Andres Portilla
Managing Director
Regulatory Affairs

March 25, 2019

Mr. Dietrich Domanski
Secretary General
Financial Stability Board
Bank for International Settlements
Centralbahnplatz
2 CH-4002 Basel
Switzerland

Re: Evaluation of the effects of financial regulatory reforms on small and medium sized enterprises

Dear Mr. Domanski:

The Institute of International Finance ("IIF") welcomes the opportunity to respond to the request of the Financial Stability Board ("FSB") to submit views on the effects of financial regulatory reforms on small and medium sized enterprises ("SME").[1] We continue to appreciate the FSB's initiative in evaluating the impact of regulatory reforms overall. Examining effects and potential unintended consequences is crucial in enabling regulatory fine-tuning and ensuring that reforms contribute to optimal outcomes for society as a whole.

The focus on SMEs for the third FSB evaluation project is timely and important. SMEs play a vital role in our society and are crucial in advancing real economic growth on a global basis. They make key contributions to gross domestic product ("GDP") and employment. However, it is well recognized that these companies face significant challenges in accessing finance. Though the reasons for this can vary, a concerted and holistic focus by the international community will help bridge the gap in supply and demand for financial intermediation in this area.

The IIF is grateful for the opportunity to build upon the dialogue which started at the FSB SME financing roundtable in Amsterdam in December 2018[2] and we thank the FSB for the deadline extension on our comments herein. We understand that this request for feedback will help shape the draft report on this subject, which will be issued for public consultation ahead of the June 2019 G20 Summit. As such, our feedback reflects our initial reactions to the issues we believe should be considered by the FSB in terms of the effects of the post-crisis reforms, along with our suggestions for the possible scope of the initial and final reports. We emphasize that this is a non-exhaustive examination of points to raise in relation to this evaluation project. Though we understand the FSB's desire for both qualitative and quantitative analysis on the impact of

[1] Financial Stability Board, *FSB invites feedback on the effects of financial regulatory reforms on SME financing*, February 25, 2019.

[2] Financial Stability Board, *FSB roundtable on the effects of reforms on SME financing: Key takeaways*, February 25, 2019.

reforms on the SME financing market, the short period on this initial request for information presents obvious limitations and we anticipate building on our preliminary feedback with further input during the full consultation phase.

An improved regulatory environment can have a strong impact on access to financing for SMEs. We look forward to engaging further with you on this topic and on future areas of regulatory reform evaluation. If you have any questions, please contact me or Matthew Ekberg (mekberg@iif.com).

Very truly yours,

Andrés Portilla
Managing Director, Regulatory Affairs
Institute of International Finance

Evaluation of the Effects of Financial Regulatory Reforms on SMEs

The IIF welcomes the focus of the FSB on understanding the effects of the post-crisis reforms and, in particular, their impact on real economic activity and their contribution to the G20 objectives for global growth. Over the last decade, the G20, through the international standard setting bodies, has enhanced supervision and prudential standards, further safeguarding the overall financial system. In turn, the industry has made significant advances in raising capital, deploying qualified staff for new responsibilities such as recovery and resolution planning, enhancing internal and external reporting, and upgrading corporate governance and risk management standards on a comprehensive basis. In doing so, banks have become more resilient and robust in terms of holding more and better-quality capital, increased liquidity and less leverage.

As we noted during the consultation period for the FSB's evaluation of infrastructure financing,[3] there is no desire on the part of the financial services industry to turn back the clock on what has been achieved. Nevertheless, the G20 reform objectives need to be considered in a dynamic environment, where economic and societal priorities have continued to evolve since the immediate post-crisis period. Undertaking such a review (and finding items that need tweaking or adjusting) is not a criticism of what went before – rather, it reflects the concepts of dynamic implementation and efficient resilience for regulation which have been promoted by the FSB.[4] As such, the FSB process presents a unique opportunity to offer both analysis *and* recommendations on refinements to the regulatory architecture on a consistent, global basis in order to improve access to SME financing.

To that end, and in order to assist with the work in the initial period of review by the FSB and its preliminary report to the G-20 in June, we offer the IIF's views on the following items: 1. the scope of the review for the initial and final reports and 2. preliminary issues of focus for the initial report.

1. Scope of Initial and Final FSB Reports on SME Financing

The opportunity for the private sector to provide input to the FSB on the various workstreams underway is always appreciated. We applaud the commitment of the FSB to engage with a wide range of stakeholders and to increase the transparency of its processes. This initial consultation undertaken as follow up to the December 2018 FSB roundtable on SME financing is a welcome addition to this stakeholder engagement, however, a three-week window for comments presents

[3] IIF/GFMA, *Letter on the Effects of Post-Crisis Regulatory Reforms on Infrastructure Finance*, August 2018.

[4] In April 2017, then FSB Chairman Mark Carney outlined the important collective efforts of policy makers, regulators and the private sector to make the financial system safer and more resilient, offering a blueprint for further progress that included undertaking dynamic implementation of the post-crisis reform agenda and delivering efficient resilience: Mark Carney, *What a Difference a Decade Makes*, speech at the IIF Washington Policy Summit, Washington, April 20, 2017.

In February 2019, FSB Chairman Randal Quarles stated: "…...there is a strong public interest in the efficiency of the financial sector, just as there is in its safety and soundness. If reforms are unnecessarily burdensome and we can achieve strong resiliency more efficiently and simply, we should be able to boost sustainable financial and economic activity, thus benefitting everyone." Randal Quarles, *Ideas of order - charting a course for the Financial Stability Board,* Bank for International Settlements Special Governors Meeting, Hong Kong, 10 February 2019.

clear limitations. We note that in a recent speech by FSB Chairman Randal Quarles, an expectation was established that public consultation periods for the FSB will be at least 60 days.[5]

Though we anticipate the consultation on the preliminary report to the G20 later this year will adhere to that expectation on the length of time for comments, the response undertaken here should be reviewed in the context of being highly preliminary and subject to further exploration, analysis and assessment by the IIF and its member firms. Based on that, we also believe the FSB should not cast judgment on the outcome of the evaluation based solely on the December 2018 roundtable report[6] and the findings from this initial consultation period. The preliminary report to the G20 should be very clear that the processes undertaken encompassed limited stakeholder feedback to-date and that the ultimate findings will be based to a large extent on the substantive feedback received from the mid-year consultation. As noted by Chairman Quarles, the FSB should only make recommendations once it has gathered and considered all points of view.[7] That gathering process needs to be fulsome in order for the points of view to be substantive and properly considered. We believe the mid-year consultation is the appropriate time for the crux of that process.

The FSB should also use this evaluation project to consider its role in working collectively with the international standard setting bodies on recommendations for changes to the global framework where the analysis warrants such changes. In its final report to the G20 on the effects of regulatory reforms on infrastructure financing, the FSB stated that the results of efforts undertaken through the FSB Evaluation Framework will not contain any specific policy recommendations, but rather findings for consideration by the appropriate bodies.[8] Though we agree final responsibility for deciding whether and how to amend a particular standard or policy remains with the body that is responsible for issuing that standard or policy, we believe there is a missed opportunity if certain specific issues are not flagged and put forward to the relevant bodies for consideration of possible changes.

In the same speech referenced above, Chairman Quarles stated in the context of the Evaluation Framework:

> *"In any system as complex and consequential as the body of post-crisis financial regulations, there will always be aspects-and sometimes material aspects-that can be improved on the basis of experience and analysis. A credible review process that is both rigorous and dispassionate will find a few."* [9]

The IIF fully agrees with this assessment. The effectiveness and utility of the Evaluation Framework will remain extremely limited if the processes are not dynamic enough to consider the actual changes needed to eliminate any unintended consequences which may emanate from the global regulatory reform architecture. The topics undertaken by the FSB for evaluation are

---

[5] Randal Quarles, *Ideas of order - charting a course for the Financial Stability Board,* Bank for International Settlements Special Governors Meeting, Hong Kong, February 10, 2019 ("Quarles, February 10, 2019").

[6] Financial Stability Board, *FSB roundtable on the effects of reforms on SME financing: Key takeaways*, February 25, 2019.

[7] Quarles, February 10, 2019.

[8] Financial Stability Board, *Evaluation of the effects of financial regulatory reforms on infrastructure finance*, November 2018

[9] Quarles, February 10, 2019.

extremely important and improvements in access to SME financing in particular will have significant societal advantages. The FSB should use its mandate to help coordinate changes on a consistent, global basis for the benefit of all.

2. Specific Issues for Consideration Regarding SME Financing Trends and the Impact of Post-Crisis Reforms

A core element of the FSB framework is comparing social benefits of regulations with social costs. We fully understand the need for appropriate levels of regulation corresponding with levels of risk involved. However, by comparing social benefits and costs of regulations on SME finance relative to risk, the FSB and the global standard setting bodies should consider certain issues that could constrain access by SMEs to financing. In that context, we believe the initial report by the FSB to the G20 should consider certain issues concerning: 1. trends in SME financing and 2. prudential standards, risk mitigation and compliance issues for SME financing, which can then be reflected upon in more detail during the mid-year consultation phase.

a. Trends in SME financing

For SMEs, bank financing is of high importance. Given their size, SMEs tend to be very dependent on bank credit, as they generally do not have access to other financing sources such as wholesale debt or capital markets. However, since the financial crisis, intermediation by financial institutions in the SME market segment has reduced, and constraints across bank portfolios have led to a reconsideration of appetite for lending to SMEs in certain circumstances.

In that sense, particular factors are sometimes unique to this type of lending segment and can add to limitations in traditional bank financing. For example, SMEs face a difficult environment for readily available credit information. Beyond a relatively small number of SMEs on company registers, smaller and informal businesses are sometimes invisible to policymakers and regulators in many countries, making credit decisions more onerous. Today, credit worthiness can be inferred from a variety of sources that are easily accessible through digital footprints and thus a more forward-facing approach should be examined in order to help improve credit information. Examination, for instance, could be undertaken as to how SMEs are voluntarily able to share and transmit the data they generate through the use of an online service provider holding this information to help in the inference of credit scoring by third parties.

Issues on the use of collateral and documentation for lending raises similar hurdles for SMEs. Lenders must consider additional security in the current regulatory environment and, as a result, unsecured lending to businesses has been reduced. As smaller and newer businesses are less likely to be able to provide collateral and guarantees, increased reliance on collateral without an equal emphasis on information will mean fewer marginal borrowers have access to loans. Passing movable collateral laws and supporting collateral registries could go hand-in-hand with improving insolvency regimes and strengthening the legal, regulatory, and institutional infrastructure for factoring and leasing as means to address issues in the system for SME financing.

A lack of consistent application of the definition of SME can also cause divergence in understanding of the market being addressed and can lead to disparity in credit decisions based on regulatory uncertainty. Basel III defines SMEs as "corporate exposures where the reported annual sales for the consolidated group of which the corporate counterparty is a part is less than or equal to EUR 50 million for the most recent financial year."[10] However, this is not uniformly applied in jurisdictions inside or outside the Basel Committee membership[11] and creates friction when applied in some Emerging Market and Developing Economies ("EMDE"), where the definition may be unsuitable to the business environment. [12]

Given these constraints, new types of lending activity have emerged to fill holes in demand. Access to credit through informal channels can replace traditional bank funding in some EMDEs, though such activity presents obvious challenges from both a financial stability and financial crime risk management perspective. There has also been a notable emergence of financial technology ("FinTech") firms to serve the emerging market population and lower credit risk clients. Speed to decision, ease of application, and high approval rates have led to more FinTech offerings versus traditional banks, though these offerings should be examined relative to risk.

In addition, some jurisdictions have taken steps to promote SME finance through regulatory changes designed to encourage lending to the SME market[13] or through growing activity by governments and multilateral institutions to boost activity through public sector guarantee programs. As we discuss in more detail in section 2.b. of this letter, we believe it will be very important to fully examine the undertakings of public sector bodies on a global basis in relation to credit risk mitigation schemes to assess them for both effectiveness and their interaction with private sector finance.

Finally, we are concerned that the last ten years of a low interest rate environment may have masked or, to some extent, partially offset the impact of the new regulatory constraints on SME lending. Although hard to quantify, it is entirely possible that lending to SMEs would further contract under a normalized interest rate environment and reduce access to financing and this should be considered for examination.

Overall, we believe the FSB has a valuable opportunity through this evaluation project to measure the current state of SME lending and the constraints to traditional financing for SMEs. In turn, the FSB should also assess the opportunities for innovation, the potential risks associated with non-bank lending in this space, the effects of external economic factors and the involvement of the public sector in supporting companies seeking to access credit. This would allow the FSB to support the international growth agenda by sharing sound practices and recommendations and ensuring that the regulatory framework is fully compatible with the promotion of SME financing. This opportunity for thorough analysis will be enhanced through full consultation with outside stakeholders during the FSB's mid-year report consultation phase.

---

[10] Basel Committee on Banking Supervision, *Basel III: Finalizing post crisis reforms*, December 2017, para 43.

[11] For example, the European Commission defines an SME for the purpose of use in EU policies as enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding €50 million, and/or an annual balance sheet total not exceeding €43 million. In the United States, there are no distinct risk-weight functions for SME exposures, therefore SME is not defined anywhere in US capital regulations.

[12] We note that Basel III does state that in some jurisdictions (*e.g.* emerging economies), national supervisors might deem it appropriate to define SMEs in a more conservative manner (*i.e.* with a lower level of sales). Basel Committee on Banking Supervision, *Basel III: Finalizing post crisis reforms*, December 2017, footnote 31.

[13] For example, the European Union under CRDIV/CRR implemented an SME supporting factor to encourage lending to SMEs. The supporting factor was defined as 0.7619 and applied to the capital requirements of SME exposures in banks' balance sheet.

b. Prudential, risk mitigation and compliance issues for SME financing

For the initial review by the FSB on the effects of post-crisis reforms on SME financing, we consider it appropriate to take into account specific issues concerning Basel III and related prudential reforms, risk mitigation and regulatory compliance. We note that these issues are preliminary examples and non-exhaustive in scope and will be expanded upon in the upcoming mid-year consultation where possible. We also note that jurisdictional issues outside the agreed international reforms, such as stress testing, play an important role in access to SME financing and should also be considered in greater depth via the mid-year consultation.

i. Prudential regulatory reforms

The impact of reforms from Basel III, and specifically those concerning implementation of higher capital requirements, a binding global leverage ratio, the Liquidity Coverage Ratio ("LCR") and the Net Stable Funding Ratio ("NSFR"), include a tightening of credit decisions across banks. It is worth noting that specific constraints can impact financial intermediation and contribute to the contraction of capital and liquidity options for short-term SME activity especially, which can cause difficulties when such products as working capital loan options are also limited. Financing which contributes significantly to the good functioning of SMEs - such as trade finance - can also be constrained, particularly by funding factors applied under the NSFR which force the use of long term funding to finance short term assets. The consideration of macroprudential measures when assessing impact for SME financing also remains important. In particular, discrepancies between jurisdictions in the application of macroprudential measures such as countercyclical capital buffers should be assessed. Overall, the unintended consequences of procyclicality of capital measures should be analyzed in order to provide an overall view of the impact on downstream lending, including lending to SMEs.

There are also major sources of uncertainty for the current regulatory environment, where the continuous evolution of the prudential framework for banks across jurisdictions (and specifically the national adoption of the finalized Basel III framework from 2017) creates difficulties in forward planning. We note that the FSB Evaluation Framework has not specifically taken the finalization of the Basel III reforms into consideration. We continue to believe this is a fundamental flaw in the overall analysis by the FSB, as these reforms now form the baseline for implementation of an updated regulatory structure for SME financing on a global basis. We consider in particular the treatment of SME corporate exposures for the purposes of the Standardized Approach and Internal Ratings Based Approach, along with the provision of equity under the finalized Basel framework, worthy of examination in terms of *ex ante* analysis.

In addition, for some jurisdictions, implementation of Basel III will need to be done consistently with local measures regarding the future of internal models or the management of Non-Performing Loans ("NPL"), along with local rules for the calculation of expected credit losses under accounting standards. At a global level, divergent supervisory practices regarding implementation of regulatory reforms could introduce bias to their outcomes. Analysis of SME financing should incorporate the impact of both regulatory and supervisory visions and specifically the willingness of banks to lend going forward given new approaches to provisioning and the relationship with capital. [14]

Lastly, derivatives reform has in some cases increased the cost of SME financing activities due to the requirement to post margin and the internal structure required to carry out the necessary reporting on hedged transactions. Limitations in hedging activity can unduly limit some SME credit transactions and should be examined in that context.

ii. Risk mitigation

Regulation is intrinsically linked to the impact of macro-economic factors such as interest rates, government policy and financing by public sector guarantee schemes, and should therefore not be seen in isolation. For instance, the involvement of multilateral development banks (MDBs) and national business or development agencies and can provide specific regulatory incentives such as credit enhancements to support SME finance.

As noted under trends in SME financing, there has been significant growth in credit risk mitigation programs by the public sector to encourage lending to the SME market segment. For example, the European Investment Fund has highlighted significant growth in credit guarantee schemes in Western Europe, with Italy (EUR 33 billion), France (EUR 16.7 billion), Germany (EUR 5.6 billion) and Spain (EUR 4.1 billion) standing out in terms of overall allocation of resources.[15] In the United States, the Small Business Administration ("SBA") has increased its offerings and its scope in supporting SMEs over the last decade.

In emerging markets, the International Finance Corporation ("IFC") has instituted numerous programs to assist in promoting trade finance and to help SMEs with their access to working capital. Individual EMDE countries are also undertaking specific efforts to boost lending for this market. For instance, the government of Mexico recently put in place an auctioning system, whereby financial institutions can bid for the right to obtain guarantees, as part of its relatively large-scale guarantee program. [16]

Though public sector guarantee schemes have grown in importance and depth since the crisis, we believe it is critical that the FSB examine these programs in detail to better understand the gaps they are meant to fill vis-à-vis private sector finance. Their effectiveness in terms of "crowding in" private sector lenders and encouraging greater credit intermediation for their target sector should also be evaluated.

For example, there are still limitations on how useful such products can be in terms of capital allocation for a private sector financial institution. If certain structural features are present, the proportion of the asset covered by the guarantee can instead be weighted using the guarantor's risk rating, which is strong in the case of development banks and government backed credit institutions. However, the products offered by the public sector often may not meet the

[14] This was recently pointed out in an EBA study on the observations of post-implementation impact of IFRS 9 – but would apply to the introduction of accounting standards – whether CECL or IFRS: https://eba.europa.eu/-/eba-provides-preliminary-assessment-on-post-implementation-impact-of-ifrs-9-on-eu-institutions

[15] European Investment Fund, *Credit Guarantee Schemes for SME lending in Western Europe*, June 2017.

[16] Organization for Economic Cooperation and Development, *Financing SMEs and Entrepreneurs*, 2017.

requirements laid out by the Basel framework and thus such capital offset for Risk Weighted Asset ("RWA") calculations may be limited, reducing the attractiveness of financial product offerings to SMEs. In the same vein, such guarantees often do not qualify for a High Quality Liquid Asset ("HQLA") classification for the purposes of the Basel liquidity standards, thus reducing their benefit in terms of bank liquidity and funding profiles. For such schemes to be effective, further consideration should be given to their treatment under the Basel framework.

iii. Regulatory compliance

As noted, the post-crisis regulatory environment has led to a critical strengthening of the global financial system. It has, however, also led in some cases to increased complexity in terms of compliance with new regulations. While banks have implemented robust and effective regimes to ensure strict compliance with agreed reforms, this has in certain circumstances brought about a considered review of lending activity where the complexity has warranted reassessment. This is compounded when operating internationally, where consistency in standards is vital. Banks do not function solely within national boundaries, and indeed some of the most important growth opportunities for financial institutions rest in their ability to serve clients abroad as well as at home. It is significant that while the compliance costs for banks of all sizes have increased post-crisis, this effect is magnified when operating across multiple jurisdictions in cases where there are inconsistent standards.

These costs often impact the users of financial products. In this context, international standard-setters play a significant role in helping to provide greater clarity as to how regulations are to be interpreted and applied. This is critical for enabling and incentivizing banks to provide cross-border financial services, and to enable the benefits of competition to be realized for end-users and the economy. While national specificities play an important role in the development of any regulatory framework, variable rules layered upon one another can lead to unintended differences and create potential conflicts. The requirements of individual jurisdictional mandates can trap resources and capital that could be more effectively deployed. This is a situation that is particularly acute for low-margin but growth-critical business lines, such as SME financing. Ambiguity in the application of rules across countries can lead to a reevaluation of transactions and a potential withdrawal from certain sectors, with ultimately deleterious consequences for downstream lending to businesses and consumers.

Regulatory coherence and level playing fields are critical for enabling banks to provide affordable financing to advance economic growth. Banks can also achieve greater risk diversification (and therefore greater stability) if they can expand geographically and develop successful businesses in different countries and markets, taking less correlated risks than those that exist in a single country. Consistent international standards and reasonable home-host rules are essential prerequisites for institutions to achieve this diversification, and inconsistency should be examined for its impact on SME lending.[17]

Looking at innovative ways to deal with compliance complexity is also important. For example, in recent years the global correspondent banking market has shrunk due to a phenomenon

[17] For further information on issues concerning market fragmentation and its downstream effects, please see: IIF, *Report on Market Fragmentation and Need for Regulatory Cooperation*, January 2019: https://www.iif.com/Publications/ID/3222/PageID/3222/IIF-Report-on-Market-Fragmentation-and-Need-for-Regulatory-Cooperation

known colloquially as "de-risking", leading to significant difficulties for banks in EMDEs to finance SME clients. The reasons for this are varied but are also linked to complexity in compliance for client onboarding and maintenance. A concerted effort to look at ways to improve the overall global compliance regime, and in particular the global compliance regime related to financial crime risk in Anti-Money Laundering ("AML") and Countering the Financing of Terrorism ("CFT"), would aid not only in improving the market for correspondent banking but also the domestic appetite for lending to SMEs. This can be examined via greater use of innovation in regulatory compliance (through Machine Learning/Artificial Intelligence ("AI"), the use of centralized Know Your Customer ("KYC") utilities and the greater regulatory acceptance of digital onboarding for clients) and through improved channels of information sharing on financial crime risk intra-bank, bank-to-bank, bank-to government, and government-to-government, in both directions.[18]

[18] For a discussion on current trends in issues for innovation and technology in AML, along with policy recommendations regarding information sharing for AML/CFT purposes, please see: IIF, *Machine Learning in Anti-Money Laundering,* October 2018: https://www.iif.com/Publications/ID/1421/Machine-Learning-in-Anti-Money-Laundering