

# POSITION PAPER



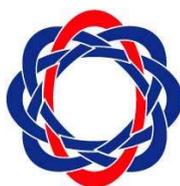
## **WSBI-ESBG response to the public consultation on the effects of financial regulatory reform on the provision of financing to small and medium-sized enterprises (SMEs)**

WSBI (World Savings and Retail Banking Group)

ESBG (European Savings and Retail Banking Group)

Rue Marie-Thérèse, 11 - B-1000 Brussels

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WSBI



ESBG



### General comments:

Lessons learnt from the financial crisis, combined with political recognition of the systemic relevance of large enterprises in the real economy sector, have improved the SME community's standing with economic policymakers. Legislators are now aware that SMEs contribute substantially to both employment and the gross added value across regions.<sup>1</sup> Moreover, SMEs have been instrumental in mitigating regional disparity, paving the way for economically underdeveloped regions to catch up. That is why dependable SME funding is a socio-political concern as well.

The current regulatory framework puts SMEs at a competitive disadvantage. On the one hand, implicit government guarantees are still helping the too-big-to-fail-institutions to refinance themselves at better terms, which they can pass on to their customers. On the other hand, since regulatory costs are mainly fixed administrative expenses, the price that small and medium-sized institutions pay for the current one-size-fits-all approach to regulation is out of proportion.<sup>2</sup> Banks solid enough to weather the crisis might now turn out too small to survive regulation. The asymmetric impact of the cost of post-crisis regulation forces smaller institutions to merge, which increases hampers customer relationships. That, in turn, negatively impacts SMEs and peripheral or economically underdeveloped regions.

Institutions whose business models are based on deposit banking and decentralised decision-making have proven to be particularly loyal lenders, not least because they draw on stable funding themselves. The geographic proximity to their borrowers provides regional institutions with a wealth of soft facts that enable them to rate their clients' credit better and for longer terms. The possible disadvantage of small and regional credit institutions of not achieving economies of scale and not offering a broad range of financial services and products can be overcome by cooperating within a financial services network. Key features of a functional regionally focused and decentralised banking system include: "I. Short distance and embeddedness in (supportive) regional bank associations ... II. Real decentralised universal banks... III. Regional principle, regional embeddedness and regional balance".

**Q1: What have been the main trends in SME financing (i.e. types of financing, volumes, prices and maturities) since the financial crisis? How do these trends differ across jurisdictions (e.g. advanced vs emerging market economies) and sectors (e.g. high-tech vs traditional firms), as well as by firm size (micro vs small vs medium-sized firms) and age (e.g. start-ups vs mature firms)?**

- Decrease in new lending volumes in recent years: According to the OECD<sup>3</sup>, new lending to SMEs shows a mixed picture with negative growth rates in 2016 for about 60% of the reporting countries. The median growth rate in new **SME lending thus fell from 2.6% in 2015 to -5.6% in 2016**. Despite a wide variety of cases across jurisdictions, new lending to SMEs depicts a more negative picture than in previous years. After a sharp post-financial-crisis decrease in the years 2007-2008 and a subsequent correction with positive new SME lending growth rate in the years 2010-2014, the current period looks more challenging for SME lending.
- Diverse trends across jurisdictions: Across the 78 jurisdictions where WSBI-ESBG members are represented, different trends have been observed regarding SME financing:

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<sup>1</sup> In 2017, SMEs in the EU-28 contributed 57 percent to the aggregate real-economic value added and 66 percent to employment, see European Commission 2018, page 14.

<sup>2</sup> See Alessandrini et al. 2016, page 5, for instance: "The uniformity of regulation penalizes local banks relative to larger banks because the implementation of complex regulation is to a large extent a fixed cost." Likewise, see Koch 2013, Hackethal & Inderst 2015, Schackmann-Fallis et al. 2016, Lange & Paul 2017, Schumacher et al. 2019. For an estimate of additional regulatory costs incurred by US community banks, see Feldman et al. 2013 and Ash et al. 2015, among others.

<sup>3</sup> *Financing SMEs and Entrepreneurs 2018*



- Supported by favorable macroeconomic conditions, savings and retail banks in emerging market economies in **Africa have maintained robust SME lending** activities. Through their decentralized network of branches, the general trend was an increase of SME loans volume especially within the trade segment.
- In advanced economies, and particularly in Europe, the SME lending situation is more diverse. In Germany, the excellent macroeconomic situation has benefited SMEs, which reinforced their equity ratio from 24.2% in 2015 to 28.3% in 2016<sup>4</sup>. It is unclear whether this reinforcement of SME's equity has impacted demand for SME lending. On the other hand, credit conditions have deteriorated in other countries in Europe thus leading to a **decrease in the share of SME lending in total lending portfolio** for several savings and retail banks.
- Support of SME financial instruments: To address the market failure of SME credit gap, **Credit Guarantee Schemes (CGSs)** have proven to be a key instrument to efficiently support SME access to finance. According to the World Bank<sup>5</sup>, more than half of all countries in the world have a CGS for SMEs and the number is growing. WSBI-ESBG supports CGSs policies across jurisdictions as CGSs are financial instruments that are particularly suitable for SMEs that lack collateral and where this lack of collateral is the main impediment for their access to loan finance.

**Q2: What have been the main drivers of the observed trends in SME financing in recent years? How do they differ across jurisdictions, sectors, size and age of firms?**

- Macroeconomic conditions: According to the International Monetary Fund<sup>6</sup>, the rate of real (inflation-adjusted) world GDP growth averaged **3.7%** during the period 2000-2010 and would have been close to 4% if not for the so-called financial crisis. By comparison, the average annual growth rate so far this decade (2010-2018) has been **3.5%**, which is slightly lower than the average rate in the 2000s, but above the **3.3%** rate in the 1980s and 1990s. Dynamic growth in some countries in Asia, South America and Africa supported corporate investments which recovered slowly and unevenly after the financial crisis which in turn stimulated SME demand for loans. The opposite situation has been observed in survey data point in some European countries such as Austria, the Netherlands and the Czech Republic where lower SME credit demand negatively impacted SME financing. A recent slowdown in international trade also weakened the demand for SME loans in both advanced and emerging economies.
- Monetary policy - Low interest rates environment: In response to a low-interest environment, financial intermediaries may have to further diversify their asset portfolios and seek alternative revenue streams by carrying out non-traditional banking activities. The traditional savings and locally focused banks may have more difficulty in asset diversification given their business model. Their profitability is being greatly undermined through a reduction of their profit margins as their business model is centered around the transformation of local savings into loans to retail customers and SMEs. By drawing a large share of their income from interest on loans, savings and retail banks are mechanically affected by any downward trend on loan interest income. **This environment has had a negative impact on SME financing.**

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<sup>4</sup> *Deutscher Sparkassen- und Giroverband e.V. SME Diagnosis 2018*

<sup>5</sup> *Principles for Public Credit Guarantee Schemes (CGSs) for SMEs, World Bank*

<sup>6</sup> *World Economic Outlook October 2018*



- Regulatory framework - increase of risk weights: WSBI-ESBG thinks there is a risk that many banks will no longer be able to perform their **intermediation role** because of higher capital requirements. Inflated risk weights also lead to reduced dividends, impacting long-term savers, as banks would not easily be able to increase their capital through other means. Eventually, the combination of the factors already impeding bank profitability and additional capital requirements will undoubtedly entail, as an undesired consequence, a selective reduction of risk weighted assets and **an increase in banks' costs**, which will need to be passed on to customers, including SMEs, which in many jurisdictions heavily rely on banks to finance their projects.
- Size of financial institutions as a driver of SME financing: The loan portfolio of a small or medium-sized bank with a regional focus differs from that of a major credit institution. The percentage of SME loans in the total loan portfolio, for instance, is significantly higher on the books of smaller banks. Besides, large banks' portfolios tend to be biased against peripheral or economically underdeveloped regions. Recent literature abounds with econometric analyses that confirm and explain such observations. The differences in the composition of the loan books of small versus large banks are mainly due to their organizational characteristics, which are indicative not only of the level of complexity of an institution's business but also of the geographic and social distance between loan applicants and credit decision makers. Those factors determine the operational, functional, sociocultural and cognitive distance between a bank and its customers.
- Complexity of the regulatory framework: The coordination efforts for ensuring financing has increased significantly due to increased demands on banks (documentation requirements, as well as ensuring that customers have the necessary collaterals, etc.). Smaller companies and start-ups especially have issues with those demands. The number of regulatory / legal requirements leads to an overload of the system / increased costs.

**Q3: Have financial regulatory reforms such as Basel III affected bank financing to SMEs (e.g. in terms of loan volumes, prices, maturities and collateralisation)? If so, how? How important have been their effects vis-à-vis other types of bank lending and compared to the main drivers identified in question 2?**

- Support for lower RWA for SME exposure: WSBI-ESBG welcomes the lower risk weight for exposures to corporate SMEs as laid out by the BCBS, as these exposures have low correlation and often more physical collateral than larger corporates. As a matter of fact, WSBI-ESBG even considers that the risk weight (85%) for SMEs could be a little bit lower under the Basel IV framework, in line with European legislation, namely 75%. Otherwise, the combined effect of higher RWAs and higher capital requirements could notably reduce the credit availability for SMEs. At any rate, there should be no national discretion to set the risk weight for SMEs higher than what BCBS proposes in its consultative document.
- Support for capital relief initiatives targeting SME exposure: WSBI-ESBG supports initiatives from banking regulators around the world where capital requirements for SME lending exposures are discounted<sup>7</sup> as it believes that capital relief is a necessary key stimulus to allow banking institutions to provide an adequate flow of finance to SMEs. Granted the significance of

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<sup>7</sup> WSBI-ESBG supports the European Commission's proposal including changes to Article 501 of the CRR in relation to the capital requirements for exposures to small and medium-sized enterprises (SMEs). Lower capital requirements on SME exposures is stimulating SME lending (which remains the most widely source of finance in the EU for SMEs) while the current factor of 0.7619 is properly calibrated regarding credit risk.



bank loans as the main source of finance in many countries, capital relief policy would have a direct positive impact on both SMEs and the real economy in terms of jobs and economic output.

- Adverse effect of the granularity criterion on SME financing: WSBI-ESBG is opposed to a mandatory application of the granularity criterion (0.2% of the overall regulatory retail portfolio) for differentiating between “regulatory retail” and “other retail” exposures. For smaller banks with a small retail portfolio, this criterion would translate into an extremely small maximum exposure amount, substantially undermining their competitiveness. If a bank had a retail portfolio of 200 million euros, for instance, its exposure to a single counterparty could not exceed 400,000 euros. In our opinion, a rule of this kind would have an especially adverse effect on lending to SMEs. Loans to SMEs would become significantly more expensive and/or lending volumes would be significantly reduced. We therefore strongly recommend that it should be possible to demonstrate the diversification of a retail portfolio using methods other than the mandatory verification of the granularity criterion.
- A negative impact of financial sector’s consolidation on SME financing: In cases where two medium-sized credit institutions merge or a large bank acquires a small one, the ensuing loss of local information channels will mostly result in a drop in the percentage of SME loans. The decline in the capture and usage of soft facts is chiefly due to the geographic and cultural distance that mergers or acquisitions put between credit decision makers and those who interact with clients. Empirical data also shows that withdrawing from SME lending does not necessarily lift the profitability of merged institutions as it affects borrowers regardless of their credit standing. Since mergers increase the information asymmetry in credit relationships, the market becomes less functional, which materializes as a mismatch between supply and demand, and resultant deadweight loss.
- Detrimental increasing supervisory practices: Other existing threats to the “boring banking” business model as well as to stability in SME lending arise from gathering quantitative requirements on loan origination and increasingly burdensome regulatory reporting obligations. The growing dominance of an approach to supervision that looks at financial ratios, above all, dismisses the soft facts which are so decisive in SME lending. Moreover, the quantitative approach gives supervisors a false sense of security, blinding them to new risk factors, and tempts supervised institutions to come up with workarounds that make even dubious business practices formally compliant with regulatory thresholds. What would make more sense, then, is a qualitative, subtle supervision that only intervenes when necessary, as laid down under the second pillar of Basel II.
- Regulation negatively affects cost of financing: In our view, financing has become more expensive as a result of regulatory reforms, which does not represent a problem at the current level of interest rates. A problem arises, when new requirements lead to a short-term increase in equity and this results in an excessive reluctance of systemically important banks to underwrite new business. It should be noted that formally, banks must hedge heavily – they are driven by the requirements of the supervisory authorities. This increased bureaucracy for financing is at the expense of the customer’s needs and massively increases the costs for banks.



**Q4: How does the impact (if any) of financial regulatory reforms vary across banks operating in different geographies and with different size and business models?**

- High cost of regulatory fragmentation: According to IFAC (International Federation of Accountants) and Business at OECD (BIAC)<sup>8</sup>, fragmentation in global financial regulation costs more than **USD \$780 billion annually**. Supporting the work of the OECD in improving international regulatory cooperation, WSBI-ESBG has decided to contribute to this survey launched in February 2017 by circulating it to its members. According to WSBI-ESBG members, **prudential requirements, financial reporting and corporate governance** are the most important types of regulations that impact their businesses. They also reported that the approach to these types of regulations was rather consistent in their jurisdictions which can be explained by the fact that WSBI-ESBG members are often subject to only one jurisdiction and that cross-border regulatory fragmentation does not apply in this case.
- Need of proportionality: the case of savings and retail banks in SME financing: WSBI-ESBG and its members have long called for proportionality as a way to achieve better regulation and supervision, which allows financial institutions to carry out their daily activities, such as SME lending, under a non-detrimental regulatory framework which increases the strength of the global banking sector. WSBI-ESBG argues that proportionate banking rules should account for factors such as an institution's size, business model and interconnectedness. Proportionality is needed because savings and retail banks, as members of WSBI-ESBG, have had to adapt to administrative burdens that were originally designed to regulate large global players with a completely different risk profile.
- Safeguarding the diversity of banking business models helps SMEs: Different regulatory regimes for different banking models would help local and regional banks to compete on an equal footing while ensuring compliance with standards being set at international level and help by curtailing the increasingly distortional effects of regulation. This would allow for a level playing field, promote growth – and therefore increase jobs – and in turn contribute to an increase in financial stability worldwide. The big beneficiary of more proportionate regulation will be, inter alia, SMEs, who will have easier access to finance.

**Q5: What other G20 financial reforms or other domestic financial regulations (if any) may have impacted financing to SMEs and how?**

- Adverse impact of IFRS9 on SME lending: IFRS 9 has an impact on banks' provisions and financial statements and may jeopardize macroeconomic growth momentum, as the rise in bank provisions might make it harder for small and medium-sized. SMEs have more difficulties obtaining bank loans under the new standard in some countries. Significant increase of provisions affects operating results and may act as a headwind against the recovering economy. Some banks change the term loans in order to control loan credit risk. Some SMEs have more difficulty obtaining bank loans because of limitations on the credit risk exposure. IFRS 9 can also impose higher interest rate costs to compensate for the higher capital requirements.
- High costs of IFRS implementation for SMEs: The costs of regulation are a burden for entrepreneurs and reduce the number of start-ups and the rate of business growth. Often, the effort of implementing new financial regulations is underestimated – mostly in documenting the

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<sup>8</sup> *Regulatory Divergence: Costs, Risks, Impacts: An International Financial Sector Study, 2018*, [http://biac.org/wp-content/uploads/2018/04/IFAC-OECD\\_Regulatory-Divergence\\_V9\\_singles.pdf](http://biac.org/wp-content/uploads/2018/04/IFAC-OECD_Regulatory-Divergence_V9_singles.pdf)



process and staff training. SMEs are a bit more behind than larger enterprises in IFRS implementation – they were lagging at the beginning and then rushing to the finish line.

**Q6: Have financial reforms prompted a shift in the provision of SME financing, e.g. between banks and other financial institutions (substitution effects)? If so, how?**

- Level playing field required: WSBI-ESBG thinks that the goal for a regulatory approach must be maintaining a level playing field for SME financing providers. FinTech - “Financial Technology” - describes an activity not a specific entity. FinTech is thus being fostered and used by banks just as much as start-ups, IT companies or third-party providers. Considering FinTech firms as different entities can lead to misjudgement in terms of defining a regulatory approach to FinTech activities. The business models of financial service providers thus need to be respected while at the same time ensuring competition law is enacted. This approach would have a positive impact on SME financing as it would ensure fair rules for market participants while offering alternative sources of finance for SMEs.

Capital markets can only complement bank lending: The transaction cost of an SME raising a loan from a bank is substantially lower than that of issuing a bond. Corporate borrowers are subject to less onerous disclosure requirements than bond issuers. This is particularly relevant to family businesses, most of which prefer to keep internal data to themselves. Borrowers need neither an external credit rating nor any expensive issuance support service. Loans are also the instrument of choice for raising smaller amounts. Conversely, it is almost exclusively large enterprises that tap capital markets directly since they are more likely to recover the high fixed cost it involves. For SMEs, there are two more reasons to prefer bank loans to capital market-based funding: transaction cost and corporate governance. Market-based financing involves publication and rating costs, and forces the board, which in most SMEs comprises members of the owning family, to focus on shareholder value and cede a substantial measure of control.

**Q7: Are there any other issues or relevant factors that should be considered as part of the evaluation?**

No



### **About WSBI (World Savings and Retail Banking Institute)**

WSBI represents the interests of 6,000 savings and retail banks globally, with total assets of \$13 trillion and serving some 1.6 billion customers in nearly 80 countries. WSBI focuses on international regulatory issues that affect the savings and retail banking industry. It supports the aims of the G20 in achieving sustainable, inclusive, and balanced growth, and job creation, whether in industrialised or less developed countries. WSBI favours an inclusive form of globalization that is just and fair, supporting international efforts to advance financial access and financial usage for everyone. Learn more at: [www.wsbi-esbg.org](http://www.wsbi-esbg.org)



World Savings and Retail Banking Institute - aisbl  
Rue Marie-Thérèse, 11 ■ B-1000 Brussels ■ Tel: +32 2 211 11 11 ■ Fax : +32 2 211 11 99  
Info@wsbi-esbg.org ■ www.wsbi-esbg.org

### **About ESG (European Savings and Retail Banking Group)**

ESBG represents the locally focused European banking sector, helping savings and retail banks in 20 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESG unites at EU level some 1,000 banks, which together employ 780,000 people driven to innovate at 56,000 outlets. ESG members have total assets of €6.2 trillion, provide €500 billion in SME loans, and serve 150 million Europeans seeking retail banking services. ESG members are committed to further unleash the promise of sustainable, responsible 21st century banking.



European Savings and Retail Banking Group – aisbl  
Rue Marie-Thérèse, 11 ■ B-1000 Brussels ■ Tel: +32 2 211 11 11 ■ Fax : +32 2 211 11 99  
Info@wsbi-esbg.org ■ www.wsbi-esbg.org