

Position Paper

UEAPME¹ position on the Basel III Implementation – CRD IV and CRR

UEAPME supports the efforts of the European institutions to increase the resilience of the financial system, in order to avoid future crises. However, enterprise financing neither caused nor added to the crisis. More stringent regulation of the financial markets therefore cannot be made at the expense of the financing of small and medium-sized enterprises.

Currently, many small and medium-sized enterprises are worried that the new Capital Requirements Rules – also in interaction with other regulatory initiatives, such as the Solvency II directive – will impede the flow of credit and loans again, as financing from banks is the single most important source of external finance for SME in the European Union. This means that access to credit and loans is critical for SMEs both to run the daily business (i.e. working capital and trade financing) and in a longer perspective to enhance competitiveness, to create growth and to increase employment by financing investments.

The current proposal will increase the financing cost and/or collateral requirements for enterprises with a normal rating, while financing of riskier projects (e.g. business start-ups, corporate successions and innovations) will become much harder to be obtained².

Furthermore, specific attention must be paid to the de-centralised banking sector in Europe, where traditional savings and cooperative banks are the main lenders to small and medium sized enterprises in many countries. Therefore, the specific situation of these banks as regards the quality of capital and the treatment of inter-group activities as well as their specific role in transforming maturity by financing investment with deposits must be respected when the international Basel III agreement is transformed into European law.

From the viewpoint of UEAPME, the following issues must be taken into account when implementing Basel III into European law:

- **Relief for SMEs to alleviate any negative impacts on business financing:** By commissioning the European Banking Authority (EBA) to review the raising of retail limits and a reduction in risk weights for SME credits, the Commission has sent an important signal towards the improvement of SME financing. Yet, this does not go far enough. A study by the Vienna Institute for Advanced Studies conducted at the request of the Austrian Ministry of Economics and the Austrian Federal Economic Chamber shows, for example, that the default probabilities of small and medium-sized enterprises remained relatively stable in the 2008/2009 crisis. Likewise, a study (Erlebach, Grasshoff, Berg "Die Effekte von Basel III", *Die Bank* 10/2010, pp. 54-58) of 150 European and American banks revealed that credit losses for 90% of these banks amounted to a maximum of 24% of the capital set aside to cover these risks.

Therefore, despite a massive recession, only one-fourth of the capital being held to back credits was used. Even without need of a review by the EBA, the risk weights for small and medium-sized enterprises to

¹ UEAPME subscribes to the European Commission's Register of Interest Representatives and to the related code of conduct as requested by the European Transparency Initiative. Our ID number is [55820581197-35](#).

² According to the ECB Bank Lending Survey, since proposals for Basel III first started taking concrete shape in late 2009² (before their *inter alia* transposition into CRD/IV), banks have started to react from day one. The margins on *less* risky loans to SMEs have widened faster than those on less risky loans to large corporates – a trend that is not mirrored in the case of riskier loans. This is not entirely unexpected. The IMF has warned that capital regulations are likely to encourage banks to take 'tail risk' (low-probability, high impact risks) at the expense of more mundane risks. (See: <http://www.imf.org/external/pubs/ft/wp/2011/wp11188.pdf>)

obtain credits must be lowered so as not to require more capital than the status quo demands. Such a “SME supporting factor” was calculated by an Italian initiative from all businesses (including the UEAPME member organisations) and bank associations³.

In concrete terms, UEAPME proposes to reduce the risk weight for the retail portfolio by 1/3 to compensate for this unjustified effect and to raise the thresholds for single loans in this portfolio from € 1 to 2 million. These improvements should be incorporated into the text of the regulation from the outset.

Such an adoption would also provide an incentive for banks engage more in real economy.

- **Encouraging securitisation of small business debt** and the creation of a secondary market in government-guarantee-backed SME loan securities: This should be approached at the European level, because national markets for such loans are likely to be too small and illiquid.
- **Minimise effects on export and trade financing:** The introduction of a risk-independent leverage ratio under Basel III can lead to a sharp rise in the cost of trade and export financing and fundamentally impede availability. The internationalisation efforts of many companies would be counteracted. Therefore, covered export credits should only be counted within the framework of the leverage ratio in terms of their corresponding risk weights. Moreover, the leverage ratio should at most be introduced as a benchmark, because low risk business (e.g. covered export credits and trade financing) would otherwise be passed over.

The liquidity provisions will also have an adverse effect on export financing. Export credits are normally medium to long term. The draw-down periods of these credits frequently extend over several years. Recourse is taken after strict documentation of the corresponding performances has been furnished. Hence, sudden liquidity outflows cannot be caused by export credits. When calculating liquidity outflows, a much lower factor than 100% should therefore be used.

- **Taking into account the specific features of credit guarantee systems in Europe:** In nearly each Member State, some institutions (mutual guarantees societies, guarantee banks...) are dedicated to offer (direct, mutual or counter) banking guarantees to SMEs acting as an essential complement to regular banks by mitigating and sharing the risks. Therefore, UEAPME suggests taking into account the specific features of the guarantees institutions by:
 - **ensuring that guarantees given by guarantee institutions and mutual guarantee schemes are eligible credit risk mitigation techniques.** If the definition of eligible protection providers for unfunded credit protection will become part of the pillar one regulation, it has to be made explicit that private and public mutual guarantee schemes and guarantee banks are covered by this definition to ensure that these guarantees are accepted as credit risk mitigation techniques **and**,
 - **recognising the different traditional forms of capital of such guarantee institutions** (i.e. mutual guarantee funds) **as core tier 1 capital** by the regulation itself **or providing some flexibility to Member States** to do so.
- **Do not place development business at a disadvantage:** SME promotional banks must moreover be exempted from the leverage ratio, because this could limit development business. Development banks conduct low risk credit business and promote start-ups, innovations and investments. They also alleviate economic fluctuations and thus aid small businesses in their financing projects. Exempting development banks from the leverage ratio is also justified because they are de facto part of the public sector. Therefore, the same exemption rules that apply to development institutions of the central states and the

³ <http://www.reteimpreseitalia.it/Approfondimenti/I-documenti-di-R.ETE.-Imprese-Italia/Analisi-a-largo-spettro-ed-interventi-di-proposta-politica/PMI-Supporting-Factor-english>

EU, which will not need to observe any leverage ratios in the future, should also apply to non-commercial development banks.

- **Preserve long-term financing culture:** An exaggerated transformation of maturity periods was a crisis factor in some financial market segments. While the need for stricter liquidity requirements is indeed comprehensible, the provisions now foreseen are too restrictive, because they would jeopardise the long-term financing culture, if a "net stable funding ratio" is introduced in the currently discussed form, which could create specific problems for traditional deposit banks like cooperatives and saving banks. The risk of fluctuating interest rates would therefore be increasingly shifted onto enterprises. Short-term interest rate turbulence would thus have a direct impact on enterprise financing and impair business planning. As foreseen by the Commission, the liquidity coverage ratio must apply at the level of institutional networks and not to each institution serving special interest groups.
- **Reassess the concept of a leverage ratio.** UEAPME raised its doubts about the rationale for an un-weighted leverage ratio already in the past, while recognising the problems created by extreme leverage ratios throughout the current crisis. Therefore, we recommend reassessing the idea of leverage ratios for different types of banking activities (.i.e. retail lending, trade financing, providing guarantees compared to financing subprime products and investing in derivatives). Furthermore, UEAPME believes that the risks of too high leverages will decrease, if the regulators get the liquidity problems and the risk weights right.
- **Remove the structural disadvantages for SME financing in the liquidity provisions.** When counting items towards liquid assets, corporate bonds, corporate credits eligible for rediscounts from central banks and ABS financing should be taken into account as well. The inability to count these assets towards the liquidity ratio reduces the attraction of these enterprises for investors, thus limiting the access of SMEs to capital market financing. The planned observation periods must also be used to study the related effects on enterprise financing and to make any necessary adjustments.
- **Implement Basel III internationally:** Basel III must be implemented globally in all major financial markets in order to avoid distortions in competition. This is of particular importance because Basel II is already applicable in Europe and – contrary to for instance the United States – not only to international banks, but to small and medium-sized banks as well. These banks are frequently creditors for SMEs and thus play a crucial role in SME financing. For this reason, too, the special features of national banking structures must be taken into account in the future framework and improvements for SME financing must be incorporated.
- **Basel Committee should reassess the risk weights:** While Basel III is mainly dealing with capital requirements (quantity and quality of capital), it does not touch the other side of the balance sheet which are the risk weights for different activities as laid down in the Basel II agreement. However, the current crisis has proved that the current regulations have also shortcomings as regards risk weights (i.e. government bonds versus corporate bond and retail lending, subprime products and other derivatives and their dependence of risk-weights from private rating agencies). Therefore, UEAPME asks the European Commission and the Member of the Basel Committee to reassess the current risk-weight structure in the light of the experiences made at the current crisis.

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