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FACTORING AND REVERSE FACTORING REFORMS IN THE EBRD REGION

Cash is vital for businesses – to pay staff wages, purchase stock and raw materials, and meet tax obligations and other operating costs. Securing the amount of working capital needed to finance regular business cycles is one of the most critical issues facing businesses today across the world. Statistics on payment delays and bankruptcies, compiled in the Organisation for Economic Co-operation and Development (OECD) Scoreboard,[1] show that companies have difficulties maintaining cash flows because of the stalled recovery and tightening of credit markets, which is reflected in the decline in small and medium-sized enterprise (SME) loans and the increase in interest rates and collateral requirements.

“On the demand side, SMEs are the main target group for factoring and reverse factoring.”

The European Union’s review on SME performance[2] concluded that banks now require substantial guarantees as they must comply with a number of new regulations, such as Basel III. SMEs find it difficult to provide required guarantees as they rarely have assets available for collateralisation (long-term assets have often been leased or are already encumbered by a previous bank loan).

In addition, SME suppliers are usually required to offer trade credit to their large buyers and to hold accounts receivable on their balance sheets, which increases their working capital funding problems as they typically lack available cash. Factoring, as a financial service based on the sale of accounts receivable, is a useful financing tool because it allows for quick access to working capital for SMEs, off the balance sheet (in certain cases), and usually at a better rate than a short-term unsecured loan because it is priced against the often better credit standing of SME customers than that of the SME.

Despite having been used for decades, factoring is experiencing a marked revival in the current economic context, boosted by the development of more sophisticated legal and technical solutions.

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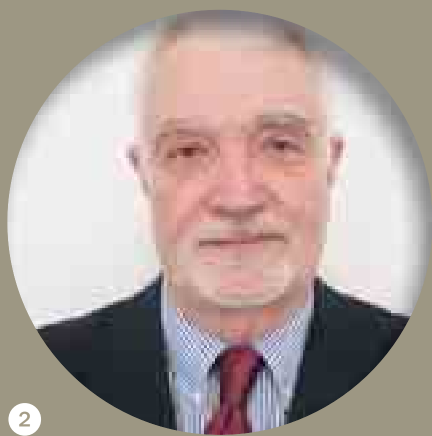

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The EBRD has been involved in the promotion of factoring services for businesses through its Trade Facilitation Programme for some time and the Financial Institutions Team has also been investing in the development of factoring businesses. With the development of factoring operations in the EBRD region, it has become increasingly clear that the suboptimal legal and regulatory environment limits the development of factoring, which in turn undermines the Bank's efforts in promoting factoring.

While the assignment of accounts receivable – the core of factoring from a legal perspective – is legally possible in countries where the EBRD works, the legal provisions of general laws (civil codes, obligations acts, and so on) are not always tailored to the needs of factoring services. This can increase factoring transaction risks (for example, courts redefining recourse factoring transactions as secured lending, which limits the rights of the factor if the client goes bankrupt) or limit the scope of factoring transactions (for example, no validity of assignment of future claims).

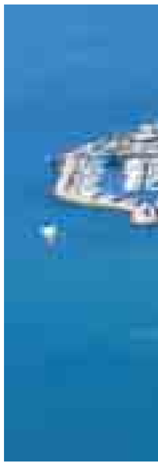
As a result, the EBRD Legal Transition Team set up the Factoring Legal Development Programme, which supports legislative reforms in order to create a more enabling legal framework for factoring activities. Work on the legal framework consists of introducing concise rules to encourage the development of factoring services by raising the legal certainty of factoring transactions. In broad terms, the legal framework should: (i) define the factoring (framework) agreement as a contract of its own kind; (ii) provide clear definitions of the different types of factoring; (iii) allow for simple and clear assignments of present and future accounts receivable; and (iv) ensure the legality of factoring by electronic means. The tax treatment of factoring activities should also be conducive to the business.

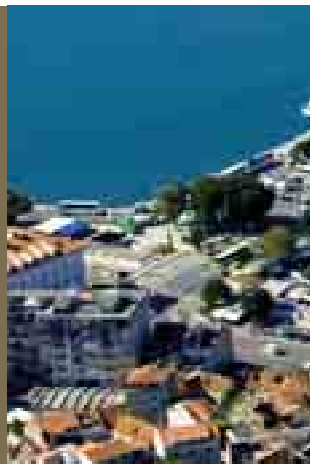
The Factoring Legal Development Programme targets countries where the Bank has already invested, where expansion of activities is planned in the near future or where the EBRD's comparative advantage in leading the work would be best leveraged by future investments in the sector. In this article we will demonstrate how the Bank's efforts through technical assistance resulted in the enactment of a factoring law in Croatia and we will present the results of a feasibility study in establishing a reverse factoring programme in Serbia.

LEGISLATION REFORM ON FACTORING IN CROATIA

With the development of factoring companies in Croatia, certain legal issues have become more prominent and have required special legislative attention in order to increase efficiency and decrease the legal uncertainty of factoring. The purpose of introducing the new law was to facilitate the further development of factoring services by creating a sound, clear and predictable legal framework tackling the abovementioned issues and introducing meaningful oversight that guarantees the stability and legitimacy of the industry (that is, ensuring that the market players are well-established commercial entities capable of meeting certain regulatory requirements).

Some of the essential features of the law include: (i) the definition of a factoring (framework) agreement as a contract of its own kind; (ii) clear definitions of the different types of factoring services, including recourse and non-recourse factoring, as well as a definition of the supply (reverse) factoring agreement; (iii) facilitation of simple and clear assignments of future and/or multiple accounts receivable; (iv) recognition of the nature of factoring as a sale transaction; (v) legality of factoring by electronic means; (vi) licensing and minimum initial capital requirement of not less than 1 million kuna (€150,000 equivalent) paid in cash in full prior to formation; (vii) no capital adequacy requirements (respecting the systemic low-risk nature of factoring); and (viii) clear rules and procedures for supervision (authority, reporting measures, and so on).





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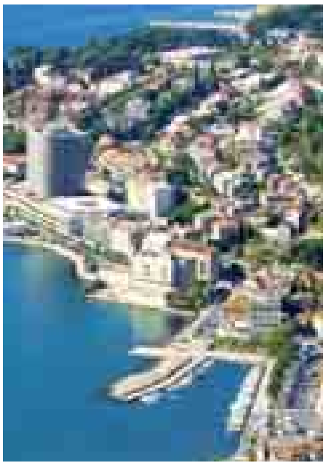


In "ordinary (classic) factoring", the SME sells individual accounts or its complete portfolio of receivables from multiple buyers to a single factor. Many factors will only purchase complete portfolios of receivables in order to diversify their risk to any one seller. However, this diversified portfolio approach requires factors to collect credit information and calculate the credit risk for many buyers, which is labour-intensive and costly. One solution to this is a specific type of factoring often referred to as reverse factoring (now regulated in the new law).

In reverse factoring, the factor purchases without recourse (basically pays out) accounts payable only from well-known, high-quality buyers. The factor's credit risk is thus based on the default risk of the high-quality customer, not on the more risky SME. Under pre-agreed conditions, the buyer accepts the supplier's invoice by confirming the delivery of the supplier's goods and then transfers the invoice to the financier, who will assume the debt under the invoice and pay the supplier, discounting the invoice for an early payment rate based on the buyer's credit standing. On the due date the buyer pays the financier. Hence, reverse factoring serves as a mechanism to mitigate the adverse effects of information asymmetry on the supplier's (SMEs) cost of finance, thus lowering the costs of working capital financing for SMEs.

Reverse factoring schemes are made even more efficient owing to the establishment of online platforms where the buyer can register its approval of the supplier's invoice on an information system that is accessible to all three parties (supplier, buyer and interested financiers) and thanks to the automatically generated financing conditions, the

SME supplier is just one click away from the money being transferred to its account. Following the successful example of a reverse factoring platform in a developing country (Nacional Financiera, a development bank in Mexico), the international financial community is currently looking into the possibility of replicating it.

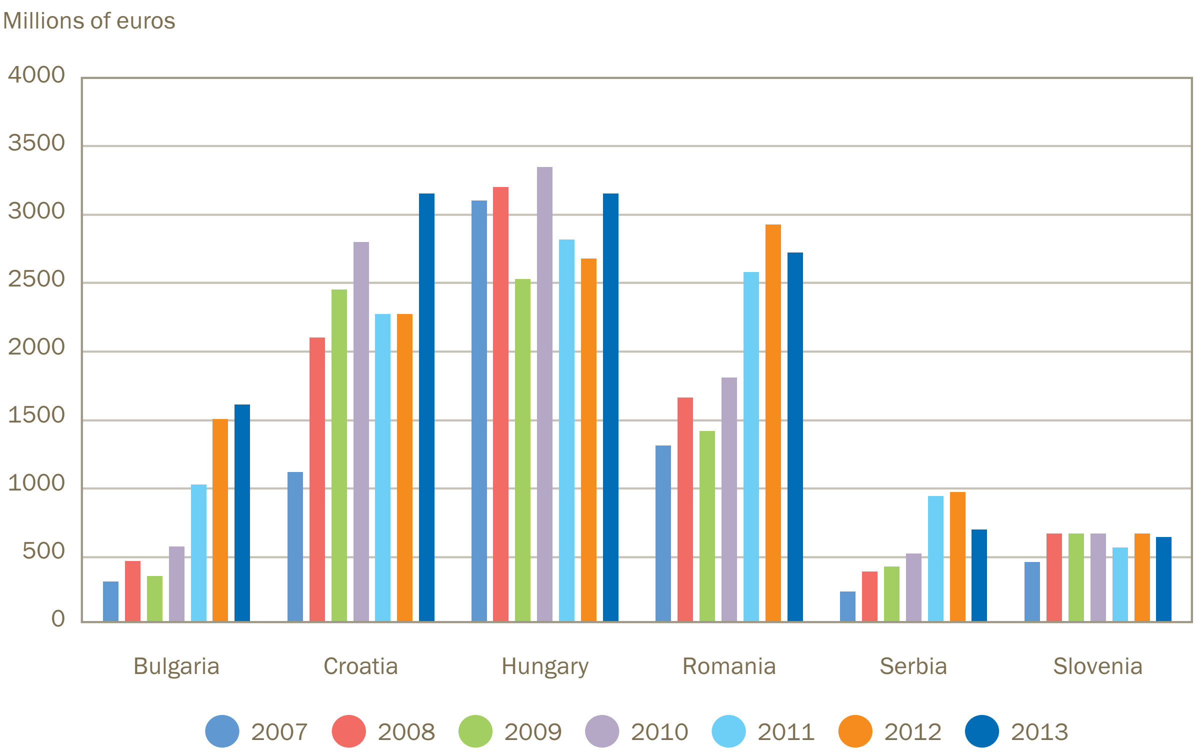
The Croatian Factoring Act was enacted in July 2014 and it will be interesting to see whether, and in which form, factoring will develop in the Croatian market in the future. However, what is certain is that providing a comprehensive legal framework underpinning factoring services was a positive step towards further developing the Croatian financial sector.

POTENTIAL FOR DEVELOPING A REVERSE FACTORING PLATFORM IN SERBIA

Serbia enacted its Law on Factoring in 2013, providing for the first time definitions of various factoring products, establishing rules for factoring of receivables and introducing regulations for factoring providers. The law also defined reverse factoring as a special type of factoring. The notion of reverse factoring is new to the Serbian financial system, while traditional factoring has a much longer history. Under the right conditions the reverse factoring market has great potential in Serbia.

Traditional factoring developed rather spontaneously over the last decade despite many uncertainties and a lack of legislation, which created a mixture of financial instruments based on elements of factoring, reverse factoring and discounted promissory notes. There were particular doubts whether state-owned enterprises (SOEs) and public entities (Serbian budget beneficiaries) struggling with liquidity constraints were eligible to conduct

CHART 1 FACTORING VOLUME IN SELECTED COUNTRIES



Source: Factors Chain International, Annual Review, 2014.

factoring and reverse factoring operations. They could potentially constitute a significant market, since the public sector in Serbia still comprises 40 per cent of the country's GDP. In addition, at the time, many markets for goods and services had oligopoly structures, where large buyers exercised strong market power and set favourable terms for purchase contracts, including informal extensions on the payment period beyond the due date. Unsurprisingly, many small and medium-sized suppliers experienced cash flow constraints and the government responded by introducing the Late Payment Law to cut late payments (without much success) and the Law on Factoring to facilitate the development of factoring services.

The factoring law came into force in 2013 and it seems that this helped to shape the early development of the reverse factoring market. However, reverse factoring still comprised only 3 per cent of the total factoring volume in 2013 and it is logical to conclude that there are other obstacles that prevent this market from developing faster in Serbia. In order to identify these obstacles, we need to study the factoring market in Serbia in more detail.

The data show that Serbia is lagging behind regional peers in factoring transactions. Chart 1 provides information on the volume of factoring turnover over the past seven years in Serbia and its neighbouring countries. Serbia and Slovenia have on average a factoring volume below €1 billion annually. Bulgaria has a slightly higher volume, while Croatia, Hungary and Romania approach €3 billion. All countries, except Slovenia, reveal an upward trend in factoring turnover, with some downward pressure in Hungary over the last three years, and Serbia this past year. Compared with its neighbours, Serbia still has a lot of room for improvement, and widening the factoring base through reverse factoring structures (by actively involving big buyers) may be an important opportunity for the country.

For example, mainly large companies are involved in factoring transactions in Croatia. This explains the remarkable level of factoring turnover in this country. Quite the opposite in Serbia, where only SMEs participate (that is, start the process) in factoring. The law in Serbia precludes public entities from engaging in reverse factoring, but SOEs – a significant part of the Serbian economy – are free to engage in both factoring and reverse factoring transactions.

As mentioned, factoring practices in Serbia are still built on the mostly individual initiative of SME suppliers, as depicted in Chart 2. Standard reverse factoring schemes, on the other hand, require the active involvement of the buyers with factors, as presented in Chart 3. A switch from one chart to the next shows the path Serbia needs to take in order to boost reverse factoring operations.

CHART 2 FACTORING IN SERBIA

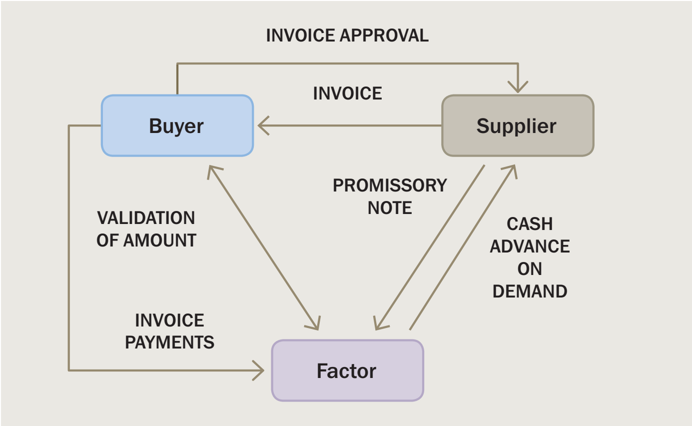
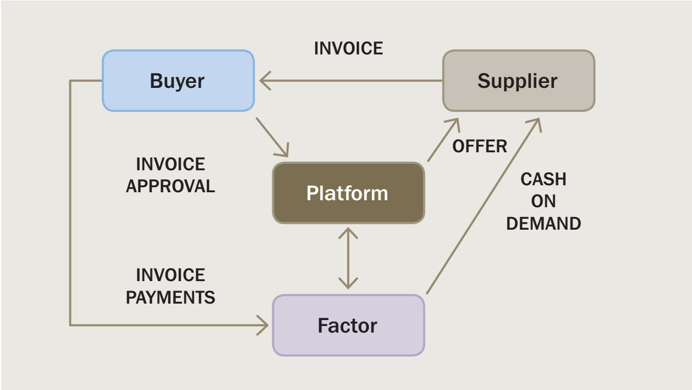


CHART 3 REVERSE FACTORING SCHEME



Serbian SMEs have lower credit ratings than large buyers and have difficulty accessing the market to finance working capital, and therefore pay higher interest rates than their trading counterparts. In addition, under the currently prevailing factoring scheme, they take the complete risk in factoring receivables under unfavourable terms because the majority of factoring is done with recourse (guarantee for payment). This harms the business. As such, it makes sense to switch from factoring to reverse factoring if one wants to improve supply chain finance in Serbia.

A typical reverse factoring process is started by the buyer. In this way the buyer shows that it cares about the supply chain and that it is ready to help suppliers access liquidity at favourable terms (based on its credit rating) before the invoice due date. In order to start the process, the buyer must make the first move and agree to an open credit line with the factor on behalf of its suppliers. Since the large buyer guarantees invoice payments, the factor may be ready to pay on demand the full amount of receivables. Under Serbian law this implies that the supplier must agree to assign the debt to the factor in a reverse factoring transaction. It is deemed that such consent is given if the supplier demands cash payments from the factor.

The benefits for large buyers participating in reverse factoring schemes are manifold. By keeping their suppliers liquid, large buyers can ensure regular delivery of goods and services. In addition, not only can the company ask suppliers for longer invoice payment terms and discounts for early payment (*cassa sconto*), but it also does not have to deal with collecting and managing receivables and getting frequent requests from suppliers for early payment, which all reduce operational costs.

Reverse factoring also has benefits for factoring companies, such as a stable income and a large volume of transactions. Factors have an excellent source of income over a long period of time. Compared with doing business directly with SMEs, reverse factoring generates higher transaction volumes, which would not be possible in case-by-case transactions with small companies.

The development of an online reverse factoring platform requires certain favourable legal and market conditions. All interested buyers, suppliers and factors must sign an agreement, which defines legal and operational terms under which the platform operates. If an agreement is signed, the buyer can then post the approved invoice on the platform after it receives goods and services from the supplier. By doing so, the buyer fully commits to paying the invoice amount on the due date to any one factor which may, in the meantime, purchase the invoice from the supplier. This means that suppliers can access the platform to select which invoices they want to have paid to them earlier than dictated by the standard payment terms. However, they will only receive the money if and when factors accept the discount terms. Factors not only assess the credit rating of the large buyer, the payment period and other conditions of the contract, but also propose invoice discount terms to the supplier. Competition between factors will set the proper discount rate. General legal conditions for this exist; nevertheless, a specific by-law regulating detailed aspects of the trade should be enacted.

The supply side of the financial market is vulnerable to insolvency in the real sector, which constrains banks' exposure to factoring companies and SMEs. The share of non-performing loans (NPLs) to gross loans in Serbia reached 21.4 per cent in 2013 and further increased to 23 per cent in the second quarter of 2014. The corresponding figures for short-term loans are 34 per cent in the corporate sector and 25 per cent in the sole proprietor sector (all of which are SMEs). However, despite the banking sector facing significant levels of NPLs, it nonetheless has the required level of loan loss reserves and is well capitalised. Provisions to potential losses were 116 per cent in the second half of 2014, while the capital adequacy ratio stood at 20.4 per cent. The structure of financial assets and liabilities is dominated by short-term deposits and short-term loans. New investments primarily depend on inflows of foreign capital, which are expected to be below the historical average this year. Financial assets are highly euroised with more than 70 per cent of loans and deposits being either in euros or indexed in foreign currency. A moderate financial depth and higher risks in the financial system as a result of this situation call for additional funding of supply chains.

In 2014 the government provided interest rate subsidies for working capital loans scheduled to affect €2 billion worth of placements. However, these opportunities are far from being fully realised owing to the reluctance of SMEs to apply for subsidised loans as they do not have guarantees that large buyers will fulfil their payment obligations on schedule. Large buyers are struggling to find customers due to low consumer demand and are therefore trying to transfer the burden of adjustment to their suppliers. The pressure is not only on price discounts, but also on the extension of payment periods. The payment period is regulated by the law to a maximum of 60 days, but this obligation is rarely obeyed in practice. The consequences are silent breaches of contracts that could jeopardise long-term trade relationships between buyers and suppliers. For these reasons it may be wise to consider channelling a portion of the subsidies towards the development of a reverse factoring market.

On the demand side, SMEs are the main target group for factoring and reverse factoring. SMEs are unable to raise sufficient financing for their working capital and are forced to pay high interest rates. According to our study, the average interest rate in factoring agreements in terms of hard currency (without exchange rate risk) was 9 per cent annually in 2013 and 7 per cent in 2014. In terms of Serbia's local currency (the dinar), large buyers offer premature contract payments at 3 per cent monthly, while factoring companies charge on average 2 per cent monthly. This has not changed much in 2014, even with the annual inflation rate dropping to 2 per cent.

Based on interviews conducted with a wide range of stakeholders in Serbia, a SWOT matrix for reverse factoring was carried out in 2013, the results of which are presented in Table 1. According to the

NOTES

1
Financing SMEs and Entrepreneurs 2013, an OECD Scoreboard, available at: www.oecd.org/cfe/smes/Scoreboard_2013_extract_chapter2.pdf (last accessed 3 December 2014).

2
Progress on the implementation of SBA in Europe 2012-2013, European Commission, August 2013, available at: www.ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/supporting-documents/2013/summary-paper_en.pdf (last accessed 3 December 2014).

TABLE 1 SWOT MATRIX FOR REVERSE FACTORING

	Strengths 4.17		Weaknesses 2.51
4.31	Improving liquidity	2.50	Inefficient legal system
3.91	Delivery on time	2.43	Weak internet access
	Opportunities 4.04		Threats 2.80
4.28	Boosting activity	2.80	False warranty
3.59	Providing employment	2.67	Increasing risks and fraud

Note: A SWOT analysis (alternatively SWOT matrix) is a structured planning method used to evaluate the strengths, weaknesses, opportunities and threats of a project or business venture.

Source: Reverse Factoring Study in Serbia, commissioned by the EBRD and conducted by Belox Advisory Services, Belgrade, 2014.

expressed views, strengths are higher than weaknesses (average score 4.17 against 2.51) and opportunities are greater than threats (average score 4.04 against 2.80). Stakeholders see inefficient legal systems as the main weakness of the proposed reverse factoring project and identified false warranties as the main threat for it. On the other hand, they unanimously agree that the strengths and opportunities of reverse factoring lie in improving liquidity and boosting activity, respectively.

From all analysed data it can be concluded that if an online platform were created and the government initially supported reverse factoring transactions by introducing SOEs to the platform and/or offering subsidies, the market could further develop on its own.

CONCLUSION

Despite having been used for decades, factoring is experiencing a marked revival in the current economic context, boosted by the development of more sophisticated legal and technical solutions. However, a suboptimal legal and regulatory environment can limit the development of the service, which in turn undermines the Bank's efforts in promoting factoring. As such, the EBRD Legal Transition Team set up the Factoring Legal Development Programme, which supports legislative reforms to create a more enabling legal framework for factoring activities. The Bank has supported factoring reforms in Croatia, Montenegro and Serbia, with plans to expand activities in Armenia, Turkey and other countries in which the EBRD invests in the near future.