European Banking Authority

Discussion paper and Call for Evidence on SMEs and the SME supporting factor

The British Bankers' Association ("BBA") is the leading trade association for the UK banking sector with 200 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Eighty per cent of global systemically important banks are members of the BBA. As the representative of the world's largest international banking cluster the BBA is the voice of UK banking.

All the major banking players in the UK are members of our association as are the large international EU banks, the US banks operating in the UK and financial entities from around the world. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit taking and other conventional forms of banking.

Our members manage more than £7 trillion in UK banking assets, employ nearly half a million individuals nationally, contribute over £60 billion to the UK economy each year and lend over £150 billion to UK businesses.

The BBA is pleased to respond to the European Banking Authority's (EBA) Discussion paper and Call for Evidence[1] on SMEs and the SME supporting factor.

We would be happy to have further discussion with the EBA to explain in further detail our comments.

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[1] https://www.eba.europa.eu/documents/10180/1153414/EBA-DP-2015-02+Discussion+Paper+on+SME.pdf

Introduction

Most of our member banks provide loans to the SME sector. The assessment of any changes of the approach to the calculation of the minimum capital requirement for credit risk arising from exposures to SMEs is thus of importance to them. The BBA is aware that many of our members will be responding with detailed comments setting out their own experience.

Context to the EBA discussion paper

Article 501 of the CRR states

4. The Commission shall by 2 January 2017, report on the impact of the own funds requirements laid down in this Regulation on lending to SMEs and natural persons and shall submit that report to the European Parliament and to the Council, together with a legislative proposal if appropriate.

5. For the purpose of paragraph 4, EBA shall report the following to the Commission:

- *a) analysis of the evolution of the lending trends and conditions for SMEs over the period referred to in paragraph 4;*
- *b) analysis of effective riskiness of Union SMEs over a full economic cycle;*
- *c) the consistency of own funds requirements laid down in this Regulation for credit risk on exposures to SMEs with the outcomes of the analysis under points (a) and (b).*

Contents of the discussion paper [2]

The discussion paper seeks to set out the facts as required by Article 501 so that the EBA can submit a report to make a recommendation with respect to whether the Capital requirements for credit risk on exposures to SMEs should continue to be multiplied by the factor 0.7619 (SME Supporting Factor - SMESF), or this factor be changed or be eliminated. Taking each of the points set out in Article 501 5. a), b) and c) in turn.

Section 4.4 sets out various tables of SME lending trends and condition. It highlights that during 2014 - coinciding the introduction of the SMESF - the share of new lending to SMEs has reached the same share as pre-crisis levels [3] although it is not possible (due to the absence of data) to determine the actual share of SME loans in the total of all corporate loans. [4]

Section 4.3 sets out the EBA views on the riskiness of exposures to SMEs for the period Y2000 to end of Y2014. The EBA concludes "*SMEs tend to be riskier than large firms in "moderate, business-as-usual" times; during the recessionary phase of the cycle, the indicators point to a sheer deterioration; both findings are magnified for small SMEs; differently, medium-sized SMEs are consistently the relatively best performing, less risky players*". [5]

[2] This is included for the benefit of those who may not have had the opportunity to read the entire 58 pages of the DP and are interested in a high-level summary: http://www.eba.europa.eu/documents/10180/1153414/EBA-DP-2015-02+Discussion+Paper+on+SME.pdf

[3] Para 41 on page 30

[4] Para 43 on page 32

[5] Para 29 and page 26 – Refer to Figure 8.

Although the simple average of the five financial ratios is a very stylised and simplistic comparison, nonetheless we agree with the EBA analysis that leads to the conclusion that:

1. During 'business-as-usual' times smaller firms are more risky than larger firms.
2. During 'periods of system-wide economic stress' the inverse is true.

Commencing with paragraph 62 on page 41 the EBA sets out a review of the "*consistency of own funds requirements with lending trends and conditions given the SF*". It concludes that "*empirical evidence suggests that reductions in individual bank lending are indeed one of the main short-run costs of binding* (increased) *risk-based capital requirements".*

Paragraph 66 includes a table showing the volume of new loans to SMEs (in only EUR countries) covering the 15 months prior to and since the introduction of the SMESF on 1 January 2014. The EBA concludes in these EUR countries that "*overall, at this stage there is no clear-cut answer to whether the SF fostered new lending to SMEs*". The report also includes an assessment of the regulatory changes on Spanish lending (excluding the construction and real estate sector) in which the Bank of Spain cautions that "*the results should be interpreted with all due caution*".

Taking into account the data on lending trends and conditions, the riskiness of lending to SMEs, **Section 4.2** sets out to assess the regulatory treatment of SMEs and the SME Supporting Factor (SMESF). The data relates to a set of 144 EU banks that used the SMESF in their IRB models and have reported the data in 2014Q4. In the IRB reporting institutions the EBA has calculated that the effect has been a reduction in the CET1 capital ratio of 0.19% equal to an estimated reduction of capital of EUR10.5 billion [6] concentrated in Italy, France, Spain, UK, Netherlands and Germany.

Key issues and recommendation

The EBA discussion paper provides an interesting set of data and links to various publications. [7] However, the overriding impression of the 23 tables set out between pages 29 and 41 [8] is that it is not possible to draw any definitive conclusions with respect to the impact of the SMESF "*for the exclusive purpose of providing an adequate flow of credit to SMEs established in the Union*". [9]

The key points we raise are:

1. We believe that the reason for introducing the SMESF of 0.7619 was and remains a well-intentioned measure to support the growth of EU economies via availability of bank credit to SMEs.

[6] The calculation of this amount is not explained as thus it is unclear whether it is based upon the weighted overall CET1 capital ratio of 12.5% or the required minimum of 4.5%.
[7] Some of the publications are not in the public domain and it has been therefore not been possible to validate the EBA's interpretation of the research
[8] Paragraphs 38 – 61: Figures 9 through 25
[9] Preamble paragraph (45) in the CRR

2. The data presented by the EBA predominantly relates to the EUR countries and thus typically excludes the UK and other non-EUR countries. We believe that the EBA study should be expanded so that it includes all countries.

3. The EBA study only looks at the comparison of the correlation between SMEs and large corporates. The SMESF has de facto changed the relativity of the stressed riskiness of exposures to SME with all asset classes (Corporate and Retail) as well as within the Standardised Approach. It is therefore not possible to assess the impact of the SMESF in isolation without assessing the impact of the entire portfolio of risk and bank's response to it. This is particularly important for banks – especially the UK 'Challenger banks' [10] - that use the Standardised Approach and have adapted their business models to take into account the SMESF.

4. Our view is that it is premature at this point to reach any conclusions with respect to the impact of the SMESF. The reasons for this include: i) the CRD IV transitional arrangements have not yet been implemented, ii) we do not believe that the SMESF has yet been fully implemented by banks given the need to ensure appropriate data is captured to ensure that the definition of an SME in Article 501 is met, iii) significant changes in regulation in areas beyond risk-based capital requirements are currently underway, including the implementation of the Liquidity Coverage Ratio, Leverage Ratio, Net Stable Funding Requirements, Loss Absorbency Capacity (through MREL and FSB-defined TLAC) and other possible changes at international level are expected in the medium term, such as Pillar 1 charge for interest rate risk in the banking book, a revised Standardised Approach to credit risk, revised approach to operational risk and imposition of capital floors. These changes are likely to have a material influence upon the flow of lending to the different segments of the real economy. As such, assessing the SMESF in isolation at this point risks arriving at a partial, incomplete view

5. Consistent with the views of the BBA in response to the recent European Commission consultation paper on the possible impact of the CRR and CRD IV on bank financing of the economy, we think it is too premature to look at the impact of the implementation of one small aspect the CRR when there are so many other changes that are impacting the business and risk strategy of institutions. [11]

In summary any proposals or changes by the EBA to change the current CRR in terms of the SMESF would be premature and unwelcome at this point.

We strongly urge the EBA to retain the SMESF in its current form and conduct a further review at a later date. 2019 would seem to be an appropriate point at which to review.

At this time,

I. there should be a substantially complete transition to the end-state requirements of the CRD IV throughout the EU,

[10] Challenger banks in the UK banking sector represent a cohort of recent entrants whose business models are focused on competing directly with incumbents in specific areas of the latter's franchise
[11] See http://ec.europa.eu/finance/consultations/2015/long-term-finance/index_en.htm

II. full implementation of the SMESF across the EU,

III. more clarity on the international and EU developments to the risk-based capital and leverage framework for banks and implementation of Loss Absorbency Capacity requirements under MREL and TLAC, and

IV. a wider, deeper body of performance data from which to draw conclusions on the credit performance of SMEs that can be independently validated.

We are confident that in view of the significance of risk-based capital ratios (following the implementation of the higher standards under CRDIV) that a withdrawal or reduction of the SMESF will adversely impact the level of lending by banks to SMEs, although it is not possible to assess the magnitude of this impact.

At a time when the Commission and national governments are looking for SMEs to support growth of economies, such changes to the SMESF would not currently appear to be appropriate.

This response also includes answers to the specific questions posed by the EBA.

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.

- Our members calculate the RWA for exposures to SMEs with and without the SMESF as necessary to comply with reporting obligations to the EBA. Our members comply with COREP – the EU-wide standard for regulatory reporting.

Additional supporting commentary

The EBA study seems to presume that the only influence upon an institution's decision to lend to the real economy is the capital rules defined by the CRR. Whilst these are indeed important, there are many other factors that an institution takes into consideration, including (but not limited to) other regulatory changes. Beyond regulatory changes, these factors will include execution of post-crisis restructuring plans and commensurate changes in risk appetite, compounding the impact of regulatory changes.

The EBA suggests that the implementation of the SMESF of 1 January 2014 is a threshold date at which it is possible to review, compare and contrast the business activity, trends, risks and capital requirements before and since that date. We disagree with this premise. We note that the date is coincident with implementation of the entire CRR and hence a much broader range of drivers on an institution's decision to lend were in effect at that time and subsequently. This makes it inappropriate to look at the impact of the SMESF as a standalone rule. The assessment of risk for SMEs needs to be assessed within the entire context of all credit risk, the interaction with the other regulatory changes and the current and future EU economy.

Our view is that it is premature to reach any conclusions with respect to the SMESF before the transitional arrangements for the entire suite of regulatory changes have been implemented. Our view is that the implementation of the Liquidity Coverage Ratio, Leverage Ratio, Net Stable Funding Requirements and other possible changes such as Pillar 1 charge for interest rate risk in the banking book, a revised Standardised Approach to credit risk, revised approach to operational risk, imposition of capital floors and MREL / TLAC will also have an influence upon the flow of lending to the different segments of the real economy.

In addition, taking into account evolution of the operating environment faced by institutions and corporates within the EU, and acknowledging the impossibility of directly observing the relevant counterfactual (i.e. no implementation of the SMESF), our members are of the opinion that it is too early to make any conclusions with regard to the effect of the SMESF.

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.

- With respect to the impact upon banks using the standardised approach, we note that the EBA has not presented any data on this and neither does the BBA have any data from its members.
- For those members that have implemented the SMESF they are of the opinion that the benefit is being used to pass onto SME clients to support that sector of the economy as well as further facilitating an improved comparison of the unexpected loss of SMEs vis a vis large low PD corporates.
- Many institutions have not yet implemented the SMESF and thus these are further reasons to conclude that it is impossible to draw any conclusions on the impact of the SMESF at this time.

Additional supporting commentary

The impact of the SMESF is to require more capital to held against exposures to large corporates relative to SME i.e. to widen the difference between the calculation of the RWAs for these segments calculated using both the Standardised and IRB approaches. For institutions using the Standardised Approach (SA) the effect of the SMESF has reduced the RWA % from 75% to 57.14%.

However, our members are of the opinion that this change has had the effect of improving the risk-sensitivity of the credit risk framework by capturing the difference between the minimum capital requirements calculated using the Standardised and IRB approaches for exposures to SMEs.

The BBA's membership spans many banks – sometimes also referred to as 'challenger banks' that use the Standardised Approach. One of the reasons why challenger banks have been able to positively support and accelerate plans to support SMEs from 2014 has been due to the supporting SME factor. Due to there being less capital required it has allowed the challenger banks to lend more than what they would typically have done so (but of course ensuring no deterioration in credit risk assessment). The recent Q2 FLS (UK – Funding for Lending Scheme) usage data highlights that three of the top five net lenders to UK SMEs were challenger banks (i.e. those operating on the standardised approach).

The UK is a significant participant in the SME market and should be included in the study. The data presented by the EBA predominantly relates to the EUR countries and thus excludes the UK and other non-EUR countries. We believe that the EBA study, its data sources and analysis should wherever possible be expanded, so that it includes all countries subject to the CRR.

Furthermore, the EBA survey covers only 144 EU banks that have implemented the SMESF. The EBA admits that the data covers only IRB models and therefore the institutions in the sample represent c. 2% of all EU regulated institutions.

The sample excludes all institutions reporting RWAs using the Standardised Approach and thus may exclude many banks such as the challenger banks segment in many countries that are contributors to the change in risk appetite for lending to SMEs across the EU and specifically identified in the UK.

Thus we consider that the sample data is incomplete and suggest a new survey at a later date, which is comprehensive and includes all EU institutions, including those reporting on the Standardised Approach. Consistent with our over-arching view, the timing of such a review should logically be after 2019, when firms will have substantially completed the transition to full CRR requirements.

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.

- Our members are fully aware of the definition of SMEs as set out in the Commission's recommendation 2003/361/EC of 6 May 2003 as well as the clarifying consolidated guidance set out by the EBA in Annex 3 of its Discussion Paper. Our members that have implemented the SMESF consider that they comprehend the differences.

- However, the approach to managing SMEs necessarily differs by bank and exposures are managed within different divisions and units in different institution in line with their business and strategy. For example SMEs can be managed within the Corporate, Commercial, dedicated SME units, Retail Business Banking, Asset Finance etc. This impacts the implementation of Commission's recommendations.

- Other members are in the process of assessing the differences.

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)?

- Our members have processes in place to aggregate exposures to customers and thereby determine the total exposure value. A complicating factor for UK institutions is the volatility of the GBP/EUR exchange rate and the need to translate GBP exposures into EUR to comply with the CRR

- In terms of their general pattern of financial need, the exposure limit of €1.5m for eligibility for the supporting factor seems low against the range of business size covered and consideration should be given of increasing this.

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

- Harmonisation definitions are a benefit when it can be proven that the definition is applied to the same underlying risk across all EU member states.

- There are a number of different SME definitions used for internal, risk and regulatory reporting. For example the COREP reports also include splits for Retail SME and Corporate SME asset classes. Our members are of the view that having having one consistent definition would simplify the reporting and reduce the potential for misunderstanding.

- Moreover, having a consistent definition would make it easier to track the benefit of reductions in weights to be applied and it would help to reduce differences for the capital requirement for loans. For example please refer to the wide range of SME results in RWA review carried out by EBA 17 December 2013, which attributed two-thirds of risk-weight dispersion to differences in underlying credit risk, use of credit risk mitigation, modelling and supervisory practices, as well as definitional issues.

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

- Whilst the five factors identified may very well be suitable proxies of SME riskiness a key problem for our members will be how to assess them objectively. We would place most emphasis on EBITDA / Total Debt Service Capacity. For secured finance, LTV ratios are typically considered and loans are extended only if appropriate covenants (based on relevant financial metrics) are put in place. For lending to some sectors, different hurdle rates for different financial ratios are applied

- Many of the proposed risk drivers are based on accounting conventions that are not yet globally harmonised - it is difficult to see how the use of metrics based on numbers in financial statements that may differ from country to country will contribute to a standardised approach to credit risk calculation. Furthermore, in many jurisdictions smaller companies can opt out of the requirement to publically file any accounts at all. Where they do file accounts, this may be up to nine months after the financial year end. Furthermore, accounts are usually based on a historic cost approach to the valuation of assets which is likely to distort the leverage measure. We do not believe it is right to require small business to change their accounting conventions in order that banks can observe this required risk driver on a current value basis.

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.

- The vibrancy of the SME market and competition for business means that our members have different approaches to the measurement of the true economic risk of exposures to this segment.

- The provision of collateral is a material risk mitigant and where appropriate, should be on basis of first lien.

- At least 3yrs' worth of financial should be made available, where the customer has been trading long enough. Latest management information and updates on trading are also valuable in assessing prospective credit risk.

- Further factors / aspects relevant to the assessment of creditworthiness, riskiness of potential SME borrowers are factors such as dependency on key customers / suppliers / markets, the vulnerability of the business to competition, quality of management, quality of management information etc.

- The approach to treat the exposure as 'relationship managed' and thus subjected to the rules and standards of risk management covering the Corporate asset class (Standardised and IRB) leads to more bespoke and at times judgmental assessment of the risk with overrides and more flexible approaches to the value of collateral.

- Whereas the approach to treat the exposure within a 'portfolio' in which there is little if no bespoke relationship management and thus are subjected to the rules and standards of risk management covering the Retail asset classes (Standardised and IRB) leads to homogenised approach across the exposures.

- In summary the diversity of this sector leads to different approaches to the assessment of the risk especially for larger SMEs such as sensitivity to economic environment and interest rate changes, the evolution of the business (start-up v mature), assessment of management and overall size etc. We note that the EBF has included in its response to Q7 a list of key risk indicators that are used to assess the riskiness of SME borrowers. (Please refer to Annex 1 for the list)

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

- The historical evidence as set out in the supporting documentation published by Gordy and the Basel Committee in 2002 – 2005 [12] with respect to the Asymptotic Single Risk Factor model clearly explains the basis for the correlation parameters for all asset classes covering Large enterprises, SMEs (Sales Turnover adjustment), (including the impact of the maturity scaling factor adjustment), Retail Mortgages, Qualifying Revolving Retail Exposures and Other Retail. Those parameters have been included in the CRR subject to the additional SMESF of 0.7619 for SMEs.

- We do not see any reason for any change to the calculation of the RWAs as set out in the CRR. We believe that the work being carried out by the Basel Committee to assess the overall calibration of the regulatory capital as well as consideration of revisions to the Standardised Approach are the appropriate ways to answer the question raised by the EBA

- A 2009 study by EIM Business and Policy Research, for the European Commission considered the cyclicality of lending to European SMEs. [13] That study found lending to small enterprises was not particularly sensitive to the business cycle (suggesting the possibility of credit rationing by banks), whereas lending to medium-sized firms was much more sensitive to the business cycle. The findings of the EIM study – although somewhat dated – could be interpreted as being consistent with the risk profile of SMEs being less cyclical than that of large enterprises.

Additional supporting commentary

We recognise that the EBA's previous assessment of SME proposals for CRD IV/CRR published in September 2012, [14] did include an assessment of the correlation parameters explicit in the Basel formula. The paper concluded "*in the EBA"s opinion, lowering the RWs for the SMEs sector is not adequately supported by the riskiness of this type of lending.* ",[15] noting also that any reduction should not become a permanent change in the framework. [16]

The current discussion paper repeats many of the points put forward in the September 2012 paper. The primary focus however remains a comparison of the correlation between SMEs and large corporates.

However, the SMESF has de facto changed the relativity of the stressed riskiness of exposures to SME with all asset classes (Corporate and Retail) as well as within the Standardised Approach. It is therefore not possible to assess the impact of the SMESF in isolation without assessing the impact of the entire portfolio of risk and bank's response to it.

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[12] A Risk-Factor Model Foundation for Ratings-Based Bank Capital Rules: Michael B. Gordy Board of Governors of the Federal Reserve System October 22, 2002 and Basel Committee on Banking Supervision: An Explanatory Note on the Basel II IRB Risk Weight Functions July 2005

[13] Cyclicality of SME finance: Literature survey, data analysis and econometric analysis May 2009 European Commission Enterprise and Industry: Arjan Ruis (EIM), André van Stel (EIM), Achilleas Tsamis (CSES), Wim Verhoeven (EIM) and Mark Whittle (CSES) Zoetermeer, 23 March 2009

[14] https://www.eba.europa.eu/documents/10180/16148/EBA-SME-Report.pdf

[15] Page 56 of the September 2012 Assessment

[16] Page 2 of the September 2012 Assessment

The difference in the sizes of firms and their correlation to the single risk factor (the global economy) is as the EBA states "*an integral part of the regulatory framework of Basel II/III through the Asymptotic Single Risk Factor (ASRF) model of Gordy (2003)51 that is the basis of the regulatory minimum capital requirements in the Internal Ratings Based (IRB) Approach of Basel II/III.*" [17] The EBA documents the research that confirms "*that asset correlations increase with firm size*". [18] We agree with this in principle but believe that the conclusions have been taken out of context.

During 'business-as-usual' times the average expected PD of a portfolio of exposures to smaller firms is higher than the average expected PD of a portfolio of exposures to larger firms. The EBA September 2012 assessment confirms this. [19] The consequence of this is reflected in the calculation of the own funds requirement.
However as practitioners are aware the scaling of the expected PD into the conditional 1 year PD to a 99.9% level of confidence taking into account how the PD specific correlation parameter is not linear. The scaling factor for low Expected PD into Total PD [20] is very high multiple (c. 23x) declining to a scaling factor of 1x at the point of default.

The consequence is that for SMEs the Expected Loss represents a higher % of the Unexpected Loss compared to large firms. This is consistent with the underlying concepts of the ASRF model. The effect is that during business-as-usual times the cost of expected risk – higher EL - is reflected in the higher price of risk to SMEs. This is a further argument in favour of the SMESF that results in the minimum capital requirement being calculated as an even lower multiple of the expected loss in line with concepts of the Basel framework in both the Standardised and IRB approaches. Conversely the scaling up of the low EL to the UL (RWAs) is significantly higher for larger firms. In other words through a full cycle the volatility of expected losses is higher for larger firms than for lower firms. It is Low PD that creates higher uncertainty and high PD that creates smaller uncertainty.

The EBA cites various studies that have sought to measure the appropriateness of and the calibration of the correlation parameters. A list is included in footnotes 52 – 58 on page 28. However, the studies look at SMEs in isolation as if the RWAs for the SMES represent a proxy for the capital required only for that sub-asset class and thus can be compared to other asset classes.

The principal study cited by the EBA refers to a study only of German SME relative to other German corporates. [21] It is our view that the studies cited by the EBA are too narrow in their focus.

The conceptual regulatory framework for the calculation of RWAs is based upon "*the single risk factor assumption, in effect, imposes a single monolithic business cycle on all obligors. A revised Basel Accord must apply to the largest international banks, so the single risk factor should in principle represent the global business cycle.*

[17] Para 33 page 27
[18] Para 34 page 28
[19] Refer to table 8 in Annex 4 on page 90 of the September 2012 assessment
[20] Expected PD is scaled up to Total Conditional PD. Expected PD is then deducted from Total Conditional PD in order to derive the Unexpected Loss PD that is the basis of calculating the minimum capital requirement and thus RWA.
[21] Düllmann, K. and Koziol, P. (2014). Are SME Loans Less Risky than Regulatory Capital Requirements Suggest? The Journal of Fixed Income, 23(4), 89-103.**This article is not available in the public domain.**

By assumption, all other credit risk is strictly idiosyncratic to the obligor. In reality, the global business cycle is a composite of a multiplicity of cycles tied to geography and to prices of production inputs.

A single factor model cannot capture any clustering of firm defaults due to common sensitivity to these smaller-scale components of the global business cycle. Holding fixed the state of the global economy, local events in, for example, Spain are permitted to contribute nothing to the default rate of Spanish obligors. [22] . In summary the assumption is *(a) there is only a single systematic risk factor driving correlations across obligors, and (b) no exposure in a portfolio accounts for more than an arbitrarily small share of total exposure.* [23] Please refer to the Basel Committee's papers on the subject. [24]

It is therefore inappropriate to focus on the comparison of the sales turnover correlation parameter scaling factor with only large corporates, without also taking into account the entire portfolio of risk and thus all correlation parameters of all the Retail asset classes and implied PD and correlation parameters of the Standardised and Supervisory Slotting Approaches. The calculation of the minimum capital requirement for credit risk using the Standardised Approach is an alternative yet complimentary approach to the granular IRB approaches. It is for these reasons that many banks use the total regulatory credit risk capital calculated by the Basel formulas (Standardised and IRB) as a guide to be compared with economic capital and losses predicted by portfolio management models.

The past 11 years [25] has coincided with significant changes to individual and regional economies, as well as other changes to the regulatory framework within which banks operate. This poses challenges for regulators and risk managers to assess the appropriateness of all correlation parameters set out in the CRR - that are the same as those set out in Basel 2 and 3. Therefore, conclusions reached from an assessment of how some institutions in some EU countries focussing only on IRB modelled exposures to SMEs in only year of implementation of the CRR is too narrow a focus and too short a timeframe to reach any conclusion on the future of the SMESF.

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[22] Page 22 A Risk-Factor Model Foundation for Ratings-Based Bank Capital Rules: Michael B. Gordy Board of Governors of the Federal Reserve System October 22, 2002 http://www.federalreserve.gov/pubs/feds/2002/200255/200255pap.pdf
[23] Refer to the Abstract of that paper
[24] Basel Committee on Banking Supervision: An Explanatory Note on the Basel II IRB Risk Weight Functions July 2005 http://www.bis.org/bcbs/irbriskweight.pdf
[25] The period in which the IRB approach to calculating the Unexpected (and Expected Loss and thus ergo Total Loss) has been used covers the rollout of Basel 2 (CRDII), the implementation of and use of CRDII and transition to Basel 3 (CRD IV).

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.

- The EBA's question requests our opinion on the various research papers (noted in paragraphs 32, 33, and 33 on pages 27 and 28) that have sought to explore the systematic risk on firm size. In particular the EBA refers to the source publication by M B Gordy "A Risk-Factor Model Foundation for Ratings-Based Bank Capital Rules". However, overall the EBA's "proposed methodology" lacks clarity in the CP.

- We draw the EBA's attention to the fact as set out in response to Q8 above, Gordy's and the Basel Committee's own supplementary papers explain that it is not possible to look at the riskiness of SMEs in isolation, nor solely in relation to corporates with sales turnover in excess of EUR50m, but only in relation to exposures across all credit risk asset classes.

- The Asymptotic Single Risk Factor model contains many assumptions. The real world is far more complex than can be accurately captured in a simple applicable formula. Given its central place in the Basel regime, there can be a tendency to attribute significance to its outputs and parameters which is misguided and would caution against this.

- Furthermore the EBA will be aware that the subject of concentration risk (granularity scaling adjustment) has been the subject of discussion since Basel 2 was first considered. The EBA will be aware that the original proposals for this risk to be included in Pillar 1 were changed to be included in Pillar 2 in the final accord. Therefore it is not possible to assess the riskiness of SMEs without taking all factors into account including Pillar 2 concentration risk charges applicable to large names as well as any caps imposed by regulators on large exposures.

- In summary, we cannot answer the question based upon the CP. We look forward to the publication of the results of the EBA empirical project but urge the EBA to publish this report to allow further industry consultation before reaching any conclusions on the future of the SMESF.

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.

- Our members will be responding to EBA on an individual basis should they choose to do so. The EBA will be aware of firms' disclosures regarding the extent to which expected losses exceed loan loss provisions (reflected in corresponding deductions from regulatory capital).

- However, we urge the EBA to review the purpose or indeed the relevance of the question to the CRR Article 501.

- The EBA seems to suggest that they may be some link between limits and actual experiences with regard to arrears and loss experiences in the years 2009-2010-2011 that might have a bearing upon the EBA's recommendation with regard to the SMESF going forward from 2016. We do not see any connection between these and urge caution on the relevance of the questions posed by the EBA.

- The EBA will be aware that volatility and divergence between expected and actual losses and the impact upon capital ratios of losses less or more than expected is complex topic. The introduction of IFRS 9 may reduce the divergence between actual losses and provisions yet it may also result in additional buffers of capital being retained by management that may need to be considered in the flow of lending to every segment.

- Therefore we do think that looking at SMEs in isolation is relevant. We believe that any review needs to also take into account the difference between the treatment under the Standardised and IRB approaches and the losses in other credit risk portfolios.

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

- The EBA has presented a range of statistical data. Most of this covers the Eurozone countries and thus excludes the UK and non-EUR countries.

- Given the significant changes to the economies of EU countries between 2003 and 2015 and the future growth prospects for the EU and to countries and regions outside the EU we do not see any specific data that leads to any conclusion to change the CRR.

- Whilst the data does bear out that there has been a reduction in lending to SMEs as a proportion of GDP, it does not examine the reasons for this, which are likely to be a complex combination of factors affecting supply of and demand for bank credit.

- UK banks have for a number of years commissioned an independent review of the demand for, and availability of finance for SME which has involved interviews with over 85,0000 SMEs, since the project started in Q2 2011. More information is available at the SME Finance Monitor website:

    - http://bdrc-continental.com/products/sme-finance-monitor/

- Looking at the work of the SME Finance Monitor, common themes which have emerged over the period since 2011 include:

    - Only one-third of SMEs are using external finance:

    - Most SMEs are 'happy non-seekers of finance:

    - The large majority of applications by SMEs for bank funding were successful:

    - And that it has been the current economic climate that has been a barrier to running an SME business, although this now declining:

    - Interestingly the awareness of crowd-funding has improved steadily over the past 18 months:

- Broadly, UK data exhibits similar patterns to that shown in EBA consultation paper (which is based on euro area data), with no discernible changes in trends following SME-SF implementation in Jan 2014. As Charts 1 – 4 (attached at Annex 1 at end of this response) show:

- The stock of lending to SMEs has shrunk since 2011, mirroring the c18% decline observed for the wider UK corporate population;

- SME new loan pricing has been remarkably stable, as has the spread to pricing of overall corporate lending.

- SME demand for lending has been subdued for a prolonged period, whilst availability of lending to SMEs has begun to improve recently.

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.

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.

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.

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.

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.

- We will leave each member to respond as they consider appropriate. We recognise that the SMESF will result in reductions of the capital contribution to the overall minimum capital requirement for exposures to SME reported using the IRB Retail and Standardised Approaches relative to exposures to larger corporates and other asset classes. The effect of the CRR has been to increase the difference of the calculation of the capital contribution with respect to exposures to large corporates relative to SMEs.

- There are many factors that influence the appetite for risk not only to the SME segment but also to other segments. Therefore we do not see that there would be any direct correlation between changes to credit lending and assessment policies and procedures and the implementation of the SMESF.

- The EBA will be aware that institutions take into account many factors and review these on an on-going basis to determine its risk appetite for exposure to the SME segment. Many of our members segment the SME portfolio into smaller segments that take into account all of the attributes set out in the *EC – Enterprise and Industry publication - The new SME definition: User guide and model declaration,* [26] size, industry classification etc. We consider that the diversity of the EU SME segment and different institutions approaches to the assessment, management and mitigation of the associated risks (not just credit risk, but also operational and market risks) to be a source of strength.

- We also believe that other factors need to be considered when assessing the impact of the SMESF. For example member states have the capacity to implement their own policies to provide further support to SMEs. There are though a wide range of factors influencing lending conditions in the marketplace. One of these is the availability of lower cost funding through The (UK) Funding For Lending Scheme (FLS) that may have resulted in the increase in lending in some institutions relative to others.

[26] http://ec.europa.eu/enterprise/policies/sme/files/sme_definition/sme_user_guide_en.pdf

Annex 1

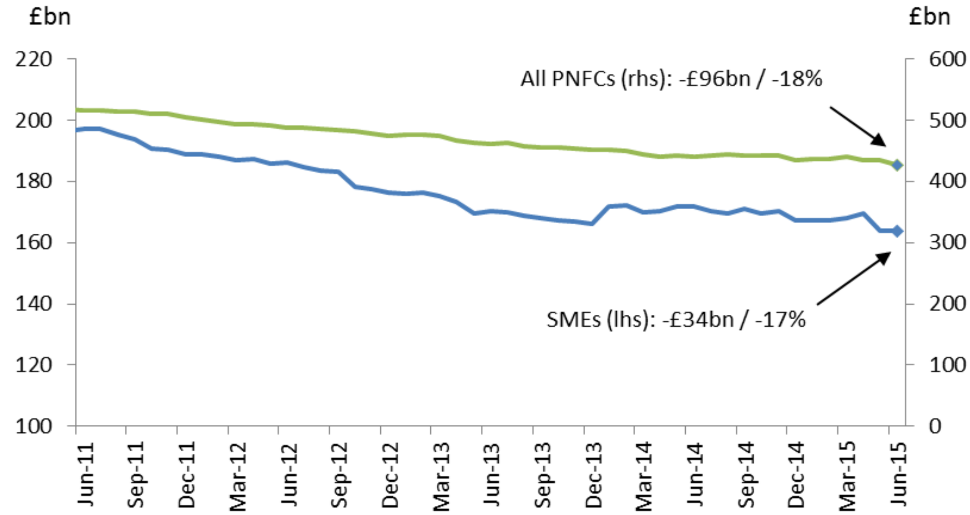
Other key risk indicators used to assess the riskiness of SME borrowers include:

- Debt Service Coverage Ratio (EBITDA / Capital Repayments + Interest)
- Debt / EBITDA
- Overall size of the business
- Life stage of the business
- Consolidation risk in the case of lending to finance mergers and acquisitions
- Ownership and financial position of natural person(s) behind the company
- Quality of management (competences, professional experience and perspectives about the succession)
- Quality of financial information
- Competitive position of the customer in the specific market; diversification of customer base; diversification of supplier base; number of competitors in market.
- Maturity of customers products in terms of life cycle and diversification / concentration of customers products
- Value of collateral offered
- Sensitivity to economic environment and interest rate changes
- Payment behavioural information
- Financial debt and behaviour in the financial system
- The stable relationship with the institution, measured, for example, by the costumers' history or by the percentage of the business activity performed with the entities
- Indicators should be estimated both at a given time and with a past and forward-looking perspective
- Some specific indicators for individual entrepreneurs and self-employed, as for example:
    - Turnover (except if it is included in the overall size of the business indicator)
    - Taxes
        - VAT
        - Income tax
    - Financial Assets Statements

Annex 2 – Supporting graphs

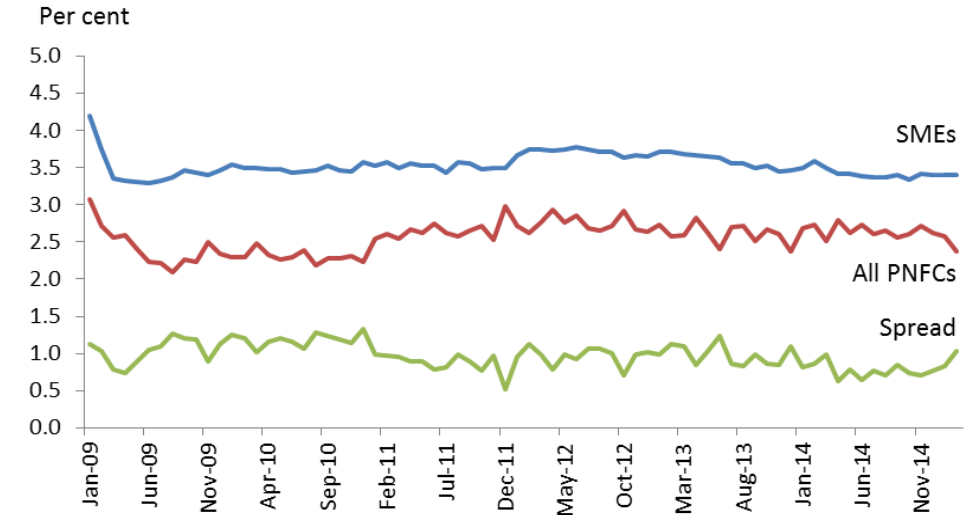
- Refer to the following pages supporting the answer provide in Q11

Chart 1: Stock of lending to UK SMEs, all UK non-financial corporates



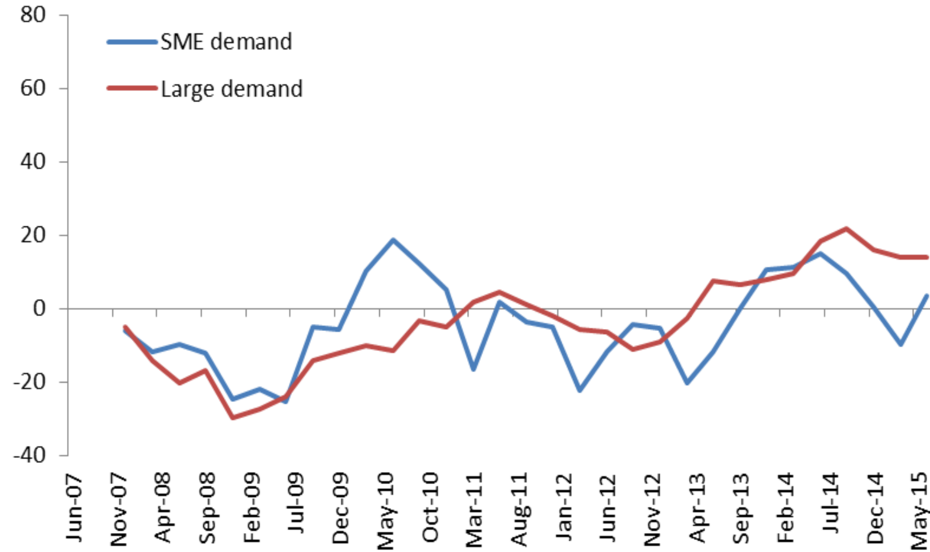
Source: Bank of England

Chart 2: Effective Rate on new loans to UK non-financial corporates



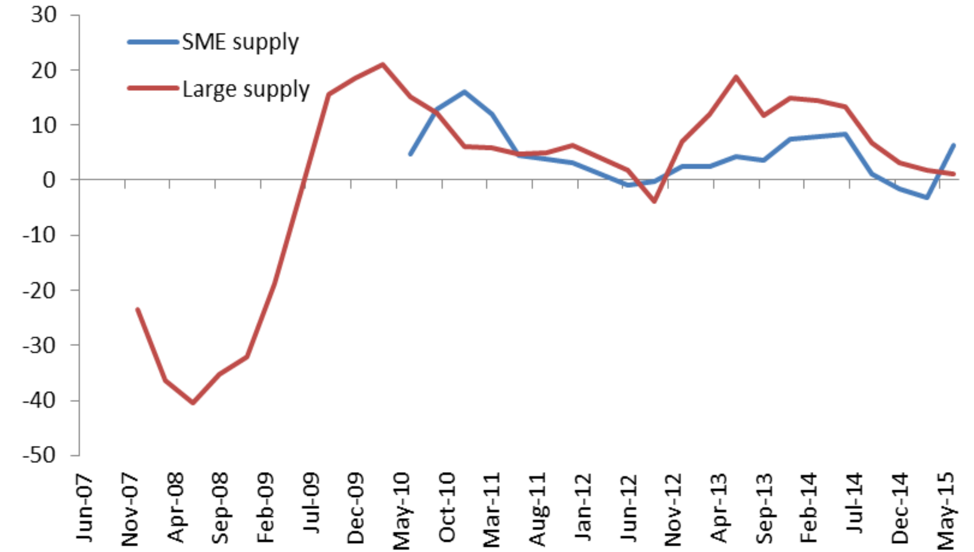
Source: Bank of England

Chart 3: Demand for new bank lending from SMEs and other non-financials



Source: Bank of England Credit Conditions Survey

Chart 4: Availability of new bank lending to SMEs and other non-financials



Source: Bank of England Credit Conditions Survey

END