Small and Medium Sized Business (Finance Platforms) Regulations 2016

ABFA Policy Guidance

1. INTRODUCTION

1.1. The Small and Medium Sized Business (Finance Platforms) Regulations (laid under the Small Business, Enterprise and Employment Act 2015, referred to as 'the Regulations') introduce a requirement for Designated Banks (DBs) to provide information about Small and Medium-sized Enterprise (SMEs) clients that have been unsuccessful in seeking a finance facility to designated Platforms.

1.2. Such information is only provided with the consent of the SME. The information is then to be made available to 'alternative' providers of finance through the platforms. Budget 2016 announced the intention to designate Bizfitech (BusinessFinanceCompared), Funding Options and Funding Xchange as platforms. An additional expression of interest has also been issued by the British Business Bank for further platforms seeking potential designation.

1.3. The Regulations became law on 1 January 2016 but the legal obligations under the Regulations come into effect once designation takes place.

2. PURPOSE OF PAPER

2.1. Factoring and invoice discounting agreements (referred to in this paper as 'invoice finance') are defined as finance facilities under the Regulations. Therefore an unsuccessful application by a qualifying SME for an invoice finance facility to a DB would require the DB to offer the SME the opportunity to be referred to alternative providers of finance via the designated platforms.

2.2. The purpose of this guidance is to provide a practical interpretation of the requirements of the Regulations in the context of invoice finance, with the objective of facilitating effective and consistent implementation of the policy.

2.3. It particularly focuses on the "extension" of existing facilities (as per 2(1) of the Regulations) and sets out the core parameters that determine the quantum of funding available within an invoice finance facility. Those parameters thus comprise the minimum criteria that would trigger an offer of referral. In assessing their obligations under the Regulations, DBs must consider their own business processes and contractual arrangements and consider whether there are other criteria that should be included in their referral processes.

2.4. This guidance has been prepared by the ABFA in consultation with HM Treasury and the BBA, as well as with directly impacted Members of the ABFA. In addition, the DBs will have conducted their own assessment of the policy and the implementing Regulations, and may have carried out their own engagement with HMT on the issues covered.

2.5. This paper constitutes the ABFA's interpretation of the policy and sets out the most effective method of implementing the policy on that basis. HMT agrees that this guidance matches HM Government's policy intent as it relates to invoice finance in general, and the parameters explicitly discussed, but emphasises the requirement noted in 2.3 above for DBs to consider their own businesses processes carefully and take any additional steps they believe necessary to ensure compliance.

2.6. For the avoidance of doubt this guidance does not - and the ABFA cannot - provide a definitive interpretation of the Regulations. Reliance should not be placed on this paper and it should not be taken as legal advice. Interpretation and enforcement of the Regulations is ultimately a matter for the Financial Conduct Authority and the Courts. A party must decide for itself how to comply with the Regulations and proceed accordingly at its own risk. If a party is in any doubt about what is required to comply with the Regulations in the context of its own business it should seek independent legal advice.

2.7. This guidance may be amended from time to time as required. In addition to the Regulations themselves, this document should also be considered in conjunction with the wider Policy Guidance prepared by the BBA that sets out in greater detail the general implementation of the Regulations.

2.8. The following section provides additional information about invoice finance and how it is provided to inform and provide appropriate context for the interpretation set out subsequently.

3. ABOUT INVOICE FINANCE

3.1. Factoring and invoice discounting[1] are both types of asset based finance. Finance is provided based on the assets held by a client business; in the case of invoice finance, the assets are the unpaid debts owed to the client by its debtors (its customers).[2]

3.2. Invoice finance is by far the most significant type of asset based finance in the UK. Members of the Asset Based Finance Association (ABFA) will be providing around £17.5 billion of finance against debts (invoices), supporting around 40,000 client businesses in the UK.[3]

---

[1] A factoring arrangement combines the provision of finance with an additional service element, with the financier managing the sales ledger and collecting the debts directly from the client's customers. In an invoice discounting arrangement the client manages and collects the sales ledger themselves. The processes are very similar however and the differences between the two are not relevant for the purposes of this paper. In addition, in a wider asset based *lending* arrangement finance will be provided against other assets, including stock, plant, property and machinery. For lending of that type it is proposed that the process established for loans, leasing or mortgages should be followed. It should be noted that the products are variously described by different providers.

[2] Note, in the course of providing invoice finance, ABFA Members will only provide funding to businesses that trade B2B – they do not fund debts that are payable to or from consumers.

[3] ABFA Members provide the majority of invoice finance to UK businesses, both by value and in terms of numbers of clients.

Whole turnover facilities

3.3. ABFA Members will generally provide invoice finance on a 'whole turnover' basis whereby all debts due to the client business will be assigned on creation and notified to the finance provider automatically as they arise.[4]

3.4. This automatic assignment of debts generates an available amount of finance. This will typically be around 80 percent of the face-value of the invoices assigned, subject to certain other restrictions set out in advance in the contract. Once operational, the facility is dynamic with availability increasing and decreasing in real-time as invoices are raised and paid. The client is able to draw down this availability from the finance provider as they require it.

3.5. Thus the majority of client businesses use invoice finance to provide an *ongoing rolling finance facility*. The client business will enter into a contract with the finance provider that will either be fixed in length or rolling (with defined notice periods).

3.6. In a whole turnover invoice finance arrangement, funding is being provided against an asset base (the debtor book) the value of which will vary continuously as the client business trades. This is distinct from finance provided against a single 'asset' – such as a single invoice – that would be fixed in value. It is an essential feature of the facility that the finance provider is able to identify and monitor the value of the underlying security and manage the funding advanced against it as appropriate.

3.7. The provision of invoice finance is intensively risk-based; significant analysis and due diligence is carried out by the finance provider on the client business and also on the business's customers prior to the agreement being entered into. Once operational, an invoice finance facility will also be actively risk-managed by the finance provider in real-time; the provider will verify transactions or conduct audits, for instance.

3.8. In assessing a request for an invoice finance facility the volume and value of invoicing will be key considerations but so will the nature and performance of the business and its debtors, and the type of debts generated; highly contractual debts are unlikely to be funded to the same extent as simpler debts for instance. In addition, the exposure of the client SME to particular sectors or debtors will also be significant considerations. An invoice finance agreement does not guarantee the provision of finance against every invoice raised.

3.9. Some providers, including a small number of ABFA Members, do provide selective invoice financing (sometimes referred to as single invoice finance). In such facilities the client will be able to choose which invoices (if any) to assign to the finance provider. These facilities are provided by some, but not all, DBs and also by a number of other providers.

3.10. Whole turnover and selective/single invoice finance are distinct products meeting different client requirements; the former generally providing a long-term

[4] The majority of debts will be automatically assigned. However certain categories of debt may be excluded from the facility and these will be set out in the agreement beforehand.

continuous financing relationship and the latter providing short-term occasional finance on a transactional basis. The different nature and basis of these two types of facility require that differing approaches to implementation of the requirements of the Regulations are taken.

Funding parameters

3.11. In the operation of a whole turnover invoice finance facility, the maximum extent of funding available at a point in time will be determined by the application and interaction of a number of different factors. The precise interaction of these factors and their management will vary between finance providers and different providers may use different terminology (with minor variations in legal definition).

3.12. In preparing this paper the ABFA has consulted to establish practical minimum criteria that can be applicable and consistent across <u>all</u> the DBs. The two significant core parameters that determine the amount of funding available within an invoice finance facility, and that are common across providers, are facility limits and prepayment percentages (details below). These will be defined contractually in the legal agreement between the client and the finance provider at the outset of the facility.

3.13. ***Facility limit*** (this may also be referred to variously as *funds in use limit, review limit, refer limit* or *finance limit*). This figure will set out the maximum quantum of funding that will be provided under a facility. This will be informed by both qualitative and quantitative considerations and will be based on an overall assessment of the prospective client's whole ledger.

3.14. ***Prepayment percentage*** (this may also be referred to variously as *advance rate/percentage* or *initial payment (IP) rate/percentage*). This sets the proportion of the value of the invoices assigned that the finance provider will provide prepayment against.[5] Again, the prepayment percentage will depend on the nature and circumstances of the client's business and their debtors, and will be agreed between the client and finance provider in the contract.

3.15. Depending on how the relevant contracts and processes operate in each DB, there may be other criteria that a DB would conclude are appropriate to incorporate within its referral processes. A DB will wish to consider these issues carefully in preparing and implementing its referral processes.

4. DEFINING UNSUCCESSFUL APPLICATIONS

4.1. What constitutes a finance application is defined at 2(1) of the Regulations. It is noted that whether it be for a new facility or for the "renewal or extension" of an existing facility, an application must be supported by sufficient information for an informed decision to be made (or the DB must have responded requesting such information).

[5] So invoices to the value of £100,000 under a facility with an 80 percent prepayment will release £80,000 in availability (subject to the overall facility limit above).

Applications for new facilities

4.2. This paper submits that for a 'new'[6] application for invoice finance, an unsuccessful application will be one where sufficient information has been provided (as per 2(1) of the Regulations) and where either a DB:

- cannot or will not provide a facility at all; or
- cannot or will not provide one on terms that are acceptable to the client.

4.3. In those circumstances an offer of referral should be made to the client. Consistent with 2 (3) (b)(ii) of the Regulations, a referral is not mandatory where the stated reason of rejection by the SME is on the basis of proposed fees or interest.[7]

4.4. Whilst the terms on which such facilities would be offered would clearly be very different, the general principle here would be the same for a whole turnover or a selective facility; the terms are either acceptable to the SME client or they are not.

'Applications' for renewal or extension of an existing facility

4.5. To ensure efficient and effective implementation, it would be beneficial to clarify the interpretation of the Regulations as to what constitutes a 'finance application' where a business has already entered into a whole turnover invoice finance agreement but may seek finance additional to that permitted under the original terms. (As noted above a whole turnover invoice finance agreement will normally be either fixed in length or rolling with defined notice periods.)

4.6. As described above, an invoice finance facility will be dynamic, continuous and actively risk-managed. An essential characteristic of an invoice finance facility is that within the overall Facility Limit (see above) the funding available will fluctuate on a daily basis as invoices are raised and paid, and as the facility is risk-managed by the finance provider. It is essential that the facility is managed in this way in order to support the quantum of funding that will often be released. This is one of the key benefits of this funding type for SMEs.

4.7. As set out above, the core common parameters determining the amount of finance that will be made available under a whole turnover invoice finance agreement will be **facility limits** and **prepayment percentages**. In normal circumstances, a request by a client SME to increase the amount of funding available under a facility will require a change in one or more of these two core parameters.

4.8. This paper submits that under the Regulations a request to vary one of the two core parameters (as a minimum) should be considered to be an application to extend an existing facility, provided it is properly supported by sufficient information to allow an informed decision to be made by the DB. As noted above, a DB should include any other additional criteria in its referral process that it believes to be appropriate.

---

[6] New in the sense of the business not being a current client using invoice finance provided by the DB, the SME may be using other types of finance from the DB.
[7] Note, relating back to the technical distinction from 'lending', the equivalent of interest in an invoice finance arrangement is 'discount charge'.

4.9. If the Bank is not able or willing to accept the ‘application’ or if the requirements of the client cannot be otherwise accommodated in an acceptable way by other products or services, then the application is unsuccessful and thus eligible for referral should the client give permission.

4.10. Similarly, it is submitted that any variation sought by the DB to the core parameters that would have the effect of reducing the funding available that is unacceptable to the client should trigger the opportunity to request a referral.

4.11. It must be noted that whilst a referral can be made and the SME can receive alternative offers of finance, they will still be bound by the terms of their contract and they would need to serve or come to an agreement with the DB about outstanding contractual notice periods. This will be the same for any other time-limited finance facility (a term loan, for instance).

4.12. It should also be noted:

- That an SME simply going into an overpaid position on an invoice finance facility (where the funds drawn down exceed their availability) should not, in itself, be interpreted as a formal application for finance, in the same way that issuing a cheque on a business current account where there are insufficient funds available should not be interpreted as a formal application for finance.

- Formally requesting a variation to one of the parameters defined above to unlock greater funding would be considered to be a finance application, in the same way as formally requesting an increase in an overdraft limit that would allow a cheque to be cashed would be. However, to reiterate it has to be a specific request supported by sufficient information in order to trigger an offer of referral.

4.13. It should be further noted that an offer of referral is not mandated where the facility applied for is of short-duration (for less than 30 days) or less than £1000 (as per 3(3) of the Regulations). An application has to be a specific request for an increase in funding which would be effected through one of the core parameters of the facility rather than simply a short-term request for additional funds.

5. SUMMARY

5.1. In summary, in order to facilitate effective and consistent implementation of the policy objective in the context of invoice finance, it is submitted that a proposed definition of an ‘unsuccessful’ finance application for a whole turnover invoice finance facility that would thus mandate an offer of referral would be as follows:

- Where a DB receives a new application for funding through invoice finance from an SME that it is unable to provide at all or unable to provide on terms that are acceptable to the prospective client.

- Where a DB receives a formal request from a current qualifying SME client to increase the funding available for a period of time longer than 30 days (and for more than £1000 in value) that would require a change in one or more of the two core parameters (and/or other relevant criteria) that define the value of funding available under the contract. If the DB cannot accommodate the request through that facility or through any other products or services acceptable to the client, this would mandate an offer of referral. (Note, the client business would be bound by the terms of the current agreement for its defined duration.)

- Where, for whatever reason, a DB wishes to reduce the amount of funding available under a facility by reducing one or more of the two core parameters and where the client is not willing to accept the reduction and requests finance additional to that.