

**Kraainem, 29 January 2015**

**Re: EUF Position Paper on EBA "Draft Regulatory Technical Standards on materiality threshold of credit obligation past due under Article 178 of Regulation (EU) 575/2013"**

The EU Federation for the Factoring and Commercial Finance Industry (EUF) is the Representative Body for the Factoring and Commercial Finance Industry in the EU. It is composed of national and international associations for the factoring and commercial finance industry that are active in the EU, representing 97% of the EU industry turnover of €1.260 Tr. in 2013.

Factoring is a flexible 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. This is achieved by the supplier assigning and selling its accounts receivables to a factoring company. The factor will provide a range of services to its clients, including providing capital against the assignment of their receivables, accepting the risk of bad debts and collecting on past due accounts. Factoring has been considered a stable financing alternative by many companies, particularly during the financial crisis over the last five years. Many SMEs that were unable to obtain traditional bank funding were able to do so under factoring facilities, offered by factoring companies. Indeed, as confirmed by the ECB<sup>1</sup>, "as SMEs are typically perceived to have a higher probability of default than larger firms and, additionally, to be more informationally opaque, they are more likely than larger firms to be penalised by banks in times of heightened bank risk aversion. In addition, it is predominantly larger firms that have the option of substituting alternative sources of financing, in particular debt issuance, for bank lending. For SMEs, by contrast, trade credit, leasing and factoring are closer substitutes for bank loans". Hence, the factoring industry thrived during the financial crisis, helping hundreds of thousands of SMEs throughout the EU to obtain capital.

The EUF is pleased to answer the EBA's question as follows.

**Q1. Do you agree with the approach proposed in the draft RTS (option 1) that default should be recognized as soon as one of the components of the threshold (absolute or relative limit) is breached? Or would you rather support the alternative option, i.e. recognition of default after both thresholds are breached (option 2)?**

In order to answer Q1, the EUF believes it is necessary to start by making an overview on the concept of "past due loans" in factoring.

With regard to the definition of "past due credit obligations", it is useful to underline that the sensitivity of the factoring industry to any change in the definition of the materiality threshold for past due credit obligations is differentiated among the EU Countries, depending on various factors: i) the structure of the market (financial companies vs specialized banks vs divisions of banks), ii) whether individual

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<sup>1</sup> ECB, Financial Integration in Europe, April 2014

financial companies are supervised or not and to what extent, iii) the accounting standards applied at individual level, iv) the presence of specific provisions in National regulations, v) the materiality threshold set by the National Authority and v) the payment behavior in trade relationships.

Even if the issue of late payments may originate a high amount of "past due" exposures (in some countries more than in other), the factoring industry is able to limit the actual risk of the exposure. Although a complete analysis of the industry is not available, a small survey on the balance sheet of 15 main factors operating in different Countries among the EU shows that for the year 2013 the average cost of risk in factoring is estimable to 0.6-0.7%, while the average cost of risk in banking is 1.90%, according to the EBA key risk indicators<sup>2</sup>. This confirms the statement of the academic literature that factoring is a very low risk financial service, thanks to the assignment of the receivables raising from the business activity of the client that allows the factor to rely on two counterparty and mitigate the risk of the operation and to the close relationship that the factor establishes with its client, thus reducing asymmetrical information, particularly adapt to emerging economies or period of crisis.

The practice itself is not homogeneous, in particular with regard to factoring with recourse: in most of the EU Countries, factors consider as "past due" an exposure to a client (and therefore start the counting of the days past due to determine default) when they withdraw the advances granted to such client or when the latter presents an overdraft, while in some Countries (i.e. France and Spain) there is a case-by-case approach and only in Italy there is evidence of instructions by the Bank of Italy on how to determine a defaulted past due loan in recourse factoring, based on the maturity of the underlying receivables and on the current materiality threshold set in Italy.

Also the materiality thresholds set by each National Authority are differentiated, as shown in the EBA Consultation Paper (Table 1).

Although the current framework is not harmonized, **the EU factoring industry is unanimous in considering the approach proposed in the draft RTS (option 1) that default should be recognized as soon as one of the components of the threshold (absolute or relative limit) is breached as too penalizing and not predictive of the actual risk of the exposures in factoring.**

The EUF maintains that Option 1 would not consider appropriately the issue of technical defaults and that, according to this approach and considering that most factoring clients are businesses of small and medium dimensions as well as corporations, it is very likely that the absolute limit will always overcome the relative limit, making the latter actually ineffective.

Therefore, Option 1 does not achieve an appropriate balance as it would not be predictive of the real defaults but would instead lead to a dramatic increase in technical defaults, in particular within the factoring industry, where the presence of past due amounts is more likely due to late or neglected payments, payment processing errors or delays, complaints and claims on the supply, etc....

Besides, it is also worth noticing that Table 1 of the EBA Consultation Paper also highlight that, currently, the breach of the sole absolute limit is not the most common choice among the National Authorities, being adopted, with regard to the biggest factoring markets, only by UK. The change in the approach for most of the Countries would definitely exacerbate the increase in the technical defaults in the short run, with severe impacts on capital requirements, and would eventually affect cost and availability of credit for the businesses, in particular SMEs.

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<sup>2</sup> EBA Risk Dashbord, Q1 2014, Data as of Q4 2013.

Therefore, the EUF strongly support the alternative option, according to which the recognition of default occurs after both threshold are breached (Option 2). Such approach would be much more predictive of the materialization of risk than Option 1, allowing an effective exclusion of most technical defaults.

As an instance, a survey among some main Italian factoring companies, conducted by Assifact<sup>3</sup>, confirms for the Italian case that Option 1 would be significantly disadvantageous for corporations but would not lead to a significant increase in the ability to predict losses, while Option 2 would not lead to significant delays in default identification but instead increase the predictivity of the materialization of risk. According to this survey, the factoring companies estimate that Option 1 would bring to an increase in the amount of defaulted exposures of about 95% with respect to Option 2. These tests on the current portfolio, moreover, suggest that (at least in Italy) Option 1 would have a dramatic impact also on the SMEs, notwithstanding the EBA's expectations, while Option 2 would lead to a more balanced situation.

## **Q2. Do you agree with the proposed maximum levels of the thresholds?**

In general, the EUF believes that the maximum levels of the thresholds are too restrictive to assure a significant risk predictivity to the class of past due over 90 days exposures in all EU Countries and will lead to an increase in technical defaults.

With regard to the absolute threshold, the EUF highlights that the limits proposed by EBA (200€ for retail exposures, 500€ for the other exposures) seems too low to assess the actual risk and will lead to the recognition of default as soon as any amount due over 90 days occurs. Moreover, the amount of each payment in trade relationships is usually much higher than the limits proposed by EBA: the EBA should consider the possibility to increase the absolute threshold for all exposures to an amount not below €5.000-€10.000, and in particular to provide a higher, specific limit for exposures to corporations as well as exposures to central governments or central banks, to regional governments or local authorities, to public sector entities (not below €25.000-€30.000).

However, the current definition of "retail exposures" within the standardized approach allows the exposures to change class depending on the amount of the exposures: a more stable definition would help in the application of the absolute limit. As an alternative to overcome this issue, the EBA may wish to consider a different, single absolute limit for the exposures stemming from factoring operations, ranging from €25.000 to €30.000, regardless the class where the exposures are allocate.

With regard to the relative threshold, the EUF would like to suggest to clarify further that the amount to be considered as numerator is the sum of all amounts that are past due more than 90 days and that amount due by less than 90 days are not included in this sum. The limit at 2% appears again to be restrictive, having regard to the current levels of the relative thresholds in use in the EU Countries (that range between 2% and 5%).

The EBA should consider to raise the maximum relative limit, i.e. up to 5%, allowing the National Authorities to set the most appropriate limit, consistently with the peculiarities of each Country..

In particular, the EUF highlights that late payments by PAs represent a very important issue in some EU Countries, e.g. in Greece, Italy, Portugal and Spain in which exposures stemming from the purchase of trade receivables to PAs register, in average, payment periods up to 180 days. In this cases,

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<sup>3</sup> Assifact, the Italian Association for Factoring, is founding member of the EUF.

past due over 90 days should not be considered as an appropriate indicator of default because the actual credit risk of the relative exposures is very low, if existent<sup>4</sup>. Moreover, receivables against PA are often purchased by the institution when already due.

According to the EBA Consultation Paper (page 13), "technical defaults" are small amounts that are past due as a result of technical circumstances rather than the financial situation of the obligor, which is what should drive the materiality of default. Therefore, this definition may well entail late payments by public entities, as past due amounts (though not being "small") are often the result of specific payment processes provided by the law and also of laws that temporarily hinder the payment by the debtor and / or the enforcement of the payments by the creditor with respect some public entities, thus reducing the significance of the payment terms indicated on the receivables.

In these Countries, factoring represents a crucial source of liquidity for the SMEs who are suppliers of the PA and would not be able to manage such late payments otherwise: the significance of the factoring industry for PA's suppliers is confirmed by the presence of factors specialized in this business only. Therefore, it is strictly necessary to consider appropriate solutions that take into account the specificity of the public sector in each EU Country in order to reduce the amount of technical defaults in this sector.

A possible solution to this issue can be drawn from the Italian national regulation, that currently 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 or in presence of laws that temporarily hinder the collection or the enforcement of payments by such debtor<sup>5</sup>. For instance, should such waiver be erased from the Italian regulation, in Italy this would mean that most (if not all) the portfolio of receivables to PAs would become past due over 90 days, and Italian factors estimate the amount of past due over 90 days to be almost ten times larger than it is under the current regulation, regardless the selected Option<sup>6</sup>, while the actual amount of bad debts in the public sector is less than 0.6%<sup>7</sup>.

The EUF, in order to consider properly the specificity of the public sector and reduce the impact of technical defaults within the PAs, advises the EBA to consider either or both the following items:

- i. a waiver for the exposures to central governments or central banks, to regional governments or local authorities and to public sector entities similar to the above-mentioned one already in use in Italy, perhaps to be adopted at national level at discretion of each Supervision Authority, and / or, subordinately,
- ii. an increase in the relative threshold for the exposures to central governments or central banks, to regional governments or local authorities, to public sector entities to 20% as well as a concurrent increase the count of days past due to 180 for such exposures.

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<sup>4</sup> Assifact, Survey on trade receivables to PAs, 2011 (available only in Italian).

<sup>5</sup> Bank of Italy, Circolare n. 272 of 30 July 2008 and Circolare n. 217 of 5 August 1996.

<sup>6</sup> See Annex 2.

<sup>7</sup> Assifact, Survey on trade receivables to PAs, 2011 (available only in Italian).

Moreover, the previous proposals appear to be consistent with the principle stated in art. 178 b) of the CRR, that allows the National Authorities to change the 90 days period with a longer period of 180 days for certain exposure classes.

**Q3. How much time is necessary to implement the threshold set by the competent authority according to this proposed draft RTS? Given current practices, what is the scope of work required to achieve compliance?**

A change in the definition of the materiality threshold will definitely have a severe impact on banks and financial companies, requiring a review of the credit monitoring processes (to manage the combination of the absolute and relative threshold, currently not used in many Countries), as well as of the IT and risk measurement systems. The maximum period of two years from the date of application of this Regulation for the application of the threshold appears - currently - to be sufficient, but may be underestimated, in particular for IRB institutions or if the current national waivers should not be confirmed.

**Q4. Do you agree with the assessment of costs and benefits of these proposed draft RTS?**

The EUF believes that the assessment of costs and benefits of these proposed draft RTS overestimate the benefits and underestimate the costs of the proposed draft RTS. Option 1 (absolute OR relative), in particular, appears to dramatically increase the issue of technical default, while Option 2 (absolute AND relative) allows for a better balance between costs and benefits and a better representation of defaulted clients. An even better balance could be achieved if the above-mentioned proposals about the maximum levels of the thresholds were adopted.

A more detailed impact study to assess precisely the estimated impact on credit quality, risk predictivity and processes of the two alternative options could be useful to orientate the choice.

**Q5. What is the expected impact of these proposed draft RTS?**

Under Option 1, as a result of the increase of non performing exposures, cost of risk, risk weighted assets and capital requirements will be substantially higher and this will increase costs and decrease availability of credit for businesses. Option 2 would present a lower impact.

Impact on processes, credit management and IT systems will be significant as well, regardless the Option that will be eventually adopted. Moreover, a very restrictive approach will eventually affect the competitiveness of the European banking and factoring industry against the extra-EU competitors.

With kind regards,



John Gielen  
Chairman - EUF

## Annex 1

The following survey was conducted by Assifact on 6 main Italian factoring companies.

The following figures take into account the current waiver granted for exposures to PA in Italy (see answer to Q2).

### Test of the current portfolio on materiality thresholds proposed by EBA

	Current regulation	HP1: Exceeds either or both the absolute threshold or/and the relative threshold	HP2: Exceeds both the absolute threshold and the relative threshold
<b>Number of clients with past due over 90 days exposures at 31st december 2014, of which:</b>	<b>2.584</b>	<b>3.692</b> (+42.9%)	<b>2.575</b> (-0.4%)
Retail exposures / SMEs	1.695	2.466 (+45.5%)	1.591 (-6.1%)
Exposures to PAs	409	585 (+43.0%)	501 (+22.5%)
Other exposures, including corporate	480	641 (+33.5%)	483 (+0.6%)
<b>Amount of exposures past due over 90 days at 31st december 2014, of which:</b>	<b>383.009.254</b>	<b>1.248.350.064</b> (+225.9%)	<b>781.451.384</b> (+104.0)
Retail exposures / SMEs	26.503.182	96.725.755 (+265%)	30.342.747 (+14.5%)
Exposures to PAs	60.271.665	98.952.941 (+64.2%)	87.236.723 (+44.7%)
Other exposures, including corporate	296.234.407	1.052.671.369 (+255.4%)	663.871.914 (+124.1%)

### Predictivity analysis of materiality thresholds proposed by EBA

Figures in €.	Current regulation	HP1: Exceeds either or both the absolute threshold or/and the relative threshold	HP2: Exceeds both the absolute threshold and the relative threshold
<b>Number of clients with past due over 90 days exposures at 31st december 2013</b>	<b>4.284</b>	<b>4.716</b> (+10.1%)	<b>3.812</b> (-11.0%)
of which incurred in loss or specific allowance during year 2014	1.227	1.226 (-0.1%)	1.090 (-11.2%)
<b>Amount of exposures past due over 90 days at 31st december 2013</b>	<b>327.912.045</b>	<b>754.730.318</b> (+130.2%)	<b>385.371.526</b> (+17.5%)
of which incurred in loss or specific allowance during year 2014	46.140.157	44.419.954 (-3.73%)	39.213.088 (-15.0%)

## Annex 2

The following survey was conducted by Assifact on 4 Italian factoring companies, 2 of which specialized in purchasing trade receivables to PAs.

The following figures does not take into account the current waiver granted for exposures to PA in Italy (see answer to Q2).

### Test of the current portfolio on materiality thresholds proposed by EBA

	Current regulation	HP1: Exceeds either or both the absolute threshold or/and the relative threshold	HP2: Exceeds both the absolute threshold and the relative threshold
<b>Amount of exposures past due over 90 days at 31st december 2014, of which:</b>	<b>122.358.545</b>	<b>1.295.363.338</b> (+958.7%)	<b>1.096.426.528</b> (796.1%)
Retail exposures / SMEs	10.813.280	21.911.918 (+102.6%)	13.382.194 (+23.8%)
Exposures to PAs	41.419.005	1.086.013.470 (+2522.0%)	957.818.070 (2212.5%)
Other exposures, including corporate	70.126.260	187.437.950 (+167.3%)	125.226.263 (78.6%)