FSB FINANCIAL STABILITY BOARD

25 February 2019

FSB roundtable on the effects of reforms on SME financing

Amsterdam, 12 December 2018

Key takeaways

The FSB organised a roundtable in Amsterdam on 12 December 2018 to exchange views with stakeholders on recent trends and drivers in small- and medium-sized enterprise (SME) financing across FSB jurisdictions, including the possible effects that financial regulatory reforms may have had on this market.

Around 35 external participants from financial institutions, trade associations, credit rating agencies, think tanks, academia and civil society attended the roundtable. Each session included short presentations by selected invitees followed by open discussion. The roundtable followed the Chatham House Rule[1] and remarks were not for attribution. Participants welcomed the opportunity for such an exchange of views, and were invited to continue their engagement through submissions of relevant information that could inform the evaluation.

This note summarises the main points raised in the roundtable. It does not represent the views of the FSB and its member authorities, or reflect consensus views expressed by stakeholders at the roundtable. The main takeaways will inform the draft evaluation report, which will be issued for public consultation ahead of the June 2019 G20 Summit; the final report will be published in the second half of 2019.

I. Information on the SME financing evaluation

Following the global financial crisis, the G20 launched a comprehensive programme of financial reforms to increase the resilience of the global financial system, while preserving its open and integrated structure.[2] With the main elements of the post-crisis reforms agreed and implementation of core reforms underway, a more systematic analysis of the effects of these reforms is now possible. To that end, the FSB developed a framework for the post-implementation evaluation of the effects of the G20 financial regulatory reforms.[3] The

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[1] See https://www.chathamhouse.org/chatham-house-rule.

[2] For details, see the November 2018 FSB *Fourth Annual Report on the Implementation and Effects of the G20 Financial Regulatory Reforms*.

[3] See http://www.fsb.org/2017/07/framework-for-post-implementation-evaluation-of-the-effects-of-the-g20-financial-regulatory-reforms/.

Framework guides analyses of whether these reforms are achieving their intended outcomes, and help to identify any material unintended consequences that may have to be addressed, without compromising on the objectives of the reforms.

One of the first two evaluations under the Framework is an examination of the effects of the G20 regulatory reforms on financial intermediation. 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 has two parts: the first part, which was published in November 2018,[4] examined the effects of reforms on the financing of infrastructure investment. The second part – which was the focus of the roundtable – involves an evaluation of the effects of reforms on the financing of SMEs.

Given that banks are the primary providers of SME financing, the post-crisis reforms that appear most relevant – and have been implemented to date – relate to the initial Basel III package agreed in 2010.[5] Other financial regulations that may be relevant for SME financing are either national/regional in nature (e.g. stress tests, structural banking reforms, investment rules for insurers and pension funds) or their implementation is at an earlier stage (e.g. certain accounting standards, finalised Basel III reforms agreed at end-2017). Consistent with the FSB evaluation framework and the approach used in the infrastructure finance evaluation, this latter set of regulations will only be analysed qualitatively.

In carrying out this work, the evaluation team will identify relevant transmission channels through which the reforms may affect financial institutions, and thereby influence SME financing; and examine the implications of the empirical and qualitative findings in terms of the benefits and costs of reforms. In accordance with the evaluation framework, the evaluation results will not contain any specific policy recommendations, but rather findings for consideration by the FSB and the relevant standard-setting bodies. The 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.

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[4] See http://www.fsb.org/2018/11/evaluation-of-the-effects-of-financial-regulatory-reforms-on-infrastructure-finance/.

[5] This includes the risk-based capital ratio, leverage ratio, liquidity standards (Liquidity Coverage Ratio and Net Stable Funding Ratio), frameworks for global and domestic systemically important banks (G-SIBs and D-SIBs respectively) and the securitisation framework. The initial Basel III package was agreed in 2010, while the finalised one was agreed in December 2017. See https://www.bis.org/bcbs/basel3.htm for details.

II. Key takeaways from the roundtable

1. SME financing trends

This session sought to establish the characteristics, prevailing trends and main drivers in SME financing. The presenters noted that access to finance and credit conditions have generally improved in recent years; that banks remain the key providers of SME financing; and that new innovative forms of financing (e.g. peer-to-peer platforms, crowdfunding) are growing rapidly, albeit from a low base in most countries. SME loan growth has been strong in most emerging markets, more sluggish in advanced economies, and negative in countries most hit by the global financial crisis. Data gathered by the Organisation for Economic Co-operation and Development (OECD)[6] show a marked shift toward longer-term bank loans, while asset-based SME lending has been growing steadily in numerous countries.

Several participants noted that the resumption in SME lending growth and the fact that access to finance is not perceived in many cases as the main problem for SMEs anymore, especially in advanced economies, should not be a cause for complacency. The fact that SMEs are not tapping external financing sources more could indicate demand-driven constraints and limitations in their ability to create investment and growth opportunities, which may merit further investigation. In that regard, a relevant question would be whether the financial system delivers the type and amount of financing that SMEs need to grow. Disentangling demand factors (e.g. changes in the structure of SME sector from capital-intensive to more service-oriented SMEs, replacement of external finance by internal sources or supplier credit) and supply factors (deleveraging and disintermediation trends, also due to financial and other regulations) was an important consideration.

Participants highlighted the significant heterogeneity across jurisdictions in terms of SME definitions and characteristics (size, sector, age), as well as in terms of needs for financing and support services, including in particular access to knowledge. Access to finance is still seen as a major issue in developing economies and for micro and young firms.

Participants agreed that an in-depth examination of trends and effects at the domestic (individual jurisdiction) level is important given this heterogeneity. This includes the structure and competition of the banking sector and the availability of non-bank financing providers as important variables. Participants noted that small banks, or those banks that have a strong local presence, can lever on longer term relationships and may be better able to provide funding when it is needed. This relationship advantage may lead to a different assessment of riskiness than that based on hard information and statistical models. At least in some jurisdictions, cooperative credit institutions have supported SME financing and gained market share.

Participants also discussed the role of public policies (e.g. credit guarantees, tax incentives, directed lending) in fostering SME access to finance. Consistent with a shrinking of the

[6] See OECD (2018), *Financing SMEs and Entrepreneurs 2018 - An OECD Scoreboard* (http://www.oecd.org/cfe/smes/financing-smes-and-entrepreneurs-23065265.htm).

macroeconomic public support in normal times, these policies have largely shifted from broad-based countercyclical support in the aftermath of the crisis to more targeted policies in recent years aimed at promoting innovation and start-ups. A few participants noted that while guarantees can represent an effective means to facilitate access to finance for SMEs, the treatment of guarantees for prudential purposes may pose challenges especially if a loan-by-loan modelling approach is required.

Participants highlighted an important distinction between the timing and the nature of implementation on the effects of financial reforms. In many jurisdictions the transmission channels on SME financing depend on how these reforms have been implemented by regulatory and, most importantly in the view of some participants, supervisory authorities. In the European Union (EU), for example, this includes the introduction of an SME Supporting Factor in the regulatory capital framework, while in some other jurisdictions the effects may have been influenced by accompanying supervisory activities and expectations.

Many participants also highlighted the need for additional efforts to collect data in order to effectively monitor trends and better understand the drivers of SME financing. Several noted that it is striking how little is known given that SMEs are the backbone of economies, and that a common database would lower the cost of credit assessment and make it (almost) transferable. More generally, views varied in terms of data access versus data protection issues, and on whether open banking initiatives could advantage some players while not necessarily improving SMEs' access to finance.

2. Effects of reforms on bank financing to SMEs

In this session, participants discussed the effects of G20 financial reforms on bank financing to SMEs. The research in this area finds that some regulatory reforms (e.g. capital and liquidity requirements) and the introduction of macroprudential policies seem to generate credit supply effects, particularly if borrowers cannot easily find substitutes. However, identifying those effects is not easy given the many confounding events taking place at the same time (e.g. multiple reforms, accommodative monetary policies). According to the empirical literature, the effects seem to vary depending on initial conditions and on banks' lending techniques. The intensity of the effects depends largely on the "bindingness" of the reform across jurisdictions and banks. Banks that were capital constrained at the time of the implementation of new regulations seemed to be more heavily affected, while less constrained banks less so.

Basel III was identified by participants as the most relevant reform. Some participants expressed concern that banks may have increased the pricing and the proportion of secured SME lending – as well as reduced credit to riskier firms – including as a result of the reduced eligibility of collateral (both intangibles and physical collateral) for regulatory capital purposes. In that context, some participants raised the question of whether regulation strikes the right balance in terms of overall financing structure needs of SMEs.

Some participants identified other potentially relevant reforms. These included accounting rules (IFRS 9),[7] which may incentivise banks to reduce the maturity of SME loans, to request higher collateralisation, and to reduce credit availability in a downturn; insurance regulation such as Solvency II,[8] preventing insurance companies from investing in securitisations of SME loans; and domestic stress test frameworks, which may disproportionally affect SME finance because of the penalising implicit risk weight assumptions embedded in some of these tests. It was noted that while internationally agreed reforms play a role, the interaction of the reforms with other domestic regulation and public policies, as well as how the regulation is implemented and interpreted by relevant authorities, ultimately determines the extent to which various economic actors, including SMEs, are affected.

Finally, a few participants noted that the cumulative impact of regulations on SME lending may be driven also by the increased complexity and compliance costs, which may affect differently various types of banks. Small banks can be particularly affected by higher (fixed) compliance costs, while large banks may be incentivised to focus on bigger loans, this making it harder for smaller SMEs to obtain financing overall. Some participants expressed concern about the apparent convergence in business models across large banks, which may reduce diversity and build up systemic risks.

Some participants noted that the role played by small (and cooperative) banks during the financial crisis seemingly calls for providing some more proportionality in regulation, although views were mixed about how to strike a balance between ensuring proportionality and safeguarding a level playing field across lenders.

A few participants noted that while public policies such as SME credit guarantees can have partly offset the effects of higher prudential requirements, such instruments can be introduced to support different public policy purposes and different types of firms. Consistency and more broadly neutrality across different policy instruments cannot be taken for granted.

It was also pointed out that, while several of the concerns expressed by participants can be tested empirically, the financial system is still in a state of transition towards full-fledged new regulatory regimes (so the effects to date may not be conclusive) and that there may not be sufficiently granular data to allow strong conclusions to be reached.

3. Effects of reforms on non-bank financing to SMEs

This session examined the possible impact of post-crisis financial reforms on the provision of SME financing by non-bank financial institutions and capital markets. It was noted that the growth in alternative financing is particularly evident in a few jurisdictions (e.g. China, UK,

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[7] IFRS 9 is an International Financial Reporting Standard promulgated by the International Accounting Standards Board. It addresses the accounting for financial instruments. See https://www.ifrs.org/issued-standards/list-of-standards/ifrs-9-financial-instruments/ for details.

[8] The Solvency II Directive is a Directive in European Union law that codifies and harmonises the EU insurance regulation. See https://eiopa.europa.eu/regulation-supervision/insurance/solvency-ii for details.

US). Participants commented that there may have been some substitution effects (disintermediation) between banks and other financing providers, with the latter increasingly attracting institutional funds in search for yield. While this fostered the emergence of a more diversified pool of SME finance providers, some banks are adjusting their business models in response to this competition (e.g. by channelling SME loans to online platforms), while big techs are beginning to become active by leveraging their access to behavioural data and technology. Bank and non-bank finance, however, should not only be seen as alternative, as joint projects to exploit complementarities among new and traditional intermediaries are gaining pace.

Several demand and supply side factors drive this trend, one of which may be a lower regulatory burden for non-bank providers coupled with initiatives to promote alternative sources of finance (e.g. open banking, official support of venture capital/private equity funding, EU regulatory capital framework for simple, transparent and standardised securitisations). Other drivers include crisis-induced bank retrenchment from lending as well as technological innovation that enables access to customers whose merit of credit is more difficult to assess, such as self-employed and discouraged borrowers. Lending platforms can also provide an enhanced customer experience (and potentially lower pricing) due to the speed and simplicity of online interactions and more tech-based and automated decisions, while allowing access to a variety of investors. Some participants noted that the target business model provides investors with a commoditised, scalable and efficient way to access SME finance as an asset class, while allowing for similar scrutiny to the one provided by a traditional lender.

Participants noted that SME loan securitisation is concentrated in Europe and, while it performed well after the crisis, it has not represented a significant source of financing. Banks remain the principal issuers, with the majority of securitisations retained for funding purposes (used as collateral for refinancing with the European Central Bank). One participant also noted that regulatory frameworks that impose high capital charges on securitisation or rely on net asset value reporting for illiquid assets, may prevent institutional investors from providing investment capital to SMEs thereby reducing the universe of potential funding providers.

Some participants noted that the long-term sustainability of some alternative, non-bank financing providers is not yet clear since they have not been tested in a downturn, and expressed concern that they may create amplification mechanisms in the crisis through flight to quality reactions. Participants also noted that the growth of alternative finance may at present lever on regulatory arbitrage opportunities that might disappear in the future should the regulatory perimeter be adjusted or regulation be more activity-based.