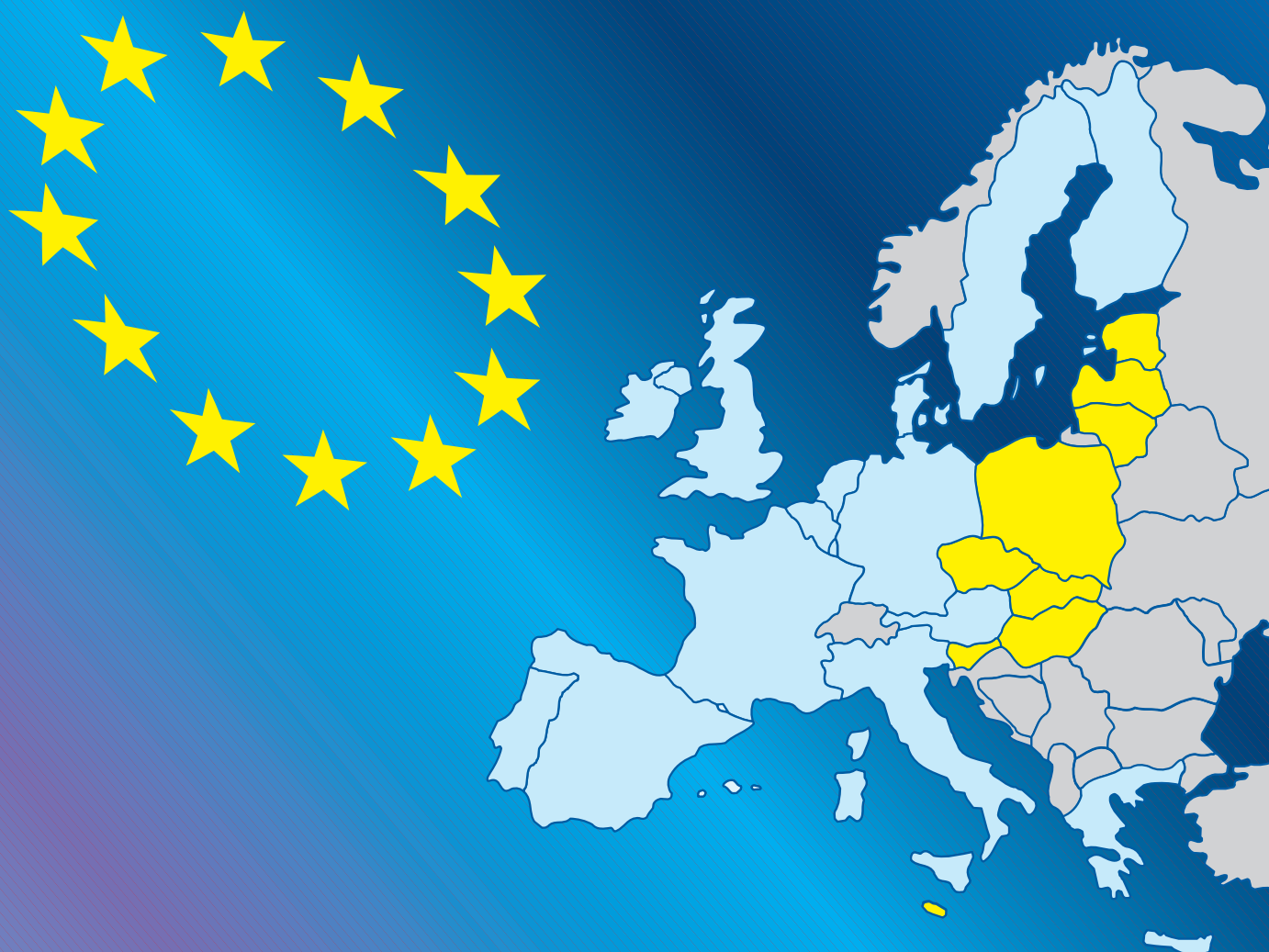


# Financing Small and Medium-size Enterprises with Factoring: Global Growth in Factoring—and Its Potential in Eastern Europe



**Marie H. R. Bakker, The World Bank**  
**Leora Klapper, The World Bank**  
**Gregory F. Udell, Indiana University**

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May 2004

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## EXECUTIVE SUMMARY

In recent years factoring has experienced phenomenal growth and has become an important source of financing—especially short term working capital—for small and medium-size enterprises (SMEs) and corporations, reaching a worldwide volume of 760 billion euro in 2003. Although the importance of factoring varies considerably around the world, it occurs in most countries and is growing especially quickly in many developing countries. This paper explores the advantages of factoring over other types of lending for firms in developing economies, and discusses the informational, legal, tax and regulatory barriers to its growth. It also examines the role of factoring in the eight Eastern European countries that became EU members on May 1, 2004—the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia, referred to as the EU 8.

Factoring is a form of asset-based finance where the credit extended is based on the value of the borrower's accounts receivable—that is, the payments owed by the borrower's customers. Unlike the other main form of asset-based finance, asset-based lending, the receivables are purchased by the factor rather than used as collateral in a loan. That is, under factoring, title and ownership of the receivables shifts from the seller to the factor. Factoring also typically involves more than just financing and generally includes two other services: credit and collections.

This bundling of services is one of factoring's advantages over other types of lending, particularly for SMEs that do not have the expertise or resources to manage their credit and collection activities. Factoring is also useful for providing financing to high-risk, informationally opaque borrowers, because underwriting is based on the risk of the borrower's accounts—not the risk of the borrower. Thus factoring may be especially well-suited to financing receivables from large or foreign companies more creditworthy than the factoring client. Finally, factoring can play an important role in financial systems with weak commercial laws, contract enforcement, and bankruptcy systems. Under such conditions the virtue of factoring is that factored receivables are removed from the bankruptcy estate of the borrower and become the property of the factor.

This paper starts by summarizing factoring's distinguishing features, origins, and mechanics. It then examines factoring's role in the international financial landscape, including how it compares with other lending products for SMEs. The paper then analyzes issues that drive the importance of these products around the globe, including countries' information infrastructure, legal and judicial frameworks, and tax and regulatory environments. After that the paper focuses on the EU 8, assessing conditions that will foster—or undermine—the development of the factoring industry in these countries. The paper concludes that factoring offers key advantages over other lending products and is likely to become more important in these countries, and suggests policies to accelerate its development.

## WHAT IS FACTORING?

Around the world, factoring is the dominant form of asset-based finance and an important source of external financing for corporations and small and medium-size enterprises (SMEs). Under asset-based finance the credit provided by a lender is explicitly linked on a formula basis to the value of a borrower's underlying (working capital) assets, not the borrower's overall creditworthiness. This explicit link is continuously managed so that the value of the underlying assets always exceeds the amount of the credit. In factoring the underlying assets are the borrower's accounts receivable—that is, sale payments due from customers—which the factor (lender) purchases at a discount. For example, a seller (borrower) might receive from a factor 70 percent of the value of an account receivable, and the remaining 30 percent (less interest and service fees) upon receiving payment from the customer.<sup>1</sup>

In developing countries factoring offers several advantages over other types of lending. First, factoring may be particularly useful in countries with weak secured lending laws, inefficient bankruptcy systems, and imperfect records of upholding seniority claims, because factored receivables are not part of the estate of a bankrupt SME. Second, in a factoring relationship the credit is primarily based on quality of the underlying accounts—not the quality of the borrower. Thus factoring may be especially attractive to high-risk SMEs. Factoring can mitigate the problem of borrowers' informational opacity in business environments with weak information infrastructures if factors can develop proprietary databases on account payment performance and if the underlying accounts are the obligations of relatively transparent firms. The latter condition holds when a borrowing SME has receivables from larger enterprises or has foreign receivables from firms in countries with a stronger information infrastructure.

Occurring around the world, the global volume of factoring reached 760 billion euro in 2003, an increase of 67 percent over 1998 (Table 1A). In some countries, such as the United States, factoring's importance as a primary source of working capital is concentrated in certain industries. But in other countries, such as Italy, factoring's importance as a primary source of working capital is far more widespread. Both domestic and international factoring are becoming major sources of financing in developing economies—including in Eastern Europe (EU 8 plus Romania), where factoring grew by 434 percent in aggregate between 1998 and 2003, with some individual countries displaying even higher growth rates (Table 1B).

Like traditional commercial lending, factoring provides SMEs with working capital. But factoring and asset-based lending (another type of asset-based finance) are both quite different from traditional commercial lending, where credit is primarily based on the borrower's creditworthiness rather than the value of the borrower's underlying assets. In a traditional lending relationship in well-developed financial markets, the lender looks to collateral only as a secondary source of repayment. The primary source of repayment is the borrower and its viability as an ongoing concern.

In addition, in a traditional commercial loan the extension of credit—even when it is collateralized by accounts receivable—is not explicitly linked to the value of the underlying assets (such as the continuously updated value of accounts receivable). In contrast, under asset-based finance the under-

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<sup>1</sup> The other type of asset-based finance, known as asset-based lending, is practiced in only a few countries—mainly the United States, and to a lesser extent Australia, Canada and the United Kingdom. (In the United Kingdom asset-based lending is known as invoice discounting.) Whereas under factoring the lender (factor) purchases accounts receivable from the seller, under asset-based lending the lender secures the assets as collateral. Moreover, collateral is not limited to accounts receivable: it can also include inventory and equipment. Thus, asset-based lending requires good secured lending laws, electronic collateral registries, and quick and efficient judicial systems, which are often unavailable in developing countries. Asset-based lending is discussed in greater detail later in this paper.

**Table 1A. Global Factoring Annual Volume by Country (million euro)**

	1998	1999	2000	2001	2002	2003	Percent Change 1998-2003
Austria	1832	2007	2275	2181	2275	2932	60.0%
Belgium	4366	7630	8000	9000	9391	11500	163.4%
Cyprus	959	1120	1410	1554	1997	2035	112.2%
Czech Republic	468	780	1005	1230	1681	1880	301.7%
Denmark	2894	3360	4050	5488	5200	5570	92.5%
Estonia, Latvia, Lithuania	213	470	615	1400	2143	2262	962.0%
Finland	5230	5630	7130	7445	9067	8810	68.5%
France	44255	53100	52450	67660	67398	73200	65.4%
Germany	20323	19984	23483	29373	30156	35082	72.6%
Greece	596	850	1500	2050	2694	3680	517.4%
Hungary	115	144	344	546	580	1142	893.0%
Iceland	21	100	125	26	16	25	19.0%
Ireland	3957	6160	6500	7813	8620	8850	123.7%
Italy	75319	88000	110000	124823	134804	132510	75.9%
Luxembourg	0	0	0	0	197	257	..
Netherlands	17702	20500	15900	17800	20120	17500	-1.1%
Norway	3787	4260	4960	5700	7030	7625	101.3%
Poland	609	605	2085	3330	2500	2580	323.6%
Portugal	5545	7450	8995	10189	11343	12181	119.7%
Romania	20	37	60	98	141	225	1025.0%
Russia	0	0	0	0	168	485	..
Slovakia	179	160	160	240	240	384	114.5%
Slovenia	14	35	65	71	75	170	1114.3%
Spain	9936	12530	19500	23600	31567	37486	277.3%
Sweden	7677	7550	12310	5250	10229	10950	42.6%
Switzerland	1464	1300	1300	1430	2250	1514	3.4%
Turkey	4043	5250	6390	3947	4263	5330	31.8%
United Kingdom	84255	103200	123770	136080	156706	160770	90.8%
<b>EUROPE TOTAL</b>	<b>295779</b>	<b>352212</b>	<b>414382</b>	<b>468324</b>	<b>522851</b>	<b>546935</b>	<b>84.9%</b>
Argentina	1026	1481	1715	1017	71	70	-93.2%
Brazil	13620	17010	12012	11020	11030	12040	-11.6%
Canada	1863	1952	2256	2699	3100	3161	69.7%
Chile	1991	2600	2650	3123	3130	3500	75.8%
Costa Rica	162	226	258	208	210	185	14.2%
Cuba	0	185	108	113	120	93	..
El Salvador	0	0	0	123	157	102	..
Mexico	2519	3550	5030	6890	6340	4535	80.0%
Panama	0	11	220	220	0	160	..
U.S.A.	70059	88069	102268	101744	91143	80696	15.2%
<b>AMERICAS TOTAL</b>	<b>91240</b>	<b>115084</b>	<b>126517</b>	<b>127157</b>	<b>115301</b>	<b>104542</b>	<b>14.6%</b>
Israel	108	219	460	429	354	190	75.9%
Lebanon	0	0	0	10	22	35	..
Morocco	187	57	45	50	190	160	-14.4%
Oman	14	21	30	36	29	10	-28.6%
Saudi Arabia	0	0	0	150	100	50	..
South Africa	3957	5340	5550	5580	5860	5470	38.2%
Tunisia	54	73	60	171	153	210	288.9%
United Arab Emirates	0	0	0	0	0	37	..
<b>AFRICA &amp; MIDDLE EAST TOTAL</b>	<b>4320</b>	<b>5710</b>	<b>6145</b>	<b>6426</b>	<b>6708</b>	<b>6162</b>	<b>42.6%</b>
China	11	31	212	1234	2077	2640	23900.0%
Hong Kong	1294	1800	2400	2690	3029	3250	151.2%
Indonesia	28	33	3	0	1	1	-96.4%
India	174	257	470	690	1290	1615	828.2%
Japan	38980	55347	58473	61566	50380	60550	55.3%
Malaysia	687	805	585	842	610	718	4.5%
Singapore	1510	1970	2100	2480	2600	2435	61.3%
South Korea	17149	15120	115	85	55	38	-99.8%
Sri Lanka	38	62	99	115	110	102	168.4%
Taiwan	1004	2090	3650	4511	7919	16000	1493.6%
Thailand	715	1010	1268	1240	1274	1425	99.3%
<b>ASIA TOTAL</b>	<b>61590</b>	<b>78525</b>	<b>69375</b>	<b>75453</b>	<b>69345</b>	<b>88774</b>	<b>44.1%</b>
Australia	3319	5100	7320	7910	9527	13716	313.3%
New Zealand	162	184	100	410	465	263	62.3%
<b>AUSTRALASIA TOTAL</b>	<b>3481</b>	<b>5284</b>	<b>7420</b>	<b>8320</b>	<b>9992</b>	<b>13979</b>	<b>301.6%</b>
<b>WORLD TOTAL</b>	<b>456410</b>	<b>556815</b>	<b>623839</b>	<b>685680</b>	<b>724197</b>	<b>760392</b>	<b>66.6%</b>



Table 1B: Global Factoring– Relative Importance

	Domestic Volume (2003)	International Volume (2003)	Percent International (2003)	Total Volume 2002/GDP 2002	Domestic Credit to Private Sector 2002/GDP 2002	Exports of Goods and Services 2002/GDP 2002
Austria	2598	334	11.4%	1.2%	106.4	52.1
Belgium	9500	2000	17.4%	4.0%	76.3	82.3
Cyprus	2000	35	1.7%	20.7%	125.4	..
Czech Republic	1600	280	14.9%	2.5%	33.4	65.2
Denmark	3570	2000	35.9%	3.2%	146.4	44.9
Estonia, Latvia, Lithuania	2012	250	11.1%	7.8%	21.8	58.2
Finland	8545	265	3.0%	7.2%	60.0	38.1
France	68200	5000	6.8%	4.9%	87.2	27.1
Germany	27131	7951	22.7%	1.6%	118.9	35.5
Greece	3500	180	4.9%	2.1%	67.1	20.5
Hungary	1080	62	5.4%	0.9%	35.3	64.5
Iceland	0	25	100.0%	0.2%	100.5	39.7
Ireland	8800	50	0.6%	7.4%	110.3	..
Italy	124510	8000	6.0%	11.9%	82.3	26.9
Luxembourg	237	20	7.8%	1.0%	111.4	145.3
Netherlands	16000	1500	8.6%	5.0%	147.9	61.7
Norway	6800	825	10.8%	3.9%	86.3	41.5
Poland	2450	130	5.0%	1.4%	28.8	28.0
Portugal	11828	353	2.9%	9.8%	147.9	..
Romania	90	135	60.0%	0.3%	8.3	35.4
Russia	470	15	3.1%	0.1%	17.6	34.7
Slovakia	296	88	22.9%	1.1%	40.6	72.8
Slovenia	140	30	17.6%	0.4%	39.2	57.9
Spain	36443	1043	2.8%	5.1%	111.1	28.5
Sweden	9650	1300	11.9%	4.5%	..	43.3
Switzerland	1298	216	14.3%	0.9%	159.0	44.2
Turkey	4200	1130	21.2%	2.4%	14.9	29.7
United Kingdom	158270	2500	1.6%	10.5%	142.6	25.8
<b>EUROPE TOTAL</b>	<b>511218</b>	<b>35717</b>	<b>6.5%</b>	<b>5.4%</b>		
Argentina	65	5	7.1%	0.1%	15.3	27.7
Brazil	12000	40	0.3%	2.6%	35.5	15.8
Canada	2131	1030	32.6%	0.5%	82.2	..
Chile	3300	200	5.7%	5.1%	68.1	35.9
Costa Rica	180	5	2.7%	1.3%	30.1	42.4
Cuba	30	63	67.7%	..	..	..
El Salvador	100	2	2.0%	1.2%	..	26.7
Mexico	4435	100	2.2%	1.0%	12.6	27.2
Panama	160	0	0.0%	0.0%	97.6	28.2
U.S.A.	77496	3200	4.0%	0.9%	140.6	9.8
<b>AMERICAS TOTAL</b>	<b>99897</b>	<b>4645</b>	<b>4.4%</b>	<b>1.0%</b>		
Israel	20	170	89.5%	0.4%	97.8	37.2
Lebanon	35	0	0.0%	0.1%	90.8	13.9
Morocco	130	30	18.8%	0.6%	54.4	32.3
Oman	10	0	0.0%	0.1%	38.6	56.8
Saudi Arabia	50	0	0.0%	0.1%	58.2	40.8
South Africa	5350	120	2.2%	5.9%	131.7	34.0
Tunisia	160	50	23.8%	0.8%	68.6	44.8
United Arab Emirates	36	1	2.7%	0.0%	55.9	..
<b>AFRICA &amp; MIDDLE EAST TOTAL</b>	<b>5791</b>	<b>371</b>	<b>6.0%</b>	<b>1.3%</b>		
China	2400	240	9.1%	0.2%	136.5	28.9
Hong Kong	2000	1250	38.5%	2.0%	150.1	150.8
Indonesia	1	0	0.0%	0.0%	22.3	35.4
India	1500	115	7.1%	0.3%	32.6	15.2
Japan	60000	550	0.9%	1.3%	175.3	11.1
Malaysia	690	28	3.9%	0.7%	146.1	114.1
Singapore	2060	375	15.4%	3.1%	115.5	..
South Korea	0	38	100.0%	0.0%	115.6	40.0
Sri Lanka	94	8	7.8%	0.7%	28.5	36.2
Taiwan	11700	4300	26.9%	2.9%	..	53.8
Thailand	1400	25	1.8%	1.1%	102.5	64.7
<b>ASIA TOTAL</b>	<b>81845</b>	<b>6929</b>	<b>7.8%</b>	<b>1.0%</b>		
Australia	13656	60	0.4%	2.4%	..	19.6
New Zealand	250	13	4.9%	0.8%	118.1	33.2
<b>AUSTRALASIA TOTAL</b>	<b>13906</b>	<b>73</b>	<b>0.5%</b>	<b>2.2%</b>		
<b>WORLD TOTAL</b>	<b>712657</b>	<b>47735</b>	<b>6.3%</b>	<b>2.5%</b>		

Source: Factors Chain International, World Bank.

writing focus is the value of the underlying assets (that is, the accounts receivable, and the inventory under asset-based lending in Australia, Canada, the United Kingdom and the United States). The borrower's viability and creditworthiness, though not irrelevant, are only of secondary underwriting importance.

Factoring can be done on a non-recourse or recourse basis. In well-developed financial markets a lot of factoring occurs on a non-recourse basis, where the factor assumes title to the accounts as well as all or most of the default risk, because the factor does not have a claim (recourse) against its client (the borrower) if the accounts default. Under recourse factoring, on the other hand, the factor has a claim against its borrower for any account payment deficiency. Thus losses occur only if the underlying accounts default and the borrower cannot make up the deficiency.

In developed countries factoring is usually done on a non-recourse basis. In Italy, for example, 69 percent of factoring is done on a non-recourse basis (Muschella 2003). Similarly, a study of publicly traded U.S. firms found that 73 percent factored their receivables on a non-recourse basis—but that sellers (borrowers) with low-quality receivables were more likely to factor under recourse (Sopranzetti 1998).<sup>2</sup> But in emerging markets, where it is often difficult to assess the default risk of underlying accounts, most factoring is done on a recourse basis.<sup>3</sup>

In addition to the recourse/non-recourse dimension, factoring can be done on either a notification or a non-notification basis. Notification means that the client's customers are notified that their accounts (that is, their payables) have been sold to a factor. Under notification factoring the client typically furnishes the factor with delivery receipts, an assignment of the accounts, and duplicate invoices that clearly indicate to the client's customers the identity of the factor and the fact that their accounts have been purchased by the factor.<sup>4</sup>

As noted, in a typical factoring relationship the factor provides a bundle of services: financing, the credit risk assumption service, and the collection service. The credit services involve assessing the creditworthiness of the client's customers whose accounts the factor will purchase, based on the invoices associated with each account. (This does not mean that the client cannot sell and extend trade credit to a customer whose credit has been denied by the factor—but the client will not receive funding for those invoices.) Factors typically base these assessments on a combination of their proprietary data and publicly available data on account payment performance.

The collection services involve collecting current accounts and collecting delinquent accounts and minimizing the losses associated with the latter. This means dunning delinquent accounts and pursuing collections through the judicial system.<sup>5</sup> Essentially, SMEs that use factors are outsourcing their credit and collection functions—another important distinction between factors and traditional commercial lenders.<sup>6</sup>

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<sup>2</sup> Sopranzetti's results are consistent with the theoretical model he presents in his paper. This model allows for the possibility that factors have better monitoring capacity than sellers—a view that appears quite consistent with the typical way that factoring is conducted. His model is also based on the assumption that sellers and factors have equal ability to observe account quality. This assumption may be difficult to reconcile with industry practice. It appears that in most cases factors have better information about the quality of the underlying accounts because of the economies of scale they enjoy in developing large databases on account payment performance (Udell forthcoming). As noted in the main text, factoring may best be viewed as a bundle of services, one of which is outsourcing of the credit function.

<sup>3</sup> One exception to the dominance of recourse factoring in Eastern Europe (and other emerging markets) appears to be the case of factoring foreign receivables. As discussed later in the paper, most foreign receivables appear to be factored on a non-recourse basis, though they typically also involve either a factoring alliance or credit insurance.

<sup>4</sup> In general, factoring with recourse does not include notification, but factoring without recourse may. Because in many countries there is a negative association with factoring, firms may be apprehensive to use factors that notify customers.

<sup>5</sup> Dunning refers to notification to the obligor by the obligee, or the obligee's agent, that an account is delinquent (that is, past due).

<sup>6</sup> Factors, in turn, may outsource the collection of delinquent accounts to bad debt collectors.

### Box 1. The History of Factoring

Factoring is one of the oldest forms of commercial finance. Some scholars trace its origins to the Roman Empire (Rutberg 1994)—and some even further back to the Hammurabi, four thousand years ago (Papadimitriou, Phillips, and Wray 1994). The term *factor* comes from the Latin verb *facio*, which means “he who does things.” As the Latin verb suggests, the history of factoring is the history of agents doing things for others.

For example, factoring was a well-developed activity in England in the 14<sup>th</sup> century, where it evolved with the growth of the wool industry. The job of factors centered on their functions as sales agents, or commission merchants, for textile mills. The distances between customers and manufacturers made commerce problematic—given the primitive forms of transportation and communication—so factors assumed complementary functions to address the business challenges that arose because of these distances.

At the center of these functions was the factors’ role as the sales force for the textile mills. As a byproduct of this activity, factors assumed other marketing and distribution functions, including offering advice on customer tastes, product demand, and warehousing services—so that mills could ship merchandise to the factors, who would then ship to the final customers.

Factors also assumed some critical financial functions on behalf of the mills. They offered credit advice on how much to sell on account to potential customers. They also guaranteed payments to the mills, assuming full responsibility for the creditworthiness of the mills’ customers. To protect themselves, factors established reserves to cover claims for defective merchandise and any disputes that arose out of those claims. Finally, and equally important from an historical perspective, factors advanced funding to the mills based on the value of the merchandise sold. Thus, in essence, factoring was fully reflected economically in the financial component of the factoring business as it existed 600 years ago.

The difference between today and 600 years ago is that the sales, or “agenting,” component has been purged from the factoring relationship. But factoring as it is typically practiced in both developed and developing economies can still be viewed as a bundle of activities. In addition to financing, factors typically provide their clients with two other services: credit and collections.

A factor may enjoy several important advantages in offering credit and collection services. First, it may reap significant economies of scale in both activities relative to its clients. Because the factor performs these services for many different clients, it can amortize the fixed costs associated with them. In addition, most small SMEs likely have little expertise in either area. Finally, factors generate proprietary databases on account payment performance. The largest and more experienced factors essentially become the equivalent of large credit information exchanges, offering an alternative to private commercial credit bureaus and public credit registries. They also enjoy the same economies of scale in information exchange that credit bureaus and public credit registries do (Kallberg and Udell 2003a).

Another feature of the factoring relationship is that a factor typically advances less than 100 percent of the face value of the receivable even though it takes ownership of the entire receivable. The difference between this advance amount and the invoice amount (adjusted for any netting effects such as sales rebates) creates a reserve held by the factor. This reserve will be used to cover any deficiencies in the payment of the related invoice related to customer claims or allowances.<sup>7</sup> If and when the invoice is paid in full, the factor remits the reserve amount to the client.<sup>8</sup> A typical advance rate might be 70 percent (although this could be up to 90 percent), which establishes a 30 percent reserve.

Factors charge their clients a commission fee, and an additional interest charge (if the client avails himself of the funding option). In the simplest arrangements this could all be subsumed in a single commission. Thus, for example, if the factor purchases a \$100 receivable from its client under

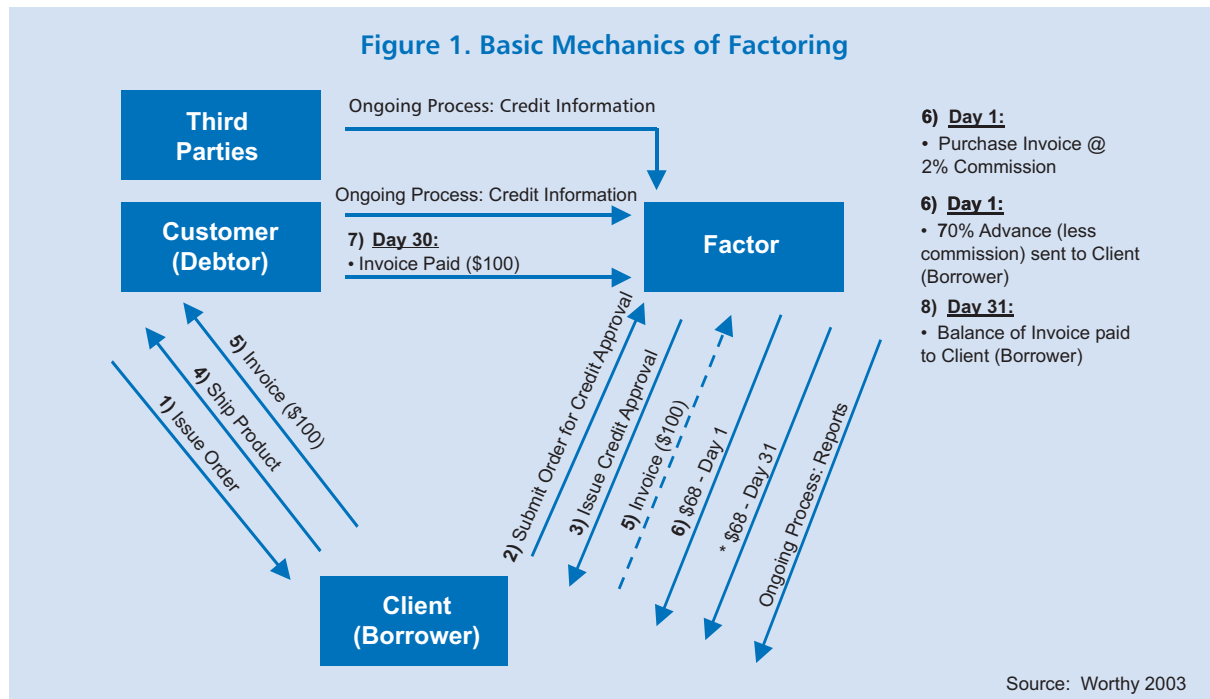
<sup>7</sup> The availability of this reserve to cover deficiencies may vary. In the situation described above, the reserve is applied only to the invoices of a specific account. Alternatively, the factoring contract could permit reserves against one account to be applied to deficiencies in other accounts.

<sup>8</sup> The reserve account represents a liability of the factor to its client. In effect, the client has extended contingent credit to the factor, exposing the client to risk. If the factor becomes insolvent, the client will become a general creditor of the factor and be exposed to a potential loss up to the amount of the reserve. Thus the factor’s reputation and creditworthiness may be important considerations for the client.

## What Is Factoring?

a factoring relationship that specifies a 70 percent advance and 2 percent commission, the factor would advance \$68 and acquire ownership of the receivables on the day the invoices are generated. If the invoices are paid in 31 days, the factor remits \$30 to the client on the 31<sup>st</sup> day (Figure 1).

Factoring usually involves additional fees beyond the commission. For example, interest may be charged on the outstanding balance of receivables or on the balance of receivables outstanding more than a fixed number of days.<sup>9</sup> Alternatively, interest can be fixed and included in the commission. Factoring may also include an application fee, credit checking fees, an origination fee, pre-contract due diligence fees (to conduct onsite and offsite reviews of client books and records), and fees to search public records for tax liens or judgments, lawsuits, bankruptcy filings, administrative actions, news items, press releases, and the like (Worthy 2003).



The specific fees will be defined in the factoring agreement. This agreement will also cover a broad range of other issues associated with the relationship between the factor and the client, including the effective date of agreement, initial terms, renewal options, exclusivity of the factoring relationship, invoices required to be factored, minimum factored volume requirement, maximum cash advances available to client, purchase price of invoices, percentage of purchase price to which client is entitled to be paid in advance, minimum required reserve percentage or amount, and termination provisions.<sup>10</sup>

<sup>9</sup> In some factoring relationships, known as maturity factoring, the factor advances funds only on invoices outstanding more than a specified period, such as 30 days.

<sup>10</sup> For more detail on the practice of factoring see Salinger (1999).

## FACTORING FROM A GLOBAL PERSPECTIVE

This section assesses the importance of factoring in different countries, including the conditions that determine that importance. The discussion begins with an analysis of where factoring fits in the menu of lending products for SMEs. Next it considers the special case of factoring foreign receivables. After that, the global factoring market is summarized. The section ends with a discussion of how a country's information infrastructure and legal environment affect the use of factoring relative to other financing techniques.

### LENDING PRODUCTS: WHERE FACTORING FITS

Private debt markets offer highly structured, complex contracts to informationally opaque SMEs. Except for trade credit, most external financing to SMEs is extended by financial intermediaries that produce information about small businesses to solve the problems that arise from information asymmetries. The access to credit information and the technology in local lending environments determine the extent to which SMEs obtain sufficient external financing to exploit profitable projects. The extent to which the business environment inhibits the optimal provision of credit determines the size of the funding gap that SMEs might face.

This section examines how factoring and the other lending products used in SME financing differ in terms of the underwriting process and the contracts associated with each product, and how each product addresses asymmetric information. This discussion will be helpful for the sections that follow, and will help explain why factoring may be better suited for developing economies than some other lending products.

From a policy perspective the importance of these various types of lending stems from the possibility that SMEs face significant funding gaps, which would occur if firms encountered significant financial constraints due to systematic credit rationing.<sup>11</sup> In a Modigliani and Miller world with complete information transparency, there would be no financial constraints that would inhibit SME growth. Therefore, the severity of the funding gap problem depends on the magnitude of information problems in SME financing (i.e., deviations from information transparency) and the strength of lending technologies to mitigate these problems.

Evidence suggests that the funding gap is a serious problem for SMEs. For example, insider finance is extremely important in SME funding—suggesting an information-driven pecking order to such financing (Berger and Udell 1998). Personal net worth and personal assets are important factors in determining whether potential entrepreneurs decide to start businesses (Evans and Jovanovic 1989; Evans and Leighton 1989; Holtz-Eakin, Joulfaian, and Rosen 1994; Lel and Udell 2002) and how they initially invest in their firms (Ando 1985; Holtz-Eakin, Joulfaian, and Rosen 1994).<sup>12</sup> SME funding gaps are also indicated by the fact that small firms' cash flows affect their investment decisions (Fazzari, Hubbard, and Petersen 1988).

<sup>11</sup> There is a long theoretical literature on equilibrium credit rationing based on asymmetric information, beginning with Stiglitz and Weiss (1981). Around the world, governments invest billions of dollars a year in loan and equity guarantee schemes, venture capital trusts, soft loan schemes, grants, equity investments, and other programs to address the perceived funding gaps in their national economies. These initiatives are often partly motivated by the belief that SME growth is critical to solving unemployment problems (e.g., Cressy 2002).

<sup>12</sup> Although these findings are generally consistent with the presence of funding constraints, they may also be consistent with other explanations. It may be that these results are driven by risk aversion rather than financial constraints. There is even evidence that informational opacity may lead to excess SME funding (de Meza 2002).

Perhaps the most persuasive evidence that this is not a Modigliani and Miller world is the fact that financial markets are not indifferent about financial contracting. The contracts associated with SME financing are not the same as the contracts associated with funding for larger firms. For example, covenants tend to be more restrictive for smaller enterprises (Carey and others 1993) and for more informationally opaque firms (Berlin and Mester 1993), loan maturities tend to be shorter for smaller enterprises (Carey and others 1993), and collateral tends to be used more often for riskier borrowers (Berger and Udell 1990, 1992; Carey, Post, and Sharpe 1998; Booth 1992; Klapper 1998).

Although it is useful to think about SME contracting in terms of these kinds of contract features, this approach is incomplete—particularly for understanding how SMEs are financed across the globe. Instead, recent analyses of SME financing emphasize that lenders use a variety of financing “technologies” (that is, credit products) partly comprised of different combinations of these contract features (Berger and Udell 2002). More fundamentally, however, these technologies can be differentiated based on how they deploy contract features in underwriting and monitoring borrowers in ways that address problems associated with informational opacity, the type of financing needed, and the lending environment of the borrower. Although factoring has some advantages over the other technologies, it also has disadvantages. But on balance, the advantages significantly outweigh the disadvantages in developing economies.

This section assesses five lending technologies (including factoring) and two quasi-lending technologies used to mitigate the funding gap problem. All of these technologies address the challenge of financing SMEs whose severe informational opacity makes financial contracting problematic because firm insiders (entrepreneurs) know much more about their firm’s quality than do outsiders. This opacity leads to adverse selection when external finance is originated (that is, underwritten) because weak firms mimic strong firms to obtain more favorable financing. It also leads to moral hazard after funding, because entrepreneurs may exploit lenders by shifting from low- to high-risk strategies or may engage in expense preference behavior.<sup>13</sup>

### Financial statement lending

Financial statement lending involves underwriting loans based on a borrower’s financial statements. There are two requirements. First, the borrower must have informative financial statements (such as audited statements prepared by a reputable accounting firm according to widely accepted accounting standards). Second, the financial ratios calculated from these statements must show that the borrower has a strong financial condition. The loan contracts that arise from analyses of these financial statements may reflect a variety of contracting elements, including collateral, personal guarantees, and covenants. But under financial statement lending the lender will view the company’s performance as an ongoing concern (that is, its cash flow) as the primary source of repayment.

Financial statement lending addresses the asymmetric information problem by generating information about borrowers through informative financial statements. Interest rates, covenants, collateral, and other contracting elements can be used in conjunction with this information to further ease the

<sup>13</sup> There is also a private equity market that provides financing for a select group of SMEs—startup companies with extremely high growth opportunities that often cannot get external debt financing because they lack tangible assets on their balance sheets. In developed countries these enterprises are concentrated in the computer software, health care, and biotechnology markets. Investments in these firms are driven by the prospect of eventually taking the firms public. The investment side of this market is composed of individual investors called “angels” and venture capital firms. In the United States the angel market is much smaller than the commercial loan market, supplying only 3.6 percent of SME financing, while commercial lending supplies 23.6 percent and trade credit supplies 15.8 percent (Berger and Udell 1998). (Because of severe data limitations, the angel market estimate should be viewed with caution.) Venture capital firms provide even less funding: 1.9 percent. Venture capital firms are much more developed in the United States than in most other countries, though there was a notable increase in Western Europe in the late 1990s.

risks of adverse selection and moral hazard. To successfully use financial statement lending, a financial system must have well-defined accounting rules, and the borrower must have audited financial statements. For small SMEs this latter condition is problematic—even in economies with strong accounting standards—because of the cost of such statements.

### Relationship lending

Relationship lending addresses the information deficiencies that make financial statement lending problematic for some SMEs. The primary information used by lenders is “soft” information about the relationship between the lender and the borrower (Rajan 1992). Over time lenders acquire proprietary information about borrowers and their businesses from the provision of loans (Petersen and Rajan 1994; Berger and Udell 1995) and other products (Nakamura 1993; Cole 1998; Mester, Nakamura, and Renault 1998; Degryse and van Cayseele 2000). This includes information on the local community and business environment and the entrepreneur and the SME’s interaction with that environment. But this type of labor-intensive lending can be quite costly—costs that are likely passed on to borrowers in the form of higher fees.

Relationship lending is important in many countries, including Germany (Elsas and Krahnert 1998; Harhoff and Körting 1998), Italy (Conigliani, Ferri, and Generale 1997; Ferri and Messori 2000), Japan (Hoshi, Kashyap, and Sharfstein 1990), Spain (Jimenez and Saurina 2003), and the United States (Petersen and Rajan 1994, 1995; Berger and Udell 1995). The strength of the lender-borrower relationship often affects financial contracting on dimensions such as interest rates, collateral, dependence on trade credit, and credit availability.

There is no hard evidence on the relative importance of relationship lending—or, for that matter, financial statement lending. Unlike some other lending technologies, such as asset-based lending or factoring, relationship lending and financial statement lending do not appear to be delivered out of separate departments in lending organizations. But there is some indirect evidence. Several studies indicate that large banks tend to make loans based on hard information (such as financial statements), while small banks tend to emphasize soft information (that is, relationship lending), suggesting that relationship lending may be best delivered through smaller banks (Berger and Udell 2002; Berger A. and I. Hassan, 2004; Cole, Goldberg, and White 2004; Scott 2004). These studies are consistent with Stein (2002), which shows that the processing and communication of soft information may be difficult for large banks.

### Credit-scored lending

Credit scoring and similar quantitative techniques have been developed to evaluate credit risk. These statistical models are used to quantify default probability or default risk classification and include the linear probability model, logit models, and linear discriminant analysis (Saunders 1997).<sup>14</sup> Widely used in consumer lending for three decades, credit scoring has only recently been applied to SME and micro-enterprise lending.<sup>15</sup>

The credit scoring models used in SME and micro-enterprise lending tend to be more complex than those used in consumer lending and place considerable weight on factors associated with the entrepreneur’s financial history (Feldman 1997). This follows from the fact that for the smallest

<sup>14</sup> For a more detailed discussion of credit scoring models and newer quantitative techniques that can be used for credit risk measurement and pricing, see Saunders (1999).

<sup>15</sup> A type of credit scoring based on the original Altman Z-score model has been used for lending to medium-size and large business enterprises since the 1970s (see Udell 1987). Even today, however, credit scoring does not appear to be used as the primary underwriting criteria in these segments of the commercial loan market (see Udell 2004, ch. 5).

SMEs, the creditworthiness of the owner is likely closely intertwined with the creditworthiness of the business (Ang 1992; Mester 1997).<sup>16</sup> But like consumer credit scoring, SME and micro-enterprise credit scoring depends on a strong information infrastructure—particularly informative data from credit bureaus. The adoption of SME and micro-enterprise credit scoring by lenders in countries with weak information infrastructure may be problematic.

### **Asset-based lending**

Lenders may be able to overcome information asymmetry by using asset-based lending, where the borrower's underlying assets are offered as collateral and considered the primary source of repayment. When providing working capital financing, banks look to short-term assets such as accounts receivable and inventory, and to equipment. The pledging of collateral does not, by itself, distinguish asset-based lending from the three previous lending technologies. Collateralization with accounts receivable, inventory, or equipment can be associated with financial statement lending, relationship lending, and credit scoring. The difference is that with the other lending types, collateral (if it is used) is viewed as a secondary source of repayment—whereas under asset-based lending, it is viewed as the primary source of repayment.

The amount of credit extended under an asset-based loan is explicitly linked on a formula basis to the liquidation value of the assets used as collateral. This link is continuously monitored to ensure that the value of the assets always exceeds the amount of the loan. A key benefit of asset-based lending is that an SME's riskiness is not necessarily a barrier to finance if its underlying assets have sufficient liquidation value. Thus, asset-based lending is well suited to high-risk SMEs.<sup>17</sup>

Another strength of asset-based lending is its ability to generate information about borrower performance through the continuous monitoring of the underlying assets. This helps eliminate the extreme form of risk shifting (moral hazard) that occurs when a firm's insiders know that the company is in distress before outsiders do (Udell forthcoming). Asset-based lending is an important source of financing in the United States, where asset-based loans account for about one-third of total bank commercial and industrial loans. But it is only significant in two other countries, Canada and the United Kingdom. To be feasible, asset-based lending requires well-defined commercial law that clearly specifies security interests, an efficient lien registration system that clearly defines when liens are filed, and an efficient bankruptcy system that preserves lender priority (particularly security priority) and minimizes time in bankruptcy.

### **Factoring**

As discussed, factoring involves the purchase of accounts receivable by a lender known as a factor. Though factoring is similar to asset-based lending, there are three important differences. First, factoring involves only financing of accounts receivable, whereas asset-based lending also involves financing of inventory and equipment. Second, under factoring the underlying asset, accounts receivable, is sold to the lender (factor). Thus, title to them passes from the borrower to the lender—which means that if the borrower becomes insolvent, the underlying asset (the factored accounts receivable) is not part of the bankrupt's estate. This distinction can be extremely important in financial systems with ambiguous commercial law or inefficient bankruptcy systems (see below).

<sup>16</sup> Lenders can purchase small business credit scoring models from vendors such as Fair Isaac.

<sup>17</sup> There is relatively little empirical evidence on asset-based finance. Among the exceptions are recent studies that find evidence consistent with practitioner and conventional wisdom that asset-based finance is associated with riskier borrowers (Carey, Post, and Sharpe 1998; Klapper 2000). For a more detailed and institutional perspective on asset-based lending, see Udell (forthcoming).



Third, factoring is essentially a bundle of three services. The first is financing. Factors purchase receivables on a formula basis in a manner similar to the accounts receivable component of an asset-based loan relationship. The formula takes into account the creditworthiness of the underlying accounts, dilution issues (for example, merchandise disputes, returned items), and the cost of collections. As noted, factoring can be done on a recourse or non-recourse basis. Under the recourse approach the factor has a contingent claim against the borrower for any deficiency in the collection of the receivables. Under non-recourse factoring the factor assumes the risk associated with any loss in the collection of the receivables. In non-recourse factoring the factor typically advances less than the full face value of the receivables, and this “discount” is the difference between the advance and the face value (e.g., 30 percent). A small portion of this discount is compensation for services rendered, but the bulk of it is a reserve that can be used to offset merchandise disputes, returned items or other customer claims or allowances.

The second service under factoring is the credit function. As noted, SMEs who use factoring are essentially outsourcing their credit functions. The added value here is that factors enjoy significant economies of scale when making credit decisions, reflecting their superior access to credit information (including their own proprietary databases—“payment performance” being the most important). The third service is collecting on delinquent accounts. Again, SMEs essentially outsource their collection activities to factors,<sup>18</sup> and factors enjoy significant economies of scale in this regard.

### Trade credit

Trade credit is an important source of SME financing. Trade credit is credit extended by a firm’s suppliers when the supplier sells the firm goods or services on account. Instead of paying for the goods and services with cash (i.e., immediately), the firm pays its suppliers with a lag which creates the equivalent of a loan (i.e., trade credit) from the suppliers to the firm. In the United States, for example, trade credit accounts for 16 percent of SME financing (Berger and Udell 1998). Still, the categorization of trade credit as a separate lending technology hinges on whether its underwriting involves elements that distinguish it from the technologies already discussed.

Many of the previous technologies appear to be used in underwriting trade credit. For example, credit scoring and similar quantitative techniques have long been part of the underwriting process used by credit managers. For large accounts, financial statements are analyzed as part of the underwriting process. And “soft” information and mutual trust developed over time undoubtedly play a role in some trade credit, as in relationship lending.

The argument in favor of categorizing trade credit as a distinct lending technology is based on the possible advantages that trade creditors have over other lenders. Researchers have suggested comparative advantages in funding (Schwartz 1974), production and inventory management (Emery 1987), price discrimination (Meltzer 1960; Schwartz and Whitcomb 1979; Brennan, Maksimovic, and Zechner 1988; Mian and Smith 1992; Petersen and Rajan 1997), and product quality guarantees (Long, Malitz, and Ravid 1994). Some have suggested that trade creditors have an information advantage over other lenders in evaluating their customers’ ability to pay (Emery 1984), solving incentive problems (Biais and Gollier 1997), repossessing and liquidating goods in the event of default (Mian and Smith 1992; Petersen and Rajan 1997), and withholding future supplies (Petersen and Rajan 1997). For these reasons, it has also been suggested that trade credit technology has an advantage over the other technologies in less developed countries (Cook 1999).

Finally, it has been argued that if product sellers (that is, trade creditors) have an information advantage over other lenders (such as banks) and have an automatic collateral priority under local

<sup>18</sup> However, in some cases the originator continues to be the collector.

commercial law, then more trade credit will be used by less creditworthy companies (Frank and Maksimovic 2003)<sup>19</sup>. This argument is consistent with the empirical findings of Chan and others (2001). ( See Petersen and Rajan 1997 for a more complete summary of theories of trade credit.)

But there are reasons to suspect that these distinguishing features of trade credit may be limited. For example, in countries with well-developed information exchanges (private commercial credit bureaus or public credit registries), an established factoring industry, or a well-developed credit insurance industry, it is not clear that trade creditors would have an advantage in terms of access to credit information, given the economies of scale in information that these other institutions enjoy. In fact, when trade creditors are SMEs, the opposite would seem to be true.

In addition, arguments based on trade creditors having an advantage in understanding their customers' business turn on whether the suppliers sell to industries closely related to their own and on the extent to which they sell to a wide variety of industries (which would dilute their industry-specific knowledge). Moreover, arguments based on trade creditors having a superior ability to repossess and liquidate inventory may be problematic in countries where access to bankruptcy estates is limited (as in the United States) or bankruptcy efficiency is weak (as in Italy).<sup>20</sup>

Finally, the existence of a significant credit insurance industry (see below) and the global pervasiveness of factoring cast doubt on the superior information advantage enjoyed by trade creditors. If this advantage existed, then vendors would not outsource their credit function to factors or credit insurers. Given all these issues, and the lack of empirical cross-country analysis that addresses them, it is not clear that trade credit is a separate lending technology.

### **Credit insurance**

Credit insurance involves indemnifying accounts receivable against default. Financial institutions that sell credit insurance to SMEs assume the risk associated with the possibility that some of the firms' invoices may be uncollectible. Credit insurance does not involve credit extension and so cannot be considered a lending technology. But it is closely related to factoring. Like factoring, credit insurance involves the outsourcing of the credit functions. Like the factor, the credit insurer assumes the risk associated with default (normally up to 80– 90%, versus factoring at 100%).

Credit insurance can be purchased by companies that sell to SMEs and by SMEs that sell to other companies (SMEs or large enterprises). In some ways credit insurers compete directly with factors. If a traditional lender (that is, a lender using financial statement or relationship technologies) buys credit insurance on the receivables that it takes as collateral, this is essentially synthetic factoring. Alternatively, an SME could purchase credit insurance on its receivables, enhancing the strength of its balance sheet to make it eligible for a financial statement loan. Finally, a company that primarily seeks to outsource the indemnification of credit risk, but not the financing function, might purchase credit insurance instead of factoring.

Credit insurance is also used to complement factoring. Factors uncomfortable with their exposure on some portion of receivables—say, when exposure on specific accounts or groups of accounts becomes too large—may buy credit insurance to manage this risk. This would be an internal decision

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<sup>19</sup> The general applicability of the Frank and Maksimovic (2003) model might be somewhat limited. Many countries do not give significant collateral priority to trade creditors. For instance, U.S. trade creditors generally do not have a collateral interest in the products they have sold unless they file a purchase-money security interest. This is not common in most trade relationships because the inventory has to be specifically identified (and identifiable) and filed with every invoice.

<sup>20</sup> In addition, in some countries liquidation of assets such as inventory and equipment has become significantly more efficient in the past decade. Large liquidators have substantial databases on asset values, and Internet liquidation auctions appear to have changed liquidation from a local to a national market (Udell forthcoming). So, even if trade creditors enjoyed an advantage in liquidation in the past, this advantage has diminished recently.

of the factor and would typically not affect the factor's client. Government-backed export credit agencies also provide insurance for export factoring.

## FACTORING FOREIGN RECEIVABLES

Factoring of foreign receivables involves additional issues centered on the fact that the account obligors operate in different countries with different information infrastructures and different legal and bankruptcy environments. One solution to this problem is a factor that operates in multiple countries, as is the case with a few of the large factors that operate in Europe. This is not a feasible option, however, for smaller or start-up factoring companies. For these factors, there are two other solutions: export credit insurance and the two-factor system ("correspondent" factoring).

Credit insurance is a straightforward solution. A domestic factor simply purchases credit insurance on the foreign receivables it buys from its local client. In effect, the domestic factor is outsourcing the credit component of the factoring relationship on its foreign receivables while retaining the financing and collection component. The domestic factor gains by retaining an account that it otherwise might not be able to service. The credit insurer gains from the additional business. Thus, in this case credit insurance and factoring are actually complementary activities (Charpentier 2003).

The other alternative is the two-factor system as promulgated by Factors Chain International (FCI). Members of this organization use each other as "correspondent" factors. When a factor in Country A, for instance, is asked to factor exports from Country A to Country B, the factoring company (in Country A) will ask a correspondent factor in Country B to underwrite the credit risk on the importer (in Country B) and to take over the collection task in order to expedite prompt payment by the importer in accordance with the payment terms. The factor working closely with the exporter is referred to as the Export Factor; while the factor in the country of the importer is referred to as the Import Factor. FCI ensures that all its members work along standard rules and offers its members its own communication system.

Using an Import Factor rather than a credit insurance company may not necessarily be the cheapest alternative for the Export Factor, but combining local expertise in the exporter's country with local expertise in the importer's country often leads to superior service to the exporter. In particular, for long-distance trade or for trade between countries with substantial commercial differences, the two-factor solution is often the system of choice.

Not only does the exporter benefit from the two-factor system, but the Export Factor itself also gains from the cooperation with foreign correspondents. By the nature of world trade, factorable merchandise often flows from developing countries to highly developed markets. Export factoring is normally the introductory and principal type of factoring in most developing and transition countries, because in many cases it is easier and safer to factor export receivables, relative to domestic receivables, as in export factoring the underlying receivables are usually located in countries with stronger legal, information, and bankruptcy environments. Relatively inexperienced Export Factors gain in know-how by working closely with foreign Import Factors, companies which have usually existed for many years and have reached leadership in their respective markets. This transfer of know-how has assisted many factors in developing markets to prepare themselves for successful entry into domestic factoring.

## FACTORING IN A GLOBAL CONTEXT—A DESCRIPTIVE ANALYSIS

This section considers factoring from a global perspective. The focus here is merely descriptive: how does the impact of factoring differ by country? The next section builds on this analysis by examining

potential reasons why the importance of factoring differs across countries. Data limitations prevent a detailed, country-level analysis of the size of most of the lending technologies described above. For example, there are no data that permit an analysis of the absolute or relative size of financial statement lending compared with relationship lending. But factoring is an exception: data are available on the volume of factoring at the country level.

Table 1A shows the volume of factoring by country and region from 1998–2003. The top three countries in 2003 were the United Kingdom (160 billion euro), Italy (132 billion euro) and the United States (86 billion euro). Growth in factoring was strongest in Australasia and Europe but evident in all regions. Not surprisingly, growth in factoring was extraordinarily strong in Eastern Europe (EU 8 plus Romania)—growing by 434 percent in aggregate, though from a very small base. (The factoring industry in the EU 8 is discussed in greater detail later in the paper.) Even more established factoring markets in Western Europe, however, displayed unusually strong growth during the period under review: 91 percent in the United Kingdom, 76 percent in Italy, and 73 percent in Germany.

Table 1B shows the volume of factoring as a percentage of GDP in 2002, allowing for comparisons across countries about the importance of factoring to each economy. Factoring is much less important to the financial system in the United States than it is in Cyprus, Italy, the United Kingdom and Portugal, the four countries where factoring plays the largest role in the economy. In regional terms, factoring is most important to the financial system in Europe. But, it is also quite important in countries elsewhere in the world such as Chile, Singapore and South Africa.

In some countries a significant share of receivables is factored internationally, often through factoring alliances. Thus, credit and collection of a receivable generated in international trade can be factored effectively. In most countries the fraction of internationally factored receivables is quite small. However, in some countries such as Israel and Hong Kong this fraction is quite large. The case of Hong Kong (though not the case of Israel), which has a high ratio of exports to GDP, may suggest a positive association between international factoring and higher export activity. Equally striking is the variance of factoring's importance. Even in Europe, where factoring is relatively important, there are big differences in its importance across countries. Relative to credit to the private sector as a percentage of GDP, it appears that countries with more developed factoring sectors have more developed credit markets (Table 1B). But in some cases factoring seems to substitute for weak credit markets, as in Italy, Portugal and the Baltics. In addition, factoring plays only a minor role in some large economies, such as Canada and Germany (the latter for primarily legal reasons). Research on these associations that controls in a multivariate regression analysis for other factors that might affect the volume of factoring indicates that: (i) there is a positive relationship between a higher fraction of international factoring and a larger percentage of exports; and (ii) there is a positive relationship between a higher level of factoring (as percentage of GDP) and greater financial development (Klapper 2000).

## **FACTORING, THE GLOBAL CREDIT MARKET, AND COUNTRY CONDITIONS**

Just as the importance of factoring varies significantly across countries, the relative importance of other credit products varies widely as well. For instance, the fact that factoring plays a much larger role in the Italian than in the U.S. economy likely implies that other types of lending play a much larger role in the United States than in Italy. Although data limitations prevent a complete analysis of all the lending technologies—particularly for financial statement lending and relationship lending—in the case of Italy and the United States there is enough information to speculate that factoring substitutes for asset-based lending. In Italy asset-based lending is nonexistent, while in the United States it is 25 times larger than factoring.

The example of Italy and the United States suggests a more general pattern where lenders adopt the lending products that work best in their credit environments. This implies that the importance of factoring might vary across countries in a systematic way, in line with key aspects of the credit environment. This section explores that possibility by examining some of the factors that drive differences in the importance of factoring across countries.

### Information infrastructure

A financial system's information infrastructure may play a critical role in determining the level of available credit, the mix of available lending products, and the importance of factoring in that mix (Box 2). One key aspect of this infrastructure is information about payment performance. This information may be critical because a firm's record of paying its past obligations may be the best indicator of its ability to pay its future ones.

Third party information exchanges are the most important source of such information. On the consumer side of lending this means consumer credit bureaus. On the commercial side it means public or private business credit bureaus. Credit bureaus address one of the main impediments to credit availability: asymmetric information. If the information divide between borrowers and lenders is too wide, credit rationing may result (Jaffee and Russell 1976; Stiglitz and Weiss 1981).

#### Box 2. The Role of Reverse Factoring

In some developing countries with weak information infrastructure, factors use a different approach to offer their services. In ordinary factoring the factor (lender) generally purchases many accounts receivable from a limited number of sellers. But this approach requires the factor to collect credit information and calculate the credit risk for a large number of customers. In the alternative, known as reverse factoring, the lender pools and purchases receivables payable by only a few high-quality and/or international customers from many suppliers. Thus the lender only needs to collect credit information and calculate the credit risk for a few large, transparent, internationally accredited firms. Because the credit risk is lower, lenders in developing countries can absorb it and are better able to offer non-recourse factoring.

For example, Heller Financial and Wal-Mart have a reverse factoring arrangement in Mexico. Wal-Mart offers its Mexican suppliers the option of having their accounts automatically factored by Heller and receiving immediate payment of 80 percent of the sale. (The additional 20 percent, less interest and service charges, is paid upon Heller's receipt of Wal-Mart's payment.) Although the sellers may not have any relationship with Heller, they can receive short-term financing because they are borrowing on Wal-Mart's credit risk. By providing short-term financing, Wal-Mart is able to negotiate better terms with its suppliers and reduce its payment transaction costs (by paying one bill to Heller rather than to a large number of suppliers). Furthermore, Heller can raise less costly financing by securitizing its portfolio of Wal-Mart accounts receivable, which has a credit rating equal to that of Wal-Mart.

Source: Klapper and Vittas 2003

Participation by lenders in public credit bureaus, typically called credit registries, is often legally mandated above a certain threshold. Most public credit registries are operated by the country's central bank or bank regulator. These government agencies typically require participation by regulated financial institutions above a certain size (see Miller 2003, p. 37). In some countries, such as Belgium and Italy, this threshold is very low for both consumers and businesses— meaning that participation (and, thus, coverage) is very high.

Unlike public credit registries, private credit bureaus are voluntary. That is, lenders voluntarily provide credit information to the credit bureaus. The inclusion of data on commercial bank loans varies by country. For example, in the United States the three private credit bureaus (Equifax, Experian and Trans Union) collect only consumer loan information, while in Argentina Equifax collects and distributes both private business and consumer information and additional information, such as ownership links among firms and credit scores.

In addition, commercial information providers (sometimes called mercantile credit exchanges) such as Dun and Bradstreet (D&B) provide credit reports that they generate typically from payment performance information submitted by vendors. D&B is the world's largest private business credit registry, with a database of 64 million records, 13 million of which are in the United States.

The information produced by business credit bureaus can be quite valuable in making credit decisions. In particular, failure prediction models that include mercantile credit information produced by business credit bureaus have power in predicting firm failure beyond financial ratios and descriptive information about the firm (Kallberg and Udell 2003b).<sup>21</sup> Moreover, the existence of third party information exchanges can affect credit availability and macroeconomic performance. A recent World Bank survey indicates that without credit bureaus the time to process loans, the cost of making loans, and the level of defaults would all be higher (Miller 2003). Another study found that countries with more intense, established formal information sharing—either through credit registries or voluntary information exchanges—exhibit greater bank lending relative to GNP (Jappelli and Pagano 2001). That survey also found that credit risk is negatively correlated with measures of formal information sharing.

There has not been any empirical analysis of the impact of credit bureaus on factoring. Studies have found a strong relationship between higher credit information sharing and more bank lending and less credit rationing (Jappelli and Pagano 2001; Love and Mylenko 2003). And it seems likely that credit bureau information would benefit all credit products. But the degree of its importance may differ among lending technologies. For instance, credit bureau information is necessary for business credit scoring. Consumer credit bureau information is particularly important here because in microenterprise lending where credit scoring has been applied, the creditworthiness of the entrepreneur—as opposed to the business itself—tends to dominate (Cornett and Saunders 1999). In terms of relationship lending, credit bureau information may be crucial in the early stages of the bank-borrower relationship, when the borrower's reputation is still being formed.

But the importance of information exchanges to asset-based finance—asset-based lending and factoring—is less clear. On the one hand, such lenders primarily base their credit decisions on the value of a firm's collateral, not the firm itself, so business credit information about their borrowers may be of only secondary importance. On the other hand, business credit bureau information about the obligors on their receivables could be quite valuable.

However, an offsetting effect might be that factors and asset-based lenders develop their own databases on account payment performance (that is, on obligors' accounts). This could make information from business credit bureaus less valuable for institutions that offer asset-based finance—particularly in countries where factoring is a dominant lending technology and factors are large. Large factors in these countries may enjoy significant economies of scale because of the size of their proprietary databases on account payment information. Indeed, some of these large factors may have better databases than the business credit bureaus operating in their markets. This superiority could come from wider database coverage or from higher reliability if private and public credit bureaus suffer from relatively greater organizational inefficiencies (i.e., agency problems).

Table 2A contains information from a recent international study of public credit registries and private credit bureaus. The second column indicates whether a country has a public credit bureau (business or consumer) and the third whether a country has a private bureau (business or consumer). A "1" indicates the presence of such an institution; a "0" indicates the absence. Most developed countries have private credit bureaus—for example, Canada, the United Kingdom, and the United

<sup>21</sup> For detailed global analysis of public and private credit bureaus, see Miller (2003). For detailed analysis of information collection by a private credit bureau, see Kallberg and Udell (2003a).

States. Countries with the weakest information infrastructures are likely to have neither public nor private credit bureaus (as in Oman). This suggests that in these countries factors would have to rely substantially on their own databases for payment information on obligors' accounts.

The quality of accounting information is another aspect of the information infrastructure. This dimension is important because the strength of accounting standards determines the extent to which lenders can accurately assess borrowers' quality and condition. It is also important because it substantially determines the efficacy of the use of covenants. Consequently, a country's ability to develop financial statement lending will likely be highly dependent on the quality of accounting information. The first column of Table 2A presents data on the strength of accounting standards from a study of 49 countries covering a variety of factors that affect financing (La Porta and others 1998). The index used to assess accounting standards was constructed in 1991 by the Center for International Financial Analysis and Research. It measures the comprehensiveness of financial statements in seven areas: general information, income statements, balance sheets, flow of funds statements, accounting standards, stock data, and special items.

Table 2A shows wide variation in the strength of accounting standards. In general, more developed economies have stronger standards. But even among these countries there are significant differences. For example, Sweden has a score of 83, the United Kingdom 78 and Finland 77, while Austria is at 54 and Portugal 36. Some less developed countries score quite low, such as Argentina 45 and Chile 52. Financial statement lending is quite problematic in countries with poor accounting standards. These countries might be able to offset this weakness if they have strong credit bureaus and strong banking systems that can make relationship loans. Alternatively, factoring may be a viable alternative because it does not depend on accounting information. As noted, Portugal has one of the world's most active factoring markets (relative to GDP). Egypt, on the other hand, does not even appear in the Factors Chain International database—indicating that it may not have an economically significant level of factoring.

### Legal and judicial environment

A country's legal and judicial environment may play a critical role in determining the mix of available financing products and the importance of factoring in that mix. A key issue for factoring is whether a financial system's commercial law views factoring as a sale and purchase transaction rather than as a loan. If it does, creditor rights and loan contract enforcement are less important for factoring because factors are not creditors. That is, if a firm went bankrupt, its factored receivables would not be part of its bankruptcy estate because they would be the property of the factor.

Still, creditor rights and contract enforcement are not irrelevant to factoring, for at least two reasons. First, they define the environment in which the factor engages in collection activities. This will affect underwriting standards because factors must take into account the anticipated cost and efficiency of their collection activities when they make credit decisions about which invoices to purchase. Second, under recourse factoring the factor has a contingent claim against the borrowing firm if there is a deficiency in the collection of a receivable. This contingent claim can be secured or unsecured depending on whether the factor filed a security interest in some or all of the firm's assets (as a secondary source of repayment).

The last four columns of Table 2B show four measures that proxy for the rule of law around the world: the cost of contract enforcement, the rule of law, corruption, and political stability (Kaufmann, Kraay, and Mastruzzi 2003). Most developing countries suffer from weak enforcement. Although a weak rule of law likely affects all lending products, it may affect factoring less because factoring represents a property sale and purchase (as opposed to a secured loan). This exchange of property

Table 2A. Comparative Business and Legal Environments

	Strength of Acc'tg Standards	Information Infrastructure Public Credit Registry	Private Credit Bureau
Bulgaria	.	1	0
Czech Republic	.	1	1
Baltic States	.	.	.
Hungary	.	0	1
Poland	.	0	1
Romania	.	1	0
Slovakia	.	1	0
Slovenia	.	1	0
<b>EASTERN EUROPE</b>	.	<b>0.7</b>	<b>0.4</b>
Austria	54	1	1
Belgium	61	1	1
Cyprus	.	.	.
Denmark	62	0	1
Finland	77	0	1
France	69	1	0
Germany	62	1	1
Greece	55	0	1
Iceland	.	.	.
Ireland	.	0	1
Italy	62	1	1
Netherlands	64	0	1
Norway	74	0	1
Portugal	36	1	1
Spain	64	1	1
Sweden	83	0	1
Switzerland	68	0	1
Turkey	51	1	1
United Kingdom	78	0	1
<b>WESTERN EUROPE</b>	<b>63.8</b>	<b>0.5</b>	<b>0.9</b>
Argentina	45	1	1
Brazil	54	1	1
Canada	74	0	1
Chile	52	1	1
Colombia	.	0	1
Costa Rica	.	1	1
Cuba	.	.	.
El Salvador	.	1	1
Mexico	60	0	1
Panama	.	0	1
U.S.A.	.	0	1
<b>AMERICAS</b>	<b>57.0</b>	<b>0.5</b>	<b>1.0</b>
Israel	64	0	1
Morocco	.	1	0
Oman	.	0	0
Saudi Arabia	.	1	1
South Africa	70	0	1
Tunisia	.	1	0
<b>AFRICA &amp; MIDDLE EAST</b>	<b>67.0</b>	<b>0.5</b>	<b>0.5</b>
China	.	1	0
Hong Kong	69	0	1
Indonesia	.	1	0
India	57	0	1
Japan	65	0	1
Malaysia	76	1	1
Philippines	.	0	1
Singapore	78	0	1
South Korea	62	0	1
Sri Lanka	.	0	1
Taiwan	65	1	1
Thailand	64	0	1
<b>ASIA</b>	<b>67.0</b>	<b>0.3</b>	<b>0.8</b>
Australia	75	0	1
New Zealand	70	0	1
<b>AUSTRALASIA</b>	<b>72.5</b>	<b>0.0</b>	<b>1.0</b>
<b>TOTAL WORLD</b>	<b>64.2</b>	<b>0.5</b>	<b>0.8</b>



Table 2B. Comparative Business and Legal Environments

	Macro-Environment	Creditor Rights		Cost of contract Enforcement	Strength of Enforcement		Political Stability
	Per Capita GDP (PPP)	Secured Paid First	Overall Creditor Rights		Rule of Law	Corruption	
Bulgaria	6,625	.	3	6.4	0.05	-0.17	0.56
Czech Republic	14,495	.	3	18.5	0.74	0.38	1.02
Baltic States	10,959	.	.	.	0.80	0.66	0.98
Hungary	12,656	.	2	5.4	0.90	0.60	1.08
Poland	10,021	.	2	11.2	0.65	0.39	0.71
Romania	6,024	.	0	13.1	-0.12	-0.34	0.42
Slovakia	11,781	.	2	13.3	0.40	0.28	1.01
Slovenia	17,137	.	3	3.6	1.09	0.89	1.21
<b>EASTERN EUROPE</b>	<b>11,212</b>	.	<b>2.1</b>	<b>10.2</b>	<b>0.56</b>	<b>0.34</b>	<b>0.88</b>
Austria	28,150	1	3	1.0	1.91	1.85	1.29
Belgium	26,412	1	2	9.1	1.45	1.57	0.97
Cyprus	17,725	.	.	.	0.83	0.89	0.36
Denmark	29,386	1	3	3.8	1.97	2.26	1.26
Finland	25,333	1	1	15.8	1.99	2.39	1.63
France	25,749	0	0	3.8	1.33	1.45	0.73
Germany	26,146	1	3	6.0	1.73	1.82	1.06
Greece	17,406	0	1	8.2	0.79	0.58	0.83
Iceland	29,715	.	.	.	2.00	2.19	1.55
Ireland	32,397	1	1	7.2	1.72	1.67	1.31
Italy	25,181	1	1	3.9	0.82	0.80	0.81
Netherlands	27,228	1	3	0.5	1.83	2.15	1.37
Norway	35,433	1	2	10.4	1.96	2.00	1.49
Portugal	17,595	1	1	4.9	1.30	1.33	1.43
Spain	20,279	1	2	10.7	1.15	1.46	0.82
Sweden	24,924	1	1	7.6	1.92	2.25	1.43
Switzerland	28,204	1	1	3.9	2.03	2.17	1.61
Turkey	5,790	1	2	5.4	0.00	-0.38	-0.61
United Kingdom	25,141	1	4	0.5	1.81	1.97	0.81
<b>WESTERN EUROPE</b>	<b>24,642</b>	<b>0.9</b>	<b>1.8</b>	<b>6.0</b>	<b>1.50</b>	<b>1.60</b>	<b>1.06</b>
Argentina	11,544	1	1	8.5	-0.73	-0.77	-0.74
Brazil	7,571	0	1	2.4	-0.30	-0.05	0.17
Canada	27,888	1	1	28.0	1.79	2.03	1.06
Chile	9,354	1	2	14.7	1.30	1.55	1.04
Colombia	6,050	.	0	5.9	-0.75	-0.47	-1.78
Costa Rica	8,543	.	1	22.6	0.67	0.88	1.06
Cuba	.	.	.	.	-0.94	-0.13	0.22
El Salvador	4,614	.	3	7.3	-0.46	-0.54	0.35
Mexico	8,738	0	0	10.0	-0.22	-0.19	0.22
Panama	6,146	.	4	20.0	0.00	-0.24	0.36
U.S.A.	34,322	.	1	0.4	1.70	1.77	0.34
<b>AMERICAS</b>	<b>12,477</b>	<b>0.6</b>	<b>1.4</b>	<b>12.0</b>	<b>0.19</b>	<b>0.35</b>	<b>0.21</b>
Israel	.	1	3	34.1	0.97	1.08	-1.35
Morocco	3,628	.	1	9.1	0.11	-0.04	-0.14
Oman	13,247	.	0	4.8	0.83	1.03	0.98
Saudi Arabia	11,516	.	2	.	0.44	0.57	0.05
South Africa	9,916	1	3	16.7	0.19	0.36	-0.09
Tunisia	6,501	.	0	4.1	0.27	0.35	0.24
<b>AFRICA &amp; MIDDLE EAST</b>	<b>8,962</b>	<b>1.0</b>	<b>1.5</b>	<b>13.8</b>	<b>0.47</b>	<b>0.56</b>	<b>-0.05</b>
China	4,135	.	2	32.0	-0.22	-0.41	0.22
Hong Kong	25,393	1	4	6.9	1.30	1.52	1.03
Indonesia	3,020	.	2	269.0	-0.80	-1.16	-1.37
India	2,493	1	3	95.0	0.07	-0.25	-0.84
Japan	25,672	1	2	6.4	1.41	1.20	1.20
Malaysia	8,725	1	2	19.4	0.58	0.38	0.51
Philippines	3,919	.	1	103.7	-0.50	-0.52	-0.49
Singapore	22,456	1	3	14.4	1.75	2.30	1.28
South Korea	15,528	1	3	4.5	0.88	0.33	0.49
Sri Lanka	3,234	0	2	7.6	0.23	-0.14	-0.90
Taiwan	.	1	1	0.5	0.95	0.81	0.71
Thailand	6,452	1	3	29.6	0.30	-0.15	0.55
<b>ASIA</b>	<b>11,002</b>	<b>0.9</b>	<b>2.3</b>	<b>49.1</b>	<b>0.5</b>	<b>0.3</b>	<b>0.2</b>
Australia	26,864	1	3	8.0	1.85	1.91	1.18
New Zealand	20,204	0	4	11.6	1.91	2.28	1.35
<b>AUSTRALASIA</b>	<b>23,534</b>	<b>0.5</b>	<b>3.5</b>	<b>9.8</b>	<b>1.88</b>	<b>2.10</b>	<b>1.27</b>
<b>TOTAL WORLD</b>	<b>16,283</b>	<b>0.8</b>	<b>1.9</b>	<b>18.3</b>	<b>0.82</b>	<b>0.83</b>	<b>0.59</b>

Source: Doing Business 2003

rights should minimize the threat of competing interests from other creditors. Still, a weak rule of law will make a factor's collection activities more costly and less efficient. It will also decrease the value of the factor's recourse against its customers when it engages in recourse factoring and when it takes a security interest in its customer's assets as a secondary source of repayment.

As noted, factoring is the world's dominant form of asset-based finance, and there are no significant amounts of asset-based lending except in Australia, Canada, the United Kingdom, and the United States. Although it is difficult to draw strong conclusions from the data, these four countries score extremely high on the rule of law measures—while many countries where factoring is widespread (such as Greece and Italy) score much lower. On the other hand, there are countries with a strong rule of law that have significant amounts of factoring, the most notable of which is the United Kingdom. Other examples include Austria, Denmark and the Netherlands. This suggests that variables other than a weak rule of law may be important in driving factoring. One may be how well commercial law works; another may be how security interests are treated in commercial law.

A financial system's commercial law and the level of its enforcement help determine the environment in which financial contracting occurs. Commercial law specifies the property rights associated with a commercial transaction, and enforcement of these rights determines the confidence of contracting parties in financial contracts. Together these two features constitute the rule of law. At one extreme are countries where commercial law is unambiguous and conducive to commercial transactions and where enforcement is predictable. At the other extreme are countries where commercial law is ambiguous and incomplete, enforcement is problematic, and criminal and racketeering behavior block the creation of new businesses, undermine existing ones, and deter foreign investment (EBRD Transition Report 2003a, p. 24).

In terms of security interests—that is, collateral liens—a country's commercial law should clearly define how a collateral lien can be perfected, how collateral priority is determined, and how notification of a lien is made. Rules on security interests likely affect the efficacy of all non-factoring lending technologies because collateral can be used in conjunction with each of them. But even in a factoring relationship, a factor may take a collateral interest in the non-receivables of a client firm as a secondary source of repayment.

Still, a country's commercial law on security interests likely has the biggest impact on asset-based lending, because collateral is the primary source of repayment under such lending. Australia, Canada, the United Kingdom, and the United States have well-defined and strongly enforced laws on security interests, which partly explains why asset-based lending exists in these countries but not elsewhere. Such laws give asset-based lenders confidence that they will have the right to liquidate their collateral or receive comparable value in case of bankruptcy.<sup>22</sup> (See Udell forthcoming for a detailed discussion of U.S. law and Clark 1999 for a discussion of Canadian law.)

The third column of Table 2B presents data on the strength of creditor rights, from La Porta and others (1998). This composite index ranges from 0 to 4, with 4 reflecting the strongest rights. The index is constructed by adding a "1" for every one of the following conditions: if secured creditors have priority over others, if there are restrictions on management's right to file for reorganization, if there is no automatic stay, and if management is forced out in bankruptcy. An automatic stay involves

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<sup>22</sup> There has been an attempt to encourage the adoption of a standard set of laws on security interests on a global basis. In December 2001 the United Nations, under its United Nations Commission on International Trade Law (UNCITRAL) initiative, approved a template for security interests in accounts receivable. It is also working on a template for security interests in other assets. The main goal of these initiatives is to promote cross-border lending. Arguably, an important byproduct of global adoption of these templates would be an improvement in creditor rights worldwide. At this stage, however, it is not clear whether a meaningful number of countries will adopt these templates.

imposition of an immediate restriction on all creditors from taking action to collect their debt, including repossession of collateral.<sup>23</sup>

Although these collateral-related contracting features may be more important to asset-based lending and financial statement lending, collateral is also useful in the early stages of relationship lending (Berger and Udell 1995). But it becomes less important as relationships between banks and borrowers strengthen. Finally, factoring should be least affected by weak creditor rights—suggesting that, other things being equal, factoring should play a bigger role in countries with weaker creditor rights.

### Tax and regulatory environment

A country's tax structure can also affect the size of the factoring industry. Stamp duties on factored invoices and other levies on factoring can impede the growth of the industry. Value added taxes (VATs) may also have an effect, depending on the structure of the tax system. For example, although the services fee associated with factoring should typically be subject to VAT, the financing should be exempt to ensure a level playing field between factors and other lenders. Similarly, factors should ideally enjoy the same tax treatment of provisioning for bad receivables as other lenders (e.g., banks) but often they don't as they are not recognized as formal financial institutions, particularly if they are totally outside the scope of formal regulation (see below). Factoring of foreign receivables can be problematic if foreign currency exchange laws present obstacles. For example, while in Sri Lanka local factors, notwithstanding restrictive foreign exchange regulations, can offer export factoring by negotiation slightly different procedures with foreign correspondent factors, they cannot engage in import factoring.

The regulatory environment also has an important effect on the factoring industry. At one extreme, factoring operates entirely outside the purview of any regulatory structure or authority. At the other extreme factoring, is regulated along with other financial services such as banking and insurance. In most countries the level of regulation falls somewhere in between.

Bank regulation of the factoring industry may have implications not only for the industry's performance but also for aggregate macroeconomic performance. Trade financing tends to be countercyclical, and becomes more important when firms are in distress (Calomiris, Himmelberg, and Wachtel 1995; Chan and others 2001). Yet commercial bank regulation tends to be procyclical, because bank regulators tend to scrutinize bank loans more carefully when an economic downturn begins. This is consistent with other evidence that prudential regulation of commercial banks can cause a credit crunch (Peek and Rosengren 1995).

Independent finance companies may play an important role in assisting the countercyclical behavior of trade credit by providing financing for receivables (Udell forthcoming). But the ability of finance companies to perform this function may depend on the share of the industry that is independent of bank regulation. To the extent that some factoring has moved from outside to inside the bank industry—as in the United States—finance companies may be less able to perform this

<sup>23</sup> Caution should be exercised in interpreting these findings. For example, the United States has a score of 1, for giving secured creditors priority. It gets a zero for having an automatic stay and for removing management in bankruptcy. Although the United States has an automatic stay, secured creditors can ask a court for relief from the stay if they can show that it does not provide them with "adequate protection" and that it jeopardizes their interest in the property of the debtor. Asset-based lenders routinely successfully petition for waivers of the automatic stay with respect to their collateral. Moreover, if a court limits the ability of a secured creditor to liquidate its collateral, it is obligated to give it "comparable value" in lieu of the proceeds from liquidation. In terms of removing management in bankruptcy, management is not automatically removed, but neither is it automatically entitled to stay in place. Thus the United States is arguably closer to a 3 than to a 1 on the overall index of creditor rights. If having well-defined commercial laws and an efficient registration system were factored in, the United States would likely rank at or near the top along with Canada.

role.<sup>24</sup> Concern has been expressed that new international banking rules on bank capital (Basel II) may exacerbate this problem, but it is too early to assess their impact.

## THE ROLE OF FACTORING IN THE NEW EU MEMBER STATES

The previous sections laid the groundwork for this paper's main focus: the current and future role of factoring in Eastern Europe, particularly in the eight countries that became EU members on May 1, 2004: the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia, referred to here as the EU 8. As discussed, factoring is one of the main lending technologies used in SME financing. Relative to other lending products—financial statement lending, relationship lending, asset-based lending, credit-scored lending, and trade credit—it has both strengths and weaknesses. For example, it is more costly than financial statement lending and it does not provide inventory financing like asset-based lending. But its advantages suggest that factoring should play an important role in developing economies such as those in the EU 8.

Several characteristics of factoring may give it an edge in the EU 8. First, the fact that factoring removes receivables from the borrower's estate in bankruptcy may be useful if a country's judicial system is primitive, inefficient, or both—conditions that apply to certain EU 8 countries, as indicated by World Bank Reports on Observance of Standards and Codes (ROSCs) for insolvency and creditor rights.<sup>25</sup>

Second, as a type of asset-based financing, factoring has a distinct advantage in providing funding to high-risk SMEs. It is important that risky SMEs be able to develop in transition economies, as the private sector in these countries develops and works to catch up to systems and mechanisms in Western Europe.

Third, as an asset-based technology, factoring may have an advantage over other credit products in lending to informationally opaque borrowers. Factors can base their lending decisions primarily on the condition of SMEs' underlying accounts rather than on their creditworthiness. This is likely to be particularly important in the EU 8, where business activity may be skewed toward SMEs that by nature are more informationally opaque than larger businesses. Two characteristics of a weak information infrastructure—weak accounting standards and a shortage of audited financial statements—are common in most EU 8 business environments.<sup>26</sup>

But another aspect of a weak information infrastructure would be problematic for factors. Limited data on payment performance—such as that collected by public credit registries, private business credit bureaus, credit insurance companies, or by factors themselves—would be problematic for factoring domestic receivables. It would be much less problematic for factoring foreign receivables, where the account obligors are in industrial countries with stronger information infrastructure.

Fourth, and closely related, factoring may be extremely useful in the early years of development of SMEs that export to more developed economies. Large factors that operate in an importer's country

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<sup>24</sup> Independent finance companies may also be vulnerable to procyclical prudential supervision if they are small and depend on banks for funding. Larger independents and captives of large industrial groups may be much more insulated because they have access to capital markets such as the eurobond market.

<sup>25</sup> For selected country insolvency and creditor rights ROSC reports see <http://www.worldbank.org/ifa/rosc.html>.

<sup>26</sup> While going forward the EU 8, as new EU member states, must comply with the requirements of the EU *Acquis Communautaire* in the accounting & auditing area, which should result in significant improvements in this respect, these requirements (e.g., the use of IFRS) apply primarily to listed companies rather than to SMEs and also will take time to translate into improved accounting and auditing practices and enforcement capacity.

will likely already have generated information about the importer’s payment record. In addition, domestic factors in the EU 8 have always factored foreign receivables by participating in alliances such as Factors Chain International or, more recently, by buying credit insurance. Indeed, it may be easier for factors in the EU 8 to develop their business around foreign rather than domestic receivables.

This section first considers the extent to which these advantages have been exploited in the EU 8. It then examines the characteristics of these countries that have shaped the development of their factoring industries, based primarily on a World Bank survey of factors operating in them. The section concludes with some predictions about how the factoring industry may develop in the region, and suggests policy initiatives that may facilitate its growth and improve credit availability more generally.

## FACTORING MARKETS IN THE EU 8

To the extent that banks are able to provide financial statement lending, relationship lending, and credit-scored lending, the need for factoring is probably less. Figure 2 shows bank credit to the private sector (as a share of GDP) in the EU 8 and in the 15 countries that made up the European Union before entry of the new members (referred to as the EU 15). Considerably more bank credit is available in the EU 15—suggesting a significant funding gap in the EU 8 and the potential for factoring to fill it.

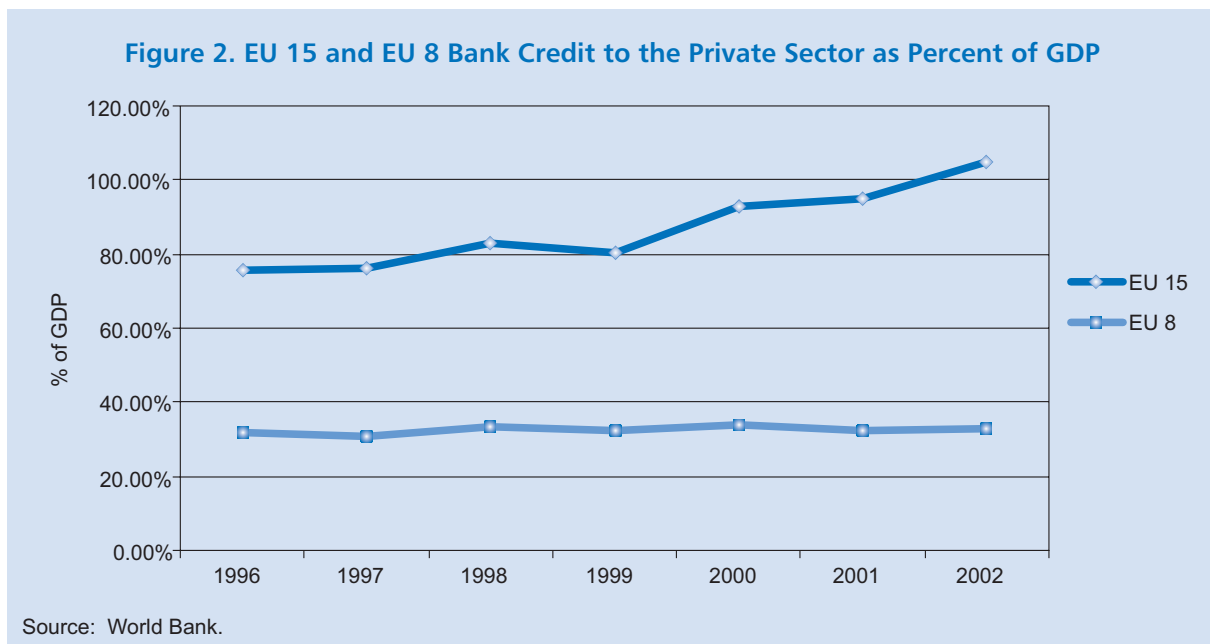
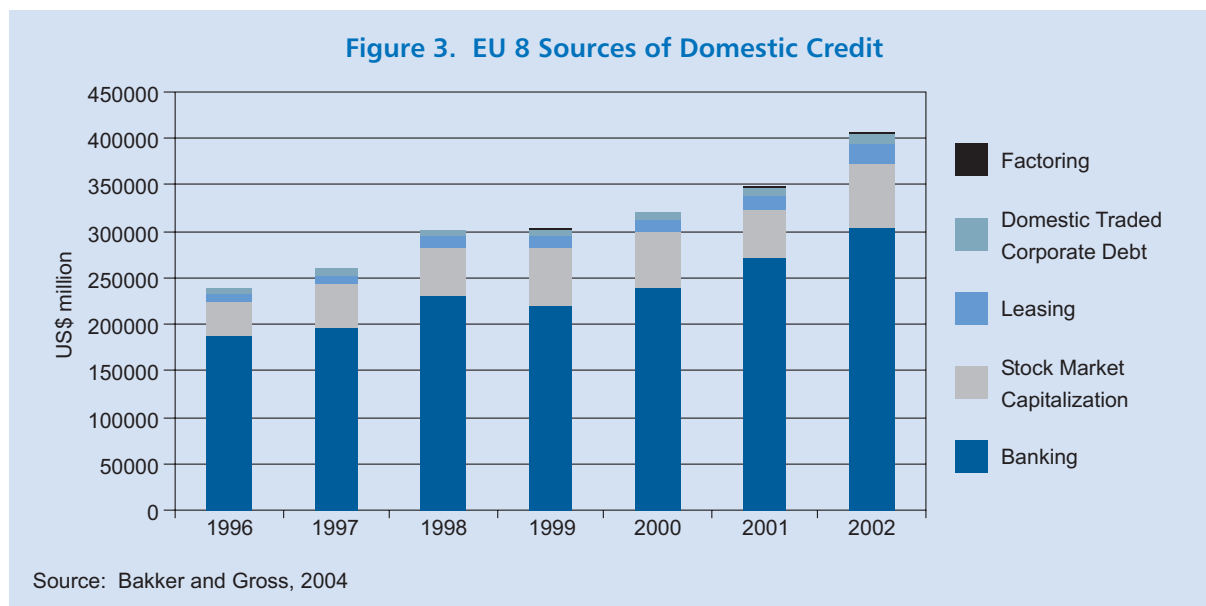
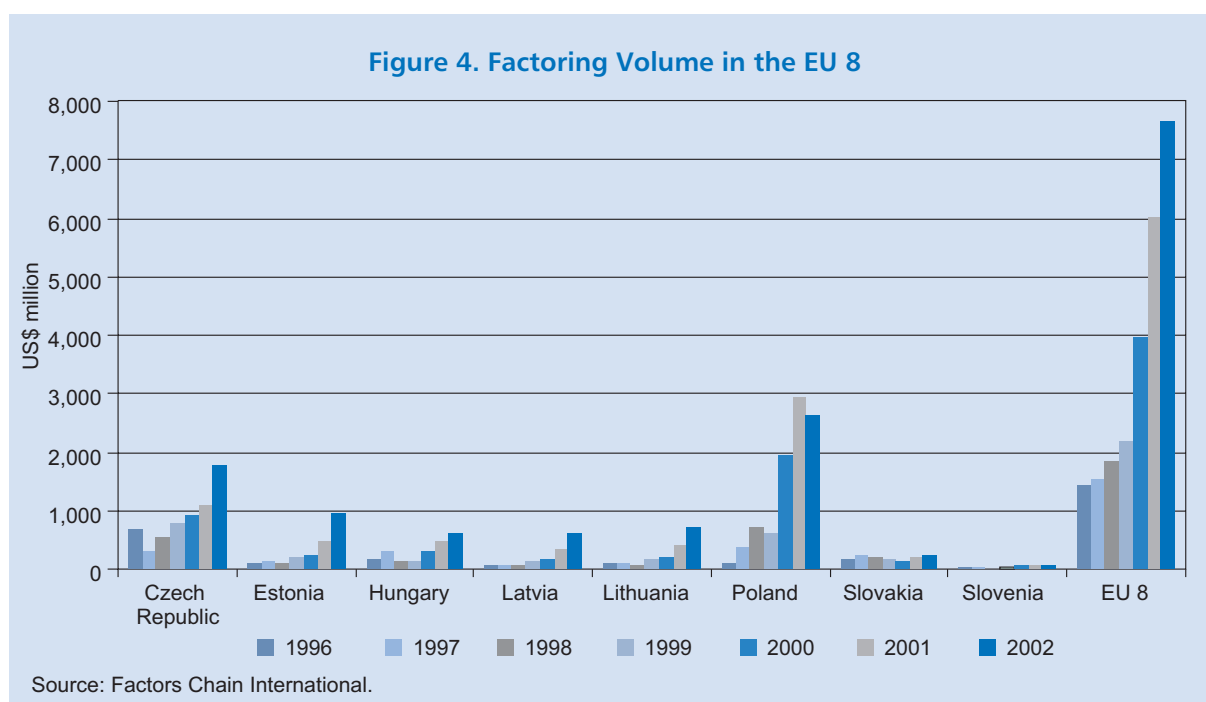


Figure 3 takes a more detailed look at the EU 8, breaking down sources of domestic financing for the private sector. Although equity markets play a significant role, it is clear that the EU 8 have banking- oriented financial systems. Intermediated finance dominates capital market financing even for large firms. Thus, given that bank credit is insufficient in the EU 8, factoring could provide an important source of financing even for large enterprises.

In recent years the factoring industry has grown significantly in most EU 8 countries, both in absolute terms (Figure 4) and as a percentage of GDP (Figure 5). Poland has the largest volume,

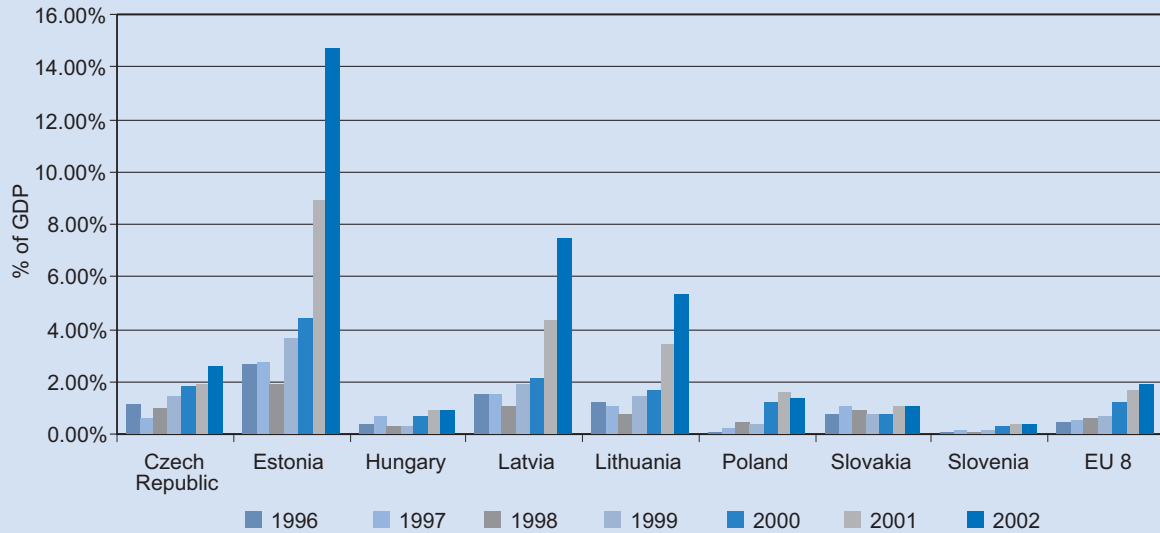


followed by the Czech Republic and Estonia. Relative to GDP, however, Estonia is far ahead, followed by Latvia and Lithuania. The very high level of development observed in Estonia, however, may at least be partially explained by the unusual factoring of construction receivables (which are typically not considered to be factorable, and hence excluded from factoring statistics), which may overstates actual factoring penetration. The Czech Republic, Poland, Slovak Republic, and Hungary are next, and are grouped relatively closely. Factoring penetration is considerably lower in Slovenia. The penetration of factoring is considerably lower in the EU 8 than in Western Europe, though in the latter there also is considerable variation (Figure 6). For example, factoring is much lower in Germany than in the rest of the EU 15.



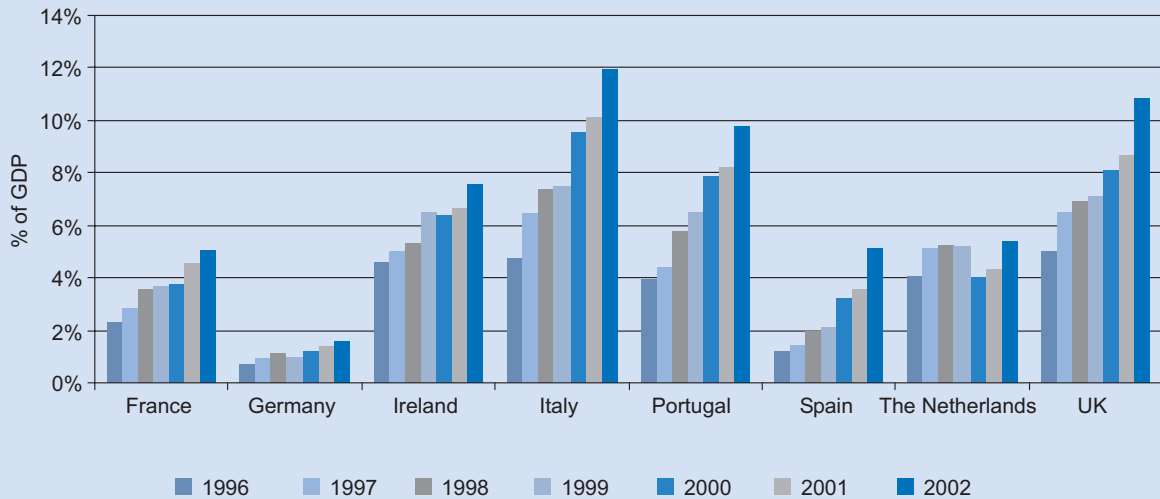
The significant growth in factoring in most of the EU 8 suggests that factors in these countries have been able to generate databases on domestic accounts, rely on external sources of such information (such as business credit bureaus and credit insurers), or target exporters and finance their cross-border receivables. Moreover, if the EU 15 can be used as a benchmark, there is considerable room for further growth.

Figure 5. Factoring Volume in the EU 8 as Percent of GDP



Source: Factors Chain International, World Bank.

Figure 6. Factoring Volume in Selected EU 15 Countries as a Percentage of GDP



Source: Factors Chain International, World Bank.

## FACTORING ENVIRONMENTS IN THE EU 8: SURVEY RESULTS

To better assess the factoring environment in the EU 8, the World Bank conducted a survey of factors doing business in these countries. There were 13 respondents (all privately owned and operated

factoring companies), with at least 1 in each country. All but 2 of the respondents were bank subsidiaries. Most received their funding in the form of bank loans (presumably from their bank affiliates or parents, although no information was collected on this issue).

**Table 3. Summary of Survey Findings on Factoring in the EU 8**

TAXES	Regulation	Legal Code	Factoring Practices	Barriers to Growth
<p><b>Value added taxes (VATs)</b></p> <ul style="list-style-type: none"> <li>Applied to pre-financing – Lithuania (18%)</li> <li>Applied to service fees – Estonia, Latvia, Lithuania, Slovenia (~18%)</li> </ul> <p><b>Stamp taxes</b></p> <p>None</p> <p><b>Factoring losses not treated as tax cost</b></p> <p>Poland</p>	<p><b>Supervisory authority</b></p> <ul style="list-style-type: none"> <li>Central bank: Estonia, Latvia, Lithuania</li> <li>Bank supervisor: Hungary</li> </ul> <p><b>Cross-border factoring regulations</b></p> <ul style="list-style-type: none"> <li>Latvia and Lithuania</li> </ul> <p><b>Factoring licenses</b></p> <ul style="list-style-type: none"> <li>Hungary: ~\$4,000 (minimum capital requirement) (five months)</li> <li>Czech Republic and Slovak Republic: ~\$30 (one month)</li> </ul> <p><b>Laws on initial capital requirements</b></p> <ul style="list-style-type: none"> <li>Yes: Hungary, Latvia, Lithuania, Slovenia</li> <li>No: Czech Republic, Estonia, Poland, Slovak Republic</li> </ul>	<p><b>Factoring provisions included in civil or commercial code</b></p> <ul style="list-style-type: none"> <li>Estonia, Latvia, Lithuania, Slovenia</li> </ul> <p><b>Security laws permitting lenders to collateralize working capital assets (account receivables, inventory, and the like)</b></p> <p><b>A recording system to register liens on accounts receivable</b></p>	<p><b>Sources of financing</b></p> <ul style="list-style-type: none"> <li>Bank loans (88%)</li> <li>Equity (44%)</li> <li>Retail deposits (17%)</li> <li>Corporate bonds (0%)</li> </ul> <p><b>With notification</b></p> <ul style="list-style-type: none"> <li>All countries</li> </ul> <p><b>With and without recourse</b></p> <p><b>Sources of information on customers</b></p> <ul style="list-style-type: none"> <li>Self-reported</li> <li>Parent bank or insurance company</li> <li>Credit bureaus                             <ul style="list-style-type: none"> <li>Public: Czech Republic, Lithuania, Slovak Republic, Slovenia</li> <li>Private: Poland</li> </ul> </li> </ul> <p><b>Sources of information on underlying account obligors</b></p> <ul style="list-style-type: none"> <li>Dun &amp; Bradstreet</li> <li>Credit bureaus</li> </ul>	<p><b>Lack of understanding of factoring; considered a lender of last resort</b></p> <p><b>Difficulty of accessing credit information and predicting credit risk</b></p> <p><b>Slow legal recovery</b></p> <p><b>Lack of refinancing</b></p> <p><b>Non-assignment clauses (Poland)</b></p> <p><b>Unfavorable tax laws</b></p>

Source: World Bank.

As noted, a country’s tax structure is among the most important determinants of whether factoring can serve as a viable source of credit. The survey asked several questions related to taxation of factoring in the EU 8. In only one country (Lithuania) is VAT applied to interest payments on pre-financing (Table 3). In four countries no VATs are applied to service fees for receivables administration and collection services, while in four they are applied (with the tax rate in all four around 18 percent). Perhaps more important, factors in all of the EU 8 countries indicated an absence of stamp duties and other duties on document transfers applied to factoring. In some countries stamp taxes have been a major constraint to the development of factoring. Only one country (Poland) indicated that losses incurred on bad receivables are not recognized for tax purposes. Ex ante provisioning by factors (as opposed to ex-post recognition of actual losses incurred) for problematic receivables is typically not allowed in the EU 8. As most of the factors that responded to the survey are owned by banks, however, the differential tax treatment in this respect (with banks allowed to deduct provisions) was



not identified as a major issue. So, on balance the tax environment in the EU 8 appears favorable to factoring.

The survey also asked whether EU 8 countries had a factoring act or a reference in the law (civil or commercial code) legally recognizing factoring as a financial service. Such recognition clarifies the nature of the transaction—for example, explicit recognition in the law of factoring dictates how judges must rule toward factors in cases of default by sellers or customers. Recognition also tends to legitimize the factoring industry. Only half of the EU 8 have such explicit legal provisions. Factoring volumes (as a percentage of GDP) are higher in countries with explicit legal recognition of factoring, although the development of such provisions may partly be in response to the development of, and pressures from, domestic factors.

Several survey questions addressed regulation of factoring. Respondents from four of the EU 8 indicated that they were not subject to regulation. All the respondents in these countries were bank subsidiaries. In three other countries (Estonia, Latvia, Lithuania) the central bank regulates the factoring activities of respondents (all of whom were banks or bank subsidiaries). In Hungary the respondent, who is not affiliated with a bank, is regulated by the Hungarian Financial Supervisory Authority. Respondents from these four countries indicated that regulations include reporting requirements.

Respondents were asked several questions about other lending technologies, including whether banks extend collateralized loans against receivables under funding formulas explicitly linked to the level of receivables. (These could be interpreted as being similar to asset-based loans if the links are updated daily; otherwise these could be financial statement or relationship loans where collateral serves as a secondary source of repayment.) Most respondents indicated the presence of such loans. But most also indicated that the commercial laws governing security interests—which assure lenders that their collateral liens can be perfected and that their priority will be upheld in bankruptcy—were weak and difficult to enforce. Moreover, most indicated that their countries did not have a recording system for clearly registering liens. These weaknesses in legal systems likely give factoring an advantage over secured lending, so long as bankruptcy courts recognize factoring as a sale and purchase (that is, recognize that factored receivables are not part of bankruptcy estates).

Survey respondents were also asked what proportion of their domestic-factored and foreign-factored receivables were factored with recourse. On average, 66 percent of domestic receivables are factored with recourse, while only 35 percent of foreign receivables are factored with recourse. This result is consistent with the finding of Sopranzetti (1998), discussed earlier, that recourse is more likely if sellers' receivables are of lower quality (assuming that the foreign receivables of respondents' customers are of higher quality than their domestic receivables).

The survey asked respondents about their primary sources of information for their customers (borrowers) and their underlying account obligors. For customers, six of the thirteen respondents said that the information came from credit bureaus or other information providers (typically Dun and Bradstreet or domestic bank supervisors). Five said that they used information from their proprietary databases. Because of the large extent of recourse factoring, the creditworthiness of borrowers (the sellers of receivables) is more important in the EU 8 than in more developed economies.

Perhaps more interesting are the findings about the underlying account obligors. Only four of the respondents said that they relied, in whole or in part, on their proprietary databases—suggesting that factors in the EU 8 have not built up their databases to the point where they are superior to other sources, though there is potential for this source of information to improve as the industry develops. Eight of the respondents said that they relied, in whole or in part, on business credit bureaus, and two relied, in whole or in part, on credit insurers. Thus, third party information exchanges may be

more important in producing information about payment performance than the factors, as found by Jappelli and Pagano (2001).

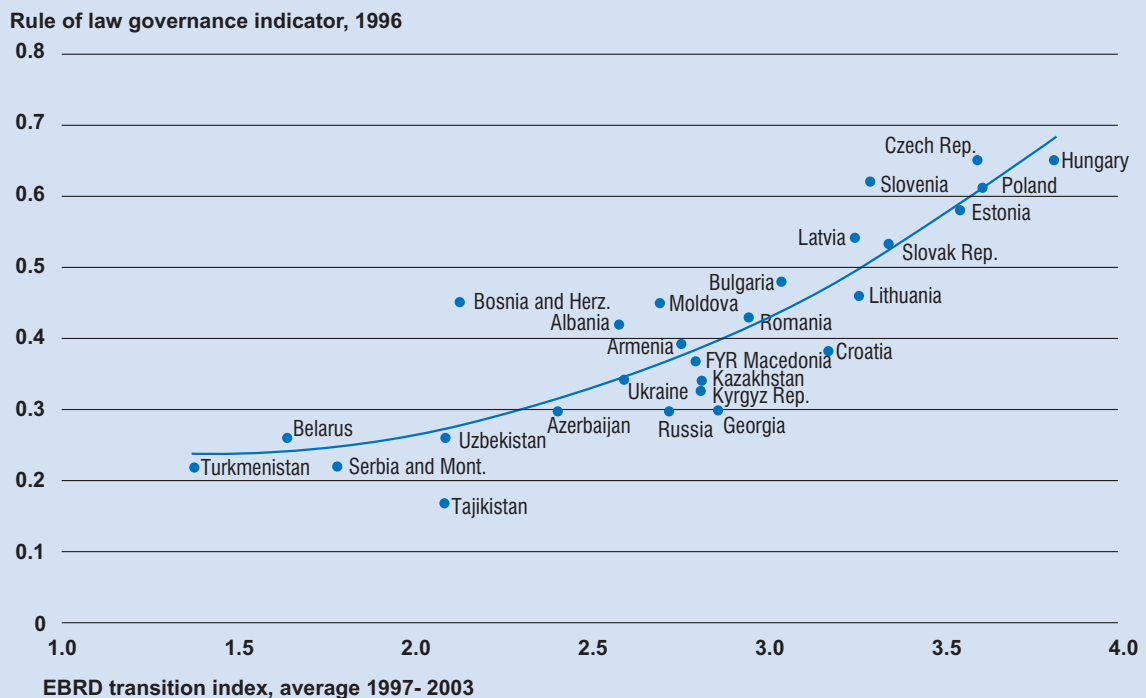
## LEGAL ENVIRONMENTS IN THE EU 8

This section examines EU 8 legal environments—and their effects on factoring—from various perspectives, assessing the strength of the rule of law, commercial law, contract enforcement, and bankruptcy proceedings.

### Rule of law

The strength of a country’s rule of law affects the level of mutual trust in transactions among state institutions, ordinary citizens, and firms (EBRD Transition Report 2003a). Arrow (1972, 1974) calls trust an “important lubricant” in commercial transactions, and it has been shown empirically that the level of trust influences the terms on which banks lend to SMEs (Harhoff and Korting 1998).

**Figure 7. Rule of law and progress in transition**



Sources: EBRD and World Bank.

Note: The rule of law governance indicator measures perceptions of the effectiveness of the judiciary, the enforceability of contracts, and the incidence of crime. In the chart, 0 represents the lowest and 1 the highest level of rule of law.

In Eastern Europe there is a positive association between the rule of law and structural and institutional reform. That is, the countries with the strongest rule of law have generally made the most progress in transition (Figure 7). Such countries also have the highest levels of trust (as measured by vendors’ demands for prepayments) and lowest levels of corruption (as measured by the World Bank’s “control of corruption” variable and Transparency International’s corruption perceptions index).

## Commercial law

In recent years there has been considerable analysis of commercial law on security interests in Eastern Europe, particularly in the EU 8. For example, in 2003 the European Bank for Reconstruction and Development (EBRD) launched the New Legal Indicator Survey, which focuses on secured transactions. The survey, prepared by EBRD legal experts, assesses the extent to which country laws comply with international standards. These assessments are supported by case studies that evaluate the extent to which legal systems provide efficient outcomes.

The survey found that transition economies have made considerable progress in bringing their commercial laws on secured transactions up to international standards. But progress has been slow in some areas, such as in the scope of assets that can be secured, in public notification, and in enforcement and priority. Although in principle most countries allow security to be granted over most types of movable property (such as accounts receivable and inventory), restrictions often exist in the general law—particularly in the need for specific descriptions of each asset included as collateral. Such restrictions preclude the use of many modern financing techniques that involve granting security over groups or pools of assets. Among the EU 8, only Hungary and the Slovak Republic do not have problems in this area (EBRD Transition Report 2003a).

A registration, or notification, system is critical. Creditors must be alerted immediately when another creditor files a lien against assets. In addition, the system must unambiguously sequence these claims so that a secured lender can have confidence that its lien will be registered as having priority. Clear rules must be established about where claims must be filed. (This can be problematic for borrowers with multiple locations.) Though much progress has been made, EBRD Transition Report 2003a) finds that registration systems have weaknesses in most countries in the region. (See the annex for detailed descriptions of EU 8 systems for registration and secured transactions.)

Among the EU 8, Hungary, Lithuania, and the Slovak Republic have undertaken the most extensive reforms in adopting legal and institutional frameworks for secured transactions, although in Lithuania financing instruments still suffer from deficiencies in formal requirements for defining collateral. The Czech Republic, Latvia, and Poland have made substantial progress in this area, having conducted major overhauls of their commercial laws on secured transactions. But in many cases there are still significant shortcomings. In Poland, for example, the time required for registration is problematic, and it takes an average of 1,000 days to enforce a contract (see <http://rru.worldbank.org/doingbusiness>).

Finally, Estonia and Slovenia have made only minor reforms with respect to secured transactions. Slovenia appears to be the least reformed of the EU 8, though it is introducing new provisions for collateral. But the taking of security is limited, and there is no public register to allow tracking of priorities and to alert third parties of existing charges. Box 3 provides more detailed analysis of commercial laws and their effects on factoring in the EU 8.

## Contract enforcement

No matter how strong a country's commercial law, lien registration, and bankruptcy law, they will have a limited impact on credit availability if they are not enforced in a timely, predictable and uniform fashion. Progress on this front is mixed in the EU 8. Compounding this problem is the fact that assessments of this progress vary, with the EBRD reporting more favorable developments than the World Bank. Still, both institutions agree that the EU 8 have made more progress on passing laws consistent with international standards than on consistently applying them.

In 2003 the EBRD surveyed lawyers in transition economies to determine how well the law works in practice. Lawyers were presented with a hypothetical scenario regarding the enforcement of a security interest over movable tangible assets. The specific assets used as collateral were equipment and an

### Box 3. Legal Frameworks for Factoring in the EU 8

#### *Czech Republic and Slovak Republic*

The civil codes of the Czech and Slovak republics contain similar provisions on the assignment of receivables. Receivables may be transferred, pursuant to a contract of assignment (as defined by the civil code), to a special purpose vehicle. The vehicle need not be a particular form of business entity and does not require authorization to purchase receivables. The validity of any assignment depends on its notification to the underlying debtor. There is no legally prescribed system for making the assignment valid against third parties through a public register. Thus a third party could seek to ignore the assignment in such circumstances. Czechoslovakia signed the Convention on International Factoring, sponsored by the International Institute for the Unification of Private Law (UNIDROIT), in 1990.

#### *Estonia*

Estonia's Credit Institutions Act enables credit and financial institutions to offer a wide array of financial services, including lending, leasing, and money market instruments. Moreover, institutions can provide services other than those specified as long as they are directly ancillary or supplementary to their principal activity, and they may found or acquire an ancillary undertaking order to provide such services. Although the act does not explicitly use the term *factoring*, it is sufficiently universal to encompass factoring among the financial services listed. Companies that engage in leasing and factoring are often subsidiaries of credit institutions. In addition, a number of financial leasing firms offer factoring services. Factoring transactions may be with or without recourse. Under recourse the factor is entitled to resell the claims to the seller in full or in part. General rules for claims valuation also apply to factoring claims.

#### *Hungary*

Only financial institutions can purchase receivables, subject to the authorization of the Hungarian Financial Supervisory Agency. Receivables are transferred to a special purpose vehicle by way of an assignment (as defined by the civil code). The UNIDROIT Convention on International Factoring entered into force in Hungary in 1996.

#### *Latvia*

Latvia's Law on Banks allows banks to perform leasing and factoring operations. In addition, the UNIDROIT Convention on International Factoring entered into force in Latvia in 1998.

#### *Lithuania*

In 1999, to widen the range of banking operations, the Bank of Lithuania approved additional operations for commercial banks—namely, factoring, financial intermediation, and cash management. In addition, in 2001 a new civil code harmonized with international law the treatment of many aspects of various contracts, including for factoring.

#### *Poland*

The 1997 Banking Act lists activities that banks can engage in, laying the ground for banks to offer factoring services. But the activities listed were not restricted to banks, so other institutions can provide factoring as well.

#### *Slovenia*

The 1999 Banking Law says that banks can provide factoring services, defined as the "assumption of claims through installment payments, with or without recourse." Credits and guarantees between residents and non-residents are regulated by the Foreign Exchange Act. The law differentiates between commercial and financial credits, classifying factoring agreements as commercial credits as long as the underlying contracts are also commercial credits.

Source: World Bank

inventory of finished goods. Respondents were then asked how the security rights of the hypothetical client bank would be enforced in their country. Key findings from the survey include data on how much a secured creditor can expect to recover (the amount), how quickly, and how simply.

The survey provides a surprisingly positive picture of enforcement, indicating that in all but one EU 8 country (Poland) it is possible to recover at least 80 percent of the market value of the assets taken as security in six months or less. But the efficiency of the process can be influenced by a number of factors, including whether there are preferred creditors whose claims supercede a bank’s claim, whether there is variation in enforcement on immovable assets (including receivables), and whether the borrower is declared insolvent (see EBRD Transition Report 2003a, table A.2.2.2).

The World Bank offers a somewhat different assessment of how well commercial laws have been implemented in terms of creditor rights. The Bank has conducted three in-depth country-level assessments of insolvency and creditor rights, the most recent of which was an assessment of the Czech Republic published in October 2003 (World Bank 2003). This study found that the average time to enforce a contract by unsecured creditors was considerably longer in the Czech Republic than in the five economies to which it was compared (Lithuania, Russia, the Slovak Republic, Turkey, and Ukraine), and somewhat longer than in the EU 15—but shorter than in the United States (Table 4). The study also found that delays in contract enforcement in the Czech Republic left unsecured creditors with little practical means to ensure that the debtor’s assets would be protected from dissipation or value loss.

**Table 4. Contract Enforcement in the Czech Republic and Various Other Countries**

Indicator	Czech Republic	Five other transition economies	EU 15	United States
Time to enforce a contract (days)	270	196	252	365
Cost to enforce a contract (percentage of per capita income)	18.5	12.6	5.9	0.4

Source: World Bank, “Czech Republic Policy Note: Insolvency and Creditor Rights Systems”, 2003

The most notable difference between the Czech Republic and other countries is the cost of enforcement. The Czech Republic compares quite unfavorably with the other countries, which themselves compare unfavorably with the EU 15—all of which compare very unfavorably with the United States.

In addition to debt collection by unsecured creditors (outside of bankruptcy) through the court system, the Bank report on the Czech Republic addresses two other important avenues: pursuit of secured claims by secured creditors (outside of bankruptcy), and pursuit of claims through bankruptcy. On the first, the Bank indicates that the recovery of collateral should be facilitated by the Public Auction Law, because the law will likely improve discipline among lenders. The law should also improve non-judicial auction procedures and potentially streamline the foreclosure process. But the report cautions that if recovery by unsecured creditors is improved under the new law, it may come at the expense of secured creditors. Moreover, the Bank notes that under Czech commercial law secured creditors must surrender to unsecured creditors up to 30 percent of their collateral proceeds and do not enjoy significantly stronger standing in taking security in real estate—and that the situation is even worse for movable assets (such as receivables and inventory).

These problems would be significantly mitigated if the third avenue, bankruptcy, were favorable for creditors. A recent EBRD report assessing bankruptcy laws in transition economies gave the Czech Republic and three of the other EU 8 a “medium” rating (EBRD Transition Report 2003b). No transition economy scored a “very high” rating, which would be equivalent to international best practice, and

only five countries received a “high” rating. Three of the remaining EU 8 (Hungary, Latvia, Slovenia) received a “low” rating and one (Lithuania) was considered “very low”—the worst rating. The average rating for the 27 transition economies was “low.”

Though the Czech Republic’s bankruptcy laws are moderately effective, the World Bank considers filing for bankruptcy to be the worst alternative for creditors, with unsecured creditors usually receiving little or nothing for their claims. The outlook for secured creditors is also grim, with limited rights, long delays and no compensation for them, and collateral often sold for much less than the creditors’ claims. As a result creditors often do not consider liquidation proceedings a viable option for recovering debt (World Bank 2003, p. 5). Moreover, the Bank concludes that the Czech bankruptcy law has had a detrimental effect on non-performing loans and led to a reduction in the availability of credit.

In its report on Lithuania the Bank indicates a similar disconnect between the legal structure and its implementation (World Bank 2002a). The Bank’s report on insolvency and creditor rights in the Slovak Republic echoes similar themes, though it also indicates that alternative forms of finance—including factoring—have developed to circumvent problems with bankruptcy (World Bank 2002b). These issues are not unique to transition economies: many developed countries also have shortcomings in bankruptcy law, particularly its implementation. Such weaknesses influence not only the resolution of bankruptcies and the enforcement of loan contracts but also the construction of contracts, which affects the choice of lending technologies. Further research is needed in this area.

Given the legal environment in most countries, it may be understandable that factoring is the main type of asset-based finance. The most likely reason is property rights: with factoring, possession of the assets passes from the debtor to the lender. As long as factoring is legally recognized as a sale and purchase, it may be a more attractive lending technology outside Canada, the United Kingdom, and the United States.

## RECOMMENDATIONS TO ADVANCE FACTORING IN THE EU 8

As the economies of the EU 8 mature and their business and financial markets become more integrated with the EU internal market, the factoring industry in these countries will likely grow significantly. Given the importance of factoring as a source of SME financing (especially short-term working capital), governments in the EU 8 should promote the industry’s development by removing the barriers to growth identified above. They should also address other policy issues that arise from the industry’s structure, such as the dominance of bank-owned factoring companies in most EU 8 markets. The following steps—supported by overall improvements in the business environment to promote financial development and improve access to financing—would help develop the factoring industry in the EU 8.

First, EU 8 governments should strengthen creditor rights by upgrading bankruptcy and collateral legislation and infrastructure to international best practices (as identified in World Bank Reports on Observance of Standards and Codes for insolvency and creditor rights, referenced earlier). There are few EU rules to guide the EU 8 in this area. Moreover, in recent years policymakers in the EU 8 have been focused on preparing for EU accession. Both issues help explain why the remaining reform agenda is still so large at this late stage of the transition.

Second, credit information infrastructures should be strengthened. Although governments typically do not own commercial credit bureaus, they can facilitate their development by easing legal limits on the sharing of debtor information and by encouraging equal access to credit information by banks and non-bank financial institutions such as factoring and leasing companies. Upgrading accounting

standards for SMEs—most of which still prepare their financial statements using tax reporting standards set by ministries of finance, rather than general purpose financial reporting standards designed to clarify pertinent business and credit information—to International Financial Reporting Standards (or a simplified version of them) would also be helpful. Estonia began requiring SMEs to use these standards several years ago, and the successful development of its factoring industry may at least in part be due to the high-quality financial statement information available for SMEs.

Third, while there are no strong arguments for government regulation and supervision of the factoring industry—given that factoring companies do not take deposits—some formalization of the activities of factoring companies would likely benefit the industry’s development.<sup>27</sup> For example, governments could:

- Define or refer to factoring in civil and commercial codes and other financial sector legislation. Doing so would recognize factoring companies as legitimate financial service providers, on par with banks and leasing companies, and make factoring companies more visible in financial circles.
- Allow factoring companies to make tax deductible provisions for bad receivables, to level the playing field between factoring provided by bank subsidiaries or independent factors and bank credit and factoring provided directly by banks.

#### Box 4. The Factoring Industry in Poland

The factoring market in Poland is expanding rapidly from a low base. In 2003, volume grew by 20% and the value of purchased receivables reached 12.2 billion Polish Zloty (approximately \$3.4 billion) (these data reflect the business of the 9 leading domestic factoring companies and does not include other “factoring-like” products offered by some 34 banks in Poland (e.g., invoice discounting). The 9 key players on the market are:

- Pekao Faktoring—owned 100% by Pekao SA Bank (Uni Credito Italiano Group);
- Raiffeisen Faktoring—owned 100% by Raiffeisen Bank;
- Forin—company was liquidated in February 2004 and merged with Millenium Bank;
- Handlowy-Heller—owned 50% by Citibank Handlowy, 50% by ING and GE Capital;
- Polfactor—owned by BRE Bank and Intermarket AG (Austrian factoring Bank);
- Arvato Services—owned by Bertelsmann Group;
- Bibby—Factors—owned by Bibby UK—privately owned chain of factoring companies in the UK;
- BZ WBK Faktor—owned by BZ WBK Bank ( Allied Irish group); and
- Eurofactor—100% privately owned by Polish entrepreneurs.

In terms of products, the Polish factoring market still has a long way to go before it reaches maturity, as about 80–85% of factoring volume is done with recourse, with the remainder being either export factoring or domestic factoring without recourse. Domestic factoring without recourse is offered on the basis of a contract with one of two major foreign export credit insurance companies—either Coface or Hermes.

The future of factoring in Poland relies heavily on the development of the SME sector of the economy on the one hand and the removal of legal and accounting/taxation barriers on the other hand. Poland has about 3.4 million registered businesses—the largest number in Central and Eastern Europe. Over 90% of them are small and medium sized enterprises with huge liquidity problems (only about 3% of SME say they have no problems with liquidity) and lack of equity and current asset financing. Poland is probably the only country in the region with a rather unfavorable legal environment for factoring. Major bottlenecks are:

- widespread use of non-assignment clauses—80% of supermarket chains are using such clauses, making financing of receivables impossible for suppliers of many FMCG goods;
- inability to write off bad debts for factoring companies, as financed receivables cannot be booked in factors’ books as revenues;
- very poor understanding by the courts of factoring-related cases; judges, especially in the local courts, are mixing up factoring companies with other legal entities, allowing debtors to engage in various kinds of frauds and causing losses to factors.

Source: Handlowy-Heller.

<sup>27</sup> For example, the Bank of Italy has perhaps gone furthest among EU financial regulators in applying prudential and reporting requirements to factoring companies (Muschella 2003).

- Encourage factoring companies to use the same accounting standards when preparing their financial statements and have the statements audited using the same auditing standards that apply to their parent owners—particularly when these owners are banks. This approach will make it easier for factoring companies to obtain financing in capital markets and to diversify their funding sources beyond lines of credit from their parent banks, by exploiting the credibility and cost advantages deriving from high-quality financial statements prepared for a financial group or holding company using uniform, preferably internationally recognized accounting and auditing standards (such as International Financial Reporting Standards and International Standards on Auditing).<sup>28</sup>
- Recognize the unique nature of factoring companies' credit exposure when setting provisioning rules for large and connected exposure limits applicable to banks and bank-owned financial subsidiaries (such as factoring companies). Depending on the level and nature of recourse factoring, the credit exposure of factoring companies is not or is not fully to the sellers of receivables (often SMEs with limited credit history), but instead is partly or fully to the obligors of those receivables (often larger, more established companies).

Fourth, hindrances to the development of factoring should be addressed. In Poland, for example, 80 percent of large supermarket chains use non-assignment clauses—making financing of receivables impossible for suppliers of many fast-moving consumer goods.

Fifth, establishing domestic factoring associations and encouraging factoring companies to join them could give the industry a voice in discussions with government authorities on policy issues facing the industry. In more developed factoring markets such associations actively promote the interests of factoring companies.

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<sup>28</sup> These efforts also increase the reliability of consolidated financial statements of financial groups, benefiting the supervision of such groups in cases where they are headed by or comprise regulated entities such as banks.



## ANNEX: SECURED TRANSACTION REGIMES FOR MOVABLES IN THE EU 8

Country	Pledge Registration System	Comments
Czech Republic	Yes	<p><b>OVERVIEW</b></p> <ul style="list-style-type: none"> <li>• The Register of Pledges was introduced by an amendment to the Czech Civil Code (effective as of 1 January 2002).</li> <li>• The purpose of the Register is to provide reliable evidence of the existence of certain types of pledges.</li> <li>• The Register is maintained by the Czech Notary Chamber in electronic form and is not publicly available. Rather, a notary public issues a copy or extract from the Register, as well as confirmation that the particular object is not subject to a pledge, only if: (i) the requesting person proves a justified interest; or (ii) the owner of the collateral approves it in writing.</li> </ul> <p><b>TYPES OF PLEDGES</b></p> <ul style="list-style-type: none"> <li>• A pledge encumbered by a lien may be a movable or immovable object, an enterprise or another collective asset, a set of objects, a receivable, or some other property right if its nature so admits, a flat (an apartment) or non-residential premises in ownership, a shareholding in a business (an ownership interest), securities or the subject of a specific industrial (i.e. intellectual) property right.</li> <li>• A receivable can be secured by a lien on several separate objects (joint lien).</li> <li>• A lien may secure both a pecuniary and a non-pecuniary receivable.</li> </ul>
Estonia	Yes	<p><b>OVERVIEW</b></p> <ul style="list-style-type: none"> <li>• Has a commercial pledge register. Registration of movables is regulated by the Commercial Pledge Law and the Property Law.</li> <li>• Database is centralized and electronic.</li> </ul> <p><b>TYPES OF PLEDGES</b></p> <ul style="list-style-type: none"> <li>• A commercial pledge extends to all movable property of a company or movable property relating to the economic activity of a sole proprietor. A commercial pledge may be established on the movable property of the Estonian branch of a foreign company.</li> <li>• A commercial pledge extends to all encumberable property, which belongs to an undertaking at the time the pledge entry is made, and to property, which the undertaking acquires after the pledge.</li> <li>• A commercial pledge does not extend to money in a cash register or credit institution; shares, stocks, investment fund shares, contributions in co-operatives or participation in other companies belonging to an undertaking; promissory notes or other loan documents accepted in common usage; or other securities.</li> </ul>

Hungary	Yes	<p><b>OVERVIEW</b></p> <ul style="list-style-type: none"> <li>• Has a modern and efficient regime for secured transactions (EBRD 2003 Transition Report).</li> <li>• The Charge Registry is kept at the Hungarian National Chamber of Public Notaries.</li> <li>• The registry is accessible for anybody to inspect.</li> <li>• The registry is centralized and computerized.</li> <li>• The secured transaction system is defined in the Hungarian Civil Code of 1959. Modifications of the code in 1996 amended the secured transaction system and have led to an increased use of security over movables. The law was further updated in September 2001.</li> </ul> <p><b>TYPES OF PLEDGES</b></p> <ul style="list-style-type: none"> <li>• The charged asset may be any tangible object, any transferable right or claim.</li> <li>• A charge on rights and receivables may be created by agreement.</li> <li>• A floating charge may be created on the whole of a business association without legal entity or on a part of it that operates as a separate economic unit without having to define the objects, rights and receivables constituting the asset, by concluding the charge agreement in form of a notary instrument and registering the charge in the charge registry.</li> </ul>
Latvia	Yes	<p><b>OVERVIEW</b></p> <ul style="list-style-type: none"> <li>• Commercial pledges are registered in the Register of Commercial Pledges, a database on commercial pledges.</li> <li>• The register is fully accessible to the public.</li> <li>• The system is centralized and electronic.</li> </ul> <p><b>TYPES OF PLEDGES</b></p> <ul style="list-style-type: none"> <li>• The object of the commercial pledge may be: <ul style="list-style-type: none"> <li>• a movable tangible or intangible object which belongs to a legal person engaged in business („enterprise“ or „business company“).</li> <li>• a pool of objects (as mentioned above);</li> <li>• the complete assets of an enterprise.</li> </ul> </li> <li>• Aircraft and land mechanical means of transportation and their trailers as well as an enterprise as a pool of objects; capital shares of an enterprise; shares, stocks of a closed issue; and bonds of a closed issue may be the object of the commercial pledge irrespective of their ownership.</li> <li>• The commercial pledge where the object is a pool of objects shall include the existing as well as future parts of the pool if it is not explicitly clear that the intent of the pledgor of the commercial pledge has been to pledge only the part of the pool as it was at the moment of creating the pledge right.</li> </ul>

Lithuania	Yes	<p><b>OVERVIEW</b></p> <ul style="list-style-type: none"> <li>• Has a modern and efficient regime for secured transactions (EBRD 2003 Transition Report).</li> <li>• Pledges are registered in the Register of Mortgages administered by the mortgage departments of district courts.</li> </ul> <p><b>TYPES OF PLEDGES</b></p> <ul style="list-style-type: none"> <li>• Types of collateral include: <ul style="list-style-type: none"> <li>• any movable object defined by individual or species characteristics except objects subject</li> <li>• to mortgage under the Law on Mortgage;</li> <li>• securities;</li> <li>• intellectual property rights;</li> <li>• money in the bank account of the debtor;</li> <li>• rights in rem;</li> <li>• rights in person arising from a written agreement.</li> </ul> </li> </ul>
Poland	Yes	<p><b>OVERVIEW</b></p> <ul style="list-style-type: none"> <li>• Has a Pledge Registry system.</li> <li>• In Poland the pledge registries are maintained by district courts.</li> <li>• The pledge registry is maintained in an electronic form and data are accumulated nationwide.</li> <li>• The system has problems of excessively long periods of processing request in the pledge registries. The registered pledge as a form of collateral does not significantly diminish credit risk. In fact, the long processing times may even contribute to/create higher risk.</li> </ul> <p><b>TYPES OF PLEDGES</b></p> <ul style="list-style-type: none"> <li>• The collateral may be any movable object or property right which is transferable. In particular, a registered pledge may encumber: <ul style="list-style-type: none"> <li>• objects which may be specifically identified,</li> <li>• objects identified as to type, if in the pledge agreement their quantity or means for differentiating them from other objects of the same type is specified,</li> <li>• a collection of movable objects or rights constituting an economic entity, even though the individual object may be replaceable,</li> <li>• claims,</li> <li>• intellectual property rights,</li> <li>• rights from securities.</li> </ul> </li> <li>• A registered pledge may also encumber objects or rights, which the pledgor [debtor] is to acquire in the future. In such case the encumbrance of these objects or rights shall be effective at the moment title is acquired by the pledgor [debtor].</li> </ul>

<b>Slovak Republic</b>	<b>Yes</b>	<p><b>OVERVIEW</b></p> <ul style="list-style-type: none"> <li>• Has a modern and efficient regime for secured transactions (EBRD 2003 Transition Report). System considered one of the best in Europe.</li> <li>• Registration is made in the new Charges Register operated by the Slovak Chamber of Notaries.</li> <li>• The register is maintained in a single electronic database. Registration is made instantly via a terminal in a notary's office.</li> </ul> <p><b>TYPES OF PLEDGES</b></p> <ul style="list-style-type: none"> <li>• Under the new law, any legal or physical person can give a charge over its assets (objects, residential or non-residential property, rights or other assets) in favor of any creditor, to secure his own or another person's debt. The charge can be taken over any single or collective object, right or asset that is capable of being transferred. This may include: <ul style="list-style-type: none"> <li>• movable assets,</li> <li>• land and buildings,</li> <li>• rights and receivables,</li> <li>• or even a group of assets, which is constantly changing, such as inventory, trade receivables, stocks of raw materials or an entire enterprise.</li> </ul> </li> <li>• It may also include assets to be acquired in the future. The fruits of the collateral are included until they become separated unless otherwise agreed.</li> </ul>
<b>Slovenia</b>	<b>No</b>	<p><b>OVERVIEW</b></p> <ul style="list-style-type: none"> <li>• This area is currently under reform. There is no public register to allow tracking of priorities and to alert third parties of an existing charge, although the Law on Enforcement provides for a register, which is to be developed by the Chamber of Notaries.</li> </ul> <p><b>TYPES OF PLEDGES</b></p> <ul style="list-style-type: none"> <li>• Only charges on motor vehicles are currently registered with the Ministry of Interior on the basis of an agreement with the Chamber of Notaries.</li> </ul>

Source: EBRD Regional Survey of Secured Transaction Laws, national country websites, and national civil codes and laws on property rights, pledges and secured transactions.

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This paper assesses the role of factoring as a source of working capital finance for small and medium size companies, both globally and in the new EU member states in Eastern Europe—the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia, referred to as the EU 8.

It describes the distinguishing features, origins, and mechanics of factoring and then examines its role in the international financial landscape, including how it compares with other lending products for SMEs. The paper then analyzes issues that drive the importance of these products around the globe, including countries' information infrastructure, legal and judicial frameworks, and tax and regulatory environments. Subsequently, the paper assesses the conditions that will foster—or undermine—the development of the factoring industry in the EU 8, and concludes with policy recommendations for accelerating its development.

