CENTER FOR CAPITAL MARKETS COMPETITIVENESS

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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 (SME financing)

To Whom it May Concern:

The U.S. Chamber of Commerce ("the Chamber") appreciates the opportunity to provide comment on the Financial Stability Board's (FSB) evaluation ("the evaluation") on the effects of the G20 financial regulatory reforms on small and medium-sized enterprise (SME) financing.[1] Our members include banks that operate only in the United States ("U.S."), banks with global operations, and banks headquartered outside of the U.S. Perhaps more importantly, our membership includes non-financial companies that rely on banks to access the capital markets and fund their operations.

The consultation notes the FSB will publish a final report of its findings in November 2019. The consultation states, "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 Chamber has consistently called for holistic study of the myriad regulations, including the G20 financial regulatory reforms, which have been implemented since the financial crisis. The Chamber supports the FSB's efforts to understand the effects of financial regulatory reforms on SME financing and is eager to assist in this effort.

[1] Consultation available at https://www.fsb.org/wp-content/uploads/P070619-1.pdf

The Chamber agrees with the FSB's characterization of the contribution of SMEs to job creation and the global economy. SMEs form the backbone of the economy and account for a large share of employment and value-added and are "important drivers of job creation, entrepreneurship and inclusive economic growth worldwide."

In the United States, small businesses are key drivers of economic growth and job creation: they employ nearly half of U.S. employees and have produced 61% of net job creation since 2010.[2] This is also generally true of other jurisdictions. The consultation notes, "A survey of firms in 99 countries for the period from 2006 to 2010 estimated that 66% of total workers are employed by SMEs."[3] If these businesses are successful they oftentimes grow into medium, large, and even global enterprises that may employ tens of thousands of people.

However, according to the U.S. Census Bureau, only 414,000 small businesses were founded in 2015, a decline of 26% since 2006.[4] Evidence suggests a number of factors are driving this trend. The Chamber consistently hears from small businesses that financial regulations and access to capital, at affordable terms, are a key barrier to starting and growing companies.

The Chamber supports the work of the FSB, and its evaluation of SME lending, but disagrees with the primary conclusion of the evaluation, which states:

" . . . For the financial reforms in scope, the analysis thus far does not identify material and persistent negative effects on SME financing in general, although there is some differentiation across jurisdictions. There is some evidence that the more stringent risk-based capital (RBC) requirements under Basel III slowed the pace and in some jurisdictions tightened the conditions of SME lending at the most 'affected' banks (i.e. those least capitalized ex ante) relative to the other banks. These effects are not homogenous across jurisdictions and they are generally found to be temporary."

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[2] Angel, J. (fall 2018). Impact of Bank Regulation on Business Lending. U.S. Chamber of Commerce Center for Capital Markets Competitiveness. Available at https://www.centerforcapitalmarkets.com/wpcontent/uploads/2018/09/CCMC_RestoringSmallbizLendingReport_9.10.18-1.pdf

[3] *Small vs. Young Firms Across The World – Contribution to Employment, Job Creation, and Growth, World Bank Policy Research Working Paper 5631 (April 2011).*

[4] Press Release, U.S. Census Bureau, Startup Firms Created Over 2 million Jobs in 2015 (Sept. 20, 2017), available at https://www.census.gov/newsroom/press-releases/2017/business-dynamics.html

The FSB's evaluation references broad research to reach this conclusion; however, we believe it is inconsistent with the experience of our members. There is strong evidence to suggest that the 2010 Basel III capital and liquidity requirements ("2010 Basel III requirements") have been detrimental to SME lending, at least in the United States.

The FSB should recognize that the report it plans to issue in November 2019 in and of itself could affect the availability of credit for SMEs if it is used as the underpinning or justification for future policy recommendations.

The Chamber offers the following comments in response to select questions posed by the consultation:

Question One: 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?

The Chamber agrees with the consultation's assessment that SMEs tend to rely on relationship lending, "which requires soft information and a thorough understanding of local markets." However, the relationship-lending model necessary to extend credit to SMEs does not comport to the 2010 Basel III requirements. These standards make it cost-prohibitive to extend credit to SMEs by increasing the cost of capital and increasing the cost of underwriting. The cumulative costs of complying with financial regulations may cause banks to focus on bigger loans. Banks should have the flexibility to provide financing to all SMEs; however, the Basel III capital and liquidity requirements has prevented this or encouraged banks to lend to other enterprises.

Question Two: Are the SME financing trends presented in this report comprehensive? Are there other important trends that should be considered for inclusion?

The Chamber appreciates the broad perspectives regarding SME lending referenced in the report. However, we believe important data trends are absent, or at minimum, not appropriately emphasized to reflect the conditions in the United States.

The evaluation finds that "SME lending growth has resumed in recent years after falling during the financial crisis for a number of jurisdictions. Notwithstanding this positive trend, the volume of bank lending to SMEs remains below the pre-crisis level in some of these jurisdictions."

The Chamber partners with MetLife to publish a quarterly small business index. According to the index, 27% of small business owners plan to increase investment in their company over the next year, continuing a trend from the last two quarters.[5] However, their investment needs, and their ability to grow, cannot be fulfilled if the 2010 Basel III requirements are inhibiting credit availability.

Fall 2018 Report by the U.S. Chamber of Commerce Finds Small Business Lending by Banks Has Not Recovered

Small business lending by depository institutions has not kept pace with the development of the U.S. economy according to a report by the U.S. Chamber of Commerce.[6]

Small business lending by U.S. financial institutions dropped by nearly 50 percent according to our analysis of data from the U.S. Federal Deposit Insurance Corporation.[7]

- Small business loans less than $1 million decreased from 2.5% of gross domestic product in 2001 to 1.7% in 2017.
- Small business loans less than $1 million make up a smaller portion of total bank assets, dropping from 4.0% in 2001 to 2.1% in 2016.

The Chamber's report concludes that, "Strict capital and liquidity requirements were put in place in response to the 2008 financial crisis. The unintended consequences of these changes are contributing to the decline of small business lending." This means fewer new businesses and less access to resources to drive the innovation necessary to grow the businesses that the U.S. economy will depend on in future years.

Spring 2019 Survey of Corporate Treasurers by U.S. Chamber of Commerce Finds Financial Regulation Continues to Impede Access to Credit

The Chamber regularly conducts a survey of corporate treasurers, chief financial officers, and other corporate financial professionals to inform our

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[5] MetLife & U.S. Chamber of Commerce Small Business Index (Q2 2019). Available at https://www.uschamber.com/sbindex/pdf/sbi_reports/SBI_2019_Q2.pdf

[6] Financing Main Street: The State of Business Financing in America. Spring 2019. Available at https://www.centerforcapitalmarkets.com/wpcontent/uploads/2019/04/CCMC_CorpTreasurerSurvey_v4_DIGITAL.pdf

[7] Analysis uses U.S. Federal Deposit Insurance Corporation Data for U.S. Commercial and Industrial and Nonfarm Residential Loans less than or equal to $ 1 million, available at https://www.fdic.gov/bank/analytical/qbp/timeseries/small-business-farm-loans.xls

understanding of how financial regulations, and other policies, affect their financing needs. The Chamber's Corporate Treasurers Survey was most recently conducted in spring 2019.

After a challenging decade that included a financial meltdown, recession, and a historically slow recovery, American businesses are reporting that their ability to access capital is steadily improving, and generally, they are optimistic about their expected performance over the next 12 months. This improvement is a welcome development; given the difficulties Main Street businesses had raising capital in the years immediately following the financial crisis. However, these modest improvement are overshadowed by some major challenges that have hindered a full recovery for small businesses.

A key component of a strong financial system is a regulatory structure that promotes economic growth. Unfortunately, the post 2008 financial crisis regulatory response imposed enormous costs on the economy while doing little to fundamentally reform the U.S. financial regulatory system. As a result, Main Street businesses found it more difficult to access the capital they needed to innovate, grow, and hire new employees.

The Chamber's survey, which includes insight from more than 300 corporate finance professionals, illuminates their attitudes regarding financial regulation. Lingering effects of the post-financial crisis regulatory response in the U.S. and abroad continue to present a challenge to American businesses. Bank capital charges in particular are cited as an impediment to capital access. The survey finds that among American businesses:

- 82% report taking some action as a result of changes to banking regulations, up from 61% in 2013 and 79% in 2016.
- 45% report absorbing the higher costs of banking services and loans, while 28% report increasing prices for customers as a result of financial regulation.
- 27% report substituting or reducing the number of financial institutions that provide services to them.
- 66% report that increased bank capital charges have led to increased costs or other challenges, up from 50% in 2016.
- 63% support federal regulators recalibrating capital requirements for large banks when lending money to small businesses.

Federal Reserve System Small Business Credit Survey

Finally, a survey of small businesses by the Federal Reserve confirms this finding. A survey published in 2019 of small businesses access to credit found serious shortfalls in small business lending despite widespread demand:[8]

- 43% of firms sought external funds for their businesses.
- 53% of firms that sought new funding experienced a financial shortfall, meaning they obtained less funding than they sought.
- 48% of small businesses stated their funding needs are satisfied among all small businesses.
- 23% of small businesses have shortfalls among all small businesses, and an additional 29% of small businesses, including debt-averse and discouraged firms, may have unmet funding needs.

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

The evaluation also states that SME financing trends are "largely driven by macro-economic conditions and factors other than financial regulation." The Chamber agrees that there are drivers other than financial regulation that effect SME financing; however, regulatory costs and uncertainty that affecting financing choices and cost is a concern most consistently voiced by our members.

The Chamber agrees that financial conditions, including the interest rate environment, would have an effect on SME financing. The United States, and other G20 economies, have exercised accommodating monetary policy since the financial crisis and during implementation of the reforms. Therefore, it would be difficult to disentangle the relatively punitive and beneficial policy changes, even when controlling for the low interest rate environment. However, this begs the question of whether increasing interest rates would have a more punitive effect on SME financing than pre implementation of the 2010 Basel III requirements.

Question Six: 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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[8] U.S. Federal Reserve System Small Business Credit Survey (2019). Available at https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2019/sbcs-employer-firms-report.pdf

The evaluation should be a holistic review of all financial regulations that influence the availability of credit for SMEs. However, a focus on the 2010 Basel III requirements is appropriate given there is evidence that they directly affect SME financing and they have been implemented, at least in part, for a sufficient period for study. In addition, the evaluation should consider how G20 reforms might be redundant to other reforms in some jurisdictions.

The Chamber complements the evaluation for featuring concerns addressing stress testing and expected credit loss in addition to its assessment of the 2010 Basel III requirements.

Stress Testing

Combining these tests with the Basel standards results in a form of double counting. The goal of the capital standards is that banks have enough capital to withstand a serious shock without collapsing or being so stressed that they stop lending. Thus, the capital requirements are set rather high. The stress tests also have the same goal. However, in practice, passing the stress test means that the minimum capital ratios are never breached even in the most adverse scenario.

Small business loans are particularly disadvantaged in the stress tests. By one estimate, the effective risk weight used in the Federal Reserve's Comprehensive Capital Analysis Review (CCAR) for small business loans is between three and five times the Basel III risk weight.[9]

The cumulative impact of stress tests combined with the Basel III requirements is a de facto level of capital requirements that is much higher than needed to protect the solvency of the banking system. This restricts the ability of banks to lend during a recession, which will increase unemployment in the next recession.

Expected Credit Loss

The Chamber appreciates the evaluation noting that expected credit loss provisioning could affect SME financing. Specifically, FSB states, it "might affect the

[9] Covas, Francisco, 2017, Capital requirements in supervisory stress tests and their adverse impact on small business lending, The Clearing House Staff Working Paper 2017-2, available at https://www.theclearinghouse.org/-/media/tch/documents/research/articles/2017/08/capital-requirements-insupervisory-stress-tests-and-their-adverse-impact-on-small-business-lending.pdf?la=en

maturity, collateralization and cyclicality of lending in general, including credit to SMEs."

The Current Expected Credit Loss (CECL) accounting standard, developed by the Financial Accounting Standards Board (FASB), is scheduled to take effect for public institutions in the United States beginning in January 2020. The Chamber has raised questions about the implementation of expected credit loss provisioning.

The Chamber has heard from our members that CECL would, amongst other things, have a negative impact on long-term lending, be "pro-cyclical" and disincentivize lending, particularly during economic downturns, and would exacerbate many of the hurdles to extending credit that institutions are already facing in the wake of increased capital requirements under the Basel accords and the Federal Reserve's stress test regime for certain institutions.[10]

To be clear, the Chamber has always and continues to support the independence of FASB and we believe it is inappropriate to bring improper political or other influence to accounting standards. However, we do expect policymakers to, at minimum, work together to understand how this new accounting standard will interact with financial regulations imposed on credit providers such as banks.

The Chamber strongly recommends that the FSB further study the impact of expected credit loss provisioning. The consultation notes a comprehensive assessment of their impact is not possible at this stage. We recognize the difficulty of assessing the impact of the standard at this stage, but would encourage the FSB to monitor its implementation closely.

The Chamber also recommends the FSB consider changes to bank capital and liquidity requirements and stress testing requirements to mitigate concerns about the implementation of expected credit loss provisioning, especially unintended consequences, such as pro-cyclicality.

Question Seven: Is the analytical approach used to evaluate the effect of reforms appropriate? Are there other approaches to consider for this evaluation?

The evaluation notes that the evaluation focuses on G20 reforms that have are applicable to banks given they are the "primary providers of external SME financing."

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[10] Quaadman, T. (2019, January 8). Implemented of the Current Expected Credit Loss Accounting Standard [Letter to Wes Bricker, Russ Golden]. Available at https://www.centerforcapitalmarkets.com/wp-content/uploads/2019/01/Chamber-CECL-Letter.pdf?#

The evaluation therefore focuses on the 2010 Basel III requirements, including both qualitative and quantitative analysis. The Chamber agrees with this approach, but would also underscore that other financial institutions are necessary for competitive and vibrant capital markets that permit for healthy SME financing options.

The Chamber agrees with the statement that access to public capital markets for SMEs is not common. Regrettably, over the years, the public company model has become increasingly unattractive to businesses. The United States is now home to roughly half the number of public companies than existed 20 years ago and companies are typically going public later in their lifecycle. The Chamber has advocated for reforms in the U.S. that would make it easier for companies of all sizes, especially SMEs, to make the transition to the public markets and continue to rely on them as a reliable, cost-effective means of financing.[11]

The evaluation does not include a quantitative analysis for more recent reforms, including the 2017 Basel III reforms and changes to the accounting treatment for expected credit losses.

Question Eight: Do you have any comments on the considerations of social costs and benefits of the reforms with respect to SME financing?

Financial regulation undoubtedly imposes costs on SME lending. Policymakers should focus on accurately measuring these costs. In addition, of course, policymakers should accurately measure the benefits of regulation. There should then be a determination for whether the benefits exceed these costs.

To be clear, the Chamber agrees that post-crisis financial regulations have made the financial system more resilient, which is an important benefit to financial institutions, their customers, and the overall economy. However, this benefit is accompanied by real costs to financial firms and non-financial firms. Any analysis must weigh the benefits against the costs.

The introduction of the consultation references the November 2018 G20 report on supply of credit to the real economy. It concludes that ". . . higher financial system resilience is being achieved without impeding the supply of credit to the real economy . . ." The Chamber disagrees with this assessment and is concerned about how this reasoning may be applied.

[11] Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public (Spring 2018). U.S. Chamber of Commerce. Available at, https://www.uschamber.com/sites/default/files/ipo_report_expanding_the_on-ramp.pdf

There is clear qualitative and quantitative evidence that the supply of credit is impeded due to the costs of financial regulation. However, there is room for reasonable debate about to what degree these costs are realized and if they are exceeded by the benefits.

Bank regulation serves a critical purpose — to promote the safety and soundness of the financial system. Yet these regulations must be properly calibrated and well-reasoned, to allow the financial system to serve its purpose: providing the financing and capital Main Street businesses need to start, hire, thrive, and contribute to broad economic growth.

Question 11: 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?

The Chamber is also concerned about the Net Stable Funding Ratio (NSFR) and its implementation in the United States. The Chamber requests the FSB closely monitor the impact of NSFR implementation on SME lending.

To date, the FSB has deemed five jurisdictions compliant with the NSFR while another fourteen have yet to implement the standard.[12] This may not be sufficient for a robust analysis; however, at minimum, it should permit for anecdotal observation and qualitative assessment. Federal banking regulators in the United States have proposed a rule to implement the NSFR, but it has not been finalized.

The NSFR is a long-term funding requirement that requires covered banking organizations to maintain a minimum level of stable funding relative to the liquidity of their assets, derivatives, and commitments, over a one-year period. The risk-weights for small business loans require banking organizations to maintain a high level of "stable funding." This funding is relatively costly thus discouraging lending by banking organizations to small businesses.

The Chamber has expressed concern that the NSFR would punitively treat corporate debt and impede SME lending.[13] The illiquid nature of loans to businesses,

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[12] Bank for International Settlements: RCAP on consistency, jurisdictional assessments. (Retried August 2, 2019) Available at https://www.bis.org/bcbs/implementation/rcap_jurisdictional.htm
[13] Gil, A. (2016, August 4). Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements, RIN 1557-AD97, RIN 7100-AE 51, RIN 3064-AE 44, Docket ID OCC-2014-0029, Docket No. R-1537 [Letter to Federal Reserve Board of Governors, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation]. Available at

especially to SMESs, put them into a higher weight category, and thus business loans lead to higher required stable funding than more-liquid assets.

The proposed rule in the United States includes an impact assessment that states federal banking regulators have considered, "possible costs to customers in the form of increased borrowing costs;" however, the overall lack of risk sensitivity in the U.S. NSFR strongly contradicts this assertion. This assumption is based on cost assumptions for present day (2016) calculations of NSFR funding shortfalls, when such costs could dramatically change in the future—particularly with rising interest rates.

Conclusion

Thank you for your review on the impact of the 2010 Basel III requirements on SME financing. This important subject merits your close attention as this capital and liquidity framework is implemented. Additionally, we appreciate your attention towards understanding how other G20 standards may affect the availability of SME financing.

Sincerely,

Tom Quaadman

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https://www.federalreserve.gov/SECRS/2016/August/20160829/R-1537/R-1537_080416_130393_501312881931_1.pdf