ABI Associazione Bancaria Italiana

ABI's comments on the FSB Consultative Document

"Evaluation of the effects of financial regulatory reforms on small and medium-sized enterprise (SME) financing"

August 2019

POSITION PAPER

Preliminary Remarks

The Italian Banking Association (ABI) welcomes the FSB's initiative in evaluating the impacts of the G20 Financial Regulatory Reforms. Examining effects and potential unintended consequences is crucial in enabling regulatory fine-tuning and ensuring that reforms contribute to optimal outcomes for the economy as a whole.

The focus on small and medium sized enterprises (SMEs) is timely and important as they play a key role in advancing real economic growth. SMEs make key contributions to gross domestic product ("GDP") and employment.

The ABI is therefore glad to have the opportunity to comment on the FSB consultative document on this important topic "*Evaluation of the effects of financial regulatory reforms on small and medium-sized enterprise (SME) financing*".

ABI comments are mainly focussed on the analytical approach used to assess the effects of reforms and therefore on the main findings of the study. ABI acknowledges that the FSB study provides a thorough picture of trends and features of SME lending, as well as good basis for identifying regulatory reforms which might have affected it. Anyway, in ABI's opinion certain conclusions drawn in the report do not fully capture the negative implications of some reforms on SMEs access to bank lending. ABI would therefore encourage the FSB to continue the analysis, also with a view to studying the effects of regulation at national/regional level, and to extending its scope to other pieces of regulation likely to entail significant effects on SME lending.

In the following, ABI provides some comments and specific recommendations in that respect, along with some evidence on the effects of to the so called "SME Supporting Factor" applied in the EU (henceforth, the SME SF[1]).

This note is articulated as follows:

1. Comments on the main findings of the study
2. Comments on specific aspects of the methodology of the quantitative assessment
3. Other relevant regulatory reforms that could be worth addressing
4. Evidence on the effects of the EU SME SF

[1] Reference is made to the "SME Supporting Factor in the EU" addressed in the Box 4 (page 28) of the FSB report.

1. Comments on the main findings of the study

ABI acknowledges that the assessment of the effects of regulatory reforms is a more than challenging task and that the FSB faced many difficulties and constraints, first of all the lack of comparable data among jurisdictions.

Anyway, in ABI's opinion a few comments are worth in order to highlight some points where we believe the findings of the report should be read with caution or would deserve further attention.

As a general remark, we would emphasize that it would be very valuable that the FSB not only described the effects, but also elaborated on elements of the regulatory framework that could be improved.

In this respect, for example, the study shows that a one-size-fits-all pattern for all jurisdictions cannot be outlined, since the impact of reforms on SME lending depends on country-specific factors. In particular, the study shows that, in countries hit by an economic downturn during the reform implementation period, the pace of lending was reduced for both SMEs and other firms. In other words, the study finds some evidence of **procyclical effects of the regulatory reforms**, hardly fitting with the aim of the regulatory reforms of fostering financial stability. We deem such result should be considered for further in-depth examination by the FSB, in order for the specific measures giving rise to procyclical effects to be identified (and hence addressed by the regulators/standard setters).

More in general, while we agree that the post-crisis G20 reforms created significant benefits to financial stability, we believe a more thorough analysis should be carried out to assess these benefits compared to the actual cost of such reforms.

Indeed, the report highlights that, with respect to the effects on SME financing, based on the evidence collected the reforms resulted only in a temporary slow in the pace of SME lending – and, in some jurisdictions, in a tightening in the cost of credit and collateral requirements. These effects seem to be driven by the capital measures, while the introduction of the liquidity ratios and the leverage ratio seem not to have determined significant impacts. Also based on the findings of the qualitative analysis, the consultative document emphasises, in front of a negative impact on credit supply in the short-medium term, a long-term positive impact, since better capitalised banks would foster financial stability and growth. It is basically assumed, rather than demonstrated with dedicated analysis, that the benefit in the long term outweighs the negative impact of the reforms on SME lending. This issue should therefore be further assessed; to be more meaningful, this analysis should be conducted over a full economic cycle.

More precisely, the study discriminates between "persistent" – i.e. lasting for the entire period observed after the reforms – and "temporary" effects of the reforms. The quantitative assessment tends to conclude that reforms determined only temporary effects: the FSB acknowledges that, due to the important data and methodological challenges and the difficulty in isolating the effects of macroeconomic conditions from the effects of financial regulation at a global level, the analysis does not identify material and persistent negative effects on SME financing in general, although there is some differentiation across jurisdictions.

Anyway, it might be worth highlighting that the within-country analysis seems to show a more articulate picture as to the effects of capital measures on SME financing.

The table below shows the output of the econometric analyses performed by the FSB. For each analysis (the rows of the table), the number of countries is indicated where negative and statistically significant effect on SME financing is found (black square, meaning that reforms led to a decline of SME financing in that country), where no effect is found (white triangle) or where the effect is positive (black circle). The effects on corporate financing are illustrated in the same form in the right block.

Table 3: Effects of Risk-based capital (RBC) reforms – SME and non SME lending growth

Results of within-country satellite analyses - By type of data, region, advanced versus emerging markets, average 2010-2017 GDP growth

Results indicated with: ● positive (at the 10% level); ■ negative (at the 10% level); △ not significant

	Credit growth to SMEs		Credit growth to corporates			
			Total corporates		Non-SME	
	Transitory	Persistent[1]	Transitory	Persistent[1]	Transitory	Persistent[1]
Cross-country						
FSB questionnaire data	■	△	△	△		
Satellites by type of data						
Bank Level	■■■■ △△△△△ ●●	■■ △△△△△△△△△	■■ △△△△△△ ●●●	■■ △△△△△△△△ ●	■■ △△△△△△△ ●	■■■ △△△△△△△△
Bank Firm level (based on balanced sample)	■■■■ △△	■■■■ △△	■■■ △△ ●	△△△△ ●	■■■ ●	■ △△ ●
Satellites by region (based on bank-firm level data where applicable)						
Americas	■ △●	■ △△	● △△	△△△	△ ●	△ ●
Asia	■ △△	■ △△	■■ ●	■ △△	■■ △	■■ △
Europe	■■■■ △	■■■ △△△	■■■ △△	△△△ ●	■■■ △	■ △△△
Satellites by Advanced versus Emerging Markets (based on bank-firm level data where applicable)						
Advanced economies	■■■■■ △△△ ●	■■■■ △△△△△	■■■■■ △△△ ●	■ △△△△△△ ●	■■■■■ △△△	■■■■ △△△△
Emerging markets	■ △	■ △	△ ●	△△	●	●

The analysis on bank-level data (blue box) shows that, in 4 out of 11 jurisdictions, temporary significant negative effects of capital measures on SME financing are observed. In 2 out of 11 cases, the effects are persistent over the entire post-reform period. It might be worth noting that for non-SME corporates, effects are persistent in 3 out of 11 cases.

Anyway, considering bank firm level data (red box) – allowing for better identification of effects, also according to the FSB – the findings of the empirical analysis show far more penalising results, in particular with respect to SME financing: in 4 out of 6 countries, significant negative effects of reforms on SME financing – both temporary and persistent - are found.

In Europe (orange box), temporary significant negative effects of reforms on SME financing are found in 4 out of 5 countries – in 3 out of 6 persistent effects are found. A significant presence of these effects is observed also when studying advanced economies (green box – temporary effects in 5 out of 9 cases and persistent effects in 4 out of 9 cases).

All in all, the more sophisticated empirical analysis seems to show significant evidence of negative effects of the reforms on SME lending, both temporary and persistent.

Indeed, the FSB itself mentions elements limiting the comparability of results among jurisdictions. First, in some jurisdictions, at the time the reforms were implemented, similar measures were already into force, or policies were enacted aimed at enhancing access to finance for SMEs. Both cases would result in underestimating the effects of the reforms. This point is significant as, for example, measures such as the SME Supporting Factor – that came into force in conjunction with the Basel III reforms – could have contributed to significantly limit the extent of possible restrictions in credit supply in the EU[2]. We deem the SME SF played a crucial role in keeping the conditions for ensuring the supply of credit to SMEs and performed dedicated analysis on the effects of the SME SF (see paragraph 4), in order to show that its continuation is necessary in light of the new wave of regulatory reforms envisaged in the forthcoming years (finalisation of Basel III).

In any case, we would encourage the FSB to further engage in the analysis of significant effects on SME financing due to jurisdiction-specific measures and policies. Although the findings cannot be assumed to be true at international level, nonetheless, identifying the relevant measures and the main drivers of their impact could provide useful insight.

[2] In the same vein, the possible effects of the low interest rate environment, which may have mitigated the negative effects of financial reforms, should be taken into account.

2. Comments on specific aspects of the methodology

Some remarks might be worth on the methodology applied for the quantitative assessment of the effects of the reforms, focused on the 2010 Basel III package.

In our understanding, the empirical analysis is based on a model (the "baseline approach") aimed at estimating the effects of the reforms on banks' financing to SMEs. More precisely, the model considers the evolution of SME financing before and after the Basel III reforms. To identify the effects of measures, the sample banks are divided into two groups, depending on their exposure to the reforms (ex-ante). This is to compare the effects of the reforms for the two groups. Classification of banks in groups is based on the levels of their capital/liquidity ratios before the reforms. A bank is identified as "more exposed to the regulatory change", if its capital or liquidity ratios are below a threshold set at the bottom quartile of the distribution for all banks. Otherwise it is considered "less exposed" (control group). The composition of the two groups remains constant over time.

The effects of regulatory reforms are assessed only in relative and not in absolute terms. The underlying assumption is that "more exposed" banks are more likely to be affected by the reforms and should therefore show stronger effects on SME financing. Anyway, if "more exposed" banks show higher reduction in SME lending compared to the control group, this does not imply that less exposed banks are not affected by the reforms. This clarification is provided by the FSB itself.

In our opinion, this represents a weakness of the study. Indeed, taking it to the extreme, this implies that if the effects of the reforms were huge for both groups the study would conclude that the reforms had no impact on SME financing.

This paradox puts into question the criteria applied for identifying banks exposed to reforms. Identification based on the ranking (i.e. percentiles of the distribution) does not consider all available information, namely the severity of the reforms. If the reform is such that also banks in percentiles of the distribution higher than the bottom quartile need to raise capital, the relative positioning of banks might not be the better indicator of exposure to the reforms. Other indicators, e.g. the presence of a capital shortfall to the post reform capital target level, could be more meaningful.

In the study, the FSB highlights that the effects of reforms seem to be relatively stronger for jurisdictions affected by an economic crisis and that in these countries, after the reforms, credit to SMEs and to corporates declines, irrespective of the level of banks' capitalisation[3]. While confirming the procyclical effects of the reforms, this

[3] See paragraph 4.2.4 "*Robustness analyses indicate that the effects might have been stronger in countries hit by a macroeconomic crisis. In these jurisdictions, lending to SME and total corporate declined in the post-reform period and independently from the fact that their banking systems were relatively more or less capitalised*".

seems also to show that this systemic effect represents a bias of the proposed approach. Indeed, if SME financing is affected irrespective of banks' capitalisation, this puts into question the whole approach (relative analysis).

3. Relevant regulatory reforms not addressed

Some examples of financial reforms that are not addressed in the report but could be worth mentioning are those concerning the treatment of non-performing loans recently undertaken in the EU.

The wave of new EU prudential regulations and supervisory actions about NPLs and the definition of default raises concerns in respect of its impact on SME financing. The European Union Regulation on minimum loss coverage requirements, combined with European supervisors pushing banks to take losses on NPLs could play against SME lending (current and future).

The regulation on minimum loss coverage requirements (so-called *calendar provisioning*), imposes strict requirements in terms of accounting provisioning or capital deductions on NPLs in banks' balance sheets, depending on the vintage in non-performing status and on whether (and how) the exposure is secured or not.

Such measure could have at least two effects on SME financing. First, the severe treatment for unsecured exposures which turn NPLs is likely to determine a tightening in credit conditions and namely a higher request for collateralisation – that the FSB acknowledges to be an obstacle to SME financing. Secondly, the time pressure is likely to discourage banks form providing forbearance measures to SMEs (and other clients) experiencing temporary liquidity difficulties. In these cases, once the exposure turns NPL, time might be needed before it can be considered as cured - while a bank has to put capital aside, so granting forbearance measures might represent a more penalizing option than proceeding with the enforcement of collateral.

4. Evidence on the effects of the EU SME SF

Dedicated analysis has been performed to assess the positive effects of the SME supporting factor (SME SF). More specifically, the effects have been assessed by studying the evolution of some key variables for SME financing, compared to larger firms, before and after the application of the SME SF.

The outcomes of the analysis show that such measure, applied since January 2014, has sorted positive effects. In particular, **following to the introduction of the SME SF**:

- **the flow of new bank lending to SMEs,** which suffered a significant backdrop after the start of the financial crisis, began to rise again rather quickly; more in detail, in the period from January 2014 to May 2019, the growth in the flow of new lending to SME was **16 percentage points higher than lending to larger firms**;
- in addition, the differential between large companies and SMEs in terms of **the cost of credit narrowed - to the benefit of SMEs - by around 22%**;
- furthermore, the **conditions for access to bank lending by SMEs improved** as well, both in absolute terms and in relative terms compared to large companies.

<u>Flow of new bank lending to firms</u>

The first phenomenon observed in order to study whether the SME SF has sorted positive effects or not is the trend in new lending to SMEs.

Based on data on the Euro Area from the ECB statistics, the trends in the flow of new lending before and after the introduction of the SME SF can be studied. More precisely, the trends in the flow of new lending to SMEs compared to larger firms is studied, looking at monthly data on the cumulated 12-months flow of new loans[4].

In line with the approach followed by the EBA in its "*EBA REPORT ON SMES AND SME SUPPORTING FACTOR (EBA/OP/2016/04*)", for the purpose of this analysis, loans to SMEs are proxied by loans up to and including EUR 1 million, while loans to large enterprises are proxied by loans over EUR 1 million.

The outcomes of this exercise (see Chart 1) show that, following to the introduction of the SME SF, (i.e. over a 65-months period) the flow of bank lending to SMEs immediately slowed the pace (until end 2014) of the existing downward trend, which turned positive, so that the flow as of May 2019 (latest figure available) is 20% higher than it was in 2013 - before the SME SF. On the other hand, bank lending to larger firms continued the downward trend until end 2016 and is only 4% higher as of May 2019 than it was on average in 2013. **In other words, over the period of application of the SME SF, the pace of the flow of new bank lending to SMEs in the Eurozone is 16 percentage point stronger than lending to larger firms**.

[4] In other words, monthly data represent the cumulated amount of the flow of new lending granted over the preceding 12-months.

Chart 1 – Flow of new lending to firms in the Euro area (index; average 2013=1) (cumulated 12-months flow calculated on a monthly basis)

Source: ABI analysis of ECB data (*Statistical Data Warehouse - Bank Interest Rates*)

This evidence is confirmed and better explained in Table 1. Here, the monthly average of the flow of new lending to SMEs and larger firms, over the 65-months periods before and after the application of the SME SF, is reported on a country basis.

On aggregated basis, in the Euro area, since the application of the SME SF, the average flow of SME lending declined by 3.5%, while for larger firms it dropped by 22.5%. Therefore, comparing the periods before and after the SME SF, SMEs gained a relative advantage in the dynamics of credit of around 19 percentage points compared to larger firms (see column "*SMEs vs large firms*").

Figures on a country basis show that such advantage is widespread: among the 10 countries of the sample, in Ireland only the SMEs does not benefit of a relative advantage. In Germany and France the difference is approximately 13 percentage points, in Italy 27 points and in Spain nearly 43 points (22 percentage points on average in the four biggest country of the Eurozone).

Table 1 – Flow of new lending to firms
(average figures; EUR million)

Country	Small Firms			Large Firms			
	Pre SMESF Average	Post SMESF Average	Var %	Pre SMESF Average	Post SMESF Average	Var %	Small vs Large
Austria	1,163	1,070	-8.0%	7,899	7,098	-10.1%	2.1%
Belgium	6,560	6,320	-3.7%	6,560	4,762	-27.4%	23.7%
Germany	10,485	11,193	6.8%	56,562	53,082	-6.2%	12.9%
Spain	16,298	14,035	-13.9%	34,568	15,088	-56.4%	42.5%
Finland	705	741	5.1%	2,995	2,267	-24.3%	29.4%
France	6,560	8,302	26.6%	14,563	16,509	13.4%	13.2%
Ireland	576	259	-55.0%	2,720	1,261	-53.7%	-1.4%
Italy	14,489	14,023	-3.2%	27,529	19,157	-30.4%	27.2%
Netherlands	1,492	1,514	1.5%	9,306	8,782	-5.6%	7.1%
Portugal	1,788	1,495	-16.4%	2,150	1,239	-42.4%	26.0%
Euro Area	62,389	60,199	-3.5%	194,180	150,514	-22.5%	19.0%
Big 4 (De+Fr+It+Es)	47,832	47,553	-0.6%	133,223	103,836	-22.1%	21.5%

Source: ABI analysis of ECB data, *Statistical Data Warehouse - Bank Interest Rates*

Cost of borrowing for firms

Another variable worth studying to assess whether the SMEs benefited from the SME SF or not is the evolution in the cost of borrowing.

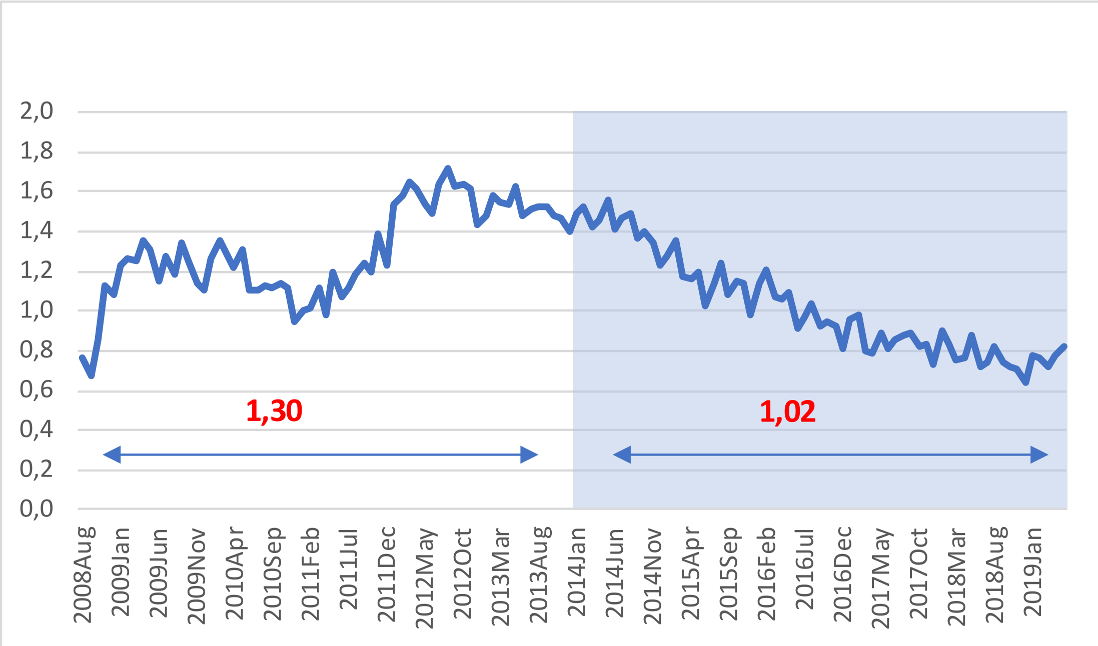
For this purpose, the following chart (Chart 2) shows the gap that SMEs experienced towards larger firms[5] in interest rates applied to new lending (aggregate figures for the Euro area). This is still analysed over the 65-months periods prior and following to the start of the SME SF.

The chart clearly shows that the gap, fairly wide before the application of the SME SF, started narrowing after its application. More precisely, over the period of observation prior to the SME SF, the "spread" in the interest rate paid by the SMEs over larger firms was on average around 130 basis points. In the 65-months period

[5] Identification of lending to SMEs versus larger firms is still based on the amount of loans, below or above 1 million euro respectively.

following to the introduction of the SME SF, the average gap is around 100 basis points and it is around 80 basis points as of May 2019.

*Chart 2 – Spread between bank loans interest rates to small and larger firms **
(Euro area; %)



* Interest rates to SMEs are those applied to loans up to EUR 1 million, interest rates to larger firms are those applied to loans over EUR 1 million.

Source: ABI analysis of ECB data, *Statistical Data Warehouse - Bank Interest Rates*

Therefore, in the flow of new loans to SMEs not only better dynamics are observed, but also a narrowing of the gap in the cost of credit compared to larger firms.

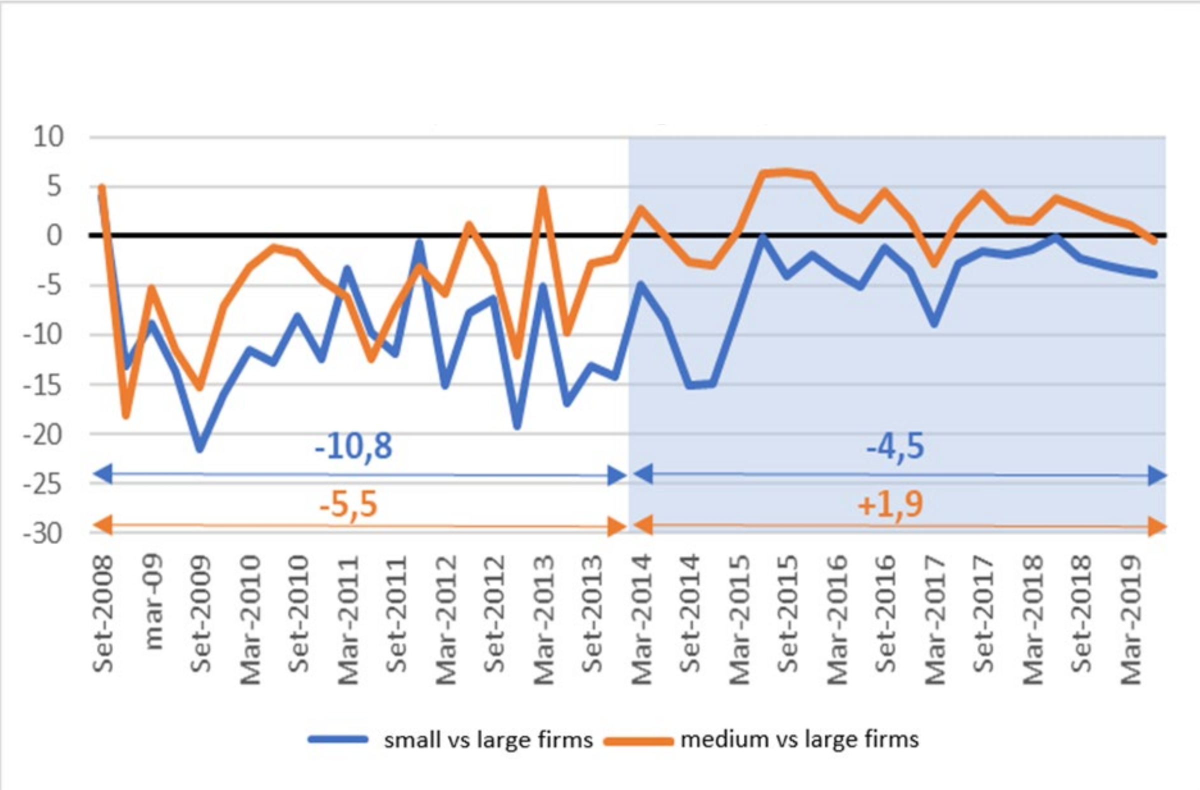
Access to bank lending

The improvement in the conditions for SME access to bank financing can also be studied as a further indicator of the SME SF effectiveness.

With respect to Italy, this analysis can be carried out based on Istat[6] survey on *Business confidence in the manufacturing sector*, providing indications on the percentage of success of firm's applications for bank loans, with a breakdown by firm size[7].

The following chart (Chart 3) shows – for both the periods before and after the SME SF - the trend in the percentage of success of firms' applications for bank loans. The two lines represent the gap in the percentage of success, between small firms and large ones and between medium-sized firms and large ones, respectively.

Chart 3 – Share of successful application for loans
(spread to the share of larger firms; Italy; %)



Source: ABI analysis of Istat data, *Business confidence in the manufacturing sector*

Evidences show that, prior to the SME SF, the percentage of successful application for SMEs was lower by around 11 percentage points (on average over the observed

[6] Istat (Italian National Institute of Statistics), a public research organisation, is the main producer of official statistics in Italy.

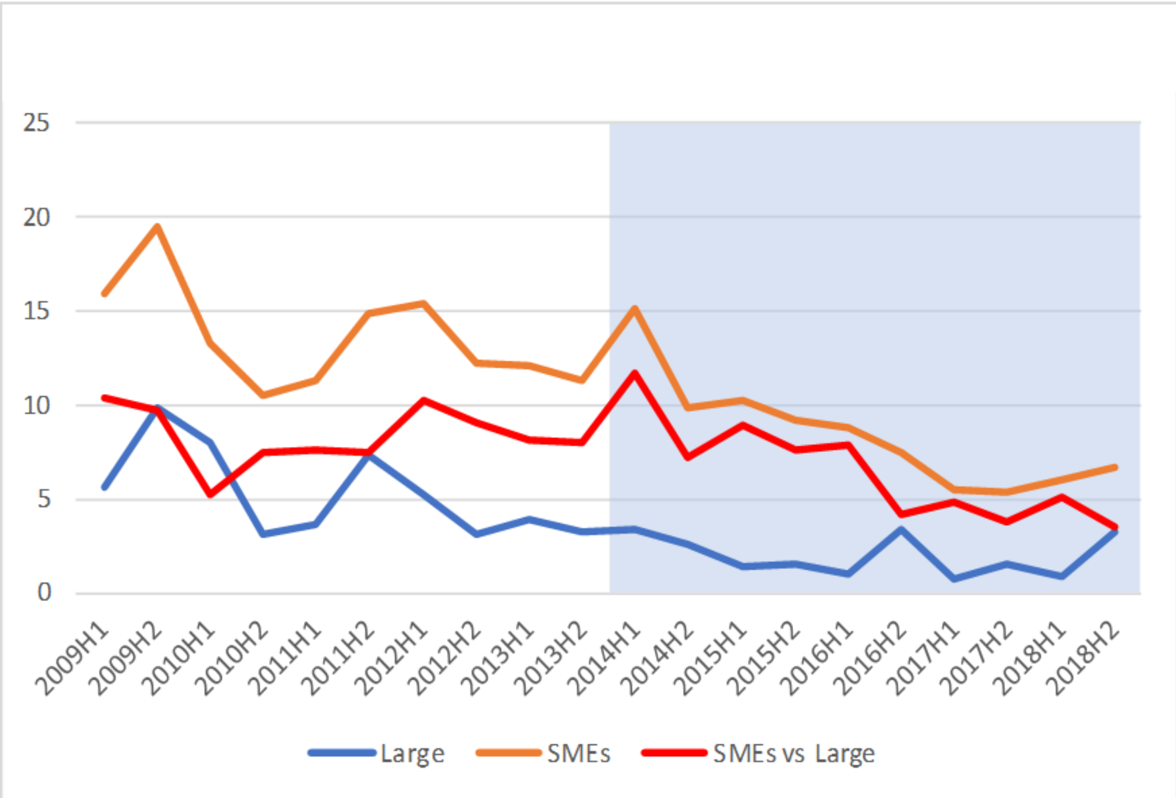
[7] In this case the firm size is identified based on the number of employees (1-49 for small firms, 50-249 for medium firms, 250 or more for large firms).

period) than the percentage for large firms. In the period after the enactment of the SME SF, this gap declined to 4.5 percentage points.

The share of successful applications for medium-sized enterprises, 5.5% lower than the average figure for large firms prior to the SME SF, after the SME SF exceeds the latter by nearly 2%.

For the Euro area, the probability of success of loans applications can be studied based on the ECB *Survey on the access to finance of enterprises*[8] (SAFE). The following chart (Chart 4) and table (Table 2), represent figures obtained as the sum of the share of applications rejected by banks and the share of loans refused by firms.

Chart 4 – Share of firms' application for bank loans with negative outcome (Euro area)



Source: ABI analysis of BCE data, *Survey on the access to finance of enterprises (SAFE)*

Table 2 – Share of firms' application for bank loans with negative outcome

[8] The survey on the access to finance of enterprises (SAFE) provides information on the financial situation of enterprises, and documents trends in the need for and availability of external financing. The survey results are broken down by firm size, branch of economic activity, country and other features. The survey is conducted twice a year: once by the ECB covering euro area countries and once in cooperation with the European Commission, covering all EU countries plus some neighbouring countries.

(Euro area; average over the observed period)

	Pre SMESF Average	Post SMESF Average	Var
SMEs	13.6	8.4	-5.2
Large	5.3	2.0	-3.3
SMEs-Large	8.3	6.5	-1.8

Source: ABI analysis of BCE data, *Survey on the access to finance of enterprises (SAFE)*

Over the observed period, the share of applications with negative outcome declined for both SMEs and larger firms. More precisely, prior to January 2014 the share of applications with negative outcome for SMEs was 13.6%, which falls by more than 5 percentage points (to 8.4%) in the period in which the SME SF has been applied. Figures for larger firms are lower but still declining (from 5.3% to 2.0%).

Even in this case, to identify the effect of the SME SF it is worth considering the trend in the difference between the share of negative outcome for SMEs and for larger firms. The average gap in the period prior to the SME SF is around 2 percentage points higher than the average gap in the period with the SME SF in place (8.3% vs 6.5%). This trend strengthens over time: the gap observed in the last two years is on average 4.3%, which nearly halves the average gap prior to the SME SF application.

Overall, along with benefits in terms of lending volume and cost of borrowing, the SME SF seems to have granted EU SMEs better access to bank lending, both in absolute terms and compared to larger firms.