

Brussels, 18 March 2019

EBF\_036241

## EBF Answers to the FSB consultation on the evaluation of the effects of financial regulatory reforms on the provision of financing to SMEs

### Introductory remarks:

The European Banking Federation (EBF) would like in the first place to endorse the timely consultation by the FSB on the effects of the financial regulatory reforms on the provision of SME financing.

This is a critical exercise, in order to identify and assess impacts and potential unintended consequences of regulation. The results of this exercise are crucial to be taken into account and factored in regulatory fine-tuning.

As an upfront clarification, we would like to mention that given the short time provided to respond, it was not possible to conduct *ad hoc* analyses, therefore:

- the response relies on available evidence and public studies only, and
- some issues are included in the answer, being self-evident or based on shared views among members, despite this, it was not possible to collect further evidence for the moment.

Consequently, this first input should be considered as preliminary evidence gathering that will help to frame some of the key concerns of European banks. The EBF is committed to developing a more comprehensive feedback for the full consultation in the summer.

### European Banking Federation aisbl

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## Key points

Financial markets are global, market actors are competing on a global level. Regulation should therefore be coordinated globally as far as possible. The financial regulatory reforms introduced in recent years have done much to enhance the stability of the financial markets and market participants.

The more stringent capital and liquidity requirements, in particular, are sensible safety nets in a complex environment. It remains reasonable that the G20 and the FSB continue with this coordination. However, we warn against overtightening the regulatory screws at this juncture by introducing further requirements and call for a thorough review of existing regulation.

With regards to content, we would like to note our core findings and remarks, that we understand merit the utmost attention so to ensure a smooth review of regulatory impact and shape the fine-tunings to come.

- SMEs are the main components of the corporate landscape in Europe. Bank loans are the most important and demanded form of SME financing in Europe. The financing mix of SMEs in the EU differs quite substantially from other jurisdictions around the globe and entails varied specificities.
- The impact of regulatory measures in such an SME-filled environment need to be carefully calibrated as to avoid unintended consequences. Regulatory measures taken at European level can be strongly felt. Continued regulatory support to bank financing of the economy is critical to ensure proper financial intermediation and risk management.
- The new regulatory reform might put SME exposures at a disadvantage with regard to other alternative uses of capital in the banking sector. This might be an unintended consequence of the vast regulatory overhaul that has put the banking sector worldwide on a much stronger footing overall (higher need for collateral, long-term loans becoming more difficult etc.).
- These negatives effects have not yet really been perceptible (even if some hints are sprouting). This comes attached to the improvement of the economic situation in recent years/after the crisis, fostered by the unconventional monetary policy by the ECB (phase of zero interest rates), and its asset-purchase programme. However, the Basel III package has not yet been in place over a complete business cycle. In addition to that, modern economies are undergoing structural change and have a strong need for innovation and its financing. The capital requirements need to take into account that the economy need banks that are able to fulfil these financing needs.  
In addition, SME-focused policies at EU level, in the shape of direct public support or additional regulations on alternative financing methods have occupied the place of banks. However, direct capital market access is unlikely to be able to replace the financing of [average] SMEs. Direct market access is usually a possibility for larger corporates only.
- Policies affecting banks more concretely, have taken very specific shapes at European level, which we reflect on our analysis below: tackling the impact of Basel III and the

its finalisation (Basel IV), securitisation, the SME Supporting Factor, the critical issue of NPLs in Europe and changes in its management due to regulation, IFRS 9 and the heightened regulatory scrutiny.

- Regarding other reforms impacting SMEs, as mentioned above, we mention the focus on European topics (in connection with the Capital Markets Union project), dealing with the European SME definition, SME growth markets, regulation of crowdfunding, among others. Specific substitution effects on specific business lines and also with respect to public finance and the different financing mix in innovative companies / new entrepreneurs.
- Finally, we shortly highlight positive voluntary initiatives from the banking to improve the information possibilities of SMEs and their ability to reach the financing they need.

We look forward to discussing these issues more in depth and engaging with you in the more focused consultation to be launched in June to develop more arguments and clarifications.

**Question 1: What have been the main trends in SME financing (i.e. types of financing, volumes, prices and maturities) since the financial crisis? How do these trends differ across jurisdictions (e.g. advanced vs emerging market economies) and sectors (e.g. high-tech vs traditional firms), as well as by firm size (micro vs small vs medium-sized firms) and age (e.g. start-ups vs mature firms)?**

**Answer 1:**

To answer these questions, we would like to analyse briefly the most recent EU surveys on the subject matter, namely the European Commission (EC) /European Central Bank (ECB) Survey on the access to finance of enterprises (SAFE)<sup>1</sup> and the European Investment Bank (EIB) Investment Survey (EIBIS)<sup>2</sup> & EIB Investment Report<sup>3</sup>.

The latest EBF Facts and figures<sup>4</sup> are also a good source of aggregated information to understand the perspective of the Banking sector and have more granularity on specific credit conditions.

For a more concrete view on different jurisdictions, more information on those issues can be found on the country-by-country analyses of the surveys mentioned.

As an extra note, we would like to note the actual lack of available data on SME financing flows. There are no aggregated or comparable country-by-country statistics regarding the amount of SME loans (or new SME loans), in the European Union or in Eurozone.

This may sometimes translate into biased proxies when analysing SME lending.

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<sup>1</sup> SAFE Survey 2018, aggregated and per-country data available at:  
[https://ec.europa.eu/growth/access-to-finance/data-surveys\\_en](https://ec.europa.eu/growth/access-to-finance/data-surveys_en)

<sup>2</sup> EIBIS Survey 2018 available at:  
<https://www.eib.org/en/infocentre/publications/all/econ-eibis-2018-eu-overview.htm>

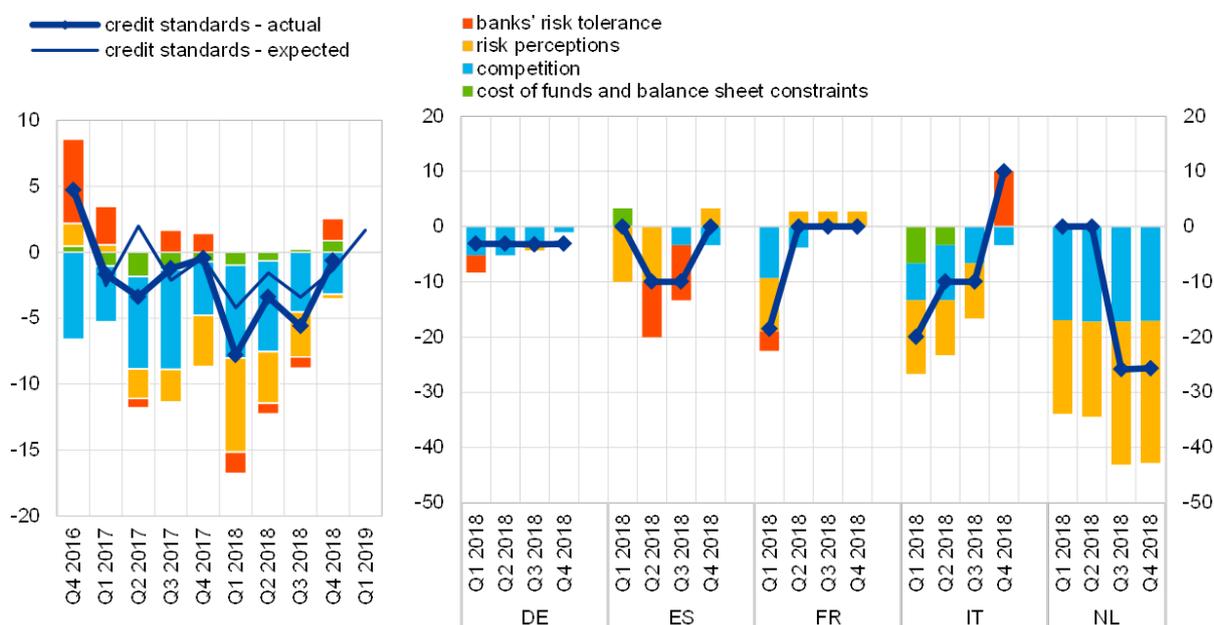
<sup>3</sup> EIB Investment Report 2018/2019 available at:  
<https://www.eib.org/en/infocentre/publications/all/investment-report-2018.htm>

<sup>4</sup> Facts and figures complemented in this paper with the EBF Spring Economic Outlook. EBF Facts and Figures available at: <https://www.ebf.eu/facts-and-figures/>

Regarding the SME population, in 2017, around 99.8% of all companies in the EU are SMEs, and they account for almost two-thirds of total EU employment (66.4%) and around 56.8% of the value added generated by the non-financial business sector. Additionally, Micro SMEs represent the vast majority of SMEs in EU, with around 93% of all enterprises and of all SMEs in the non-financial business sector.<sup>5</sup>

If we take a look at the general evolution of credit standards and demand for bank lending from the ECB Bank Lending Survey, we see a steady easing of standards and a continued increase in demand.

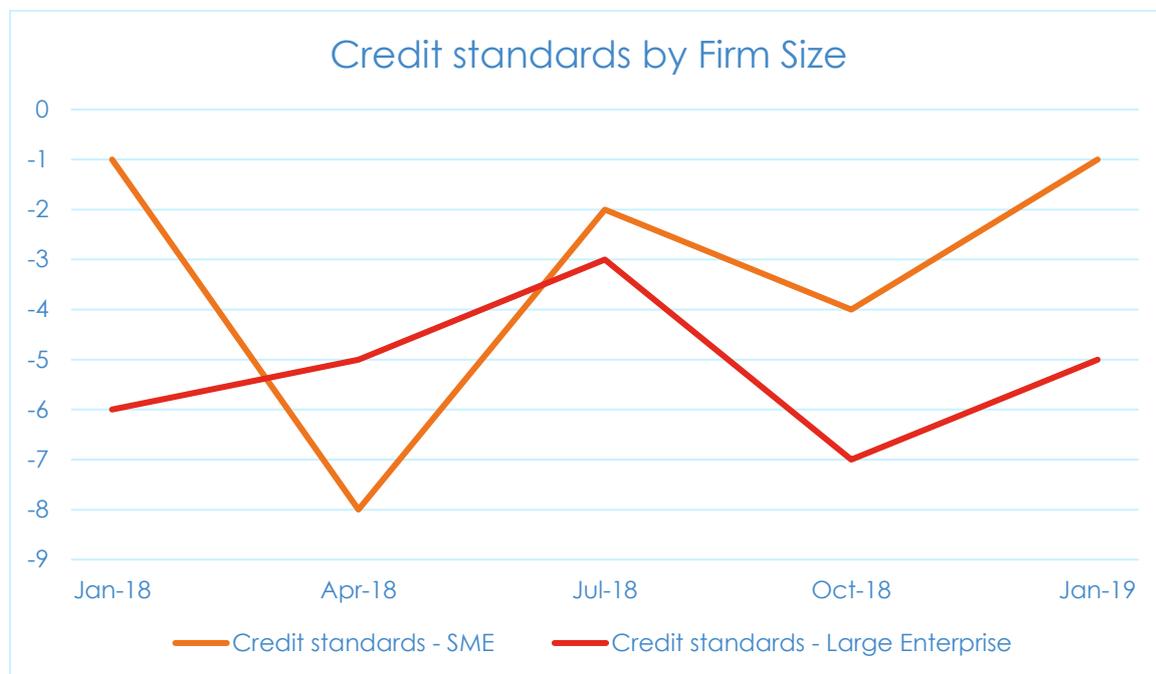
**Changes in credit standards applied to the approval of loans or credit lines to enterprises, and contributing factors** (net percentages of banks reporting tightening credit standards and contributing factors)



Source: ECB Bank Lending Survey

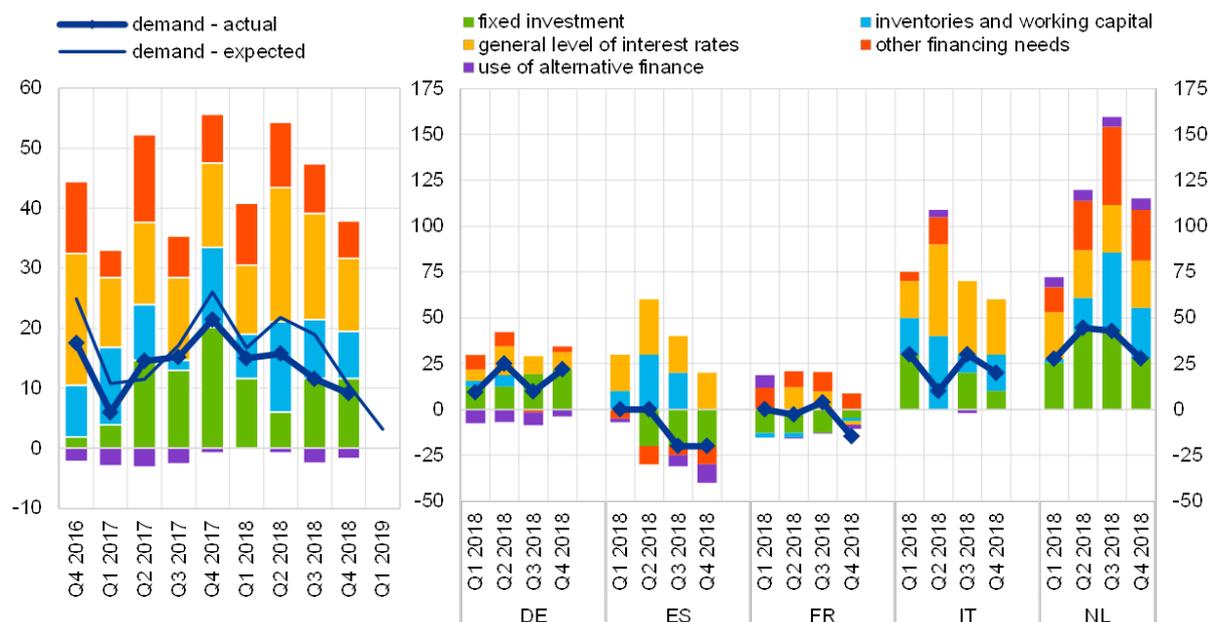
<sup>5</sup> EC Annual report on European SMEs. Available at: [https://ec.europa.eu/growth/smes/business-friendly-environment/performance-review\\_en#annual-report](https://ec.europa.eu/growth/smes/business-friendly-environment/performance-review_en#annual-report)

Trends and the factors driving those trends differ significantly by country, but banks have generally reported an easing of credit standards in recent years, driven by competitive pressure, especially from other banks. However, credit standards for SME lending have eased less than for large enterprises.



Source: ECB Bank Lending Survey

### Changes in demand for loans or credit lines to enterprises, and contributing factors (net percentages of banks reporting an increase in demand and contributing factors)



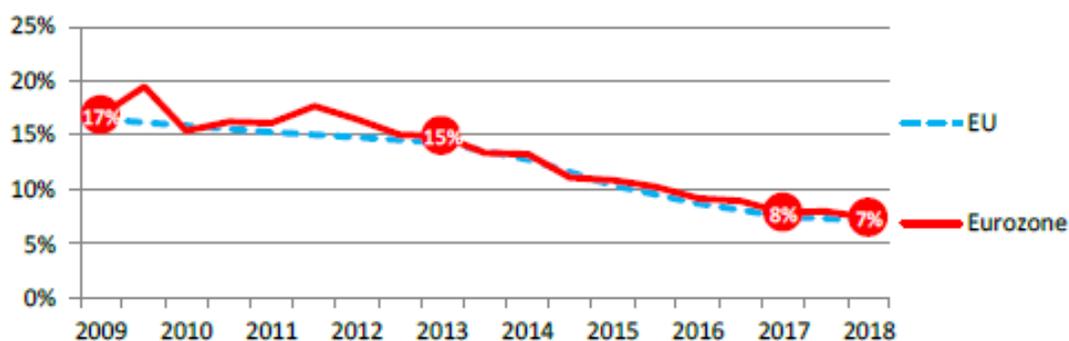
Source: ECB Bank Lending Survey

Net demand for loans to enterprise continued to increase with demand for fixed investment and working capital, both supporting rising demand, as well as the level of interest rates. Net demand was higher among SMEs, on average, than among large enterprises.



Source: ECB Bank Lending Survey

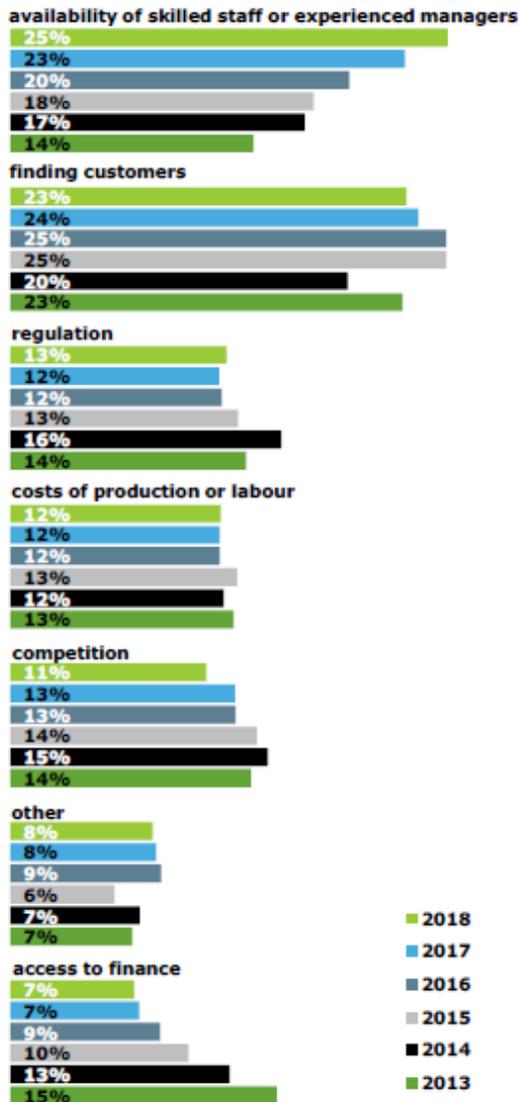
This easing in credit conditions and increase in demand, reflects the findings of the SAFE Survey, in which SMEs do not list access to finance as their most important concern. It went down from 16% in 2009 to a 7% in 2018.



Source: Infographic: SME access to finance in the EU 2018, p.1

The three most pressing concerns SME list are the availability of skilled staff or experienced managers (25%), finding customers (23%) and regulation (13%). Followed by costs of production or labour, competition, other concerns and the least relevant - access to finance.

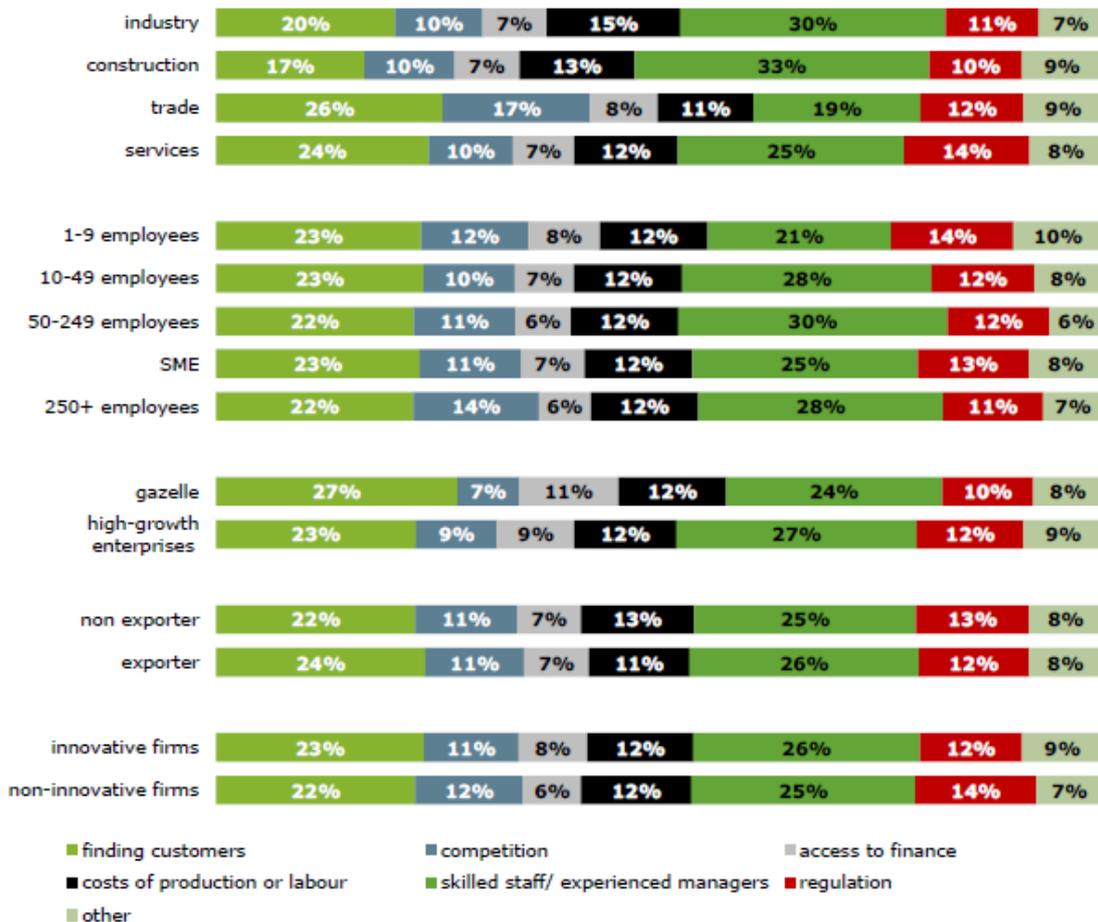
figure 112 Most pressing problems in the past six months (April to September) for SMEs in the EU28. Percentages in the figure indicate the percentage of SMEs that consider a specific problem to be the most urgent problem.



Source: SAFE Survey 2018, p. 132

A breakdown of concerns by company characteristics shows that access to finance becomes a higher problem in the list for “gazelle” companies, at 11%, compared to the average 7%.

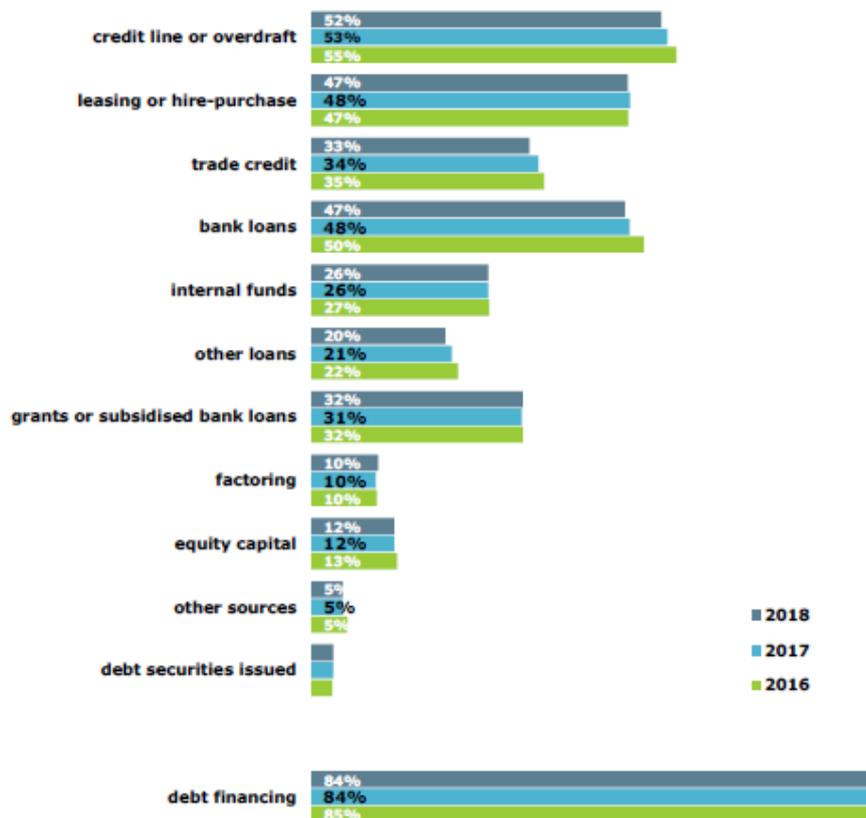
figure 115 Most pressing problems in the past six months (April to September 2018) for SMEs in the EU28, by enterprise characteristic. Percentages in the figure indicate the percentage of SMEs that consider a specific problem to be the most urgent problem.



Source: SAFE Survey 2018, p. 136

With regards to the most relevant types of financing used by SMEs in the EU, they mention credit lines or overdraft (52%), leasing and hire purchase (47%), bank loans (47%) and trade credit (33%) as the most relevant sources of external financing. Followed by grants, internal funds, other loans and equity capital.

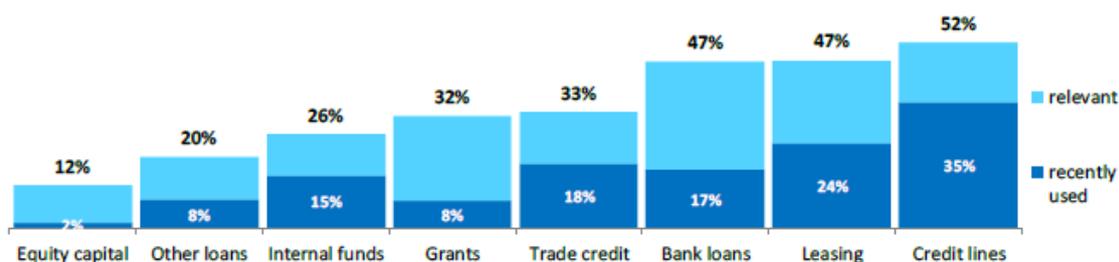
figure 1 Relevance of different types of financing for SMEs in the EU28 in 2016, 2017 and 2018.



Source: SAFE Survey 2018, p. 10

Altogether, debt financing is relevant for 84% of SMEs, and is still preferred over equity financing by SMEs for growth ambitions. In the EU28, 65% preferred bank loans in 2018, while another 14% preferred loans from other sources (e.g. trade credit), and 6% preferred equity investments. These proportions tend to be stable over the years.

Regarding the most recently used types of financing, we see that between April and September 2018, credit lines have been the most used (35%), and among the three most relevant, bank loans have been the least used (17%) in comparison.



Source: Infographic: SME access to finance in the EU 2018, p.1

Further focusing on bank loans, as the most relevant form of financing for 47% of the SMEs in the EU, and breaking it down by SME characteristics (sector, size, type of growth, exporter status, and innovativeness) we see that SMEs in industry most often used bank loans and SMEs in services used this type of financing least often.

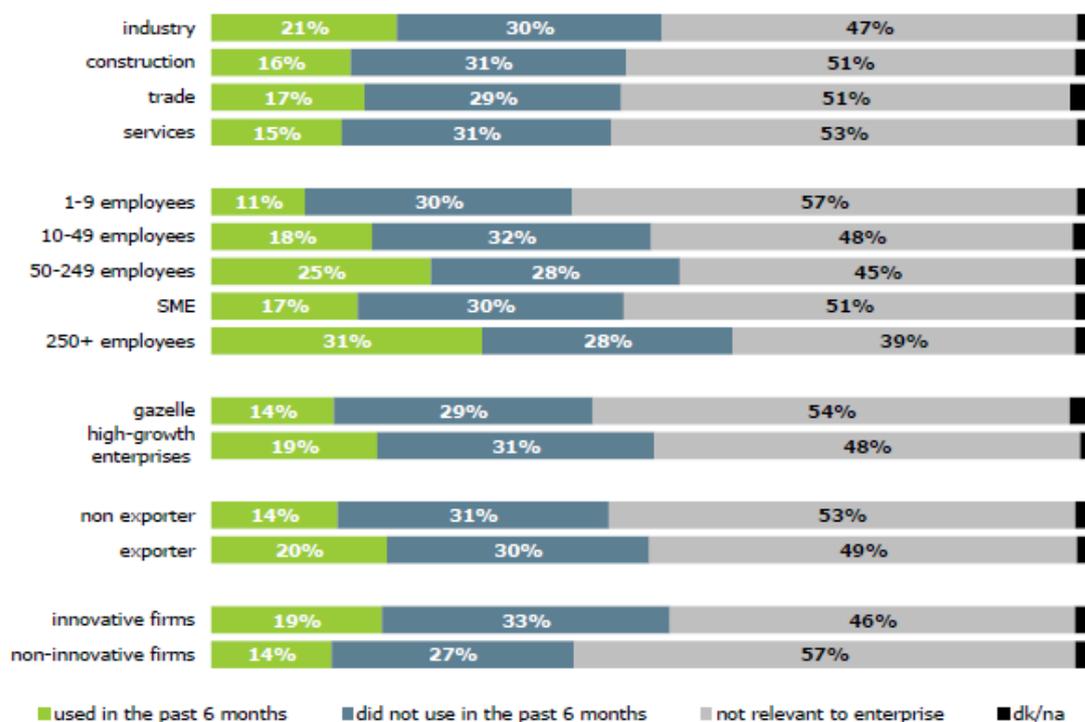
The proportion of enterprises that used bank loans between April and September 2018 increases with enterprise size. The use of bank loans is most prevalent among large enterprises and smallest among micro enterprises.

Between April and September 2018, 14% of gazelles used a bank loan compared to 17% of SMEs in the total EU28. The proportion of use for high-growth SMEs is slightly larger than that of SMEs in the EU28.

Compared to non-exporting SMEs, exporting SMEs are more likely to use bank loans.

In addition, the use of this type of financing is more prevalent among innovative SMEs.

figure 8 Use of bank loans in the past six months (April to September 2018) for SMEs in the EU28, by enterprise characteristics

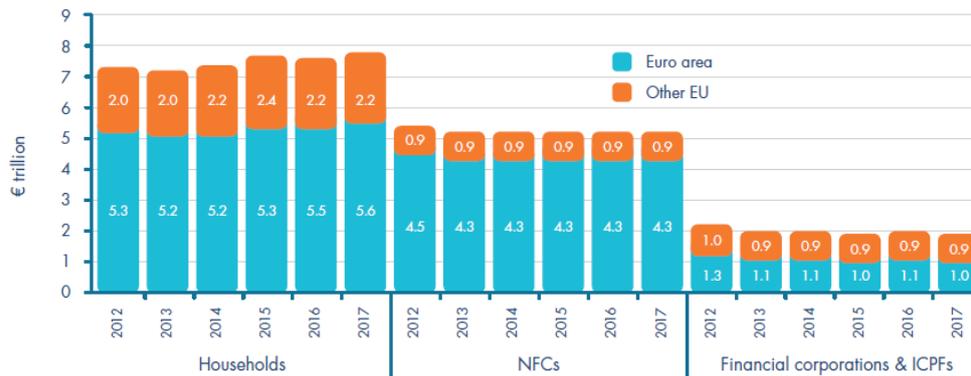


Source: SAFE Survey 2018, p. 17

EBF Facts & Figures confirm an increase in the stock of outstanding loan balances to households and corporates.

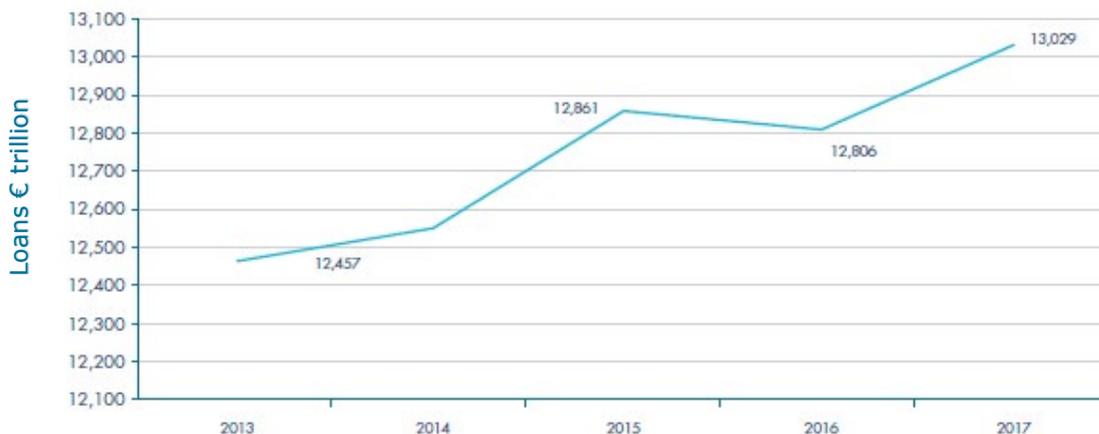
At the end of 2017, the total outstanding loans amounted to 24.5 trillion, of which households and non-financial corporates accounted for 7.8 and 5.2 trillion Euros, respectively, with the NFCs loans standing at their highest level since 2013.

### Loans by counterparty sector



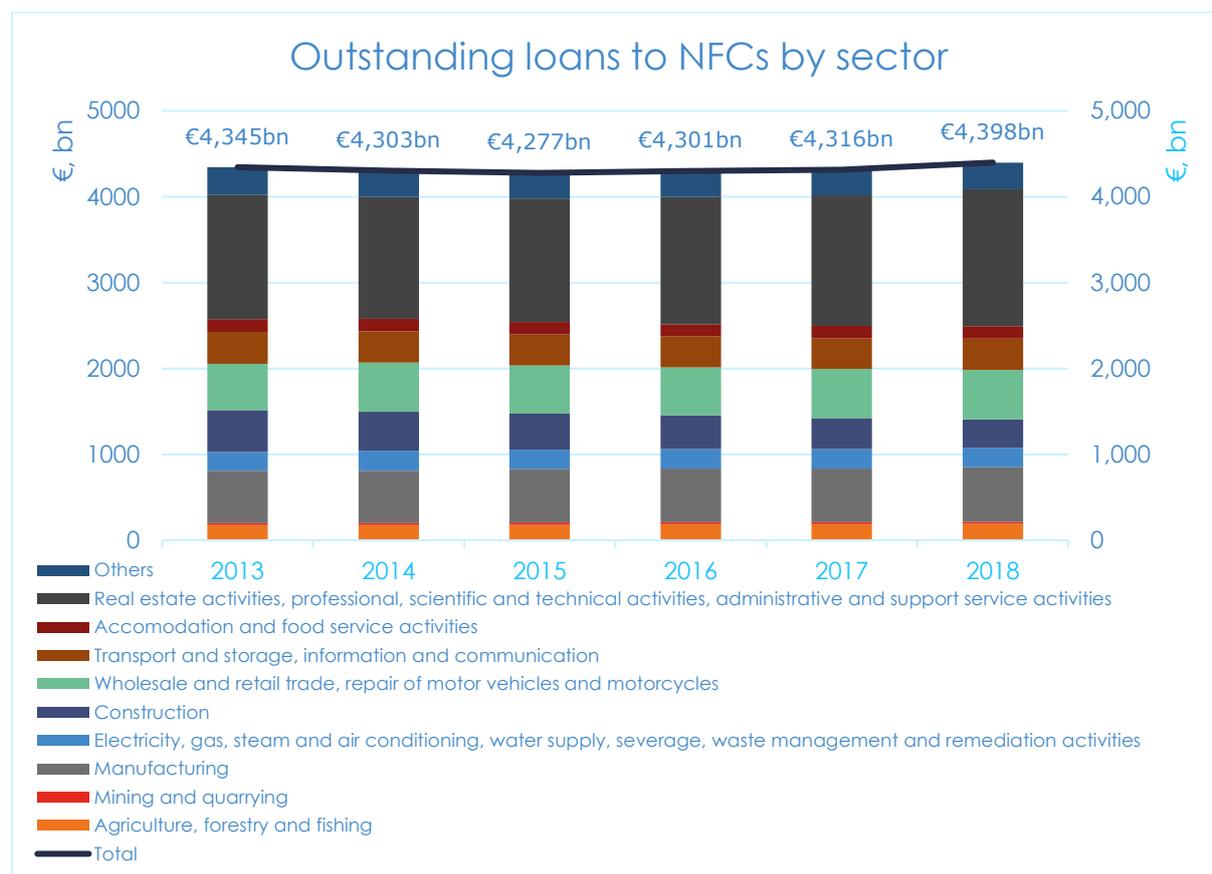
Source: EBF Facts & Figures 2018.

### Outstanding loans to non-financial corporations and households in EU



Source: ECB Data – EBF own calculations.

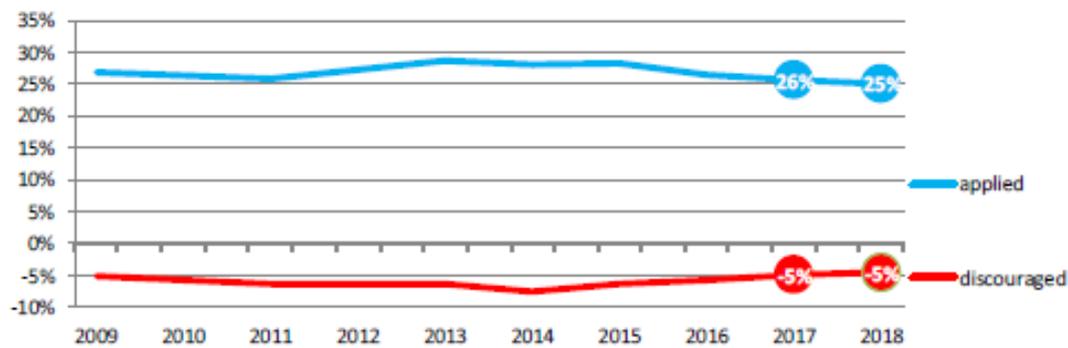
Supported by growth in new lending, outstanding loans to NFCs rose to their highest level since 2012 at the end of 2018 (€4,398 billion), of which 36% were directed towards real estate activities, professional, scientific and technical activities, administrative and support service activities, while manufacturing and wholesale and retail trade (including motor trade and repair) accounted for 14% and 15%, respectively.



Source: ECB data<sup>6</sup>

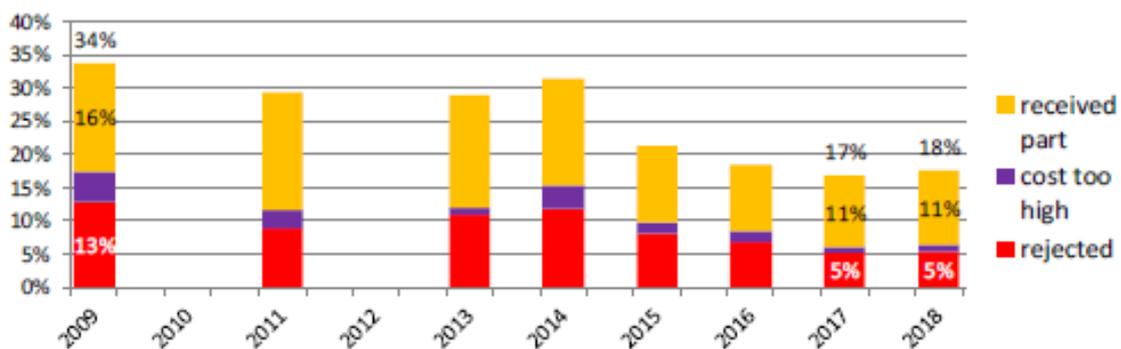
<sup>6</sup> Data Source in SDW:  
[http://sdw.ecb.europa.eu/browseTable.do?df=true&ec=&dc=&oc=&pb=&rc=&DATASET=0&removeItem=&removedItemList=&mergeFilter=&activeTab=BSI&showHide=&FREQ.14=Q&MAX\\_DOWNLOAD\\_SERIES=500&SERIES\\_MAX\\_NUM=50&node=bbn3598&legendPub=published](http://sdw.ecb.europa.eu/browseTable.do?df=true&ec=&dc=&oc=&pb=&rc=&DATASET=0&removeItem=&removedItemList=&mergeFilter=&activeTab=BSI&showHide=&FREQ.14=Q&MAX_DOWNLOAD_SERIES=500&SERIES_MAX_NUM=50&node=bbn3598&legendPub=published)

Regarding the number of SMEs applying for a bank loan in the EU, 25% have done so between April and September 2018, while 5% did not do it due to fear of rejection.



Source: Infographic: SME access to finance in the EU 2018, p.2

5% of the loan applications by SMEs in the EU were rejected. 11% of the companies successfully receiving a loan settled for a lower amount than originally requested and 1% declined the loan offer by the bank. Rejection rates have lowered considerably since 2009.

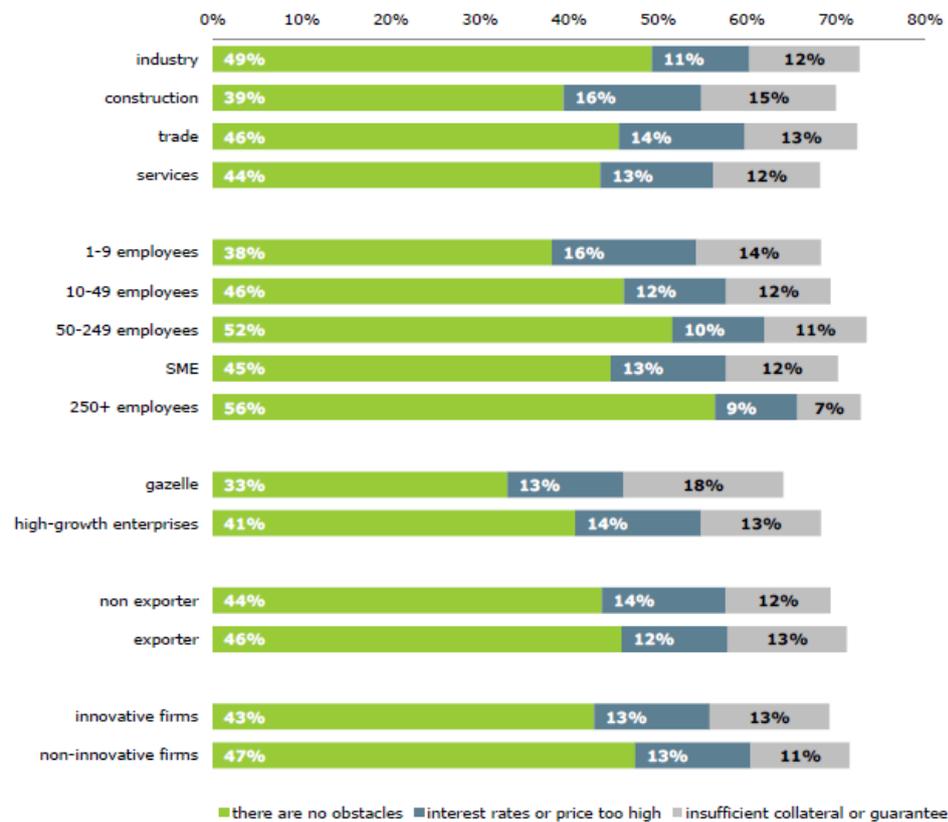


Source: Infographic: SME access to finance in the EU 2018, p.2

Finally, regarding the most relevant factors perceived as limiting the access to future financing, EU SMEs generally do not list many obstacles. When they do, interest rates or prices to high and insufficient collateral or guarantee rank highest.

Micro companies, gazelles and innovative firms, are among the most affected.

figure 95 Three most cited perceived factors limiting the access to future financing for SMEs in the EU28, by enterprise characteristic.



Source: SAFE Survey 2018, p. 111

When looking more concretely at how firms finance their investments in the EU using EIBIS, we see that, more than 60% of SMEs finance their investments via internal financing. The outstanding amount is financed externally, and of that external financing, the share of bank finance is very high.

Bank loans account for a 55% of the external financing received, and if combined with other bank finance received, we see that more than 60% of external investment financing to SMEs has been provided by banks (data reflecting the main sources of financing used by SMEs in the EU as per SAFE above). A per-country analysis reveals great differences on the split of bank financing among EU Member States.

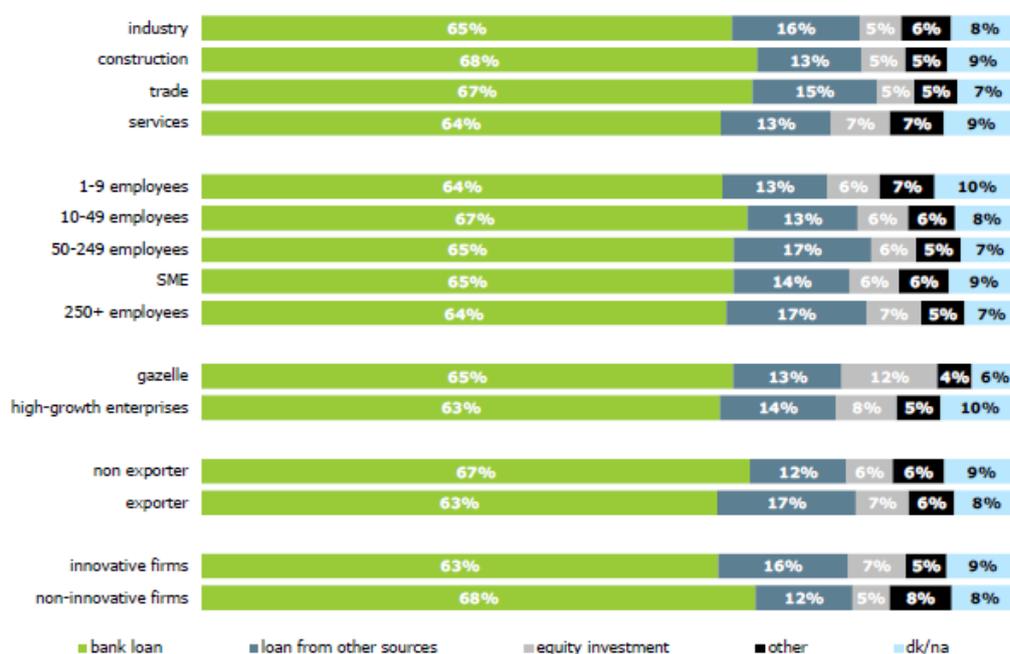
Regarding the share of firms happy to rely exclusively on internal sources to finance investments, we see that only 20% of SMEs are happy to do so. Together with a very low dissatisfaction with the external financing received (that we would like to recall is predominantly bank-based) amounting to only a 3% of SMEs dissatisfied with the amount obtained, 8% with the cost of financing, 4% with the length of time, 9% with the collateral and 3% with the type of finance.

Regarding the financing of digitalisation projects and highly innovative companies, we also provide extra information from our members.

While SMEs are generally in need of classic bank lending, as demonstrated by their perceived need of bank lending as the most relevant type of financing needed for their future projects, they increasingly need new forms of financing for “riskier” projects, such as innovation, digitalisation and internationalisation.

High-tech start-ups and fast-growing SMEs need access to wider and collaborative means of financing, including blending with bank financing components, crowdfunding (which can be understood above as a “loan from other sources” relevant to 14% in average) and equity investment (which 12% of gazelle companies name as relevant, double that of SMEs on average: 6%).

figure 92 Types of external financing preferred to realise growth ambitions for SMEs in the EU28, by enterprise characteristic.



Source: SAFE Survey 2018, p. 108

When looking at financing for the adoption of digital technologies more in detail, taking into account the EIB Investment Report 2018/2019, the investment financing conditions and the satisfaction depicted above, take a different shape, especially for the youngest “born digital” companies<sup>7</sup>.

Reflecting the more general results of the SAFE and EIBIS surveys, the report acknowledges that a relatively small number of firms mention inadequate access to finance as the main barrier to adopt digital technologies more concretely. However, if we look closely at the subgroup of digital native young firms, we can see that they face higher access to finance barriers and are at a funding disadvantage in general terms.

While the financing of digitalisation projects that require more easily available technologies is relatively straightforward, more complex projects or those requiring specific skills to be acquired, are more difficult to finance.

<sup>7</sup> EIB Investment report 2018/2019, pp 201-212 & 353-355

On top of this, the financing mix and access to growth capital that these companies need, are not met by the current state of play in Europe when compared to US counterparts. However, demand of bank loans and credit lines remain one of the highest priority for SMEs.

## Q2: What have been the main drivers of the observed trends in SME financing in recent years? How do they differ across jurisdictions, sectors, size and age of firms?

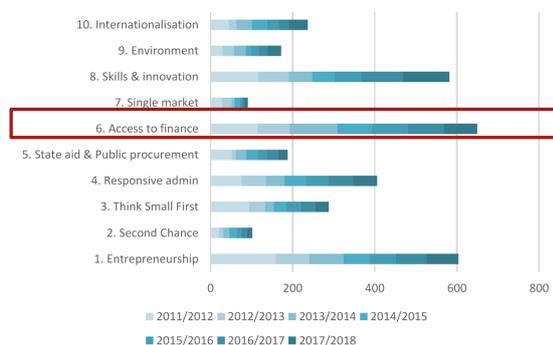
### A2:

As a general comment, it is important to mention that SME financing has improved over recent years, along with a general recovery of the European economy. It can be argued however, that a great part of these positive developments were backed by an unconventional monetary policy: Targeted Long-term Refinancing Operations (TLTRO-II), in combination with asset purchases and negative rate on deposit facility. TLTROs will be phased out by 2020-2021 and are expected to be replaced soon by a new programme of refinancing operations. We fear that the conditions to be offered by the ECB might be less favorable and provide less incentives to corporate lending, thus harming SME financing.

Regarding the broader SME policy measures taken under the Small Business Act<sup>8</sup> in Europe and the annual SME Performance Review that continuously monitors and assesses its implementation and tracks the performance of SMEs, we would like to remark the following:

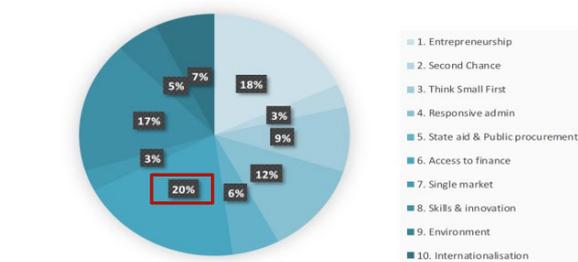
According to the Annual Report on European SMEs 2017/2018, since 2011, the policy implementation of the 'access to finance' principle has enjoyed one of the greatest progress, with around 20% of the identified policy measures adopted/implemented (around 650 policy measures). The most commonly implemented measures - over 150 - are related to financing programmes.

Figure 8: SBA policy implementation – EU-28 (2011-2018)



Source: CARSA and PwC

Figure 9: Distribution of policy measures adopted/implemented per SBA principle – EU-28 (2011-2018)



Source: CARSA and PwC

Access to finance	Question	Count
<b>No. of EU-28 Member States with the answer 'Yes'</b> • 0-7 • 8-14 • 15-21 • 22-28	Are there bank loans and corresponding guarantee schemes to provide access to loans?	28
	Are there national grants and risk capital to support SMEs and start-ups?	28
	Is there funding dedicated to starting up a business as well as for innovation, proof of concept and for the commercialisation of innovation?	28
	Are there Business Angels funds and Venture Capital Funds established?	26
	Are EU-based funds for SMEs relatively easily accessible?	23
	Is there a 'one stop shop' to support SMEs in accessing the required funds?	13

Source: Annual Report on European SMEs 2017/2018

<sup>8</sup> The Small Business Act 2008 (SBA) is an overarching framework for the EU policy on Small and Medium Enterprises (SMEs). It aims to improve the approach to entrepreneurship in Europe, simplify the regulatory and policy environment for SMEs, and remove the remaining barriers to their development. Available at: [https://ec.europa.eu/growth/smes/business-friendly-environment/small-business-act\\_en](https://ec.europa.eu/growth/smes/business-friendly-environment/small-business-act_en)

All EU Member States now have funding dedicated to starting up a business as well as for supporting innovation, proof of concept and commercialisation (e.g. bank loans and corresponding guarantee schemes, national grants and risk capital).

EU-based funds for SMEs are relatively easily accessible in most EU Member States. Business Angel funds and Venture Capital funds are also established in most EU Member States. Member states have however taken few measures to further boost venture capital funds.

Regarding the complexities and challenges to finance digitalisation and innovative projects, for “born digital”, “gazelles”, and high-growth SMEs, European banks are aware of the situation these companies are faced with, needing more diverse sources of funding while maintaining a high demand for bank products. Banks also mention three elements that constrain their capabilities as risk managers to ease their credit to these customers:

- The high-risk profile that especially younger companies have: little credit history and normally using people to innovate – so their income streams are more difficult to trace, and they do not have suitable underlying collateral, among other reasons.
- The complexity that their highly innovative business models bring, needing digital products that are not well known or not as readily available as the ones a non-digital native firm would require.
- Moreover, no matter what the risk standing of the company is, the project also becomes subject to risk assessment during which innovation is analysed from many perspectives (impact on business model, company experience with technology, financial standing improvement etc.).

Lending becomes very much dependent on the companies’ repayment capacity, and the main challenge for lenders is to assess the economic sustainability of their cash flows. Banks are taking measures to facilitate lending to digital native companies, and they are finding different ways of doing so.

**Q3: Have financial regulatory reforms such as Basel III affected bank financing to SMEs (e.g. in terms of loan volumes, prices, maturities and collateralisation)? If so, how? How important have been their effects vis-à-vis other types of bank lending and compared to the main drivers identified in question 2?**

**A3:**

*General remarks*

Evidence suggests that SME finance was not at the core of the financial crisis bursting in 2007. In actuality, EU SMEs made a significant contribution to the recovery and subsequent expansion of the EU economy following the crisis. They accounted for 47% of the total increase from 2008 to 2017 in the value added generated by the non-financial business sector and for 52% of the cumulative increase in employment in the sector. In fact, their contribution exceeded what would have been expected on the basis of their relative importance in the economy<sup>9</sup>.

Decisions taken at European level to alleviate the unwarranted overall pressure on SME lending up to that point in time, were critical, and show the critical correlation of effects that can be felt along the system.

Continued regulatory support to bank financing of the economy is critical to ensure (especially in Europe, taking into account the importance of Bank lending for European SMEs) proper financial intermediation and risk management that the banking sector critically holds. However, the new regulatory reform might put SME exposures at a disadvantage with regards to other alternative uses of capital in the banking sector. This might be an unintended consequence of the vast regulatory overhaul that has put the banking sector worldwide on a much stronger footing overall.

As stated above, banks have a very important responsibility in channelling funds to the real economy. Despite the fact that allocated capital has indeed increased under Basel III (mostly due to higher minimum ratio requirements), banks have not transmitted these impacts 1:1 to SMEs.

In restraining volumes and market shares: banks have "sanctuarised" their domestic SME franchises, remarking their role as responsible lenders, financing the real economy (SMEs are the backbone of European economy), sometimes under increased pressure from governments. But the capital hit was real, and had to be absorbed by other, arguably less core, or more agile businesses, such as large Corporates and capital markets businesses. This aspect must be considered, as otherwise, it seems that there was no impact at all.

According to *ad hoc* questions in the latest ECB Bank Lending Survey, supervisory or regulatory action (especially CRR/CRDIV) had, on average, a net tightening impact on banks' credit standards for SMEs in the last few years and are expected to tighten in the next months. In addition, supervisory or regulatory action had a broadly neutral impact on credit margins for loans to enterprises but lead to a strengthening of banks' capital position.

Euro area banks expect regulatory or supervisory action to lead to a further strengthening of their capital position and to have a tightening impact both on credit standards and credit margins across all loan categories.<sup>10</sup>

We highlight that these conclusions are generic and, even though important, are based on aggregate and sample data, which nevertheless might include divergent point of views among Euro Area members.

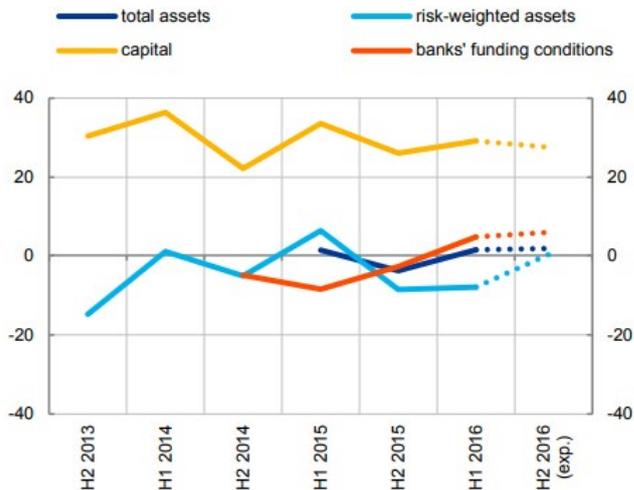
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<sup>9</sup> Annual Report on European SMEs 2017/2018, p.62

<sup>10</sup> Available at: [https://www.ecb.europa.eu/stats/ecb\\_surveys/bank\\_lending\\_survey/html/index.en.html](https://www.ecb.europa.eu/stats/ecb_surveys/bank_lending_survey/html/index.en.html)

## Impact of regulatory or supervisory action on banks' risk-weighted assets, capital and funding conditions

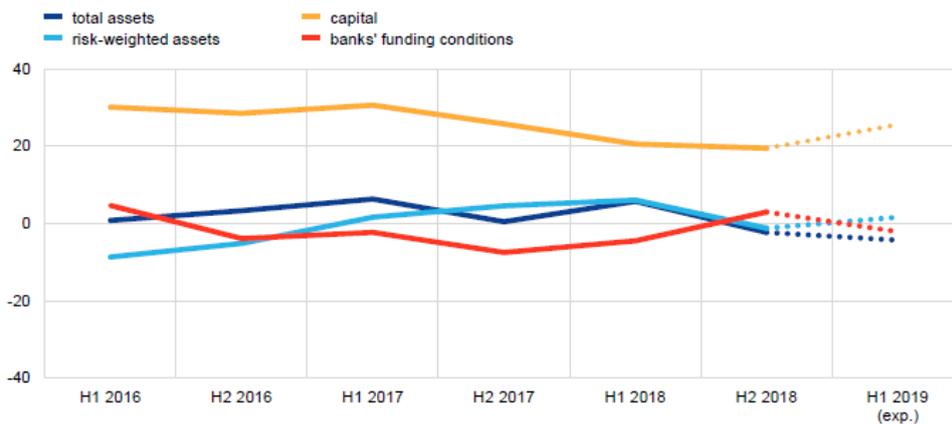
(net percentages of banks)



Notes: For "total assets", "risk-weighted assets" and "capital", the net percentages are defined as the difference between the sum of the percentages for "increased considerably" and "increased somewhat" and the sum of the percentages for "decreased somewhat" and "decreased considerably". For "banks' funding conditions", the net percentages are defined as the difference between the sum of the percentages for "experienced a considerable tightening" and "experienced a moderate tightening" and the sum of the percentages for "experienced a moderate easing" and "experienced a considerable easing".

## Impact of regulatory or supervisory action on banks' risk-weighted assets, capital and funding conditions

(net percentages of banks)

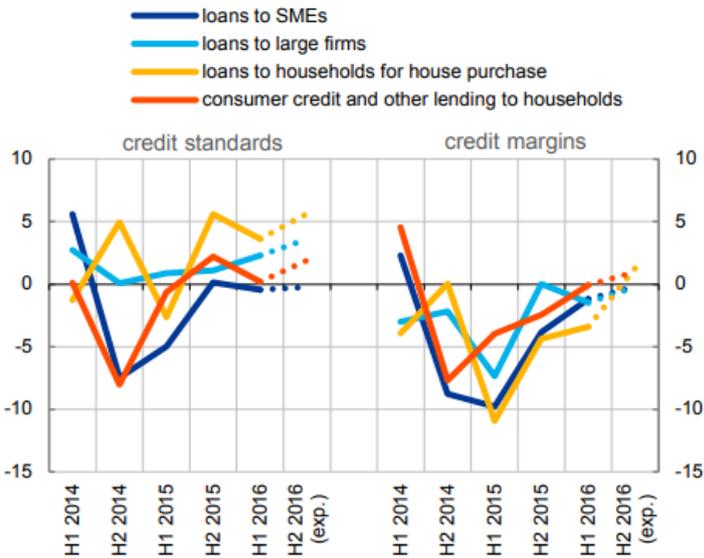


Notes: For "total assets", "risk-weighted assets" and "capital", the net percentages are defined as the difference between the sum of the percentages for "increased considerably" and "increased somewhat" and the sum of the percentages for "decreased somewhat" and "decreased considerably". For "banks' funding conditions", the net percentages are defined as the difference between the sum of the percentages for "experienced a considerable tightening" and "experienced a moderate tightening" and the sum of the percentages for "experienced a moderate easing" and "experienced a considerable easing".

Source: ECB Euro Area Bank Lending Survey - Fourth quarter of 2018 and Second quarter of 2016

## Contribution of regulatory or supervisory action to the tightening of banks' credit standards and margins

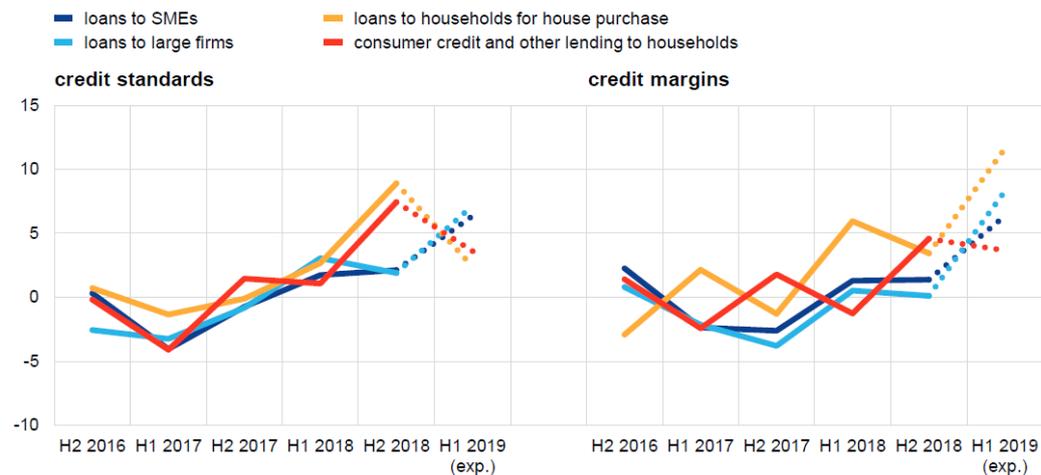
(net percentages of banks)



Notes: The net percentages are defined as the difference between the sum of the percentages for "tightened considerably" and "tightened somewhat" and the sum of the percentages for "eased somewhat" and "eased considerably". The results shown are calculated as a percentage of the number of banks which did not reply "not applicable".

## Contribution of regulatory or supervisory action to the tightening of banks' credit standards and margins

(net percentages of banks)



Notes: The net percentages are defined as the difference between the sum of the percentages for "tightened considerably" and "tightened somewhat" and the sum of the percentages for "eased somewhat" and "eased considerably".

Source: ECB Euro Area Bank Lending Survey - Fourth quarter of 2018 and Second quarter of 2016

### *More concrete impacts of regulatory reforms*

We would like to reiterate the specificities of the SME financing mix in Europe with regards to their preference for bank loans, and the critical implications this has when regulating.

Unlike other exposures, SME lending is hit by assorted regulatory standards: it is subject to higher capital requirements just as any other asset; it is subject to the leverage ratio; it represents a cost in terms of compliance with the liquidity coverage ratio; risk transfer via securitisation is subject to significantly heightened requirements; and only credit lines with extremely short terms may help to comply with the NSFR.

Moreover, the ECB is now running a liquidity stress testing in anticipation of the phasing out of the Asset Purchase Programme.

In addition, in the new credit risk framework under Basel III, SME lending will be disproportionately hit by the provisions regarding the Capital Conversion Factor (CCF), as it penalises undrawn credit facilities, largely used by SMEs.

As a result, SME finance is becoming one of the least attractive uses of regulatory capital for banks nowadays, amid a very complex and demanding regulatory framework that pushes them to other more liquid assets in the balance sheet. SME finance is also an ever increasing compliance cost – due to a continually increasing set of standards and rules.

### *SME supporting factor*

Regarding the SME supporting treatment. Given the fact that SMEs carry a lower systematic risk than larger corporates, capital requirements for SME exposures should be lower than those for large corporates to ensure an optimal bank financing of SMEs. It is also important to recall that small and medium-sized corporates are key drivers for growth and job creation and that this evidence is already recognised by European Authorities in their workplan to establish a Capital Markets Union for example.

As stated above, we welcome and support the best solution for the moment achieved at European level to allow an increase of the limit for exposures from €1.5 million to €2.5 million.

EBF reiterates the importance of such a measure to ensure access to finance to SMEs and encourages its adoption at international level. Indeed, it is important to consider that the scope of application of the risk weight proposed by the Basel Committee 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.

Considering the financing mix of EU SMEs, maintaining the EU SME supporting factor is critical for the European economy.

### *Treatment of unrated corporates*

Banks' lending to unrated corporates, which are the vast majority in Europe, is extremely penalised rather than being promoted under the reviewed standardised approach. This affects SMEs acutely.

Indeed, corporates make very little use of rating agencies and have therefore to be considered as unrated corporates which are assigned a high-risk weight of 100% under the reviewed framework.

Basel IV allows an alternative identification of investment grade exposures for which it is envisaged to apply a 65% risk weight. But this treatment can only be used in jurisdictions

where external credit ratings are not eligible for the calculation of prudential capital requirements. Therefore, an issue of a level playing field with other jurisdictions arises.

### *NPLs*

In addition to that, European banks are steadily and diligently reducing their NPLs. NPLs from SMEs are sticking to banks' balance sheets. The costs of due diligence are higher than the benefits that could be extracted from selling them off.

More generally, the wave of new EU prudential regulations and supervisory actions about NPLs and the definition of default raises concerns in respect of its impact on SME financing.

The European Union Regulation on NPL backstop which requires stringent provisioning requirements for uncollateralized lending, combined with European supervisors pushing banks to take losses on NPLs could play against SME lending (current and future).

Moreover, the ESRB has considered in its last report on NPLs that there could be further prudential measures in relation to buffers focusing on some sectors or targeting for instance non-financial corporations. Also, measures in relation with commercial and residential real estate activities are in the balance: enhancement of large exposure framework, possible raise of LGDs.

### *Trade/Export finance*

While the current economic conditions show that access to finance is no longer one of the top concerns for European SMEs, the regulatory support to expanding the SME Supporting Factor does not mean that SMEs are not facing problems to access the bank finance they need. As mentioned above regarding digitalization and innovation, in addition to general SME lending, bank financing is also a critical means to finance other SME related-actions and processes.

Trade credit provided by banks and especially loans, are the preferred means of external financing by exporting SMEs as exemplified by the SAFE results above. While the EU is actively fighting against external barriers to trade, European SMEs face resource constraints such as lack of funding or lack of financial resources as one of their main barriers to internationalization<sup>11</sup>.

The application of the Leverage Ratio to banks' exposures to Export Credit Agencies and the NSFR treatment of Trade Finance cannot become unintended internal legislative barriers to trade.

### *Securitisation*

Securitisation is a great tool to bundle together loans coming from SMEs and transfer risks more efficiently.

Following the financial crisis, changes were already made to major aspects of how securitisation is regulated, in order to make products more transparent, tighten incentive and liability mechanisms, and reduce the risk associated with securitisations overall.

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<sup>11</sup> Annual Report on European SMEs 2017/2018, p.78

Excessive requirements would make it economically unviable for banks to transfer risks through securitisation, thus putting at risk this key instrument, which enables banks to diversify the risks associated with a pool of corporate loans.

### *Retail Exposures*

The mandatory application of the granularity criteria to qualify a retail exposure as regulatory retail in the standardised approach would result in an extremely low maximum loan amount in the case of smaller banks with limited retail portfolios: this would undermine their competitiveness. For example, if a bank has a retail portfolio of EUR 200 million, the exposure to a single counterparty should not exceed EUR 400,000. Such a scheme would have a particularly negative impact on lending to SMEs. Loans to SMEs would be significantly more expensive and/or the loan volume would be significantly reduced.

### IFRS 9

At international level, the issue of procyclicality in the capital framework was discussed, we have as a concern that this may actually be further exacerbated by the recent accounting framework, as it creates incentives for short-term tenors vs long-term investments.

We fear that this procyclicality may further worsen with the advent of Expected Credit Loss (ECL, both under IFRS9 and US GAAP's CECL) requirements. Though the impact of IFRS 9 is being monitored by the EBA since the start of IFRS 9 implementation, it seems to date the impact is not known exhaustively. When assessing the SME financing, the IFRS9 framework should be part of the reflection.

Finally, as an extra element to this section, we would like to mention the European supervisory scrutiny and European Banking Authority (EBA) work. While not considered as regulatory reforms, there seems to be some areas in which there could be impacts for SMEs.

The influence of supervisory actions in a broad range of fields must be considered when assessing SME financing. Especially as supervisory practices may also differ between jurisdictions. There seems to be discrepancies between institutions which are relevant to consider when making an assessment. The SSM (European supervisor for significant institutions) seems to have requested the toughest requirements for significant institutions in relation with prudential topics:

- scrutinising all credit internal models through their TRIM exercise has also focused some of their missions on SME portfolios; in addition, microprudential measures are reputed to be procyclical, which means that measures are still applied, constraining more SME financing even if the economic conditions are considered favourable;
- the focus on commercial and residential real estate activities by the SSM: some institutions have faced particular inspections in such sectors;
- the request made by the SSM to significant institutions to prepare the implementation of the Future of IRB approach (two-step approach) is currently leading banks to rush into significant changes of their risk management framework; new definition of default, and coming recalibration of internal credit risk parameters;
- in addition, regarding the EBA program on IRB framework : The Future of IRB Approach. During the last few years, the EBA has published several regulatory

papers in order to harmonise the IRB framework; the objective of the EBA is to harmonise requirements within the European Union, when it comes in particular to the definition of default and the risk quantification of credit risk parameters. Such workstream though welcome as they strongly restore confidence into internal models, could lead to a loss of risk sensitivity and increase of capital requirements especially on SMEs

**Q4: How does the impact (if any) of financial regulatory reforms vary across banks operating in different geographies and with different size and business models?**

**A4:**

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**Q5: What other G20 financial reforms or other domestic financial regulations (if any) may have impacted financing to SMEs and how?**

**A5:**

In the European Union, some projects to support SME financing, regulate non-banks and other financial institutions are still underway.

The Capital Markets Union (CMU) project includes different proposals to help SMEs to access capital markets as a complementary sourced of financing through bond issuance that can be considered in this regard, together with policies included in the Small Business Act and other actions.

*SME definition*

The EBF understands that the SME definition is, in general terms, an appropriate tool that helps to ensure that there is a standard of reference at European level<sup>12</sup>, helping to develop appropriately targeted SME policies, improve equal treatment of these entities and allow a proper identification of these entities for appropriate provision of financing by banks.

While many guidelines and policies in the EU are linked to the definition and changes which might lead to considerable (also unforeseen) implementation impacts, some issues still remain that could pose challenges to SME financing.

Until very recently, SMEs were classified as clients only in case of a loan request. As long as they remain “passive-clients” (no loan request), there is no legal basis for asking for more data from the client than KYC-data. To be able to classify an SME as client, a bank will have to implement costly processes that could interfere with the provision of finance to these businesses. The classification of an SME as client must be legally secure, both for the bank and the client. It is therefore very important, that both the definition of SME, and the process of identification must be as clear and simple as possible for all concerned.

No far-reaching changes were suggested regarding headcount and turnover. However, we remark the definition and identification of non-autonomous enterprises as especially complex, and has negative implications for private equity and venture capital-backed companies. We advocate for the Commission to reassess the role of these funds as linked enterprises and to have a clearer picture on ownership and independence, so as not to impede the smooth financing of these corporates.

<sup>12</sup> The main factors determining whether an enterprise is an SME are:

1. **staff headcount**
2. either **turnover** or **balance sheet total**

Company category	Staff headcount	Turnover	or Balance sheet total
Medium-sized	< 250	≤ € 50 m	≤ € 43 m
Small	< 50	≤ € 10 m	≤ € 10 m
Micro	< 10	≤ € 2 m	≤ € 2 m

In addition, we mention the consideration of the concept and status of small midcap, and midcap, as a positive step to take, in order to expand the general understanding of these terms to be used in different EU and national instruments to support small and medium enterprises more effectively.

### *SME Growth Markets*

The EBF supports the initiative by European regulators to build a proportionate regulatory environment to support SME Growth Markets and SME listing.

The initiative takes relevant steps to improve the capability of SMEs to access wider financing options, especially for those corporates trying to list and issue securities on financial markets. The initiative on "SME growth markets" sets the requirements of this recently introduced category of trading venue dedicated to small issuers.

We understand this recently approved proposal as a positive step to foster the access of a more diverse range of companies to public markets. The proposed thresholds seem to allow SMEs of different sizes and bases to compete for funding on an equal footing, and to support the increased need of "gazelle" companies and start-ups to access non-loan forms of finance.

European Banks, as key intermediaries in financial markets, ensure a smooth participation of corporates of all sizes wishing to raise money in the markets, and accompany them during their ascension on the "funding escalator".

### *Crowdfunding regulation*

Due to the steady increase of presence of Crowdfunding Service Providers in Europe, without enjoying a common framework to which adhere at EU level (beyond the compliance with local regulations), the EU launched a proposal for a regulation in this sense.

The regulation takes the shape of an opt-in regulation (Crowdfunding platforms can choose to comply with local regulations or the EU framework that grants them passporting rights), while we understand that it is still key to ensure that the future landscape to regulate crowdfunding platforms does not remain as an opt-in system but to propose consistent framework across the EU to which all European Crowdfunding Service Providers (ECSP) adhere.

The regulation is approaching its latest stages of negotiation.

It lays down the basic requirements for the Crowdfunding Service providers, in terms of prospectus-like documents to be provided, capital requirements, financing thresholds, investor protection, etc.

The regulation provides a clearer framework for scaling up these platforms at EU level and ensuring that SMEs, in need of these services, can access them in an appropriate way and with all the safeguards duly in place. EBF-supported increases in threshold, sound requirements and passporting, are positive elements that will ensure a good starting point for regulating these activities.

### *Business Insolvency*

The European Commission's proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring,

insolvency and discharge procedures (business insolvency proposal), includes different provisions that we expect will have a negative impact on the cost of future lending.

As mentioned above, SMEs (especially younger companies) tend to have little credit history, lower credit score and low-quality collateral. Secured creditors are “secured” by having a right to a collateral/security. Having a good collateral – meaning a collateral that can be enforced when a borrower fails to make payments – decreases the cost of credit.

Business insolvency provisions that negatively affect the economic interest of secured creditors will increase the cost of future loans, hitting especially hard SMEs with poor collateral.

The EBF has been working to improve the proposal and ensure it provides as many safeguards against abuse as possible and that it does not lead to lower rates or return for secured creditors (and thus to much higher cost of secured lending for future entrepreneurs).

**Q6: Have financial reforms prompted a shift in the provision of SME financing, e.g. between banks and other financial institutions (substitution effects)? If so, how?**

**A6:**

In some jurisdictions, we see a bigger influence of non-bank financing in more “classic” banking activities. Different entities are starting to be more active in direct lending, while not being bound by the same regulatory requirements that banks have.

Financial reforms at national level have also helped SMEs to have access to complementary sources of financing.

Shadow-banking activities in supply chain finance, factoring and leasing are steadily increasing. In some jurisdictions, factoring and reverse factoring through non-banks is increasingly being used by SMEs.

Yet this is not mainstream as we have seen reflected in the data from surveys referenced above.

As an additional element, we would like to mention the impact of public and blended funds in the financing of SMEs.

In the EU, several financial instruments were created during the last years, such as the COSME Programme, fostering the financing of SMEs, through equity or loan facilities. The European Fund for Strategic Investments (EFSI) was also an important instrument to finance SMEs, namely through the SME window, that now is going to be followed up under the “Invest EU” banner.

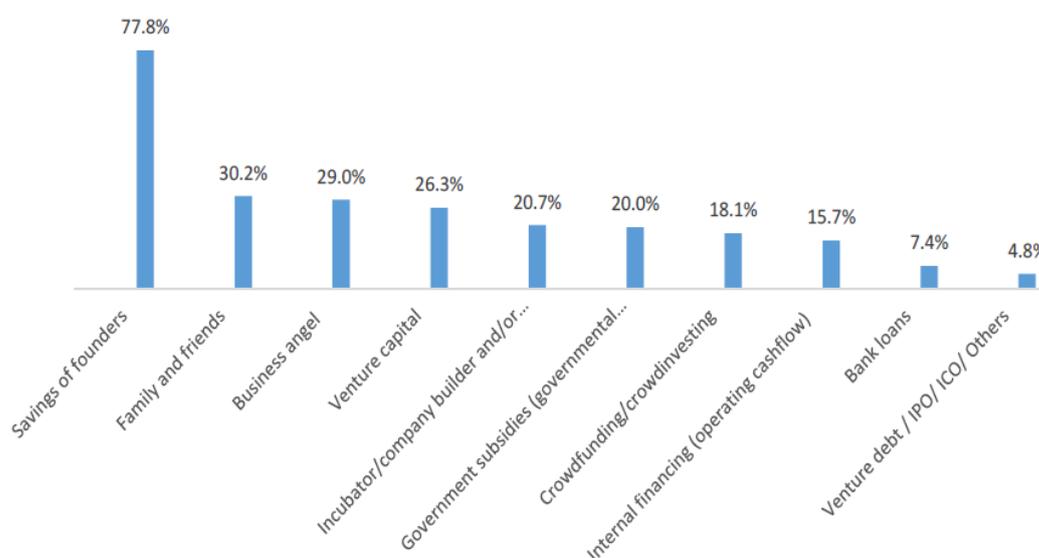
These instruments, together with different policy measures directed towards SMEs, had and still have a positive effect on SME financing by banks. For example, the financing and guarantee mechanisms provided by the European financial institutions, such as the EIB/EIF. The benefits of those instruments and policies are considered as positive thus they may have reduced the effects of regulation on SME bank financing, either by reducing capital requirements or by improving the general risk profile of SMEs or SME projects.

In this way, the positive effects of some policies regarding the improvement of SME access to finance should, therefore, be duly considered when trying to establish links between SME bank financing flows and conditions with the implementation of financial regulatory reforms. This potential overlap of measures, policies and regulation might hamper the needed assessment of the direct effects of financial regulatory reforms on SME financing. Furthermore, the assessment of SME financing might be constrained by the availability and granularity of data.

From our perspective, public and blended finance funds (such as those of the EIB, EBRD) must be used in a focused and anti-cyclical way to prevent the crowding out of private financing thus avoiding diverting public funds away from society’s real needs.

If we take the more concrete example of start-ups in the EU<sup>13</sup>, we see that for this unofficially defined set of corporates<sup>14</sup>, we can see very interesting trends in their financing mix, which differ significantly from the rest of the SME groups identified in the surveys cited above.

**Figure 27: Sources of financing**



Source: Annual Report on European SMEs 2017/2018, p. 51:

While generally SMEs source their external (private) financing needs from bank loans, start-ups primarily rely on Business Angels (29%), Venture Capital (26%) or Crowdfunding services (18%).

These findings mark an interesting dynamic for a specific SME segment in the EU, that needs to be further analysed with more detailed data, in order to understand the possible substitution effects.

<sup>13</sup> Annual Report on European SMEs 2017/2018, pp.50-56.

<sup>14</sup> Annual Report on European SMEs 2017/2018, p. 51: "The term 'start-up' has no official definition but is commonly based on three criteria, namely: - age (younger than ten years), - innovation (of product or business model), and - aim to scale up (intention to grow the number of employees and/or markets in which they operate)"

**Q7: Are there any other issues or relevant factors that should be considered as part of the evaluation?**

**A7:**

In order to foster SME businesses it is necessary i) to streamline key documents between countries as to improve internationalisation and SME settlement beyond their national borders (avoiding account opening issues, KYC procedures, etc.) and ii) to have further policies to improve business owners' trust so as to start projects and increase the number of new entrepreneurs (e.g. by public-private investments as mentioned above).

Measures of this second nature, can come linked to voluntary private initiatives aimed at supporting the possibilities for SMEs to have better information and to improve their ability to reach the funding they need.

As complementary relevant factors, we can mention non-regulatory initiatives, such as the CMU High-Level Principles (HLPs) on SME credit applications (signed by the EBF, other banking and financial market representatives and business and SME associations) as good examples of collaboration between public and private sector to improve SME financing and the information available for all sides.

As we have seen in the SAFE data above, SME applications for bank loans remain stable since 2009. Rejection rates and dissatisfaction with the financing received have decreased notably, from 13% of applications being rejected in 2009 to 5% in 2018.

In some cases and jurisdictions, the principles to communicate why a negative decision with respect to financing has been given, need to include alternative methods of financing that SMEs can access (including Crowdfunding, Venture Capital...).

This commitment to better information, allows SMEs to be better prepared for their next funding applications, or to understand that their needs would be covered more effectively by another source of external finance.



## About EBF

The European Banking Federation is the voice of the European banking sector, uniting 32 national banking associations in Europe that together represent some 4,500 banks - large and small, wholesale and retail, local and international - employing about 2.1 million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that securely handle more than 300 million payment transactions per day. Launched in 1960, the EBF is committed to creating a single market for financial services in the European Union and to supporting policies that foster economic growth.

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