Business at OECD (BIAC) feedback on FSB consultation on:
The effects of financial regulatory reforms on SME financing

Questions 1:

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)?

- Interesting are not the volumes per se, but how the volumes have been created.

- On the one hand, the reforms have increased the risk weighting and hence the pricing, thus reducing the credit to SMEs. On the other hand, countries have implemented policies (e.g. guarantee schemes, the Funding for Lending Scheme (FLS) in the UK, etc.) to compensate for the unintended consequences caused by the increase risk weighting.

- [Note that the discussion on prescribed risk weights relates to non-AIRB banks, while increased risk weighting would not be an issue for AIRB banks. While AIRB banks can compete on price, they are however less likely to be willing/able to fund SMEs. Non-AIRB banks are arguably better positioned to fund SMEs, but for such banks standardized risk weight make pricing prohibitive.]

Questions 2:

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?

- The US has announced its intention to recalibrate post-crisis regulation in banking, capital markets and asset management, while part of Europe and the rest of the world continue to be under pressure to further de-risk. This creates a major un-level playing field for the financial sector and for the financing of the economy; one of the factors that leads to regulatory fragmentation. Therefore, there is an urgent need to address the risk of divergence in regulatory agenda.

- A poll conducted by the International Federation of Accountants and *Business at OECD* (BIAC), involving more than 250 executives from around the world, suggests that different regulations costs businesses more than USD 780 billion. The burden translates in different barriers to financial institutions' international growth , impacting liquidity of Emerging Market debt, as well as bank lending to corporates and specialized lending.

- Consistent policy implementation plays an essential role in mitigating any unintended consequences of policies and regulations. A new dialogue system should formalize the current ad hoc approach to consultation and discussion and seek to address upfront any possible unintended consequences from conflicting regulatory objectives. (The B20 have suggested that an international principles-based implementation process for financial regulation should be introduced, possibly based on a Multi-Party Implementation Agreements (MPIA) model for regulatory cooperation. This also provides opportunities for cross-border consultation and mutual recognition.)

Questions 3:

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?

- Since the global financial crisis overall minimum capital levels have increased. In addition, risks weights on several loan classes have increased. This means that, all other things being equal, bank needs to hold more capital to support their loan book.

- To meet higher capital requirements, banks must either raise new capital by issuing securities (usually common equity), or by shrinking their loan book by reducing lending.

- In countries such as Canada, Australia and the US, where banks have been able to raise capital readily, they have been able to adapt to new capital standards without reducing lending. But it does have an effect on the price of credit because holding capital is a cost to lenders.

- In countries where banks have had more difficulty raising capital (several European countries), banks had often to reduce lending to business in order to meet higher capital standards.

- Finally, while the IFC estimates that the benefits of the G20 reform exceed its costs, the reform could nevertheless produce cross-border adverse spillover effects to emerging and developing economies that are not required to implement these types of reforms themselves, but relate to their implementation in other markets.

- Looking forward, we need to consider the economic consequences of the extremely high risk weights applied to venture capital investment and similar forms of more speculative financing that emerging businesses rely upon for growth.

- If the objectives of governments is to promote the growth of these sectors then they will need to consider whether bank capital standards and risks weights need to be better aligned with this objective.

Further details:

- Equity funds: For banks investing in equities through a collective investment undertaking (such as BGF in the UK), if the portfolio is sufficiently diversified, the shareholding is risk-weighted at 150%-190% under the EU Capital Requirement Regulation (CRR). This has enabled banks investing in such funds to take a long-term view on returns and build a broad-based, patient capital business.

- Unintended Consequences of new Regulation: Under the Basel 3 reforms, the risk-weight for most equity investments is set at 250% – already a material increase on the current CRR – but this is increased further to 400% for venture capital investments. The definition of venture capital is unclear, and the Basel guidelines do not follow the European model in providing lower risk-weightings for diversified portfolios, despite strong academic research and practical experience confirming that this is the case.

- In certain countries, a particular issue relates to a lack of competition in the small business lending market, which is keeping interest rates on small business loans relatively high, and, in turn, inhibits the expansion of small businesses (e.g. the case in Australia over the last decade).[1]

Questions 4:

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

- It is critical to ensure that implementation of the regulatory framework allows banks to continue to support economic growth. The G20 Hamburg Communiqué restated the objective "to finalize the Basel III framework without further significantly increasing overall capital requirements across the banking sector, while promoting a level playing field". However, the recently published Basel reform package, while providing additional regulatory certainty for the global industry, fails the G20 mandate, as:

    - It creates further unintended consequences,

    - The capital and liquidity frameworks are applied differently across jurisdictions.

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[1] A lack of appetite for riskier small business loans since the global financial crisis and tighter lending standards by the Australian Prudential Regulatory Authority (APRA) in more recent times has made it increasingly difficult to access finance for small business owners. Around 80% of small business loans are currently held by the country's four major banks at markedly higher interest rates than those paid by their larger peers.

Questions 5:

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

- Here one important example is IFRS 9.

- The key challenge is that it front-loads provisions (also when not required) creating an incentive for short-term tenors vs longer terms investments. Under IFRS 9 the ideal is a 1-year tenor. Anything longer gets Lifetime EL under Stage 2, so having the following impact: unclear why any bank should do longer term lending, as it may wait for a great extent on the Balance Sheet under Stage 2 (which is not real default, but only alleged deterioration).

- IFRS 9 (its Stage 2) is significantly pro-cyclical, as in face of a downturn it will force banks to reduce balance sheets and thereby taking away resources when most needed to support the economy and customers in an increasingly challenging environment.

- Implementation is significantly inconsistent cross-border, but also within each country across different forms. Modelling is significantly different and all depends on parameters used rather than actual deterioration which it is meant to capture. Finally, all capital planning of banks is meant through the cycle, where IFRS 9 is meant point in time, which exacerbates the pro-cyclicality.

Questions 6:

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?

- Yes, from highly regulated banks to non-regulated shadow banks. Potential issues relate to the weak regulation and rapid growth of the latter. The same applies to non-regulated funds. There is a clear risk that the next crises will be triggered by these entities.

- The post-crisis banking regulation action plan led to a new norm where less risk is carried by banks, but more by market participants; for example the Governor of Banque de France commented that the main issue now is no longer the solvency of banks, but the liquidity of non-banks.

- Shadow banking has risen from $73 trillion of assets in 2007 to $92 trillion in 2015 – i.e. 150% of total GDP in the jurisdictions monitored by the FSB. This reflects the combination of rising leverage across the global economy together with some concerning developments in the specific ways in which credit is being extended in certain markets and countries.

Question 7:

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

- Work needs to done internationally to converge on a definition of SMEs and to then set up the right infrastructure at both the international level and domestic level to have good data for proper monitoring.

- Structural vulnerabilities from certain asset management activities, shadow banking, digital and cybercrime call for a need to refocus the banking regulation to foster the financing of the economy, while addressing new sources of financial instability: same activity, same risks, same regulation. This is a crucial step, as regulation today is still tackling the weaknesses of the last financial crisis, rather than getting ready to address the systemic vulnerabilities of the next one. The risk is that "generals may be preparing to fight the previous war".

- It should also be noted that each country is unique and solutions will ultimately be local. The FSB could encourage countries to set up domestic mechanisms to bring together banks, SME representatives and governments to discuss the issues under the FSB remit in their countries and report back solutions to the FSB during a certain timeframe.

Finally, please note that the comment period for this consultation is very short and more time would be appreciated in order to provide more substantive comments on this important topic.