FSB FINANCIAL STABILITY BOARD

7 June 2019

Evaluation of the effects of financial regulatory reforms on small and medium-sized enterprises (SME) financing

Template for the responses to the consultation

The Financial Stability Board (FSB) is seeking comments on its consultative document on *Evaluation of the effects of financial regulatory reforms on SME financing*.

Background

With the main elements of the G20 reforms agreed and implementation underway, an analysis of the effects of these reforms is becoming possible. To that end, the FSB developed a *Framework for Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms* that will guide analyses of whether the reforms are achieving their intended outcomes, and help identify material unintended consequences that may have to be addressed, without compromising on the objectives of the reforms.

This evaluation examines the effects of financial regulatory reforms on the financing of small and medium-sized enterprises (SMEs). The motivation for this evaluation stems from the need to better understand the effects of the reforms on the financing of real economic activity and their contribution to the G20 objective of strong, sustainable, balanced and inclusive economic growth. The evaluation is part of a broader examination of the effects of the G20 regulatory reforms on financial intermediation.

This consultation report sets out the results of the evaluation to date for public comment. The final report will be published in November 2019.

Responses to this consultative document should be sent to fsb@fsb.org by Wednesday 7 August 2019. Responses will be published on the FSB's website unless respondents expressly request otherwise.

Respondent information

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Questions for public consultation

The FSB invites comments on the consultative document and the following specific questions. Please provide details and supporting information where possible.

SME financing trends

1. **Structure of SME financing:** Does the report accurately describe the characteristics of SME financing provided by banks and other financial institutions? Is there any aspect of SME financing that merits additional analysis?

As the FSB points out in its current report, smaller, less complex banks have the best prerequisites for relationship lending, i.e. lending on the basis of close, long-term customer relationships. Relationship lending is particularly important in SME financing, as the FSB rightly points out. Not only do large supra-regional banks often grant fewer SME loans in relation to their balance sheet total, but they also generally prefer transaction lending, in which collateral and independently verifiable information, such as published company data, take precedence (Berger & Udell, 2001).

Increased attention should be paid to the finding that in phases of economic downturn, relationship lending is clearly superior to other types of lending. (Beck et al., 2014). Future analysis should therefore also consider the possible long-term effects of structural changes in the banking market. In the Euro area, the market share of the five largest banks rose from 44 percent to 48 percent between 2008 and 2016 (European Central Bank, 2017). At the same time, the number of small banks fell by 35 per cent between 2008 and 2018 (European Central Bank, 2019).

This development is in part attributable to the fact that administrative burdens in the Euro area due to banking regulations (e.g. extended reporting obligations as a result of Basel III) have increased significantly in recent years, placing a disproportionate burden on smaller institutions. Due to the great importance of relationship lending, banking regulation should urgently avoid placing smaller, low-risk credit institutions at a disadvantage, as their size and business model make them predestined for this SME lending method.

Sources:

Beck, T., Degryse, H., De Haas, R. & van Horen, N. (2014). When arm's length is too far. Relationship banking over the business cycle, BOFIT Discussion Papers 14/2014, Bank of Finland, Institute for Economies in Transition, https://helda.helsinki.fi/bof/bitstream/handle/123456789/13354/dp1414[2].pdf.

Berger, A.N. & Udell, G. F. (2001). Small business credit availability and relationship lending: the importance of bank organizational structure. Finance and Economics Discussion Series 2001-36, Board of Governors of the Federal Reserve System (US), https://www.federalreserve.gov/pubs/feds/2001/200136/200136pap.pdf.

European Central Bank (2017). Report on Financial Structures, October 2017, https://www.ecb.europa.eu/pub/pdf/other/reportonfinancialstructures201710.en.pdf.

European Central Bank (2019). Statistical Data Warehouse, Consolidated Banking data, http://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=359.CBD2.A.U2._Z.11._Z._Z.S.A.R0100._Z._Z._Z._Z.LE._Z.PN, accessed: July 31, 2019.

2. **Trends:** Are the SME financing trends presented in this report comprehensive? Are there other important trends that should be considered for inclusion?

   As a result of a positive economic development, the financing situation of small and medium-sized companies in many regions of the world is currently benign, as the FSB confirms. However, it is unclear whether these conditions will persist in the long term. As experience shows, the financing conditions for SMEs change during economic downturns. Differences between banking models – especially between banks that practice relationship lending and institutions that predominantly rely on transaction lending – become more apparent in such phases. Therefore, a longer-term view of the development of financing conditions for SMEs under the changed regulatory environment is necessary.

3. **Drivers:** Are the drivers of SME financing described in this report comprehensive? How important have demand versus supply factors been for SME financing across jurisdictions and types of firms? Are there other important drivers that should be considered in the evaluation?

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Financial regulations

4. **Regulation vs other factors:** Does the report accurately describe the importance of financial regulatory reforms relative to other factors in terms of their impact on SME financing?

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5. **Basel III reforms:** Does the report accurately describe the transmission channels through which Basel III reforms impact bank financing to SMEs? Are there other major transmission channels that the evaluation has not considered

   Subject to additional analysis should be the question of how increasing bureaucratic burdens on smaller institutions impact the structure of the banking market and how these changes will affect the financing situation of small and medium-sized enterprises in the long term. In 2019, the EU adopted a set of measures to increase proportionality in European banking regulation (European Commission, 2019). Future analysis should therefore also focus on the question of whether measures such as these succeed in strengthening banking structures that have proved particularly successful in SME financing.

   Sources:
   European Commission (2019). Adoption of the banking package: revised rules on capital requirements (CRR II/CRD V) and resolution (BRRD/SRM), Press release, https://europa.eu/rapid/press-release_MEMO-19-2129_en.htm.

6. **Other relevant reforms:** Does the report accurately identify financial reforms other than Basel III that might have an effect on SME financing? Through what channels do these reforms function? Please elaborate.

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Evaluation approach

7. **Methodology:** Is the analytical approach used to evaluate the effect of reforms appropriate? Are there other approaches to consider for this evaluation?

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8. **Cost-benefit considerations:** Do you have any comments on the considerations of social costs and benefits of the reforms with respect to SME financing?

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Effects of reforms

9. **Effects of G20 reforms on SME financing:** Are the findings in the report about the effects of G20 reforms implemented to date (particularly the initial Basel III package agreed in 2010) on SME financing consistent with your own experience? Is there any additional information to support (or contradict) these findings?

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10. **Effects across jurisdictions:** Are Basel III reforms having a differentiated effect on the provision of SME financing (in terms of volumes, pricing and other financing terms) across jurisdictions? If so, what determines the differentiation in effect? Are there other differences in terms of impact that should be considered by the evaluation?

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11. **Effects of other reforms:** G20 reforms that are at an earlier implementation stage and other national financial regulations have only been examined qualitatively. For these regulations, is there any further relevant information about their impact on SME financing that should be considered by the evaluation?

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12. **Alternative finance:** To what extent, if any, have financial reforms created incentives for the provision of financing by non-banks to SMEs of different types and sizes? In particular, how has SME financing through innovative forms (such as FinTech credit platforms) been affected by these reforms? Please elaborate.

    Local and regional banks bring along optimal conditions as providers of financing to SMEs, as they are intensively familiar with their business customers and their economic environment and have an interest in the long-term positive economic development of their region. In contrast, information asymmetries, moral hazard and procyclical investor behaviour pose substantial risks for alternative forms of capital market or platform-based financing.

A negative example is the market for German SME bonds. Between 2010 and March 2018, 173 bonds with a total volume of around Euro 7.3 billion were issued. At the beginning of 2018, 58 of these bonds with a total volume of around Euro 2.7 billion were already distressed (Breinich-Schilly, 2018).

As Feihle and Lawrenz (2017) demonstrate, issuers of SME bonds showed on average a significantly worse operating performance after the issuance of these securities than companies whose publicly available economic data were initially comparable but which did not issue any bonds. Retail investors, in particular, who had acquired SME bonds due to the initial euphoria suffered heavy losses as a result. As a result, the willingness of investors to finance small and medium-sized enterprises through bonds declined considerably and the issue volume fell sharply (Breinich-Schilly, 2018).

The example of German SME bonds shows that alternative sources of finance – as already noted by the FSB – should not solely be judged on their initial placement successes and their short-term performance. Information asymmetries and procyclicality can lead to a boom being followed by a downturn with significant negative consequences for both investors and potential issuers. A critical long-term analysis of such forms of financing over the economic cycle is therefore required.

Sources:

Breinich-Schilly, A. (2018). Mittelstandsanleihen mit hoher Ausfallquote, Springer Professional, https://www.springerprofessional.de/anleihe/bonitaet/mittelstandsanleihen-mit-hoher-ausfallquote/15595580.

Feihle, P. C. & Lawrenz, J. (2017). The Issuance of German SME Bonds and its Impact on Operating Performance. Schmalenbach Business Review, Springer; Schmalenbach-Gesellschaft, vol. 18(3), pages 227-259, August, https://link.springer.com/article/10.1007%2Fs41464-017-0036-9.

Additional considerations

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

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