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- submitted online via EBA consultation website -

Berlin, 31st of May 2024

Response to EBA consultation of Draft Regulatory Technical Standards on the allocation of off-balance sheet items and UCC considerations under article 111(8) of Regulation (EU) No 575/2013

Dear Madam or Sir,

As the **leading interest group representing the German factoring industry**, with currently **45 members generating a total turnover of 384.4 billion Euro in 2023** and neutral analyses showing that these members cover a **market share of 98 percent of the turnover volume of factoring companies organized in associations in Germany**, we would like to thank you for the opportunity to comment on the draft Regulatory Technical Standards on the allocation of off-balance sheet items and UCC considerations under article 111(8) of Regulation (EU) No 575/2013 (hereinafter referred to as draft RTS).

We will **respond to questions 1, 5 and 7, and include a more thorough and detailed explanation of factoring as well as suggestions regarding the transitional arrangements below**.

Our main points are the following:

- Systematically, **limits in factoring (on individual debtors or on maximum exposures regarding the factoring client) are not commitments** within the meaning of art. 5 para. 10 of Regulation (EU) No 575/2013 in the version following the so-called banking package to implement Basel III in the EU (CRR III).
- Moreover, **all conditions set out in art. 5 para. 10 letters a-e of CRR III are generally met with** – another reason that factoring limits are not to be considered as commitments.
- Even **if factoring limits were to be viewed as commitments, an allocation into bucket 3 (instead of bucket 5) is uncalled for, inadequate and disproportionate**, also due to the negative economic implications this could have for financing availabilities through factoring, especially for SMEs.
- If (despite our view to the opposite) limits in factoring were to be allocated to bucket 3, **transitional arrangements analogous to those foreseen for unconditionally cancellable commitments in art. 495d no. 1 of CRR III** are necessary.

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I. A more detailed explanation of factoring

In Europe, **factoring is a generic term for a range of asset based finance services** which inter alia includes factoring, invoice discounting and supply chain or supplier finance/reverse factoring. In Germany, factoring is classified as a regulated and supervised financial service which is defined in § 1 para. 1a no. 9 of the German Banking Act (Kreditwesengesetz - KWG) as the "*ongoing purchase of receivables on the basis of framework agreements with or without recourse*". The **members of our association all offer factoring services that fall under the aforementioned definition of the KWG and are therefore either credit institutions that fall under the Regulation (EU) No. 575/2013 (CRR) or financial service institutions (Finanzdienstleistungsinstitute) that fall under the KWG, some of which are also part of banking groups**. All our members are licensed and supervised by the BaFin. Hereinafter, we will generically use the terms "factoring" and "factoring company" for ease of reference.

Due to differences between national laws, especially in civil or contract law, and also because of diverse requirements and wishes of the factoring clients, there are **many variations of factoring**, and the precise nomenclature and arrangements vary from market to market in Europe, but **all exist to provide working capital funding and financing solutions to businesses/clients, particularly SMEs, based upon the receivables originated by the client**. With a factoring solution and based on a contract entered into by the factoring company and its client, the factoring company agrees to pay a certain percentage (usually between 80-90%) of approved receivables as soon as the receivables are sold and assigned to it by its client. Usually, the client is obliged to tender all receivables against the agreed debtors to the factor. If credit risk protection is part of the factoring agreement, it is referred to as **non-recourse factoring**, while a factoring agreement where the credit risk on the debtor remains with the factoring client/seller is called **recourse factoring**; in Germany, non-recourse factoring is predominant, mainly for reasons of civil law (non-recourse factoring is seen as a purchase and assignment of rights, also according to several judgments of the German Federal Court of Justice since 1977, and it generally has priority over the assignment in connection with a prolonged reservation of title). The factoring company will often also undertake all credit management and collections work: 27.7% of the factoring turnover generated by our members stems from such full service factoring.
Factoring is ultimately a unique blend of services designed to ease the traditional problems of selling on open account terms, and is mainly aimed towards and used by SMEs. Due to the self-liquidating structure of non-recourse factoring (i.e. the credit risk lying with the debtor), it is particularly viable for companies that face financial hardship and struggle to find alternative working capital financing, which often also are SMEs. **More than 96% of our members' factoring clients receive funding in the SME-typical segment of up to 10 million Euro**. Hence, factoring is a **very important part of the financing mix, especially for SMEs**, and here in Germany, the **total factoring turnover of our members in 2023 made up for 9.3% of the German GDP** (**European average GDP penetration** in 2023: **12.1%**). Accordingly, drastically increasing regulatory capital costs for factoring (limits) will probably **lead to decreased financing and funding for businesses, with SMEs likely being affected the worst**. Due to these implications on the economy in general, we are sending a copy of this position paper with our responses to your consultation to the German federal ministries of finance and of economics (Bundesfinanzministerium, Bundeswirtschaftsministerium).

Factoring needs to be **distinguished from banking credit, loans or traditional lending**. Factoring is the financing of suppliers to the real economy directly against their commercial invoices, providing liquidity against these invoices through an outright purchase of them. The suppliers to the real economy benefit because they receive 90% or more of an invoice value within a day or two from shipment instead of waiting for the contractually agreed period of time to pass in order to receive payment by their end customers, or having to deal with the end customers' late payments. This differs from traditional banking credit, which is the

provision of debt capital to finance a business' general working capital or long term assets by way of a loan.
Moreover, the (contractual) relations in traditional bank lending differ widely from the factoring business, last but not least because **factoring (in contrast to traditional lending) involves three parties which are de facto involved in the financing process**: The factor (=purchaser of the receivable), the factoring client (=seller of the receivable) and the debtor of the receivable.
Another difference between bank lending and factoring concerns the terms "credit lines" and "(loan) commitments": These terms generally entail that the client of an institution may use or withdraw funds up to a pre-approved limit, with or without prior notice to the credit institution. With factoring, limits are also used, mainly in order to ensure risk diversification, but these are either so called "debtor limits" or "factoring client limits" which differ substantially from credit lines and loan commitments in traditional bank lending.
Debtor limits refer to the maximum sum of receivables against one debtor which the factor will purchase from the factoring client, while **factoring client limits** are maximum exposures as regards the factoring client, i.e. the highest overall amount of liquidity the factoring client can expect to receive from the factoring company when selling/assigning receivables against different debtors. **Both kinds of factoring limits are subject to all prerequisites of the factoring agreement being met as well as inter alia creditworthiness checks, i.e. there are several steps before such limits actually become an enforceable claim of the factoring client against the factoring company**.
Accordingly, such **debtor limits do not grant the debtor of the purchased receivables (i.e. the source of credit risk in non-recourse factoring) the right to use or withdraw funds**, but simply represent the maximum amount of receivables the factoring usually are obliged to tender to and the factoring company is potentially obliged to purchase, subject to various additional requirements being met. Based on information from our members, **the average sum of limits is often set around 5 to 7 times higher than the actual total utilization**, i.e. the amount of liquidity actually provided to the factoring client in the form of the purchase price as consideration for the sale/assignment of the receivables. Reasons for this are, inter alia, that factoring clients want to make sure that no additional applications need to be made to obtain higher limits in the future (avoidance of costs), seasonal trade, the existence of many one-time-customers where limits are maintained for a longer period of time before getting cancelled as well as expected growth (however, clearly not in the amount of factor 5 to 7 on compared to the average utilization).
Moreover, debtor limits in factoring are generally covered by credit insurance that in turn fulfil the regulatory capital requirements under Solvency II, which is why a (higher) allocation of regulatory capital to such limits also in factoring would lead to an unnecessary double capitalisation of ultimately the same exposure.

II. Responses to questions 1, 5 and 7

On question 1: Do you have any comment on the non-exhaustive list of examples provided?

The non-exhaustive list of examples of specific off-balance sheet items provided in the draft RTS also mentions "*[u]ndrawn amounts of factoring arrangements in the context of commitments to finance the seller of receivables, invoice discount facilities*" as off-balance sheet items to be allocated to CCF bucket 3 instead of CCF bucket 5.

Firstly, we wish to clarify that the aforementioned **factoring limits (debtor and factoring client limits) can generally not be considered as commitments in the meaning of art. 5 (10) of the CRR and should therefore not be allocated neither to CCF bucket 3 nor 5**.

According to art. 5 para. 10 of CRR III, commitments are "*any contractual arrangement that an institution offers to a client, and is accepted by that client, to extend credit, purchase assets or issue credit substitutes*". With non-recourse factoring, the credit risk lies with the

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debtor, not with the factoring client, and since debtors are not the clients of factoring companies and generally no contractual arrangements exist between the debtors and the factoring company, debtor limits do not fulfil the aforementioned definition of "commitment".
Furthermore, debtors cannot even trigger the credit risk, since the realisation of the factoring company's credit risk mainly depends on the factoring client selling goods or providing services and then selling/assigning the receivables resulting therefrom to the factoring company. This systematic difference is also the reason why in cases of non-recourse factoring, debtor limits need not be reported under AnaCredit (cf. point 5.4.8 of AnaCredit Reporting Manual, Part III – Case studies); similarly, the Deutsche Bundesbank clarified in July 2020 that at least for purposes of reporting loans/credit facilities of a certain amount (Millionenkreditmeldungen), debtor limits in factoring are not considered as commitments. In this context, it should also be noted that for liquidity requirements purposes, art. 411 no. 16 of the current CRR (which remains unchanged by CRR III) defines factoring, but does not classify factoring (limits) as a commitment.

Another reason that factoring limits are not to be considered as commitments is that generally in factoring, **all conditions set out in art. 5 para. 10 letters a-e of CRR III are met with**:
"(a) ... institution receives no fees or commissions to establish or maintain those contractual arrangements"
The factoring fee and any interest to be paid by the factoring client are only incurred through the purchase, assignment and funding of a receivable and do not serve as consideration for establishing or maintain the factoring agreement as such (in contrast to e.g. commitment fees). In particular the factoring fee is payment for the factoring company's services to the factoring client in the form of debtor and collection management. This is why the factoring fee is generally also the basis on which VAT is calculated.
"(b) … client is required to apply to the institution for the initial and each subsequent drawdown under those contractual arrangements"
In order to receive liquidity in the form of the receivables purchase price, factoring clients always have to tender the receivable(s) to the factoring company for purchase; the factoring company then decides individually on each purchase and payment. This is therefore the factoring client's application for each "drawdown".
"(c) institution has full authority … over the execution of each drawdown" and *"(d) institution [assesses] the creditworthiness of the client immediately prior to deciding on the execution of each drawdown*"
Factoring agreements generally contain clauses to the effect that debtor/factoring client limits can be cancelled at any time and according to equitable judgment in consideration of the debtor's creditworthiness. By checking the limit availability prior to each purchase/assignment, this creditworthiness is also assessed with each purchase/assignment, hence giving the factoring company the final say over each purchase/assignment.
"(*e) ... offered to a corporate entity, including an SME, ... closely monitored on an ongoing basis"*
In addition to the aforementioned checks on limit availability prior to each purchase/assignment, factoring limits and debtors' creditworthiness are closely monitored on an ongoing basis in factoring, e.g, through regular cross-checks with limits set by credit insurances for the purchased receivables and the debtors, through checks of debtors' payment behaviours with other factoring clients as well as through the factoring client's duty to report any negative debtor payment behaviour.

In view of this, **neither debtor limits nor factoring client limits are commitments in the meaning of art. 5 para. 10 of the CRR III**.

Secondly, **if factoring limits were to be viewed as commitments** (despite all of the aforementioned arguments), they should at least be **considered as unconditionally cancellable commitments** since they fulfil the corresponding prerequisites of art. 5 para. 10 of the CRR III:

Factoring companies generally have binding internal guidelines that limits are to be cancelled in the case of critical deteriorations in creditworthiness. These guidelines ensure that, **in the event of a relevant deterioration in creditworthiness, limits are cancelled without further discretion and therefore "automatically"**, as foreseen in art. 5 para. 10 of the CRR III. Furthermore, such limit cancellations do generally not have to be announced to the factoring client before they take effect, and in contrast to other commitments, there is also **no increased probability that the factoring limit will be utilised if the factoring client's financial/economic situation deteriorates**. This applies all the more when focusing on the party with the relevant default risk in non-recourse factoring, namely the debtor.
Taking art. 2 of the draft RTS into consideration (cf. also question 7 below), there are **also no factual reasons to maintain the factoring limit despite creditworthiness doubts**. The cancellation of limits due to a deterioration in the creditworthiness of a debtor is completely standard practice in factoring and is actually inherent to the structure of the factoring business, so that it is quite inconceivable that a corresponding cancellation of limits could have e.g. reputational consequences for the factoring company or negatively influence the perception of the factoring company in the market. Similarly, maintaining factoring limits for fear of legal disputes is also hardly conceivable: Legal disputes, in particular with the debtors of purchased/assigned receivables, are part of the debtor management and collection aspect of non-recourse factoring and hence quite normal.

Thirdly, even if factoring limits were to be classified as commitments, an allocation of all factoring limits into bucket 3 (instead of bucket 5) is uncalled for, inadequate and disproportionate.

A CCF of 40% by no means appropriately reflects the probability with which it may be reasonably in factoring expected that undrawn limits are converted into actual credit risk exposures or positions. Factoring clients are generally obliged to tender all of their receivables against the relevant debtors to the factor. **Generally applying a CCF of 40% would therefore effectively mean that factoring clients are expected to increase their turnover (!) on average by 40%, based on the undrawn debtor limits. It goes without saying that this assumption is untenable.**
Moreover, a comparison with the other examples provided for bucket 3 clearly demonstrates that undrawn factoring limits show systematically fundamental differences from a risk perspective which do not justify the application of the same CCF. While a CCF of 40% may well be appropriate for granting revolving overdraft limits on current accounts (cf. example 3 of the consultation paper) because there is a corresponding probability of drawdown (especially if the customer's financial situation deteriorates), the same cannot be said of factoring limits due to the systematic differences already mentioned. In factoring, the **debtor cannot trigger the credit risk being assumed by the factoring company**. For the factoring client, on the other hand, **to trigger said credit risk, the factoring client must first carry out a real economy transaction, which then triggers the conditions for the factor's purchase of the hereby generated receivables**. In addition, a factoring client facing economically hard times in no way increases the probability of a sale of goods / services and thus (theoretically) a corresponding exposure or credit risk on the debtor. On the contrary: **With economically challenging times, experience shows that factoring clients face a higher probability of sales difficulties** due to e.g. shortages in material and dwindling confidence on the debtor side, i.e. factoring clients confronted with economic challenges are likely to generate less receivables that can be sold/assigned to factoring companies in return for liquidity in the form of the purchase price.
A comparison with example 1 regarding bucket 3 as stated in the draft RTS also shows fundamental differences to non-recourse factoring. In this example 1, the institution has submitted a takeover bid with a recognisable price offer, which will lead to an increased likelihood of the transaction being implemented and thus the emergence of a corresponding credit/default risk. In contrast to factoring, the institution itself has the sole power to let such a situation

arise in the first place by setting the parameters of the offer, which in turn may justify a corresponding CCF of 40%.
As stated above, the sum of undrawn factoring limits are usually 5 to 7 times higher than the average utilization. Allocating factoring limits to bucket 3 in this scenario would hence effectively entail higher capital requirements for "undrawn" factoring limits than for the actual risk weighted assets following the purchase and assignment of receivables against debtors, even if the factoring companies were to lower their limits considerably. A **(conservative) example calculation** with a factoring limit only 5 times higher than the actual utilisation can easily illustrate this:
Debtor limit for an SME corporate factoring client: 1 million Euro
Utilisation: 200.000 Euro
800.000 Euro off-balance sheet exposure, risk weight with 40% credit conversion factor (CCF) due to allocation to bucket 3 results in 320.000 Euro and a capital requirement (13-15%) of 41.600-48.000 Euro (theoretical risk), while the actual utilisation of 200.000 Euro only requires 21.000 Euro regulatory capital. In cases where the limit is 7 times higher than the actual utilisation, this difference is obviously higher still.
Extrapolating this to the overall factoring turnover in 2023 in Germany of more than 384 billion Euro, this could mean additional capital requirements for (theoretical) factoring limits of factoring companies of around 11-16 billion Euro.
If factoring limits were to be allocated to bucket 3, the theoretical, not materialised credit risk would require a multiple of the amount of regulatory capital for the utilised, materialised credit risk (even more so where credit insurances are used for credit risk mitigation purposes in accordance with CRR, thus lowering regulatory capital requirements for actually purchased receivables). This is inadequate and disproportionate. In this context, we also wish to point out that since particularly national civil law influences how factoring is executed and factoring contracts (including limits) are drafted, such national differences need to be taken more into consideration in order to maintain a level playing field.

Considering the **low-risk nature and history of factoring (limits)**, **the very widespread use of credit risk protection through credit insurances** in factoring (who in turn also follow capital requirements) and since the **wording of the draft RTS implies that the examples given for allocation into bucket 3 are non-exclusive**, i.e. that an allocation to bucket 5 remains possible ("…unless assigned to bucket 1 or bucket 5…"), we therefore **advocate to make this distinction clearer in order to allocate factoring limits to bucket 5 at most, should they still be considered as (unconditionally cancellable) commitments**.

On question 5: Do you have any comment on the allocation criteria proposed under Art. 1?
and
On question 7: Do you have any comment on the factors that may constrain unconditionally cancellable commitments proposed under Art. 2?
The **factors presented in art. 2 and referenced to in art. 1 of the draft RTS** may in theory lead to an unconditionally cancellable commitment not being cancelled, but this is **rarely (if ever) the case in practice, especially not in factoring** (if factoring limits were to be considered as commitments, cf. our response to question 1). In factoring, there are no factual reasons to maintain the factoring limit despite creditworthiness doubts or deteriorations. The **cancellation of limits due to a deterioration in the creditworthiness of a debtor is completely standard practice in factoring** and is actually inherent to the structure of the factoring business. Hence, it is **quite inconceivable that a corresponding cancellation of limits could have e.g. reputational consequences for the factoring company** or negatively influence the perception of the factoring company in the market and that this is turn would influence the decision or hinder the factoring company's ability to cancel a commitment. Similarly, maintaining factoring limits for fear of legal disputes is also hardly conceivable: **Legal disputes, in particular with the debtors of purchased/assigned receivables, are part of**

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the debtor management and collection aspect of non-recourse factoring and hence quite normal.
The consequence resulting from the (in practice unlikely) constraining factors in art. 2 is that unconditionally cancellable commitments are allocated to bucket 3 according to art. 1, i.e. with a CCF of 40% instead of 10%. Due to this **significant and considerable consequence and given the difficulty of proving the absence of/non-decisive influence of factors presented in art. 2, the exceptional nature of cases** where the factors mentioned in art. 2 of the draft RTS may actually play a decisive role **should be better reflected in the wording of arts. 1 and 2**, e.g. by adding "… may **in few cases** constrain…" to art. 2 and ""is **actually** constrained" in art. 1.

<u>III. Transitional arrangements</u>
According to the **wording of art. 495d no. 1 of CRR III**, the **transitional arrangements only apply to unconditionally cancellable commitments under bucket 5**, but not to "undrawn amounts of commitments" under bucket 3. Therefore, **if (despite our aforementioned arguments to the opposite) limits in factoring were to be considered commitments allocated to CCF bucket 3, transitional arrangements analogous to those foreseen for unconditionally cancellable commitments in art. 495a no. 1 of CRR III would be necessary** since the **increase in CCF from currently 0% (as undrawn debtor limits under non-recourse factoring clearly do not fall under undrawn credit facilities) to 40% under bucket 3 is even harsher** than in the case of unconditionally cancellable commitments from currently 0% to 10% under bucket 5. In this context, it should also be noted that IRB-credit institutions can make use of their IRB-CCF for exposures arising from undrawn revolving commitments as long as these revolving exposures continue – this is also supports the necessity of the aforementioned transitional arrangements.

Please do not hesitate to contact us should you have questions regarding factoring or the aforementioned arguments, suggestions and requests.

Sincerely,

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Managing Director

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