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?

We consider that the report does not provide a comprehensive view of the characteristics of SME financing provided by banks and other financial institutions.

Whilst the report focuses on bank and non-bank lending to SMEs, it fails to clarify which types of products are covered by each type of lending, and this clarification is crucial given the key differences in nature between bank and non-bank lending. We welcome the fact the report highlights the major role trade credit and bank loans have in financing SMEs, however we think the lack of reference to the role of leasing specifically is a major oversight, especially in light of the following:

- In 2018, a higher percentage of EU28 SMEs used leasing or higher purchase more than other traditional forms of credit. Nearly a quarter (24%) used leasing or hire purchase, whilst less than a fifth used trade credit and bank loans (18% and 17% respectively). Leasing or hire purchase remains the most used form of long-term finance by SMEs[1].
- Leasing is a source of finance with different characteristics from regular bank loans. SMEs can access leasing through various channels, where the banking channel is frequently used. [2] Importantly, the structure of the economy, the type of asset being commonly leased and the maturity of the various sales networks in each country influence how firms access the leasing market. Therefore, we feel leasing deserves to be referred to in its own right as an important source of SME funding.

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

This section of the report rightly mentions that the sources of financing for SMEs are diverse, and notes important differences across jurisdictions. It does however fail to provide evidence, such as the latest available data on the actual use of different internal and external types of finance by SMEs. The trends on bank lending also seem to focus more on types of lenders in the banking sector, as well as being based on geographical comparisons rather than the types of finance products offered by these lenders. Therefore, we suggest that some of the key findings of the European Commission and the ECB SAFE Survey -which looks at sources of

[1] European Commission SAFE Survey, (Apr – Oct 2018)

[2] Oxford Economics (2015), The use of leasing amongst European SMEs. A report prepared for Leaseurope (July 2015)

finance by type- should be referenced more in the report. This would make the analysis of SME trends more comprehensive.

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?

The report correctly notes that a number of trends, including new forms of SME financing and Government sponsored credit risk mitigation programmes, have played a large role in driving SME financing. It does however fail to reference the major role leasing plays in SME financing (in 2013 SMEs financed nearly a fifth of their total investment through leasing, more than any other form of bank lending[3]). A reference to the importance of leasing would be a welcome addition to the report, and help make it more comprehensive. Leasing contributes to SME financing in the following ways:

- Providing SMEs with sources of funding through specific programmes/initiatives. There are a number of initiatives offering SMEs leasing-specific finance, with one of the most notable being the EIBs €400 million leasing finance initiative in 2018.
- Enabling SMEs to finance important assets and business essential equipment, whilst freeing up capital that may otherwise have been spent on buying assets outright for other areas of the business.
- Allowing SMEs to use resources more efficiently and avoid the hassles of maintenance, including costly repairs and upgrades.
- The leasing industry is one of the key drivers of the circular economy, with one of the main focuses being on maximising the re-usability of an asset. This contributes indirectly to SME financing through allowing companies to use their resources in the most cost-efficient way, including sourcing and financing second hand assets.

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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[3] Oxford Economics (2015), The use of leasing amongst European SMEs (July 2015)

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

The current Basel III regulation do not appropriately reflect the real risks of leasing. As owners of the leased asset and physical asset specialists, the leasing business has a relatively low risk profile[4]. The current CRR in Europe already overestimates the real risks of leasing exposures and the proposals included in the finalisation of Basel III agreement would disincentivise leasing even more, in particular for the financing of SMEs.

Introducing a specific risk weight for leasing exposures under the Standardised Approach would recognise the positive influence of lease collateral, while also ensuring any output floor does not result in excessive limits on the IRB Approaches. Cologne University estimates that current capital requirements for leasing under the Standardised Approach are around 8 times higher than the real risks[5].

Benchmarking IRB Approaches to the Standardised Approach through an output floor artificially limits the benefit of internal modelling, particularly since lease collateral is not recognised in the Standardised Approach and thus capital requirements here are high.

In addition, the introduction of input parameter floors unjustifiably penalises lending products with intrinsically low levels of defaults and losses. Furthermore, increasing overcollateralisation requirements to 166% of the exposure value in order to consider lending as 'secured' is excessively conservative, particularly for assets where prices are well known such as passenger cars. Much more lending would be considered 'unsecured' and the input floors in this case are way too high.

For instance, an IRB bank with extensive leasing operations across Europe has estimated that the impact of the new Basel agreement on capital requirements for leasing leads to total Risk-weighted asset (RWA) escalation for leasing of 119%. RWA is estimated to increase by 65% purely as a result of input floors and limits on IRB-A use. Retail SMEs are hit particularly hard. An additional 54% increase in RWA is forecast as a result of the output floor. Clearly in the case of leasing, these floors are not catching 'outlier' values and limiting heterogeneity, they would have a vast negative impact on the entire leasing industry.

Leasing should have a differentiated prudential treatment as its business model and risks are completely different than other types of lending. To adjust the prudential framework in Europe to the real risk of leasing we have proposed to the European Commission the following:

[4] See Deloitte, The Risk Profile of Leasing in Europe: The Role of the Leased Asset (Report available upon request)

[5] University of Cologne, Capital Requirements for Leasing: A Proposal for Adjusting Low Risk (Available upon request.)

a) STANDARDISED APPROACH	
Amend Art. 122 & 123 CRR to include new leasing risk weights	Proposed risk weights for leasing exposures: 50% Retail leasing / 65% Corporate leasing
IRB-FOUNDATION	**IRB-ADVANCED**
b) Add specific haircut for leasing collateral of 20% OR equivalent overcollateralization of 125%	
c) Specific leasing collateral in Art. 230(2) Table 5 CRR: 20% leasing LGD	d) Specific LGD input floors for leasing portfolios (both Corporate & Retail): 10% secured leasing / 20% unsecured leasing

Last but not least, many lessors who utilise bank loans will see their funding costs rise as a result of an increased capital required for banks providing credit due to finalisation of Basel III changes. This will have a detrimental effect on the capacity of leasing companies to provide financing to SMEs.

Regarding the SME supporting factor introduced in Europe, we have seen a reduction of capital requirements for leasing to SMEs which have had a direct positive effect on our capacity to lease to SMEs. The new CRR II expands the scope of the factor, which we very much welcome. Therefore, we advocate for the SME supporting factor to be maintained.

To conclude, Leaseurope calls on the FSB to support a form of finance that has been proven over the years to be both low risk and sustainable, which is crucial for the future growth of SMEs and the move towards a more environmentally friendly world. Basel standards should support a sustainable financial system, without hampering growth and SMEs.

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.

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Additional considerations

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

    We consider this FSB survey as backward looking. However, in our experience the regulatory pressure on how to comply with Basel III has increased in the last two years considerable in various jurisdictions which will have a significant impact on risk assessment and capital requirements (e.g. ECB's Targeted Review of Internal Models (TRIM) or the new definition of default in Europe). The period covered in the survey may not be representative for the impact on financing SMEs of the Basel III reforms. Moreover, as explained in our response to question 5, it is expected that the finalisation of Basel III agreement will impact the financing strategy of banks significantly. In our opinion, this FSB report should not be used as a prediction on how SMEs and corporate lending will be impacted by the implementation of the upcoming Basel III proposals.