

2019.08.02

**FRENCH BANKING FEDERATION RESPONSE TO THE CONSULTATIVE  
DOCUMENT ON EVALUATION OF THE EFFECTS OF FINANCIAL REGULATORY  
REFORMS ON SME FINANCING**

*The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorised as banks and doing business in France, i.e. more than 340 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 340,000 people in France and around the world, and serve 48 million customers.*

The FBF welcomes the opportunity to share its comments on the FSB consultative document on evaluation of the effects of financial regulatory reforms on SME Financing. Please find our main comments below.

Small and medium-sized corporates are key drivers for growth and job creation. This evidence is recognised by European Authorities in their workplan to establish a Capital Markets Union for example.

The steady improvement of access to bank financing for SMEs would not have happened so rapidly without the relief provided by the European regulation (cf. SME supporting factor set up in article 501 of regulation 575/2013 - CRR).

As a matter of fact, French banks have continuously granted loans to SMEs to support their development and investment projects. Following the implementation of the Supporting Factor, in particular, the decline in loans granted to SMEs was clearly reversed.

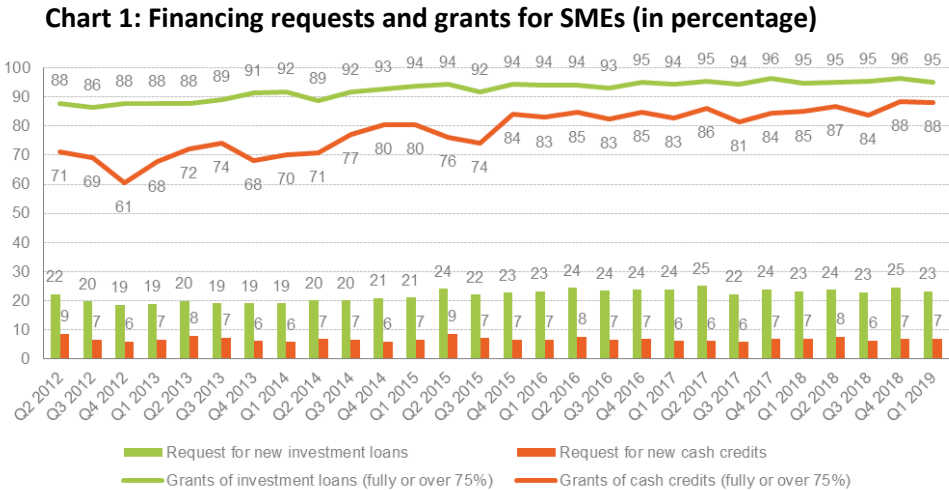
In particular, a recent paper by economists from Banque de France<sup>1</sup> finds significant positive effects of the SME Supporting Factor (SME SF) on credit volumes.

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<sup>1</sup> Sandrine Lecarpentier & Mathias Lé & Henri Fraisse & Michel Dietsch, 2019. "Lower bank capital requirements as a policy tool to support credit to SMEs: evidence from a policy experiment," EconomiX Working Papers 2019-12, University of Paris Nanterre, EconomiX

In this study the authors find evidence showing that the SF has been effective in supporting bank lending to targeted SMEs. First, they show that eligible exposures have increased by 5% to 10% on average as compared to ineligible exposures after the implementation of the SME SF (vs. before the reform) depending on the specification. In the most conservative estimation including group specific trends, they still find that the SME SF has boosted eligible exposures by 2%. This average effect is corroborated to various robustness checks. They find that the magnitude of the effect of the SME SF has increased over time: the effect is almost zero in the first year after the entry into force of the SME SF but it has then intensified to reach a magnitude of 8% to 10% two years after the entry into force. At the same time, they do confirm that the trends of eligible and ineligible exposures did not diverge in a significant way before the reform. They identify this effect by exploiting the €1.5m limit for the bilateral exposures and conduct a diff-in-diff analysis taking the exposure of SMEs above the €1.5m threshold as a control group. The analysis conducted by the EBA in 2016 (“EBA report on SMEs and SME supporting factor”, March 2016) was arguably less likely to identify the causal effect of SME SF due to the nature of the data used. The control group in their analysis was made of large enterprises whereas there is clear evidence that the credit dynamics of those firms can markedly differ from the one of SMEs.

Furthermore, the acceptance rate for loan applications has always remained high during the crisis and further increased after the implementation of the Supporting Factor.



Source: Banque de France

Nevertheless, it is important to recall that RWA is a key parameter in the allocation of their resources by banks. In Europe, Credit Risk RWAs are by far the largest. Also, a detailed breakdown of Credit Risk RWA shows that the largest line item is Corporate RWA.

Should banks need to reduce their total RWA, banks management might challenge credit activities (implying a strong reduction of the volumes of loan granted and an increase in the cost of financing for clients).

Yet, the revised Basel 3 framework is likely to have a significant negative impact on SMEs’ RWA :

- Should the European supporting factor be removed for IRB exposures, RWA would automatically increase by 31%.
- The Standardized Approach must also be examined not least because of its connection with the output floor. It is important to consider that the scope of application of the risk weight proposed by the Basel Committee for SME exposures (85%) is limited to unrated SMEs and remains much smaller than the scope of application of the European current SME supporting factor which also applies to retail SMEs or SME exposures secured by a mortgage on commercial properties. Therefore, a full alignment with the Basel proposals would result in a significant increase in SMEs' Risk-Weighted-Assets (RWA) in Europe.
- Moreover, the output floor corresponds to 72,5% of the total risk weighted assets calculated using only the standardized approaches listed in the Basel revised framework. Therefore the revised standardized approach may have unintended consequences by increasing significantly the RWA for all SMEs transactions (direct impact for banks applying the standardized approach and through the output floor for IRB banks).

For example, we estimate<sup>2</sup> that the SMEs loans spread could increase between 15 and 67 basis points because of the output floor. For French SMEs, this represents an increase between 10% and 40% in the average interest rate on new loans. In addition, should the SME supporting factor be removed, the loans interest rates would rise by 85 basis point. This represents a rise of over 54% in the financing cost.

Finally, Corporates (inc. SME) are likely to suffer restrictions on the availability of many banking services and products needed to support their activities (guarantees, credit facilities etc...). In such, it is essential to reflect at an European level on the treatment of unrated corporate in the Basel III framework as well as the necessity to keep the application of SME supporting factor in CRR2 modalities.

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<sup>2</sup> Cf annex

## Annex: Impact assessment of the regulatory measures on SMEs financing cost

As part of the "finalization of Basel III", the introduction of the output floor could, according to our estimates, lead to an increase in the cost of credit for French SMEs between 0.15 and 0.67 percentage points. In other words, the average interest rate on new loans to SMEs (1.58% in May 2019 according to the Banque de France) would increase by 10 to 40%. Assuming the removal of the SME supporting factor, the rise in the cost of borrowing could reach 0.85 percentage points in the worst case, which would represent a 54% increase.

This estimation results from the transposition to the French case of the model used by the Basel Committee to assess the long-term economic impact of the implementation of Basel III (BCBS, 2010)<sup>3</sup>. Our impact study focuses only on the effects of the introduction of the output floor and the potential withdrawal of the SME supporting factor as recently recommended by the EBA<sup>4</sup>. By convention, we assume that the size of bank balance sheets is constant. The increase in regulatory capital (CET1) is assumed to be exogenous. The additional capital replaces other less expensive sources of financing. Wider lending spreads and lower dividend payouts contribute to banks' ability to use retained earnings to build capital (Cohen, 2013<sup>5</sup>), as the issue of new shares is unlikely with current price-to-book ratios. Apart from this substitution, the structure of bank balance sheets is assumed to be unchanged, identical to that observed over the past three years on average. This is a low range estimate. The rise in the interest rate on new loans is likely to be even greater than that estimated as long as credit flows to French SMEs do not fully renew the outstanding stock of loans (whose average maturity is close to four years). The theoretical literature suggests that as leverage declines, the riskiness of banks' equity declines as well, and so does the rate of return investors required to hold equity. This is the well-known Modigliani-Miller (M-M) theorem on the irrelevance of the capital structure for the value of the firm. The M-M effect is taken into account in the range estimated by the ECB (2011)<sup>6,7</sup>.

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<sup>3</sup> BCBS, 2010, *An assessment of the long-term economic impact of stronger capital and liquidity requirements*, Bank for International Settlements, August 2010, <https://www.bis.org/publ/bcbs173.pdf>

<sup>4</sup> EBA, 2019, *Call for advice on Basel III implementation*, Public hearing, 2 July 2019, <https://eba.europa.eu/documents/10180/2733006/EBA+Public+Hearing+-+2+July+2019+-+Basel+III+Call+for+Advice.pdf>

<sup>5</sup> Cohen, B.H., 2013, *How have banks adjusted to higher capital requirements?*, BIS Quarterly Review, September 2013

<sup>6</sup> ECB, 2011, *Common equity capital, banks' riskiness and required return on equity*, Financial Stability Review, December 2011, <https://www.ecb.europa.eu/pub/pdf/fsr/financialstabilityreview201112en.pdf?219921fe8e58fd3418d7ed7581d1583c>

<sup>7</sup> Based on a sample of large international banks, the ECB's assessment supports the existence of a sizeable, but not full, M-M effect. An increase in the equity ratio (a decrease in leverage) is associated with a decline in both the riskiness of the bank (as proxied by the equity beta) and the required return on its equity (as proxied by the earnings yield). The estimates range between 41% and 78% of what would be predicted under a full M-M effect.

Modigliani-Miller effect <sup>8</sup>	Impact of the introduction of the output floor on the average interest rate on new loans to SMEs (in percentage points)		
	SME supporting factor maintained	SME supporting factor removed	Removal of the SME supporting factor and introduction of the revised Basel III framework for SA (a 75% RW for retail SMEs and an 85% RW for corporate SMEs) (EBA Recommendation CR 2)
Null	0.67	0.83	0.85
Moderate	0.40	0.49	0.50
High	0.15	0.18	0.19

Data sources:

Average risk-weighting of SME exposures: EBA (2018) EU-wide transparency exercise, <https://eba.europa.eu/risk-analysis-and-data/eu-wide-transparency-exercise/2018/results>  
Balance sheet and income statement items: ECB Supervisory banking statistics, <https://www.bankingsupervision.europa.eu/banking/statistics/html/index.en.html>

Settings:

Target return on equity<sup>1</sup>: 10%  
Common Equity Tier 1 (CET1) ratio<sup>2</sup>: 14.01%  
Interest rate on deposits<sup>3</sup>: 0.73%  
Cost of short term debt<sup>4</sup>: -0.305%  
Cost of long term debt<sup>4</sup>: 0.939%  
Average maturity of SME loans<sup>5</sup>: 3.9 years

<sup>1</sup>Banks publications

<sup>2</sup>ECB Supervisory banking statistics, 2016-2018 average CET1 ratio of the 11 significant French banks (directly supervised by the ECB)

<sup>3</sup>Banque de France, 2016-2018 average interest rate on outstanding amounts of bank deposits (of non-financial corporations and households)

<sup>4</sup>Datastream, 2016-2018 average Euribor 3M rate (for cost of short term debt) and 2014-2018 average of CDS 5 years + 5 years swap rate (for cost of long term debt)

<sup>5</sup>BNP Paribas calculation, based on Banque de France data

<sup>8</sup> We consider the ECB's estimated range of the M-M effect. A full M-M effect implies that when the capital ratio doubles (from 5% to 10% for example), the beta should decline by half (from 1.1 to 0.55). In the ECB study, the empirical data show that if the equity ratio goes up by 5 percentage points, the beta will fall by 0.225. Given that with a full M-M effect, the beta would fall by 0.55, this implies a M-M effect of 41% (0.225/0.55). This is the "moderate" M-M effect. ECB computations also imply that the reduction in the risk premium on bank equity is around 78% of the reduction expected under a full M-M effect. This is the "high" M-M effect.