21 Invoice finance

Note: This sectoral guidance is incomplete on its own. It must be read in conjunction with the main guidance set out in Part I of the Guidance.

Products

21.1 Invoice finance companies offer a number of products to fund the working capital requirements of their clients; these generally fall into two categories – Factoring agreements and Invoice Discounting agreements. These can be operated on a Recourse or Non Recourse basis, and with or without disclosure of the assignment of the sales invoice to the client's customers, the debtors.

Factoring Agreements

21.2 *Factoring* is a contract between an invoice finance company and their client where revolving finance is provided against the value of the client's sales ledger that is sold to the invoice financier. The invoice finance company will manage the client's sales ledger and will normally provide the credit control and collection services. The client assigns all their invoices, as usually a whole turnover contract is used, after the goods or service has been delivered or performed. The invoice finance company will then typically advance up to 85% of the invoiced amount – the gross amount including VAT. The balance, less charges, is then paid to the client once the debtor makes full payment to the invoice finance company. The assignment is usually disclosed to the debtor, (although some contracts are operated on an agency basis, via the client, without disclosure of the assignment to the debtors and on occasions the management of the sales ledger can remain with the client as well).

Invoice Discounting Agreements

21.3 *Invoice Discounting* is a contract between the invoice finance company and their client where revolving finance is provided against the value of the client's sales ledger. The client will manage the sales ledger and will normally continue to provide the credit control and collection services. The client assigns all invoices, as usually a whole turnover contract is used, after the goods or service have been delivered or performed. The invoice finance company records and monitors this on a bulk sales ledger basis rather than retaining the individual invoice detail. The invoice finance company will then typically advance up to 85% of the invoiced amount. The balance, less any charges, is then paid to the client once the debtor makes full payment to the invoice finance company. The client undertakes the collection of the debt under an agency agreement within the contract. The client is obligated to ensure that the payments from debtors are passed to the invoice finance company. Where there is an agreement that the assignment is not disclosed, the colloquial title of Confidential Invoice Discounting is used to describe the undisclosed product, but confidentiality only exists at the discretion of the invoice finance company (whilst they are prepared to operate the agency arrangement).

Asset-Based Lending

21.4 Asset-Based Lending in the Invoice Finance industry would usually have the client's sales ledger at the core of the facility. It is a contract between the invoice finance company and their client where revolving finance and/or fixed amortising finance is provided against a 'basket' of assets – accounts receivables, inventory, plant machinery, property, etc.

Recourse Agreements

21.5 *Recourse agreements* can apply to factoring or invoice discounting agreements. If the customer fails to pay the amount due to the client, then the invoice finance company will look to the client for reimbursement of any money they have advanced against that invoice.

Non Recourse Agreements

21.6 *Non-Recourse agreements* can apply to factoring or invoice discounting facilities. The invoice finance company effectively offers a bad debt protection service to the client. If the customer fails to pay the amount due to the client, due to insolvency, the invoice finance company stands the credit loss up to the protected amount, which is the value of the credit limit provided against the particular customer, less any agreed first loss amount.

Affiliated Factoring Companies

21.7 Assigned sales invoices may include overseas sales which require international credit control and collection services. Where the invoice finance company is not able to undertake this cross border activity, typically due to the lack of its own international network, it may enter into an arrangement with an Affiliated Factoring Company [AFC] in the appropriate country. This is often known as Export Factoring.

21.8 Affiliated Factoring Companies, operating in their own countries, will frequently have sales invoices with sales that require credit control and collection services to be performed in the United Kingdom. Where the AFC is not able to undertake this cross border activity, typically due to the lack of its own international network, it may enter into an arrangement with an invoice finance company in the United Kingdom. This is often known as Import Factoring.

21.9 The activities and associated risks are considered to be similar to correspondent banking* albeit are considered to be a lower risk, the financier being fully aware of the underlying transaction and the purpose of payment. For export facilities, the use of an approved AFC, in the country in which the debtor is domiciled also assists in reducing the risk associated with the transaction. *See Part II, sector 16: *Correspondent banking* for specific guidance on the risks and controls applicable to this type of activity.

What are the money laundering risks in invoice finance?

21.10 As with any financial service activity, invoice finance products are susceptible to use by criminals to launder money. Both Factoring and Invoice Discounting products facilitate third party payments and may therefore be used by criminals for money laundering activity. The different invoice finance products available vary greatly and the degree of risk is directly related to the product offering.

21.11 The level of physical cash receipts directly received within the invoice finance sector is extremely low, as the vast majority of debtors settle outstanding invoices by way of cheque or electronic payment methods. Therefore the susceptibility of the invoice finance sector at the traditional placement stage is very low. The risk within the invoice finance industry is at the layering and integration stages of money laundering.

21.12 The main money laundering risks within the invoice finance sector are payments against invoices where there is no actual movement of goods or services provided, or the value of goods is overstated to facilitate the laundering of funds. As stated, the level of risk will depend upon the nature of the product and the level of involvement by the finance company. Factoring should be considered to be a lower risk than invoice discounting, in view of the fact that direct contact is maintained with the debtor. Invoice discounting would represent an increased risk of money laundering due to the 'hands off' nature of the product.

21.13 The following factors will generally increase the risk of money laundering for invoice finance products:

- Cross border transactions
- Products with reduced paper trails
- Products where the invoice financier allows the client to collect the debt
- Confidential products
- Bulk products

21.14 The following factors will generally decrease the risk of money laundering for invoice finance products:

- Individual items (invoices, customers, receipts) being recorded and managed by the invoice financier
- Collections activity being undertaken by the invoice financier
- Non-recourse facilities
- Regular ongoing due diligence and monitoring including on-site inspections and verification of balances
- Regular statistical monitoring
- For export facilities, the use of an approved AFC, in the country in which the debtor is domiciled

(NB moved, see 21.18)

21.15 Frequent occurrences, within the Invoice Finance sector, are short-term breaches of the underlying agreements by the clients. These are often due to client error or the clients' need for short term funding to cover a temporary deficiency. The vast majority of these short term breaches are not material in nature and the intelligence value of many of these occurrences, e.g., where invoices have been assigned prior to the actual delivery date by a matter of days, is extremely limited. However, the invoice financier should be aware that such instances could be one of the first indicators of the presence of money laundering and that a period of increased vigilance may be appropriate to ensure there is no reason to suspect money laundering.

21.16 The risks associated with short term breaches should be documented within the invoice finance company's risk assessment and appropriate controls established to ensure that, where there is a suspicion of the presence of money laundering, an appropriate report is filed with SOCA.

21.17 Invoice finance companies should recognise within their risk assessment that even though they may appear to be the only party affected by the client's, (or the client's customer's) action, the action in itself may represent an offence under POCA and as such the invoice finance company is obligated to file an appropriate report with SOCA.

Assessment of risk

21.18 It is important that each invoice finance company within its risk assessment has developed robust procedures to monitor the money laundering risks. Many of these procedures will overlap with those that are routinely used to manage credit risks within the sector, however other checks may need to be implemented, such as improved knowledge of the source of funds, that are different to the usual credit risk checks.

21.19 With extremely low levels of cash being transacted the susceptibility of the invoice finance sector at the traditional placement stage is very low.

21.20 Invoice finance products may be used to launder money at the layering and integration stages. However there are a number of factors that make the invoice finance facility less attractive to the money launderer, they are:

- The high levels of contact between the financier and the client, in terms of physical audits and visits, and of statistical monitoring
- The sophisticated IT monitoring techniques used to detect issues with the quality of the underlying security, consisting of the quality of the goods and the customers (debtors),
- In the case of factoring the item by item accounting and the regular direct contact with the debtors
- The focus on the debtors in terms of creditworthiness and assessment of risk
- The double scrutiny of payments, by the receiving bank and by the invoice financier

21.21 An invoice finance company operating a full factoring agreement, with regular contact, monitoring and review of the third party transactions, may determine that the risk level of Factoring Agreements, due to the level and frequency of the mitigating controls is low.

21.22 Invoice Discounting facilities, while generally considered higher risk than factoring facilities may also be characterised by regular due diligence by the Invoice Financier. The nature of these controls and the rationale for any reduction in risk assessment should be documented within the invoice finance company's overall risk assessment, which should be updated and reviewed on a regular basis.

21.23 Cross border transactions represent an increased risk of the presence of money laundering. The nature of the agreement will lead to these transactions being managed in different ways. This risk is reduced when the credit control procedures are managed by an approved AFC in the country in which the debtor is domiciled.

21.24 In general, the normally low to medium risk of money laundering will increase with the reduction of the levels of intervention by the financier and the increase in the size of foreign transactions through the account.

Who is the customer for AML purposes?

21.25 In the invoice finance sector the party with whom the factoring company holds a contract to provide finance is usually referred to as a 'client' and the client's customers as either 'debtors' or 'customers'. Therefore references in Part I of the Guidance to 'customer' refer to the client within the invoice finance sector.

21.26 The identification requirements on which guidance is given in Part I, Chapter 5 will only apply to an invoice finance company's clients – the parties with whom they have a contractual relationship. The client will be a business entity; a public limited company, private limited company, partnership or sole trader.

21.27 Whilst customers [the client's debtors] may be identified for routine credit risk or collection purposes by the invoice finance company, the requirement to identify, or verify the identity, of these customers does not apply.

21.28 Where invoice finance companies are involved in syndicated arrangements, the customer is as defined within Part II, sector 17: *Syndicated lending*. In such cases, the guidance in sector 17 should be read in addition to the guidance in this part of the Guidance.

21.29 Where invoice finance companies are involved in arrangements with Affiliated Factoring Companies (AFC) the AFC becomes the customer in an export relationship and the client in an import relationship. .

Customer Due Diligence

21.30 The CDD measures carried out at the commencement of the facility and the ongoing due diligence are very closely linked to anti-fraud measures and are one of the primary controls for preventing criminals using invoice finance facilities. Invoice finance companies should ensure that they coordinate both the identification and ongoing customer due diligence processes for clients in order to provide as strong a gatekeeper control as possible.

21.31 Invoice finance companies should carry out detailed initial CDD measures to gain a full understanding of the client and their business before opening a facility. This should be at a level to provide identification and establish expected activity patterns of their clients and their activities to meet the requirements set out in Part I, Chapter 5.

21.32 The identity of the client's debtors will normally only be obtained from the client, as part of the understanding of that client, without verification being required. The invoice finance company's risk assessment could determine that verification of the identity of some of the client's debtors will also be required under appropriate circumstances.

21.33 In terms of money laundering, some invoice finance products are considered higher risk than others; in these cases, enhanced due diligence measures are required.

21.34 Enhanced due diligence is appropriate in the following, but not exhaustive, list of situations:

- Where any party connected to the client is a PEP. See Part I, paragraphs 5.5.18-5.5.25.
- When the client is involved in a business that is considered to present a higher risk of money laundering. Examples should be set out in the firm's risk-based approach and should reflect the firm's own experience and information produced by the authorities. See Part I, paragraphs 5.7.1-5.7.8 for guidance. These are likely to include the following, although this list should not be construed as exhaustive;
    - A client with any party associated with a country either on a residential or business activity basis that is deemed to have a relatively high risk of money laundering, or inadequate levels of supervision (see Part I, paragraphs 3.24-3.26). Examples of these countries can be found listed within the country assessments made by the International Monetary Fund or the Financial Action Task Force. Another source of information can be found within the Transparency International Corruption Perception Indexes that are published on an annual basis.
    - A client who carries a higher risk of money laundering by virtue of their business or occupation. Examples of which could be;
        - A business with a high level of cash sales.
        - A business with a high level of cross border sales, including Import-Export companies.
        - A business selling small high value goods that are easily disposed of.
- Where transactions or activity do not meet expected or historic expectations, it is likely they will include the following:
    - Size – monetary, frequency, etc.
    - Pattern – cyclical, logical, frequency, amount, etc

  - Location – cross border, NCCT, rationale, etc.
  - Goods / Service – Type, Use, Payment norms, etc.

21.35 Monitoring aspects of enhanced due diligence should be set out in the invoice finance company's risk-based approach. It is likely they will include the following:

- More frequent and detailed on-site inspections of the client's books and records, frequently called an 'Audit', with appropriate management oversight and action of any significant deficiencies.
- More frequent and extensive verification, usually by telephone contact with the debtor, of the validity of the sale and invoice values.
- Greater management oversight of these facilities.
- Extended KYC