

Factoring and Commercial Finance: An Introduction



The EUF is the Representative Body for the Factoring and Commercial Finance Industry in the EU. It comprises national and international industry associations that are active in the EU.

The EUF seeks to engage with Government and legislators to enhance the availability of finance to business, with a particular emphasis on the SME community. The EUF acts as a platform between the factoring and commercial finance industry and key legislative decision makers across Europe bringing together national experts to speak with one voice.

The EUF acts as a source of reference and expertise between the factoring and commercial finance industry and key legislative decision makers across Europe. Its aim is to provide legislators and policy makers with vital industry information to inform, influence and assist with the direction of existing and future finance legislation. It seeks to ensure the continued provision of prudent, well structured and reasonably priced finance to businesses across the EU.

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An Introduction to Factoring and Commercial Finance

Factoring Basics

Factoring is a long-established way of providing a range of business support services:

- Working Capital (Finance)
- Credit Assessment of customers/ buyers
- Sales Ledger Management and Collection
- Credit Cover

Across Europe, where it is well established, **the Industry represents 10% of GDP**; globally the figure is around 3.5% and rising. **That's €1.5 Trillion of client user turnover** in Europe, €2.4 Trillion in the world.

The Industry in Europe has grown from €845Bn in 2008 to its current level; this growth confirms the **important role played by the factoring industry in sustaining liquidity supply to businesses**, particularly through a period of financial crisis.

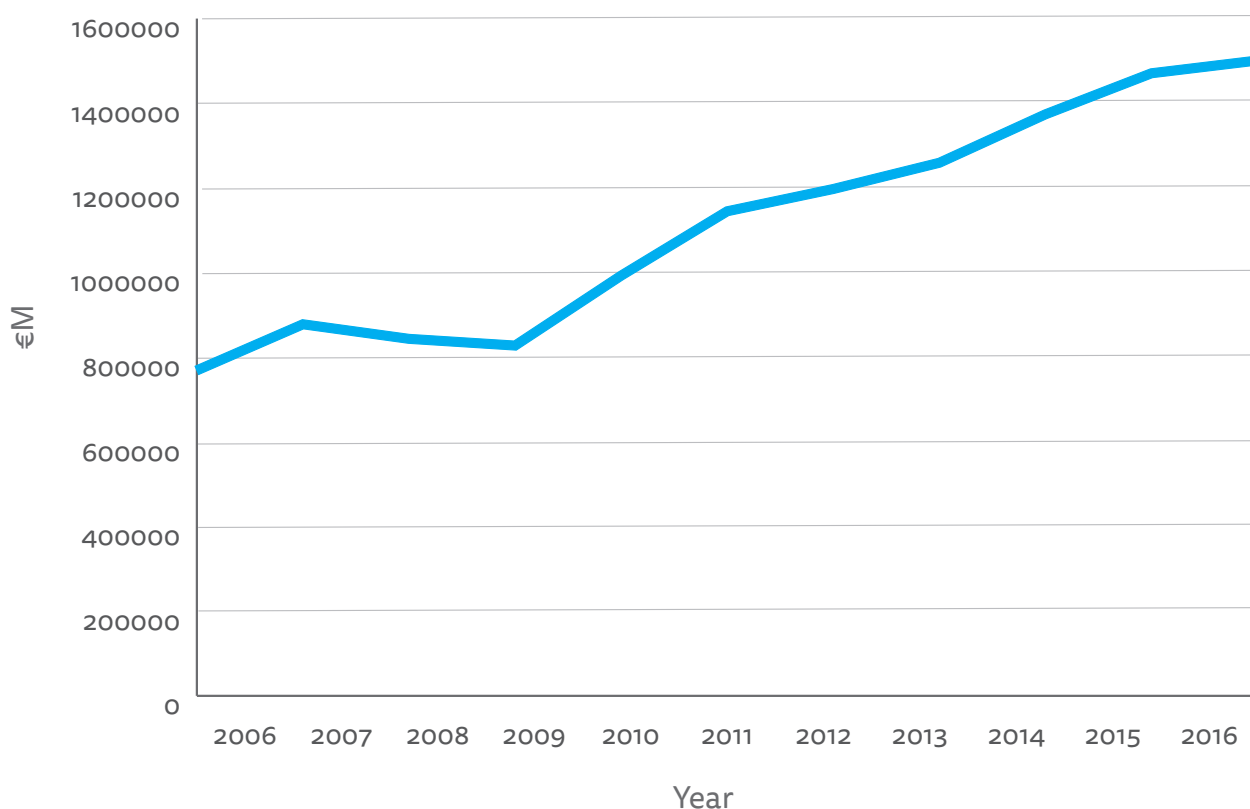
At the end of 2016, around 200 providers were **supporting 180,000 business users** and providing them **with €200Bn of funding**. Of these users, nearly **90% are Small and Medium sized Enterprises**.

Factoring can provide higher levels of finance to the user with fewer conditions than comparable traditional methods of funding. In other words, factoring helps EU Industry to enhance its financial competitiveness, an essential element in allowing it to thrive and compete in domestic, the single and in international markets.

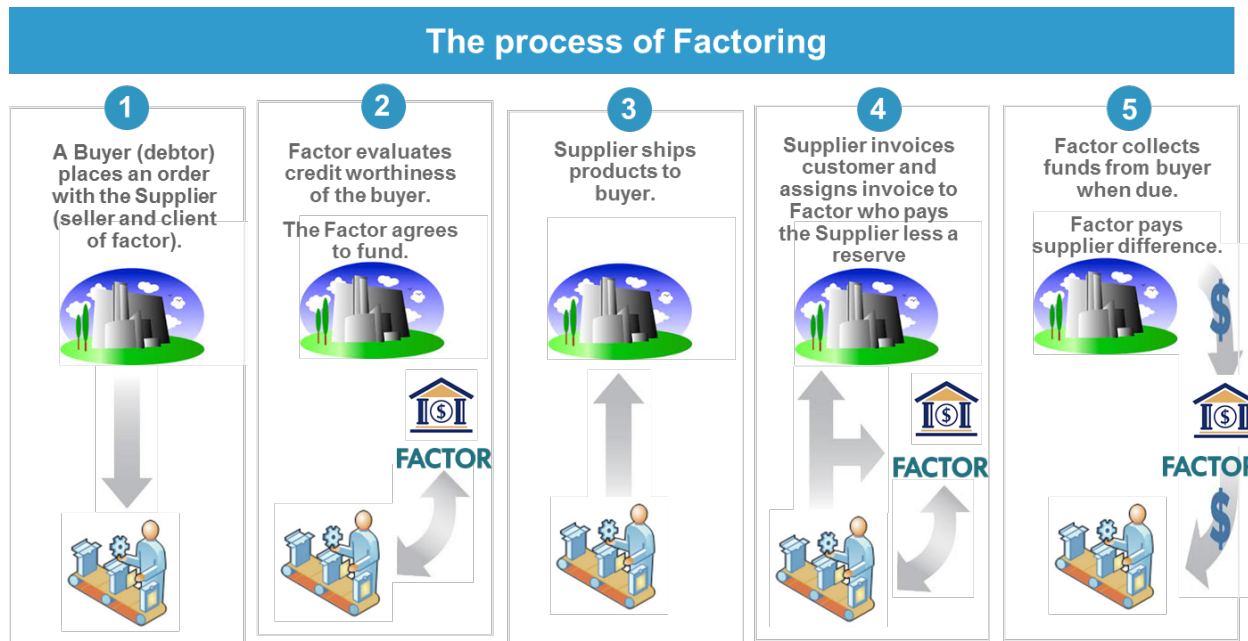
Not only that, **it also is a low loss given default solution**. The EUF's 2015 Whitepaper showed it to be **around four times safer** for the financial institution **than traditional lending**.

That's why the Industry calls it **win: win finance!**

EU Factoring Volume Growth 2006-2016



How does it work?



Suppliers (of goods and services) are the Factoring users who sell to their customers known as buyers or debtors

Source: FCI

Factoring and Commercial Finance companies (the Factors) work with client businesses to provide finance to enable them to trade. These Factors offer businesses (the Sellers) the funding they need to meet day-to-day business expenses, including payments to suppliers, salaries, rent and rates. This funding is known as “working capital”. The amount of funding that a factor can provide is contingent on the volume of sales the Seller generates; it may be sufficient to meet the needs of the Seller on its own or may be complementary to that raised from traditional sources.

Factoring and Commercial Finance is based on the idea of selling / assigning a business’s unpaid receivables (sales invoices) to the Factor for a payment equivalent to the value of the invoices less a fee for offering the service and a charge for the period the invoice is financed. This means that instead of having to wait 30 or 60 days, or even longer for payment from their customers (the Buyers), the Seller can have access to their funds usually within 24 hours and often sooner. The Factor will then collect the invoice payment from the Buyer and recover their advance.

The Factor can also offer additional services to the Seller. They will offer assessments of the creditworthiness of the Buyers that the Seller is selling to. This service will be available to the Seller both on existing and potential Buyers and is a constant review service, helping the Seller to make informed real time decisions about offering credit.

The Factor can include Sales Ledger Management and Collection services. These may be fully outsourced to the Factor or may be kept in house by the Seller depending on the product offered.

For an SME, the opportunity to outsource its collection activity and manage the ledgers can be a very valuable benefit. For larger companies with developed and dedicated accounts departments, the collection and ledger monitoring and management activity can more easily be kept in house.

The Factor can offer Credit Cover, a type of buyer default protection which can give the Seller greater confidence in selling in volume to its buyers, also in a cross border context. Because of economies of scale, the cost of such credit cover is usually much less via the Factor than it would be for the Seller to obtain on a stand-alone basis.

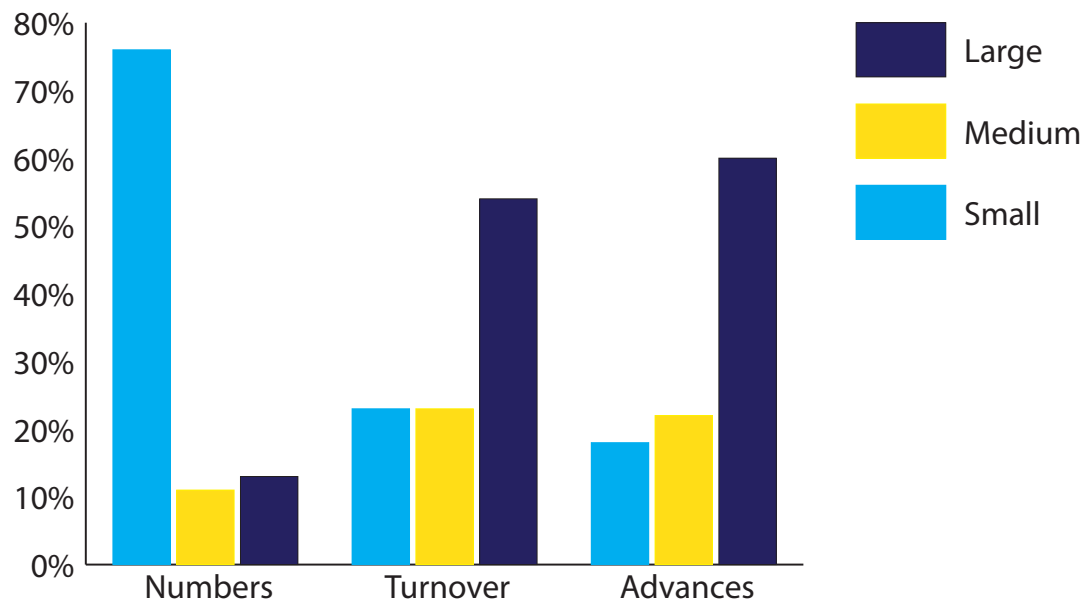
Which version of the factoring offer is used depends on the detailed circumstances of the Seller, its Buyers and the local market.

Regardless of the specific form factoring takes, it will always be a Secured and a Monitored form of financing. Secured because the Receivables are assigned to the Factor and payments from the buyers have to be made directly to the Factor, even in the case of the seller’s insolvency. Monitored, because the Factor will permanently follow up on the details of the receivables portfolio it is financing.

A win-win form of funding; financing economic growth while ensuring financial stability

Factoring and its variants have historically been used principally by SMEs and increasingly the benefits are being enjoyed by mid and large corporates. The EUF's research indicates that the user structure is as below; by number of users, SMEs completely dominate, but by funding utilisation (advances), large corporates are significantly the major party.

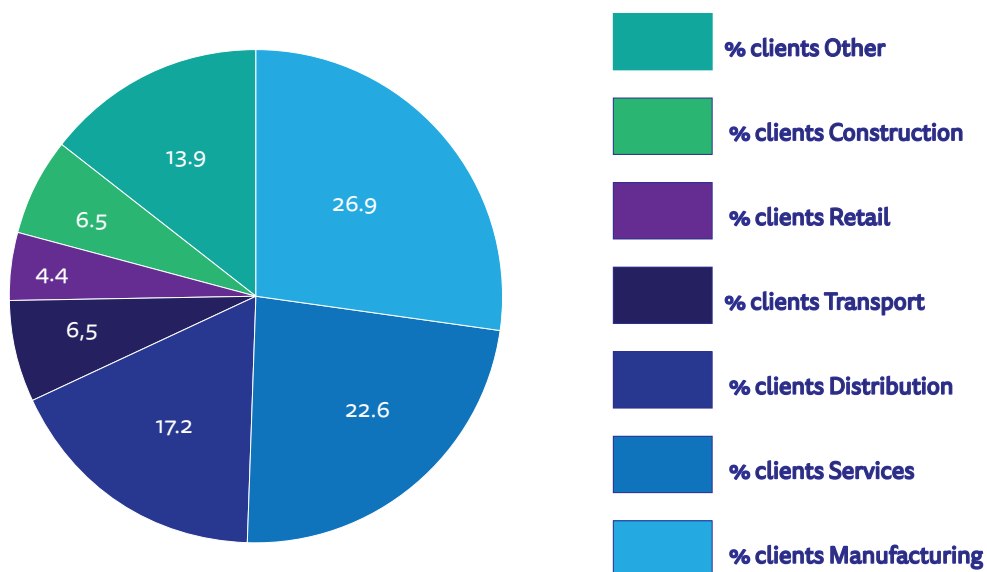
Comparison of Clients by Company Size



Source: EUF Whitepaper on Factoring 2015

The most popular sectors for users are key real economy sectors: Manufacturing, Services and Distribution, representing around two thirds of number and about three quarters of value.

Client Sector Distribution by % of Clients Numbers



Source: EUF Whitepaper on Factoring 2015

Factoring Benefits

For SMEs the benefits include:

- A source of working capital that doesn't require an established business or significant other assets, the level of funding available is directly proportional to the level of sales the business makes and the debt outstanding. This means that unlike traditional funding, the facility usage does not need to be renegotiated in times of growth.
- The opportunity to outsource the labour intensive administrative functions outsourcing of collection and sales ledger management.
- The opportunity to separate sales relationships from collection activities
- A form of funding that usually provides a higher level of finance than traditional lending and does not usually require extra security or collateral
- The opportunity to protect against bad debt.

For large corporates and multinationals:

- The same finance and outsourcing benefits as for SMES are enjoyed.
- For large businesses, the finance is generally offered with fewer operating and performance conditions (covenants) compared to other forms of funding. It also gives the opportunity to link to more extensive Asset Based Lending, where other assets of the business are also included and contribute to the finance package.
- Not based on Balance Sheet strength, but on current performance.
- It can raise more working capital than traditional lending approaches.
- In some environments, it can be used to improve the Return on Asset/ Equity Ratios (ROA/E)
- The opportunity to protect against bad debt.
- It can help support Restructuring, Merger and Acquisition activity.

For Factoring and Commercial Finance Providers:

- Factoring solutions allow the Factor to advance relatively more funds, more securely than a traditional lending product.
- Factoring and Invoice Finance is a low loss given default solution; this improves returns, supports competitive pricing and can reduce the Factor's cost of capital.
- The EU Federation's White Paper shows that the losses are around four times lower than traditional financing loan products.

All stakeholders benefit from the unique characteristics of this solution.

A stability focused financing tool

Because of its secured and monitored status, Factoring is a very stable low loss given default financing solution, which makes it an important offering in the funding of the real economy in both growth and recessionary periods of the economic cycle.

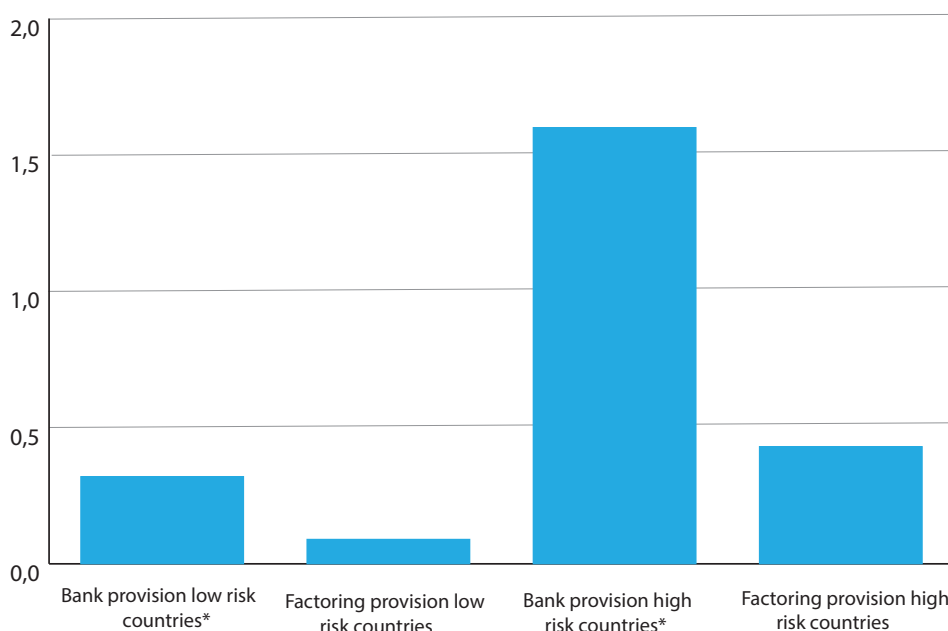
The EUF's 2015 Whitepaper undertook large scale analysis of the European factoring market and compared the loss provisioning performance with that of the traditional lending industry as recorded by the ECB.

In both the stronger and weaker EU countries, factoring consistently performed better, with the performance being around four times better than other forms of working capital funding.

Loss rates in factoring in 2014 averaged 0.26% of advances with a median 0.09%; loss rates in comparable bank lending in 2013 were 0.96%.

The proportion of Industry client turnover provided for was 0.042%. To put this in context, the distance between Brussels and Strasbourg is approximately 350Km. If one imagines the Industry turnover spread out over this distance, the losses represent 150m.

Provision % rates in 2014



Source: EUF Whitepaper on Factoring 2015

*<https://www.ecb.europa.eu/pub/pdf/other/financialstabilityreview201511.en.pdf?24cc5509b94b997f161b841fa57d5eca>
page 70, chart 3.6 SNL Financial

To get more detail

Who can use factoring? Who offers the service?

Factoring and Commercial Finance can be an ideal source of working capital funding.

It is typically used by SMEs but in many markets increasingly it is now being utilised by mid and large corporate sellers (often in the form of invoice discounting and Asset Based Lending).

The potential range of users is very large and in many markets, there is significant opportunity for this kind of funding to grow in scale.

Across Europe, where it is well established, the Industry represents 10% of GDP; globally the figure is around 3.5% and rising. That's €1.5 Trillion turnover in Europe, €2.4 Trillion in the world!

This does not mean that this form of finance is suitable for all businesses; for it to work well, the business must generally have some important characteristics:

- The seller offers goods or services that are straightforward and easily measurable; for example, 100 boxes of printing paper or 40 hours of someone's time. Businesses which offer goods or services where completion and satisfaction are harder to define, or which are invoiced in stages, involve complex contracts or need third party involvement for completion are more difficult to support because of the increased risk of disputes; most Factors will not offer finance in these circumstances.
- The seller operates on open account terms; that is, the sales invoice is expected to be paid after an agreed period of credit, say 30 or 60 days. Invoices that are paid in advance or on delivery are not suitable for finance. In most markets, invoices that are payable after very long periods of credit, usually >90 days (after due date of the receivable) are not funded.

Most Factors will only finance business to business transactions.

Most providers offer full turnover agreements which fund all existing and future receivables, although some offer selective partial funding against particular buyers.

European Providers of Factoring are primarily Banks (40%) or specialized factoring subsidiaries of banks (40%) or independent commercial providers (20%).

How does it work?

In most markets, Factoring is effected through the selling of invoices using a process known as assignment. This legal process transfers the ownership of the sales invoices from the Seller to the Factor.

In this way, Factoring is different from a traditional loan where monies are passed on the basis that they may be secured against an asset which remains the property of the borrower. Here the invoices become the property of the Factor, who transfers money to the seller. The Factor is then economically free to dispose of (for example re-sell) the receivables assigned to him.

It is often the case that the buyer must be advised of the assignment for the process to be effective. So the invoice (physical or electronic) will normally carry a notice of assignment to advise the buyer that it has been sold to the Factor and payment must be made to it, not to the seller. The Factor may from time to time also send letters and statements which remind of the buyer of this transfer of ownership.

In most factoring arrangements, once the invoices have been assigned (and in some case checked or verified to confirm their validity) the Factor will normally immediately make available a proportion of the invoice value to the Seller. This proportion varies depending on the agreement and is typically

between 80 and 90% of the face value of the invoices accepted for funding.

If invoices are assigned which fall outside pre-agreed conditions or limits, (for example if debtor limits are exceeded or the concentration of debt in a particular buyer goes beyond an agreed percentage) it is possible that they will not be financed immediately but will be subject to further investigation or discussion.

The Factor will want to maximize the level of funding available to the Seller, and the seller will want to ensure there are no restrictions on their cash flow from the facility.

Because of these imperatives, both parties will work together in advance of assignment to ensure that any potential barriers to immediate funding are removed.

Any new business for the Seller can be referred to the Factor who can undertake a credit reference check on a buyer to assess its financial strength and to set an appropriate funding limit. If credit protection is included as part of the factoring agreement, a cover limit can also be set.

As a process for Risk Control, the Factor will regularly contact buyers to confirm that the debt represented by the invoice is good and due for payment after the agreed period of credit.

The Factor may use a combination of methods to contact the buyers including telephone, e-mail, letters and ledger statements. This collection process and its timing will usually be agreed in detail with the seller.

When the buyer pays the Factor, the payment will be allocated to the seller's account and the appropriate sales ledger management accounting entries made. The Factor will make available to the seller the balance of the invoice value (remember that the seller has already received 80-90% of its value) less its service fees and the discount charge.

It's perhaps easy to see how this works for a single invoice but of course in the real world there will be a constant stream of new invoices, payments to the seller, receipts from the buyers and the reality is more complex. However, the principle always remains the same.

As new invoices are assigned and payments are made to the seller, the total balance of the advances account increases. As payments are received in from buyers, the total balance reduces. On a day to day basis, the effect is to create a facility that rises and falls according to the total value of invoices outstanding, the payments made and received.

In this sense, the advances account is a little analogous to an overdraft; as payments are made out, the balance increases, as payments are received, the balance reduces. But the clear difference from the bank overdraft is that these are purchase payments for the invoices and not a loan against them.

Main Product Types

“Recourse” Factoring

By volume, Recourse Factoring is the most widespread and common form of domestic factoring available.

The Factor will purchase the invoices of the Seller, provide funds to the Seller against approved debts receivables and collect money from the Buyers as the debts fall due. The Factor assumes responsibility for the maintenance of the sales ledger by:

- chasing debtors
- sending regular statements of account
- allocating payments received against outstanding balances
- regularly reporting the movements on the sales ledger to their clients

With expertise in receivables management, the Factor can provide an extremely valuable service not available with the traditional bank overdraft. However, a Factor is not a debt collection agent, although many will have the ability to employ debt collectors if required. (The difference is that a debt collector is employed to collect a defaulted or impaired debt, the Factor manages live and good debts.)

Factoring arrangements are usually operated on a disclosed basis, so the Seller's buyers are aware of the Factor's involvement. A notice is placed on the Seller's sales invoice instructing customers to make payment directly to the Factor. This is usually referred to as the Notice of Assignment.

Recourse factoring involves making a prepayment to the Seller at an agreed percentage (the prepayment percentage) for a pre-determined period. 'Recourse' means that while the Factor is the legal owner (and has the economic right to dispose of the receivable) he can re-sell the receivable back to the Seller. Accordingly, the Seller might consequently still be at risk should its customer become insolvent or cease to trade. It also means that the debt is funded for a pre-determined period, typically 90 days after due date of the receivable. If the invoice has not been paid at the end of this period, any prepayment may be withdrawn and repayment may be required from the Seller. This is typically deducted from the prepayment created by more recent invoicing or from Buyer payments received.

Sellers remain responsible for undertaking their own credit research and they choose which Buyers they will give credit terms to (and to what level) but this will typically be done with the advice and support of the Factor who will generally have access to credit information and can advise accordingly.

The Seller is also responsible to ensure that the invoice is payable in full; in the event of a dispute it will be liable to repay the factor the purchase price that has been received in advance.

In some “Recourse Factoring” Contracts, the Seller may have a Credit Insurance policy in place that protects against bad debts. In this situation, the benefit of the policy is then assigned to the Factor (who owns the insured receivables) who will use the credit insurance policy for its own risk monitoring. In this case the With Recourse Factoring + credit insurance mechanism is very similar for the Seller as the Non-recourse Factoring mechanism.

“Non-Recourse” Factoring

Non-recourse factoring operates in most senses like recourse factoring and offers the same services. In addition, the Factor accepts the financial credit risk of the Seller's buyers failing and takes responsibility for any bad debts up to individually agreed limits. Funding is therefore not withdrawn after a specific period.

Each Buyer is carefully researched by the Factor and a specific 'debtor limit' applied. Subject to confirmation, the Factor will class invoices up to this limit as 'approved' and any trading in excess of the limit is usually at the Seller's risk. All invoices within the agreed debtor limit are subject to bad debt protection, which means that any bad debt loss is absorbed by the Factor rather than the Seller.

The credit cover only relates to credit default non-payment and not to disputes or refusal to pay for other reasons. Just as with Recourse factoring, in the event of a non-credit default, the Seller is required to repurchase the invoice from the Factor.

For this reason, some people prefer to describe the product as factoring with credit protection.

Invoice Discounting (or undisclosed Factoring)

Invoice Discounting is a form of invoice finance that dominates the UK market and is established (and growing) to varying degrees in many other countries.

Invoice discounting is usually a non-disclosed facility, i.e. unlike factoring, the Buyers are not aware of the Factors involvement.

A Factor will purchase the sales ledger and provide funds to the Seller against approved debts but will not undertake the collection of the debt, which remains the responsibility of the Seller.

All Buyer monies are directed to a joint trust or nominated account and the Seller will deposit any/all buyer payments received into that account, and it has no rights to withdraw funds. The Factor will usually transfer those funds to their own account at the close of business each day.

Historically, most invoice discounting facilities were managed on a bulk basis where account level totals rather than each individual invoice were entered onto the Factor's system. However, improved technology now means that while the Factor will still finance at an account level, invoice level data can be transferred and retained where the Seller accounting software is compatible.

Routine month end reconciliations and regular audits of the Seller are usually applied. If the facility operates on a recourse basis, then third party bad debt cover can be sourced and assigned to the invoice financier if required.

Invoice Discounting is not available in all markets as some jurisdictions may not allow invoice finance where the assignment of each invoice is not notified to the Buyer and some legal systems do not allow nominated bank accounts which are in the name of the Seller but owned and controlled by the Factor.

Other Product variants

There are many more variations on the delivery of Factoring and Invoice Finance but the above three methods represent around 95% of the total global market. In this introduction, we therefore will not cover the other types in detail but simply mention other versions which include:

- Reverse Factoring – where funding is offered to all the suppliers of a single buyer. This is sometimes known as Approved Payables Finance and is important in some markets, especially Spain.
- Maturity Factoring – Where funding generally is made available once the invoice is due for payment. This variant is found in e.g. Italy.

How Risks are managed in Factoring?

Factoring is a low loss given default financing solution as evidenced in the EUF's Whitepaper, which identified loss rates of around 26 basis points compared to 96 basis points for traditional lending products across Europe in 2014. But despite this impressive safety record, Factoring is not without its risk and it is the result of many years of collective learning, knowledge, experience and skill that has led it to today's position.

The types of risk may be categorized into two main classes; those which relate principally to the client, and those which principally arise from the debtor.

Client Risk

In respect of clients, the financial risk for the factor is that it will make advances that it cannot recover. This situation might arise if the factor provides funds against invoices which for any reason either are or become uncollectable, or if the client seller diverts funds which are due from the buyer debtors to the Factor.

- Invoices may become uncollectable if there is an issue that leads to genuine dispute and non-payment; for example, there is a mismatch in quantity, quality or nature of goods or services supplied compared to those invoiced, or goods and services prove in practice to be sub-standard or faulty.
- The client seller may raise invoices fraudulently, creating paperwork for incomplete or imaginary "fresh air" goods and services; this may be done with or without active collusion from the buyer debtor. If the Factor advances funds against such invoices in these circumstances, then these will prove to be uncollectable.
- The client might advise debtors that payment is due directly to them and not to the factoring company, meaning that they effectively receive double payment for the invoice.

The factor will protect itself through a range of sophisticated risk assessment and control mechanisms which may include initial underwriting techniques, ongoing monitor and control, client audits, automated and manual verification of invoices and accounts as well as trend monitoring and client industry competitor comparisons.

Debtor Risk

A principal risk for the seller and the factor is the creditworthiness of the client's buyers which reflects their ability to pay. The factor will use a range of methods to assess the creditworthiness by using a selection of indicators; these will include information from professional credit reference agencies, filed and management accounting information, statutory reporting (where information is held on centralized government registers) as well as analysis of payment performance and past operational experience.

Based upon this array of information, it will set a debtor limit which it considers appropriate to the level of credit risk. In a non-recourse environment, this will generally represent the maximum level of funding that will be available to the seller. This position can be secured by providing credit cover, which may protect the seller (and the factor) against such credit default loss in the event of debtor failure. If the client requires funding at a higher level than the debtor limit, the factor may consider providing this on a non-covered basis.

In a recourse environment, where there are other compensating features (for example if the debt is a very small percentage of the outstanding ledger) the funding may also be set at a higher level at the discretion of the factor.

Debtor limits will be reviewed on a regular basis to ensure they reflect the current level of risk.

The factor will also ensure that the level of funding in any one particular debtor is controlled so that it does not represent too high a proportion of the overall debt outstanding. In this way, by limiting the concentration risk, it can ensure that in the event of an individual debtor failing, the loss damage is recoverable and not fatal to the security of either party.

This active management, monitoring and control is typical of a factoring facility and clearly differentiates the solution from a traditional lending environment where decisions are based on historic performance strength and operational forecasts, and it also explains its far superior provision performance.

Accounting & Reporting for Factoring

The general historical approach to identifying factoring transactions on the Balance Sheet of the Factor has followed the logic of the transfer of ownership through assignment and the purchase of the invoices.

The assigned purchased invoices are therefore shown in full value as an element of the current assets of the Factoring Company. The residual amounts owed to the clients, that is, the balance of purchase price not paid in advance to the clients, is shown as a short-term liability which will be expunged when the debtors pay the Factor, who will then make those residual balances available to the clients.

This traditional model is widespread but is subject to variation in form, notably under IFRS principles which make an artificial distinction between recourse and non-recourse treatments.

Whatever the accounting requirements – and these tend to be decided upon by the factoring companies, their accountants and the custom and practice in a particular jurisdiction – the Factor is likely to have a set of reporting procedures that will characterise the client and debtor portfolios.

The Factor will use technology to identify trends and events at micro and macro level; assignment levels and days outstanding calculations by client sector and portfolio is a common example.

At a client level the Factor may monitor assignment levels, debtor concentration, dilution (the reduction in collectable debt caused by e.g. disputes or deductions), credit note levels, cash collection performance, average client life and profitability.

At a debtor level, the factor may monitor remitter creditworthiness and payment performance.

At a company portfolio level, the factor will monitor its overall volumes, collections, profitability and provisions for bad and doubtful debt. It will assess the credit risk of the portfolio and those Factors that operate within a Basel compliant environment and which operate advanced internal ratings approach will categorise risk and monitor PD, EAD and LGD figures.

The Factor will use a sophisticated array of technology tools and experiential knowledge to manage its portfolio and the range of risks inherent in providing this type of working capital finance; successful delivery requires particular understanding, awareness and sensitivity to the dynamics of receivables finance. In this way, Factoring is therefore not just another finance product but a technique that provides a win-win for both user and provider; higher and safer levels of funding for real world business, more secure and sustainable operations for the provider.

The factor will also ensure that the level of funding in any one particular debtor is controlled so that it does not represent too high a proportion of the overall debt outstanding. In this way, by limiting the concentration risk, it can ensure that in the event of an individual debtor failing, the loss damage is recoverable and not fatal to the security of either party.

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Glossary

The author has made every effort where possible to use plain English and to explain any technical terms as they arise.

Further definition, analysis and translation of terms relating to factoring into a range of languages may be found at the EUF's website:

<http://euf.eu.com/glossary-and-translator.html>

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