



BANKING STAKEHOLDER GROUP

CONSULTATION ON EBA/DP/2015/02 ON
CALL FOR EVIDENCE ON SMES AND THE SME SUPPORTING FACTOR

General Comments and Replies to Questions

BY THE EBA BANKING STAKEHOLDER GROUP

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Foreword

The EBA Banking Stakeholder Group (“BSG”) welcomes the opportunity to comment on the Consultation Paper EBA/DP/2015/02 on the Call for Evidence on SMEs and the SME Supporting Factor.

This response has been prepared on the basis of comments circulated and shared among the BSG members.

As in the past, the BSG supports an initiative that aims at harmonizing supervisory rules and practices across Europe, in order to ensure fair conditions of competition between institutions and more efficiency for cross-border groups. The BSG also expects these initiatives to facilitate data sharing between European supervisors and avoid reporting duplications for banks. This response outlines some general comments by the BSG, as well as our answers to the questions indicated in the Discussion Paper.

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General comments

The BSG welcomes this Discussion and Call for Evidence on SMEs and the SME Supporting factor. The EBA has the mandate to report to the European Commission on the analysis of the evolution of the lending trends and conditions for SMEs, their effective riskiness over a full economic cycle, and on the impact of own funds requirements on lending to SMEs. The SME sector is vital for the European economy, since 99 out of 100 enterprises in Europe are SMEs, they employ two thirds of total employment and produce more than half of the total value added. Furthermore, the main source of external financing for these enterprises is bank lending, since they do not have easy access to the alternative of capital markets in the way that large enterprises have. Therefore, monitoring lending trends to SMEs, and ensuring that the flow of capital to these enterprises is not hindered, is an important part of the EU’s effort for achieving a stable growth rate in the economy.

On the other hand, it is important to recognise that SMEs consist of three subgroups of enterprises (micro, small and medium) with distinct differences in terms of access to financing, as the Survey on Access to Finance to Enterprises of the ECB points out. Micro enterprises differ much in terms of organization, productivity, risk, information availability and financing trends when compared to medium. Therefore, it is worth exploring whether it would be worthwhile to develop a mechanism that would monitor financing flows and its conditions to enterprises according to this categorization of micro, small and medium

enterprises, which is already adopted in other areas of data gathering and dissemination at the European level. For the time being, there are no data available that follow this categorization, meaning that it is impossible to draw safe conclusions for capital flows to SMEs as a group and specifically to its sub-categories.

Regarding the SME Supporting Factor, initially designed to shield SMEs financing from the tougher regulatory standards imposed to financial institutions for financial stability, we argue that conclusions cannot easily be drawn on whether the Factor has constituted a crucial factor to support lending to SMEs. It is very difficult to isolate the impact of the SME Supporting Factor from all the other aspects and there is no evidence that can be provided showing either an increase or decrease in SME lending. It seems that other factors, such as macroeconomic conditions, may have more explanatory power in explaining SMEs lending trends. It is also worth noting that the Basel Committee of Banking Supervision is completing a thorough review of the framework; this revision includes among other significant modifications to existing methods of measuring risk-weighted assets and capital floors. The impact of the new regulatory initiatives on SME funding should be carefully analyzed before taking a regulatory action.

The rest of our response refers to the Group's answers¹ to the specific questions given in the Discussion Paper.

Replies to Questions

4.1 Market development and sources of SME financing

No questions

4.2 Regulatory treatment of SMEs and the SME Supporting Factor

**Q1: Do you have systems in place to track the reduction in capital due to the application of the SME Supporting Factor (capital relief)?
Yes/No. Please explain and provide evidence.**

Yes: in the central reporting systems an SME indicator is included. Given the exposure value, capital reduction can be applied and tracked. However registration of SME Support Factor is impeded due to entities being exempted from reporting annual turnovers. Additionally, article 3 of the “recommendation 2003/361/EC” describes several types of enterprises which results in additional complications in determination of the SME Support Factor.

¹ Please note that the answers provided for questions directly referring to banks (such as 1,2,3,4,9,10, 12) come from BSG members representing financial institutions.

In addition, institutions shall report to supervisors (COREP Templates) information related to exposures to SMEs and SMES subject to the supporting factor (Standardized Approach) and Risk Weighted Assets Pre and Post Supporting Factor (IRB Approach)

Q2: In your experience, is the reduction in capital requirements due to the application of the SME Supporting Factor (capital relief) being used to support lending to SMEs? Yes/No. Please explain and provide evidence.

Generally, in this period of crisis, it is not easy to demonstrate how the CRD IV implementation has influenced the lending policies to any particular business. There are many factors, in addition to regulation, that have conditioned funding and financing policies during the crisis, such as: (a) credit demand, (b) cost and level of access to finance in different countries, (c) indebtedness of the private sector (increase in non-performing loans, forbearances etc.), (d) the deleveraging process

With the application of the SME Supporting Factor by definition a reduction in capital requirements is achieved. However, it is very difficult to isolate this effect from the data. The exposure on SMEs could be increased, an institution could provide credit to riskier SMEs, and other portfolios could have become more or less risky. Therefore no clear evidence can be provided to prove the reduction in capital requirements apart from the multiplication factor of 0.7619 being applied. However, it should not be disregarded that the regulation has helped in some way to counterbalance the negative effects of other factors affecting the lending policies.

Q3: Is your internal definition of SMEs in line with the definition of SME exposures subject to the SME Supporting Factor? Yes/No. If no, how are you reconciling the internal definition of SMEs with the definition of SMEs subject to Supporting Factor? Please explain and provide specific examples.

Complications arise when clients are exempted from reporting annual sales. Additionally details were included in EBA Q&A which were not described in article 501 of the CRR. This results in some differences between the internal definition and the SME definition for the SME Supporting Factor. Examples include the off-balance-sheet part of the exposure with respect to the threshold value of EUR 1.5 million and not excluding contingent claims secured on residential property.

Q4: In monitoring the total amount owed to you, your parent and subsidiary undertakings, including exposures in default, by the borrower and its group of connected clients (as defined in CRR Article 4(1)(39)), what reasonable steps do you take to ensure that amount does not exceed EUR 1.5 million in accordance with Article 501(2)(c)?

Efforts were made to implement automated checks. However, it is observed that in some cases the aggregated exposure over Business Units (BUs) may exceed the EUR 1.5 million threshold. While for some BUs the impact is not material, an add-on is introduced in the Appendix of COREP to compensate for the events where the SME support factor was incorrectly applied.

Q5: Do you see merits in having a harmonised definition of SMEs for reporting purposes? Yes/No. Please explain and provide specific examples.

Yes: it would be beneficial if all institutions apply the same definitions resulting in a level playing field preventing one institution applying the Support Factor whereas other institutions would not. There are, however, practical issues as mentioned earlier, such as not having turnover when the obligor is exempted from reporting. Furthermore, third countries SME definition is based on local criteria and the information required under CRR could not be available and/or representative of the SMEs portfolio in those countries. Therefore, it would also be beneficial if the SME definition would be applied consistently throughout the CRR. Articles 123 and 147 mention SMEs but do not provide a clear definition, whereas article 501 only indicates when the Support Factor specifically may be applied.

4.3 Riskiness of EU SMEs over a full economic cycle and consistency of own funds requirements with the SME riskiness

Q6: Do you agree with the proposed measures of SME riskiness? Yes/No. Are some of these measures more relevant than others? Yes/No.

The factors chosen in the paper were:

1. profitability (EBITDA/total assets),
2. activity (net turnover/total assets),

3. coverage (EBITDA/interests on financial debts) ,
4. leverage (total equity/total assets) and
5. liquidity (current assets/total assets)

In general, most of these factors are also used in the credit risk models for these entities. However, the use of specific ratios depends on the risk assessment methodology applied by the particular banking institution. It is quite likely that different institutions use different definitions of ratios to measure profitability, liquidity, interest coverage, etc. For example, profitability (defined in the BACH database as EBITDA/total assets) may very well be defined as a relation to turnover, and instead of EBITDA net profit may be used. Furthermore, the growth in assets or leverage is also considered an important aspect determining its creditworthiness. In internal models, solvency is considered the most relevant factor followed by debt coverage.

Q7: Are other aspects relevant in your assessment of the creditworthiness/riskiness of potential SME borrowers? Yes/No. If yes, please provide a list of those aspects and explain how you measure SME riskiness.

Part of this question is covered in our Answer to Q6. However, it is worth noting that it is also important to take into account qualitative factors. These concern the quality, qualifications and reputation of the directors, and management in general. As credit information on SMEs is often difficult to obtain (as they are not subject to the same requirements for publication), for local banks, a lot of confidence is put on the personal knowledge of the directors/entrepreneurs. It may also be important to assess access to finance (facility/difficulties, capital market access, bank financing only) and the competitive position in the market. Last, in some economies, if an SME is active in the export market, this is considered a positive sign to assess its creditworthiness.

Q8: In your experience, are SMEs as cyclical or more/less cyclical than large enterprises?

The length of the cycle period is not considered to be substantially different from the larger enterprises. As for the impact, it could be argued that the cycle is slightly more volatile for SMEs in comparison with large enterprises, as SMEs (i) often depend on large enterprises (for example subcontractors), (ii) they are usually concentrated in the domestic market, which makes more difficult to cushion the national cycle and (iii) they are often mono-sectorial, i.e. if their sector is in a downturn, they cannot, or have more difficulties, to compensate with another sector. However, there are also diversification effects which may compensate this risk.

Q9: Do you agree with the proposed methodology to assess the own funds requirements in relation to SME riskiness? Yes/No. If no, please provide alternative methodologies or indicators, if available.

This may depend on the particular financial institution. Banks specialized in SMEs applying a high PD in combination with a SME Support Factor may not be preferred by the regulator as the risk is underestimated. However, the PDs estimated within this bank's specialized in SMEs may be lower than other larger banks, but that may depend on diversification which would result in lower systemic risk. It is difficult, therefore, to provide an objective answer to this question. Additionally, it would be argued that the asset correlation should be directly affected in the capital calculation formula itself rather than via a multiplication factor.

Q10: Did the arrears and loss experience in 2009/2010/2011 exceed an (internal) limit? Yes/No. Were (expected/unexpected) losses adequately covered by loan loss provisions? Yes/No. Please explain and provide specific figures.

It is not clear what is meant with an (internal) limit. Internally no limits are defined with respect to arrears and loss experiences. The arrears and losses exceeded the original (model) expectations in that period, which is not unexpected in hindsight. As for the loan loss provisions, these were usually estimated on an accurate level in line with the realized losses, and in some countries a dynamic provision was added, which helped absorbing the effects of the crisis in the first stages of the crisis.

4.4 SME lending trends and conditions and impact of the SME Supporting Factor on lending trends and conditions

Q11: Do you agree with the above interpretation of statistical data on lending trends and conditions? Yes/No. If no, please explain.

First, it is worth noting that the area of SMEs consists of three subgroups of enterprises (micro, small and medium) with distinct differences in terms of access to financing. For example, according to ECB's most recent survey (June 2015) on the access to finance of enterprises in the euro area (SAFE): (a) among SMEs, access to finance was a more important problem for micro enterprises, (b) micro enterprises is the only size class to report a deterioration of availability of external financing, and (c) collateral is most important for micros to get access to finance. Because of these considerations, looking at SMEs as a whole could lead to

erroneous conclusions, that could not stand for all three subgroups of SMEs. Following on this, a methodology needs to be established so as to monitor capital flows to each of these three categories, so that we have a better understanding about how funding flows to the real economy.

Another point that should be raised is that there are distinct differences between Member States in lending trends, and no clear conclusions about the explanatory variables of SME lending seem to be drawn from the ratios used and their respective analysis, in the per country domain. Perhaps the macroeconomic conditions and environment (per country) could provide higher levels of explanatory power. Whilst academic research is still lacking especially for SMEs, research on large enterprises shows that macroeconomic conditions have been found to be important factors in analyzing firms' financing choices (e.g. Choe et al., 1993²; Gertler and Gilchrist, 1993³; Korajczyk and Levy⁴, 2003) and that firms tend to adjust faster toward their target leverage in good macroeconomic states relative to bad states (Cook and Tang, 2010⁵). Macroeconomic conditions are also important for the determination of credit interest rates (ECB, 2014⁶), as weak economic growth translates into higher credit risk and bank risk aversion. In the same document, the reduction of sovereign market tensions has also played a role in the improvement of credit conditions in peripheral economies.

Another interesting approach is stated in a UK report⁷, which mentions that negative net lending largely reflected higher repayments and not a fall in new lending: Net investment has been going down, but the Bank of England stressed in their bank lending survey that many firms have been repaying loans, which has adversely affected those data. A document of the Banque de France (BdF)⁸ shows that credit conditions are following the same trends between big and small enterprises, with a difference of +80bps for the interest rates of SMEs. Specifically, the Banque de France Statistics show a slump at the end of 2013/beginning 2014 but a steady behaviour in the last six months. In another

² Choe, H., Masulis, R., Nanda, V., 1993. « Common stock offerings across the business cycle: theory and evidence” *Journal of Empirical Finance* 1, 3–31

³ Gertler, M., Gilchrist, S., 1993. “The role of credit market imperfections in the monetary transmission mechanism: arguments and evidence”, *Scandinavian Journal of Economics* 95, 43–63.

⁴ Korajczyk, R., Levy, A., 2003. “Capital structure choice: macroeconomic conditions and financial constraints”, *Journal of Financial Economics* 68, 75–109.

⁵ Cook, D. O. & Tang, T., (2010), “Macroeconomic conditions and capital structure adjustment speed”, *Journal of Corporate Finance* 16 (1), 73-87.

⁶ Darracq, M., Moccero, D., Krylova, E. and Marchini, C., 2014. The retail bank interest rate pass-through. The case of the Euro Area during the financial and sovereign debt crisis. ECB Occasional Paper Series 155. August.

⁷ <http://www.publications.parliament.uk/pa/cm201415/cmselect/cmtreasy/204/204.pdf>

⁸ https://www.banque-france.fr/uploads/tx_bdfstatistiquescalendrier/2015-03-stat-info-financement-des-pme-en-france.pdf

document, BdF states that access to credit remains large and that there is no evidence of auto-control or auto-restriction by SMEs to request new credit⁹.

Summing up: (1) it is questionable whether the SME Supporting Factor is the main factor affecting SME lending trends, (2) SMEs should be treated as a broad group of enterprises with sub-categories that show distinct differences when analyzing their access to bank financing and (3), there are various interpretations of the data concerning lending trends that need to be taken into account.

Q12: Since 1 January 2014, have you changed your SME credit lending and assessment policies and procedures, specifically as a result of the introduction of the Supporting Factor? Yes/No. If yes, please explain and provide specific examples.

In general, the credit lending and assessment policies and procedures have not changed by this article. Given that the article states that the Commission shall report the impact of the own funds requirements on lending to SMEs and natural persons and potentially submit a legislative proposal (if appropriate) in January 2017, it is not known how long this measure will be valid. Additional risks could be incurred for long term loans when policies and procedures would be adjusted.

An issue that falls in the context of this question is that of unsuccessful SME bank loan applications. The EU average shows a constant increase in rejection rates between 2011-2014. On the other hand, improvements are observed in the majority of countries between 2010 and 2014. Thus, firm conclusions are not easily drawn. An interesting piece of (currently missing) data would be to explore reasons for rejections, so that a better understanding of this trend can be achieved.

Q13: Have changes to your SME credit lending and assessment policies and procedures been driven by other factors (e.g. competition from alternative sources of SME financing as described in section 4.1)? Yes/No. Please explain and provide specific examples.

The alternative sources described in section 4.1. refer to structured finance (i.e. covered bonds and securitisations), debt finance on capital markets (i.e. mini bonds), and initiatives of equity investments, portfolio guarantees, securitisations and microfinance. These sources can constitute a complement to banking credit,

⁹ <https://www.banque-france.fr/economie-et-statistiques/stats-info/detail/acces-des-entreprises-au-credit.html>

in particular for risky projects or the first stages of a firm. However, it is difficult for smaller enterprises with a limited number of employees to understand and access these new sources of finance, as they lack financial knowledge. Thus it is first worth exploring whether these alternatives cover the broad context of SMEs, or fit better to specific sub-categories. For example, covered bonds and securitisations (especially the new approach of low-risk securitisations) do not seem to refer to micro and small enterprises; on the other hand, microfinance fits better to the financing needs of these enterprises (micro and small).

Summing up, competition raised from the alternatives described in section 4.1. seems to affect mainly medium enterprises, which comprise the 1% of total enterprises in the EU-28. In the context described above, it would also be worth investigating whether other alternative sources of financing, mainly crowdfunding and peer to peer lending, which seem to be better suited to the specificities of micro and small enterprises, have affected SME credit lending and assessment policies; even though these alternatives are still at an infant stage, their annual growth is so impressive that it would be worth investigating the interrelationship of these sources with bank SME lending. In general, however, the SME credit lending and assessment procedures have not changed by other factors directly. The other sources of finance that SMEs could consider did not result in a change of the policies or procedures either.

Q14: In your experience, is there an impact of the SME supporting factor on the volume of SME lending compared to other loans? Yes/No. Please explain and provide evidence.

As explained in Q2, it is very difficult to isolate the impact of the SME Supporting Factor from all the other aspects. It is therefore not evident to provide objective figures that show either an increase or decrease in SME lending compared to other loans. The reduction in capital results in additional resources. For some Business Units (focused on SME lending) this implicitly leads to an increase in SME lending volume.

Furthermore, and looking at the available data on lending trends and on the heterogeneity across countries, as described in section 4.4., it is questionable whether the SME Supporting Factor is the main variable affecting SME lending trends, even when compared to other loans, although it seems to have had a positive impact.

Q15: In your experience, is there an impact of the SME supporting factor on the pricing and overall conditions of SME lending

compared to other loans? Yes/No. Please explain and provide evidence.

According to the available data described by the EBA Discussion Paper, the interest rate spread between SMEs and larger non-financial corporations has declined since 2014. Furthermore, ECB's most recent SAFE reports that SMEs reported, on balance, a fall in interest rates (-25%, down from -9%) and an increase in the available size (8%, up from 3%) and maturity (2%, up from -1%) of loans and overdrafts. The significantly negative net percentages of the respondents (euro SMEs) regarding the level of interest rates reflect the reduction in aggregate bank lending rates, including those on very small loans (up to EUR 0.25 million) that occurred in the period from October 2014 to March 2015 and confirm the recent results of the euro area bank lending survey, which showed a net easing of credit standards. On the other hand, a net percentage of SMEs continued to indicate a tightening in the collateral and other requirements of banks. However, it is again difficult to identify whether it is the SME Supporting Factor that explains these positive improvements in overall conditions of SME lending.

Q16: Do you consider SMEs are a consistent group when it comes to access to credit or should a distinction be made between different types of SMEs (e.g. micro, small and medium ones)? Yes/No. Please explain and provide specific examples.

This is discussed in our answer to Question 11. SMEs should not be viewed as a homogeneous group when it comes to access to financing in general, and to credit in particular. Particularly, micro enterprises is an area that needs to be further explored. These are approximately 20 million firms which account for 92.4% of the total number of enterprises in Europe and there is a lack of knowledge and understanding of micros and self-employed enterprises, especially when it comes to access to financing. On the other hand, the monitoring and administration costs of small amounts of loans may be too high for financial institutions. It is therefore debatable whether it would be worthwhile to make such a distinction in regulation.

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Submitted on behalf of the EBA Banking Stakeholder Group

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