MFSA

MALTA FINANCIAL SERVICES AUTHORITY

BANKING UNIT

POLICY DOCUMENTS

POLICY DOCUMENT ON THE REGULATORY PROVISIONS FOR THE UNDERTAKING OF LENDING ACTIVITIES BY INSTITUTIONS AUTHORISED UNDER THE FINANCIAL INSTITUTIONS ACT 1994

FACTORING
FORFAITING

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INTRODUCTION

1. In terms of Section 3(1) of the Financial Institutions Act 1994 (the Act), an institution may be licensed to carry on the business of a Financial Institution through the undertaking of activities which are listed in the Schedule to Section 2 of the Act. One of the activities included in the list is **Lending** *(including personal credits, mortgage credits, factoring with or without-recourse, financing of commercial transactions including forfaiting).*

2. Section 3(2) of the Act states that:

> "*In the event of reasonable doubt as to whether an activity constitutes the business of a financial institution, or whether the business of a financial institution is or is not being transacted in or from Malta by any person, the matter shall be conclusively determined by the competent authority.*"

3. Section 13(1) of the Act states *inter alia* that:

> *"It shall be the duty of the competent authority … to ensure that financial institutions carrying on business in Malta comply with this Act … and with the conditions of their licenses…"*

4. In view of these statutory obligations and responsibilities, the competent authority[1] therefore deems it appropriate to state its general views on the undertaking of specialised types of lending activities by institutions licensed under the Act.

5. The views expressed in this policy document should not be interpreted as replacing the responsibilities of the competent authority as defined in paragraph 2 above. The competent authority therefore advises financial institutions intending to undertake such activities to consult it in cases of doubt.

PURPOSE OF POLICY DOCUMENT

6. This policy document is being issued:

    a) to convey the views of the competent authority as to what it considers are the general principles of good lending, and methodical approaches towards appraising lending propositions;

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[1] *In terms of Legal Notice 324 of 2001 the Minister of Finance appointed the Malta Financial Services Authority as the competent authority for the purposes of the Act.*

b) to create awareness by financial institutions of specialised types of lending activities and their specific characteristics;

c) to inform financial institutions on the specific risks associated with such specialised lending activities in general.

7. As part of their considerations for undertaking these activities, Financial Institutions are therefore expected to consult and consider the various concepts, definitions and provisions included in this policy document.

TYPE OF LENDING ACTIVITIES

8 The policy document addresses Lending in terms of the Schedule of licensable activities to the Financial Institutions Act 1994. Factoring and forfaiting activities are however specifically addressed due to their specialized characteristics and risks involved.

9. The competent authority however advises financial institutions to consult it in cases of doubt in relation to lending activities in general as specified in the following paragraphs or in relation to any other lending activities of a similar nature that are not included in this policy document.

GENERAL PRINCIPLES OF GOOD LENDING

10. The competent authority stresses the importance of a professional approach by financial institutions in making objective lending decisions in order to minimise associated risks. The competent authority deems that the application of the undermentioned principles of good lending may lead to more structured and objective and sound lending decisions. Therefore:

- Lending decisions are to be taken after detailed analysis of financial and other relevant information (e.g. feasibility study, repayment generation) concerning proposals. Clarifications, where necessary, are to be sought during clients' interviews. In general, a review of a lending appreciation would include:

  - customer reliability and means;
  - ability of customer to repay;
  - interest margin reflecting lending risk;
  - purpose and feasibility of the lending facility;
  - amount of the facility;
  - repayment programme;
  - adequate collateral; and

– the issue of the relevant sanction letter including any related conditions.

- Certain decisions related to the granting of lending facilities require more vigorous assessment irrespective of the amount involved and the customer.

- Financial institutions are advised to ask customers to provide all information that has a bearing on a lending proposal, including extent of existing borrowing from other institutions. It is important not to make *unnecessary assumptions* when such proposals are forwarded.

- Customers' statements are not to be taken at face value, and evidence for independent corroboration should be sought.

- A clear distinction between facts, estimates and opinions is to be made when forming a judgement on a proposal.

- Further clarification may also be requested, if despite satisfactory assessment, the overall analysis would still warrant caution.

11. Before any advance has been granted, a financial institution has to establish at the outset a monitoring plan, including a provision for information updates from the customer, if deemed necessary. Continuous monitoring through regular reviews assists the identification of problems at an early stage. This would facilitate the periodical evaluation of the asset quality and the subsequent determination of any courses of action that may be necessary to safeguard the lender's interests. For such reviews to be meaningful, updated financial information on the customer should be available at all time.

12. The competent authority expects financial institutions to have in place clear policies (preferably laid down in a Credit Policy Document that has had Board approval) which identify the institution's procedures in granting and monitoring credit facilities including provisioning requirements.

13. These principles of good lending, in general, should apply to all types of lending activities, including but not limited to, personal credits, mortgage lending, factoring, forfaiting and other types of commercial transaction financing.

FACTORING

14. Factoring is a means of finance whereby a financial institution (factor) buys a company's trade debts. The consideration for these debts from the eventual settlement by debtors may be immediate, delayed or for fixed period of time or paid when the underlying sales invoices are settled.

15. The factoring service is an alternative means of assisting and financing rapidly growing small companies that may be encountering difficulties in obtaining

normal bank finance to sustain their growth. Therefore factoring may be considered as complementary finance to any other credit facilities that are made available to the company.

16. *Non-recourse* factoring is where a financial institution bears the risk of loss if the debtor in unable to pay. In *recourse-factoring* a customer will be expected to cover bad debts expense.

17. A financial institution must not at any time or under any type of factoring accept responsibility for:

(a) the acceptance of the goods or services provided by the customer of the institution to its clients;

(b) the discharge of the customer's responsibilities towards clients;

(c) product liability; or

(d) the accuracy of the invoices issued.

Customer Characteristics

18. The competent authority considers that *suitable* customers for factoring services are normally those entities that have the following characteristics:

- be a well managed company or other commercial undertaking[(2)] with a substantial turnover;

- the business of the company/commercial undertaking is carried out in a low risk market;

- the company/commercial undertaking preferably sells a broad range of products and has a manageable clientele; and

- the company/commercial undertaking does not have any single customer with a significant portion of the total turnover and outstanding debts.

19. Consequently, although factoring with other types of customers is not excluded, the competent authority expects financial institutions to have in place specific and appropriate policies to measure, monitor and manage the higher risks that might be involved.

Assessment of a Factoring Customer

20. The competent authority considers that there are three main risk areas that a financial institution needs to assess when considering a request for a factoring

[2] *Includes sole traders wherever referred to in this document.*

service. Other risk areas relevant to specific cases are expected to be identified by the Financial Institutions and addressed accordingly. The main risk areas are:

Financial Performance

21. The assessment of the financial position of a potential customer by a financial institution is an important issue and will be more significant in accordance with the specialised characteristics of the facility that is being sought.

The Quality of the Security

22. In factoring funds are advanced against the discounted value of an invoice, which typically does not exceed 80% of the value of approved invoices. The balance of 20% represents the margin and acts as a buffer against any deductions in the event of the insolvency of the debtor. This margin is to vary directly to the institution's perception of the potential debtor risk. The quality of the factor's assurance of being repaid may be established from:

- quality of debtors complemented by credit references where available;
- debtor insurance;
- quality of the debt, i.e. the underlying collectability of the invoices; and
- the collectability of funds advanced from debtors in the event that the customer ceases to trade.

The Quality of the Management

23. An important consideration that must be addressed by a financial institution is whether the management of potential corporate customer has the necessary skills to achieve its targets. The assessment of management skills is highly subjective and due diligence must be undertaken by an institution to establish the management's track record and performance. A financial institution would require prospective customers to fill in a proposal form for proper assessment. A proposal form would normally seek information on the following:

- company structure and management including financial policies;
- management Information Systems;
- products and services;
- directors/partners and other shareholders;
- associate companies;
- accounting records;
- audited financial statements;

- debtors age list and bad debts history;
- sales analysis; and
- additional information as necessary.

The Process of Factoring

24. Pursuant to the provisions of the applicability of the Large Exposures Directive (BD/02) the financial institution is expected to establish internal criteria on factoring exposures, taking into consideration:

    - maximum lines for each customer;
    - maximum concentration for each customer; and
    - maximum for new customers.

25. Generally the summarised process of factoring is as follows:

    a) The financial institution makes prior assessment of the debtors of the customer;

    b) The goods/services are delivered to debtors by customer who must issue the relevant invoices payable to the factor;

    c) The financial institution receives and processes the customer's copies of invoices and verifies that the goods/services have been delivered and that debtor intends to settle invoice;

    d) The financial institution then issues the advance to the customer and monitors the invoices for payment;

    e) After receipt of payment from debtors, the financial institution is to issue the residual balances to customer less any interest and commission charges.

26. A financial institution is expected to maintain planned, regular and sound audit processes, covering all aspects of the customer's credit and liquidity management.

27. In this respect the competent authority expects financial institutions to have in place a Factoring Policy Document, approved by the Board, and which defines the internal procedures to be followed to apply such policies.

Security Implications of Factoring

28. A financial institution taking over the assignment of a customer's book debts is to ensure that there are no prior claims on the debtors, since these are the source repayment.

Import and Export Factoring

29. In *import* factoring the agreement is made directly between the financial institution and the overseas client, who in turns assigns debts to the institution. Where bad debt protection is provided for, an institution is expected to investigate the buyers' credit standing and establish credit lines. Bad debt protection usually covers from 75% to 100% of invoice value subject to the debt being approved by the financial institution.

30. An export factor occurs where the factor is in the country where the customer (exporter) is undertaking business. A financial institution and the exporter will enter into a factoring agreement, with the exporter assigning export invoices to the institution.

31. In order to enter into such agreements, a financial institution is expected to have arrangements in place with its overseas correspondents to whom it assigns these debts. Such agreements would normally provide bad debt protection in case of debtor insolvency.

32. The competent authority deems that this activity should only be offered by financial institutions with substantial resources e.g. strong capital base, sound communication systems, network of overseas correspondents and trained personnel, to ensure an effective service.

Invoice Discounting

33. The authority considers invoice discounting as the provision of sales linked finance. This would therefore involve a confidential arrangement between the financial institution (*invoice discounter*) and its customer whereby the institution undertakes to purchase trade debts. In this service the customer's clients are unaware of the financial institution's involvement, therefore ensuring that the customer/client relationship remains unaffected.

34. Keeping in view the contents of paragraph 33 and in accordance with international standards the authority would expect a financial institution to normally advance not more than 80% of the selected invoices in this type of facility.

35. Furthermore the competent authority expects that invoice discounting would be made *purely for the advance of cash,* and is normally requested by a customer for a temporary cash shortage.

36. In this arrangement the financial institution would therefore allow customers to continue managing their sales ledgers, collect payments and also remain responsible for the bad debt risk. A financial institution must however be informed when its customers issue sales invoices to their clients.

37. Invoice discounting is usually provided on a *'with-recourse basis'*, but a financial institution could also consider offering *'without-recourse'* finance against an additional charge and after taking the necessary steps to ensure that its interests are protected.

38. A financial institution must ensure that payments received by customers are credited to a designated account. The balance of funds due to customers is only to be released upon the clearance of payments.

Risks of Invoice Discounting

39. Since a financial institution does not control debt administration and the customer collects debts, confidential invoice discounting is considered a riskier activity than the normal factoring service. In the circumstances, therefore, financial institutions are expected to only agree to offer this service to reliable and well-established companies with good internal control systems and who must be able to demonstrate clear financial success.

40. In order to support its risk management, the competent authority recommends that a financial institution should carry out regular audits to validate the security of the customer's sales ledger.

FORFAITING

41. Forfaiting is a means of providing medium-term export finance. The undermentioned features are common to most forfaiting transactions:

- Without recourse finance to exporter;
- Fixed interest rate finance;
- Guaranteed by government[3], a bank or other financial institution of good repute;
- Discounting of bills of exchange or promissory notes; and
- Non-insurance by a export credit agency or a private insurance company to the finance provided.

3 *Guarantees of Governments of Zone A countries as specified in the Large Exposures Directive (BD/02).*

Characteristics of Forfaiting

42. Forfaiting by definition is *'without-recourse'* short to medium term trade finance intended to meet the requirements of both the exporter and importer. In this service the exporter renounces the right to payment, while the financial institution waives its right of recourse in the event of non-payment by the importer.

43. The competent authority therefore recognises that finance may be provided in the form of deferred credit to overseas purchasers of goods and services with the repayment period normally being between 3 months and 5 years.

44. Within the parameters indicated in paragraph 43, finance may be given either through the issue of promissory notes or bills of exchange spread throughout the agreed credit period. Since in most transactions the importer is unknown to the financial institution, the competent authority would expect the financial institution to ensure that in such cases the importer's debts are guaranteed (avalised) by a first class institution. The financial institution may then provide the exporter with finance by discounting the bills or notes. The institution may then opt to:

- hold these bills/notes until maturity date; or
- discount these negotiable instruments on the secondary markets[(4)] when and if applicable.

45. Although the documentation in forfaiting finance is relatively simple, it is expected that such documentation should, at the least, consist of the financial instruments, a guarantee of payment by the importer's bank and contract letter drawn between the exporter and the forfaiter.

Risks to Forfaiter

46. The competent authority recognises that, being a *without recourse* business, forfaiting poses a number of risks to a financial institution which intends to undertake this activity. A quotation for a forfaiting transaction is normally expected to be firm on the forfaiter's side although not necessarily so on the exporter's side until he concludes the contract. Although it is normal for firm quotes to be held for a maximum pre-set time, consideration should be given to interest rate movements.

47. Funding a forfait portfolio calls for structured financing. Looking at the total maturity structure of a forfait portfolio over a period of time, repayments of the portfolio will occur on a regular basis monthly or even daily depending on

[4] *Trade Paper is sold on secondary markets, where institutions can trade the bills or notes among themselves, with the most important markets lying in London and Zurich. The three major activities within the market are the purchasing of trade paper with a view of either holding to maturity, reselling in the near future or simultaneously buying and reselling.*

the size of the portfolio. Funding of a forfait portfolio would, therefore, be normally considered on the basis of the portfolio in total although funding each individual new asset as it is purchased is not excluded.

48. Forfaiting is also subject to the general risks that are inherent to cross-border export finance. The competent authority therefore recommends that a financial institution be fully aware of the undermentioned and other risks that could occur in such activities:

Sovereign/Political Risk

49. This risk refers to the inability or unwillingness of a country to honour its international obligations. Such risks may arise out of extraordinary state measures or political incidents like war or civil unrest. A financial institution is advised to keep abreast with current political developments and may consider setting a research unit to this effect.

Commercial/Credit Risk

50. This risk refers to non-payment arising out of the inability to assess the creditworthiness of the importer. To avoid this risk a financial institution would usually request that debts are avalised or guaranteed by the importer's bank or by another first class institution.

Currency Risk

51. A financial institution accepts the foreign exchange risk since it holds the promissory notes/bills of exchange and has given value to the exporter. To mitigate such risk an institution must ensure that it only negotiates bills/notes in those currencies that readily allow their refinancing on a matched basis.

Transfer Risk

52. This risk lies in the inability or unwillingness of states or other official bodies in the buyer's country to effect payment in the currency agreed upon. To minimise such risks it is recommended that financial institutions regularly monitor country ratings as issued by reputable International Rating Agencies.

Documentary Risk

53. This risk refers the inability of a financial institution to enforce payment owing to defective documentation. This might lead to expensive cross-border legal litigations. A financial institution must therefore seek to be fully aware of the main legal implications concerning forfaiting transactions.

Implications of Forfaiting

54. A forfaiting transaction involves a contract for the sale of debt instruments. The debt instruments legally stands on their own irrespective of the underlying

contracts. However, the financial institution should have a process of periodic review of the underlying contracts as these could impact the debt instruments.

55. Forfaiting transactions may involve a variety of legal jurisdictions. It may be advisable in such instances to stipulate the particular jurisdiction that applies in the event of any subsequent disputes. A financial institution must ensure that its contractual documentation includes such provisions.

56. When a financial institution agrees to a *'non-recourse'* purchase, it must carry out due diligence tests to ensure prudential conduct. In this respect it is important to ascertain the accuracy of information provided by the exporter so as not to prejudice any rights, if there is a breach of warranties.

57. Financial institutions operating within the market are therefore to be aware of the general contractual obligations as well as the principles applying to negotiable instruments. Moreover they must ensure that the counterparties with whom they are dealing are similarly experienced.

CONCLUSION

58. The competent authority advises financial institutions that are considering undertaking lending and related activities to be conversant with the technical and legal characteristics together with the various associated risks. Moreover financial institutions are to ensure that they have all the necessary resources to carry out such activities effectively.

59. Financial institutions must also ensure that they have sound internal control and monitoring systems in order to ensure effective management control and to minimise related risks.

60. The competent authority emphasises that the undertaking by financial institutions of activities included in this policy document could entail the entering into an exposure as defined in the Large Exposures Directive (BD/02) and the requirements under the Solvency Ratio Directive (BD/04) as applied through the Supervisory and Regulatory Directive (FID/02). Consequently it is strongly recommended that financial institutions are fully conversant with the provisions of these directives.

61. Finally the competent authority would remind that acceptable levels of exposures in terms of the Large Exposure Directive (BD/02) as applied through the Supervisory and Regulatory Directive (FID/02) is subject on the level of own funds of the financial institution. Consequently financial institutions licensed to carry out activities included in this policy documents should maintain the necessary levels of own funds in compliance with the provisions of the Own Funds Directive (BD/03) as applied through the Supervisory and Regulatory Directive (FID/02).