EUROPEAN BANKING AUTHORITY

EBA Call for Evidence and Discussion Paper on SMEs

Preliminary analysis for the SME report in accordance with the EBA mandate in Article 501 CRR

Public Hearing - 4 September 2015

Contents

1. Background and rationale

- **Article 501 of the CRR** introduces a capital reduction factor of 0.7619 for SME exposures fulfilling certain eligibility criteria – so called **SME Supporting Factor (SF)**.
- Considerations behind the introduction of the SF:
  - the general credit contraction after the financial crisis;
  - SMEs has historically had a high reliance of bank financing and limited access to alternative forms of financing
  - ensure that higher capital rules did not impact SME lending, hence a transitional measure to be reviewed
- **Recital 44 of the CRR** says that credit institutions should effectively use the capital relief produced through the SME Supporting Factor for the exclusive purpose of providing an adequate flow of credit to SMEs established in the Union.
- *To be noted, 2012 EBA SME report assessed the appropriateness of several CRR/CRDIV proposals regarding SME exposures, including the capital reduction, and concluded that there is not enough evidence to justify it.*

2. EBA mandate

EBA will report on SME lending, riskiness and impact of the SME SF

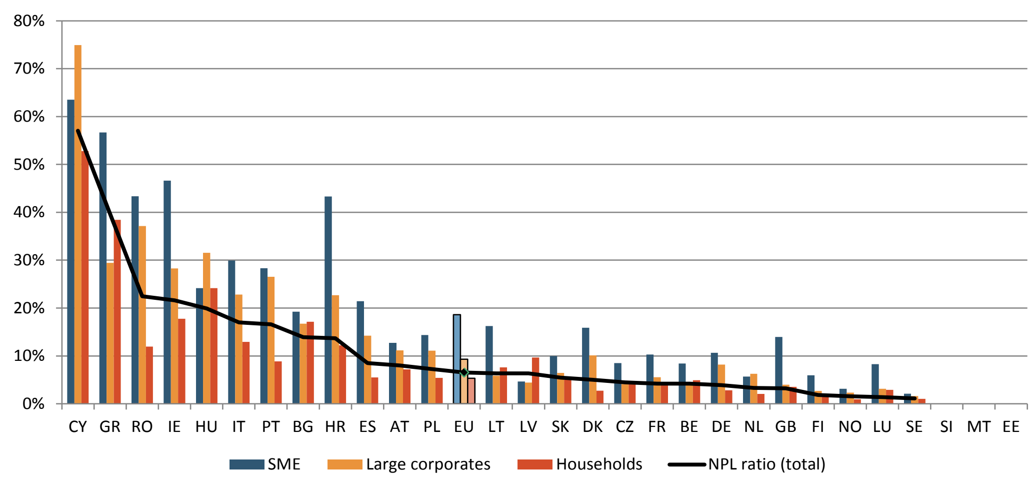
- The European Commission shall report to the Parliament and Council on the impact of own funds requirements on lending to SMEs by 28 June 2016.
- The EBA will provide input to the Commission's report on the impact of own funds requirements as set out in the Regulation. For this purpose, **EBA has the mandate to report to the Commission** on the following:
  a) Analysis of evolution of lending trends and conditions for SMEs
  b) Analysis of effective riskiness of Union SMEs over a full economic cycle
  c) Consistency of own funds requirements for credit risk on exposures to SMEs with the outcomes of points (a) and (b)
- **EBA report expected in 2016 Q1**
- **Why a Call for evidence and Discussion Paper?**
  - To initiate a discussion
  - To collect evidence from industry and other stakeholders

3. SME riskiness over the cycle (1/2)

SMEs are generally perceived as riskier than large companies

- SMEs are generally perceived as riskier than large companies, which is confirmed in the EBA supervisory data
  - The EU weighted average NPL ratio was 6.5% in December 2014, with financially stressed countries showing generally the highest NPLs.
  - Within the NFC sector, SMEs NPL ratio is 18.6% compared to 9.3% for large corporates.
  - The high NPL for SMEs may indicate that SMEs suffer more in times of crisis and restructuring may be more challenging and prolonged.

Non-performing loans to NFCs by firm size and to households, 2014 Q4



Note: SMEs is defined in accordance with the EU 2003 Recommendation
Source: EBA (2015), Risk Assessment of the European Banking System, June 2015, based on EBA Supervisory Reporting data.

3. SME riskiness over the cycle (2/2)

During downturns SMEs show more severe deterioration in riskiness

- The EBA supervisory data has a harmonised definition on NPL only starting 2014, therefore analysis over the cycle of this indicator is not possible
- To conduct the analysis over the cycle, financial information from the European Bank for Accounts of Companies Harmonised (BACH) has been used
  - The riskiness of a SME, is assessed based on five financial ratios identified in Altman and Sabato (2006)* specifically for SMEs: Profitability, Leverage, Activity, Liquidity, Coverage.
  - The five financial ratios have been analysed separately and also collapsed into a single index (simple average of the 5 normalised financial ratios)

- Findings:
  - SMEs tend to be riskier than large firms in "moderate, business-as-usual" times
  - During the recessionary phase of the cycle, increase in riskiness is higher for small firms
  - Differently, medium-sized SMEs are consistently the relatively best performing, less risky players

Composite index: simple average of the five financial ratios normalised using re-scaling

Source: Own calculations based on BACH database.

Altman and Sabato (2006), Modeling Credit Risk for SMEs: Evidence from the US Market.

4. SME lending trends and conditions (1/2)

Lending to SMEs has recovered but did not reach the pre-crisis levels

- The volume of new lending to SMEs in the euro area:
  - between 2003 and 2008, increased and peaked at about EUR 95 billion
  - since 2008, declined
  - from 2012, stabilised, but did not reach their pre-crisis level yet (2003/2004).

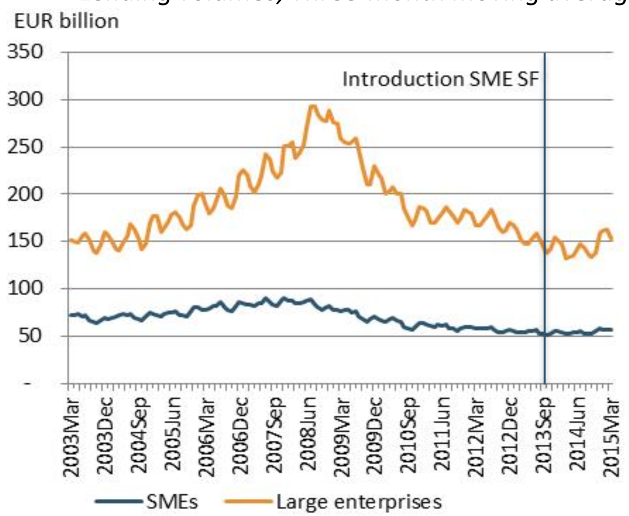
To be kept in mind:

- No consistent EU SME lending dataset over the cycle (COREP starts in 2014)
- No common EU definition consistently used across EU

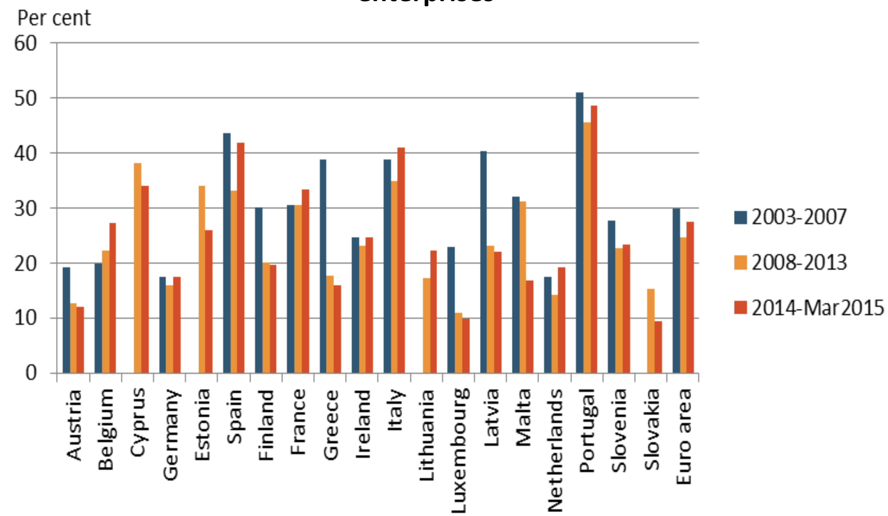
- Besides the general euro area trend, there is significant heterogeneity in the new lending across countries .
- Since the beginning of 2014, new bank lending to SMEs has on average accounted for roughly one third (28%) of total bank loans to NFCs , reaching almost its pre-crisis level (30% in 2003-2007)

New lending to SMEs in the euro area

Lending volumes, Three-month moving average



New bank lending to SMEs as a share of total bank loans to enterprises



Note: New lending is defined as 'loans other than revolving loans and overdrafts, convenience and extended credit card debt' to non-financial corporations; SMEs are proxied by loans up to and including EUR 1 million.
Source: ECB Monetary and Financial Institutions Interest Rate Statistics and Eurostat (Quarterly National Accounts).

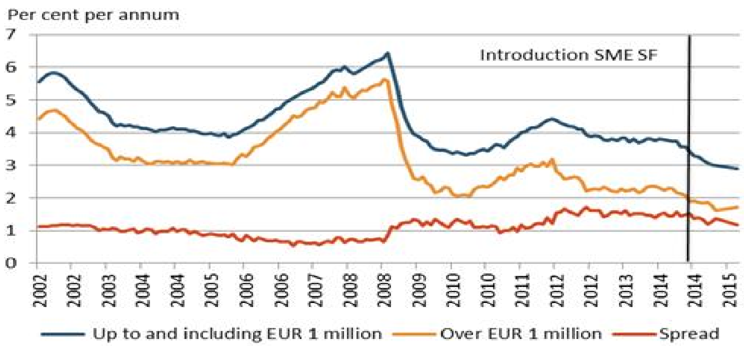
4. SME Lending trends and conditions (2/2)

SMEs face more obstacles to finance, such as higher interest rates and higher rejection rates

Interest rates

- For SME loans, the average spread between min and max has gone up to 4.3 p.p. from 2.3 p.p. since 2009. Interest rate does not seem to go below 2%.

Bank interest rates to non-financial corporations in the euro area



Bank interest rates to SMEs in the euro area

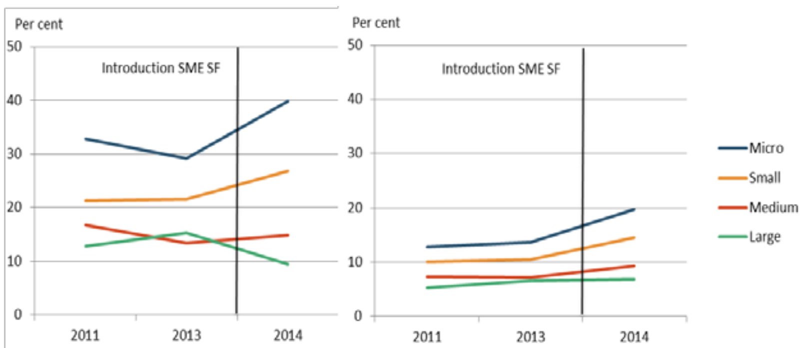
Note: SME loans proxied by loans up to and including EUR 1 million.
Source: ECB Monetary and Financial Institutions Interest Rate Statistics

Other lending conditions

- in 2009-2014 about 30% of euro area SME did not get the full finance they needed, compared to 20% for larger companies.
- The largest increase in obstacles is seen for micro and to a lesser extent small enterprises. For medium firms the share of applicants that applied for a loan but did not get it actually decreased.

Financing obstacles in the European Union by enterprise size (Net percentage of respondents - a positive number denotes an increase)

A: Enterprises that applied for a loan B: All enterprises



Note: Financing obstacles refer to applicants that applied for a loan but refused because the cost was too high, that applied but were rejected, those that applied but only got a limited part of it. For panel B, it also includes discouraged applicants (those that did not applied for fear of rejection). Micro refers to enterprises with less than ten employees, small refers to companies between ten and 50 employees, medium to companies between 50 and 250, and large to companies over 250 employees.
Source: European Commission Survey on Access to Finance of Enterprises.

5. SME Supporting Factor (1/2)
How does it work?

- The Supporting Factor is applied to the RWA of eligible SME exposures → decrease in RWAs → increase in capital ratios

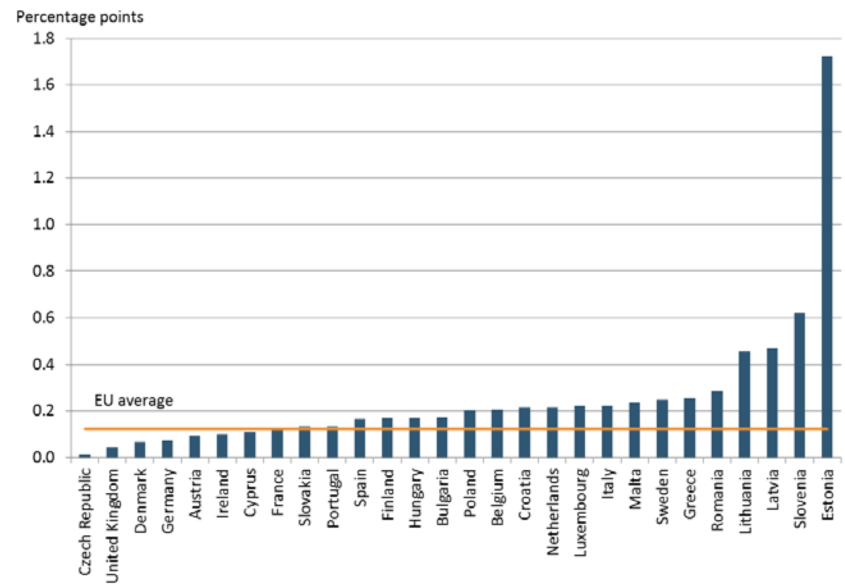
Capital relief due to SF

- 60% of institutions that report at the application of SF, had an increase in CET1 ratio of less than 0.2 p.p. (average CET1 ratio - 12.5%)
- The total capital relief for all EU banks: EUR 10.5 billion (54% concentrated in IT, FR, ES)

Questions we want to answer:

- Has the capital relief been used for "providing an adequate flow of credit to SMEs established in the Union"?
- If yes, how? Channelling of capital towards lending? Change in pricing of loans?
- If yes, are the capital requirements consistent with SME riskiness?

Increase in CET1 capital ratio due to SME Supporting Factor, 2014Q4



Note: countries are ordered according to increasing impact on CET1 ratio; the sample includes all reporting institutions, including those that did not apply the SME Supporting Factor.
Source: European Banking Authority Supervisory Data (preliminary).

5. SME Supporting Factor (2/2)

What is impact of SF on lending trends and conditions?

- <u>To be assessed in the final report</u>
- Available evidence is related to studies of the relationship between minimum capital requirements and bank lending :
  - strong inverse relationship between capital requirements and lending has been found in Francis and Osborne (2012) , Aiyar et al. (2014), Bridges et al. (2014) , Brun et al. (2013)
  - studies focusing instead on banks' observed capital ratios find a positive but small relationship between capital and lending (Berrospide and Edge (2010) and Carlson et al. (2013))
- Difficult to disentangle the effect of the Supporting Factor from other regulatory changes that were introduced with CRR
  - In Spain a capital discount of 25% was introduced in September 2013 (instead of January 2014). This allowed a study* to assess the impact of this change, which found that following the introduction of the reduced capital requirements the lending to SMEs have increased both to the existing and new SME bank clients.
- <u>For the final SME report:</u> An empirical study has been launched to identify the credit supply effects related to the introduction of the SF in the EU.
  - Data used: SAFE survey - large firm-level cross-country sample of SMEs and large corporations that contains information on loan applications and respective bank lending decisions, together with firm level characteristics and perception of economic and financing conditions developments .

*Bank of Spain (2014), Analysis of the impact on lending of the new capital requirements and the change in the definition of SMEs, Bank of Spain Financial Stability Report 05/2014

6. Next steps and submission

Next steps	Dates
End consultation period	1 October, 2015
Finalisation of EBA report and submission to Commission	2016 Q1
Report by the Commission	Deadline: 28 June, 2016

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