European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

EACB Comments on EBA DP and Call for Evidence on SMEs and the SME Supporting Factor

EBA/DP/2015/02

Brussels, 1st October 2015

EACB AISBL – Secretariat • Rue de l'Industrie 26-38 • B-1040 Brussels
Tel: (+32 2) 230 11 24 • Fax (+32 2) 230 06 49 • Enterprise 0896.081.149 • lobbying register 4172526951-19
www.eacb.coop • e-mail : secretariat@eacb.coop

Contact:

For further information or questions on this paper, please contact:
- Mr. Volker Heegemann, Head of Department (v.heegemann@eacb.coop)
- Mr. Marco Mancino, Adviser, Banking Regulation (m.mancino@eacb.coop)

The **European Association of Co-operative Banks** (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 31 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 4.200 locally operating banks and 68.000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 205 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 78 million members and 860.000 employees and have a total average market share of about 20%.

For further details, please visit www.eacb.coop

Introduction

The Members of EACB welcome this EBA exercise aiming to collect input and foster discussions on a key measure of the CRR such as the SME Supporting Factor (SF) as provided by Art. 501 CRR.

Accessing capital and funding is a key factor for SMEs and essential to put them in the conditions to contribute to the economic recovery and the creation of jobs across Europe. Restrictions to the availability of capital and funding may impede SME growth. SMEs need to be enabled to perform necessary investments to adopt new technologies, equipment and processes that will increase their competitiveness. SMEs In Europe depend heavily upon bank loans, alternative sources of funding (such as those open to listed companies) are usually not available for SMEs. It is for this reason that the SME SF retains a central role in the regulatory framework.

The EACB supports the maintenance of the SME factor. Repealing the SF after such a short implementation period would not allow a full and complete evaluation of the actual impact and benefits of the measure, and could instead have detrimental impacts on funding of the real economy in a time of yet weak recovery.

General comments

SMEs are deeply rooted in the European economic landscape. 99.8% of enterprises active in the EU are SMEs, of which about 92% are micro enterprises, employing fewer than 10 persons, and provide 67% of the employment in the non-financial business economy. Thus SMEs have a crucial impact on welfare, economic growth, and innovation. The slow pace of recovery of the economy and the high rate of unemployment in the EU Member States show the need for continued support through targeted regulatory measures, especially as far as SMEs are concerned.

A tailored regulatory support for European SMEs is also necessary in light of the lack of harmonisation in tax systems that puts SMEs at a disadvantage compared to larger-sized enterprises, due to lower flexibility and more conservative tax policies.

While EBA is mandated to present a report according to Art. 501(5) CRR, we believe that more time is needed to have a better overview of what are the long-term effects of the supporting factor in SME lending provision. In any case, the use of the supporting factor could hardly have a negative impact on credit supply to SMEs. Overall, it is too early to tell whether the supporting factor is fulfilling its objective, as institutions have had little time to apply it. Indeed, the figures provided by the EBA are unclear and show little evidence in one sense or the other. Different figures from different sources are leading to different conclusions.

Therefore, we believe that the SME-supporting factor shall be maintained at least until more conclusive evidence can be collected in due time.

Moreover, the overall design of the regulatory capital framework gives room for the SME SF. The CRR has introduced additional capital buffers that, together with increased capital requirements, have triggered the stabilisation of the banking sector. In addition, the counter-cyclical buffer avoids excessive lending growth, given that the buffer needs to be built during periods of economic growth or during boom phases, whereas the buffer may be used to cover losses in difficult time.

In this context, also the ongoing work of the Basel Committee to amend the Standardised Approach (SA) must be taken into account. The planned amendments may indeed negatively affect the financing of SMEs due to largely increased capital requirements.

In the absence of any sufficient evidence that the risk of SME exposures has increased since the introduction of the SME Supporting Factor, there seems to be no justification to repeal the SF. Indeed, also the accompanying memorandum of the LCR delegated act from 2014 recognised the need for specific support for SME financing, considering relevant mechanisms in the regulations. It should also be considered that a higher proportion of NPLs among SME loans is only evident in certain cases (see also graph. 6 page 23 DP).

Repealing or increasing the SME SF would not create any added value for growth and stability, while it might instead hold the risk of a credit crunch difficult to estimate. It is indeed difficult to ascertain whether past data exercises and surveys provide reliable indications regarding developments of terms and conditions for SME lending, and on the actual riskiness of SMEs in a sufficiently isolated and all round analysis, also in light of the various pieces of new regulations stemming from the CRR implementation.

The SME factor was introduced mainly as a tool to support lending to the real economy and, some of our Members reported that it contributed to tackling this aim and the goal was successfully achieved under different perspectives. In these cases, while the total RWAs were reduced, the RWAs for SME were kept stable. In addition, with the reduction of RWAs necessary triggered by higher regulatory standards (SREP ratios), some institutions may be pushed to further decrease RWAs, especially if the SF cannot be factored in any longer, further reducing lending. SMEs would then compete for loans at a higher cost than previously, making new business more expensive to fund.

Financing via the capital markets and the unregulated sector

For EU SMEs, debt financing via the capital markets and structured transactions are in general a more costly and burdensome alternative to traditional financing via bank loans.

The costs involved in issuing bonds or promissory note loans are higher, and more difficult and complex to anticipate, than for bank loans. Providing extensive data for the capital markets requires significant efforts. Small businesses often do not have the requisite IT environment or risk management platform at their disposal, in particular in the case of family-owned, owner-operated businesses. While for young, start-up businesses, such disclosure may also be unwelcome for competitive reasons. In this context, banks often play a decisive role acting as a facilitator, raising finance for the enterprise, as well as identifying potential providers of debt capital more easily, functions difficult to fulfil for the capital markets.

Capital market financings cannot be a substitute for bank financing but rather a supplement in individual cases.

Suppressing the SF factor is likely to result in increased cost of borrowing, as well as an increase in rejection rates for SME loans. This may push towards the unregulated financial sector at a time when a European Capital Markets Union is yet to be established. Such a shift would entail a loss of the unique expertise and intimate knowledge of customers provided by bank staff who carry out a differentiated assessment of each financing request, where the lending decision depends upon the borrower's business model, and on market conditions.

Answers to selected questions

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)? Yes/No. Please explain and provide evidence.

Some of our Members reported to have such systems in place. As a practical example: the RWA calculation engines consider the SME SF. Technically the SF is configured as parameter within RWA calculation engines. Additionally the capital relief is reported on the COREP Sheet, where both pre- and, if applicable, post- SME Supporting Factor figures are shown. Furthermore, the RWA calculation engines contain separate attributes for RWA before and after SME Supporting Factor (if applicable).

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.

We believe that given banks' practices this is the case, and that without the SF lending to SMEs would be quite lower.

However, it is difficult to prove that the SME lending volume has increased or decreased due to one single factor since there are many other elements that are relevant for this evaluation. A key point concerns the demand side. A still sluggish economic seems in fact to play a determining role in the overall supply of credit. Cooperative banks, due to their governance and business model, are committed to lending to local economy and small businesses. Capital savings are very likely to be addressed to such clients, provided that there is sufficient demand. This is a further reason to test the SF also in a context of full economic recovery. Moreover, as pointed out by the EBA, there is no consistent EU SME lending dataset over the cycle (COREP started in 2014).

In addition, as already mentioned, the SF has only been in place for one budgeting cycle and one credit lending policies cycle. Thus, there has not been sufficient time to institutionalize the change. Business appetite has not changed since the introduction of the SF and risk appetite is constant over time.

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 specific examples.*

The segmentation for steering business and risk portfolios is based on the same criteria. Still, different thresholds are used and so entities are distributed over multiple segments.

As the same criteria are used for internal segmentation purposes, the data required for identification of exposures eligible for the SME SF are available in central databases.

Q.4 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)?

As the same criteria are used for segmentation purposes, all data required for identification of exposures eligible for SME Supporting Factor are available in central databases.

Q.5 Do you see merits in having a harmonised definition of SMEs for reporting purposes? Yes/No. Please explain and provide specific examples.

The implementation efforts and the time needed should not be overlooked. This might create uncertainty concerning the raising of capital for necessary investments. Such a structural measure would raise the hurdles for raising capital and funding, where SMEs already face difficulties.

In addition, there are certain regulatory aspects to consider. Firstly CRR has two different SME related exposure limits in article 501 (€ 1.5m for SME SF) and article 147 (€ 1m for retail exposures). Secondly banks may have set lower internally limits for exposures qualifying as retail exposures according to article 147. If SME retail exposure limit or SME definition would be changed or harmonised, this would trigger a material change to IRBA (according to the RTS assessing the materiality of extensions and changes of IRBA and AIRBA, adopted as Commission delegated regulation 529/2014) and thus a huge burden for Competent Authorities to go through banks' applications for such IRBA changes.

Q.6 Do you agree with the proposed measures of SME riskiness? Yes/No. Are some of these measures more relevant than others? Yes/No.

Overall the risk indicators chosen by EBA seem appropriate, however the specific characteristics particularly critical to SME success have not been sufficiently taken into account.

A sufficient flow of liquidity and low leverage are key prerequisites to ascertaining the timely and sufficient servicing of debt obligations. However, such indicators are also highly industry specific (especially leverage), and may vary across SMEs simply due to the nature of their activities and their size. In addition, with regard to leverage the usually low minimum levels of capital to start a non-financial SME should be taken into account. However, it seems fair to assess that a liquidity crisis is an indicator that a company may become insolvent, but as EBA's analysis shows (see page 25 DP), SMEs have notably higher liquidity than larger companies.

It is also worth pointing out that existing tax systems within the EU are not always comparable across Member States and this may have a direct impact upon the assessed profitability of enterprises. Due to the fact that SMEs in particularly have lower flexibility and are usually more conservative in their tax policies, they seem at a disadvantage compared to large companies. Thus, also profitability does not seem an appropriate term of comparison between SME and large corporates to assess SME riskiness.

SME riskiness should be based on a much more differentiated assessment, incorporating further elements also of qualitative nature. Small business lending relies to a large extent on "soft" information, which is available only via the direct knowledge of borrowers and local economic conditions, which is a key feature of the cooperative banking model.

Finally, the methodology for the selection of sources, the choice of data categories and the conclusions is unclear and leaves some doubt. In the section "*riskiness of SMEs in the European Union*" several data sources are used without putting them into context (BACH-data are mixed into one single index, see point 29.) Also the conclusions seem quite contradictory: while the outcome of the BACH-data is quite differentiated and does not seem to point at clear cut evidence (see point 26), the conclusion proposed seem to be that SMEs tend to be riskier than larger firms.

Q.7 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.

SMEs present a wide and even granular diversity in business models, competitive position, ownership structure, dependency upon macroeconomic development. Such diversity is even more evident across Member States. A strict range of generalised risk indicators may fall short of its purpose. Individual assessments based on a differentiated list of criteria would be more opportune. The different economic environments and legal frameworks in the various member states should be taken into consideration, since these may have a significant influence on the performance and risk situation of SMEs.

External rating agencies use additional standards when assessing the credit quality of SMEs, for instance assessing not only profit margins but also the competitive position, which may have a positive influence on revenues. Also corporate and ownership structures play key roles as risk or success factors. For owner-operated family businesses, business performance significantly depends upon the entrepreneur's personal performance. Also, the financing mix of family-run businesses is often characterised by a higher level of internal financing, stronger equity (with a view to retaining their independence), and a higher risk aversion.

Q.8 In your experience, are SMEs as cyclical or more/less cyclical than large enterprises?

Cooperative banks financing of SMEs is deeply rooted in the local presence of cooperative institutions, that support the local economy and have direct and consolidated knowledge of their customers. The loan portfolios of cooperative banks are thus likely to be more granular, and less risky. This seems to justify the rationale of the SME SF, as lower risk exposure should be reflected in lower capital requirements.

Overall, we would see no economic cross-relationship between SME lending and lending to large corporate groups. What emerges from ECB reports is that SMEs find it difficult to identify alternative sources of financing and are particularly dependent upon the economic situation of their Member State, indicating that a credit crunch is one of the key risks in the event of economic trouble.

Finally from a lender's perspective, the introduction of the counter-cyclical capital buffer already addresses the risk of excessive lending growth.

Q.9 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.

Any appropriate assessment of consistency of own funds with SME riskiness should require a more differentiated risk analysis. Taking into account only the size of SMEs would have a narrow scope. The heterogeneity of SME portfolios should be taken into account. Furthermore, individual exposures and the actual impact of a defaulting SME loan on the stability of the entire institution should be considered. As the Commission intends to foster growth and support SMEs, a comprehensive view of the regulatory measures and their impact on institutions should be considered to have a realistic picture of appropriateness of RWs overall.

In addition, we have some doubts on the approach followed. The a EU-wide figure-based approach should be more differentiated, as the influence on SMEs default on the systemic risk varies across Member States.

Also the assumption that large corporates pose a less systemic risk than SMEs seems questionable. A broad diversified portfolio of a bank with a numerous SME-exposures could be safer than a portfolio with a few large corporates. A broad portfolio of SME-exposures could allow diversification and higher stability. It also has to be taken into account that often exposures to small businesses are highly collateralised and that often (for partnerships and non incorporated companies) there is no actual separation between the resources of the company and those of the entrepreneur. Large corporates may pose a much higher threat to the systemic risk in case of insolvency than a lot of smaller SME-exposures.

From our perspective there is also a lack of consistent data to monitor capital flows to SMEs. From the figures provided by the EBA using data from the "ECB Monetary and Financial Institutions Interest Rate Statistics" we can draw the conclusion that the supporting factor may recently be having a positive effect in terms of the reduction in spread between the interest of large companies and small companies. This reduction in interest rates, both in general and, in particular, for SMEs, should have a positive impact on the provision of credit to the real economy in the medium term as soon as the economy shows a sustained growth rate.

Q.10 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.

In Germany, the data of cooperative banks pointed to a strong surplus coverage of 60.01% in relation to regulatory capital requirements, even during the peak of the financial crisis. This would confirm the opportunity to maintain the SME Supporting Factor.

Also in Italy the level of loan loss provisioning resulted overall adequate. In addition, guarantees the level of guarantees, bad loan collection and recovery rates resulted higher for cooperative banks than for other institutions.

National specificities should also be incorporated in regulatory considerations, such as conservative accounting or prudential measures with a risk-reducing impact that have not been taken into account in the DP.

Q.11 Do you agree with the above interpretation of statistical data on lending trends and conditions? Yes/No. If no, please explain.

In general we agree with the interpretation of the statistical data. However the economic conditions in Europe before and after the crisis are different and, as a result, the SMEs are operating in a different macroeconomic environment. So the comparison of pre-crisis to post-crisis levels may not be meaningful. Also, there are additional factors influencing the SME lending/demand which should be taken into consideration. The lending trends for SME are highly dependent on the specific macroeconomic conditions of the respective country in which they operate. Some of the EU countries have recovered more quickly while others are still in recession. For those countries in recession, credit demand is still low and lagging behind pre-crisis levels, regardless of the introduction of the SF.

The SF was introduced in the beginning of 2014 thus the observation period is too short for conclusive estimation since:

- The SF was not reflected in the credit lending policies and practices of 2014 since it was introduced after their rollout. It could only be considered in 2015 documentation.
- The SME credit lending policies were already strengthened after the crisis (independently from the SF) due to 1) the deterioration of the pre-crisis portfolios and 2) the subsequent cleaning of the portfolios.

Q.12 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.

The credit lending policies in some credit institutions were not adapted explicitly as a result of the implementation of the SF but in order to reflect easier lending conditions to SME under national or EU programs.

Additional steps are taken into account in order to support the lending to SME, e.g. by more precise risk assessment allowing for increased product choices. These measures are feasible because the SME lending is currently RWA efficient and if the SF is removed the approach will be scaled down or completely removed as certain products will become too RWA-heavy.

Q.13 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.

As already indicated (see Q.2), the analysis of SME lending should encompass more than one single factor (e.g. the SME supporting factor). Some credit institutions also changed their lending policies driven by:

- The introduction/continuation of EU subvention programs (EIF, JEREMIE, COSME, etc.).
- A change in customer demands.
- Growth in retail funding.
- Availability of ECB funds.
- The tightening of the lending in foreign currency due to the evolution on the market and the regulation imposed on financial institutions.

Q.14 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.

The SF was introduced at the beginning of 2014, thus the observation period is insufficient for conclusive estimation. Nevertheless SME lending is currently RWA efficient and if the SF is removed, then it would be safe to expect that volumes decrease.

As mentioned also at pag. 16 DP the purpose of the RW relief would be to allow credit institutions to increase lending to SMEs in the current economic context. As the economic situation has not yet drastically changed, repealing the SME SF could well have a negative impact on the lending volume to SME.

See also answer to Q.8.

Q.15 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.

Overall pricing for SME customers is higher than corporate customers, regardless of the introduction of the SF. However, recently years the spread between SME and corporate rates has been decreasing, which can be reconciled also with the introduction of the SF.

Q.16 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.

As already pointed out in the DP (pag. 37) the differentiation between micro-/very small enterprises and medium-sized enterprises plays a role when ascertaining the obstacles to utilisation of different financing sources. A differentiation of various SME size categories would in this vein be sensible. In fact, the very scope of the SME concept requires a differentiated perspective. SMEs include a range of businesses from very small enterprises with few employees and low revenues to medium-sized enterprises with many employees and revenues of up to € 50 million. While 92.4% of all SMEs are very small businesses, their number and the number of their employees saw the strongest decline from 2008 to 2013. However this differentiation shall not imply, considering the current economic environment, the current threshold for SMEs exposure (€ 1.5M) and an appropriate application of the SF, different levels of the SF.