Consiglio del 13 dicembre 2017

Punto 6 all' ODG
Stato di avanzamento delle attività associative sulla regolamentazione relativa al factoring

ALLEGATO 6.1
Consultazione pubblica sul progetto di addendum alle linee guida della BCE per le banche sui crediti deteriorati

ASSIFACT
Associazione Italiana per il Factoring

Consultazione pubblica sul progetto di addendum alle linee guida della BCE per le banche sui crediti deteriorati

Sintesi del contesto

La BCE ha emanato in ottobre un documento per la consultazione introducendo un sistema di accantonamenti minimi per le esposizioni deteriorate, che dovranno essere interamente accantonate:

- Entro due anni per le esposizioni non garantite
- Entro sette anni per le esposizioni garantite

Il riferimento per la presenza di garanzie è l'ammissibilità al trattamento della mitigazione del rischio di credito.

La Commissione Europea, che stava già trattando il tema, ha quindi anticipato l'uscita di una propria consultazione sullo stesso argomento, proponendo un approccio lievemente differente, e nello specifico:

- Prospettando approcci di accantonamento totale per la posizione deteriorata alternativamente lineari, progressivi o non scalari
- Proponendo una alternativa basata sull'applicazione di haircut graduali alla garanzia ammissibile.

Le due consultazioni si sono quindi svolte contemporaneamente.

Sintesi delle risposte di Assifact

Assifact ha risposto a entrambe le consultazioni, mantenendo la stessa posizione (mutatis mutandis), focalizzandosi in particolare su:

- Rigetto di un approccio basato su backstop minimi agli accantonamenti, considerato non conforme ai regolamenti nazionali (codice civile) e internazionali in materia (IFRS 9)
- Critica del riferimento alle garanzie ammissibili per la definizione delle esposizioni "garantite": il factoring è una forma di asset based lending, basata sulla cessione del credito e pertanto "secured" per definizione. Inoltre l'eventuale presenza di assicurazione del credito andrebbe considerata nel valutare gli accantonamenti. Tuttavia l'ammissibilità di crediti commerciali e assicurazione del credito alla CRM non è prevista se non in talune circostanze non del tutto chiare.
- Possibili distorsioni in caso di applicazione del backstop minimo alle esposizioni "past due", per le quali non rileva un reale incremento del rischio di credito e attualmente accantonate in accordo con le reali valutazioni di rischio dell'intermediario
- Richiesta di esenzione dal trattamento minimo degli accantonamenti per le esposizioni verso pubbliche amministrazioni in considerazione dell'assenza di reali rischi di credito
- Richiesta di porre attenzione alla possibilità di incremento della volatilità dei bilanci delle società di factoring e alle possibili distorsioni in termini di disincentivo all'offerta di prodotti a basso rischio quali il factoring ed effetti involontari quali l'incentivo ad escutere prontamente le garanzie disponibili riducendo l'efficacia delle normative fallimentari, sempre più orientate alla continuità del business.

Di seguito si riportano le risposte inseriti nei relativi form previsti dalle due istituzioni. L'EUF ha proposto documenti in linea con quelli prodotti da Assifact (fatte salve alcune integrazioni dell'ultima ora in tema di PA).

Allegato 1.

Position paper on

Consultation document European Commission

Statutory prudential backstops addressing insufficient provisioning for newly originated loans that turn non-performing

Questions

1. What are your views on the rationale for statutory prudential backstops as described above? In particular:

a. Do you support the idea that statutory prudential backstops should complement the improvements that the application of IFRS 9 is expected to bring with regards to loan loss provisioning for the new loans that turn non-performing?

b. Do you support the idea that statutory prudential backstops (Pillar 1 measure) should complement the use of existing supervisory powers to address through institution-specific measures the (under)capitalisation of NPLs (Pillar 2 measure)?

Please explain the reasons for your answers.

Assifact does not support the idea of statutory prudential backstops addressing insufficient provisioning for non performing loans. In particular:

a. We do not believe that such backstops would actually improve provisioning in the view of IFRS 9. Actually regulatory backstops would deny the positive effects of IFRS 9. While the new accounting principle goes in line with the Basel/CRR risk-based approach, the adoption of prudential backstops would reduce the consistence of the provisioning with the expected loss amount and at the end of the day make worhtless the efforts made by the institutions to build models to estimate lifetime expected loss.

Moreover, given that the situation is very different across Europe, any common regulatory backstop would however need to be compared and set accordingly with the length of time it takes to conclude legal proceedings in each country. Otherwise, the requirement would add unuseful and unwanted volatility to the profit&loss and to the CET1 capital of the institutions: if the time granted to fully provision a loan is shorter than the average lenght of legal proceedings to enforce it, there would be a lot of extraordinary profit due to unnecessary provisioning in the previous year. Last but not least, an EU-wide common backstop would intensify difference between institutions working in different Countries, unleveling the playing field: intitutions operating in “virtuous” Countries, where late payments are not an issue and legal systems are more efficient, would be unduly favoured if the parity was on the rule but not in the context, thus breaching the “par condicio” between European institutions.

b. No, we believe that institutions should be allowed to determine their capital requirements and the provisioning according to their estimates of risk. The ECB Guidance to banks on non performing loans already set a framework to deal with NPLs, while the CRR already provides that institutions shall keep capital requirements in excess of the non performing exposure, as well as the accounting principles already state that provisioning should be made according to the expected loss. We would support the application of case-by-case backstops should the supervisory authority identify a situation of insufficient provisioning, which is already in the powers of the SSM.

Last but not least, we feel uncomfortable with such important issue being treated with lack of coordination between the European bodies (two ongoing consultation on the same topic providing different approaches by the European Commission and the ECB) and without a proper time schedule to analyze the framework, provide impact assessment and propose appropriate solutions to the numerous issues that the proposal raises.

2. Do you think that the statutory prudential backstops as described above are feasible?

a. If yes, please explain your views.

b. If not, what are the features that appear problematic to you and why?

c. Is there any alternative design of backstops via prudential deductions that you could envisage for new loans that turn non-performing? Please provide details.

The short deadline does not allow to perform an appropriate feasibility study on the proposed approach. We would like however to underline some potential pitfalls of the approach that could generate practical and feasibility issues:

- Potential conflict with the CRR treatment for credit risk, as the approach does not explain the effects of the deduction on risk weighted assets (150% for default exposures under the standardized approach). In perspective, it looks like the waiver that allows to weight 100% instead of 150% NPEs that are impaired for more than 20% of the value is being questioned in the future evolution of the Basel agreement, so that there could be a double counting of risk;
- Conflict with national laws or international regulation, such IFRS 9, providing different principles for loan loss provisioning;
- Conflict between the legal validity of collaterals/guarantees and the proposed approach to consider only collaterals eligible for credit risk mitigation purposes;

- Conflict with insolvency frameworks that are more and more oriented to allow the continuity of the client's business as institutions will be incentivized to enforce promptly and immediately any client in default status, thus reducing the likelihood of its survival.

3. In your view, which should be the cut-off date for the origination of loans that will be covered by the prudential backstop: the date of publication of this consultative document, the date of the publication of a possible legislative proposal introducing prudential backstops, the date of entry into force of such possible legislative measure, a later date of application? Please explain.

As the institutions are already engaged in the implementation of IFRS 9, that already requires significant efforts, we believe that the discussion of such new requirement should be postponed at least at the end of the first year of application of IFRS 9. Indeed, one of the main innovations of IFRS 9 is that it seek a more accurate and forward-looking provisioning based on the expected loss. We therefore suggest to wait for IFRS 9 to show its effects before to introduce another piece of regulation which looks in open conflict with the former.

Moreover, although we understand and agree the underlying principle, we underline also that practical issues may rise from the definition of "newly originated loans" in the case of revolving facilities. Our understanding is that in that case the backstop would apply to new client relationships starting from the cut-off date.

a. Would you see a need to address explicitly potential circumvention possibilities, for instance through prolongation of existing contracts? Please explain.

No opinion on that for the time being.

4. Do you think a full coverage of unsecured (parts of) NPLs after 2 years and of secured (parts of) NPLs after 6 to 8 years is appropriate?

a. For secured (parts of) NPLs, do you think it appropriate to treat them as unsecured after 6 to 8 years, effectively adding two more years before full coverage?

b. For secured (parts of) NPLs, do you think an alternative approach, such as the introduction of specific levels of haircuts on collateral/guarantee values, would be more appropriate?

c. If none of the approaches work in your view, how should the backstops be alternatively calibrated? Please explain the reasons for your answer.

First of all, we are concerned with the very definition of "secured NPLs", intended here as "covered by eligible credit protection". Indeed, the factoring industry presents some peculiarity: it is based upon the purchase by a bank or financial company of a business' trade receivables, against which the factor might advance part of all of the purchase price (otherwise paid to the client when the factor collects the invoice) and thus definitely represents a form of asset based lending. Please note that factoring usually entails a revolving facility available to the client.

Such purchase agreement (depending on the legal context) provides recourse to the client if the assigned debtor fails to fulfill the payment, unless the factor agrees to underwrite the risk of the receivables, upon request from the client, under a "without recourse" agreement. It is useful to highlight that from a legal point of view, in any case, "recourse to the client" means that the factor's risk is, in first instance, related to the fulfillment by the assigned debtor of its payment obligation rising from the receivables, while the client only guarantees in case of non-fulfillment by the former.

According to IAS 39 and IFRS 9, the balance sheet exposures generated by such purchase depends on the substantial transfer of all risk and rewards of the receivable. To make it simple, the factor shows an exposure to the debtor of the purchased receivables when the assignment trasfers substantially all risks and rewards and an exposure to the client otherwise. Please note that around Europe the International Financial Reporting Standards are not applied uniformly, so that the factoring transaction is not represented in the same way, as well as accounting standards may provide different rules for provisioning: that introduce another factor of variability among different Countries that may breach the level playing field in the factoring industry.

According to the CRR, purchased trade receivables are not considered as eligible credit protection for the purposes of credit risk mitigation exception made, under some circumstances, for Internal Rating Based Models (see artt. 199, 209 and 230). The CRR also allows the adoption, under the IRB approaches, of specific approaches to the estimate of expected credit loss in the case of purchased trade receivables that build on the role of the underlying receivables as the primary source for reimbursement (see artt. 153, 154 e 184). However, Internal Rating Models are not common in factoring, also due to its low risk profile and the consequent lack of properly deep default time series, so, generally, factoring transactions and in general invoice-based finance would be considered as unsecured loans.

On the other side, when the factor purchases trade receivables, it often obtains further protection through insurance policies offered by a credit insurance company. Such policies can combine both recourse and non recourse agreement, in the latter case operating as a re-insurance of the debtor risk underwritten by the factor. Although they provide a very effective protection, credit insurance policies are usually not eligible as credit protection under the CRM framework.

In both the abovementioned situation, according to the proposed model, the factor would have an unsecured exposure while, actually, it has strong collaterals provided by the purchased trade receivables and re-insurance. It is not a case that, in Italy, according to the latest figures, the factoring industry shows a significantly lower NPL ratio than traditional banking, respectively 7% (5.4% unlikely to pay) vs 15% (14.8% unlikely to pay). The numbers are even more compelling when looking to the full EU picture: data from the EUF White Paper on Factoring and Commercial Finance show that the total cost of risk in factoring is immaterial compared to that of banks (0.09% vs 0.32% in low risk Countries, 0.43% vs 1.6% in high risk Countries).

We strongly challenge the assumption that factoring represents a form of unsecured lending and advise that every approach based on that assumption would generate bias on provisioning.

Usually, such collaterals deploy their benefits in the short term. However, in the case of legal proceedings, it is not uncommon that the enforcement takes a certain number of months or even years (that is the case, e.g. of public entities which are subject to administrative procedures). There is no reason to penalize the related exposures by way of a minimum required level of provisioning or deduction from the regulatory capital. We therefore suggest that a backstop model on provisioning built on the separation between "secured" and "unsecured" exposures is too simplified and biased.

Moreover, we wish to underline that, due to the link with late payments in trade relationships, the factoring industry shows, in some Countries more than in others, a significantly larger amount of default exposures to debtors due to the 90 days past due rule, which is close to 21 times the same share in traditional banking (Assifact estimates). Such default are normally not a real indicator of increasing risk, reflecting the payment behaviours of a business or industry. Thus, the cure ratio of those past due exposures is very high (Assifact estimates that for Italy only 1.72% of new unlikely to pay exposures in 2016 in factoring came from the past due over 90 days exposures). The coverage ratio on those exposures is lower than in traditional banking reflecting the abovementioned overestimation of default due to late payment (while, to provide a full picture, the coverage ratio on unlikely to pay exposures is higher, on average).

We wish to underline that a prudential backstop would unnecessarily exacerbate volatility in P&Ls or prudential CET1 of the factoring companies if applied. Indeed, it is highly probable that such unnecessary increased provisions would be compensate by recoveries in the following quarter(s) or year.

In order to reduce the unintended impact of the (potential) introduction of a regulatory backstop on provisioning:

i. we strongly advise that, in the case a backstop shall be provided, it should not (only) be based on the eligibility of the collateral as credit protection under the CRM framework but also consider other collaterals i.e trade receivables or credit insurance, and that a more granular approach should be adopted, i.e. diversifyng the treatment having regard to the type of the collateral. Due to time constrains, it is impossible to properly assess the consistency of the proposed approaches and express a prefence, yet we note that the haircut approach moves towards this direction even though it provides a more complex methodology. In that case, purchased trade receivables and credit insurance could properly fit the “financial collaterals” class (even if the CRR puts purchased receivables in a stand-alone class for IRB purposes – see art. 209);
ii. we feel that the calibration of the approach should not be set arbitrarily but should take into consideration the lenght of legal proceedings to enforce the loan, which is different from country to country, so that any EU common backstop would breach the level playing field if not properly adjusted. In the case a regulatory prudential backstop was to be implemented, we suggest that the National Supervision Authority could make such adjustments in order to get a consistent balance between the expectations of the EU Supervisors, the needs of the banking industry and the need of transparency and accountability of their financial reports at investors’ benefit;
iii. One should also discriminate according to the counterparty: an unsecured loan to a business and an unsecured loan to a public administration bear very different risk profiles (credit risk is almost non existent in the latter case, even though the enforcement of the loan may take a long time). Debtors that are public entities should be exempted from such minimum level of provisioning.

5. Do you agree that prudentially sound collateral valuation is an important element for addressing NPL-related risks? In this context:

a. Would a common (non-binding) methodology for collateral valuation suffice to foster consistent outcomes and transparency or would specific (binding) valuation rules be needed?

b. More generally, should specific prudent valuation requirements apply to assets and off-balance sheet items accounted for amortised cost as it is already the case for fair-valued assets?

With specific reference to the purchased trade receivables, we underline that it is a kind of collateral that is not affected by market changes, as its value may vary only in the case of debtor default. Therefore, we feel such receivables do not need any common methodology for valuation. The high recovery power of purchased trade receivables is confirmed by the low NPL ratio in factoring, which (see above) in the case of Italy is in average 50% lower compared to that of general banking and even 64% lower when true unlikely to pay exposures are compared.

6. Do you agree that prudential coverage needs should ultimately depend on the actual recoverability rather than the valuation of the collateral to provide for a backstop?

We agree with the principle in general, yet the actual recoverability of a collateral is a function of various factors that need careful assessment and valuation like, e.g.:

- Type of collateral
- Type of security (i.e. pledge / assignment / …)
- Type of debtor (e.g. private / public entity)
- Local legal environment
- And so on…

so that, again, a case-by-case approach driven by the institution's own judgment looks preferable to a top down - "one size fits all" methodology.

7. Do you agree that the application of the statutory prudential backstops should not result in cliff-edge effects, but should rather be implemented in a suitably gradual or progressive way by banks from the moment of the classification of the exposure as non-performing?

a. In particular, which approach (gradual or progressive) would you consider better suited and why?

Please explain the reasons for your answer.

We are not in favor of any statutory prudential backstop. In the case it should however be applied, we fell that a progressive backstop that takes into account the above mentioned factors affecting the actual recoverability of the collateral would be most fitting and would save a certain amount of volatility in the P&Ls or in the CET1.

8. Would you see any unintended consequences due to the design and calibration of the prudential backstops?

a. If yes, which measures would you consider necessary to prevent or address unintended effects (including double-coverage of risks)?

Please explain the reasons for your answer.

Given that NPLs are not a real issue for the factoring industry, we understand that the backstop does not adress it directly. Nevertheless, as we already mentioned, we see a number of significant pitfalls and unintended consequences due to the design and calibration of a prudential backstop.

In general:

- an incentive to institutions to enforce promptly and immediately the collaterals any time a client falls in default status, thus reducing the likelihood of its survival, in spite of the attention that the insolvency frameworks put on the necessary efforts to save the business
- an increase of legal claims against the institutions due to the previous incentive to enforce
- an alteration of the parity between European institutions and a breach of the level playing field principle due to the impossibility to make provisions consistently with the legal context in which each institution operates.

In particular, in the case of factoring and purchased trade receivables:

- an inconsistent treatment of the collaterals (trade receivables or credit insurance) in case the collaterals would be considered only if eligible for CRM (the requirements stated by the CRR do not necessarily take into account the effective recoverability of the collaterals as they pursue different goals)
- a massive use of exemptions under a “comply or explain” principle which would also require significant operational burden
- an increase in volatility of P&Ls or CET1 due to the large amount of past due exposures that falls under the EBA definition of default but gets back to performing status after a while
- all in all, factoring, as well as other low risk products, would be unduly punished by an unnecessary increase in the cost of risk

We therefore suggest that no general prudential backstops but individual assessment of insufficient provisioning under the current powers of the SSM would be the best solution to properly treat the issue of insufficient provisioning for non performing exposures.

In the case a prudential backstop was however introduced, we feel that a common rule based on the proposed approach would be oversimplified and could generate more problems than benefits. To summarize, a common regulatory prudential backstop on provisioning for NPLs could have unintended negative effects on:

- the regulatory capital level and the credit policies of the institutions
- the par condicio between European institutions
- the comparability of financial reportings of institutions operating in different Countries
- the cost of risk of low risk, asset based financial products such as factoring due to unnecessary provisioning that could disincentivize their use, thus eventually increasing the overall systeming risk
- the real economy, that will eventually be harmed by stricter credit policies and reduced possibilities of turnaround the business in case of financial distress

Thus we strongly suggest, again, to have a granular approach, considering the type of collateral, the type of security, the type of debtor and the lenght of legal proceedings to provide a reliable picture of the actual value and recoverability of the collateral. In particular, the inclusion of trade receivables and credit insurance among the eligible collaterals is essential to avoid illogical provisioning on factoring and purchased trade receivables, as well as an exemption for debtors that are public entities (thus not generating an actual credit risk even in the case of past due-driven default) looks like necessary. In order to minimize the negative effects of the backstops, a progressive approach would also help.

Allegato 2.

Position paper on

Consultation document ECB

Public consultation on the draft addendum to the ECB guidance to banks on non-performing loans

ID	Chapter	Detailed comment	Concise statement as to why your comment should be taken on board
1	1 - Background	The "Addendum" states that "This addendum does not intend to substitute or supersede any applicable regulatory or accounting requirement or guidance from existing EU regulations or directives and their national transpositions, applicable national regulation of accounting, binding rules and guidelines of accounting standard setters or equivalent, or guidelines issued by the European Banking Authority (EBA)". However, we underline that in this Addendum the SSM sets its expectations and ask institutions to "comply or explain" so that those expectations cannot be really considered as "non-binding" while we also see significant conflict with existing applicable accounting rules (both at national and international level) and in particular with IFRS 9. We also wish to highlight that the Addendum addresses an issue that should need primary legislation, so that the proposed approach looks to go far beyond the SSM powers: the addendum indeed lacks the absence of legal effects as non-compliance could trigger Pillar 2 effects.	We believe the Addendum generates conflicts with existing accounting rules and addresses an issue that goes beyond the SSM powers
2	1 - Background	We feel uncomfortable with such important issue being treated with lack of coordination between the European bodies (two ongoing consultation on the same topic providing different approaches by the European Commission and the ECB) and without a proper time schedule to analyze the framework, provide impact assessment and propose appropriate solutions to the numerous issues that the proposal raises.	Lack of coordination generates uncertainty in institutions and markets

3	2 - General Concept	The calendar approach is not consistent with the prudential and accounting systems that has been at the basis of the current regulatory environment (CRD/CRR, IFRS 9) and that is based on the reliance to the institutions' internal estimates of expected losses	Inconsistency between calendar approach and current prudential and accounting regulation
4	2 - General Concept	"This addendum will be applicable as of its date of publication. Finally, the backstops are applicable at a minimum to new NPEs classified as such from January 2018 onward". We advise that the deadline for the consultation and the date of application are too close. The Addendum would impact significantly on business models and operations if adopted. Moreover, as the institutions are already engaged in the implementation of IFRS 9, that already requires significant efforts, we believe that the discussion of such new requirement should be postponed at least at the end of the first year of application of IFRS 9. Indeed, one of the main innovations of IFRS 9 is that it seek a more accurate and forward-looking provisioning based on the expected loss. We therefore suggest to wait for IFRS 9 to show its effects before to introduce another piece of regulation which looks in open conflict with the former.	The discussion should be postponed at least at the end of the first IFRS 9 exercise, as the Addendum appears to be in open conflict with IFRS 9, which already aims to prompt and adequate provisioning
5	2 - General Concept	We would like however to underline some potential pitfalls of the approach that could generate practical and feasibility issues: • Potential conflict with the CRR treatment for credit risk, as the approach does not explain the effects of the deduction on risk weighted assets (150% for default exposures under the standardized approach). In perspective, it looks like the waiver that allows to weight 100% instead of 150% NPEs that are impaired for more than 20% of the value is being questioned in the future evolution of the Basel agreement, so that there could be a double counting of risk; • Conflict with national laws or international regulation, such IFRS 9, providing different principles for loan loss provisioning; • Conflict between the legal validity of collaterals/guarantees and the proposed approach to consider only collaterals eligible for credit risk mitigation purposes; • Conflict with insolvency frameworks that are more and more oriented to allow the continuity of the client’s business as institutions will be incentivized to enforce promptly and immediately any client in default status, thus reducing the likelihood of its survival.	A calendar approach to provisioning would rise a number of unintended consequences.
6	5 - Related supervisory reporting	"All banks should report to their respective JSTs at least on an annual basis the coverage levels by NPE vintage, with regard to the newly classified NPEs after 1 January 2018." We disagree. Considered the profound impact of such approach on the institutions' credit policies, it should apply only to newly originated exposures and not on newly classified NPEs in order to avoid bias. For revolving facilities, any backstop would apply to new client relationships starting from the cut-off date.	Impacts on credit policies suggest to apply only to newly originated loans

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Associazione Italiana per il Factoring

7	2 - General Concept	Given that NPLs are not a real issue for the factoring industry, we understand that the backstop does not adress it directly. Nevertheless, as we already mentioned, we see a number of significant pitfalls and unintended consequences due to the design and calibration of a prudential backstop. In general: • an incentive to institutions to enforce promptly and immediately the collaterals any time a client falls in default status, thus reducing the likelihood of its survival, in spite of the attention that the insolvency frameworks put on the necessary efforts to save the business • an increase of legal claims against the institutions due to the previous incentive to enforce • an alteration of the parity between European institutions and a breach of the level playing field principle due to the impossibility to make provisions consistently with the legal context in which each institution operates. In particular, in the case of factoring and purchased trade receivables: • an inconsistent treatment of the collaterals (trade receivables or credit insurance) in case the collaterals would be considered only if eligible for CRM (the requirements stated by the CRR do not necessarily take into account the effective recoverability of the collaterals as they pursue different goals) • a massive use of exemptions under a “comply or explain” principle which would also require significant operational burden • an increase in volatility of P&Ls or CET1 due to the large amount of past due exposures that falls under the EBA definition of default but gets back to performing status after a while • all in all, factoring, as well as other low risk products, would be unduly punished by an unnecessary increase in the cost of risk We therefore suggest that no general prudential backstops but individual assessment of insufficient provisioning under the current powers of the SSM would be the best solution to properly treat the issue of insufficient provisioning for non performing exposures. In the case a prudential backstop was however introduced, we feel that a common rule based on the proposed approach would be oversimplified and could generate more problems than benefits. To summarize, a common regulatory prudential backstop on provisioning for NPLs could have unintended negative effects on: • the regulatory capital level and the credit policies of the institutions • the par condicio between European institutions • the comparability of financial reportings of institutions operating in different Countries • the cost of risk of low risk, asset based financial products such as factoring due to unnecessary provisioning that could disincentivize their use, thus eventually increasing the overall systeming risk • the real economy, that will eventually be harmed by stricter credit policies and reduced possibilities of turnaround the business in case of financial distress Thus we strongly suggest, again, to have a granular approach, considering the type of collateral, the type of security, the type of debtor and the lenght of legal proceedings to provide a reliable picture of the actual value and recoverability of the collateral. In particular, the inclusion of trade receivables and credit insurance among the eligible collaterals is essential to avoid illogical provisioning on factoring and purchased trade receivables, as well as an exemption for debtors that are public entities (thus not generating an actual credit risk even in the case of past due-driven default) looks like necessary. In order to minimize the negative effects of the backstops, a progressive approach would also help.	In general, an approach to provisioning based exclusively on vintage will generate significant biases for low risk exposures like factoring

8	3 - Definitions	we are concerned with the very definition of “secured NPLs”, intended here as “covered by eligible credit protection”. Indeed, the factoring industry presents some peculiarity: it is based upon the purchase by a bank or financial company of a business’ trade receivables, against which the factor might advance part of all of the purchase price (otherwise paid to the client when the factor collects the invoice) and thus definitely represents a form of asset based lending. Please note that factoring usually entails a revolving facility available to the client. Such purchase agreement (depending on the legal context) provides recourse to the client if the assigned debtor fails to fulfill the payment, unless the factor agrees to underwrite the risk of the receivables, upon request from the client, under a “without recourse” agreement. It is useful to highlight that from a legal point of view, in any case, “recourse to the client” means that the factor’s risk is, in first instance, related to the fulfillment by the assigned debtor of its payment obligation rising from the receivables, while the client only guarantees in case of non-fulfillment by the former. According to IAS 39 and IFRS 9, the balance sheet exposures generated by such purchase depends on the substantial transfer of all risk and rewards of the receivable. To make it simple, the factor shows an exposure to the debtor of the purchased receivables when the assignment trasfers substantially all risks and rewards and an exposure to the client otherwise. Please note that around Europe the International Financial Reporting Standards are not applied uniformly, so that the factoring transaction is not represented in the same way, as well as accounting standards may provide different rules for provisioning: that introduce another factor of variability among different Countries that may breach the level playing field in the factoring industry. According to the CRR, purchased trade receivables are not considered as eligible credit protection for the purposes of credit risk mitigation exception made, under some circumstances, for Internal Rating Based Models (see artt. 199, 209 and 230). The CRR also allows the adoption, under the IRB approaches, of specific approaches to the estimate of expected credit loss in the case of purchased trade receivables that build on the role of the underlying receivables as the primary source for reimbursement (see artt. 153, 154 e 184). However, Internal Rating Models are not common in factoring, also due to its low risk profile and the consequent lack of properly deep default time series, so, generally, factoring transactions and in general invoice-based finance would be considered as unsecured loans. On the other side, when the factor purchases trade receivables, it often obtains further protection through insurance policies offered by a credit insurance company. Such policies can combine both recourse and non recourse agreement, in the latter case operating as a re-insurance of the debtor risk underwritten by the factor. Although they provide a very effective protection, credit insurance policies are usually not eligible as credit protection under the CRM framework. In both the abovementioned situation, according to the proposed model, the factor would have an unsecured exposure while, actually, it has strong collaterals provided by the purchased trade receivables and re-insurance. It is not a case that, in Italy, according to the latest figures, the factoring industry shows a significantly lower NPL ratio than traditional banking, respectively 7% (5.4% unlikely to pay) vs 15% (14.8% unlikely to pay). The numbers are even more compelling when looking to the full EU picture: data from the EUF White Paper on Factoring and Commercial Finance show that the total cost of risk in factoring is immaterial compared to that of banks (0.09% vs 0.32% in low risk Countries, 0.43% vs 1.6% in high risk Countries). We strongly challenge the assumption that factoring represents a form of unsecured lending and advise that every approach based on that assumption would generate bias on provisioning. Usually, such collaterals deploy their benefits in the short term. However, in the case of legal proceedings, it is not uncommon that the enforcement takes a certain number of months or even years (that is the case, e.g. of public entities which are subject to administrative procedures). There is no reason to penalize the related exposures by way of a minimum required level of provisioning or deduction from the regulatory capital. We therefore suggest that a backstop model on provisioning built on the separation between “secured” and “unsecured” exposures is too simplified and biased.	The definition of "eligible credit protection to secure exposures" must be clarified and amended to clearly include trade receivables and credit insurance

		Moreover, we wish to underline that, due to the link with late payments in trade relationships, the factoring industry shows, in some Countries more than in others, a significantly larger amount of default exposures to debtors due to the 90 days past due rule, which is close to 21 times the same share in traditional banking (Assifact estimates). Such default are normally not a real indicator of increasing risk, reflecting the payment behaviours of a business or industry. Thus, the cure ratio of those past due exposures is very high (Assifact estimates that for Italy only 1.72% of new unlikely to pay exposures in 2016 in factoring came from the past due over 90 days exposures). The coverage ratio on those exposures is lower than in traditional banking reflecting the abovementioned overestimation of default due to late payment (while, to provide a full picture, the coverage ratio on unlikely to pay exposures is higher, on average). We wish to underline that a prudential backstop would unnecessarily exacerbate volatility in P&Ls or prudential CET1 of the factoring companies if applied. Indeed, it is highly probable that such unnecessary increased provisions would be compensate by recoveries in the following quarter(s) or year.	
9	4 - Prudential provisioning backstop	We note that the calibration lacks of any justification and statistical reference. We feel that the calibration of the approach should not be set arbitrarily but should take into consideration the lenght of legal proceedings to enforce the loan, which is different from country to country, so that any EU common backstop would breach the level playing field if not properly adjusted. In the case a regulatory prudential backstop was to be implemented, we suggest that the National Supervision Authority could make such adjustments in order to get a consistent balance between the expectations of the EU Supervisors, the needs of the banking industry and the need of transparency and accountability of their financial reports at investors’ benefit	A "one size fits all" calibration would disrupt the level playing field: Country-specific adjustment must be allowed
10	4 - Prudential provisioning backstop	One should also discriminate according to the counterparty: an unsecured loan to a business and an unsecured loan to a public administration bear very different risk profiles (credit risk is almost non existent in the latter case, even though the enforcement of the loan may take a long time). It is worth noticing that losses on public debtors are extremely infrequent, even if the delay in payments might be relevant. The long-standing experience of factoring companies active towards the public sectors in Europe and notably in Italy, Spain, Portugal, Poland and Slovakia shows that losses generated by past due receivables to the public healt sector and local governments (even when distressed) are non existent: on the contrary, past due receivables to PAs usually generate overrecoveries thanks to legal interests accruing on late payments in trade relationships. A preliminary impact assessment made by Assifact shows that such approach would significantly affect the reliability of the accounting reporting made by the banks, as it would compel them to take unnecessary provisions that will not result in losses but rather in recoveries, thus reducing the transparency to the markets. We strongly advise that debtors that are public entities should be exempted from such minimum level of provisioning.	Public debtors deserve an exemption from minimum provisioning due to absence of real credit risk

11	4 - Prudential provisioning backstop	A calendar approach to provisioning applied to all institutions would be inconsistent with the actual recoverability of collaterals, which is a function of various factors that need careful assessment and valuation like, e.g.: • Type of collateral • Type of security (i.e. pledge / assignment / …) • Type of debtor (e.g. private / public entity) • Local legal environment • And so on… The high recovery power of purchased trade receivables is confirmed by the low NPL ratio in factoring, which (see above) in the case of Italy is in average 50% lower compared to that of general banking and even 64% lower when true unlikely to pay exposures are compared. Provisioning basing only on vintage would frustrate the institutions' efforts to estimate the LGD and penalize low risk products.	A calendar approach to provisioning is not consistent with the actual recoverability of a loan, thus penalizing low risk products such as factoring
12	4 - Prudential provisioning backstop	The Addendum, in its current form, proposes an innovative approach to provisioning, the impact of which seems to go far beyond its purposes, with the counterdeductive consequence to penalize low risk exposure such as factoring by way of the introduction of a methodology to provisioning merely based on "vintage", that does not take into account the peculiarity of trade receivables. According to the impact assessment performed by Assifact (attached), the largest impact is indeed expected on the lowest risk exposures such as purchased receivables to debtors that are past due but, especially in the case of public debtors, do not present any actual significant increase in credit risk. The current provision practices of factoring companies consider such features of the purchased receivables, that would be frustrated in the case a linear calendar approach to determine miminum regulatory backstops for provisioning was adopted. The large amount of unnecessary provisioning on such exposures, that will exceed by far the actual future losses and generate proportionally large recoveries in the following reporting periods, would also reduce the reliability and transparency of the financial reporting of banks, making them less intelligible for the markets, in open contrast with the very purposes of the Addendum. Such statements are backed up by strong evidence in the factoring sector: in Italy, as above mentioned, only 1,72% of new unlikely to pay exposures in 2016 came from a "past due over 90 days status", so that for trade receivables the default based on the past due rule represents a mere accounting classification but not a real credit risk event. In particular, the unintended consequences impact on factoring companies active on public administrations debts: according to figures to end of year 2016, unlikely to pay exposures to PA are only 0,9% of the total net exposures, while looking to actual bad debts the figures show a net value below 0,2%, suggesting there is no need to address such exposures with minimum backstops on provisioning.	The application of the calendar backstop to factoring could harm reliability and transparency of financial reporting of factoring companies

Impact study on

Consultation document
Addendum to the ECB Guidance to banks on nonperforming loans: Prudential provisioning backstop for non-performing exposures

This note addresses the potential impact on the Italian factoring industry of the proposed calendar approach to provisioning for NPLs as introduced by the draft "*addendum to the ECB Guidance to banks on nonperforming loans: Prudential provisioning backstop for non-performing exposures*".

Summary of results

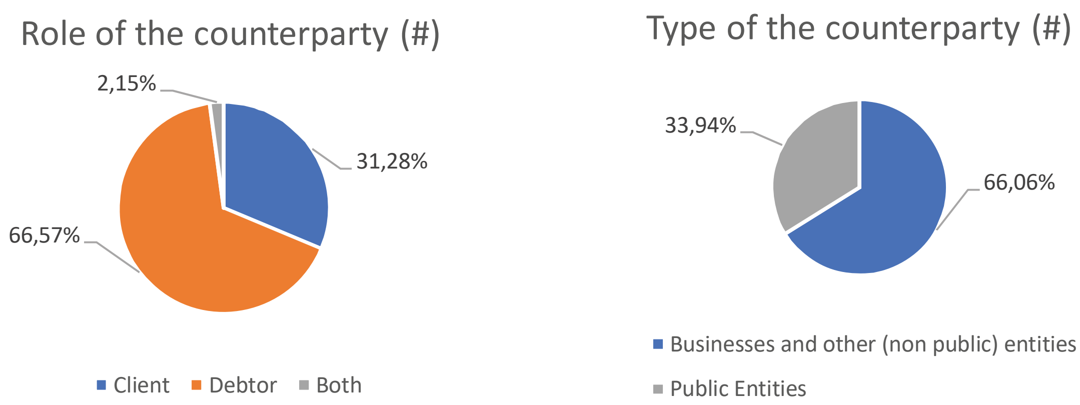
- The Addendum is likely to impact strongly on factoring with an overall increase of required provisioning of +165.9% with respect to the current level of provisioning
- The impact is higher for debtors, especially PA
- The impact would be tremendous with regard to past due over 90 days exposures, with linear minimum backstops representing up to 6,3 times the current level of provisioning
- Such impact would be counterdeductive as it would strike mostly on a low risk kind of exposures, such as receivables, where past due over 90 days is not a real indicator of impairment.

1. Sample

The impact has been analized on a sample of non performing exposures gathered by Assifact from 8 members, representing 39% of the total factoring turnover of year 2016.

The sample is made of 4.585 records representing different subjects that have been classified as non performing from 1st January 2014 to 31st December 2016.

Picture 1.1 – Description of the sample



Most of the analyzed records refer to exposures to account debtors related to non recourse purchased of trade receivables. About 1/3 of the sample is made of public entities.

2. Methodology

In order to assess the potential impact of the proposed approach, we performed a backward analysis on the previous 3 (complete) years. For each NPL we gathered info on:

- Date of default
- Role of the counterparty
- Type of the counterparty
- Status on 31/12/2014, 31/12/2015, 31/12/2016
- Balance at 31/12/2014, 31/12/2015, 31/12/2016
- Total provisioning on the exposures at 31/12/2014, 31/12/2015, 31/12/2016

The impact of the proposed calendar approach has been estimated through re-elaboration the total provisioning according to the calendar approach, under the following assumptions:

- Linear calendar provisioning proportional to the vintage of the default exposures (that has been determined as the number of days since default)
- Calendar provisioning as a minimum backstop (where current provisioning exceeds calendar provisioning, the first has been considered also in the new scenario)
- Exposures to factoring have been considered as "unsecured". Although the consultation paper refers to the eligibility of collaterals under CRM-rules, nothwithstanding the application of a Standardized or IRB approach, the eligibility of trade receivables and credit insurance is questionable and uncertain so that factoring might be considered as fully "unsecured" and subject to the 2 years full provisioning deadline. A 3-year period has then been considered as proxy of a "full provisioning cycle" under the ECB calendar approach
- All NPLs of the sample have been classified under the current classes:
  - PDU (past due over 0 days)
  - UTP (unlikely to pay)
  - SFG (bad debts)
- To simplify the analysis, only final default status has been considered.

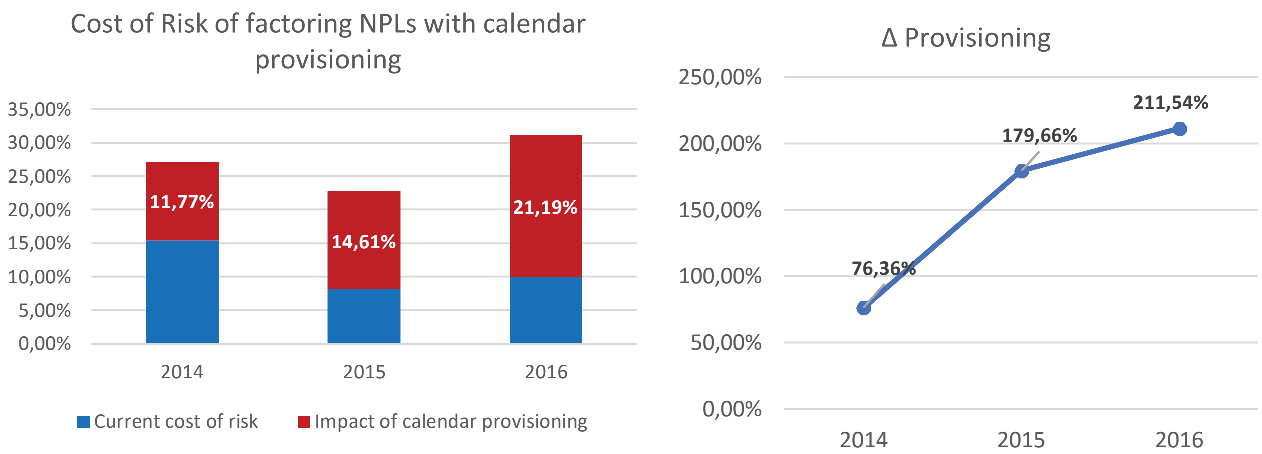
The difference between the current provisioning and the calendar provisioning for each year has been considered in order to estimate the impact on the profit and loss for each of the three year. Although the analysis is “backward looking” and not “forward looking”, the working group assessed that provisioning in factoring are more stable than in banking so the past 3 years could provide the best and simplest proxy of the actual impact on the next 3 years, also considering the strict timing of the consultation.

3. Results

The total impact on the profit and loss of factoring companies the tree years analysed is estimated to +247.093.343 €, representing an overall increase on the current provisioning of +165.9%. The increase in provisioning is growing during the three years. The lower impact on the first exercise is in line with expectations and consistent with the linear provisioning proportional to the vintage of the exposure as all analyzed counterparties defaulted after 1st january 2014. The large impact on 2016 profit and loss is consistent with the full provisioning backstop under the ECB calendar approach after 2 years since default.

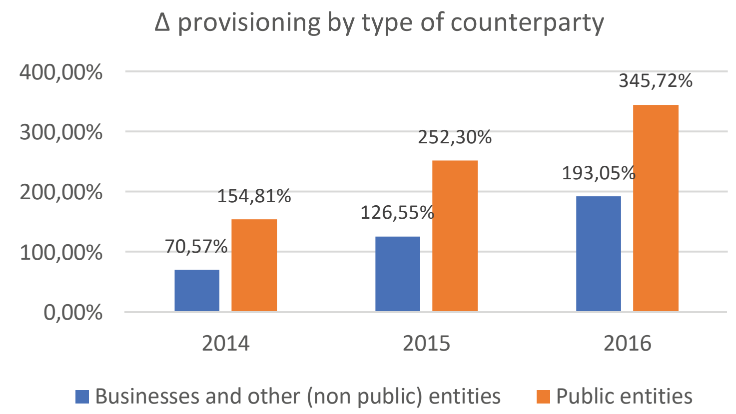
The impact on the total cost of risk ranges from 11.77% in 2014 to 21.19% in 2016.

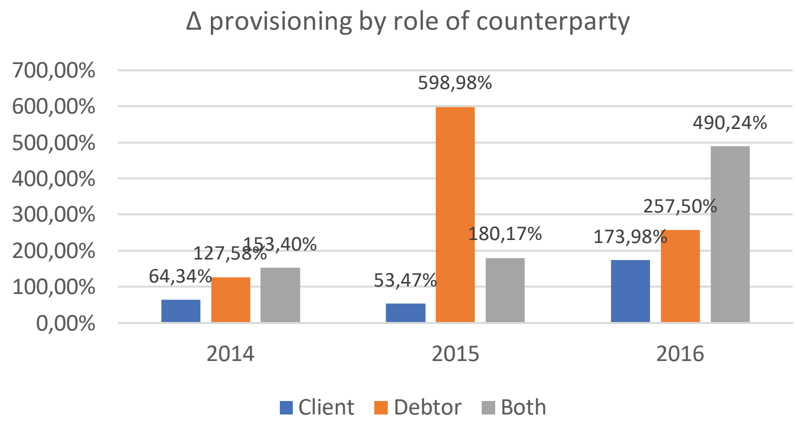
Picture 3.1 – Cost of Risk of factoring NPLs with calendar provisioning



The impact looks higher for non performing exposures to assigned debtors than for clients, and in particular to public administrations.

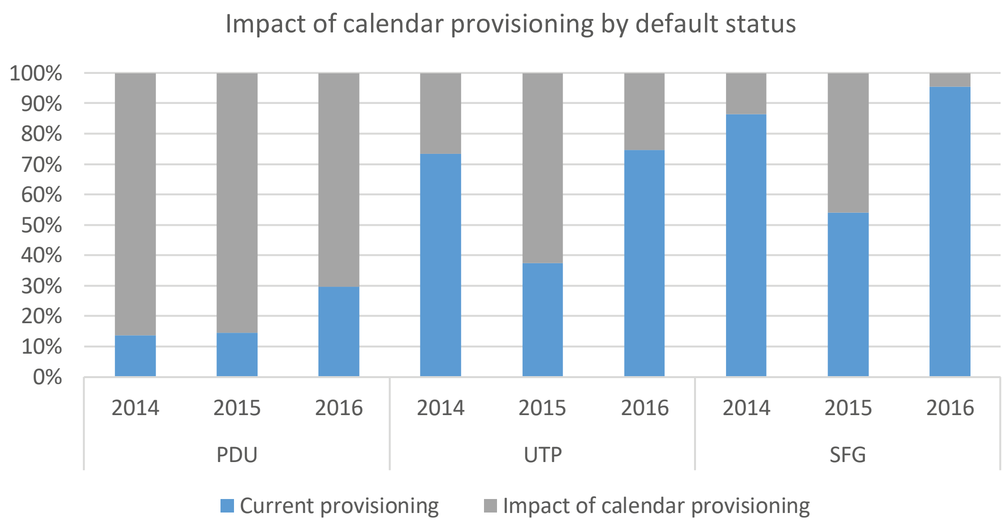
Picture 3.2 – Impact of increased provisioning under calendar approach by type and role of counterparty

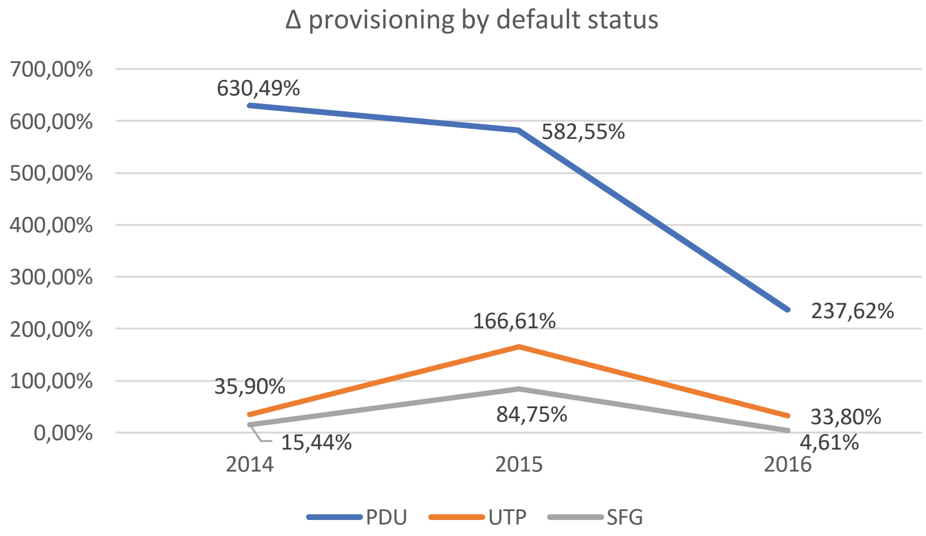




The impact varies depending also in default status. In particular, the impact is significant for UTP and SFG, and it is dramatically higher on past due over 90 days exposures.

Picture 3.3 – Impact of increased provisioning under calendar approach by default status of counterparty





Such an impact on PDU was far from unexpected: past due over 90 days, especially on debtors, does not represent a true indicator of default in factoring. There usually is lot of volatility in such status, with a significantly high cure ratio. Thus, factoring companies usually consider these peculiarities when assessing the value of the purchased receivables for provisioning. Therefore, it is not surprising that past due status would be significantly impacted by a linear calendar approach. The magnitude of such impact, however, looks tremendous, especially considered that PDU does not represent a real sign of default when trade receivables are involved.

Conclusions

Although the exercise necessarily presents some flaws, namely a simplified backward approach and a sample not covering the whole market, the estimated impact is consistent with expectations.

The Addendum, in its current form, proposes an approach the impact of which seems to go far beyond its purposes, with the counterdeductive consequence to penalize low risk exposure such as factoring introducing a methodology to provisioning merely based on “vintage”, that does not take into account the peculiarity of trade receivables.

The largest impact is indeed on the lowest risk exposures such as purchased receivables to debtors that are past due but, especially in the case of public debtors, do not present any actual increase in credit risk. The current provision practices consider such features of the purchased receivables, that would be frustrated in the case a linear calendar approach to determine miminum regulatory backstops for provisioning would be adopted.

A wider sample and clearer instruction on the treatment of purchased trade receivables could allow deeper analysis.