To:

Mr José Manuel CAMPA, Chairperson of the European Banking Authority

Re: Definition of default and materiality threshold: application to factoring and impact of the COVID-19

Dear Mr. Campa,

On behalf of the EU Federation for the factoring and commercial finance industry (hence "EUF"), I would hereby like to take the opportunity to express the concerns of the industry regarding some important issues about the implementation of the EBA Guidelines on definition of default (hence "Guidelines") and the Commission Delegated Regulation (EU) 2018/171 of 19 October 2017 (hence "Delegated Regulation") and the combined impact of them in the light of the COVID-19 pandemic.

Factoring is a flexible form of finance which is secured by means of assignment or purchase of non financial trade receivables. Consequently, the exposure of a Factor to a client is self-liquidating by nature as the reimbursement of the advanced funds is made directly or indirectly through the payments made by the account debtors. As such, the risk on the client (the assignor) is therefore mitigated and subordinated to the risk of dilution and/or default of the assigned debtor/debtors.

Thanks to the nature of the factoring transaction, Factors can control credit risk very successfully (only 0,09% average credit loss allowance in 2018 on a sample of 71 Factors across the EU[1]).

Moreover, in non-recourse assignment, the Factor also provides credit risk coverage on the assigned receivables, allowing the client not only to effectively transfer the insolvency risk on the assigned debtor but also to derecognise the receivables from its balance sheet, reducing its net working capital. Thus, in this case, according to the IFRS accounting standards, the exposure on the assigned debtor is embedded in the balance sheet of the Factor for the value of the purchased invoices.

Factoring is widely used by businesses of any size, with a total turnover of €1,91 Trillion representing 11,3% of the EU GDP. Its benefits and importance for the real economy has been recently analysed by the European Commission[2].

On default risk of the buyer in factoring

The peculiar nature of this kind of exposure encompasses some differences from the exposure rising from traditional finance products such as loans, that can be summarized as follows.

[1] EUF, "Factoring and commercial finance - a new white paper", May 2019 (https://euf.eu.com/what-is-euf/whitepaper-factoring-and-commercial-finance.html).

[2] VVA & AITE, "Study on Supply Chain Finance – Finale Report", commissioned by the European Commission, January 2020 (https://op.europa.eu/en/publication-detail/-/publication/4b1bcc59-5139-11ea-aece-01aa75ed71a1/language-en).

EU Federation for the Factoring and Commercial Finance Industry
c/o FCI Brussels Office ■ Rue Francois Vander Elst 4, ■ BE-1950 Kraainem ■ BELGIUM
■ Tel: +31 (0)20 627 0306 ■ VAT: BE 0644.822.643
■ IBAN: BE20 7390 1349 8256 ■ SWIFT(BIC) KBC: KREDBEBB

FCI Head Office
Keizersgracht 559
1017 DR Amsterdam
The Netherlands

Factoring is an agreement between the Factor (the assignee) and its client (the supplier/assignor), while the debtor generally does not enter into any contractual relationship with the Factor.

In traditional lending the repayments are subject to precise expiry dates reported in the loan agreement and the borrower must respect them unconditionally. So it is very clear when the borrower does not stick to a pre-agreed instalment plan or he breaches a covenant which triggers a complete repayment or a re-negotiation (forbearance) of the loan.

This is not the case for the payment of trade receivables, which is subject to specific terms and conditions and it is not immediate to identify a real default because the due date of the payment depends on i) bilateral negotiations between the seller and the buyer ii) industry (sector) standards and iii) local practices

Factors purchase receivables from the supplier (seller) and consequently enter into a trade agreement which has been concluded before the assignment and without any negotiation with the buyer. Generally, there isn't any contractual agreement with the latter.

The due date of an invoice cannot be considered as fully mandatory for the debtor, as in the supply contract normally there are some commercial clauses (terms of delivery, service level, goods compliance, etc.) that limit the possibility to enforce the invoice even if the due date has expired.

As a consequence, payments of payables are always subject to operational procedures as well as procurement and to working capital management policies of the buyer (particularly - but not only - in the P.A. sector), that can cause a certain delay compared to the nominal due date of the obligations. The duration of such delays may vary from Country to Country, from industry to industry or even from business to business and normally it is not linked to financial difficulties of the buyer. Ironically, observing the historical data, it seems that late payments are more customary among large corporate enterprises, with strong balance sheets, high liquidity and good credit ratings, including Public Administration Entities in comparison to SMEs, due to the increasing operational complexity.

Moreover, it requires a certain number of days to register the credit transfer on the Factor's account and correctly allocate the payment on the relevant debtor account. Therefore, even if the buyer pays on the due date, a delay can be registered due to the Factor's technical procedures.

These peculiarities of the payment process regarding factoring could result in the threshold(s) to be exceeded by any debtor, particularly in the P.A. sector, (likely) continuously.

Moreover we have to observe the factors can transfer the risk for the purchased receivables to third parties by way of e.g. credit insurance agreements that, although not generally recognized by the Regulator as a valid CRM tool in their customary forms, are very effective instrument to limit losses in the case the debtor default and also update the information about the financial situation of the debtors modifying the risk coverage

The application to trade receivables of loan-based principles to automatically identify the default of the buyers is misleading and brings, in any case, to unreasonably high levels of default exposures, which are inconsistent with the real financial situation of the debtor.

Although the current framework to identify debtor default provides some minimum flexibility to purchased receivables (namely, a technical past due situation where the debtor does not show receivables due by more than 30 days and the

EU Federation for the Factoring and Commercial Finance Industry
c/o FCI Brussels Office ■ Rue Francois Vander Elst 4, ■ BE-1950 Kraainem ■ BELGIUM
■ Tel: +31 (0)20 627 0306 ■ VAT: BE 0644.822.643
■ IBAN: BE20 7390 1349 8256 ■ SWIFT(BIC) KBC: KREDBEBB

FCI Head Office
Keizersgracht 559
1017 DR Amsterdam
The Netherlands

recognition of dilution situations), the EUF believes it is not sufficient to avoid the unintended consequences of its application on the factoring industry and its clients.

In particular, the new materiality threshold seems to pose some significant issues and needs clarifications on how it should be applied, as specified below.

On the interpretation of the new materiality thresholds

The Delegated Regulation[3] provides the general principles for the NSA to set the harmonized materiality threshold (art.1)[4]:

The European Central Bank provided its own interpretation in the feedback statement of the consultation carried out on the occasion of setting the materiality thresholds for the banks supervised by the SSM:

B.7 The ECB Regulation reflects the threshold structure and the mechanism for counting the number of days past due that are demanded by the RTS. These may, in some cases, lead to a default being identified despite no individual exposure being more than 90 days past due. For instance, this could happen where an obligor repays some material past due exposures, but the number of days past due keeps increasing – instead of being reset – because there are other material exposures that are just a few days past due. In that case, a default will be triggered when the counter reaches 90 days, in line with Article 3(3) of the ECB Regulation, but on that day the remaining material exposures could be less than 90 days past due.

The approach proposed by EBA, in the interpretation provided by ECB, appears to be calibrated on the concept of "overdraft", adopting the same calculation mechanism also for other types of operations which instead have contractual settings based on repayment plans.

This approach cannot be shared: as already highlighted during the consultation, a counting of the days past due that prescinds from the existence of at least one payment obligation continuously unpaid for 90 days would end up penalizing term and instalment loans compared to other techniques (e.g. overdrafts). This would significantly increase the number of "false positives" identified by the methodology for the counting of days past due and therefore identify as insolvent a huge number of subjects who do not actually present any symptoms of insolvency in presence of any delay (even if short).

---

[3] COMMISSION DELEGATED REGULATION (EU) 2018/171 of 19 October 2017 on supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for the materiality threshold for credit obligations past due.

[4] *2. [...] The absolute component shall be expressed as a maximum amount for the sum of all amounts past due owed by an obligor to the institution, the parent undertaking of that institution or any of its subsidiaries ('credit obligation past due'). The maximum amount shall not exceed 100 EUR or the equivalent of that amount in the relevant national currency. . [...] The relative component shall be expressed as a percentage reflecting the amount of the credit obligation past due in relation to the total amount of all on-balance sheet exposures to that obligor of the institution, the parent undertaking of that institution or any of its subsidiaries, excluding equity exposures. The percentage shall be between 0 % and 2,5 % and shall be set at 1 % whenever that percentage reflects a level of risk that the competent authority considers to be reasonable in accordance with Article 3.*
[...]
5. When setting the materiality threshold in accordance with this Article, the competent authority shall assume that the obligor is defaulted when both the limit expressed as the absolute component of the materiality threshold and the limit expressed as the relative component of that threshold are exceeded either for 90 consecutive days or for 180 consecutive days, where all of the exposures included in the calculation of the credit obligation past due are secured by residential or SME commercial real estate and the 90 days have been replaced by 180 days in accordance with Article 178(1)(b) of Regulation (EU) No 575/2013 for those exposures. [...]

EUFederation
Factoring & Commercial Finance

The EUF believes that, in order to assure full compliance with the Basel regulations and the CRR, the requirement of the continuity of the days past due on a single credit obligation is still necessary. It should be noted that in the absence of the requirement on the individual credit obligation, the "past due over 90 days" default may occur:

- in the case of overdrafts, after 90 consecutive days of exceeding the allowance;
- in the case of an exposure based on monthly instalments, with a mere payment delay of 31 days in the payment of each instalment on three consecutive months;
- in the case of purchased trade receivables, when the debtor shows payment delays, even if insignificant, but overlapped, on the invoices, as soon as there is an invoice due by more than 30 days.

It is evident that, in this hypothesis, a disparity between the various operations is generated: in the first case, 90 consecutive days of delay are required on a single credit obligation, in the others, 31 days would be enough (if repeated).

While the EUF shares that in principle 90 continuous days of exceeding a limit on an overdraft might be considered as an unequivocal signal of difficulty in repaying one's own exposures, it cannot be shared that the same applies in the case of shorter delays in paying the payables, although repeated and overlapping. Although payment delays in commercial transactions are not desirable, they certainly cannot be immediately representative of the debtor's insolvency, especially when the delay regularly ends up with the payment.

Following the above mentioned interpretation provided by ECB, the new rule would generate a hysteresis process of the past due days in which the method of calculation does not take account of the amounts paid and drags the counting of days past due as long as the subject has overdue amounts, regardless of the continuity of the delay in each single payment obligations. It would also make the provision of the technical past due on trade receivables pursuant to art. 23, d) de facto ineffective.

This interpretation would be tremendously detrimental to the factoring industry and hence to the thousands of SMEs they support as it may bring the unintended result that most debtors will be considered as past due over 90 days. An impact study performed by Assifact[5] shows that 25% of the businesses that are debtors of receivables purchased without recourse, which represents 33% of the total value of the receivables portfolio of the Italian factoring market would be considered as default following the ECB interpretation. This impact would simply be too high to be acceptable and resoundingly overblown.

For this reason, in order to assure a balanced approach between the different technical forms and avoid an excessive penalization of those based on repayment plans with respect to other lines of credit, it appears strictly necessary to apply the new thresholds considering the concept of "continuity" of the past due days on the single credit obligation, assuring that the counting of the past due days is re-modulated, on the occasion of each payment, on the oldest payment obligation among those unpaid.

This interpretation:

1. does not generate delays in the identification of a default, since it would still ensure the compliance with the provisions of Basel and the CRR (art. 178) that require continuity of the past due days on " any material credit obligation";
2. erases any disparity between subjects who use different financial techniques, since the counting of the days past due on the obligation would start, at any time, from the oldest expired due date or from the moment the exposure exceeds the agreed limit, regardless of the technical form and the method of allocation of

[5] The Italian Factoring Association.

payments, avoiding that the overlap of repeated minimal delays on consequential payment obligations is considered as equivalent, from the point of view of the definition of default, to a single exposure past due by more 90 days;
3. prevents the generation of a lot of false positive cases, with potentially very significant impacts on estimating the PD (highly overestimated) and the LGD (highly underestimated) and on the outcomes of the internal rating models.

Basically, it can be implemented alternatively:

a) counting the days past due, in case of exceeding the materiality threshold, starting from the oldest single payment obligation among those still unpaid at the reference date, or
b) counting 90 consecutive days of exceeding the materiality threshold, if there is at least one single payment obligation (instalment / invoice / overdraft) due more than 90 days

This interpretation would not change the fact that purchased receivables need more flexibility in the approach to identify default, but would help preventing from a "cliff effect" of the application of new DoD on factoring, that would be very detrimental eventually to the financing of the European corporates, especially SMEs[6].

The EUF, on behalf of their members, asks for confirmation of the above-mentioned interpretation. Please note that this would not apply only on factoring, but also to any other banking exposures based on a reimbursement schedule over time, such as e.g. leasing and mortgages.

Finally, we would like to stress that a more appropriate definition of default for purchased receivables could also be achieved through the possibility to apply under the standardized approach, for purchased receivables to corporates, the definition of default at the level of a particular facility (invoice) as already provided for retail exposures. That would be consistent with a current provision of the CRR (see art. 153.6) and reduces the detrimental effect of the new EBA definition of default.

On the impact of COVID-19

The EUF and its Member Associations share their concern that the business capacity to repay their obligations will be put under pressure by the measure taken and proposed by national governments to limit the diffusion of the COVID-19. Both national governments and EU bodies, including the EBA, are acting with speed and unprecedented strength in order to address and mitigate the adverse systemic economic impact of COVID-19 on the EU banking sector, but definitely the real economy is looking at a long period of stress.

A significantly increased delay in the average payment time of invoices is expected all around Europe, in consequence of such stress. The extent of the economic distress generated by the COVID-19 pandemic is still uncertain.

In this new scenario, which was impossible to foresee, banks and other supervised institutions such as factoring companies, will be called to change their IT systems to apply new and much stricter rules to identify default exposures: the current situation combined with impact of the new materiality thresholds which is expected to be already very high (see above),

---

[6] For information, according to the same impact study conducted on Italian factors, under this interpretation the above-mentioned "cliff effect" of the application of new DoD on factoring in terms of new NPLs would be reduced by about 75%.

might result in a "perfect storm" for the businesses that exacerbates their difficulties, as the usual and crucial support of factoring could be suddenly affected by the "cliff effect" of the application of the new DoD on their NPL.

The Basel Committee, on March 27th, announced a deferral of Basel III implementation in order to provide additional operational capacity for banks and supervisors to respond to the immediate financial stability priorities resulting from the impact of the coronavirus disease on the global banking system.

In such situation, the European factoring industry urges the EBA to consider the change in the global scenario and, following the example of the Basel Committee, proposing a deferral for at least 12 and up to 24 months of the date of application of the new materiality thresholds and of the Guidelines on the definition of default, in order to assure the resiliency of the European banking system as well as of the factoring industries and their continuous support to the real economy.

The two above-mentioned issues are not related and can be addressed separately, yet they are equally important in order to avoid unnecessary charges and uncertainty on the supervised institutions and, in immediate consequence, on the businesses.

Your sincerely,

Françoise PALLE GUILLABERT
EUF Chair

EU Federation for the Factoring and Commercial Finance Industry
c/o FCI Brussels Office ■ Rue Francois Vander Elst 4, ■ BE-1950 Kraainem ■ BELGIUM
■ Tel: +31 (0)20 627 0306 ■ VAT: BE 0644.822.643
■ IBAN: BE20 7390 1349 8256 ■ SWIFT(BIC) KBC: KREDBEBB

FCI Head Office
Keizersgracht 559
1017 DR Amsterdam
The Netherlands