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Re: EBA Discussion Paper and Call for Evidence on SMEs and the SME Supporting Factor (EBA/DP/2015/02)

To whom it may concern:

Synopsis

The EUF believes that paying more attention to important basic principles such as the proportionality principle on the one hand, as well as to low-risk and well-established specialized forms of financing on the other hand while drafting regulatory requirements for credit institutions and banking groups is the only sustainable way forward, also to ensure that a sound financing mix continues to be available for SMEs.

Therefore, the EUF cannot provide evidence about it but, in principle, it defends the SMEs Supporting Factor's continued presence as an appropriate tool to guarantee support to the SMEs' financing.

Factoring is a flexible way of financing, particularly fitting to the SMEs that present a pattern of growth and good business performance, as the best practices of the industry allows to contain risks. Therefore, in the view of supporting further, and maybe even more properly, the SMEs financing, the EUF believes the EBA should consider the same amendments already proposed to the BCBS:

a) to allow the possibility of weighting the factoring exposure to a client according to the risk weight of the assigned debtor(s), and / or

b) to provide a lower, specific risk weight for factoring exposures, by way of a cap or a cutoff on the applicable risk weight.

These proposed amendments would recognize the product's specificity and help to support the SMEs.

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We would like to thank you for giving us the opportunity to respond to your consultation on the impact of the CRR's Supporting Factor (SF) on the SME community and to respond to some of the questions raised in your document. We want to respond to the main targeted points raised in your mandate to report to the European Commission on a) an analysis of the evolution of the lending trends and conditions for SMEs (b) an analysis of effective riskiness of Union SMEs over a full economic cycle; and (c) the consistency of own funds requirements laid down in the CRR for credit risk on exposures to SMEs with the outcomes of the analysis under points (a) and (b). Your consultation focuses on the capital reduction factor for loans to SMEs, the so called Supporting Factor (SF), introduced in the CRR. The EBA consultation paper is attempting to determine if this specific measure has resulted in enhanced lending to SMEs.

Who is the EU Federation for Factoring & Commercial Finance (EUF)?

The 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 two international Factoring associations, who in turn represent over 400 Factoring and Commercial Finance companies. The EUF is a European wide association of associations, acting as one voice for the Receivables Finance and Factoring Industry in the EU. In 2014, the Receivables Finance Industry in the EU provided over €185 billion of working capital financing to over 160,000 businesses, mostly SMEs. This amount of working capital has to be seen in relation to the total Factoring turnover in the EU, which in 2014 exceeded € 1.3 trillion. If you consider that the total EU GDP was approximately € 13 trillion that same year, businesses supported by these types of finance accounted for approximately 10% of GDP, a figure representing the "real economy" in the EU. This is not too far from your own analysis (p. 9):

"SMEs in the EU remain largely reliant on bank financing. But of the remaining forms of finance available, trade credit is used by 10.3% of SMEs, <u>factoring by 6.3%</u> and non-bank loans by 6.9%."

The EUF represents an industry that is one of the leading drivers of financing for SMEs in the EU. Factoring companies in particular have been one of the leading drivers of growth for SMEs, as they provide a means to provide working capital through a highly effective operating platform that reduces the risk of default and supports the flow of finance downstream through supply chains in the real economy. Traditionally, a Factoring company provides liquidity to an SME based on the eligible receivables assigned to it. The Factoring company may provide a form of credit protection against the default risk of the client's customers as well, providing additional capital to their end buyers, many of whom are SMEs themselves, ultimately offering liquidity in the supply chain that normally would be challenged otherwise. Hence, you can say that Factoring is a unique blend of services designed to ease the traditional problems of selling on open account terms, mainly aimed towards SMEs.

As you reported in your paper (p. 5), *"following the financial crisis, SME bank lending has suffered a significant backdrop in volumes, from a peak of EUR 95 billion in mid-2008 to approximately EUR 54* *billion in 2013/2014*", a more than 40% decrease. However, if you look at the Factoring industry in Europe during about this same period, factoring volumes increased from 827 billion Euros in 2009 to 1,37 trillion Euros in 2014, a 66% increase. This confirms again that Factoring was continuously used to provide working capital solutions to SMEs while access to bank lending plummeted during this period.

Factoring's Role in the Financial Crisis

The financial crisis placed the stability of the financial system at risk in part due to the significant amounts of leverage that were never adequately revealed. However, the Factoring community had no direct correlation to the weak credit practices experienced during this period, including the financing of sub-prime paper or other high risk derivatives and most importantly, the Factoring industry did not contribute to the stress of the banking system. On the contrary: Factoring helped alleviate the effects of the credit crunch when many banks withdrew from the market.

In the EU, a very large majority of Factoring companies are owned by regulated banks or are part of a banking group. However, Factors themselves are traditionally not deposit-taking, but rather institutions that finance companies on a short term basis. Neither are they taking on excessive leverage (Factors only finance up to the value of the "eligible receive balance" that has been assigned by their clients). Factoring is a straightforward and quite simple form of financing based on a receivable/invoice originated by the SME and hence directly linked to the real economy.

In fact, when assessing the role of Factoring companies, it has to be taken into account that Factoring and Commercial Finance has proven to be a real and frequently used alternative to the classic bank loan and has helped to alleviate much of the burden caused by the recent credit crunch, especially for SMEs.

For example, in countries such as Germany and France, the number of Factoring clients increased by approximately 11% and 60% respectively from 2008 to 2009, i.e. during the worst time of the "credit crunch" (France: 28,800 clients in 2008 to 32,200 in 2009; Germany: 5,400 clients in 2008 to 8,840 clients in 2009). Also, the total Factoring turnover in the EU decreased only very slightly from 2008 to 2009 (by -2,9%), only to increase substantially in 2010 (by nearly +18% in comparison to 2009).

This shows that the financial crisis did not affect the Factoring industry negatively. Moreover, the fact that the Factoring industry did not contribute to the causes of the recent financial crisis should not be overlooked: When compared with other forms of financing, which can be considered as contributing factors to the recent financial crisis, Factoring is considered a low-risk form of financing, also thanks to its direct connection to the real economy via the purchase or transfer of receivables for delivered goods and rendered services.

Factoring's Low Record of Credit Losses

The Factoring industry has enjoyed a long history with a low record of credit losses and continuous and stable growth. As an alternative form of traditional trade finance, Factoring is one of the very few mechanisms within the wider financial services industry whereby a financial institution purchases the assets from the client, in this case the account receivables and all their underlying rights, including the right of payment by the debtor. This element strengthens the scenario that the Factor will be repaid.

The receivables assigned to the Factoring company are generally well diversified and of a short term duration (normally under a 90 day period). In addition, the financing provided to the seller is contracted on a flexible basis, often providing leeway for the Factoring company to exit quickly in a deteriorating financial condition scenario, whether it be stemming from the debtor(s) or the seller itself, which in part explains the low loss record for the industry.

Moreover, Factoring companies use strong credit metrics, they become secure not only from the assignment of the receivable but also from the intricate management system supporting the process, a robust technology platform that ledgers the receivable, supports the credit underwriting on both the seller and their buyer(s), and has the capacity to alert the Factor in such areas as a rise in dilution or concentration risk, keeping credit losses to a minimum.

Also, the flow of funds to a Factor does not come from the seller but rather from the clients' customers, as they make payment directly to an account controlled by the Factor, increasing the likelihood of repayment. Lastly, Factors can finance companies in all sectors, but most relate to consumer products/services, business to business or service industries.

Questions raised in your Consultation Document

The EBA's consultation document focuses on the impact of the Supporting Factor (SF). In brief, the SME SF allows the entity to multiply an exposure to a SME by a factor of 0.7619, thus reducing the impact on the capital requirement. The SF is available when:

a) the client is allocated in the following portfolio: retail, corporates or secured by mortgages on immovable property classes (the latter being not relevant to this industry)
b) the client is a SME in accordance with Commission Recommendation 2003/361/EC of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises, but taking into account only the annual turnover
c) the gross amount owed to the institution and parent undertakings and its subsidiaries, including any exposure in default, by the obligor client or group of connected clients, but excluding claims or contingent claims secured on residential property collateral, does not exceed EUR 1,5 million

In response to your question about the provisions contained in the CRR that may have impacted a banks' ability to finance the real economy, with the focus on Factoring as an alternative form of finance, the question remains: does the SF support the Factor's ability to fund the SME? Please note that the following answers take into account that we are not a Factoring company ourselves but the industry body, so we do not interact with the SMEs ourselves directly. However, we wanted to include below two observations from the consultation:

SME Supporting Factor

You state that by applying the SME Supporting Factor (SF) of 0.7619 to capital requirement, credit institutions will be able to increase lending to SMEs in the current economic context. This reduction came into effect in January 2014, but <u>may be reviewed by the Commission</u> in 2016. For the record, the EUF is supportive of continuing this practice, as again many of Factoring companies are regulated banks or subsidiaries of banks. Eliminating or reducing the size of the SF would have an adverse impact on the costs when financing SMEs in the EU, resulting in the consideration whether and under what conditions to fund them altogether.

Hence, the SF is a form of relief, ultimately reducing the burden that would obviously be passed on to the SME due to the increased capital reserve requirement. Therefore, **the EUF defends the SF's continued presence**. You state in your document the following, which is in our view part of the reason not only to keep the SF in place but also to improve on it (p. 42):

Estimates and researches "find that a 2 percentage point reduction in capital requirements was associated with an increase in aggregate corporate lending by 1.5% and a rise of aggregate investment by 0.5%".

Moreover, we would like to stress the fact that Factoring is a self-liquidating exposure where the default risk of the client is mitigated and subordinated to the risk of dilution and/or default of the assigned debtor. Factoring is widely used by the SMEs, usually assigning or selling receivables against their larger and more creditworthy debtors/customers, in order to effectively reduce the risk of the operation for the financier. It is also useful to notice that the value of receivables, as security, 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), thus allowing the Factor to grant higher level of advance than for example other asset-based lending solutions and, in particular, to recover most of the defaulted exposures having possibility to chase the assets of the assigned debtors and, in recourse operations, the client.

Considering the aforementioned features of Factoring, the EUF would extend to the EBA the suggestion, already proposed to the BCBS in the occasion of the consultation on the update of the Basel Standard Approach (cf. the EUF's response to the BCBS of April 2015 at http://euf.eu.com/news/newsflash/003-euf-response-to-bcbs-position-paper-on-revisions-to-the-sa-on-credit-risk-2015-03-25.html), to consider also the introduction of a specific approach for Factoring exposures in order to further support the SMEs, and in particular:

a) <u>to allow the possibility of weighting the Factoring exposure to a client according to the risk weight of the assigned debtor(s).</u>

Within the IRB approach, the Basel II framework already provided (art. 365) for exposures to purchased receivables, different approaches to determine the capital requirements (bottom-up / top-down) that considers the assigned debtor as risk counterparty of the Factor. Moreover, the IRB approach allows the bank to consider purchased receivables, subject to some conditions, as collateral for the exposure to the client.

Furthermore, Factors consider dilution risk when determining the appropriate advance rate to make available to the client, so that the residual unexpected dilution risk can be anticipated.

According to the proportionality principle and to the features of Factoring, the EUF believes that, in the view of the alignment to the IRB approach, the EBA may consider to provide also in the Standardized Approach (SA) the possibility of weighting the exposure with the risk of the assigned debtor instead of the risk weight of the client/seller even in recourse operations, subject to the same conditions required in the IRB approach to consider the receivables as a collateral. Such approach is already in place in e.g. Italy (only for supervised financial intermediaries) and appears as a good way to recognize the unique aspect of the Factoring service.

b) to provide a lower, specific risk weight for Factoring exposures, by way of a cap or a cutoff on the applicable risk weight

As already mentioned, Factors usually register recovery rates higher than other kind of asset-based facilities due to the security offered by the assigned (or purchased) receivables. Therefore, the risk weight applicable to corporates should recognize the lower risk of Factoring and be re-calibrated taking into account the lower LGD and calculating specific risk weight applicable to Factoring, by way of:

i) a cap on the applicable risk weight (i.e. Factoring exposures are weighted up to 50%), or

ii) a reduction of the applicable risk weight (i.e. Factoring exposures are weighted 50% less than the applicable risk weight).

The EUF is currently collecting figures about credit losses in Factoring and will be happy to share and discuss the results with the EBA to support these proposals.

Liability Cap of EUR 1.5 Million

You state that, for the purposes of the SF, the total amount owed to the lending institution, its parent and subsidiary undertakings (including exposures in default, but excluding the claims secured on residential property) shall not exceed EUR 1.5 million. This is actually very low, as some Factoring companies will provide financing starting at an amount of EUR 500,000 but up to amounts in the EUR 20+ Million range. This restriction could also be a significant impediment, especially when looking at the impact. When applying this liability cap to an exemplary case where the outstanding balance is EUR 1.5 Million (in terms of exposure), and assuming the receivables have credit terms less than 90 days, that means the SME could only be financed through Factoring to up to four times its balance, or in this case EUR 6.0 Million in revenue. Considering that SMEs (just like other companies) use a balanced mix of different forms of financing, which may well originate from different institutions within one banking group, the liability cap can result in restricted financing offers for SMEs. The other drawback with this liability limitation is that not all Factoring clients may be eligible for the SF in the first place. Many of the Factoring companies offer their services to companies whose receivables balance far exceeds the EUR 1.5 Million threshold, thereby possibly rendering the SF irrelevant, even though these companies are SMEs. In summary, the liability limitation is far below your designated expectation of an SME's needs based on the annual turnover of EUR 50 Million or less as stated in the Commission Recommendation 2003/361/EC to which art. 501 para. 2 of the CRR refers.

EBA Questionnaire:

Q5/Q16: Whilst harmonizing the SME-definition further would theoretically be helpful, this may be difficult in practice. After all, SMEs are also a heterogenic group of companies which may require decisions on a case-by-case basis rather than a "one size fits all"-solution (e.g. start-ups are different from established companies, which may be of a similar size when it comes to e.g. the number of employees). Also, the concept of SMEs varies from one EU member state to another for good reasons, e.g. different historical developments and different economic conditions.

Conclusion

The financial crisis has taught all of us many lessons, and one of them is to ensure the continued liquidity infusion of SMEs during their peak periods. Even though the SF may not necessarily be directly linked to an increase of capital to SMEs, the situation we experienced during the credit crunch only a few years ago should be avoided at all costs, not only by implementing constant reviews and impact analysis of financial supervisory regulations, but also by providing rules that can act as a "buffer, air bag, or derogation" for SMEs should a similar situation arise once again, thereby ensuring that a sound mix of financing options remain available to them. However, this objective should not be achieved at the cost of stable, low-risk forms of financing which have served especially the SME-community well over many decades.

The EUF believes that paying more attention to important basic principles such as the proportionality principle on the one hand, as well as to low-risk and well-established specialized forms of financing on the other hand while drafting regulatory requirements for credit institutions and banking groups is the only sustainable way forward, also to ensure that a sound financing mix continues to be available for SMEs.

Please do not hesitate to contact us should you require more information about the Factoring industry in Europe.

With kind regards

John Gielen
Chairman - EUF