FSB FINANCIAL STABILITY BOARD

29 November 2019

Evaluation of the effects of financial regulatory reforms on SME financing

Overview of responses to the consultation

Introduction

On 7 June 2019, the FSB published a consultative document on the *Evaluation of the effects of financial regulatory reforms on SME financing*. The FSB received 11 responses from industry associations representing SMEs, banks and other financial institutions.[1]

Respondents generally welcomed the evaluation on this topic, noting the importance of SMEs in the economy and their contribution to employment and economic growth. This note summarises the comments raised in the public consultation and sets out the main changes that have been made to the evaluation report in order to address them.

Summary of main issues

Respondents noted that the report provides a generally accurate and comprehensive description of the characteristics and main trends and drivers of SME financing; covers the most relevant G20 reforms implemented to date (i.e. the initial Basel III capital and liquidity requirements); and appropriately evaluates the effects using empirical techniques. Some comments suggested that the FSB should expand the scope of its analysis to cover the reforms recently approved but not yet implemented, in particular the finalised Basel III package of December 2017.

A few main themes emerged from the consultation. Most of them focus on aspects of the reforms impacting SME financing that, in the view of the respondents, were not fully or adequately addressed in the report. The main issues raised by respondents are here below.

Impact of reforms and timing of implementation in relation to the economic cycle

Comments

Some respondents noted that the evaluation does not examine whether the reforms have any procyclical impact. In particular, they asserted that the finding that the pace of lending slowed down in countries hit by an economic downturn provides evidence of procyclical effects of the reforms, and asked the FSB to repeat the analysis once data on a full cycle are available.

[1] The comment letters are published on the FSB's website.

Some respondents also felt that the report does not provide a thorough cost-benefit analysis of the reforms and pointed out that the fact that the benefits outweigh the costs is assumed (based on previous studies) rather than fully analysed. A specific concern expressed by a few respondents is that SME financing has become a less attractive "use of regulatory capital" for banks due to increased compliance costs.

Changes in response to the comments

Additional text has been added in the report to indicate more clearly that that the evaluation does not cover a full economic cycle and that the long-term benefits of the reforms are based on ex-ante impact studies. However, no references to a follow-up evaluation have been added.[2]

The evaluation assessed the effects of the reforms on SME financing within the constraints presented by data availability, differences in economic cycles across jurisdictions, and the fact that it is undertaken early after implementation that does not allow an assessment over a full economic cycle. The evaluation also included analysis of trends and extensive consultation with market participants – a call for public feedback, an industry workshop and targeted interviews – that provided a fairly consistent overall picture on effects and confirmed that the results of the empirical analysis hold at the aggregate level.

The evaluation does not find the impact of the reforms to be more severe for the financing of SMEs compared to larger firms. Where observed, a decline in lending after the global financial crisis has not generally been concentrated on SMEs. The report recognises that in some countries covered by the empirical analysis, the timing of reforms has coincided with an economic downturn. This indicates that the stage of the cycle at the time of a reform's implementation may matter in terms of effects, but it does not per se constitute evidence of procyclicality caused by the reforms.

Overall finding versus detailed effects

Comments

Some respondents noted that in jurisdictions where the empirical analysis was based on more granular (bank-firm level) data, the results indicate a more persistent negative effect of the reforms. They suggested that this result should be given more attention and should feature more prominently in the discussion of the effects of the reforms.

Some respondents also suggested performing the analysis at the jurisdictional level in order to better evaluate the effects of reforms and disentangle the different jurisdictional-specific factors that might have played a role, including for example with respect to the public policies.

Changes in response to the comments

The text has been revised in section 4 to clarify further the heterogeneity of results among jurisdictions. These depend on the macroeconomic environment and other country-specific variables, which the empirical analyses sought to take into account as possible confounding factors (see below). The conclusions in the report are based on the overall findings across a

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[2] The July 2017 FSB *Framework for Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms* states that the selection and prioritisation of topics for future evaluations will be taken by the FSB on the basis of assessments of materiality and feasibility, after consultation with the relevant standard-setting bodies.

number of studies, including both cross-country and within-country analyses at varying levels of data granularity. The empirical analysis has taken into account country specificities by: (a) using controls for time and country-specific effects (via fixed effects); and (b) considering the variation in implementation timelines and between announcement and implementation dates for robustness purposes. The report now includes more information on the findings from the granular country-level exercises, while noting that the various analyses support the main conclusion of the evaluation and that the findings do not have a 'one-size-fits all' nature.

Mitigating policies

Comments

A few respondents noted that the report does not sufficiently address the potential mitigating effects of public policies.[3] Several respondents mentioned in particular the importance of the SME Supporting Factor (SF) in the European Union, which may have dampened the impact of Basel III capital reforms on SME credit provision. Respondents noted that rather than look at the net effect of the reforms, it would be more meaningful to disentangle the effects of this confounding factor.[4] A few respondents shared their own analyses, which generally show a positive impact of the SF.

Changes in response to the comments

The potential mitigating role of public sector policies that, in many jurisdictions, have been put in place with the specific objective of supporting SME financing are discussed in the report. Notwithstanding this, the specific effect of public sector policies that go beyond the G20 financial reforms is outside the scope of the evaluation.

The report has been modified to include updates in Box 4 on the SF, including references to recent research as well to the European Banking Authority (EBA) Recommendation of August 2019 that the EU-specific SF for SME lending exposures should not be retained when adopting the finalised Basel III package.[5] In addition, text has been added in section 4 to explain that the empirical analyses have taken into account the SF by including the eligibility of the loans for the SF explicitly into the econometric specification as a control variable. The report also clarifies that the SF was not the main focus of the empirical analysis, so any inferences on its effectiveness cannot be drawn from the results.

Effects of specific elements of the Basel III capital reforms

Comments

A few respondents noted that some other elements of the Basel III capital reforms may affect bank lending to SMEs. In particular, it was noted that: (i) provisions regarding the credit

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[3] One respondent noted that the FSB should engage in more detailed analysis of the effectiveness of the public policy programmes and the gaps they are meant to fill vis-à-vis private sector finance, and suggested including an annex with a detailed assessment of the effectiveness of each policy.

[4] In this context, one respondent noted that the scope of application of the finalised Basel III risk weight for SME exposures (85%) is limited to unrated SMEs and remains much smaller than the scope of application of the current EU SME supporting factor, which also applies to retail SMEs or SME exposures secured by a mortgage on commercial properties.

[5] See *Basel III Reforms: Impact study and Key Recommendations* by the EBA (August 2019).

conversion factor (CCF) may penalise undrawn credit lines commonly used by SMEs; and (ii) trade finance, which is a preferred source of financing by SMEs in the export sector, can be penalised by the application of the leverage ratio to banks' exposures to Export Credit Agencies and by the Net Stable Funding Ratio (NSFR) treatment of trade finance exposures. In particular, a few respondents argue that funding factors applied under the NSFR can force the use of long-term funding to finance short- term assets such as trade finance, forcing up the cost to borrowers; and that the risk weights for small business loans require banks to maintain a high level of stable funding that is relatively costly, thus discouraging lending to small businesses and penalising market making activities of securities issued by SMEs.[6] It was also noted that the analysis in Box 3 on the changes to the risk weighted assets and weighted average cost of capital (WACC) for SME lending under Basel III does not take fully into account the introduction of loss given default (LGD) parameter floors.

Changes in response to the comments

Consistent with the FSB evaluation framework, this evaluation has not examined the effects of reforms – such as the NSFR and the finalised Basel III package – for which implementation is not yet at a sufficiently advanced stage. Consequently, the evaluation describes only those reforms that may have been relevant for SME financing and their potential transmission channels (Annex C). In response to the consultation feedback, the Annex has been expanded to include a more detailed description of the changes in Basel III that directly relate to the product types mentioned by the respondents. Moreover, quantitative assessments conducted by the Basel Committee ahead of finalising the Basel III reforms did not suggest that SMEs would be specifically and disproportionately impacted by the elements mentioned by the respondents.

Methodology

Comments

A few respondents suggested that the measure of "exposure"[7] to the reforms used in the analysis might underplay the severity of the impact. They note that the reforms could have affected all banks for which there was a capital shortfall, irrespective of the bank's position in the distribution of capital adequacy ratios before the reforms where implemented. Respondents therefore suggested changing the measure of exposures by categorising those banks as "more exposed" which had a capital shortfall relative to the post-reform target capital levels.

Changes in response to the comments

The evaluation team discussed extensively the most appropriate measure of "exposure". Robustness analyses, including a time-varying measure of exposure that captures the evolution of banks more exposed through time, indicate that the results are generally robust to the measure of exposure adopted in the study. This has been clarified in the text of the report. Also

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6 The respondents noted that securities issued by SMEs generally do not qualify as Level 2B assets since the issuers are not among the largest corporates whose securities are included in major indices. As a result, SME debt and equity securities will receive 85% or 100% Required Stable Funding (RSF) factors, in contrast to the 50% RSF factor that applies to large companies' securities.

7 As indicated in the consultation report, banks have been identified as "more exposed" if their capital adequacy or liquidity ratios ranked in the bottom decile or quartile of the distribution for all banks before reforms were announced nationally.

a capital shortfall measure was considered and excluded due to data limitation issues. In addition, the team considered that, even absent a capital shortfall, banks may have been affected by the reforms and changed their lending behaviour in case they wanted to preserve a capital 'buffer' over-and-above the regulatory capital requirement.

Other issues

Comments

A few respondents asked whether the evaluation examined the indirect effects of the reforms. In particular, they noted that while banks may have maintained their presence in SME lending, the resulting increase in capital requirements might have impacted their other activities, such as international capital markets or large corporate business. It was also mentioned that the analysis of SME financing should incorporate both regulatory and supervisory actions, in particular regarding new approaches to loan loss provisioning and the relationship with capital. It was mentioned that further regulatory or supervisory action in some jurisdictions can lead to a further strengthening of their capital position and have a tightening impact on both credit standards and credit margins across all loan categories.

Finally, and outside the scope of the report, a number of respondents suggested that in light of the importance of SMEs and their contribution to economic growth, the FSB should engage in work to promote SME financing, for example by addressing the issue of consistency of definitions and sparsity of data for evaluating the risks related to SME financing.

Changes in response to the comments

The report notes that the objective of the evaluation is to examine the effects of financial reforms on SME financing, including whether bank lending to SMEs was more affected by the reforms than lending to large corporates (also for large corporates, the empirical analyses carried out did not find a negative impact on lending by the most affected banks in 11 out of 15 studies (see Table 3 of the report)). Other indirect effects would be particularly difficult to address empirically due to, inter alia, data limitations and the limited observation period post-implementation. Jurisdiction-specific supervisory approaches are outside the scope of the evaluation and have not been examined.

The consistency of definitions and sparsity of data for evaluating the risks related to SME financing is outside the scope of the evaluation, but the text in the report has been amended in section 2 to better highlight the challenges to the evaluation deriving from such data limitations.