BANK POLICY INSTITUTE

March 21, 2019

Via Electronic Mail

Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: SME Financing Evaluation

Ladies and Gentlemen:

The Bank Policy Institute[1] appreciates the opportunity to submit views to the Financial Stability Board on the effects of financial regulatory reforms on the provision of financing to small and medium-sized enterprises (SMEs), and we appreciate the efforts made by the FSB to engage with the industry on this important topic, including the roundtable held in December 2018. BPI is supportive of a bank regulatory framework that appropriately aligns prudential regulatory standards and their associated burdens with the business models and risk profiles of financial institutions. Following the most recent financial crisis, banks have substantially improved both the quality and quantity of regulatory capital and liquidity they hold due to core post-crisis reforms, which we support, and banks have also substantially improved their risk management capabilities. Since the global financial crisis, the aggregate tier 1 common equity ratio of BPI's member banks has more than doubled to 11.7 percent at the end of 2018. In dollar terms, that is an increase in tier 1 common equity from nearly $400 billion to almost $1.2 trillion. Similarly, BPI member banks now hold unprecedented amounts of high-quality liquid assets to ensure that they can survive a period of persistent liquidity stress: cash, U.S. Treasury bonds, and similarly low-risk and highly liquid assets account for about $3.5 trillion or approximately 20 percent of BPI's member bank assets. Given the significant improvements in the resilience of the U.S. banking system, it is appropriate for the FSB to consider the effect of existing rules on credit availability to small businesses.

As detailed throughout this letter, evidence shows that post-crisis regulatory reforms have significantly curtailed the provisioning of credit to SMEs. In the U.S., the largest demonstrable impacts appear to be due to the implementation of stress testing and the GSIB capital surcharge framework, the latter of which was developed as an international standard, although it has been implemented more stringently in the U.S. Importantly, while other nonbank institutions may have increased the supply of credit to SMEs in the post-crisis period, research has shown that there is a significant net reduction in the supply of credit to SMEs.

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[1] The Bank Policy Institute is a nonpartisan public policy, research and advocacy group, representing the nation's leading banks and their customers. Our members include universal banks, regional banks and the major foreign banks doing business in the United States. Collectively, they employ almost 2 million Americans, make nearly half of the nation's small business loans, and are an engine for financial innovation and economic growth.

Large Banks Play an Important Role in Lending to Small Businesses.

Banks of all sizes are integral in providing loans to small businesses, which in turn provide critical financing to help these companies grow and expand. BPI's member banks, which include universal banks, regional banks and foreign banks doing business in the U.S., accounted for more than $130 billion, or close to 60 percent, of small business loans originated by banks in the United States during 2017.[2] While regulatory reform for community banks is necessary to stimulate small business loan growth, in light of the significant amount of small business loans made by large banks, regulatory changes for large banks should be a priority to ensure adequate credit is available for small businesses.

Each quarter all banks in the U.S. report the amounts of various categories of small business loans on their balance sheet on their Call Reports. Based on data as of December 31, 2018 and by defining "small business loans" as commercial real estate loans and commercial and industrial loans with original amounts of less than $1 million and "community banks" as ones with less than $10 billion in total assets, community banks hold 44 percent of commercial banks' outstanding small business loans, with larger banks holding the remainder. The "largest banks", defined as those in holding companies with at least $50 billion in assets, hold about 40 percent of small business loans.[3]

BPI Research on Credit Availability to Small Businesses

BPI has conducted a significant amount of research and analysis over the past two years on the impact of post-crisis regulations on small business lending. In January 2017, BPI issued a research note showing that the U.S. stress tests impose significantly higher capital requirements on small business loans compared to the Basel III standardized approach.[4] First, the note shows that despite the large number of different capital requirements to which large U.S. banks are subject, the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) generally yield the most stringent capital requirements, and therefore are mostly likely to constrain large banks in deciding how to allocate capital. Based on this finding, the note then calculates the implicit capital requirements in the U.S. supervisory stress tests by estimating the risk-weights that would best describe banks' post-stress regulatory capital ratios under the severely adverse scenario, controlling for differences in banks' capital actions. The results indicate that, for banks subject to CCAR, the implicit risk-weights for small business loans under the Dodd-Frank Act Stress Tests are 3.2x higher than those under the Basel III standardized approach, likely influencing bank lending decisions to small businesses.

In May of 2017, BPI published another research note showing that U.S. stress tests are constraining the availability of small business loans secured by nonfarm nonresidential properties, using Call Report data.[5] These loans account for approximately half of small business loans on the books of all commercial banks. In particular, the analysis indicates that subjecting banks to the U.S. supervisory stress tests in 2011 led to a reduction of more than 4 percentage points in the annual growth rate of their small business loans secured by nonfarm nonresidential properties, which translates to a $2.7 billion decrease (about 10 percent) in the aggregate holdings of these small business loans each year on average.

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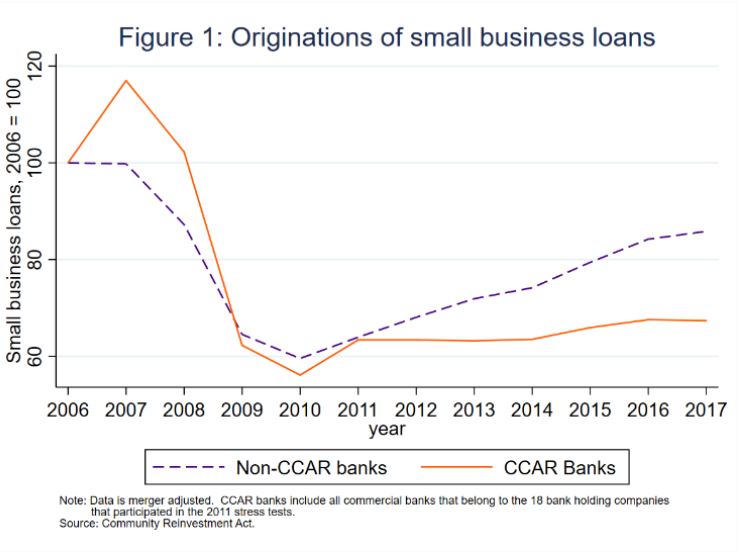
2 Based on small business loan originations collected under the Community Reinvestment Act. This data is only available for banks above $1 billion in total assets.

3 The reason large banks hold a higher share of small business loans originations is because the data on small business loan originations does not include banks below $1 billion in assets, while the Call Reports applies to all commercial banks.

4 *See* Bank Policy Institute Underwritings Blog, *The Capital Allocation Inherent in the Federal Reserve's Capital Stress Tests* (January 2017), available at https://bpi.com/wp-content/uploads/2018/07/20d957fe6fdc4607b5c24eb8506a5de5.pdf.

5 The results of the research note are available in Covas, Francisco, *Capital Requirements in Supervisory Stress Tests and Their Adverse Impact on Small Business Lending, BPI Working Paper (January 2018).*

In addition, BPI more recently analyzed data collected under the U.S. Community Reinvestment Act (CRA) on small business loans.[6] The CRA data includes small business loan originations for commercial and industrial loans and loans secured by nonfarm nonresidential properties with commitment amounts less than $1 million and from banks with more than $1 billion in consolidated assets. For purposes of the analysis, BPI divided the commercial banks in the CRA data into two groups: (i) the eighteen banks subject to CCAR in 2011; and (ii) the remaining commercial banks included in the CRA sample (banks above $1 billion in total assets). For the banks that are subject to CCAR, we then adjusted the sample for mergers to be able to construct consistent time-series. By deconstructing the CRA data sample in this way, we were able to see the impact that CCAR has on the provision of credit to small businesses.



As shown in Figure 1, originations of small business loans from banks subject to CCAR (orange line) remained depressed after 2010 and are at approximately 65 percent of their 2006 level. In contrast, small business originations for banks not subject to CCAR – the dashed purple line – recovered somewhat more significantly in the post-crisis period and are more than 80 percent of their pre-crisis level. As noted by Chen, Hanson and Stein (2017), the very largest banks are an important driver of the depressed level of small business originations at CCAR banks; the capital surcharge for global systemic banks could also be an important explanation for this finding.[7]

Impact on Small Business Loan Originations to Low-and-Moderate Income Neighborhoods in the U.S.

Another important question to consider is how post-crisis regulations are impacting the availability of small business loans in low-and-moderate income (LMI) neighborhoods. The lack of credit availability to small businesses in LMI communities could have important implications for the widening of wealth inequality over the post-crisis period. Utilizing the same CRA data, BPI analyzed small business loan originations in LMI neighborhoods at banks subject to the U.S. stress tests (CCAR) and those that are exempted (non-CCAR), shown in Figure 2 (below).[8] The CRA incentivizes banks to originate small business loans in LMI neighborhoods and the chart shows that approximately 25 percent of small business loan originations are made in LMI neighborhoods. Although the share of small business

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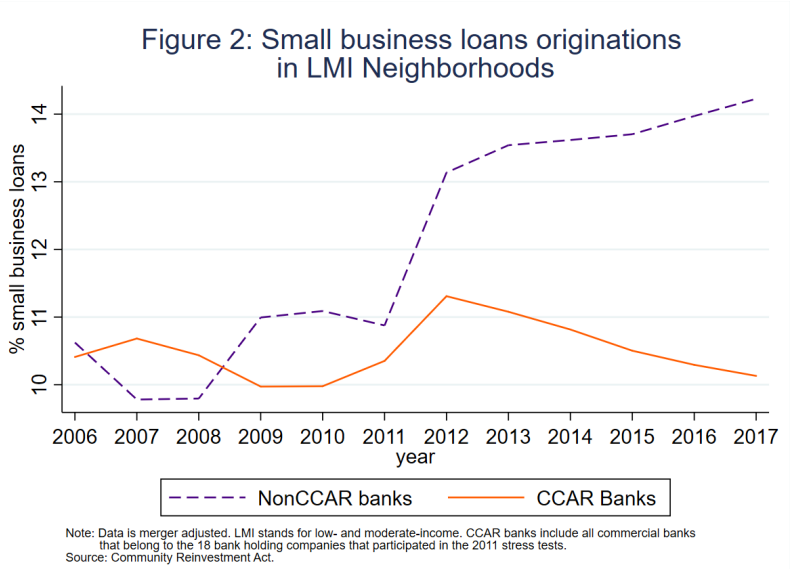
6 The CRA was enacted in 1977 to encourage insured banks to meet the credit needs of the communities in which they operate, especially low- and moderate-income neighborhoods.

7 *See* Chen, Brian, Samuel G. Hanson and Jeremy Stein, *The Decline of Big-Bank Lending to Small Business: Dynamic Impacts on Local Credit and Labor Markets*, NBER Working *Paper No. 23843 (September 2017).*

8 LMI neighborhood is defined as a census tract in which total income is less or equal than 80 percent of the median family income. Between 2011 and 2012, there was a significant change in the census-tract geographic designations and therefore in the number of tracts that are classified LMI.

loans made in LMI neighborhoods by CCAR banks initially recovered post-crisis, it has been steadily declining since 2012. In contrast, the share of small business loan originations in LMI neighborhoods by banks not subject to CCAR have increased since 2011.[9]



Survey Evidence on Credit Availability to Small Businesses

In April 2018, the Federal Reserve published its nationwide survey of small business credit conditions, the Small Business Credit Survey (SBCS), which reported widespread evidence of tight credit conditions for small businesses using firm responses collected in the second half of 2017.[10] According to the results of the SBCS, approximately 30 percent of small businesses reported not having all of their borrowing needs satisfied. More specifically:

- About 64 percent of small businesses mentioned having faced financial challenges over the past 12 months.
  - Of those, approximately 30 percent cited lack of credit availability or ability to secure funds for expansion as a reason.
  - About 67 percent of those firms with financial challenges said they used owners' personal funds to address this problem.
- About 40 percent of small businesses applied for financing over the past 12 months. Of those that applied for credit, 23 percent received none of the funds requested and 32 percent received only some portion of what they requested.

Notably, credit availability for small businesses is tighter at large banks that are subject to the highest capital and liquidity regulations. At large banks (defined in the survey as banks with at least $10B in total deposits), approval rates were just 56 percent for small businesses with less than $1M in revenues. In contrast, community

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9 BPI expects to finalize this research later in the year.

10 *See* Federal Reserve Banks of Atlanta, Boston, Chicago, Cleveland, Dallas, Kansas City, Minneapolis, New York, Philadelphia, Richmond, St. Louis and San Francisco, Small Business Credit Survey (April 2018), available at https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2018/sbcs-employer-firms-report.pdf.

development financial institutions[11] and small banks (those with less than $10 billion in total deposits) reported approval rates of 88 percent and 68 percent, respectively. This fact is significant because large banks originate a sizable share of small business loans that cannot realistically be replaced by smaller banks.[12] As noted earlier, some of the restrictions on small business lending can be attributed to CCAR stress testing and other capital requirements such as the GSIB surcharge.[13] Lastly, although there is no comprehensive data source on nonbank lending to small businesses, the survey evidence provided by the 2017 and 2018 SBCS indicates that small businesses are increasingly turning to nonbanks. Specifically, about 21 percent of small business credit applicants applied to online lenders in 2016 and 24 percent applied to online lenders in 2017.

In August 2017, the Federal Reserve published a report based on the April 2017 SBCS that finds evidence of very tight credit conditions to startups (i.e., small businesses with 5 years or less).[14] Startups account for about one-third of small businesses and play a key role in U.S. innovation and productivity. According to the results of this survey, approximately 50 percent of startups reported not having all of their borrowing needs satisfied. This number is 65 percent higher than the share of small businesses that were reported not having all of their borrowing needs satisfied in the first report and 12 times higher than the often-cited share indicated by the responses obtained from the National Federation of Independent Business (NFIB) small business survey. In addition, credit conditions to startups are tighter at larger banks, which are the ones subject to more stringent capital regulation. More specifically:

- About 70 percent of startups indicated that they faced financial challenges in the prior 12 months.
  - Approximately 55 percent cited lack of credit availability or ability to secure funds for expansion as a reason.
  - About 80 percent of startups with financial challenges said they used owners' personal funds to address the problem.
- 52 percent of startups applied for financing over the past 12 months (the large majority was for a loan or a line of credit).
  - Of those that applied for credit, 28 percent received none of the funds requested and 41 percent received only some portion of what they would like.
  - Of the remaining 48 percent of startups that did not apply for financing, about one-quarter did not apply because they thought they would be turned down (discouraged firms).
- Credit conditions to startups are tighter at large banks.
  - Approval rates at large banks were just 26 percent for medium/high credit risk startups.
  - Online lenders and small banks reported having approval rates of 45 percent and 35 percent for medium/high credit risk startups, respectively.

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11 Community development financial institutions (CDFIs) are financial institutions that provide credit and financial services to underserved markets and populations. CDFIs are certified by the CDFI Fund at the U.S. Department of the Treasury.

12 *See* Bank Policy Institute Underwritings Blog, *Myth versus Reality on Small Business Lending* (March 24, 2017), available at https://bpi.com/myth-versus-reality-on-small-business-lending/.

13 *See also* Bank Policy Institute Underwritings Blog, *The Capital Allocation Inherent in the Federal Reserve's Capital Stress Tests* (January 2017), available at https://bpi.com/wp-content/uploads/2018/07/20d957fe6fdc4607b5c24eb8506a5de5.pdf.

14 *See* Federal Reserve Banks of Atlanta, Boston, Chicago, Cleveland, Dallas, Kansas City, Minneapolis, New York, Philadelphia, Richmond, St. Louis and San Francisco, *Small Business Credit Survey, Report on Startup Firms (August 2017),* available at https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-StartupFirms-2016.pdf. The SCBS published in April 2018 has some information on startups, but the 2017 report contains a more extensive questionnaire.

Academic Literature on the Impact of Regulatory Reforms on Credit Availability to Small Businesses

Several academic papers have reached the conclusion that post-crisis reforms have caused a reduction in the availability of credit to small businesses in the United States. A study by Acharya, Berger and Roman (2018) finds that banks subject to the stress tests have reduced the supply of credit to borrowers with less than pristine credit scores or cyclical firms, including small businesses.[15] Specifically, the paper uses a difference-in-difference (DID) methodology to evaluate the impact of stress tests on small business loan originations using both CRA and Call report data. The DID methodology compares the behavior of banks in the treatment group (banks subject to stress tests) and in the control group (other banks) and it is commonly used in the banking literature. The advantage of this approach is by analyzing the difference between bank groups; the results are robust to omitted factors that affect the treatment and control groups at the same time, such as changes in demand from small businesses.

Chen, Hanson and Stein (2017) attribute the decline in small business loan originations by the largest banks immediately after the crisis to the U.S. stress tests, the global systemically important capital surcharge and anti-money laundering requirements ("know your customer" or KYC). Chen et al (2017) also show that the decline in in small business originations cannot be explained by a shift in loan demand (e.g., if large banks were disproportionally located in communities hit the hardest by the financial crisis), because their analysis looks at small business originations by large and small banks operating in the same community, thus controlling for changes in loan demand.

Cortés, Demyanyk, Li, Loutskina and Strahan (2018) also find that banks most affected by the stress tests reduced their supply of business loans by increasing loan rates and shifting their portfolios towards safer loans.[16] However, they also show that stress tests did not reduce aggregate lending to small businesses because smaller banks stepped in to fill the void left by large banks. An important limitation of their results is that the analysis starts in 2012, which is after the pronounced decline in originations of small business loans (as shown in Figure 1) so their findings could also be a result of the lack of a recovery of small business lending over the post-crisis period.

Lastly, Bordo and Duca (2018) find that an increase in regulatory compliance requirements brought by the Dodd-Frank Act (DFA) reduced the incentives for banks of *all* sizes to originate small business loans.[17] Using commercial and industrial loans from 1993-2017, they show the decline in small business loans can almost all be attributed to change in banking regulation, even after controlling for cyclical effects and bank size. In addition, the paper also reports a tightening of credit standards to small versus large businesses and a reduction in business formation post-DFA.

Although data availability on small business lending by nonbanks is scarce, the results of the paper by Chen, Hanson and Stein (2017) – which use PayNet's proprietary data that includes loan originations by both banks and nonbanks – show that there has been a contraction of aggregate supply of credit to small businesses, even considering the nonregulated sector such as online and payday lenders.

The Definitions of SME and Capital Treatment of SME Exposures are Country Specific

The precise definition of what constitutes an SME can vary significantly across countries. The absence of a common definition complicates the current SME financing evaluation across all jurisdictions, making it difficult to conduct direct comparisons. Even within a single jurisdiction, there may be multiple definitions for SME that are used for different purposes. Additionally, some jurisdictions offer a preferential capital treatment for exposures to SMEs,

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15 Acharya, Viral V., Allen N. Berger, Raluca A. Roman, *Lending Implications of U.S. Bank Stress Tests: Costs or Benefits?,* Journal of Financial Intermediation (April 2018).

16 Cortés, Kristle, Yuliya Demyankyk, Lei Li, Elena Loutskina, Philip Strahan, *Stress Tests and Small Business Lending,* Journal of Financial Intermediation (Forthcoming, 2019).

17 Bordo, Michael and John Duca, *The Impact of the Dodd-Frank Act on Small Business,* NBER Working Paper No. 24501 (April 2018).

while others offer no such benefit, further complicating attempts to measure the impact of regulatory reform on SME financing.

The Basel Committee on Banking Supervision defines an SME as a corporate exposure where the reported annual sales for the consolidated group of which the corporate counterparty is a part is less than or equal to €50 million for the most recent financial year.[18] Under Basel II and Basel III's internal ratings-based (IRB) approach, banks are permitted to distinguish between exposures to SME borrowers and to apply a firm-size adjustment lowering the risk weight compared to those exposures to larger firms. Under Basel III's standardized, regulatory retail SMEs receive a risk weighting of 75% and unrated exposures to corporate SMEs receive a risk weighting of 85%, while corporate exposures generally receive a higher risk weight of 100%. The BCBS issued their final Basel III reforms in December 2017, however they have not yet been implemented in any Basel member jurisdiction.

The EU defines an SME as a firm that employs less than 250 workers and has a turnover of less than €50 million, or a balance sheet of less than €43 million.[19] For purposes of defining the capital treatment for exposures to SMEs, under the Capital Requirements Regulation (CRR) currently applicable in the EU, SME is defined in accordance with the EU definition above, except that the balance sheet total does not factor into the determination. Exposures to SMEs below €1.5 million receive a 23.81% discount in their risk weighting.[20] The CRR further notes that "credit institutions should effectively use the capital relief produced through the application of the supporting factor for the exclusive purpose of providing an adequate flow of credit to SMEs established in the Union."[21] Under CRR II, which upon finalization will replace the existing CRR, the €1.5 million threshold will be increased to €2.5 million, and SME exposures above €2.5 million will receive a 15% discount.[22]

In the U.S., the FFIEC's Reports of Condition and Income (Call Reports) define small business loans as those secured by nonfarm nonresidential properties and commercial and industrial loans, in each case with original amounts under $1 million. All of the academic papers described herein use this definition and the paper by Chen, Hanson and Stein (2017), which uses the PayNet data, restricts the data to borrowers whose total outstanding loans in the PayNet database (potentially across multiple loans) are less than $2 million at a given point in time. The U.S. Small Business Administration however, which has the authority to define small business size standards, utilizes definitions based on receipts (i.e., revenue) or the number of employees, each of which can vary depending on the industry. The U.S. International Trade Commission in a 2010 publication on the participation of SMEs in U.S. exports defined SMEs as firms that employ fewer than 500 employees and further classifies businesses in the farming and exporting sector by annual revenue. According to a recent Small Business Lending survey published by The Federal Deposit Insurance Corporation, the $1 million loan-size proxy of an SME likely understates lending to SMEs in the United States.[23] That said, to the extent that the underestimation is time-invariant (with the exception that the loan limit is not inflation-adjusted), the results summarized in this letter should not be significantly impacted by the U.S. definition of a small business loan. It should also be noted that the U.S. proxy does not capture small business

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18 Basel Committee, Basel III: Finalising Post-Crisis Reforms (Dec. 2017) at 43 available at https://www.bis.org/bcbs/publ/d424.pdf.

19 Article 2 of the Annex of Recommendation 2003/361/EC available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32003H0361&from=EN.

20 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575&from=en.

21 Id.

22 Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements and amending Regulation (EU) No 648/2012, available at: http://data.consilium.europa.eu/doc/document/ST-6614-2018-INIT/en/pdf.

23 Federal Deposit Insurance Corporation, Small Business Lending Survey (October 2018), available at https://www.fdic.gov/bank/historical/sbls/full-survey.pdf.

lending secured by residential real estate, so it understates materially the decline in small business lending caused by the fall in house prices experienced during the 2007-2009 financial crisis. The U.S. capital regulations do not have a definition for SMEs as there is no distinct risk-weight in the U.S. for SME exposures.

Given the disparity in the definitions of SMEs as well as the related regulatory capital treatment, it is important that the FSB take these differences into account as part of its current evaluation. If the evaluation does not correct for both the differences in the applicable definitions of SME across (and in some cases within) jurisdictions, as well as the differences in capital treatment applicable to exposures to SMEs, it will result in a less robust analysis that does not provide an accurate assessment of the impact of the regulatory reforms on SME financing.

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The Bank Policy Institute appreciates the opportunity to comment on the SME financing evaluation and looks forward to continuing the discussion on this important issue, including by reviewing the draft report. If you have any questions, please contact the undersigned by phone at 646-736-3961 or by email at brett.waxman@bpi.com.

Respectfully submitted,

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Bank Policy Institute

cc: Michael Gibson
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