Assifact
Associazione Italiana per il Factoring

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

July 2003

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 April 2003.

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 July 2003. 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, 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.

This release of the document, updated to July 2003, includes also reflections after the transmission of the previous version of this position paper (July 2002), considering the documents published thereafter by the Committee.

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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.

PART 1
SCOPE OF APPLICATION

Remarks on §§ 5-8:

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 this context, the peculiarity of the business can justify, in principle, different schemes of regulation to ensure an adequate balance between the acknowledgement of the specificity of the business and the competitive dynamics among the intermediaries having different backgrounds operating in this sector.

[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 on §39*:**

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 to be applied to claims on non-bank financial intermediaries subject to supervision for the calculation of capital requirements is equal to 50%[2]. The application of a 100% risk weight would appear inadequate, given that non-banking financial intermediaries subject to supervision are required to respect the minimum asset requirements, based on specific risks, and therefore it is proposed that the weighting be brought in line with that of banks and companies engaged in the intermediation of securities firms. More burdensome asset requirements, as is also underlined by Leaseurope[3], the European association of leasing operators, could make the cost of financing the activities of a specialised company or of a multi-product intermediary greater than that of a bank operating in this sector, with undesired effects in terms of equal competition.

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

(v) Claims on regulated financial intermediaries

39. 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

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[2] Banca d'Italia (2000), *Istruzioni di vigilanza per gli Intermediari Finanziari iscritti "Elenco Speciale"*

[3] Leaseurope (2002), *Position Paper on the Working Document of the Commission Services on Capital Requirements for Credit Institutions and Investments Firms*, November.

(ix) Past due loans

Remarks on §48:

Factoring activities are based on the acquisition of commercial receivables regarding which management and financial services may be supplied. Within the group of outstanding receivables acquired, identification can be made of pools of receivables with similar risk characteristics of each counterparty, e.g. from the viewpoint of the industry, location, type of supply and the relative relevance of the supply for the trade debtors. As a result, specific provisioning policies and the consequent adjustments in value are also decided upon in accordance with a procedure based on the specific evaluation of risk in terms of uniform segments within the portfolio of receivables acquired, and not only in terms of the individual receivable acquired. It should also be noted that the making of decisions on specific reserves for uniform segments is covered in the Third Study on Quantitative Impact (QIS 3.0), where, under the section on "Purchased Receivables", the specific provisions, though handled under a top-down risk evaluation methodology, are registered with relation to the entire pool. It is proposed, therefore, that this specific characteristic be evidenced as part of the process for calculating the minimum percentages of specific provisions regarding the risk-weight to be applied to exposures come due.

We propose amending paragraph 48 of the New Accord as follows:

48. The unsecured portion of any loan (other than a qualifying residential mortgage loan) or ***of the outstanding of purchased receivables*** that is past due for more than 90 days, net of specific provisions, therein comprised those ***related to homogeneous segments of the outstanding of purchased receivables*** will be risk-weighted as follows: [22]

· 150% risk weight when specific provisions ***or provisions specifically related to homogeneous segments*** are less than 20% of the outstanding amount of the loan or ***of the current purchased receivables***;

· 100% risk weight when specific provisions ***or provisions specifically related to homogeneous segments*** are no less than 20% of the outstanding amount of the loan ***or of the current purchased receivables***;

· 100% risk weight when specific provisions ***or provisions specifically related to homogeneous segments*** are no less than 50% of the outstanding amount of the loan ***or of the current purchased receivables***, but with supervisory discretion to reduce the risk weight to 50%.

[22]The Committee, however, recognises that, in exceptional circumstances for well-developed and long-established markets, mortgages on office and/or multi-purpose commercial premises and/or multi-tenanted commercial premises may have the potential to receive a preferential risk weight of 50% for the tranche of the loan that does not exceed the lower of 50% of the market value or 60% of the mortgage lending value of the property securing the loan. Any exposure beyond these limits will receive a 100% risk weight. This exceptional treatment will be subject to very strict conditions. In particular, two tests must be fulfilled, namely that (i) losses stemming from commercial real estate lending up to the lower of 50% of the market value or 60% of loan-to-value (LTV) based on mortgage-lending-value (MLV) must not exceed 0.3% of the outstanding loans in any given year; and that (ii) overall losses stemming from commercial real estate lending must not exceed 0.5% of the outstanding loans in any given year. This is, if either of these tests is not satisfied in a given year, the eligibility to use this treatment will cease and the original eligibility criteria would need to be satisfied again before it could be applied in the future. Countries applying such a treatment must publicly disclose that these and other additional conditions (that are available from the Basel Committee Secretariat) are met. When claims benefiting from such an exceptional treatment have fallen past due, they will be risk-weighted at 100%.

B. TECHNIQUES OF CREDIT RISK MITIGATION IN THE STANDARDISED APPROACH

1. OVERARCHING ISSUES

Remarks on §79:

The factoring industry supports the granting of benefits in terms of capital requirements in cases where risk mitigation techniques are utilised.

Factoring operations should be placed under the category of attenuated risk, given that the assignment of receivables, typically on a short-term basis, both the assigned debtor and the assignor, the features of their business relation (e.g., type of goods and services supplied, relevance of the supplies to their activity, opportunity to replace the supplier in the short-period) play a significant 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 credit and at time intervals close enough to ensure a continuous control on the real risk represented by the latter. In relation to the credit management activity that they perform on a continuous basis, factors possess in-depth, up-to-date information on the debtors whose receivables have assigned. The service involving the management of receivables allows the factor to:

- *evaluate the risk of the debtors and the policy of commercial credit followed by the seller, plus, on an aggregate level, meaning in terms of the sum total of the relations involving a given assignor, evaluate the performance of the pertinent economic sector;*
- *continuously monitor the commercial relations under which commercial receivables are generated, procuring in-depth, up-to-date information on the assigned debtors. In addition, the factor carries out controls on the suitability of the documentation accompanying the receivables;*
- *analyse the level of concentration of the receivables within the portfolio to be acquired, with the evaluation of the risk of the operation being based on: an analysis of the assignor, an analysis of assigned debtors and an analysis of the relationship between the assignor and the debtors;*
- *calculate an adequate ratio between the portfolio of the purchased commercial receivables and the amount of the financing, based on the costs for the activities of collection, the advance payment service and the risk tied to the concentration as compared to the rest of the purchase portfolio and to the total assets of the intermediary.*

From a legal point of view, factoring activities are based on the purchase of business receivables in accordance with Law 52[4] *of 1991: under the provisions of art. 5, the regulatory text provides the factor with legal certainty regarding the purchase of the receivables, and this certainty can be further reinforced under the procedures of the Civil Code on the right to oppose the assignment of receivables to third parties, meaning the need for notification, under standards of trust that represent an even greater safeguard, that the debtor has accepted the sale of the receivables.*

[4] Factoring activities are also carried out through the assignment of receivables under the provisions of article 1260, plus the articles that follow, of the Civil Code.

In non recourse factoring transactions, the party representing the risk is the debtor, given that the factor guarantees successful completion of the operation. In such cases, in compliance with the current structure of both the regulation[5] *and the Credit Register of the Bank of Italy, a bad debt is registered under the debtor whose receivables have been sold at the face value of the factored receivable. In a similar operation, the attenuation of the risk results from the collection on continuous basis of information on direct relations with the debtor prior to the maturation of the receivable, made possible by the management component of the factoring service and by the fact that a number of assignments can have as their subject a single debtor and/or that the assignment of the receivables of a given debtor can be made in more than one operation by the different assignors. The risk of concentration that arises under the last two scenarios is evaluated under the second pillar of the New Accord. A non recourse factoring operation requires granting of a lower capital requirement compared to what is normally called for, based on the aforementioned characteristics that differentiate factoring operations from traditional bank loans: despite the fact that the party representing the risk is the debtor, the risk analysis carried out by the factor is geared towards evaluating the debtor in terms of the economic activities of the seller as well, meaning that economic ties may be found, in addition to the legal ones. Such information plays a key role in selecting the product.*

In recourse factoring transactions, meaning with recourse to the assignor, 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 both the supervision and the Credit Register 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 non recourse transactions.

The extent of the risk mitigation that may be attained in the non recourse and, with greater intensity in the recourse 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.

In order to mitigate credit risk, financial intermediaries utilise also other techniques, in addition to those cited under paragraph 79 and with to operations under which the obligation of repayment falls on two distinct counterparties, as in the case of factoring; one of these techniques, credit insurance, plays a noteworthy role in the sector of activities related to the purchase of assets. Within factoring activity, the financial intermediaries take out insurance policies against the risk of insolvency on the part of the debtors, with the contractual formats varying on the basis of the individual relations governed. Considering the minimum requirements contemplated under paragraphs 86, 88 and 89 of the New Accord, it is believed that qualified insurance policies designed to mitigate risks are those that present the following characteristics:

- *the insurance company possesses a minimum external rating;*

[5] Banca d'Italia (1999), *Manuale per la compilazione delle Segnalazioni di Vigilanza per gli Intermediari Finanziari iscritti nell'"Elenco Speciale"*

- *the contract governing the insurance policy calls for explicit identification of each party guaranteed, as well as the amount of the related coverage (absolute amount and percentage), without any form of individual or aggregate excess franchise;*
- *the information systems of the beneficiary financial intermediary are capable of managing the limits indicated under the previous point.*

In terms of recognition of the mitigation of risk caused by the presence of qualified insurance coverage for the purposes of calculating the assets weighted by the risk, the amount of the guarantee is equal to the line of credit granted by the insurance company for the debtor, multiplied by the percentage of the coverage.

We propose amending paragraph 79 of the New Accord as follows:

79. Banks use a number of techniques to mitigate the credit risks to which they are exposed. Exposures may be collateralised by first priority claims, in whole or in part with cash or securities, a loan exposure may be guaranteed by a third party, or a bank may buy a credit derivative to offset various forms of credit risk; ***the obligation of repayment of the debt falls on two distinct counterparties, as, for example, in the case of operations involving the purchase of receivables; to cover the risk of default, a qualified credit insurance contract may be taken out***. Additionally banks may agree to net loans owed to them against deposits from the same counterparty.

2. Overview of Credit Risk Mitigation Techniques

(iii) Guarantees and credit derivatives

Remarks on §111:

As demonstrated by the observations made under paragraph 79, in the case of with recourse factoring operations, the assignor guarantees against any default by the debtor. The guarantee presented by the seller is definitely direct, explicit, irrevocable and unconditional. In addition:

- *the financial intermediary makes timely recourse against the assignor in the event of default by the debtor*
- *the guarantee undertaken by the assignor is governed by the factoring contract*
- *in the event of default by the debtor, the assignor shall reimburse the financial intermediary for all amounts owed by the debtor.*

It is held, therefore, that, under the standard methodology, the guarantee presented by the assignor must be treated as a guarantee.

5. GUARANTEES AND CREDIT DERIVATIVES

(ii) Range of eligible guarantors/protection providers

Remarks on §165:

With reference to the range of eligible guarantors and protection providers, the factoring industry proposes that supervised non-bank financial intermediaries subject to rules relating *capital requirements, as well as certain specific risks, be equalized to banks to give guarantees and protections. Otherwise, they would be treated as corporates.*

The requirements for the admission of enterprises among the ranks of possible guarantors are judged to be much more restrictive than those contemplated under point 1 of paragraph 165: the admission of guarantor enterprises possessing a credit rating equal to at least A- excludes recognition of guarantees provided by businesses with ratings that are lower but still "in bonis" as well as by enterprises that do not possess a rating. The application of this rule has significant implications of the prudential treatment of recourse factoring operations, in which the role of the assignor is to guarantee the obligation of the debtor. The findings of a survey carried out by the Association among the main players of Italian factoring market, show that the total number of assignors with an external rating of at least A- is largely smaller than 1%.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 165 of the New Accord as follows:

165. Credit protection given by the following entities will be recognised: sovereign entities,[49] PSEs, banks[50], securities firms, ***regulated non-bank financial intermediaries***, ***corporates with a lower risk-weight than the principal obligor***. This would include credit protection provided by parent, subsidiary and affiliate companies when they have a lower risk weight than the obligor.

49 This includes the Bank for International Settlements, the International Monetary Fund, the European Central Bank and the European Community.
50 This includes multilateral development banks.

B. MECHANICS OF THE IRB APPROACH

1. CATEGORISATION OF EXPOSURES

(vii) Definition of eligible purchased receivables
(b)Corporate receivables

Remarks on § 210:

The Association agrees with the variety of different approaches, as well as the general optional nature, contemplated by the New Accord for operations involving the purchase of commercial receivables, including factoring operations. In fact, it is believed that the diversity of composition of the portfolios of receivables purchased justifies the simultaneous presence of the bottom-up and top-down methodologies, even for qualified operations, with the intermediary being able to choose on the basis of its own internal management techniques.

Remarks on § 211:

Under the New Accord, a top-down treatment is proposed for purchased receivables from qualified businesses as an alternative to the bottom-up treatment. The provision regarding pool treatment introduced under the New Accord for portfolios of purchased commercial receivables depends on the uniform nature of the exposures within the pool, which would justify unified treatment: it is thought that such treatment is adequate for certain types of factoring operations under which the portfolio of purchased receivables is sufficiently fractioned.
With regard to the minimum requirements contemplated under paragraph 211, the following observations are formulated:

- *the purchase of the receivables by connected third parties has no effect on the uniformity of the pools of receivables purchased: it is held that the primary factor in treating the pools as a unified risk activity is not the origin but the characteristics of the portfolio; it is also noted that inter-group operations, based on the purchase of receivables by companies of the group, are carried out by the financial intermediaries in accordance with criteria of management that ensure the full independence of the activities performed. It is proposed, therefore, that this requirement be eliminated;*
- *in order to clarify the qualification of an "arm's-length transaction", it is held necessary to examine the concept of the final connection in depth. What is more, the prohibition against admitting inter-group receivables and those transferred by means of transit accounts between the purchasing company and the selling company can be supported solely in the case of operations that regard the purchase of receivables, in which the assignor is involved in the management and collection of the receivables; in the reality of the current situation in Italy, the management of receivables is one of the strong points of factoring services, which excludes participation by the assignor in the management and collection of the receivables. What is more, when consideration is given to the contractual formats utilised in the factoring operations performed in Italy, the rules governing the assignment oblige the supplier to guarantee that the debtors whose receivables have been assigned do not possess any rights of compensation: violation of this rule entitles the factor to rescind the contract. It is held, therefore, that the range of application of this*

prerequisite should be further specified, differentiating the operations on the basis of whether the factoring service includes the management component or the receivable is managed by the assignor;

- *the maximum remaining maturity of commercial receivables eligible for this approach is one year: although this period is held to be adequate, it is deemed necessary to specify whether it refers to the moment of the purchase of the receivables or to the moment of observation; it is also held necessary to examine in greater depth the motives underlying the exception to this prerequisite contemplated for receivables covered by secured guarantees suitable for recognition under the IRB system applied to other bank exposures;*
- *on the topic of concentration, in order to evaluate the adequacy of the three different proxies proposed (the size of one individual exposure relative to the total pool; the size of the pool of receivables as a percentage of regulatory capital; the maximum size of an individual exposure in the pool), the difference between the concept of pool and that of total pool must be specified, in addition to which the operating requirements for the establishment of the pools must be examined in greater depth; in any event, the introduction of ties to external parameters, such as the regulatory capital level or other asset-related considerations, is not held to be adequate, given that the evaluation is performed for the purposes of the concentration under the second pillar: in fact, it is held that the concentration proxy must permit evaluation of the distribution of the exposures within the pool. In any event, it is held that the concentration proxy cannot be represented by a maximum threshold that provides a figure for the individual exposure.*

We propose amending paragraph 211 of the New Accord as follows:

211. Supervisors may deny the use of the .top-down. approach for purchased corporate receivables depending on the bank's compliance with minimum requirements. In particular, to be eligible for the proposed .top-down. treatment, purchased corporate receivables must satisfy the following conditions:

· The receivables are purchased from unrelated, third party sellers, and as such the bank has not originated the receivables either directly or indirectly.

· The receivables must be generated on an arm's-length basis between the seller and the obligor. (As such, intercompany accounts receivable and receivables subject to contra-accounts between firms that buy and sell to each other are ineligible[56], ***though solely in the case of operations in which the assignor is involved in the management of the receivables***)

· The purchasing bank has a claim on all proceeds from the pool of receivables or a pro-rata interest in the proceeds.[57]

· The remaining maturity of the receivables is not greater than one year, unless they are fully secured by collateral that would be recognised under the IRB approach used for the bank's other corporate exposures.

· National supervisors must also establish concentration limits above which capital charges must be calculated using the minimum requirements for the .bottom-up. approach for corporate exposures. Such concentration limits may refer, ***to give an example, to the size of a single exposure compared to the rest of the pool.***

56 Contra-accounts involve a customer buying from and selling to the same firm. The risk is that debts may be settled through payments in kind rather than cash. Invoices between the companies may be offset against each other instead of being paid. This practice can defeat a security interest when challenged in court.

57 Claims on tranches of the proceeds (first loss position, second loss position etc.) would fall under the securitisation treatment.

C. RULES FOR CORPORATE, SOVEREIGN AND BANK EXPOSURES

2. RISK COMPONENTS

(ii) Loss given default (LGD)

Methodology for recognition of eligible financial collateral under the foundation approach

Remarks on § 264:

*When it comes to treating exposures that originate from financial operations based on receivables, the factoring industry agrees that they should be recognised as a guarantee that mitigates risk. In the realm of factoring activities, this approach can be applied to operations carried out according the recourse assignment, with the seller advancing the value of the receivables, and with the receivables themselves being managed as a collateral covering the exposure towards the assignor. Under this methodology of management, the risk party is represented by the assignor, while the characteristics of the portfolio of debtors whose receivables have been assigned have an influence solely on the calculation of the LGD. With regard to the minimum quantitative prerequisite for the ratio between the amount paid in advance and the current value of the receivables (C**), it is held that this ratio, as a rule, should be consistent with the current operating practice observed on the Italian market.*

(iv) Effective Maturity (M)

Remarks on § 288:

The introduction of a threshold figure of 2.5 years for the foundation approach is judged to be excessively prudent for factoring operations: in fact, from a regulatory point of view, Law 52 of 1991, whose subject is the assignment of business receivables, stipulates that future receivables, meaning those not present among the assets of the seller at the moment of the assignor, may be sold only if the contracts under which they originate are signed within 24 months of the assignment. From an operating point of view, the statistics for the first quarter of 2003, gathered by the Association[6] on the basis of the regulatory reports communicated on a quarterly basis by the regulated members in pursuance of article 107 of the Banking Law (T.U.B.) to the Bank of Italy, show that the average original maturity of indexed-rate receivables, whose outstanding volume accounts for almost all current receivables, is equal to 402 days, whereas the average for fixed-rate receivables is 382 days: these figures, less than 2.5 years but more than 1 year, represent a market average that is the result, in part, of purchased receivables payable by debtors operating in economic sectors inherently characterised by longer average payment times; in addition, looking at the full distribution of due dates of factoring receivables, more than 50% of the outstanding receivables are found to have an original maturity, meaning their duration at the moment of their purchase, of less than 90 days. These figures are inherent to factoring activities, as is demonstrated by the historical series of statistics collected by the Association.

It is held to be adequate, therefore, that financial intermediaries choosing the foundation approach be given the possibility of utilising minimum thresholds of maturity lower than 2,5 for those exposures originating from operations based on the financing of receivables, such as factoring operations, which are characterised by explicitly different time horizons.

[6] ASSIFACT (2003), Statistiche 1° Trimestre 2003, www.assifact.it

With regard to the treatment of exposures guaranteed by receivables, as this applies to factoring operations carried out according to the recourse procedure, with advances paid on the value of the receivables, a more in-depth examination is held to be necessary: given that the assignor is the risk party and the receivables purchased are sources of predetermined reimbursements, it is held that maturity should be measured in terms of the purchased receivables, being calculated as their average residual life. In the case of credits that have already fallen due, a scenario found to occur under normal operations, greater attention should be given to the procedures for measuring maturity.

We propose amending paragraph 211 of the New Accord as follows:

288. For banks using the foundation approach for corporate exposures, effective maturity (M) will be 2.5 years except for repo-style transactions and for exposures ***originating from operations based on the purchase of receivables*** where the effective maturity will be 6 months. National supervisors may choose to require all banks in their jurisdiction (those using the foundation and advanced approaches) to measure M for each facility using the definition provided below.

Remarks on §§ 291,292:

The factoring industry agrees with the special treatment contemplated under the New Accord with regard to the minimum threshold of maturity for short-term exposures under the advanced approach, which would definitely include factoring operations.
On the subject of the prerequisites contemplated for application of the exceptional treatment to factoring activities, it is felt that there should be clarification of whether the evaluation of the original maturity refers to the maturity as of the moment in which the receivable was originated by the assignor or when it was acquired by the transferee. Considering the relationship that exists between the commercial credit policies of corporates and the financial instruments for financing the demand for working capital, which include factoring, it can be noted, in any event, that the maximum ceiling of 3 months could prove excessively prudent for a number of exposures originating from short-term financing operations and characterised by original durations of less than a year, especially during periods in which the average payment time tend to expand in a generalised manner, with an obvious cyclical effect. Therefore, it is proposed to increase the eligibility requirement on the original maturity to 6 months.

We propose amending paragraph 291 of the New Accord as follows:

291. The one-year floor will not apply for certain short-term exposures, as defined by each supervisor on a national basis. In such cases, the maturity would be calculated as the greater of one-day, and the effective maturity (M, consistent with the definition above). This treatment targets transactions that are not a part of the bank's ongoing financing of the obligor. These transactions include financial market transactions, and one-off short-term exposures that are transaction oriented. Additionally, in order to be eligible for the carve-out treatment, an exposure must have an original maturity below ***six*** months.

F. RULES FOR PURCHASED RECEIVABLES

1. RISK-WEIGHTED ASSETS FOR DEFAULT RISK

(ii) Purchased corporate receivables

Remarks on § 334:

With regard to note 71 of paragraph 334, it should be observed that, on the topic of discounts that are reimbursable to the assignor, the text, in the way of an example, points to the risk of dilution as the reason for the establishment by the assignor of this collateral, which entails application of an LGD of 0% for the portion of the exposure guaranteed. Given that the note is found in the section on the capital requirements addressing the risk of default, it is held that clarification should be provided as to the source of the risk (default and/or dilution) whose treatment entails application of an LGD of 0%.

Foundation IRB treatment

Remarks on § 335:

Factoring activities consist of an ongoing relationship in which a business enterprise assigns, under the Law 52 of 1991, or on the provisions of the Civil Code, a significant portion of its portfolio of receivables, either existing or future, to the factor, which provides a personalised service based on three fundamental components: management of the receivables; a guarantee against insolvency on the default of the debtors; and, through advances on the receivables, financing. In addition to the basic components that characterise the activity, the factor also, as a rule, provides services involving the evaluation of debtors, the collection of receivables and legal consulting (separately or in addition to the standard services).

Through the financial component of factoring activities, financial intermediaries can provide the assignor with advances against the value of the portfolio of the receivables purchased: such advances, however, are not identical to the face value of the receivables purchased, given that the financial intermediaries generally establish a differential between the face value of the receivables and the advances paid out; under the standard operating practice, this differential is applied in a prudent manner, based on the risk of loss tied to the underlying commercial relationship. Only in the case of certain operations, which fall under the category of invoice discounting, a practice utilised primarily in the Anglo Saxon countries, is the advance identical to the face value of the receivables purchased.
Along these lines, it should be noted that, in the case of operations for which the financial intermediary does not guarantee the debtor's fulfilment of its obligations (recourse factoring operations), the exposure at default (EAD) is not equal to the amount of the portfolio of the receivables purchased but to the advances paid to the assignor.

With regard to the treatment contemplated for margins not utilised under "revolving purchasing facilities" granted by financial intermediaries, it is held that the following points should be clarified:

a) the counterparty to which the receivables purchase commitment refers: under standard operating practice, the factors can grant to the assignor a line of credit set up for the purchase of receivables, with the amount frequently not being stipulated by contract, or limits referring to individual debtors can be established for non recourse purchases of receivables; it should also be noted that the difference is a fundamental one, given that, as a rule, the sum total of the purchase limits for individual debtors differs from the line of credit granted to the assignor;
b) the nature of the commitment – whether it is revocable or irrevocable – and, in the second case, an indication of the residual maturity.

With regard to the above, it is held that the elements found under points a) and b) play a significant role in determining the EAD for a commitment to purchase receivables, and must therefore be given differentiated treatment, depending on the degree of risk to which the financial intermediary is exposed. Finally, mention should be made of the inconsistency between the treatment contemplated for CCF under this methodology (75%) and those called for under the standard and the IRB bottom-up approaches (20% and 50% respectively) with terms of maturity less than (or equal to) and greater than one year.

In order to evaluate the effects on the EAD of the rules found under paragraph 335, it is proposed the following example.

Input data

	Value (Euro)	***Notes***
Plafond for the purchase of approved receivables (deliberated)	1.000,00	Represents the maximum figure for the total receivables which the factor undertakes to purchase on each debtor
Accepted on non recourse basis	100,00	The current total amount of the current receivables purchased on a non recourse basis
Accepted on recourse basis	20,00	The total amount of the current receivables purchased on a recourse basis
Advances	90,00	The amount advanced to the assignor of receivables purchased on non recourse basis
Revocable line of credit to seller	500,00	The maximum amount of purchased receivables the factor is available to advance to the assignor

Determination of the EAD according to the rules found under paragraph 335

HP1

Activity	*Value (Euro)*	*EAD*	*Notes*
Outstanding receivables	120	120	The amount is assumed to be the face value
Margin (calculated on basis of debtors)	900	675	The amount is obtained by applying the credit-conversion factor of 75%
	Total EAD	**795**	

HP 2

Activity	*Value (Euro)*	*EAD*	*Notes*
Outstanding receivables	120	120	The amount is assumed to be the face value
Margin not utilised (calculated on the basis of the line of credit to the assignor)	380	275	The amount is obtained by applying the credit-conversion factor of 75%
	Total EAD	**405**	

HP 3

Activity	*Value (Euro)*	*EAD*	*Notes*
Advances	90,00	90,00	
Margin	30,00	22,50	The amount is obtained by applying the credit-conversion factor of 75%
	Total EAD	**112,50**	

HP4

Activity	*Value (Euro)*	*EAD*	*Notes*
Advances	90,00	90,00	
Margin	30,00	7,50	The amount is obtained by applying the credit-conversion factor of 75% to the differential between the advance and the approved outstanding, under the forfait approach, with a result of 10.
	Total EAD	**97,50**	

Based on the current rules, revocable commitments to purchase receivables, as regards both the debtors and the assignor, are considered to be low-risk exposures, meaning that they do not entail an absorption of capital. Changing to the rules found in paragraph 355, the HP1 represents the measurement of the EAD in the event that the revolving commitment to purchase receivables refers to the debtors: in such cases, a significant amount in the EAD can be observed, in part the result of the entry of all the outstanding receivables purchased and in part the relevant undrawn amount of the plafond deliberated for the debtors approved. In any case, the conversion of the plafond by applying a constant FCC, that not differs according to the type of the commitment (revocable/ irrevocable) and the maturity, it is deemed too prudential and not consistent with the characteristics of the facility from the technical point of view. Unlike the HP 2, in the case of the HP3 the margin not utilised is calculated on the basis of the credit line granted to the assignor: the amount of the EAD is lower than is the case with the HP 2 only because the amount of line granted to the assignor is lower than the plafond, but they are worth also in this case the considerations exposed previously. It is evidenced moreover that, various from the Anglo-Saxon context, such commitments are not frequently regulated in the contract in Italy, determining relevant problems for their application.
In terms of the absorption of capital, it should be observed that, on the whole, the rules found in paragraph 335 – whose application was simulated in HP1 and HP2 – are excessively prudent, especially if no difference is established between revocable/irrevocable commitments and with regard to the maturity.

The application of the rules found under paragraph 335 in HP2 and HP3 reflects the current supervision rules, concerning credit risk, in order to calculate the risk assets[7]: EAD is determined by the advance paid to the client and by the margins, meaning the difference between the amount of the advance and the amount to be paid upon maturity: it's assumed that both the credit line granted to the assignor and the credit limits on debtors are revocable. It is underlined that, in line with the present supervision rules, the margins determine the EAD only in non recourse operations.

As regards the procedures for determining the capital requirement, it should be noted that, given the proportionate relationship between the capital requirement k and the LGD, the assumption that the EL is equal to the PD and the LGD is equal to 100% could prove overly prudent, though it does provide a formal approach for calculating the capital requirement in the event that the financial intermediary is unable to decompose the EL into the PD and the LGD. To this end, given that it is not possible to estimate the specific contributions of the PD and the LGD to the EL, it is held that, in as much as application of the risk weighting function for corporates is contemplated, the maximum LGD must be equal to that set under the bottom-up approach for corporates, meaning 45% for exposures that are not subordinate and not guaranteed and 75% for non-guaranteed subordinate exposures.

We propose amending paragraph 335 of the New Accord as follows:

335. If the purchasing bank is unable to decompose EL into its PD and LGD components in a reliable manner, the risk weight will be determined from the corporate risk-weight function using the following specifications: ***PD will depend on the bank's estimate of EL and on the regulatory estimate of LGD equal to 45%;*** EAD will be the nominal amount outstanding ***in the case of receivables purchase with non recourse and the advance in the case of receivables purchase with recourse***. EAD for a revolving purchase facility, that is

7 Banca d'Italia (1999), *Manuale per la compilazione delle Segnalazioni di Vigilanza per gli Intermediari finanziari iscritti nell'"Elenco Speciale*"

irrevocable and whose residual maturity is longer than 1 year*, *will be the sum of the current nominal amount in the case of receivables purchased with non recourse and the advance in the case of receivables purchased with recourse, and 75% of any undrawn purchase commitments.

Advanced IRB treatment

Remarks on § 336:

On the subject of operations involving ongoing assignments, the fact that financial intermediaries are not allowed to use their own internal estimates of the EAD under the advanced approach is viewed as a rule that cannot be justified in consideration of the rules stipulated for the bottom-up treatment when other forms of financing are involved; in addition, it is held that this prohibition should at least be differentiated on the basis of the characteristics of the commitment to purchase the receivables, with distinctions regarding the revocable/irrevocable nature of the commitment and its maturity.

We propose amending paragraph 336 of the New Accord as follows:

336. If the purchasing bank can estimate the pool's exposure weighted-average LGD or average PD in a reliable manner, the risk weight for the purchased receivables will be determined using the bank's estimated weighted-average PD and LGD as inputs to the corporate risk-weight function. Similarly to the foundation IRB treatment, EAD will be the nominal amount outstanding ***in the case of non recourse purchased receivables and the advance in the case of recourse purchased receivables***. EAD for a revolving purchase facility will be the sum of the current nominal amount ***in the case of non recourse purchased receivables and the advance in the case of recourse purchased receivables, and the 75% of any undrawn irrevocable purchase commitments with residual maturity longer than 1 year.***

Remarks on § 337:

With regard to commitments to purchase receivables that are not revocable and not backed by "covenants" safeguarding the financial intermediaries in the event of a deterioration in the quality of the receivables sold, the CP3 provides that the maturity (M) of the margins not utilised is to be equal to the sum of the maturity of the receivable with the most distant maturation date purchasable plus the residual duration of the line of credit granted. It should be noted that, if a receivable is purchased with a maturation date further than that of the credit line, then, at some time prior to the date of the maturation of the line, the sum of the maturities must be reduced by the days remaining before the line reaches maturity and the days during which the receivable with the most distant date of maturation had already been purchased, in order to avoid counting the days twice when determining M.

2. RISK-WEIGHTED ASSETS FOR DILUTION RISK

Remarks on §§ 338, 339:

The introduction of a capital requirement to cover the risk of dilution requires the intermediary to maintain an additional capital, above and beyond that contemplated for the risk of default. The source of this risk is represented by the possibility that events tied to the commercial transaction underlying the receivable (such as offsets or allowances arising from returns of goods sold, disputes regarding product quality, possible debts of the borrower to a receivables obligor, and any payment or promotional discounts offered by the borrower, e.g. a credit for cash payments within 30 days) can cause the financial intermediary losses different from those caused by the default of the debtor. In truth, when it comes to factoring operations performed in Italy, even when an event resulting in dilution occurs, the loss is caused from the risk of default by the assignor: in fact, even for non recourse operations, the contractual formats utilised for factoring activities in Italy call for the assignor to guarantee that the receivable exists and to provide a guarantee for any episode involving the underlying commercial relationship and capable of leading to a decrease in the value of the portfolio of purchased receivables as a result of causes other than the risk of default of the debtor whose receivables have been purchased. Along these lines, it should be pointed out that the prudential differential applied by factors to the total pool of purchased receivables at the time of the advance payment is designed to cover the risk in question, this creating an exposure that regards a source of risk which is nonexistent or entirely negligible: in fact, the exposure that remains following application of the prudent differential is not burdened by the risk of dilution. Even in the case of non recourse operations, should the risk manifest itself, the factor will not be obliged to pay the value of the receivables to the assignor when they fall due. What is more, this methodology also reveals an inconsistency in the treatment of the risk of dilution, compared to financing operations guaranteed by financial receivables and eligible for application of an LGD equal to 35% (cf. par. 481): in such cases, the risk of dilution does not require respect of an asset capital requirements, but rather represents a qualitative operating prerequisite involving the management of risk.
It should also be observed that, from a theoretical perspective, the risk of default and of dilution are treated like two independent risks that can occur simultaneously, given that the capital requirement is arrived at by taking the sum of the requirement for the risk of default plus that for dilution; in reality, according to the national contractual clauses, the occurrence of the risk of dilution leads exclusively to a risk of default on the part of the assignor, a situation which, at equal levels of exposure, does not lead to an increase in the expected loss.
What is more, application of the definition of default contained in paragraph 414 shows that defaults caused by the risk of dilution may be placed under the category of events that manifest a risk of default (maturity reached more than 90 days earlier): this circumstance can lead to estimates of average PD for the pool that already account for the risk of dilution. Even assuming that a subjective evaluation is made of the cause of the risk (default/dilution), it can be observed that this distinction is critically to make making of this distinction both a theoretical and operational perspective.
In addition, a certain amount of perplexity is expressed regarding the treatment of the risk of dilution on the basis of the risk weighting function contemplated for the corporate portfolio.

Based on the observations formulated, it is proposed that the capital requirement for the risk of dilution be eliminated not only for the "Purchased Receivables" treatment, but also for the IRB methodology (foundation and advanced) utilising the bottom-up approach: in fact, it is *held that this requirement must be adequately monitored, meaning that it should be handled together with the minimum operational requirement of the methodology.*

In effects, a survey carried out by the Association among some relevant player of Italian factoring industry, representing a significant market share, reveals the immaterial incidence of dilution, as showed by the following table.

	1999	**2000**	**2001**	**2002**	**2003**
Incidence of dilution on payments owed to the factor	1,46%	2,34%	0,69%	0,68%	0,80%

We propose amending paragraph 338 and 339 of the New Accord as follows:

338. **Eliminated**
339. **Eliminated**

(ii) Recognition of guarantees

Remarks on § 341:

The presence of a guarantee established by the assignor, or by a third party, and covering the risk of default and/or dilution, leads to, replacement of the risk weight of the debtor with that of the guarantor, if the last one is lower than the first one. In the event that the assignor is guaranteeing both for the risk of default and for the risk of dilution, it is not clear whether the risk weight following mitigation for the risk of default and the risk of dilution is equal to 2 times the risk weight of default by the guarantor or simply to the risk weight for default of the guarantor: given that the assignor, in the case of contracts for factoring operations carried out in Italy, is always the guarantor for the risk of dilution, the first option would result in an capital requirement based on a double counting of the risk of the assignor. Though further clarification is held to be necessary, it is felt that the asset capital requirement placed on the assignor, though based on two sources of risk that are evaluated as different and independent under the New Accord, should be calculated only once.

H. MINIMUM REQUIREMENTS FOR IRB APPROACH

7. RISK QUANTIFICATION

(ii) Definition of default

Remarks on § 415:

According to the treatment "Purchased Receivables", the counterparty of risk is the debtor, both in recourse and non recourse receivables purchases. In order to estimate the PD, the debtor is relevant, considering the eventually guarantee established by the assignor. It's noticed the complexity of tieing the counterparty's default to a single past due payment that , doesn't occur repeatedly on the occasion of maturities that are close-set with respect to the

total exposure, and that can depend on dispute regarding the underlying supply contract without pointing to a payment difficulty to be ascribed to the deterioration of the debtor's creditworthiness . Therefore, the definition of default at point 1 under paragraph 414 is to prefer to the one at point 2, because the first one allows the evaluation of further elements: as an example, the simultaneous default on different obligations could be evaluated.
In the case of risk shifting on the assignor, meaning considering the assignor as the counterparty of the exposure, moreover, from the operational point of view it's complex to determine when the default occurs, because the transactions between the assignor and the factor are credited and debited in a current Account and, when the credit line granted to the assignor isn't disciplined in the contract, the unique way to measure the default is by stating the debtor in arrears.

(x) Minimum requirements for estimating PD and LGD (or EL)

Remarks on § 455:

Factoring activities are performed by financial intermediaries through the establishment of a number of different relationships involving the purchase of receivables from different assignors.
The operational requirement contemplated for estimates of the risk parameters call for the pools of receivables to be constituted in a uniform manner, reflecting the credit practices of the assignor and the heterogeneous nature of the its clientele. Given that the operating reality of factoring is based on the purchase of receivables from a number of different assignors, a clarification of the potential number (one assignor/numerous assignors) of the parties from which receivables may be purchased is held to be adequate: this element is important as regards both the application of this treatment to factoring activities and the formation of the pools of receivables. In terms of the establishment of pools of receivables, different operating procedures could be adopted, or various combinations could be employed, including the following:

a) *n pools for 1 assignor, meaning that a total of n x n pools could be established for n assignors: under this procedure, receivables that are similar in terms of their characteristics but purchased from different assignors could not be combined in the same pool;*
b) *n pools of receivables, established under criteria of similarity regarding the activities of the assignor (segmentation by assignor);*
c) *n pools of receivables, established under criteria of similarity regarding the type of factoring contract (segmentation by product/ technical form);*
d) *n pools of receivables, established under criteria of similarity regarding the debtors (segmentation by debtors whose receivables are purchased); under this methodology, the factor could group the receivables into uniform pools, segmenting the sum total of the debtors on the basis of those whose receivables have been sold by a number of assignors, in this way gathering a sufficient number of observations to be able to produce sound and robust estimates of the risk parameters for each pool.*

All the previous operating procedures are eligible to carry out robust risk drivers estimates (PD, LGD, EAD) in relation to the different profiles of the financial intermediary's activities
Observing the characteristics of the factoring activities, procedure d) would appear to be the best suited in terms of its operating characteristics: in fact, it allows the factor to place like receivables in uniform pools, even if they have been purchased from different assignors; it is held that this procedure for the formation of the pools guarantees adequate numbers, and certainly larger ones than is true for procedure a), making it possible to construct robust estimates of the risk parameters.

We propose amending paragraph 455 of the New Accord as follows:

455. The purchasing bank will be required to group the receivables into sufficiently homogeneous pools so that accurate and consistent estimates of PD and LGD (or EL) for default losses can be determined. In general, the risk bucketing process will reflect the ***sellers*** *underwriting practices and the heterogeneity of* ***their*** *customers. In addition, methods and data for estimating PD, LGD, and EL must comply with the existing risk quantification standards for retail exposures. In particular, quantification should reflect all information available to the purchasing bank regarding the quality of the underlying receivables, including data for similar pools provided by the seller, by the purchasing bank, or by external sources. The purchasing bank must verify any data provided by the seller and relied upon by the purchasing bank.*

Minimum operational requirements

Legal certainty

Remarks on § 457:

This requirement is definitely present in factoring activities: in fact, the receivables assigned are not entered on the balance-sheet of the assignor but on that of the factor, which represents a separate legal entity from the assignor and can be regulated, performing one or more services involving management and financial activities.
Law 52 of 1991 guarantees the certainty of the purchase of business receivable and the right of the factor to invoke its claims against third parties from the moment the advance is paid, with the factor being entitled, in any event, to utilise the procedures of notification and acceptance contemplated under the Civil Code: on the theme of revocations resulting from bankruptcy, the legislative text calls for payments made by the factor to the debtor to be removed from the bankruptcy situation of the latter.

Effectiveness of monitoring systems

Remarks on § 458:

As a rule, it can be observed that the prerequisite is present in the factoring activities performed on the national level: the frequency of relations with the assignor and the debtors whose receivables have been assigned is the result of the supply of managerial and/or financial services whose subject is assets, the receivables assigned, and whose due dates are short term. These operational characteristics allow the factor to carry out effective monitoring activities, making it possible to note critical problems in advance. At this point it is worthwhile emphasising that the credit process, which includes the monitoring activities, is subject to regulatory standards and requirement that are part of a specific set of rules governing the administrative and accounting operations, as well as the internal controls[8]*, of regulated financial intermediaries.*
With regard to the first point, under which an internal rating is requested for the assignor, it is held that clarification should be provided regarding the type of rating of the assignor: in fact, it is felt that this rating should be consistent with the approach (foundation/advanced) utilised for the evaluation of the receivables purchased.

[8] See: Banca d'Italia (2002), *Istruzioni di vigilanza per gli Intermediari finanziari iscritti nell'Elenco Speciale –* 6th Update

Effectiveness of work-out systems

Remarks on § 459:

The process for the production of factoring activities is definitely able to provide effective solutions for problem situations: as shown in the observation contained in paragraph 458, during the phase involving the management of the relationship, the factors, thanks to their internal information systems, are able to detect, on a timely basis, any discrepancies between the contractual terms and the implementation of the relationship, adopting the necessary corrective measures. With regard to the presence of automatic procedures for the advance revocation of rotating credits, it should be noted that such commitments, on the national level, as generally revocable. At this point it is worthwhile mentioning that the credit process, which includes the definition, detection and management of anomalous (non performing) credits, is the subject of regulatory requirements that are part of a specific set of rules governing the administrative and accounting organisations, as well as the internal controls[9]*of regulated financial intermediaries.*

Effectiveness of systems for controlling collateral, credit availability, and cash

Remarks on § 460:

This requirement is definitely met by the production process that characterises the factoring activities carried out in Italy. In fact, the requirement stipulated under the first point are ideally positioned within the internal regulations, as required under a specific set of rules regarding the administrative and accounting organisation, as well as the internal controls[10]*, of regulated financial intermediaries.*

It should further be noted that the factoring activities are based on the purchase of receivables, with the result that the advances are granted exclusively on the basis of the receivables.

Compliance with the bank's internal policies and procedures

Remarks on §§ 461, 462:

The requirement is definitely met by the factoring activities performed in Italy, where regulated financial intermediaries are subject to a specific set of rules and regulations regarding their administrative organisations and internal controls[11]*. In terms of assignor/manager relations, it should be noted that the seller is in no way involved in the management and collection of the credit; for this reason, it is held that the scope of application of the requirement found in the second point of paragraph 461 should be specified.*

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[9] Cf. note 8
[10] Cf. note 8
[11] Cf. note 8

9. SUPERVISORY LGD AND EAD ESTIMATES

(iii) Requirements for recognition of financial receivables

Definition of eligible receivables

Operational requirements
Legal certainty

Remarks on § 477:

The requirement introduced is held to be consistent with the objective of legal certainty for the acquisition of the guarantee, meaning the portfolio of purchased receivables. In the interests of correct application, however, clarification should be provided regarding the procedures for the procurement of this opinion, as well as its contents and scope of application: it should also be noted that this prerequisite is of crucial importance for international factoring operations; for that matter, in the case of countries characterised by high levels of risk, the acquisition of a legal opinion regarding the efficacy of the guarantee under the law could prove to be a complex matter.

Risk management

Remarks on § 479:

In factoring activity, financial intermediaries carry out a direct evaluation of the risk connected with the pool of receivables acquired: during the preparatory phase, the factors evaluate all the clients of the assignor and identify the debtors whose receivables they are willing to purchase. As is evident, this management technique allows the factor to evaluate both the individual debtors and the overall risk of the portfolio acquired. It is held, therefore, that these specific characteristics are of importance in terms of evaluating whether or not the minimum requirement for risk management are met, meaning that they should receive a different treatment than the evaluation of the receivables performed outside of the intermediary, meaning that carried out by the assignor.

Remarks on § 481:

*The requirements contemplated under paragraph 481 stipulate that the risk of dilution must be adequately evaluated. Despite the fact that, for the purpose of applying an LGD mitigated to 35%, a minimum quantitative prerequisite of C** is contemplated, under the procedures for handling purchased receivables subject to the risk of dilution, there is the possibility of introducing an capital requirement, in addition to the requirement regarding the risk of default. It is held that similar risks involving similar assets, the receivables, should be handled in a consistent manner.*