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Supply Chain Lenders Brace for Defaults as Europe Tightens Rules

- **Supply chain finance has grown as investors search for yield**
- **But new rules threaten to push some of that debt into default**

By Nicholas Comfort

(Bloomberg) -- A fast-growing area in European finance is bracing for a wave of defaults as new rules aimed at dealing with the region's pile of bad debt go into effect.

Lenders that provide advances to suppliers waiting to get paid -- a business known as supply chain finance -- warn that a substantial portion of that debt would be reclassified as defaulted under the new rules. As much as a fifth of these firms' exposure to purchased invoices may be affected, according to Diego Tavecchia, an official at the EU Federation for the Factoring and Commercial Finance Industry.

While Tavecchia says the industry has sufficient capital to deal with the fallout, he warned that lenders may cut off some companies from funding unless there are last minute changes to the rules. Then there's the question of how the framework will affect non-bank providers such as funds that invest in the short-term debt as an attractive alternative to money markets.
How Late Payments to Vendors Spawned a New Business: QuickTake

Supply chain finance has seen a surge in popularity in recent years as Europe's negative interest rates fueled a search for yield. Third parties -- traditionally banks but increasingly also independent intermediaries backed by investors -- pay suppliers the value of their outstanding invoices minus a discount. The companies get their money faster while the investors earn a relatively safe return when the invoice is paid.

Volumes in Europe have surged 67% in the eight years through 2019, to 1.91 trillion euros ($2.34 trillion), according to EUF, which represents national groups lobbying on behalf of lenders such as Banco Santander SA and BNP Paribas SA as well as specialized firms such as billionaire Lex Greensill's Greensill Bank AG. Many of these invoices are past due because big companies often pay their suppliers late, and that's where the new rules create a headache.

Starting this year, the European Banking Authority will hold lenders in the region to a common definition of default after finding big differences in how they deal with one of the most fundamental issues in banking. The EBA's updated definition of default states that receivables booked on a firm's balance sheet should be considered technically past due after 30 days.

Default 'Paradox'

On average, the new rules could classify 15% to 20% of receivables for which the factoring firm bears the risk as defaulted, according to Tavecchia. That equates to as much as 25.5 billion euros of bad loans, he said. The short maturities of such transactions mean a firm's exposure on a given day is significantly lower than the volume it processes in a year.

“The paradox is that most of these new defaults will be on the most credit-worthy debtors because large and robust companies regularly delay their account payables,” Tavecchia said in an interview last week.

His lobby has asked the EBA to extend the grace period for late payments to 90 days, saying it would reduce the impact on the financing firms by 75%. The firms want more time to determine whether clients are delinquent or just paying bills at the last moment, he said.

While factoring firms have sufficient capital, technical defaults could prompt banks to stop buying the receivables of healthy debtors in order to preserve other business with the clients, he said.

“That could cut suppliers off from financing, small and medium-sized enterprises especially may lose access to financing and be driven outside the regulated market,” Tavecchia said.

Investment funds, too, could shy away from debt that’s officially in default, because many of these funds are marketed as safe alternatives to money market investments.