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**EBA Consultation Paper**

**on Guidelines on the application**

**of the definition of default under article 178 of regulation (EU) 575/2013[[1]](#footnote-1).**

As a unique representative body of allthe French specialised credit institutions and financial institutions which represents 290 entities, ASF contributes to an appropriate recognition of the specialised financial activities like equipment and real estate leasing, factoring, consumer credit and auto loans and leases, mutual guarantee societies which – with an outstanding of more than €215 billion in 2014 – accounts for about 20% of total amount of credits to the real economy in France.

We would like to thank you for giving us the opportunity to respond to the Discussion paper & Call for evidence on SMEs and SME supporting factor. We would like to draw your attention to some facts and suggestions related to the specificities of our credit activities.

**The specificities of factoring and the reasons for a specific treatment**

Factoring must be considered as a low risk financial product: Factoring is a flexible form of finance which is secured by way of assignment or purchase of receivables.

The peculiar nature of this kind of exposures encompasses some differences from the exposures rising from traditional finance products, that can be summarized as follows :

- the Factoring agreement is between the Factor and the client, i.e. the supplier, while the debtor does not enter in any contractual relationship with the Factor ;

- while traditional lending is subject only to terms, the credit raised from trade receivables is subject to terms and conditions : that means that the due date of the invoice cannot be considered as fully mandatory in itself for the debtor, as there may be events connected to the trade relationship that reduce the reliability of the due date (we will focus more on this issue in the following) ;

- payment of trade debts by the debtor is subject to the "payment behavior" of the debtor (habits for buying its commercial payables).

**Comments on the QIS on the GL on the definition of default. § 3.3.1 Materiality threshold**

ASF would like to express its concerns about the policy option the EBA is testing within the QIS regarding the materiality threshold, which might have major impacts on factoring industry.

The new option provides for the increase in both the absolute and relative limits and the trigger as both the limits are exceeded, but it provides a slight but significant change in the approach stating that the counting of the 90 days should start as soon as the amount past due exceeds the two components of the threshold.

The new policy option may bring the unintended result that most if not all the debtors will be considered as past due over 90 days, due to the abovementioned factoring characteristics – and whereas eventually no invoice will remain unpaid.

Moreover, the debtor may be, at the same time, both a client of the factor itself and of other banks within the banking group, thus implying that the whole exposure of the group on such subject may fall into the non performing class due to reasons other than its actual financial situation.

One solution to this problem would be to take into account for the definition of the materiality threshold only invoices which are past due of more than 90 days and trigger the default only when absolute and relative thresholds are breached.

***Question 1:*** *Do you agree with the proposed definition of technical defaults? Do you believe that other situations should be included in this definition? If yes, please provide detailed proposals on how to address further possible situations.*

Firstly, ASF has general reservations on the proposed definition of technical default, as its scope does not include some cases where the repayment delay does not depend on financial circumstance.

* We would like to make sure that payment issues coming from payment transfers, cheques treatment … are considered as technical defaults, i.e. included in the situation “where due to the nature of the transaction there is a time lag between the receipt of the payment by an institution and the allocation of that payment to the relevant account, so that the payment was made before the 90 days and the crediting in the client’s account took place after the 90 days past due”.
* As far as leasing activities are concerned, disputes related to the provision of additional services to the financial contract, for example maintenance services associated to the leasing of equipment can often take more than 90 days before being resolved. It may happen that some payments due in relation with the financial contract are suspended due to the non-performance of the provision of the additional service. In these situations, the non-payment is not due to the insolvency of the obligor, and it may take more than 90 days to solve the problem.
* Other repayment delays may occur that are not due to insolvency or unlikeliness to pay: in public sector entities or large corporations, internal processes can often lead to repayment delays which are not due to financial circumstances. As these clients are typically highly unlikely to fail and default on their agreements, we would support the ability to suspend the past due counting, in a defined limit, to clarify the “intention to pay”.

Secondly, ASF would like to underline the following specific reservations concerning factoring activities.

**Comments on the proposed definition on technical defaults concerning factoring**

Due to technical reasons, a certain delay can be innate in the exposure to debtors within a Factoring agreement with a client : indeed, the debtor may be or may not be informed about the factor's interest on the ceded receivables. In the former case, the debtor pays directly to the factor's account, and the factor requires some days for reconciliation of the amount collected with the client's account. In the other case if by mistake the debtor pays to the bank account of its supplier, i.e. the factor's client, it may be that the latter requires some days to transfer the collected amount to the factor.

These processes require a variable number of days that depends on the features of the payment. In particular, when the assignment or purchase of receivables has not been disclosed to the debtor, the client can take a few days to collect the payments and transfers the collected amount to the factor.

Other examples of "technical default" or "technical past due" exist in factoring : seller not dispatching the invoice to the buyer, no communication to the factor of discounts, deductions, netting, obligors reluctant to factoring, …

A solution to avoid most of the above mentioned issues would be to change in the technical default definition the start of the counting of the days past due (for instance, in case of undisclosed factoring, when the reimburse by the assignor of the collected amounts to the factor becomes due).

***Question 2:*** *Do you consider the requirements on the treatment of factoring arrangements as appropriate and sufficiently clear? If not, please provide proposals for additional clarifications.*

**Types of factoring**

ASF believes that the approach regarding the treatment of factoring requires clarifications. ASF acknowledges that the IAS/IFRS framework emphasizes two kinds of risk in the balance sheets of the factors :

* the risk on the client, represented by the amounts advanced by the factor ;
* the risk on the debtors, represented by the invoices purchased.

Nevertheless, ASF wants to insist on the fact that, at least at solo level, all French factors, since they do not apply IAS principles at individual level, account, for any type of factoring, the purchased receivables among the assets, and the retentions, reserves, deposits of guarantees among the liabilities ; the difference between the global amounts of purchased receivables and retention, reserves, deposits of guarantees indicate the amount of the funding granted by the factor – which is not as such written in the balance sheet.

Notwithstanding the accounting representation, when assessing the risk of a given agreement, factors usually combine both client and debtor risks to take into account the specificities of factoring.

**Client side**

*Disputes (see debtor side)*

*Factoring account in debit*

On the client side, the financing facility is usually considered as one and limited to a percentage of the amount of the outstanding receivables. ASF reckons that taking into consideration the agreed percentage of advance, as proposed by the EBA in the Consultation Paper, may represent a proper way to treat factoring.

In most cases the factor does not inform the client about a percentage of the advance : in those cases, the factor manages the position of the client according to its internal limits and implicitly considers that it is liable up to the total amount of the outstanding debts (i.e. the agreed percentage is equal to 100%).

**Debtor side**

*Principle*

In principle, we do not share the view in paragraph 20 that the classification of the obligor as in a defaulted status should not be subject to additional expert judgment. This restrictive definition is likely to strongly increase the default rate and consequently, the provision for credit loss (cost of risk), whereas factoring is known to be an activity with very low cost of risk[[2]](#footnote-2)

*Trade events*

In factoring, trade events may reduce the reliability of the due date of the invoice as a mandatory payment date for the debtor or postpone the actual payment terms for the buyer according to some conditions. Among the examples of the trade events that we assume fall under the provisions of §17 and §18, we can quote : payment after verification of the supply, extension of the payment terms to the buyer, …

This should be recognized, for instance, under the reliefs proposed in §17 and §18 of EBA Consultation Paper

*Disputes*

From a risk perspective, the disputes, as well as discounts, deductions, netting 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

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.

*Credit facility approach*

A clarification is needed regarding §23, where the consultation paper reads as follows: *"[...] for institutions that use the IRB Approach, by virtue of the fact that the ceded receivables are purchased receivables, where they meet the requirements of 154(4) of Regulation (EU) No 575/2013 or in the case of purchased corporate receivables the requirements of Article 153(6) of Regulation (EU) No 575/2013, the default definition may be applied as for retail exposures in accordance with Section 9 of these guidelines"*.

According to this wording, it is suggested that the EBA clarifies if the application of the default definition as for retail exposures to purchased receivables, where the requirements of the above-mentioned Article 154(4) or 153(6) of the CRR are met, is available for institutions that use the Standardised Approach as well.

Recourse to the credit facility approach, under IRB and SA approach, would bring an interesting solution to the problems above mentioned concerning the application of a materiality threshold to seize default in factoring and concerning the definition of default itself.

**PA Debtors**

PA trade debts are not really a source of credit risk but actually a source of liquidity risk, as the real risk is not losing money but rather getting the money back later than expected.

**Time needed for implementation**

The impact of the proposed definitions on financial institutions will vary depending on the extent to which the current approaches deviate from the proposals.

However, given the envisaged significant impact on substantial numbers of institutions, we would like to stress that sufficient time needs to be granted to change all the different operative procedures.

***Question 3:*** *Do you agree with the approach proposed for the treatment of specific credit risk adjustments?*

No specific comment.

***Question 4:*** *Do you consider the proposed treatment of the sale of credit obligations appropriate for the purpose of identification of default?*

No specific comment.

***Question 5:*** *Do you agree that expected cash flows before and after distressed restructuring should be discounted with the customer’s original effective interest rate or would you prefer to use the effective interest rate applicable at the moment before signing the restructuring arrangement? Do you consider the specification of the interest rate used for discounting of cash flows sufficiently clear?*

We believe that the best – and simpler - option is to follow the IFRS accounting principles in order to classify restructured contractual arrangements due to obligors financial difficulties. According to us, the amount of discount used for impairment purpose is calculated with the net present value of the new payment schedule using the initial effective interest rate before restructuring arrangements. We then would recommend the use of the customer’s original effective interest rate.

Yet, we notice that the back office costs of the restructuring operation itself are not taken into account in the proposed formula of diminished financial obligation… The “IFRS accounting” approach is not coherent with Basel 2 principles from this point of view.

***Question 6:*** *Do you agree that the purchase or origination of a financial asset at a material discount should be treated as an indication of unlikeliness to pay?*

No specific comment

**Question 7:** *What probation periods before the return from default to non-defaulted status would you consider appropriate for different exposure classes and for distressed restructuring and all other indications of default?*

We believe that a “one year” probation period for distressed restructuring is too long and might be not coherent with the operational gesture of the contracts, since the objective of restructured agreements is precisely to bring back the borrower to a solvency position.

If there is no default following the restructuring arrangement, a one year period of probation would lead to situations where there is no operational default but a default on a prudential basis (i.e. a reporting of prudential default with value zero). It could introduce a bias in reporting and stress testing: exposures classified in default with no default recorded in operational processes.

In France it would be contradictory with overindebtness regime where, according to the central bank, restructured loans are to be considered as non-defaulted.

We also underline the fact that IT models would be strongly affected in solving the divergence between prudential reporting and operational reality.

We consider that a fixed delay to return to non-defaulted status after restructuring arrangements could become heavily incoherent with the reality of the activity, especially for corporates exposures which return to default after restructuring is rarer than for retail exposures.

We would suggest taking into account the recurrence rate of returning to default per exposure category and to adapt the requirements accordingly.

**Question 8:** *Do you agree with the proposed approach as regards the level of application of the definition of default for retail exposures?*

We agree with proposed approach which allows institutions to choose the level of application of the definition of default (i.e. obligor/facility) for retail exposures according to their respective internal risk management practices.

It is crucial to allow sufficient flexibility, in particular for banking subsidiaries, which may not have an extensive overview of an obligor’s commitments within a group. For these smaller specialised firms, an application of the definition of default at the facility level is required.

**Question 9:** *Do you consider that where the obligor is defaulted on a significant part of its exposures this indicates the unlikeliness to pay of the remaining credit obligations of this obligor?*

We think the proposed threshold of 20 % of exposures is artificially defined and too low.

Where the definition of default applies at the level of a credit facility, institutions should not be requested to assume unlikeliness to pay for remaining credit obligations of a particular obligor.

**Question 10:** *Do you agree with the approach proposed for the application of materiality threshold to joint credit obligations?*

No specific comment

**Question 11:** Do you agree with the requirements on internal governance for banks that use the IRB Approach?

No specific comment

1. ASF is a member of EU Federation, the European Federation for the Factoring and Commercial Finance Industry. The present contribution is in several parts directly inspired from that of EUF. [↑](#footnote-ref-1)
2. See for instance, report from French supervisor ACPR « Analyses et synthèses”, p27 and 28 : “Un coût du risque en nette baisse” :https://acpr.banque-france.fr/fileadmin/user\_upload/acp/publications/analyses-syntheses/2014-Analyses-syntheses-affacturage-11-2015.pdf [↑](#footnote-ref-2)