ABI Associazione Bancaria Italiana

ABI COMMENTS ON EBA DISCUSSION PAPER AND CALL FOR EVIDENCE ON SMEs AND THE SME SUPPORTING FACTOR

October 2015

POSITION PAPER

Q.1. Do you have systems in place to track the reduction in capital due to the application of the SME Supporting Factor (capital relief)? Please explain and provide evidence.

Some banks have a system of periodic monitoring that measures the capital saving associated with application of the SME Supporting Factor. In certain cases, their procedure for classifying customers includes the identification of those entities for which the SME Supporting Factor is applicable. This information is sent to the offices that deal with Supervisory Reporting.

Q.2. 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.

In many cases, the introduction of the SME Supporting Factor has allowed the supply of loans to households and small and medium-sized enterprises to remain unchanged, despite the increased and tougher capital requirements introduced from January 2014.

Q.3. 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 evidence.

The definition of SMEs used by banks is not always perfectly aligned with that used for the SME Supporting Factor. Larger metrics are used in some cases. In other cases, the segmentation is about to be revised and aligned with Recommendation 2003/361/EC of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises.

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)?

We would like to note that the exposure limit of €1.5 million for eligibility for the SF seems too low. The range of business size covered should be more ambitious and include a wider range of SMEs.

From Q6 to Q10

1. Section 4.3 Riskiness of SMEs in the European Union

Questions q6 to q10 look at the risk profile of SMEs and, therefore, the adequacy of the current risk weightings for loans to this category. As is known, the application of a discount to the RW of loans to SMEs is justified by the lower correlation among the individual PDs of enterprises in this size class, presumably because the characteristics of SME default events are more diversified than those of larger enterprises. In prudential terms, this means that despite a higher average probability of default, over time a portfolio of SME loans may generate a lower unexpected loss than that deriving from a portfolio of loans to large firms. In Basel terms, this results in a lower capital requirement for loans to the former than to the latter.

Estimation of this correlation is somewhat complex, partly due to the limited availability of microeconomic data for a broad range of loan portfolios. In order to estimate this important parameter, in the past (Finance and economics "*Towards Basel 3. Asset correlation and SMEs: evidence from estimates using macro data*", July 2012) we proposed a macro approach, using Bank of Italy quarterly data on the rate of new defaults on loans to the productive sector (enterprises and family businesses), to estimate the default correlation (and, consequently, the asset correlation) for small and medium-sized enterprises and large firms. The estimates obtained at the time indicated that

- the asset correlations for portfolios of SME loans were systematically lower than those for large firms.
- Basel 2 uses asset correlation thresholds which require significantly higher capital absorption than that justified by the estimated risk, with the corresponding implication for policy, as translated into the SME SF, to lower the capital requirement for loans to SMEs.

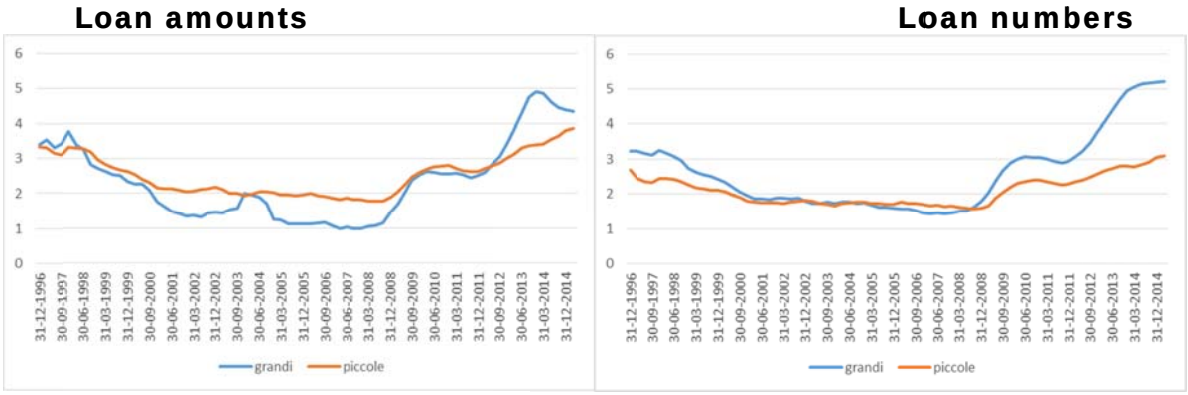
The past estimates were based on a sample time interval extending from the first quarter of 1990 to the last quarter of 2010. In this paper, we start from the above methodology to determine if the adverse macroeconomic conditions experienced over the past three years confirm the expected lower pro-cyclical nature of the risk associated with a portfolio of SME loans with respect to another comprising loans to large firms.

The time series of new default rates is currently updated to the first quarter of 2015. As a proxy for the riskiness of loans to SMEs we have referred to the new default rates of family businesses and enterprises with credit facilities of up to 500 thousand euro, while the new default rates of enterprises with credit facilities in excess of 500 thousand euro reflect the riskiness of loans to large firms.

Chart 1 shows the cyclical trend in the risk associated with the two categories of enterprise, considering the new default rate based both on the loan amount and on the "loan numbers" (summation of amounts outstanding x days outstanding).

The chart clearly shows the more cyclic nature of the riskiness of loans to large firms. When measuring risk based on the loan amounts, the difference between the max and min values of 3.9 percentage points for large firms compares with 2.1 percentage points for smaller enterprises. Considering the risk based on loan numbers, the difference between the max and min values is 3.8 points for large firms and only 1.5 points for smaller enterprises. In addition, looking at the chart for loan amounts, the risk cycle is seen to be symmetrically wider for large firms, while the risk indicator based on loan numbers shows that the more cyclic nature of the riskiness of loans to large firms mainly relates to phases during which the risk is increasing.

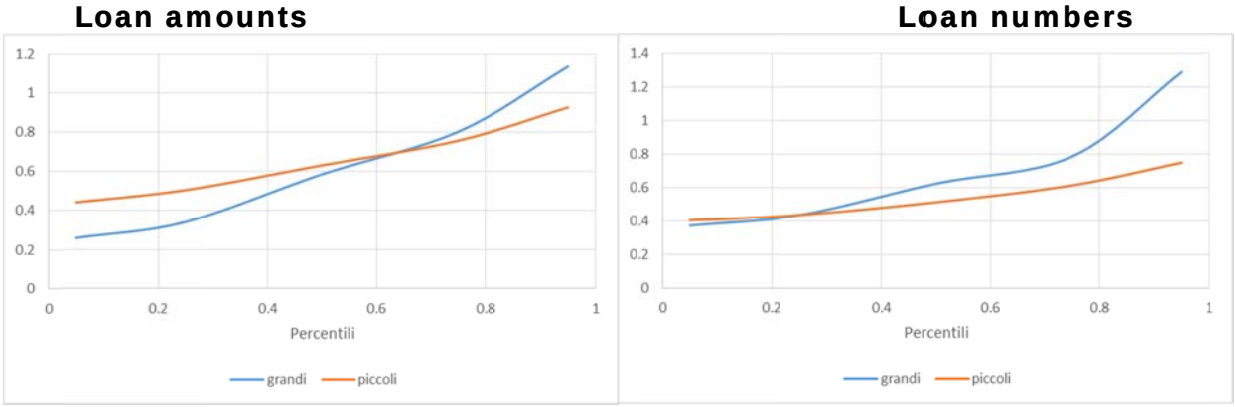
Chart 1. New default rates (moving annual rate)



It is also important to note the behaviour of risk during the recent cyclic downturn. Starting from the end of 2007, the riskiness of large firms rose by 3.3 points in loan amount terms, compared with an increase of 2.1 points for smaller enterprises. The imbalance is even clearer from the measurements based on loan numbers: in this case, the increase in risk of 3.7 points for large firms compares with just 1.4 points for smaller enterprises. So, with reference to the recent cycle, it seems fair to conclude that the hypothesised greater pro-cyclic nature of the riskiness of loans to large firms has been confirmed once again.

This fact is more clearly shown by analysing the distribution over the above time interval of these two risk indicators (Chart 2).

Chart 2. Distribution of new default rates (quarterly deseasonalised 1996q1 - 2015q1)



In both cases, the distribution of the new default rate for large firms has a heavier tail.

In particular with regard to the loan amounts, the risk distribution for large firms has heavier tails both to the left (smaller amounts) and to the right (larger amounts): as a summary indicator of variability, the difference between the 95th and the 5th percentiles is **0.9** points (**3.6** in annualised terms) for large firms and **0.5** (**2.0** annualised) for SMEs. On the other hand, considering a summary indicator of unexpected risk, the difference between the 95th percentile and the median is **0.6** points (**2.2** in annualised terms) for large firms and **0.3** (**1.2** annualised) for SMEs.

With regard to the distribution of the new default rate, determined based on loan numbers, the left tails are the same but the right tail (higher levels of risk) for large firms is very much heavier: the summary indicator of variability is **0.9** points (**3.6** in annualised terms) for large firms and **0.3** (**1.2** annualised) for SMEs. In this case, the summary indicator of unexpected risk is **0.7** points (**2.7** in annualised terms) for large firms and just **0.2** (**0.9** annualised) for SMEs.

Taken together, the macro evidence obtained from analysing the new default rates for the productive sector seems to confirm the hypothesised lower asset correlation for the risk distributions of smaller enterprises with respect to large firms.

The greater diversification of risk inherent in a portfolio of loans to SMEs appears to have strengthened during the recent downturn, during which the riskiness of large firms grew significantly more than that of smaller enterprises.

This conclusion applies regardless of whether the measurement is based on loan amounts or loan numbers, although the difference in behaviour in the latter case is much more significant.

From Q11 to Q16

2. Section 4.4 SME lending trends and conditions

Questions q11 to q16 address the effects to date of applying the SME SF on the availability of loans and the related cost. In summary, the EBA discussion paper asks two principal questions and seeks to provide initial responses:

1) Following the SME SF, has lending to SMEs started to increase? If yes, is this increase faster than the rise in lending to large firms?

2) Interest rates: following the SME SF, has the cost of borrowing for SMEs fallen with respect to that for large firms?

Two types of empirical work are presented in relation to these questions:

- the first type, based on quantitative data and emulating the analyses presented by the EBA, seeks to highlight better the differences in the trends pre and post SME SF;

- the second type, based on qualitative data and considering solely the experience in Italy, seeks to obtain the opinions of firms about the willingness of banks to grant finance.

Quantitative analysis

With regard to the analysis of quantitative data, we refer to the EBA analysis of new lending by size of firm. Based on the data available, the EBA discussion paper considers the loan amount granted to be a proxy for firm size, so:

1. loans of less than 1 million euro are treated as loans to SMEs

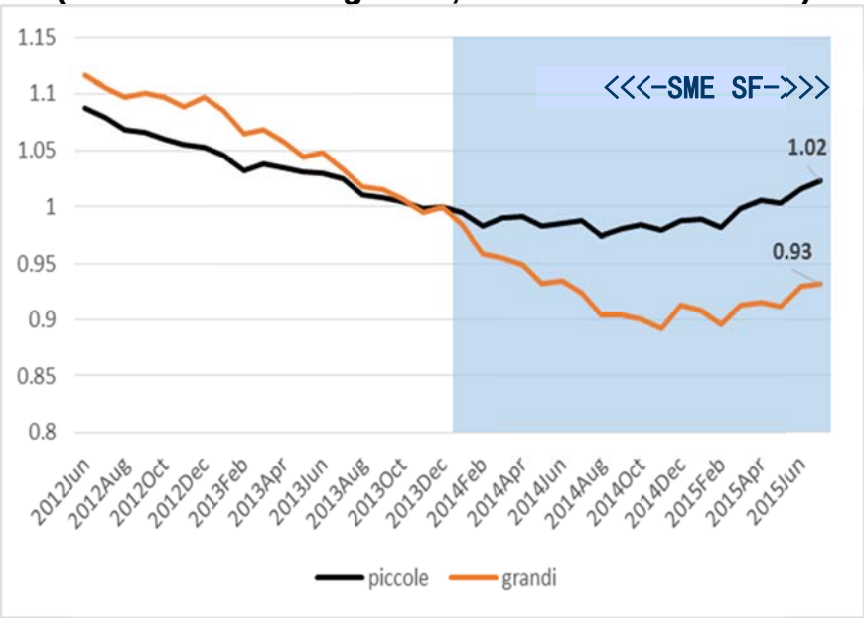
2. loans of more than 1 million euro are treated as loans to large firms

the data used by the EBA was taken from the ECB database of harmonised interest rates and refers to the volume of new loans granted to firms.

We used the same database and have tried to focus attention on the differences before and after introduction of the SME SF. For this reason, Chart 3 shows the cumulative flow of new lending over a 19-month period,

being the period from introduction of the SME SF (January 2014) to the latest available data (July 2015).

Chart 3. Flow of new lending by size of firm (19-month moving total; December 2013 = 1)



Given the accumulation period, the period-end data shown in the chart indicates the growth in new lending to firms from the start of the SME SF, with respect to a period of equal length prior to the start of the SME SF (June 2013 - December 2014). In addition, the trend in this moving total over time gives an idea of the change in the availability of finance to firms. **Just considering the change in lending during the 19 months from introduction of the SME SF, the results are very clear: lending to SMEs has increased by 2%, while lending to large firms has decreased by 7%.** Further, notice how the downward trend in lending to SMEs changed direction rather quickly after introduction of the SME SF, while the documented decline in lending to larger firms continued until the end of 2014, before showing signs of recovery. The change in the flow of new loans therefore appears to indicate that, following introduction of the SME SF, lending to SMEs has risen by more than in the past and by more than the rise in lending to large firms.

The above evidence refers to the Euro area as a whole, while Table 1 shows the same data at national level, in order to check if the improvement in lending to SMEs following introduction of the SME SF is common to all member States, or the result of dynamics found only in certain countries. This check appears to indicate that **the above result is spread somewhat uniformly among the members of the EMU. Calculating the difference between the growth in lending to small and large**

firms (last column in the table), it emerges that there is a positive growth differential of 9 p.p. at area level and that this positive differential exists for as many as 8 of the 12 countries considered; also, the greater growth in lending to SMEs is confirmed in all 4 principal EMU countries, where the positive growth differential in lending to SMEs is almost 12 percentage points.

Table 1. Flow of new lending by size of firm (data in millions of euro)

	19-month moving total ended						
	Small firms			Large firms			Small-Large
	dic-13	lug-15	Chng	dic-13	lug-15	Chng	Chng
Austria	21,728	20,235	-6.9%	150,193	142,541	-5.1%	-1.8%
Belgium	128,816	123,230	-4.3%	400,890	322,839	-19.5%	15.1%
Germany	183,727	191,923	4.5%	920,659	915,721	-0.5%	5.0%
Spain	215,499	242,860	12.7%	447,524	352,407	-21.3%	34.0%
Finland	11,605	11,838	2.0%	49,164	45,593	-7.3%	9.3%
France	113,318	114,531	1.1%	259,643	237,587	-8.5%	9.6%
Ireland	5,638	5,768	2.3%	12,954	29,623	128.7%	-126.4%
Italy	259,368	263,995	1.8%	410,064	398,136	-2.9%	4.7%
Netherlands	29,049	28,540	-1.8%	129,125	150,168	16.3%	-18.0%
Portugal	30,025	29,557	-1.6%	45,777	31,620	-30.9%	29.4%
Slovenia	3,231	2,078	-35.7%	10,560	6,960	-34.1%	-1.6%
Slovak Rep.	1,940	2,083	7.4%	18,382	19,302	5.0%	2.4%
Euro area	1,037,967	1,062,101	2.3%	3,038,016	2,830,864	-6.8%	9.1%
Big 4	771,912	813,309	5.4%	2,037,890	1,903,851	-6.6%	11.9%

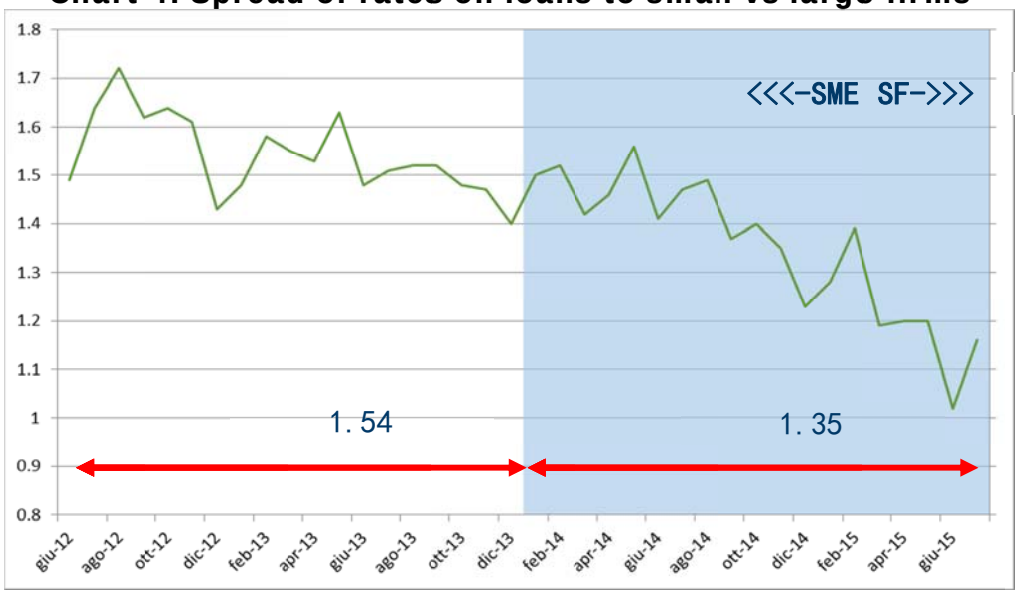
ABI analysis of ECB data

Another quantitative factor to consider is the cost of borrowing. Here too, we have followed the indications given by the EBA and considered (Chart 4) the change in the spread between the rate charged on SME loans and that on loans to large firms over the 19-month periods pre and post SME SF. Once again, the distinction between small and large firms is made with reference to the size of the loan granted.

Consistent with the previous evidence, the period following introduction of the SME SF appears to be marked by a relative improvement in the borrowing costs incurred by small firms: while the rate spread at period end was 3-tenths narrower than it was prior to introduction of the SME SF, it averaged 135 bp over the 19-month period

considered, which was almost 20 bp less than the average for the 19 months prior to introduction of the SME SF. Once again, the trends in the various EMU countries were well aligned, with a reduction in the spread between the average rates for the two periods indicated in 8 of the 11[1] countries considered.

Chart 4. Spread of rates on loans to small vs large firms



Overall, the quantitative evidence reported shows that there has been an improvement in both the availability and cost of SME loans following introduction of the SME SF: this improvement can be seen in comparison with both previous trends and the dynamics of larger firms. This fact suggests that the capital discount applied to SMEs has had the desired effect, by improving the conditions for their access to finance.

Qualitative analysis

For completeness of information, it is useful to refer to the qualitative comments expressed by SMEs about their degree of satisfaction with the availability of bank finance. This type of analysis has certain advantages, with respect to the analysis of quantitative data, when studying the dynamics of lending to firms. In particular, the separation of supply-side from demand-side considerations enables the effectiveness of the measure under review to be assessed more clearly. Additionally, there is no need to use proxies to study the flow of lending by size of firm, since the loan details are available.

[1] Out of the 12 countries considered previously, data for loans in excess of 1 million euro was not available for Belgium.

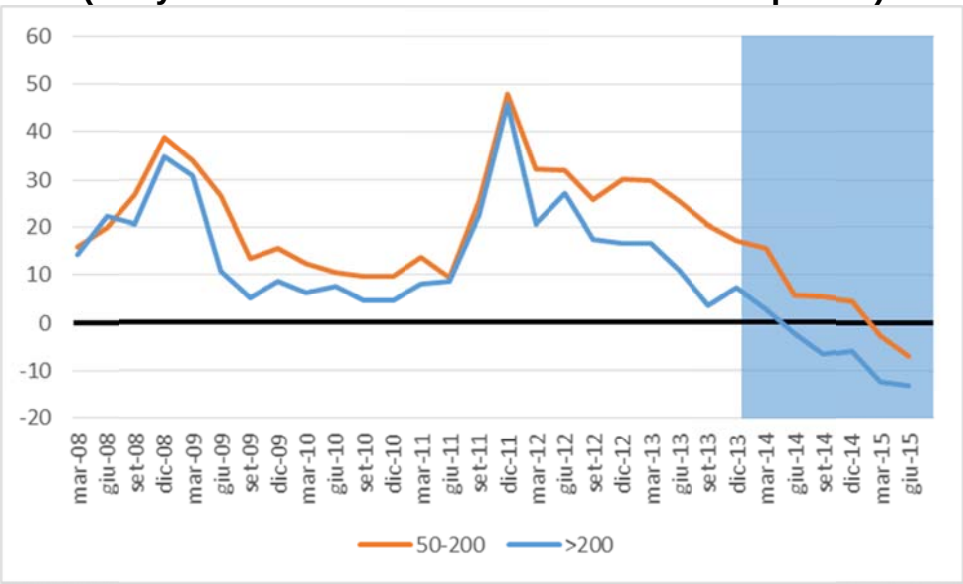
The EBA discussion paper uses some of the replies to surveys of firms and lending that were carried out on a harmonised basis as part of survey work on the "Access to finance of enterprises". For the purposes of this paper, we used the questions about loans contained in two surveys of Italian firms. In particular:

1. Survey by the Bank of Italy on the expectations for inflation and growth: this survey addressed two classes of enterprise (medium and large) in the industrial and service sectors; the results enabled us to calculate a credit restriction indicator;
2. Survey by Istat on the confidence of manufacturing firms: this survey considered three classes of manufacturing enterprise (small, medium and large), enabling us to both determine the opinion of firms about lending conditions and calculate the percentage of firms that did not obtain the finance requested.

As before, we used this information to assess whether or not, following introduction of the SME SF, the target group's (SMEs) access to finance has improved with respect to both earlier trends and that of large firms.

The first analysis developed a credit restriction indicator from the Bank of Italy's survey of expectations about inflation. This survey requested firms to express an opinion on the conditions for access to finance, making it easy to calculate a credit restriction indicator as the net of adverse responses ("conditions worsened") and positive responses ("conditions improved"). The trend in this indicator over time is shown in Chart 5.

Chart 5. Degree of credit restriction
(Italy: Industrial and service-sector enterprises)



Data

Only two classes of enterprise were considered: those with between 50 and 200 employees and those with more than 200 employees. In this case, the comparison is between medium-sized and large enterprises, rather than between SMEs and large firms. **The chart appears to tell us that overall financing conditions have improved for all firms; this said, the data in Table 2 indicates that the rate of improvement for medium-sized enterprises has accelerated following introduction of the SME SF (-24 points, compared with -15 in the 6 quarters prior to introduction of the capital discount) and, also, that the reduction was greater than that obtained by large firms.**

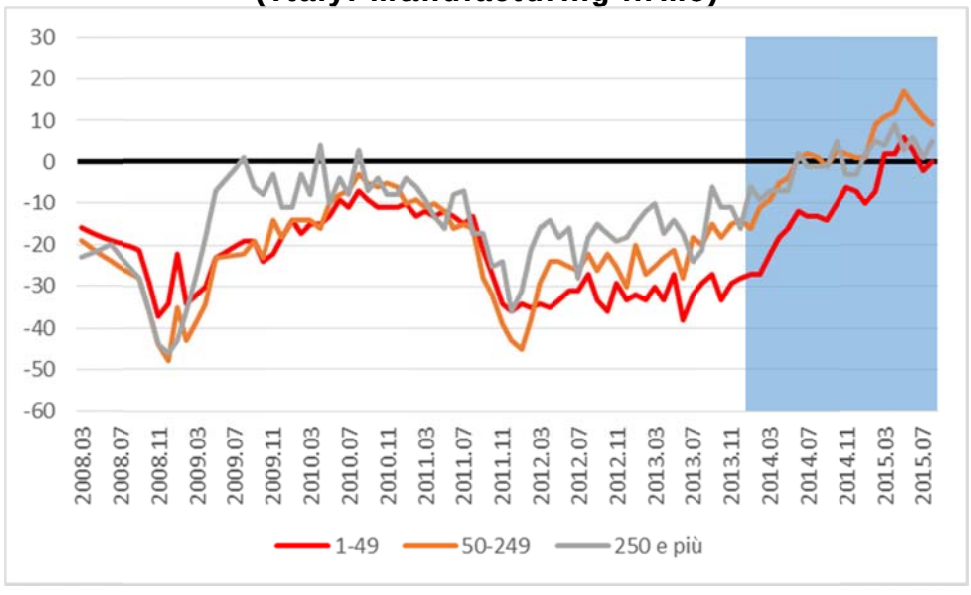
Table 2. Change in credit restriction and SME SF

	Size class	
	50-200	>200
June2012-Dec2013	-14.6	-19.7
Dec2013-June2015	-24.1	-20.4

The results are even more evident considering the Istat survey of firms in the manufacturing sector (Chart 6).

Considering both the chart and the summary provided in Table 3, the different magnitude of the improvement in the conditions for access to finance is very clear: an increase of 25-27 points for SMEs, compared with 11 points for large firms.

Chart 6. Access to finance
(Italy: manufacturing firms)



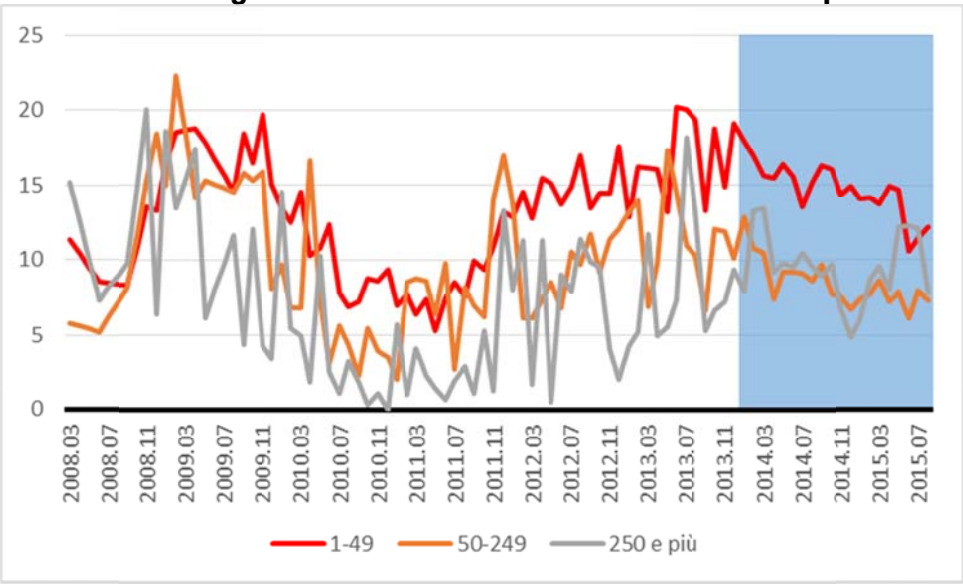
Additionally, the change in the trajectory of the SME improvement following introduction of the capital discount is very obvious, while this change is not identifiable from the information for large firms: in the 20 months prior to introduction of the SME SF the access conditions for SMEs improved by 4-9 points, while in the following 20 months there was an improvement of 25-27 points; for large firms, on the other hand, the improvement was about 10 percentage points both before and after.

Table 3. Change in the conditions for access to finance

	Size class		
	<50	50-250	>250
20 months before	4	9	10
20 months after	27	25	11

This differential effect benefiting SMEs is also suggested in relation to the rationing measures identifiable from the survey replies. In particular, the percentage of firms that did not receive a requested loan can be calculated, as shown for the three classes of enterprise in Chart 7 and summarised in Table 4.

Chart 7. Percentage of firms that did not receive a requested loan



As can be seen, the probability of not obtaining finance has decreased considerably for both small and medium-sized

enterprises post-SME SF, while it is essentially unchanged at a fairly low level for large firms.

However the change in the probability gradient before and after introduction of the SME SF is of even greater interest. In the 20 months before, both small and medium-sized enterprises complained about an increase in the probability of not obtaining finance, while it was essentially stationary for large firms. As already described, this probability declined significantly for SMEs in the following 20 months and, at least in the case of small enterprises, this inversion occurred essentially at the same time as the start of the SME SF.

Table 4. Change in the probability of not obtaining finance

	Size class		
	<50	50-250	>250
20 months before	4.2	6.1	-1.1
20 months after	-5.7	-5.6	-0.1

The evidence gathered from these sample surveys appears to indicate that application of the SME SF in Italy has had a significant positive effect on the financing conditions available to SMEs.

Following introduction of this measure, the opinions of these firms about lending conditions have improved significantly, with respect to both the past and those of large firms.

The same also seems true for the probability of not obtaining finance, which has contracted significantly for SMEs following introduction of the SME SF.

Accordingly, it appears reasonable to conclude that application of the SME SF in Italy has significantly and positively influenced the strategies of banks in their lending to SMEs.

3. Conclusions

Taken together, the evidence supports a position that:

a) requests continuation of the SME SF

b) confirms, contrary to fears expressed by the EBA and consistent with the position already taken by ABI, that the measure has not impeded the desired growth in

capitalisation ratios, having an effect of about 20 basis points on a CET1 that has risen significantly

c) highlights how, in the still brief application period, the positive effects have mitigated the adverse consequences of the deep and prolonged recession
d) confirms that the macroeconomic reasons supporting this measure combine with the structural reasons, being the lower riskiness of SME loan portfolios compared with large firm portfolios, due to a diversification effect that makes the default rate on SME loan portfolios less volatile.

* * *

ABI's comments are shared by Italian business associations Alleanza delle cooperative Italiane, Casartigiani, CNA, Confagricoltura, Confartigianato, Confcommercio, Confesercenti, Confindustria, which represent SMEs in all economic sectors: agriculture, handicraft, industry, tourism, service and trade.

The introduction of the "SME Supporting Factor" (SME SF) was strongly supported by these associations together with ABI.

After the first period of application, Italian business associations are satisfied with the results of the measure. Evidences provided by ABI, underline the importance of SME SF in balancing out - without increasing the risk of banks' portfolios - the quantity increase in minimum capital requirements, thus averting the risk of a further reduction in the supply of loans to small and medium-sized enterprises.

Considering these evidences and the lingering of credit supply constraints for SMEs, Italian business associations support ABI's request for the continuation of SME SF.

Alleanza delle cooperative Italiane
Casartigiani
CNA
Confagricoltura
Confartigianato
Confcommercio
Confesercenti
Confindustria

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