

To: Secretariat of the Basel Committee on Banking
Supervision

Bank for International Settlements

CH-4002 Basel Switzerland

Kraainem, 24 June 2016

Re: Response to the Consultative Document on Reducing variation in credit risk-weighted assets - constraints on the use of internal model approaches

To whom it may concern:

We are writing in response to your request for feedback on your consultative document on the proposed changes to the IRB approaches. The EU Federation for the Factoring and Commercial Finance Industry (EUF) is the industry body and voice for the European factoring industry. The EUF's members consist of 14 national factoring and commercial finance associations (representing 15 EU-member states, namely [in alphabetic order] Austria, Belgium, the Czech Republic, Denmark, France, Germany, Greece, Ireland, Italy, the Netherlands, Poland, Portugal, Spain, Sweden and the UK) and the international factoring chain FCI+IFG. In 2015, the Receivables Finance industry in the EU provided over €168 billion of working capital financing to over 171,000 businesses, about 85% of which are SMEs. This amount of working capital has to be seen in relation to the total factoring turnover, which in 2015 was over € 1.47 trillion. If you consider that the total GDP of Europe exceeded € 13 Trillion, this figure represents a significant portion of the real economy within the EU. Our members account for 97% of the total European factoring market, and comprise of both regulated and non-regulated factoring companies. Over half of the factored volume conducted within the EU is generated by factoring companies that are banks or part of consolidated banking groups, which fall under the umbrella of regulatory oversight.

As you may know, factoring is a means of finance which is widely used, especially by SMEs, as a method of providing working capital finance to a supplier of goods and services. This is achieved by the supplier assigning and selling its accounts receivable to a factoring company. The factor will provide a range of services to its clients, including providing working capital against the assignment of their receivables, accepting the risk of bad debts and collecting on past due accounts. The factor will usually charge an administration fee for these services and a discount charge for the advancement of funds against eligible assigned invoices. Factoring has

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been accepted as a stable financing alternative by many companies, particularly during the financial crisis over the last five years. Many SMEs that were unable to obtain traditional bank funding were able to obtain funding under factoring facilities, offered by bank owned and independent factoring companies. Hence, the factoring industry thrived during the financial crisis, helping hundreds of thousands of SMEs throughout the EU to obtain working capital. You could say that factoring companies are a direct mirror of the real economy.

The EUF, in its role of representative body of the European factoring and commercial finance industry, is pleased to share with this Committee its comments about the proposed changes. In particular, the Committee is proposing:

1. to remove the IRB approaches for some portfolios, which as a result will be subject to the standardised approach to credit risk: such portfolios being banks and other financial institutions and large corporates (defined as corporates belonging to consolidated groups with total assets exceeding EUR50bn), and to remove the option to use the A-IRB approach for exposures to corporates that are part of consolidated groups that have annual revenues greater than EUR200m;
2. within the F-IRB scheme, to introduce a lower regulatory LGD estimate for exposures collateralized by purchased receivables (20% instead of 35%) but with a higher haircut on the value of the outstanding receivables (50% instead of 20%);
3. to introduce floor on parameter estimation;
4. to introduce a definition of "commitment".

1. Criticism of The removal of the IRB approaches for certain portfolios

The BCBS is proposing to remove the option to use the IRB approaches for certain exposures, where it is judged that the model parameters cannot be estimated sufficiently reliably for regulatory capital purposes. Although the EUF fully understands the need for a reliable and comparable measure of risk even where default events are historically few and infrequent, the proposal to exclude the IRB option give raise to some criticism and unwanted consequences, and so seems inappropriate.

Firstly, we do not understand which considerations have led the Committee to assign a differentiated treatment (and much punishing) to large corporates with consolidated assets greater than EUR 50bn vis-à-vis all those large corporates belonging to groups with revenues greater than EUR 200mn which can use F-IRB. Thus we would suggest that **at least the F-IRB is envisaged for both categories of firms** (those with revenues greater than EUR 200mn and those with consolidated assets greater than EUR 50bn). This approach would also offset possible distortions in pricing that could arise for those large corporates with total assets higher than EUR 50bn (in particular for those investment grade, considering that the risk weight under the SA are extremely conservative) versus Mid-corporates (TA < EUR 50bn), with the latter potentially benefiting of more competitive pricing given the on average lower cost of capital.

Secondly, the more punitive treatment assigned to large corporates with consolidated assets greater than EUR 50bn seems illogic considering that the largest exposures are indeed the ones for which more public disclosure is available which allow banks to perform a deeper assessment of counterparty creditworthiness.

Moreover, the standardized approach is particularly penalizing for unrated counterparties and given the not negligible share of European corporates which is not externally rated, the proposal to abolish the internal model to a certain extent risks severely hindering the revamp of the economy.

Besides such conceptual issues, we also would like to underline that such differentiated approach would nonetheless increase significantly operational costs for the institutions, as they would have to manage different treatments and also detect the situation of all corporate clients, that may change (more or less frequently) from one class to another thus increasing also fluctuations in the RWA.

We consider most appropriate for these portfolios to preserve the use of the IRB Approach (with the possibility - where necessary on the basis of shared and simple criteria - of data pooling in particular for LGD and CCF). **Where the approach should remain Standardized** is required to Supervisor **to explicitly allow the mechanic extension of the external rating of the mother company to all corporates belonging to a consolidated groups** even in the absence of explicit form of support, consistently to the objective "...to not significantly increase overall capital requirements...": most of such companies are indeed without external rating.

Moreover, if the decision was taken to remove the IRB option for certain exposure, i.e. large corporates, makes even more necessary, under a wider perspective, that **also the Standardized Approach recognizes the purchased receivables approach where eligible** (i.e. option to use the risk weight applicable to the debtor or to adopt a "top down" approach as described in the Basel framework and recognized also in Art. 153.6 of the CRR 575/2013 in the Advanced approach framework) **as well as a specific and more favorable risk weight for exposures collateralized by purchased receivables** (i.e. 50%) in order to avoid a counterintuitive penalization of the larger clients, for whom the IRB approaches won't be available, with respect to the smaller ones. Moreover, a proper scheme for the treatment of credit insurance on purchased receivables should be adopted¹.

2. Fixed supervisory parameters for F-IRB

¹ For further details about the EUF proposals re. the treatment of exposures to factoring and purchased receivables and about a possible scheme for recognizing the mitigation of credit insurance, please refer to the EUF position paper Re: Revisions to the Standardised Approach for credit risk - second consultative document of 2016, 11th March.

Par. 4.2.2 provides decreasing values in fixed LGD parameters for eligible non-financial collateral under the F-IRB approach. In particular, the proposed new value of LGD for exposures secured by receivables is lower (20%) than the current one (35%), but at the same time the haircut is increasing from 20% to 50%.

The EUF appreciates that **a 20% LGD parameter for such collateral type appears to be appropriate**, having regard to the track record of factoring operations, and consistent with the proposals submitted by the Federation during the consultation on the revision of the Standardized Approach. Yet, we believe that a 50% haircut would be too conservative and far from the actual practice, that consist in a financing facility that usually ranges from 60 to 80% of the outstanding amount of the receivables. Moreover, it could bring to unwanted consequences, pushing the institutions to reduce the amount of finance provided to the client in order to benefit most from the reduced LGD parameter. That could result in a counterintuitive shift towards riskier overdraft-like products.

Therefore, we would suggest that **the haircut for receivables should remain at the same 20% level**.

Under F-IRB, the Committee does not propose to change the fixed maturity parameter (2.5 year). We believe this fixed parameter could frustrate institutions specialized in short term finance such as factoring and invoice finance, discouraging the investment in internal models for "standardized" institutions and at the same time unduly penalizing those that already adopted A-IRB by way of the proposed removal of the option to use estimates stemming from their advanced models for certain exposure classes. We therefore strongly advise **to provide, under the F-IRB approach, the following buckets of regulatory fixed values for the parameter M:**

- **M = the purchased receivables exposure weighted average maturity, at least 90 days like allowed in the current IRB framework (see also Art. 162.2.e) of the CRR 575/2013 for the Advanced approach, as far as the purchased receivables are concerned,**
- **M = 1 year for other exposures with duration up to one year,**
- **M = 2.5 year for the rest.**

3. The introduction of model-parameter floors

The BCBS is proposing to adopt exposure-level, model-parameter floors to ensure a minimum level of conservatism for portfolios where the IRB approaches remains available.

The EUF does not agree with the idea of setting floors, in principle, the floor on LGD for exposures secured by receivables (15%) appears to be extremely too conservative when the underlying portfolio or receivables is of high quality. A-IRB institution specialized in factoring and invoice finance will be highly penalized and will see significant changes in their risk appetite, especially in jurisdictions with a very good history of trade debt payments. Furthermore, such a high floor would be too close to the regulatory fixed parameter provided

for the F-IRB approach and would then reduce the appeal of the advanced (and expensive) models for specialized institutions. We therefore suggest **to reduce significantly the floor, not over 5%**.

4. The Credit Conversion Factor

As previously quoted, we remind our answer of the Revisions of the Standardised Approach for Credit Risk (of March 11th, 2016 – hereby enclosed), where our request was to keep the CCF to 0% for factoring (according to the discretion allowed to the factor in purchasing receivables) and in any case not to exceed a the 20% level, as the underlying instrument features (the invoices) are close to those handled by the Trade Letters of Credit (that intrinsically encompass the invoice in the requested documentation).

5. The proposed definition of "commitment"

The EUF understands and appreciate the effort of the BCBS to uniform and clarify the definition of "commitment". Yet, we advise the Committee **to carefully consider the potential unwanted effects** of providing such a common definition **on the compliance with other banking regulation that may apply in certain jurisdictions**. Effects might transcend the "prudential" level and hit also contractual and accounting profiles, not to speak of other specific regulatory pieces like usury (where applicable).

However, reading the proposed definition, we understand that internal limits determined by the institution, of which the customer can (or not) be aware (without having been nor "offered" nor "accepted" by the client, to be used for internal reference by the institution) is not included in the perimeter of "commitments" under the proposed definition. Concretely, this represents the limits set on receivable purchases, from the factor unilateral point of view.

Thank you in advance for your attention. We look forward to hearing back from you. In the meantime, if you have any questions or want additional information and details about the above mentioned position of the EUF, please do not hesitate to contact Diego Tavecchia, Chairman of the Prudential Risk Committee of the EUF (contact details below).

With kind regards,



Erik Timmermans, Chairman, EUF

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