PETER MULROY
Secretary General

A WORD FROM THE SECRETARY GENERAL

A few weeks ago, FCI organized its first-ever Virtual Annual Meeting on the 23rd of September. The online conference was attended by over 400 participants, representing 73 countries. The meeting kicked off with an update from the FCI Chairman, Patrick de Villepin, followed by a report by the chief economist from Atradius, and including the Year in Review, technical committee reports, and regional updates, including a report from the EUF Chairman, Francoise Palle-Guillabert. 2020 revised and 2021 annual budgets were approved, along with the 2019 FCI audited BDO annual report. A recording of the event can be downloaded by going to https://vimeo.com/461847273.

As you know, the 5-year strategic plan was postponed, to be rolled out in 2021 due to the pandemic. Since this milestone event, we are in the midst of a second wave in many parts of the world. Hence, outcomes today are harder to predict, but we are optimistic about the new year with the coming vaccines!

The impact of the crisis

As we are about to enter 2021, I wanted to reflect on some of the current challenges facing our industry, our members, and our clients. I have spoken with many of you and have heard of the industry's tremendous stress stemming from reduced demand and increased risk, resulting in a reduction in trade credit and hence access to finance for SMEs. I had reported in the last Insight that the industry had shown a decline in factoring volume for the first half of 2020 of approximately -6% in Europe, -10% in the Americas, and a – 10% in Asia. As reported by the China Banking Association (CBA), China showed a decline of -11% in the 1H2020, with domestic volume down by -4% but international down by -46%. FCI's cross-border two-factor business was down by 25% in transaction volume for the first half of 2020 as well. Hence, based on both trends, I anticipate international factoring business has experienced a far greater decline overall in the first half of 2020, anywhere between -35-45% globally. I did hear that although some large reverse factoring programs were reduced or eliminated due to bankruptcies, fraud cases, and financial conditions, some of our largest group members experienced an increase in reverse factoring business in the 1H2020. But besides this outlier, most business in our industry is down. Although business volume improved in the 3rd quarter across the board, the public lockdowns resulting from the second wave in the 4th quarter will harm the business overall. This period is normally the busiest quarter of the calendar year for the factoring sector.

I ANTICIPATE INTERNATIONAL FACTORING BUSINESS HAS EXPERIENCED A FAR GREATER DECLINE OVERALL IN THE FIRST HALF OF 2020, ANYWHERE BETWEEN -35-45% GLOBALLY

Besides the impact COVID-19 has had on business, there are some other challenges that the factoring industry is facing. As the EU accounts for over 60% of global volume, Europe truly impacts the factoring sector globally. In the previous Insight, I had mentioned that the creation of credit insurance shields in Europe helped support, at least temporarily, through this worst of this crisis, the factoring community and ultimately SMEs in Europe. The continuous flow of trade credit insured lines supported by these large shields helped ease the pain for companies who use the credit backed receivables to obtain liquidity from the factoring market. Even if these programs have limited effect, as their support will only last through the lockdown period or until the end of the year, we can acknowledge that these important players' reductions and cancellations of credit limits have remained acceptable until now. However, that same sentiment is not shared in North America and elsewhere, where no investments in such shields have been achieved. That is why FCI joined forces with the largest credit insurers Atradius, Coface, Euler-Hermes, and ICISA, the global credit insurance association based in the Netherlands, to advocate and lobby the US government/US Treasury to create a similar credit insurance shield. As this took place during a presidential election year, the reality is there will be little done. However, we at least shared with them the success stories that their European counterparts achieved.

New Definition of Default

THE NDOD, AS IT'S CURRENTLY WRITTEN, WILL RESULT IN A SIGNIFICANT ADVERSE IMPACT ON THE FACTORING INDUSTRY

However, it wasn't all sunshine and roses in the EU. The launch of the New Definition of Default (NDOD) has sewed great concerns across the factoring sector. The NDOD was introduced to the European Parliament in 2016 and is regulated by the European Banking Authority (EBA), which is expected to go into effect on the 1st of January 2021. The EUF together with FCI have been in discussion with the EBA for the past few years on this topic, as it represents a great example of the unintended consequences when regulations impacting the banking sector are affected, especially when regulators do not take into account the special nuances and unique characteristics of what factoring is all about. The NDOD, as it's currently written, will result in a significant adverse impact on the Factoring Industry. In some markets, this will increase provisions and potential losses when, in fact, the likelihood of factoring leads to default is very remote. We believe the issue stems from a lack of understanding of what factoring is at the government level.

The underlying issue stems from the legal differences between factoring and commercial loans. Trade receivables under a non-recourse factoring transaction must be differentiated from commercial loans. A loan is a legally binding agreement that a borrower undertakes and commits to make repayment at a particular date in the future. In the loan agreement, there are typically no conditions stipulated that would impact the loan's repayment. On the other hand, factoring, as we all know, is an agreement between the Factor (the assignee) and its client (the supplier/assignor) to assign or purchase a non-financial trade receivable normally on a non-recourse basis in lieu of disbursement of cash to the supplier. The client's debtor (the underlying buyer/customer and the ultimate obligor, who is in charge of paying the invoice) generally does not enter into any contractual relationship with the Factor. Hence, these trade receivables' collectability is instead subject to contractual clauses setting conditions for payment (just the opposite as compared to a traditional loan). The due date of an invoice cannot be considered as fully mandatory for the obligor to make payment as in the supply contract there are usually some commercial clauses (terms of delivery, service level conditions, certain compliance standards in terms of the goods or services provided, etc.) that limit the possibility to enforce payment of the invoice even if the due date has expired.

As a consequence, payment by the buyer is always subject to operational procedures as well as procurement conditions that can cause delays compared to the due date of the obligation. Hence, it is impossible to create regulations to define definitions of default against commercial transactions when so many variables haven't been taken into consideration! In other words, the application of factoring and specifically trade-based receivables against loan-based principles as the EBA has done unfortunately just not well thought out.

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As a result, we had organized a meeting with the new Executive Director and his staff from the EBA last week. We emphasized that the NDOD will result in a significant increase in provisions and losses when, in fact, the likelihood of factoring leads to default is remote. To automatically identify the buyers' default based on the due date of invoices is misleading at best and ultimately creates unreasonably high levels of default exposures, which are inconsistent with the obligor's true financial condition. We have asked for a derogation against the rules as they apply to the factoring industry or at a minimum and following the example of the Basel Committee, which postponed by two years the implementation of Basel III due to the crisis, to defer implementation for at least the next 24 months of the date of application of the new materiality threshold and the guidelines on the definition of default.

WE HAD ORGANIZED A MEETING WITH THE NEW EXECUTIVE DIRECTOR FROM THE EBA. WE EMPHASIZED THAT THE NDOD WILL RESULT IN A SIGNIFICANT INCREASE IN PROVISIONS AND LOSSES

SCF: Reverse Factoring/Payables Finance

The other important topic of discussion has been the rise in very critical media reports on the state of the reverse factoring industry. When used appropriately, reverse factoring enables buyers and suppliers to optimize their working capital and strengthen their relationships with each other. However, reports relating to the misuse of payables finance, notably around suppliers being forced into accepting unfavorable terms (also referred to as "bullying" by the media), are extremely worrying. With Abengoa and Carillion's bankruptcies, which spotlighted the poor accounting practices related to the lack of financial disclosure of such programs, additional scrutiny has been targeted against the industry. And the extension of trade terms for the buyer to improve their cash conversion cycle, which adversely impacted SMEs' financial well-being (stemming from aggressive tactics used by larger Corporate Buyers to convent suppliers into these programs), damaged the reputation of the industry. We have all seen numerous articles over the past year (including some from Fitch and Moodys), which have negatively portrayed the industry's practices. And finally, with the decision by the IFRS and FATF, two of the leading accounting standards boards globally are contemplating to consider changes concerning how issues like reporting/transparency by corporate buyers should be conducted and how payables on the balance sheet of the buyer should be treated from an accounting perspective, whether as trade payables or actual debt. As a result of these issues, FCI together with the Global Supply Chain Finance Forum (GSCFF) has helped lead the discussion on how this rhetoric has hurt the industry, and a campaign was waged to help bring awareness and understanding to the industry to the public, focusing on four primary themes:

FCI TOGETHER WITH THE GSCFF HAS HELPED LEAD THE DISCUSSION ON HOW THIS RHETORIC HAS HURT THE INDUSTRY, AND A CAMPAIGN WAS WAGED TO HELP BRING AWARENESS AND UNDERSTANDING TO THE INDUSTRY TO THE PUBLIC

- Regarding the extension of trade terms when implementing such contracts, the industry agrees that SMEs should never be "bullied" to join such programs. Reports of such practices are highly concerning. However, they ignore the positive attributes that can be achieved through well-structured reverse factoring programs, which help buyers and therefore assure the health of the overall supply chain and provide prompt access to suppliers on an affordable basis addressing the systemic SME cashflow challenge.

- Suppliers should feel that there is absolutely no obligation to participate in such programs. If they are not in urgent need of cash, they can opt to receive payment in full on the original due date. The report strongly encourages finance providers to follow accepted industry practice in considering extensions of terms.
- Liabilities rising from SCF programs do not create additional financial risk above and beyond those that arise from trade between a buyer and a seller. Negative outcomes can be avoided by implementing a strong credit analysis of a corporate balance sheet before engaging in an SCF program.
- Transparency of financial reporting relating to the usage of reverse factoring is desirable but requires developing parameters for disclosure incorporates financial statements in coordination with accounting standards bodies.

We are hearing that the accounting boards will first deal with this issue of transparency, with some initial commentary about this coming out of their most recent meeting. It seems the topic of accounting treatment will not be dealt with at this stage and potentially considered in the future.

Conclusion

As the new year approaches, FCI will launch a new series of events, referred to as Virtual Regional Networking E-vents. The concept is to organize a two-hour webinar to update the members on the industry's most impactful issues today. This will follow a networking event, whereby members in each region will showcase their company to the entire membership. So members will set up a short, 15-minute meeting with those members from that particular region. Members in each region will be able to have the time and spotlight to showcase their business and get to know their counterparts better. We plan to launch them over the next six months:

- Europe: 26-27 January
- Asia: 2-3 March
- Africa & Middle East: 23-24 March
- Americas: 20-21 April

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As 2020 has been such a challenge on the industry as a whole, we are delighted to share the news with you that FCI received the "Financial Innovation Award 2020: Best Trade Finance Innovator Global" by CFI, a global publishing house focused on trade and global development. You can find the link here: https://fci.nl/en/news/press-release-fci-best-trade-finance-innovator-global-2020.

We hope other good news will follow, like the successful roll-out of the vaccine, which will certainly provide a significant boost to the correspondent relationships globally, increase new business opportunities between members, and ultimately a rise in cross border factoring volumes in the years to come.