels.
Intermediaries prepare periodic reports that describe and point out positions defined as "large risk" and the levels of sector concentration, with a view to prompt taking of adequate measures for control and reduction of the risk.

Credit risk mitigation
On the question of credit risk mitigation techniques used by intermediaries operating in the factoring industry, one finds that insurance policies are of increasing importance.
Recourse to this technique for the transfer of risk associated with the debtors transferred is favoured by the fact that in both factoring and insurance the risk is accepted on a portfolio logic, even though each unit in the aggregate is evaluated specifically.
In general, the insurance cover used by factors falls into one of the following two categories:
a) Analytical insurance policies on credit;
b) "Excess loss" insurance policies.

The contractual characteristics of the traditional analytic policies used by factoring companies are as follows.

- Absence of aggregate excess,
- Insurer's liability limited to the credit lines decided or accepted by the insurer.

When these conditions are met, the factor achieves an effective transfer of the counterparty risk for the portfolio of debtors accepted by the insurer, even though in a contractual framework different from that characterised by a personal guarantee, recognised by the CRD Directive as the ideal technique for risk mitigation. Specifically, compared with the requisites envisaged by the Directive for recognition of a personal guarantee, the analytical insurance policy may differ for the following reasons:

- The effectiveness of the guarantee depends not only on the existence of the principal obligation but on payment of the premium by the insured and the latter's behaviour. The insured must have managed the credit with ordinary diligence and must not have behaved in ways damaging to the interests of the (insurance) company;
- The modalities and times of execution of the guarantee, since presentation of the claim is normally subject to a peremptory time limit. The indemnity is conditional on presentation of documentation proving the unpaid sum due and the passage of a specific time from the original due date for payment.;
- The presence of conditions that do not influence the effectiveness of the guarantee or the determination of cover, but the amount of the compensation for loss as the result of a maximum limit for the policy, normally determined as a multiple of the premiums.

The impact of these differences in comparison with the personal guarantee arrangement can be assessed considering that the insured is the same financial intermediary monitored, and therefore subject to prudential rules that are in fact much wider and more differentiated than the generic obligations of diligence that insurance contracts impose on the insured.

On the time for execution of the guarantee, the Association points out that the delay in comparison with the personal guarantee is in effect negligible and in general measured in months.

The cover of losses faced by the financial intermediary on insured exposure may be conditioned by the policy's overall limit on indemnities, which may potentially interfere with the guarantee provided at the single name level. Nevertheless, the effect of the policy maximum is significant only in the event of a high correlation between the insolvency risks of the insured debtors. In practice, a low correlation is one of the requirements that insurance companies evaluate in the stage of initial examination for such contracts.

"Excess loss" policies differ significantly from analytical ones and therefore cannot be brought within the rules regarding personal guarantees. In fact, these risk mitigation techniques operate at the portfolio level and cover the risk that a loss may occur that exceeds the amount of risk the insured has retained for itself (usually in the form of an aggregate excess), generally coinciding with expected loss.
Their purpose is therefore to stabilise the firm's risk profile, providing a variable width buffer, comparable to the annual plafond of indemnity in the face of unexpected losses appearing (adverse sector trends, large individual claims, particularly adverse temporary economic situations). This property makes this type of insurance cover particularly suitable for performing the role of protection of assets against unexpected losses.

Further techniques used for credit risk mitigation and management include recourse to setting of credit ceiling and charging of additional commission ("malus").

Regulatory Environment

Current regulations on concentration risk are based on compliance with standard limits for concentration applicable to all financial intermediaries independently of the type of activity performed and defined in terms of total exposure (overall limit) and individual risk positions (single name limit).
The index of risk concentration is calculated as the ratio between nominal exposures aggregated at the level of single party or groups of connected counterparties and the intermediary's regulatory capital. It currently aggregates nominal exposures of substantially different natures (short, medium and long term loans, disposals, trade credit, discount, property and equipment leasing etc) and therefore provides an extremely generic and abstract indication that does not correspond to the operations performed.
Application of the index, as currently defined, to specialised activities is liable to penalise such activities significantly and unjustifiably, with the risk of distorting competition.

The indicator is of fundamental importance for ensuring the splitting of credit risk, provided that it reflects the specific risk profile of the activity and also takes account of the specific nature of the mitigation techniques that contribute to defining it.
It is therefore held that regulations on concentration risk should be diversified according to the type of activity and intermediary, since application of the concentration index becomes meaningful if applied to aggregates with homogeneous characteristics.

With specific reference to factoring, it is argued that the setting of limits for concentration of risk should take account of the following factors:

a) The distinctive nature of factoring, which involves higher levels of concentration than traditional financing instruments, but lower levels of risk thanks to:
- Characteristics of the assets of this type of intermediary, which consist of trade credits, payment of which depends predominantly on sale of the products in their markets, rather than on the solvency of the debtor;
- A short duration of exposures, which allows the factor to alter its risk exposure quickly, in particular in the event of crises in large industries, these normally being preceded by an easily detected progressive deterioration;
- The structural presence of a second counterparty (transferor or debtor as it may be) which also creates a structural subdivision into several commercial relationships, independently of the accounting configuration of the exposure.

b) The use of mitigation instruments in fact adopted by the intermediaries, with special reference to the various forms of insurance cover available at both analytical and portfolio levels.