Factoring, reverse factoring and other tools for access to finance

Ivor Istuk
Outline of presentation

1. Problem of late payments

2. Factoring – good mitigation tool
   - Defining factoring
   - Types of factoring
   - Benefits of factoring
   - Misuses of factoring

3. Regulatory framework

4. Legislative framework

5. EBRD work on promotion of factoring
FACTORYING AND THE LEGISLATOR

- Turkey – Financial Leasing, Factoring and Financing Companies Law 2012
- Serbia – Factoring Law 2013
- Croatia – Factoring law under preparation
- Montenegro – looking into regulating

Squeezed liquidity of buyers and suppliers caused by late payment culture and hardened access to credit (World Economic Forum*)

## European Payment Index 2013


<table>
<thead>
<tr>
<th>Country</th>
<th>Payments between 30 – 90 days</th>
<th>Payments over 90 days</th>
<th>Businesses adversely affected by late payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>28%</td>
<td>24%</td>
<td>73%</td>
</tr>
<tr>
<td>Croatia</td>
<td>40%</td>
<td>29%</td>
<td>73%</td>
</tr>
<tr>
<td>Latvia</td>
<td>25%</td>
<td>25%</td>
<td>64%</td>
</tr>
<tr>
<td>Lithuania</td>
<td>33%</td>
<td>16%</td>
<td>93%</td>
</tr>
<tr>
<td>Poland</td>
<td>37%</td>
<td>8%</td>
<td>60%</td>
</tr>
<tr>
<td>Romania</td>
<td>29%</td>
<td>25%</td>
<td>87%</td>
</tr>
<tr>
<td>Russia</td>
<td>35%</td>
<td>7%</td>
<td>73%</td>
</tr>
<tr>
<td>Slovenia</td>
<td>26%</td>
<td>18%</td>
<td>86%</td>
</tr>
<tr>
<td>Turkey</td>
<td>43%</td>
<td>37%</td>
<td>86%</td>
</tr>
</tbody>
</table>
European Payment Index 2013

Legend:
- 101 - 129
- 130 - 139
- 140 - 149
- 150 - 159
- 160 - 169
- More than 170

Risk Index | Explanation of the Payment Index values
--- | ---
100 | No payment risk, cash on delivery, pre-payment, no credit
101-129 | Low risk profile, stay alert to keep this profile
130-139 | Low to medium risk profile, intervention necessary, take action now
140-149 | Medium risk profile, action needs to be taken
150-159 | Medium to high risk profile, take immediate actions to lower the risk
160-169 | High risk profile, immediate actions are necessary
More than 170 | Emergency risk profile
PUBLIC MEASURE AGAINST LATE PAYMENTS

• EU Directive 2011/7/EU on combating late payment in commercial transactions
  • Had to be transposed by 16 March 2013
  • Public authorities to pay for goods and services within 30 calendar days
  • Private sector should pay their invoices within 60 calendar days
  • Penalty interest of 8% above base rate chargeable

• Serbia – 2012 Late Payment Law
  • Public authorities to pay for goods and services within 45 calendar days
  • Private sector should pay their invoices within 60 calendar days
  • Penalty interest chargeable, additional fines possible

• Turkey – 2012 Commercial Code (Article 1530)
  • Addresses only private sector
  • Payment of invoices to be made within 30 - 60 calendar days
  • Penalty interest of 8% above base rate chargeable, additional fines possible
BUSINESSES RESPONSE

Negative
- Delay account payable
- Reduce inventory
- Increase prices
- Negotiate longer payment terms

Unlikely
- Bank lending
- Increase working capital
- (Cut overhead)

Positive
- Actively pursue accounts receivables
- Bill clients faster
- Sell invoices

All three positive actions found in factoring
1988 UNIDROIT Convention on International Factoring

**SUPPLIER**
Assigns AR

**FACTOR**
Finance and administration

**FUNCTIONS**

**FINANCE**
- Purchase of AR
- AR Default Protection

**ADMIN**
- Maintenance of Accounts
- Collection of Receivables
TYPES OF FACTORING

Three basic criteria

<table>
<thead>
<tr>
<th>Transfer of risk</th>
<th>Place of business</th>
<th>Debtor notification</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Non-recourse</td>
<td>• Domestic</td>
<td>• Disclosed</td>
</tr>
<tr>
<td>• Recourse</td>
<td>• International</td>
<td>• Silent</td>
</tr>
<tr>
<td></td>
<td>(one or two factor system)</td>
<td>(Invoice discounting)</td>
</tr>
</tbody>
</table>

Other categorisations possible - depending on:

- the client’s involvement in collection (client as agent for factor)
- due date for payment of purchase price (maturity or payment of invoice)
- AR debtor contracts with factor instead of creditor - Reverse Factoring (Confirming, Supply Chain Finance)
## BENEFITS OF FACTORING

**SME SUPPLIERS**
- Quick access to working capital
- Financing against buyers’ credit standing
- Cuts administration overhead costs
- Off balance sheet finance (non-recourse)
- Supports growth and diversification of business

**BUYERS**
- Extend payment terms
- Outsourced ledging (reverse factoring)
-Improved relationship with suppliers

**ECONOMY**
- Transfers credit risk from real to financial sector (non-recourse)
- Supports growth of businesses
# MISUSE OF FACTORING

<table>
<thead>
<tr>
<th>Improper use</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>For capital expenditures - equipment financing</td>
<td>Transforms working capital into long term assets – (squeezes liquidity down the road)</td>
</tr>
<tr>
<td>Last resort financing for loss making business</td>
<td>Limited breathing space as long as new receivables are created (danger of recourse) – overtrading</td>
</tr>
</tbody>
</table>
EBRD AND FACTORING

EBRD (FACTORING)

Financial Institutions Team
Investing in factors (debt and equity)

Trade Facilitation Programme
Short-term financial support to export/import factors

LTP Financial Law Unit
Supporting regulation and legislation
Exploring reverse factoring
Three approaches

<table>
<thead>
<tr>
<th>Not regulated</th>
<th>Regulated - no capital adequacy</th>
<th>Regulated with capital adequacy</th>
</tr>
</thead>
<tbody>
<tr>
<td>• UK – ABFA Russia, Slovakia, Belgium, Netherlands, Poland, Czech R., Lithuania, Estonia</td>
<td>• Germany – BaFin Portugal, Romania, Bulgaria, Serbia, Norway, Turkey, Croatia, Greece, Hungary, Malta</td>
<td>• Italy, France, Austria, Spain</td>
</tr>
</tbody>
</table>

licensure, start-up capital, qualified holdings control, approval of management, reporting, audit, internal organisational requirements (risk management and outsourcing)

Basel capital adequacy requirements with some relaxations based on source of factor’s funding or on factor’s membership in a group
### REGULATING FACTORING COMPANIES

<table>
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<tr>
<th>Three traditional criteria for application of capital adequacy regime</th>
</tr>
</thead>
<tbody>
<tr>
<td>large source of credit (macroeconomic significance)</td>
</tr>
</tbody>
</table>

**FSB, ECB and EU on shadow banking**

- EU Green Paper 2012 - Broad definition raised concerns (credit intermediation and risk transfer component in particular)

- EC Communication on Shadow Banking – 04.09.2013 (securitisation vehicles, money market funds, hedge funds, PE funds, credit guarantees) – no factoring.
### SUGGESTED APPROACH

**BENEFITS OF LIGHT REGULATION**

- licence, start up capital, qualified holdings control, approval of management, reporting, audit, internal organisational requirements (risk management and outsourcing)

<table>
<thead>
<tr>
<th>Legitimises the industry</th>
<th>Separates factoring from shadow banking, bad banks (NPLs)</th>
<th>Incentivises review of legislative base (pragmatic approach)</th>
<th>Might help attract investments</th>
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</thead>
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Legitimises the industry

Separates factoring from shadow banking, bad banks (NPLs)

Incentivises review of legislative base (pragmatic approach)

 Might help attract investments
Factoring Based On Assignment of Accounts Receivable

**Important issues**

- Sale or security (non recourse - recourse)
- Assigning future receivables (identification, bundle notice)
- Priority rules (pledge, extended ROT)
- Necessary formalities (availability of electronic assignment)
- Effects of prohibition on assignment clauses
SHOULD THE PROHIBITION ON ASSIGNMENT CLAUSE BE RENDERED INEFFECTIVE AGAINST FACTORS?

Two possible effects of the clause:

1. To render the assignment invalid
2. To allow debtor to disregard notice

<table>
<thead>
<tr>
<th>Arguments in favour</th>
<th>Arguments against</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Abuse of market position</td>
<td>• Freedom of the contract</td>
</tr>
<tr>
<td>• Know your creditor not relevant for trade credit (short term fixed relationship)</td>
<td>• Administrative burden – costs</td>
</tr>
<tr>
<td>• Factoring regulated service</td>
<td>• Choose your creditor (financiers – less flexible)</td>
</tr>
<tr>
<td>• Impedes competition for trade credit</td>
<td>• Competition Law Issue</td>
</tr>
<tr>
<td>• Impedes factoring (impossible or risky)</td>
<td></td>
</tr>
<tr>
<td>• Competition policy takes time</td>
<td></td>
</tr>
</tbody>
</table>
### NATIONAL LAWS

- **US** (UCC9)
- **Canada, AU** (PPSA)
- **Italy** (Factoring Law)
- **Serbia** (Factoring Law)
- **Latvia** (Comm. Code)
- **Romania** (Law 99/1999)
- **Croatia** (Draft Law)
- **Greece** (practice)
- **France** (CC Subrogation)
- **Austria** (CC - limited)

### INTERNATIONAL CONVENTIONS

- UN Convention on the Assignment of Receivables in International Trade (2001), Art 9
Basic elements

- Platform
  - Operator
  - Electronic transfers
- Agreements
  - Buyers
  - Factors
  - Suppliers
- Supply Chains
  - Suppliers grouped under big buyers
- Financing Chains
  - Interested factors grouped under big buyers (competition)
- Automatic offers
  - Offers created upon electronic confirmation of invoice under - pre generated terms
REVERSE FACTORING PLATFORM

Typical transaction

1 Day

- Supplier receive purchase order from Big buyer, due in 20 days
- Supplier, Big buyer and factor sign contract with organization who manage online platform (website)

10 Days

- Supplier makes a delivery to Big buyer and sends Invoice with 60 days due date. At the same time, Big buyer posts Invoice on website.
- Supplier uses website to confirm by one click his interest to charge that Invoice before due date.
- All factors in platform give their offers, and their offers are automatically appeared because they defined conditions for cooperation in advance.
- Supplier also by one click chooses factor and receives full amount of Invoice less interest at the same day.

30 Days

- Big buyer pays to factor full amount of Invoice which he received from supplier. He also can require from factor to extend deadline of payment for additional 60 days with appropriate interest rate.

90 Days
Developing Reverse Factoring - Challenges

<table>
<thead>
<tr>
<th>Factors do not want competition</th>
<th>Buyers want to do it themselves (earning margin)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Include state owned buyers (companies, funds, etc.) on the platform to attract factors</td>
<td>Channel SME support financing via platform (state, IFI, etc. - risk sharing, participations, subsidies, etc.)</td>
</tr>
<tr>
<td>Make prohibition on assignments ineffective</td>
<td>Promote benefits of platform</td>
</tr>
</tbody>
</table>
Example of Reverse Factoring Platform

- Nafin - Mexico’s development bank started platform in 2001
- Factoring market share from 2% in 2001 to 75% in 2010
- In 2009 - 700 big buyers (35% public and 65% private sector)
- In 2009 - 27,000 SMEs funded, amounting to US$15.9b
- Nafin generates revenues out of the interest that factors pay for their capital refinancing (subsidy – development bank)
- Out of revenues it covers all legal expenses and factoring fees
- Factors only charge interest
- Nafin is profitable and there are thoughts on state (subsidy) exit.
Apart from factoring, Financial Law Unit promotes:

<table>
<thead>
<tr>
<th>Secured transactions (modernisation)</th>
<th>Credit information systems (efficiency increase)</th>
<th>Grain warehouse receipts (systematization)</th>
<th>Crop receipts (introduction)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Flexible laws conductive to modern business transactions</td>
<td>Wide range of credit information collected (trade credit, utilities)</td>
<td>Increasing reliability (licencing, indemnity funds)</td>
<td>Pre-harvest financing</td>
</tr>
<tr>
<td>Electronic security interests registries</td>
<td>Wide Accessibility</td>
<td>Post harvest collateral</td>
<td>Future output as collateral</td>
</tr>
<tr>
<td></td>
<td>Transparent procedures</td>
<td>Trading</td>
<td>Monitoring and Priorities</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Efficient enforcement</td>
</tr>
</tbody>
</table>