

2019.03.18

## **FRENCH BANKING FEDERATION RESPONSE TO 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 service 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 and our detailed feedback within our answers to the FSB's questions.

### **1. General Comments**

The FBF reiterates its support for a stable and resilient global financial system, while facilitating economic growth.

However, we believe that Basel 3 reform (a/o dec 2017) and other recent regulatory or supervisory initiatives (such as the EBA program on IRB framework, the European measures tackling NPLs, IFRS 9 or European microprudential as well as macroprudential supervisory scrutiny measures) raise some major concerns for SME financing that need to be addressed by the FSB. Indeed, today these measures have no visible impact on SMEs financing for two main reasons: banks protect their domestic markets and they benefit from (temporary) favourable monetary conditions. This situation is certainly going to evolve if the announced measures are not streamlined in order to alleviate the cost for banks of this obligation to support their domestic economies.

Therefore the focus should be now on the assessment of the future (permanent) effects of these measures on SMEs financing. That is to say, the issue is not today but tomorrow and a comforting Report on what currently exists could potentially lead to overlook future threats.

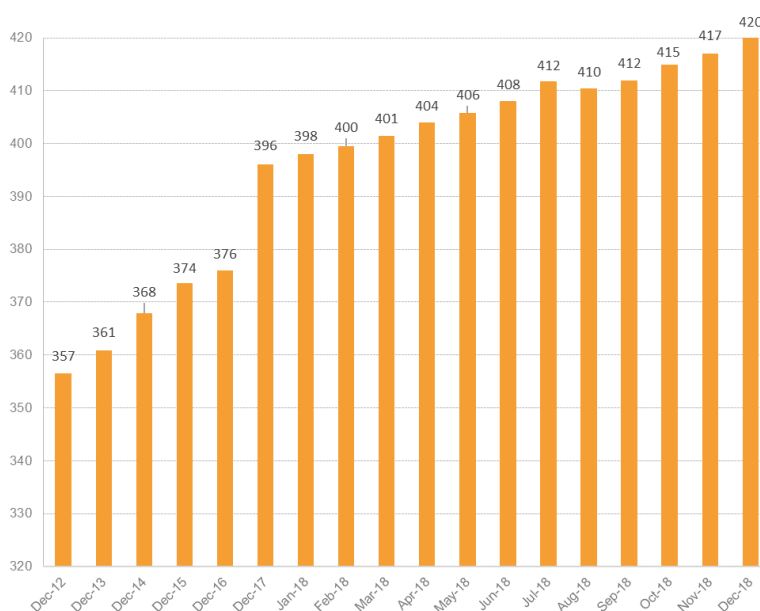
## 2. Detailed comments

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)?

### 1. **High growth of loans to SMEs in France**

More than 1.1 million SMEs are financed in France by credit<sup>1</sup>. At the end of December 2018, outstanding loans to SMEs total 420.5 billion euros in France, an annual increase of 6.2%.

**Chart 1: Loans granted to SMEs in France (in billions of euros)**



Source: Banque de France

### 2. **In France, SMEs remain highly dependent on bank financing**

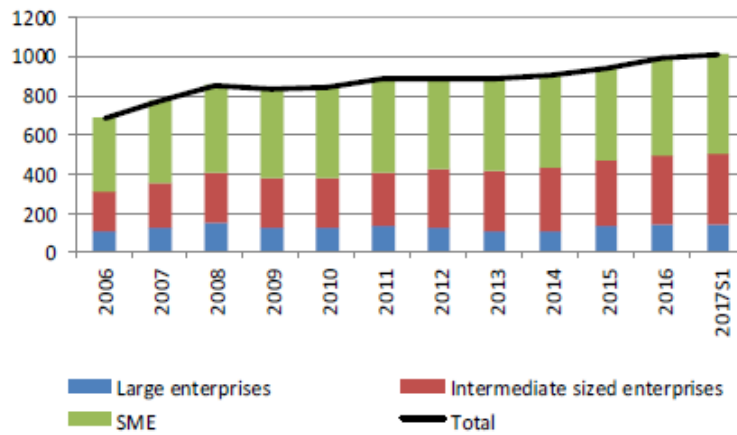
At the end of December 2018, French companies benefit from 1,609 billion euros in financing, an increase of 5.7% over one year, of which 1,018 billion euros by credit (+5.9% over one year) and 591 billion euros by the market (+5.3% over one year).

Corporate financing models have evolved: in France, the share of bank loans to market financing was 63%/37% in 2018 (vs. 70%/30% at the end of 2009).

However, it is mainly large companies that have access to market financing, while SMEs remain highly dependent on bank financing as underlined in chart 3b. This dependence on banks may, at least partially, explain why things have gone well for French SMEs. Indeed banks tend to protect, as much as they can, their domestic market (small and very small enterprises) by securing its financing.

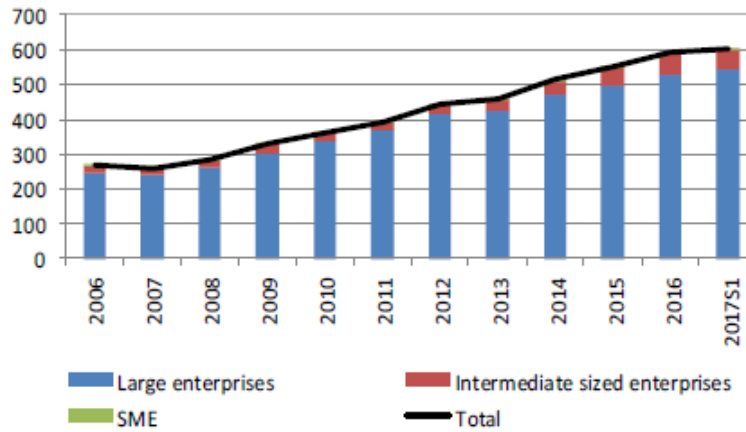
<sup>1</sup> Source: Banque de France, Loans by size of firms. The small and medium enterprises (SME) are defined as companies employing from 10 to 249 employees and with an annual turnover below 50M € or with a total balance sheet under 43M€.

**Chart 2: Gross debt of non-financial corporates, by firm size (bank credit, in billions of euros)**



Source: HCSF

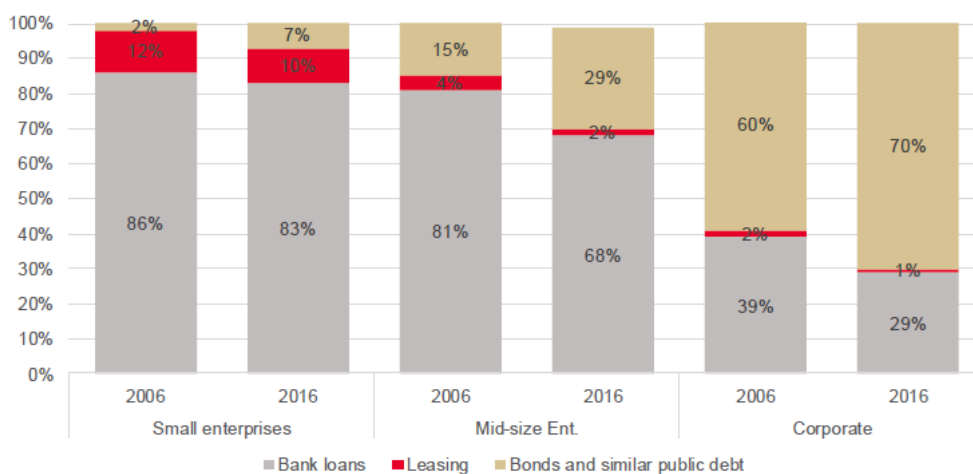
**Chart 3: Gross debt of non-financial corporates, by firm size (debt securities, in billions of euros)**



Source: HCSF

**Chart 3b: debt financing by corporate size in France**

Evolution of debt financing for French companies

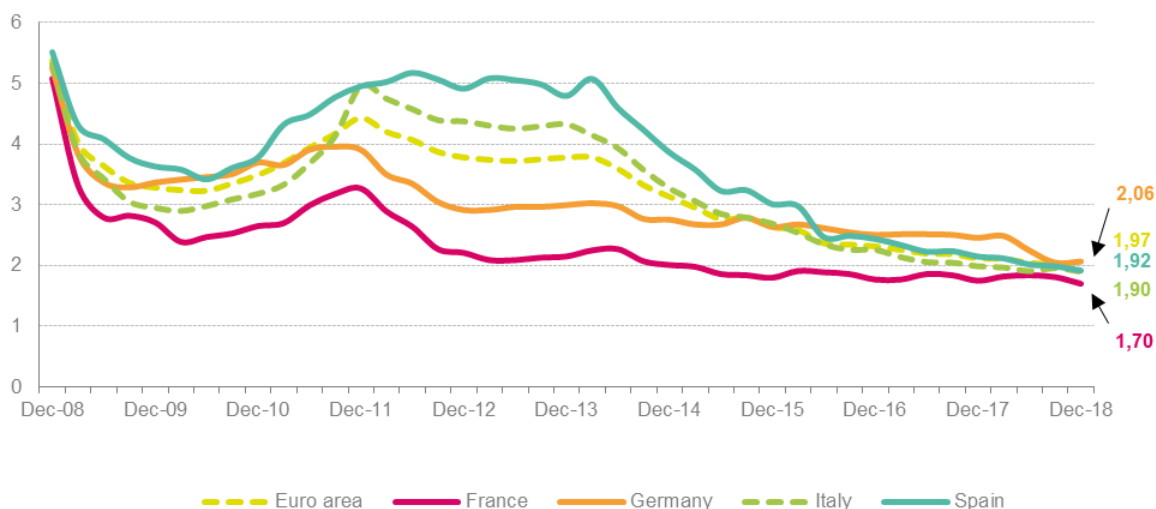


Source: SG Cross Asset Research/Global Asset Allocation, BdF: "Bulletin économique des entreprises", Nov-Dec18

### 3. SMEs get favorable interest rates in France

Since 2008, interest rates for new loans to SMEs are low in France: 1.70%. They favor SMEs projects with a difference of 27 basis points compared to the euro area average of 1.97%<sup>2</sup>.

Chat 4: Interest rates on new loans to SMEs (in percentage)



Source: ECB

### 4. In France, SMEs have abundant access to bank credit

In France, SMEs have abundant access to bank credit. Cash credit supply for SMEs grows significantly in the fourth quarter of 2018: 88% of SMEs' requests of cash credits are fully or almost fully granted, against 84% in previous quarter. Access to investment loans, even larger, raises by 2 points at 97%<sup>3</sup>.

In the fourth quarter of 2018, demand for new investment loans relates to 24% of SMEs (23% in the previous quarter). Demand for new cash credits is almost stable (7% against 6% in the previous quarter)<sup>4</sup>.

The latest figures published by the ECB indicate that 83% of French SMEs' requests of bank loans between April and September 2018 are fully granted, compared to an average of 74% in the euro area<sup>5</sup>.

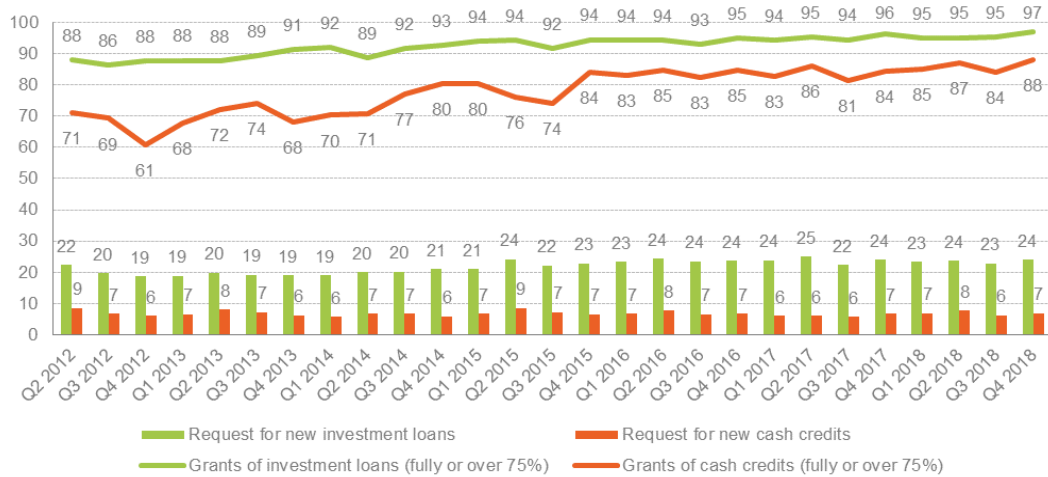
<sup>2</sup> Source: ECB, At the end of December 2018, Loans up to EUR 1 million at floating rate and up to 1 year initial rate fixation

<sup>3</sup> Source: Banque de France, Access to bank financing for companies, January 2019

<sup>4</sup> Source: Banque de France, Access to bank financing for companies, January 2019

<sup>5</sup> Source: ECB, Survey on the Access to Finance of Enterprises in the euro area, November 2018. The term "small and medium-sized enterprises" (SMEs) covers micro, small and medium-sized enterprises.

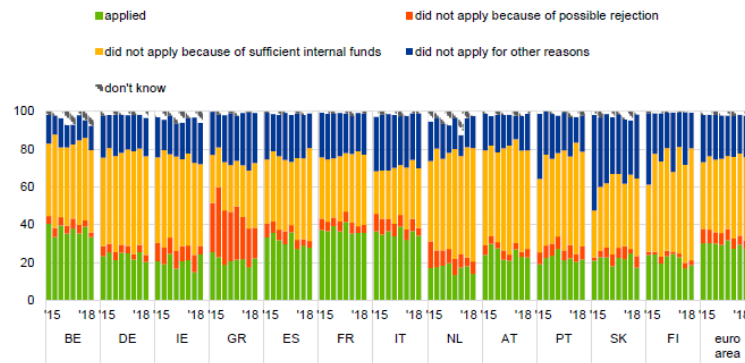
**Chart 5: Financing requests and grants for SMEs (in percentage)**



Source: Banque de France

**Chart 6: Applications for bank loans by SMEs across euro area countries**

(over the preceding six months; percentages of respondents)

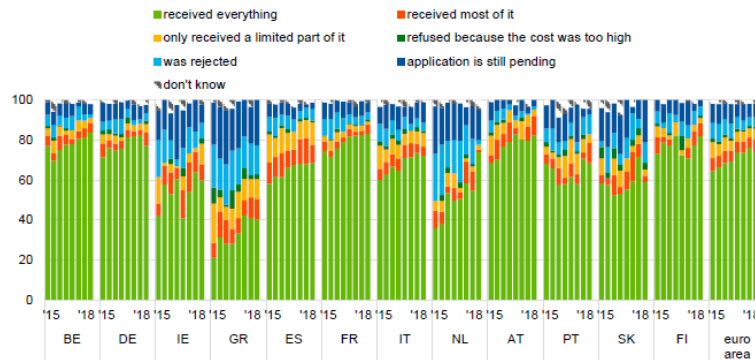


Q7A. Have you applied for the following types of financing in the past six months?

Source: ECB

**Chart 7: Outcome of applications for bank loans by SMEs across euro area countries**

(over the preceding six months; percentages of respondents)



Q7B. If you applied and tried to negotiate for this type of financing over the past six months, what was the outcome?

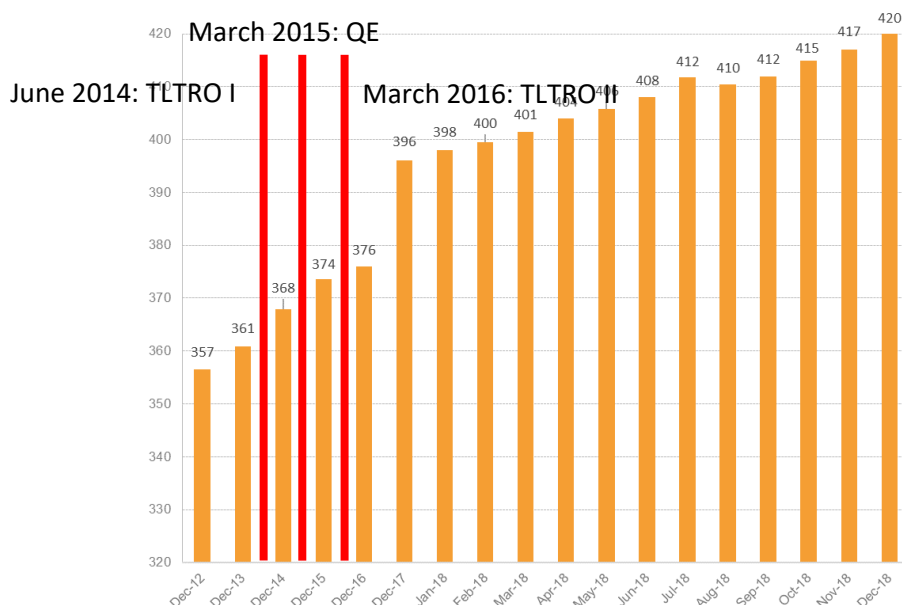
Source: ECB

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?

As said before, banks protect their domestic markets and notably the funding of domestic SMEs. They make this a priority. Thanks to the Quantitative Easing launched in March 2015, interest rates fell, and banks's funding and therefore loans became cheaper. Moreover, the series of TLTROs announced in June 2014 and March 2016 provided financing to credit institutions. By nature such stimuli can only be temporary.

Although the net purchases under the asset purchase program ended in December 2018, the ECB remains wary of withdrawing stimulus. Indeed, it announced a 3<sup>rd</sup> round of TLTROs and an extension of its forward guidance on interest rates. This underlines the determination of the ECB to maintain very accommodative financing conditions, with the central bank interiorising in its own monetary policy decisions the impact that other factors can have on bank lending conditions. This may contribute to overburdening monetary policy even more.

**Chart 8: Loans granted to SMEs in France (in billions of euros)**



Source: Banque de France

3. Have financial regulatory reforms such as Basel III affected bank financing to SMEs (e.g. in terms of loan volumes, prices, maturities and collateralization)? 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?

It is important to recall that small and medium-sized corporates are key drivers for growth and job creation and that 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).

From our perspective, the Supporting Factor has played a key role in allowing French banks to support and finance SMEs.

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.

Furthermore, the acceptance rate for loan applications has always remained high during the crisis and further increased after the implementation of the Supporting Factor (cf. chart 5).

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?

Above all, it is worth noting that most banks attempt to support their domestic market regardless of the regulatory context, the jurisdiction or the business model.

Moreover, as mentioned in our answer to question 1, Corporate financing models have evolved. In France, the share of bank loans to market financing was 63%/37% in 2018 (vs. 70%/30% at the end of 2009). This evolution has directly benefited large Corporate. The financial markets are not enough developed to provide Mid and Small Corporates with alternative financing solutions. Small and mid corporates remain reliant on bank-related lending to finance their activities.

Nevertheless, while banks' market share in large Corporate financing decreased, banks had much available cash to finance other clients. Finally, the developpement of financial markets also indirectly benefits SMEs.

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

The FSB paper should not only focus on the impact of existing regulation.

On the one hand, empirical analysis and survey data might suggest that the effect of G20 financial reforms on SMEs financing is of a second order relative to other factors. Nevertheless, as mentioned in Q2, this may tend to overburden monetary policy as the central bank has to take into account those brakes on bank lending in the calibration of its monetary accommodation. “

Despite the allocated capital has indeed increased under Basel III (mostly due to higher minimum ratio requirements), banks have not repercutated these impacts to SMEs:

- volumes and market shares : banks have “sanctuarized” their domestic SME franchises, as responsible lenders, financing the real economy, and some times under pressure of governments (ie in FRANCE, sub debt subscribed by the State in 2008 was conditional to 3% RWA growth). But the capital hit was real, and had to be absorbed by other, arguably less core, or more agile businesses, such as large Corporates and capital markets businesses. This aspect must be taken into account by the FSB, as otherwise, it seems that there was no impact at all.

- pricing: it would be very interesting to analyse the evolution of cost of funding for SMEs. To a large extent, increased capital costs (mitigated by the SME Supporting Factor) have been compensated by lower interest rates, a situation that will require normalisation one day. We cannot expect that monetary policy will permanently have to compensate for unintended consequences of regulation (see the new TLTRO, largely driven by the fear of negative impact of upcoming NSFR...) Further effects of increasing funding costs for banks should also be mentioned.

Furthermore, pre-crisis, with a liquid interbank market, SME funding conditions were relatively fungible across jurisdictions. Post crisis, heterogeneity has increased, as bank funding costs have diverged and interbank market has dried up (due to LCR). This creates a very problematic unlevel playing field between SMEs, and a pro cyclical loop where SMEs in weak countries lose competitiveness.

On the other hand, we believe that upcoming reforms (Basel 3 reform a/o dec 2017) raise some major and permanent concerns for SME financing that need to be addressed by the FSB (cf. our answer to question 7).

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?

No significant impact at this stage.

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

The FSB paper should not focus only on the impact of existing regulation. We believe that Basel 3 reform (a/o dec 2017) and other accounting and supervisory initiatives raise some major concerns for SME financing.

It is worth noting that, as opposed to central banks supportive actions (QE, LTRO...) which can only be temporary, these regulations will produce permanent negative impacts. Therefore, banks management might challenge the most affected portfolios, implying a strong reduction of the volumes of loans granted with a detrimental effect on the G20 objectives.

Indeed, by construction historical data used by the FSB cannot capture the effects of this regulation which is not yet implemented (NPL, Basel III) or that was implemented few months ago (IFRS9). Nevertheless, these regulations are part of the post-crisis financial regulatory reforms the G20 asked the FSB to analyse the effects. They need to be addressed by the FSB. In the future, the ongoing regulation tightening could weigh on the financing of SMEs – widely relying on banks' lending – and could hamper banks' ability to accompany the credit demand from enterprises.

#### Revised Basel III framework (a/o dec. 2017) and its future transposition in Europe

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)

We welcome the decision to maintain internal models on SMEs portfolios. Nevertheless, should the 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 or potential public disclosure requirements. 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 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).

Yet, RWA is a key parameter in the allocation of their resources by banks. The strong increase in RWA for SMEs would force banks to allocate much more capital against those exposures, which could only be achieved through a combination of corresponding rises in pricing conditions and degradation of loan parameters (e.g. lower advance rates, shorter tenors):

- It will imply an increase in the cost of financing for clients.
- Adequacy of the level of cost of financing bearable by the client and minimum return for the banks for these financings will be difficult to achieve given excessive RWA required relative to observed risk levels..

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.

#### The EBA program on IRB framework : the Future of IRB Approach

During the last few years, the EBA has published several regulatory papers in order to harmonise the IRB framework. The objective of the EBA is to harmonise requirements within the European when it comes in particular to the definition of default, the risk quantification of credit risk parameters. Such workstream though welcome as they strongly restore confidence into internal models, could lead to a loss of risk sensitivity and increase of capital requirements especially on SMEs.

We note that simultaneously securitisation regulation has been strengthened (following a BCBS initiative) at the risk of eliminating SMEs loans securitisation which could have been a means of relieving the banks excessive regulatory constraint.

## European measures tackling Non-Performing Loans

In March 2018 the European Commission presented its package of measures to tackle high NPL ratios. The package includes a proposal for a regulation<sup>6</sup> amending the prudential requirements (CRR) and establishing statutory prudential backstops to prevent potential under-provisioning of non-performing loans (NPLs).

The new rules introduce a "prudential backstop"<sup>7</sup> for the amount of money banks need to set aside to cover losses caused by future loans that turn non-performing. In case a bank does not meet the applicable minimum level, deductions from banks' own funds would apply.

Different coverage requirements will apply depending on the classifications of the NPLs as "unsecured" or "secured". Unsecured NPLs require higher and timelier minimum loss coverage because they are not backed by collateral.

This measure aims to make banks set aside funds to cover the risks associated with NPLs

However, this prudential approach is going to distort banks' origination, disincentivising them to carry out detailed credit analyses at origination:

- Especially for SMEs, corporates and residential real estate, banks would move from cash flow banking (that is banking proper), in which loans are granted according to the value of the expected cash flow, to collateral-oriented banking in which loans are granted based on the value of their underlying security.
- Banks would limit their lending to the CRR eligible collateral amount.
- Having to request collateral for most of the loans will complicate and slow down the granting process.
- The new framework may also lead banks to limit their lending to the best credit quality counterparties (i.e. counterparties with a significant amount of collateral).

Furthermore, this new regulation may have the following unintended consequences:

- It will reduce the targeted NPL secondary market efficiency, as it will induce a bias in the price on banks/sale side. Indeed the required public disclosure by vintage of NPL will make potential buyers aware of when banks need to dismiss their NPL portfolios (i.e. weaker negotiation position of banks in any NPL sale as vintage buckets approach deadlines under the proposed backstops). Hence potential buyers will set discounted prices accordingly.
- It will create a strong incentive to realise collateral, which would be detrimental to borrowers. For loans recognized as non-performing, the recourse to the secondary market will contribute to accelerate or amplify the loss of value for these loans in the banks' balance sheet, even though an adequate strategy could guarantee recurrent cash-flows. Should an NPL disposal be impossible through the secondary market, banks will be constrained to realise the collateral, which is pro-cyclical and could undermine financial stability.
- It will encourage banks, the weakest one notably, to forced selling. In practice, banks time lines will be further shortened due the time needed to structure a sale (notably the period for unsecured loans). In the current European secondary markets context it would mean that an

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<sup>6</sup> The new regulation should enter into force in H1 2019

<sup>7</sup> common minimum loss coverage

excessive value has been transferred out of the banking system to the so-called shadow banking system, less regulated regarding this asset class.

- As a consequence, it will make consumer protection laws (borrower protection in general) less efficient as the ownership of the NPLs by unregulated, mostly non-EU entities will expose EU SME's to much more aggressive collateral recovery strategies, as has been the case for US households in the sub-prime crisis. Banks build long-term relationship with their customers, whereas third parties will be more interested in the short-term financial profit. This policy goes completely against the EU need to regain citizen confidence and to foster financial inclusion
- Moreover, the ESRB has considered in its last report on NPLs that there could be further prudential measures in relation to buffers focusing on some sectors or targeting for instance non financial corporates. Also, measures in relation with commercial and residential real estate activities are also in the balance : enhancement of large exposure framework, possible raise of LGDs... If these measures were to be implemented, the impact on SMEs should be assessed and probably not neutral.

### IFRS 9

At international level, was discussed the issue of procyclicality in the capital framework more generally, a concern that may actually be further exacerbated by recent accounting framework. We fear that this procyclicality may further worsen with the advent of Expected Credit Loss (ECL, both under IFRS9 and US GAAP's CECL) requirements. Though the impact of IFRS 9 is monitored by the EBA since the start of IFRS 9 implementation, it seems to date the impact is not known exhaustively.

When assessing the SME financing, the IFRS9 framework should be part of the reflection. As IFRS 9 loan loss provisioning is closely correlated to the risk level of the loan and the maturity of the loan, lending to SMEs will be more specifically penalised by inciting banks to reduce the maturity of SME loans and to require a better quality of collaterals.

### European supervisory scrutiny: microprudential measures

Though not considered as regulatory reforms, there seems to be some areas in which there could be impacts for SMES. The influence of supervisory actions in a broad range of fields must be considered when assessing SME financing. Especially as supervisory practices may also differ between jurisdictions, there seems to be discrepancies between institutions which are relevant to consider when making an assessment.

The SSM (European supervisor for significant institutions) seems to have requested the toughest requirements to significant institutions in relation with prudential topics.

First of all, the SSM is scrutinising all credit internal models through their TRIM exercise, and has also focused some of their missions on SME portfolios. Any recommendation which leads to an unintended raise on portfolios such as SME could defavourably impact their financing in consequence. In addition, microprudential measures are reputed to be procyclical, which means that measures are still applied, contraining more SME financing even if the economic conditions are considered favourable.

Moreover, another workload is the focus on commercial and residential real estate activities by the SSM : some institutions have faced particular inspections on such sectors.

Then, the SSM also published supervisory expectations when tackling NPLs (overall guidance, prudential backstops on the flow and stock of NPLs) which come in addition to a pillar I prudential backstop for instance.

Finally, the request made by the SSM to significant institutions to prepare the implementation of the Future of IRB approach (2-step approach) is currently leading banks to rush into significant changes of their risk management framework : new definition of default, and coming recalibration of internal credit risk parameters.

#### European supervisory scrutiny: macroprudential measures

We may question the consistency of macroprudential decisions in the light of monetary policy considerations. We deplore the lack of a holistic view that may lead to adopt conflicting measures. For example, in France :

- On the one hand, the political authorities encourage banks to finance growth and economic development of the country. At the same time, at European level, the ECB announces measures to maintain very accommodative financing conditions (a 3rd round of TLTROs and an extension of its forward guidance on interest rates).
- On the other hand, the *Haut Conseil de Stabilité Financière*<sup>8</sup> will probably decide to raise the counter-cyclical capital buffer in order to constrain the development of credit. This will primarily affect SMEs that have no access to credit other than bank financing, unlike large companies.

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<sup>8</sup> HCSF - High Council for Financial Stability