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Code of Conduct between credit institutions and SMEs

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CODE OF CONDUCT BETWEEN BETWEEN CREDIT INSTITUTIONS AND SMES

Industry Council

The Industry Council of 5 December 2001 calls upon the Commission to draft a European Code of Conduct between banks, finance providers and SMEs in order to improve their understanding of each other.

The Industry Council limited itself to asking the Commission to draw up this Code of Conduct. It implicitly recognised that its implementation was the responsibility of the stakeholders, i.e. the banking and SME associations, on a voluntary basis.

At the same Industry Council, the Member States, for their part, were called upon to promote contacts between banks, other fund-providers and SMEs in order to improve their understanding of each other.

The Industry Council also asked for an interim report before the end of 2003: the Commission report to the Council and Parliament on the access of small and medium-sized enterprises did indeed deal with the question of the Code of Conduct between credit institutions and PMEs[1].

The Industry Council's request was particularly ambitious : to date, none of the existing codes of conduct has been drawn up jointly by the banking and SME associations even at national level. Where a code of conduct does exist it has been produced by the banking associations alone.

Furthermore, despite the existence of European banking directives, the law governing relations between credit institutions and their clients is essentially a national matter.This is why cross-border transactions regarding credit are rare. It also explains the diversity of cultures and traditions among the Member States.

Origin

At the third Round Table of Bankers and SMEs[2], the purpose of which was to promote mutual understanding between credit institutions and SMEs, the question of a code of conduct between banks and SMEs was raised. However, the banks participating in this Round Table represented only themselves and were not, therefore, representative enough to deal with this subject. However, it was already apparent that the developments in the banking sector (mergers, reduction in the number of branches, etc.) were a matter of concern for the SME associations. They expressed at the time an opinion widely shared by their members regarding SMEs' access to financing. This opinion was also reflected in the results of various surveys carried out among SMEs[3], which highlighted entrepreneurs' concerns regarding access to financing, in particular for small enterprises.

Access to financing

SME's perception of their access to financing resulted from various factors:

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1 Access to finance of small and medium-sized enterprises, COM(2003) 713 of 1.12.2003; see 4.1.

2 Enterprise Directorate-General; 3rd Round Table of Bankers and SMEs; 19.06.2000

3 Survey by the European network for research on SMEs, 19 European countries, questionnaire sent to 7 662 SMEs, August 2001.

– banks are undergoing a process of consolidation, mergers and acquisitions which is leading them, among other things, to close branches, which provide a local service particularly appreciated by SMEs since they meet their demand for personalised contact;

– quite apart from the debates regarding the development of international banking legislation, banking establishment are already more demanding regarding the transparency of SMEs. The increased transparency of SMEs allows banks to better gauge the risk which determines the cost and duration of credit.

However, there are serious market shortcomings as regards access to financing. These concern in particular:

– entrepreneurs setting up businesses who have no previous banking credentials or do not have sufficient guarantees;

– businesses interested in micro-credit, an activity considered by banks as costly with a low margin and high risk;

– the reduction in the venture capital on offer in certain segments since 2000, particularly as regards seed capital and start-up capital. This is also linked to the difficulties since 2001 of initial public offerings, a decisive element for the venture capital industry: it is with the aid of this that it produces a significant proportion of its profits before reinvesting them in early-stage financing.

– most of the accession and candidate countries, where the provision of domestic credit expressed as a percentage of gross domestic product is much lower than the Member States' average.

The main characteristics of the draft European Code of Conduct

Since 2002, the Commission has held meetings with the main European banking associations (European Association of Cooperative Banks; Banking Federation of the European Union and European Savings Banks Group) and the European SME associations (Eurochambres; UEAPME and UNICE). Initially the meetings were held informally.

In September 2002, a Working Party was set up formally with the six above-mentioned associations, plus two observers: the European Federation of Accountants (FEE) and the Network of European Financial Institutions (NEFI).

These associations agreed that the draft Code of Conduct between credit institutions and SMEs (the Code) should have the following characteristics:

– it should establish a framework: it should be a non-legislative process which aims to set out a series of principles likely to be followed by a significant number of European associations;

– observance of the Code should be voluntary;

– implementation of the Code should be carried out at national level by banking associations and SME associations;

– the Commission should act as an initiator and catalyst.

Method

The draft Code is the result of consultations between the European associations concerned: to facilitate consultation, the Commission had the role of initiator and catalyst. At the Working Party's request, the Commission submitted an annotated outline of the Code, based on existing codes of conduct[4]. The Code of Conduct Working Party met officially five times between September 2002 and October 2003. It set up within it a drafting committee, which drew up the Code on behalf of the Working Party. The drafting committee consisted of three members, one from the Commission, one from the European banking associations and one from the SME associations.

In May and June 2003, an initial version of the Code was sent by the European associations to their national members. The results of this consultation were reported at the meeting of the Working Party on 16 July 2003 and led to a second version of the Code. The consensus reached within the Working Party was the result of considerable effort on the part of all the European associations, particularly regarding the paragraph on the credit decision and the level of transparency as regards rating when a bank rejects a loan request by an SME.

The six associations had until 30 September 2003 to consult their national members. The outcome of the consultations was uncertain, since several European associations had to receive the unanimous support of their members in order to endorse the Code. The initial assumption was that at least four of the six European associations would endorse the Code, which would be sufficient for the operation to be considered a success. After the members of the European associations had been consulted for a second time, the results were reported at the meeting of the Working Party on 8 October 2003.

Final position of the European associations

On 8 October 2003, the three SME associations and the European Savings Bank Group stated that they were willing to subscribe to the Code as it stood. The other two banking associations asked for extra time before giving an opinion.

At the end of this extra period, the two European banking associations were unable to endorse the Code, despite the support, as far as it is possible to estimate, of 80% of the national federations belonging to the Banking Federation of the European Union who were ready to approve it as it appears in the version annexed. There are a number of reasons for this position, which reflects differences in tradition and culture, as follows:

– in some Member States a Code of Conduct is perceived as a source of uncertainty in terms of its place in the national legal system; furthermore, the creation of an *ad hoc* mediator to settle disputes resulting from the Code is considered an additional burden which in the long run would generate additional costs for credit establishments;

– the Code could result in a right to access to credit which could be relayed by national courts;

[4] European Code of the European Savings Banks Group; Australia, Canada, Ireland, United Kingdom; Charte banques-entreprises (Bank-business Charter), France; Caisse d'Epargne, France; Lloyds Bank, United Kingdom; Royal Bank, Canada.

- some national banking associations fear that the code of conduct between credit institutions and SMEs is just the first step towards legislation on the matter;[5]

- as regards transparency concerning rating, when a loan is rejected by a credit institution, the practice of providing an explanation is already becoming widespread in certain Member States; in other Member States this practice is rarer. Finally the value of constructive dialogue between credit institutions and SMEs is perceived differently depending on national traditions.

The institutional position of the Commission

According to the inter-institutional agreement on better lawmaking[6], which was signed by the European Parliament, the Council and the Commission on 16th December 2003, the general rule is the absence of a position on the part of the European institutions regarding codes of conduct.

Consequently, references to the Commission's support, particularly as regards the promotion and monitoring of the Code, which had been proposed initially by the drafters of the code cannot appear explicitly in the text. Nevertheless, the Commission will continue its dialogue with the European Banking Associations and European SME associations.

Conclusions

The drafting of the Code of Conduct between credit institutions and SMEs is complete: this was the remit of the Industry Council.

The Code of Conduct, as it appears in the version annexed, received the approval of three SME organisations (Eurochambers, UEAPME, and UNICE) and the European Savings Bank Group and, as far as we can estimate, 80% of the National banking federations of the Banking Federation of the European Union.

Consequently, following the conclusions of the Industry Council (predecessor to the Competitiveness Council) of 5 December 2001, it is now up to the Member States to encourage the banking associations and SME associations at national level to use the Code of Conduct, as it appears in the version annexed, in order to promote contact between credit institutions and SMEs and to increase their mutual understanding.

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5 Commission Recommendation of 1 March 2001 on pre-contractual information to be given to consumers by lenders offering home loans C(2001)477 of 1.3.2001.

6 Official Journal of the European Union C 321 of 31.12.2003, p1.

<u>**ANNEX: Code of Conduct between credit institutions and SMEs**</u>

Introduction

Good business relationships between credit institutions and SMEs will help to achieve the European Union's goal of becoming the most competitive and dynamic economy in the world (European Council of Lisbon, March 2000).

SMEs make a major contribution to growth and employment in the EU. In this respect, access to finance is a major factor in the success of enterprises and the creation of stable jobs[7].

An efficient and effective relationship between credit institutions and SMEs is one of the key issues for the development of the European economy. Irrespective of different national traditions, laws and regulations in finance, loan finance is still the most important source of external finance for SMEs in Europe and the dominant role of loan finance will likely subsist.

Against this background, the European banking sector continues to be committed to provide services to SMEs in the different phases of their life cycle. It will thereby contribute to the competitiveness of the European economy in an increasingly globalised world. By acting locally and thinking globally, the European credit sector will be a reliable partner for SMEs and will efficiently accompany them through future EU and international economic, regulatory challenges and opportunities, in particular the increasing globalisation of the economy, the consolidation and merger dynamics of the sector, the growing emphasis on profitability, as well as reforms of financial sector and banking legislation.

The Industry Council of 5 December 2001 invited the Commission to draft a European Code of conduct between banks, finance providers and SMEs in order to improve their understanding of each other.

The current European Code of Conduct is a confidence building measure. This is a voluntary Code of Conduct based on a set of common principles adopted by the main European organisations representing both banks and SMEs.

General objective

The European Code of Conduct contributes to fostering good working relations between credit institutions and SMEs by encouraging a greater mutual understanding of their respective roles and responsibilities.

Specific objective

The European Code of Conduct outlines a set of principles to ensure a mutually beneficial, loyalty-based and rewarding relationship between credit institutions and SMEs.

Scope and definitions

The European Code of Conduct refers to loan finance. This Code cannot be construed to give a right of access to credit for the applicant.

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7 3rd Round Table of Bankers and SMEs, final June 2000

The European Code of Conduct is intended to apply to all Member States of the European Union.

"SME" shall mean an undertaking defined as such in the most recent Recommendation of the Commission[8].

"Credit institution" shall mean an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credit for its own account[9].

The European Code of Conduct is open to all credit institutions and their associations, as well as to all SMEs associations.

General principles

Building mutual trust

Credit institutions and SMEs understand that a beneficial and long-term business relationship has to be based on mutual trust and confidence.

SME lending is an important segment of banking activity and both parties see their relationship as of central importance for the growth and well being of their business. Both parties understand that the other side is doing business in a highly competitive environment. Openness and the avoidance of unnecessary delays by both parties are of paramount importance in this context.

Boosting transparency

Transparency contributes to a sustainable and balanced long-term business relationship. In the business relationship between the credit institution and the SME, the credit institution shall have a transparent conditions structure and communicate all information and requests in clear language. Its SME counterpart shall supply without unnecessary delay any important information that might affect the contractual relationship, both before the conclusion of the contract and after it has been signed.

Open dialogue

Both SMEs and credit institutions recognise the importance of an open dialogue, if a solid and durable relationship is to be achieved. For the SME, this implies giving a complete picture of its business situation over time. For the credit institution, this implies communicating what kind of information it needs, discussing openly any concern it might have with the SME and giving an open and complete picture of its relevant services and fee structures, so that the SME will be able to choose the best service available for its own needs.

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8 Recommendation of the Commission 96/280/EC (OJ L 107 of 30 April 1996). From 1st January 2005, this recommendation will be replaced by the recommendation of the Commission C(2003)1422, 6 May 2003, OJ L 124/2003: Commission recommendation concerning micro, small and medium-sized enterprises.

9 2000/12/EC of 20 Mar 2000, OJ L 126 26 May 2000.

Respecting privacy and confidentiality

In line with the requirements of the legal framework, credit institutions will handle information about the customer discretely because it can be very sensitive in a competitive environment.

Non discrimination

Credit institutions are ready to start a business relationship with an entrepreneur irrespective of his/her ethnic origin, gender, religion or nationality, with due respect to proper business ethics and in compliance with relevant law.

Credit process

Transparent application process:

The SME shall provide all relevant information such as a business plan, financial statements, as well as disclose its current financial situation and financial engagements with other banks and other entities to the credit institution. The credit institution will in return give feedback on how it views the credit application. The SME has the opportunity to give additional information and explanations. The credit institution will inform the SME of the range of relevant products it offers and the related procedures.

The credit institution will communicate prior to the credit approval process what kind of data and information it needs and will offer to inform the SME of the relevant factors affecting the credit decision and, in case the credit institution uses a rating system, the principles of the rating procedure which will be applied. The credit decision will be communicated in a clear way and in general the credit institution will provide to the SME an explanation on this decision including rating, if relevant.

Transparent terms and conditions:

Prior to the conclusion of a credit agreement and at the latest with the submission of a written contract, the credit institution shall make available, in clear language, detailed information on the terms and conditions for the requested credit, including rules under which terms and conditions can be changed unilaterally by the credit institution: a legal or technical language will only be used where necessary. The SME will be informed of any subsequent changes made to the terms and conditions.

Changing circumstances:

The SME shall inform its account manager at the credit institution, when it anticipates or experiences a relevant change in circumstances that could influence its banking relationship.

The dialogue between the credit institution and the SME assumes particular importance when the latter begins facing financial difficulties, for example over indebtedness, large decreases in the business' turnover, sudden loss of a key customer or key employee vital for the success of the business. In this case, the SME will inform the bank immediately.

The credit institution will discuss openly the situation with the SME with a view to exploring the options related to finance.

Response time:

The credit institution shall avoid any unnecessary delay in communicating a credit decision to the SME.

Implementing the Code

This is a voluntary European Code of Conduct. It constitutes a common set of principles supported by the European Credit Sector Associations and European SMEs organisations: they will promote the European Code of Conduct.

The European Code of Conduct between credit institutions and SMEs is intended to be the basis of national Codes of Conduct agreed by appropriate organisations representing credit institutions and SMEs at national level. The national Code of Conduct can lead to actions linked to the purpose of the European Code, such as a joint action plan or joint actions of common interest.

The national Code may go beyond the purpose of the European one, lead to complementary initiatives and have additional provisions.

Whenever the European Code of Conduct is not agreed at national level, national, regional, local organisations or individual credit institutions can subscribe the European Code and develop targeted actions related with its purpose, such as awareness campaigns, workshops or training sessions. Complementary initiatives are also possible.

Monitoring the Code

The European Code of Conduct will take effect from the date of its adoption, for a five-year period, with a possibility of tacit renewal.

On an annual basis, the European Credit Sector Associations and European SMEs organisations will hold meetings to assess the use of the European Code of Conduct and to continue the dialogue.

Dealing with complaints

At the national level, credit institutions and SMEs organisations adhering to the European Code of Conduct are recommended to use existing dispute resolution processes for matters related with the Code. When such a quick and cost-effective dispute resolution process does not exist, it is advisable to agree upon an appropriate method, at national level.

Avoiding overlapping

By its nature, the European Code of Conduct will not enter into conflict with the Community legislation or the national legislation, in particular on credit institutions. When necessary, adaptations will be made in the national Code of Conduct by adding appropriate provisions to the European Code of Conduct.