Assifact
Associazione Italiana per il Factoring

POSITION PAPER
OF THE FACTORING INDUSTRY
ON THE NEW BASEL CAPITAL ACCORD

May 2001

GENERAL

This document outlines the point of view of the factoring industry with respect to the New Basel Capital Accord.

Special reference is made to the contents of the Basel Committee proposal introduced in the document disseminated in January 2001.

With reference to each issue deemed relevant from the factoring industry point of view, this document presents a number of remarks that support the opinion and, whenever possible, the consequent proposal for amending the reference text.

This document is the result of the activity carried out by the Italian Factoring Association in the period going from June 1999 to May 2001. It incorporates the remarks made by those working in this sector, specifically banks and specialized financial intermediaries, in particular within the context of the Council, the Steering Committee, the Technical Commissions and a special task force of the Association. The document was worked out by Prof. Alessandro Carretta and Ms. Lucia Gibilaro.

This document is intended for the Basel Committee within the context of the relative consultation procedure. The contents of this document have been debated within the context of the preparatory works for the draft of the Position Paper of the Italian Banking Association that, in its final version, incorporates the major remarks and amendment proposals of the factoring industry.

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* The layout of the document mirrors the layout of the reference document (The New Basel Capital Accord) and refers merely to the parts that are the subject of specific remarks and amendments.

COMMENTS AND AMENDMENTS PROPOSED IN RESPECT OF THE NEW BASEL CAPITAL ACCORD

PART 1
SCOPE OF APPLICATION

Remarks

The scope of application of the New Accord appears much wider when compared with the scope of the 1988 Capital Accord. With a view to strengthening the overall capital in relation to risk generation areas, the Committee proposes that the capital adequacy rules laid down in the document "The New Basel Capital Accord" (hereinafter, the New Accord) be applied on a consolidated basis to the holding companies of groups and internationally active banks. Paragraphs 5-8 of New Accord, which deal with securities firms and other financial companies, specify that all the financial activities fall within the consolidation area of a group comprising a bank.[1]

The reference in paragraph 5 to the activities to be consolidated relates to banking and financial activities carried out within a group. Taking also into consideration the separation that national regulations (definitely including the Italian regulations) may provide between the banking-financial sector and the industrial sector, the sphere of application of the New Accord is confined to the banking sector.

The factoring industry, just as other non-bank financial intermediation sectors, witnesses the presence of entities with an industrial background (captive companies) that, in a number of cases, carry out their activities mostly with subjects belonging to the same group. In pursuance of the current supervisory regulations and on the basis of the scope of application proposed in the New Accord, captive companies have no obligation to comply with capital requirements on an individual basis and – not forming part of a banking group – not even the capital requirements within the context of the consolidated supervision applies to them. Such a situation, that is nonetheless a direct consequence of the general layout of the New Accord (oriented to banking supervision) may determine distorting effects on the competition dynamics in the sector, particularly among intermediaries having banking shareholders and intermediaries having industrial shareholders, and their significance will clearly depend on the presence of demand segments "shared" by the two types of entities.

[1] Due emphasis must be laid on the lack of clarity in paragraph 5, line 1-2, of the specification in brackets on the regulated and non regulated banking and financial activities that would seem to imply that only "securities entities" are regulated.

PART 2
THE FIRST PILLAR – MINIMUM CAPITAL REQUIREMENTS

II. CREDIT RISK -THE STANDARDISED APPROACH

A. THE STANDARDISED APPROACH - GENERAL RULES

1. INDIVIDUAL CLAIMS

(v) Claims on securities firms

***Remarks*:**
Current supervisory regulations provide that non-bank financial intermediaries entered in the Special Register in pursuance of article 107 of the Banking Law (T.U.B.), including factoring companies, are subject to prudential supervision based on the bank supervision model. The currently provided risk weight of 100% to be applied to claims on non-bank financial intermediaries subject to supervision for the calculation of capital requirements corresponds to a full value risk asset. Such weighting seems inadequate, as non-bank financial intermediaries subject to supervision need to comply with minimum capital requirements in relation to specific risks. In view of the above, we propose to bring such weighting in line with that applicable to banks and securities firms. More onerous capital requirements are likely to make the cost to finance an activity carried on by a specialized company or a multi-product intermediary higher that the cost borne by a bank working in that sector.

We propose amending paragraph 34 of the New Accord as follows:

(v) Claims on regulated financial intermediaries

34. Claims on securities firms and ***non–bank financial intermediaries*** may be treated as claims on banks provided they are subject to supervisory and regulatory arrangements comparable to those under the New Basel Capital Accord (including, in particular, risk-base capital requirements[1])

1 That is capital requirements that are comparable to those applied to banks in this revised Accord. Implicit in the meaning of the word "comparable" is that the securities firm ***and the non-bank financial intermediaries*** *(*but not necessary its parent*)* ***are*** subject to consolidated regulation and supervision with respect to any downstream affiliates

(ix) Higher-risk categories

Remarks:
With reference to the minimum weighting to be attributed to the higher-risk categories within the standardized approach (based on the provision set out in paragraph 39 of the New Accord), it may be noted that factoring transactions may typically involve even assets that are past due for more than 90 days. Therefore, under given circumstances (refer to "Techniques of risk mitigation"), such a proposal would cause mitigated risk exposures, such as those resulting from factoring transactions, to fall within the most unfavorable class from the point

of view of capital requirements. As regards this subject, it should be pointed out that a factoring transaction is the assignment of a commercial claim engendered within the context of the commercial policy of the assigning firm and that a major component of a factor's activity is indeed the management of credits. Within a factoring activity, the purchase of even past due credits is a standard transaction, since the factor acts as a connection between the parties and takes over during the collection and the debt recovery phase, if any. As a matter of fact, the assigning customer may deem it more effective and efficient to delegate the credit collection to the factor, which has the know-how required to see to that phase of the credit management.

As shown also by the regular surveys of the European Commission, the mean time to settle commercial credits/debts and the related performance delays are quite long and may differ even to a considerable extent in the different countries and, in any event, take on a different meaning with respect to the delays/defaults related to financial debts. Besides, within the context of an assignment of a commercial (trade) claim, an individual default may result from events related to the underlying supply contract, without entailing that required deterioration of the creditworthiness of the assigned debtor that is a sign of a state of insolvency.

The characteristics of the factoring transaction suggest that doubtful debts may be identified in assets that are past due for more than 90 days that allow to note a continuing default (that is, occurring repeatedly on the occasion of maturities that are close-set with respect to the total exposure and pointing to a payment difficulty to be ascribed to the deterioration of the debtor's creditworthiness rather than to a supply contract). Assuming that a factor is the buyer of a number of claims from different creditors but in respect of a single assigned debtor, then such a factor has access to considerable information to estimate whether the delay is caused by events related to a supply contract or the state of difficulty of the debtor.

We propose amending paragraph 39 of the New Accord as follows:

39. In addition to the claims on sovereigns, PSEs, banks, and the securities firms rated below B- and to the claims on corporate rated below BB-, the following will be risk weighted at 150%:

- securitisation tranches tht are rated between BB+ and BB- as set out in paragraph 526
- the unsecured portion of any assets that is past due for more than 90 days ***and in trade credits purchases (e.g. factoring), only if the delay in the payments is continuous and repetitive***, net of specific provisions. For the purpose of defining the secured portion of the past due asset, elegible collateral and guarantees will be equivalent to those elegible for credit risk mitigation purposes (see section B of the standarised approach)[15]

[1] There will be a transactional period of three yars during which a wider range of collateral may recognised, subject to national discretion

TECHNIQUES OF CREDIT RISK MITIGATION IN THE STANDARDIZED APPROACH

1. SCOPE

Remarks:
The Association agrees to the recognition of benefits in terms of capital requirements in the presence of techniques of credit risk mitigation.

Factoring transactions should be considered to entail a mitigated risk since in the assignment of commercial claims, typically covering a short-time period, both the assigned debtor and the play a relevant role. Since the factor aims at a long-lasting relation with both the assignor and the assigned debtor, a risk reduction is attained through the use in the productive process of information about claims and assigned debtors that was ascertained in the course of the activity. Besides, since factoring is a management service and a financial technique addressing enterprises that require the management of commercial assets, it implies the existence of relations with the assigned debtor prior to maturity of the said credit and at time intervals close enough to ensure a continuous control on the real risk represented by the latter.

In factoring transactions entailing a “pro soluto” assignment, the risk counterparty is represented by the assigned debtor since the factor guarantees the success of the transaction. In such a case, in agreement with the supervisory reporting manual and the Risks Center of the Bank of Italy, the delay in paying the debt is ascertained on the assigned debtor at the nominal value of the factorized claim. In such a transaction, the risk mitigation results from the information collected in the direct relations with the assigned debtor prior to maturity of the credit, due to the management component of the factoring service, as well as from the possibility that a plurality of assignments relates to a single assigned debtor and/or the assignment of the same debtor in a number of transactions on the part of the same assignor. The concentration risk engendered in the last two hypotheses is subject to special capital requirements in the New Accord. The “pro soluto” factoring transaction would require the recognition of a lower than standard capital requirement in relation to the said characteristics that differentiate the factoring from a traditional banking transaction.

In “pro solvendo” factoring transactions with recourse, the factor does not stand surety for the success of the transaction, so in the event of the assigned debtor’s default, the credit is reconveyed to the assignor. In compliance with the supervisory reporting manual and the Risks Center of the Bank of Italy, the cash credit risk for the factor is represented by the amount of the assigned asset that may have been paid in advance to the assignor. Such a transaction is characterized by the presence of two co-obligor figures: the assignor and the assigned debtor. According to this assignment arrangement, a default may only be ascertained when both the assigned debtor and the assignors are defaulting. Therefore, in factoring transactions with assignment of claims according to the “pro solvendo” arrangements, the risk mitigation is due to the role and guarantee provided by the assignor, in addition to the recurrence of the elements of the “pro soluto” transactions.

The extent of the risk mitigation that may be attained in the “pro soluto” and, with greater intensity, the “pro solvendo” factoring transactions warrants the request for an explicit recognition among the techniques of risk mitigation in the New Accord for the determination of capital requirements.

We propose amending paragraph 61of the New Accord as follows:

61. Credit risk mitigation relates to the reduction of credit risks by, for example, taking collateral, obtaining credit derivatives or guarantees, or taking an offsetting position subject to a netting agreement ***or due to the presence of two significant subjects in the repayment of the debt, as in trade credits purchases (e.g. factoring)***. The new revised approach to credit risk mitigation allows a wider range of credit risk mitigants to be recognised for regulatory capital purposes than is currently the case

4. GUARANTEES AND CREDIT DERIVATIVES

(ii) Range of eligible guarantors/protection providers

Remarks:
With reference to the range of eligible guarantors and protection providers, the Association proposes that non-bank financial intermediaries subject to supervision, the supervisory rules on capital requirements, and a few specific risks, be equalized to banks and be allowed to give guarantees and protections. Otherwise, they would be treated as corporate person.

With reference to the requirements laid down for the inclusion of corporate persons in the range of eligible guarantors, they are considered much stricter than those set out under subparagraph 1 of paragraph 129. The eligibility of corporate guarantors with a credit rating of A or better rules out the recognition of the guarantee given in "pro solvendo" transaction by corporates with a lower rating but still "in bonis" and corporates that have no rating although a real risk mitigation is attained. Besides, for purposes of a proper representation of risk, it seems worthwhile to point to the real mitigation that even a guarantor with a rating lower than A or with no external rating may determine if characterized by a better creditworthiness than the main debtor.

We propose amending paragraph 129 of the New Accord as follows:

129. Credit protection given by the folllowing will be recognised: sovereign entities, PSEs, banks and ***regulated non-bank financial intermediaries, corporates including parental guarantees with a lower risk-weight than the principal obligor***

(iii) Risk weights

Remarks:
With reference to the substitution method proposed in the determination of the risk weights to be applied to guaranteed exposures, it should be pointed out that, in factoring transactions with a "pro solvendo" assignment, the recognition of the double default effect is deemed an absolute requirement, notwithstanding the difficulties inherent in the introduction of the correlation of the probability of default of the principal obligor and the guarantor. It should be noted that the factor is exposed to the joint risk of default of the assigned debtor and the assignor; therefore, the capital requirement to be set for these exposures should take into account the correlation, the level of interdependence existing between the economic trends of the two subjects involved, recognizing a decrease in case of negative correlation.

The Basel Committee specified that the goals to be attained through the introduction of the w factor included the stimulation of a continuous review of the credit quality and the coverage of legal and documental risks. With reference to the former, it should be pointed out that, in addition to being already an integral part of the activity for the attainment of a proper and constant risk measurement among intermediaries, it takes concrete form in the factoring activity, where relations with assigned debtors and assignors have a continuing character. In view of the above, the introduction of the w factor for that purpose would seem inadequate. As for the latter goal, it should be pointed out that the provision relative to capital requirements for legal risks was included by the Committee within the operational risk context. Therefore, the Association deems the w factor to be not only an excessively cautionary proposal, but also an excessively burdensome proposal. Besides, as previously pointed out, in the factoring sector the assignments of claims are usually occur in mass and on a continuing basis within a factoring agreement which lays down in detail the services to be rendered by the factor, the assignor and the assigned debtor as well as the subject of the assignment. Besides, within the international factoring context, reference should be made to the Unidroit Convention that entered into force in 1995 and was ratified also by Italy. Such a Convention aims at harmonizing the rules governing the factoring activity. Hence, the Association considers that the application of the w factor for this purpose is inadequate.

We propose amending paragraph 132 of the New Accord as follows:

132. The risk weight applicable to a fully-guaranteed exposure- i.e. where the nominal amount of the credit protection equals that of the exposure- ***if the risk assessment and monitoring processes are robust and the residual risks are negligible, as in factoring with recourse***, is:

$\boldsymbol{r^{*} = g}$

where $\boldsymbol{r^*}$ is the effective risk weight of the position taking into account the risk reduction from the guarantee/credit derivative

$\boldsymbol{g}$ is the risk weight of the guarantor/protection provider

(vi) W: remaining risks
(a) Guarantees

Remarks:
The New Accord provides that, should the guarantor be a sovereign, a central bank or a bank, the weight factor w is zero rather than the standard 0.15. In view of the fact that non-banking financial intermediaries subject to supervision are also subject to prudential supervisory rules and controls on their organizational profiles, the quality and robustness of the documentation of the guarantee given by the latter with respect to guarantees given by banks would seem to be fully comparable. In view of the above, the Association proposes an equalization of the treatment in the event that, contrary to the remarks and amendment proposal set out in the preceding paragraph, the w factor is not done away with.

We propose amending paragraph 143 of the New Accord as follows:

> 143. Where the guarantor is a sovereign, central bank, bank ***or regulated non-bank financial intermediary***, w is zero.

III CREDIT RISK - THE INTERNAL RATINGS BASED APPROACH

A. MECHANICS OF THE IRB APPROACH

2. ADOPTION OF THE IRB APPROACH ACROSS ALL EXPOSURES

Remarks:
The New Accord provides that a banking group that adopts the IRB approach to a few exposures should extend it within a "reasonably short period of time" to all the exposure and within all its major operational units, such as groups, subsidiaries and branches.

This provision is particularly relevant for the factoring companies that are a part of banking groups that, when compared with banks or other intermediaries included within the group, have recourse to less advanced risk rating systems or do not have the minimum requirements for using them for determining the capital requirements according to the IRB approach. Beside, being the intermediary focused on a counterparty, that in factoring is usually a corporate counterparty, it may turn out that there is noting to be gained, in terms of costs and benefits, by seeing to the determination of capital requirements within the IRB approach for those exposures – negligible as far as amount and risk profile are concerned – on the total portfolio. On the other hand, the reference set out in paragraph 160 as to the possibility that a few exposures in secondary operational units might be exempted from the application of the IRB approach is left at the discretion of the national authority and requires an accurate specification of the quantitative and risk-related limits that cause the exemption to apply.

5. DERIVATION OF RISK WEIGHTED ASSETS UNDER THE IRB APPROACH

Remarks:
The adjustment of capital requirements in relation to the granularity of the exposures with respect to a single counterparty is already the subject of the supervisory regulation that apply to intermediaries entered in the Special Register in pursuance of article 107, even though according to different arrangements with respect to the methodology set out in the third part of Section F of the New Accord. The utmost relevance is attached to the attainment of a consistency between the proposals laid down in the New Accord and the EU discipline on major risks and individual limits, acknowledged by the national supervisory regulations, in order to avoid that the determination of excessively onerous requirements for intermediaries might alter the international competitiveness.

B. RULES FOR CORPORATE EXPOSURES

1. RISK WEIGHTED ASSETS FOR CORPORATE EXPOSURE

(i) Formula for derivation of risk-weights

Remarks:
The risk weight determination provided for by the New Accord in the foundation approach assumes a conventional residual maturity of three years. The possibility of introducing a different residual maturity among the risk weight determinants is only provided for by the advanced approach and, in the foundation approach, limitedly to the existence of an explicit maturity dimension.
It is hard to understand why the general formula for the derivation of risk weights excluded maturity from among the determinants: the strict minimum requirements provided for the adoption of the advanced approach would actually avoid to get to a proper weight in relation to the real underlying risk outside it.
Such a limitation is particularly onerous for the exposures being dealt with in the factoring sector since, having a commercial nature, their maturity is considerably lower than the maturity of financial credits: as a rule, typical maturities are included between 30 and 180 days. Therefore, while stressing the relevance of taking into account the different residual maturities that characterize a corporate exposure, the Association proposes a modification of the rule set out in the New Accord.

We propose amending paragraph 177 of the New Accord as follows:

177***. In the foundation and advanced approach*** for exposures with a matiurity other than three years, the exposure's risk weicht would be scaled upward or downward based on the exposure's PD and level of M. Thus, a corporate exposure's risk weight, RW_C , can be expressed as a function of PD, LGD, and M according to the following formula:
RW_C= (LGD/50) x BRW_C (PD)x [1+ b(PD)x(M-3)], or 12.5x LGD, whichever is smaller.

The sensitivity of the maturity adjustment factor to M is denoted by b, and depends on PD. The Committee will be developing a treatment for calibrating b. See paragraph 226 for the definition of M.

(ii) Inputs to the risk-weight function
(a) Probability of default (PD)

Remarks:
The treatment of the techniques of risk mitigation in the foundation IEB approach closely follows the treatment provided in the standardised approach. Therefore, an equivalent amendment is proposed in respect of the range of eligible guarantors/protection providers.

We propose amending paragraph 182 of the New Accord as follows:

182. The foundation approach to guarantees and credit derivatives closely follows the treatnìment outlined in paragraphs 117 to 145 in the standardised. In particular, the minimum conditions and operational requirements for recognition as set out in paragraph 117 to 128 are identical. In terms of the range of elegible guarantors or protection providers, credit protection will be recognised for the same entitieds as under the standardised approach (see paragraph 129). These include sovereign entities, PSEs, banks and ***regulated non-bank financial intermediaries, corporates (including insurance companies) including parental guarantees with a lower PD than the principal obligor.***

Remarks:
The remarks made in relation to the weight determination in the standardised approach for borrowers assisted by guarantee apply also to the determination of the probability of default, a determinant of the BRW_C and, indirectly, the RW_C weighting function. Therefore, equivalent amendments are proposed.

We propose amending paragraph 183 of the New Accord as follows:

183. The effective probability of default (PD^*), ***in the presence of significant risk valuation and monitoring processes and negligible residual risks, as in the pro solvendo factoring transactions,*** applicable to the covered portion of the exposure will be:
$PD^* = PD_G$
PD_G is the guarantor's risk weight.
The uncovered portion of the exposure is assigned the PD of the underlying obligor.

Remarks:
In much the same way as provided in the standardised approach, the same remarks should be made as to the need to assimilate non-bank financial intermediaries subject to supervision, including factoring companies, to banks in the event that the w factor is not done away with.

We propose amending paragraph 187 of the New Accord as follows:

187. The treatment of residual risks will be the same as under the standadised approach. For guarantees recognised as giving protection, w will be 0.15 . As with the standardised approach, where the guarantor is sovereign, central bank, bank or ***regulated non-bank financial intermediaries***, w will be zero. For all credit derivatives recognised as giving protection, w will be 0,15.

(c) Maturity

Remarks:
Within the advanced approach, which explicitly includes maturity among the determinants of the weighting function, a minimum yearly limit is set while lower residual maturities are ignored. Based on the maturities reported on average in the commercial credits of factoring transactions, the anticipation of such a minimum limit may not be agreed upon and, therefore, the Association proposes to do away with it.

We propose amending paragraph 226 of the New Accord as follows:

226. ***Maturity is defined as*:**
(I) Unless otherwise provided below, the maximum ramaining time (***in years or months if lower than one year***) that the borrower is permitted to take to fully discharge its contactual obligation (principal, interest, and fees) under the terms of loan agreement. Normally, this will correspond tot the nominal maturity of the instrument .
(II) For an instrument subject to pre-determined, minimum amortisation schedule, the weighted maturity of the remaining minimum contractual principal payments, ise defined as:

Weighted Maturity: $\Sigma_t \, t \, P_t / \Sigma \, P_t$
where P_t denotes the minimum amount of principal contractually payable in period t.

2. MINIMUM REQUIREMENTS FOR CORPORATE EXPOSURES

(iii) Criteria to ensure meaningful differentiation of risk
(b) Rating grade structure

Remarks:
The New Accord provides that the exposures within the context of each class of the counterparties may not concentrate on a single ratings class for more than 30% of its gross amount.
Specialized financial intermediaries, including factoring companies, owing to the focused nature of the counterparties, typically corporate in the factoring industry, could find it hard to comply with such a requirement with reference to the claims on counterparties that have a residual weight on the total portfolio.
In view of the above, the utmost relevance is attached to the proposal to make the rule more flexible in relation to the activity being carried out.

(vi) Minimum requirements for estimation of PD
(a) Estimation using reference definition of default

Paragraph 272 of the New Accord provides for a rather broad range of events that are deemed to give rise to a default when they take place. With reference to the event set out in the third sub-paragraph, that is a delay of over 90 days on any credit obligation, it should be stressed that the application of that rule in the factoring context would entail the risk of mistakenly viewing still acceptable positions as being defaulting. As a matter of fact, as previously pointed out in relation to the standardized approach, in factoring transactions an episodic default or a delay in payment of even 90 days are not events pointing to a state of

insolvency. The adoption of such a rule in the definition of the state of insolvency, particularly in factoring transactions, would give rise to a distorted measurement of the real risk within an approach – such as the internal ratings approach – conceived to bring capital requirements in line with underlying economic risks through the use of all the information, whether internal or external, available to the target users of the New Accord.

We propose amending paragraph 272 of the New Accord as follows:

272. A default is considered to have occurred with regard to a particular obligor when one or more of the following events has taken place:
- it si determined that the obligor is unlikely to pay its debt obligations (principal, interest, or fees)
- a credit loss event associated with any obligation of the obligor , such as a charge-off, specific provision, or distressed restructuring involving the forgiveness or postponement of principal, interest, or fees;
- the obligor is pat due more than 90 days on any credit obligation ***and, in trade credits purchases (e.g. factoring), only if the delay in the payments is continuous and repetitive***, or
- the obligor has filed for bankruptcy or similar protection from creditors

(viii) Use of internal ratings
(d) Lenght of time a rating system has been in place

Remarks:
In paragraph 301 of the New Accord the Committee affirms that the use of the IRB approach needs to be backed up by an experience of at least three years in the adoption of internal ratings in line with the minimum requirements laid down in the New Accord.

Notwithstanding what was affirmed by the Committee, such a provision appears to be excessively onerous and, if combined with the minimum data requirement set out in paragraphs 164-165 of the New Accord, extremely discouraging, particularly in respect of those intermediaries that are currently using less evolved risk assessment method. Therefore, the Association proposes a mitigation of and a greater flexibility in that requirement.

3. MINIMUM REQUIREMENTS FOR THE ADVANCED IRB APPROACH

(i) Own estimates of loss given default
(e) Minimum requirements for estimation of LGD

Remarks:
Paragraph 338 of the New Accord refers to the definition of default set out in paragraph 272 of the New Accord with respect to the LGD estimation and the collection of data relating to losses or recoveries. Therefore, the Association proposes to refer to paragraph 272 as amended by the Association.

V. OPERATIONAL RISK
C. THE MEASUREMENT METHODOLOGIES

1. THE BASIC INDICATOR APPROACH

Remarks:

The New Accord provides that the requirement to be complied with in the face of an operational risk be proportional, according to an alpha coefficient, to the gross income. The fact that the document supporting the operational risk sets the alpha factor at approximately 30%, this being a weight of operational risks approximating 20% of the overall capital, is a result of data acquired from internationally active banks. In view of the above, the Association deems it necessary to see to a grading of the percentages in relation to the size and the diversification of the activities carried out by the intermediary.