European Association of Guarantee Institutions – AECM
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AECM's comments on the DG FISMA "Consultation Paper on the possible impact of the CRR and the CRD IV on bank financing of the economy"

Brussels, 07 October 2015

A/Introductory remarks

AECM's 41 members, who are mutual / private sector guarantee schemes, public institutions or mixed, all have in common the mission of providing guarantees for SMEs who have an economically sound project but do not dispose of sufficient bankable collateral.

AECM represents the political interest of its member organizations both towards the European Institutions, such as the European Commission, the European Parliament and Council, as well as towards other, multilateral bodies, among which the European Investment Bank (EIB), the European Investment Fund (EIF), the Bank for International Settlement (BIS), the OECD, the World Bank, etc. It deals primarily with issues related to prudential supervision, to state aid regulation relevant for guarantee schemes within the internal market and to European support programs.

The development and maintenance of SMEs is paramount for AECM and its members. The activities of the guarantee institutions have to be sustainable and quite some members are obliged by national law to observe CRR legislation.

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B/ As to the consultation

Regarding Capitalisation:

1. *What role has been played by the CRR and CRD IV requirements in the recapitalisation process, in terms of the timing and overall effect on the levels and quality of capital held by banks? How have market, supervisory and regulatory capitalisation demands interacted to make banks adjust the level of capital they hold to the current level? Whilst these three factors may be interlinked, is it possible to identify which has/have played the most important role?*

In general, the CRR and CRD IV improved the quality and the adequacy of own funds in banks and, therefore, led to more safety for depositors. It has also forced banks to hold higher risk provisions and coverage potentials and to incur less concentration risks. However, increasing regulatory requirements have no positive effect on lending itself. On the contrary, higher capital requirements force banks to refuse more borrowing requests than before. For guarantee banks there is less influence because they do not have dividend payouts. They are capitalised through their profits.

For commercial banks the increasing capital requirements in combination with the low interest rate level cause dramatic profitability problems which lead to realignments of business models and strategies. Additionally, mergers between banks have increased and will further increase.
Most banks focus on retail and the corporate business which has further increased competition.

This development is at the same time negatively influenced by higher regulatory compliance costs which cannot be covered by revenues. The total impact of the complete Basel III package might only fold out later in the future.

During the recapitalization process, banks tried to reduce business volumes especially in nonperforming portfolios and increased capital via diverse capital transactions and disposal of business segments.

Especially the market put pressure on the banks to be in line with regulatory requirements and to meet the capital requirements. Additionally, market intermediaries and rating agencies focused on the development of the common equity tier 1 and therefore demanded banks to transform their capital into CET 1 very soon. Supervisory pressure was given due to short timeframes for adaption and consistent reporting requirements for providing supervisors the data to analyze and evaluate the implementation of Basel III. Especially with regard to capital, banks were forced to hand in capital plans and to report on their measures. The highest pressure came from supervisors, especially due to the fact that banks were confronted with different supervisory authorities which demanded a large volume of information for stress testing purposes, recapitalization, asset quality reviews and other exercises at the same time.

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2. *If you consider that capital levels go significantly beyond what is necessary in light of the level of risk incurred and posed by banking activities in certain areas, please specify those areas and back up your view with specific evidence.*

Especially risk weighting for lending to SME is too high in comparison to lending to large companies, in particular without the SME supporting factor. So AECM suggests that in comparing SME loans with those for large companies the former should actually even have lower equity ratio requirements.

Stable lending to small and medium-sized enterprises strengthens the financial system. This is due to the fact that numerous smaller SME loans are generally often lower risk than loans of equal amount to a small number of larger companies: SME loans are less dependent on large global fiscal trends. This reduces the risk that many creditors simultaneously get in trouble – and trigger a crisis which could threaten the bank's existence.

Therefore, the SME supporting factor is not a special concession which was introduced to privilege a specific group of companies. On the contrary: It simply recognises the stabilising effect that the spreading the risks through SME credits has on a bank's business. Further, there are a number of grounds which argue that it might even have been set too low.

3. *What role have the additional capital requirements and buffers exceeding the harmonised requirements set out in the CRR played in the capitalisation process? Are such additional micro- and macroprudential capital requirements and buffers commensurate to the level of risk incurred and posed by banks? Please back up your view with specific evidence.*

At the moment the observation period is not long enough yet to finally comment on the adequacy of the requirements to cover the risk incurred. Especially with regard to the capital buffers which are partly not yet in place the adequacy for each single target could not be observed. However, banks have to prepare to comply with the increasing requirements and therefore still are in the process of increasing capital.

Still, investors have incorporated them into their expectations regarding minimum capital levels, taking effect immediately. This is further enforced by new capital instruments like AT1, which have triggers around these buffer-levels, forcing banks to hold capital levels well above the trigger-/buffer-levels.

The same holds true for buffers for globally systemically important institutions. On the other hand, the European specialty "Systemic Risk Buffer" drives complexity and reduces transparency for investors, banks and regulators.

This is the case for other macro prudential measures like Art. 124 CRR, too. Furthermore it unlevels the playing field. Finally, the European implementation of buffers for other systemically important banks (BCBS: domestically important banks) is too complex. So it leads to the same issues as the Systemic Risk Buffer in Europe.

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Investors, in regulatory capital like AT1 and Tier 2, but also in subordinated debt and even in senior debt require regulatory capital levels well above possible trigger-levels which would affect their positions.

Since certain buffers – like countercyclical capital buffer, systemic risk buffer and other – are highly unpredictable, they tend to assume the "worst case scenario" when demanding certain capital levels from banks. So this uncertainty about the height of the buffers leads to a "new normal" of required capital for banks, as investors demand additional buffers above these regulatory buffers to protect their own positions.

Regarding Regulation:

4. *Have increased capital requirements influenced the overall capacity of banks to lend? Which factors, including demand-side factors, regulatory changes and other supply-side factors (such as the volatility of interbank and capital markets), contributed most significantly to the change in the volume of loans? How do you think bank lending would have developed had regulatory changes to capital requirements not been introduced?*

With Basel III, significantly higher equity ratios were decided. We estimate that this will cause reduction of credit volume in general and increase credit costs for borrowers.

To our observation banks have duly screened their portfolios due to the changed capital requirements. As a result they have reduced their exposures in market segments which can be characterized as high volume, high risk and long-term tickets. These portfolios are in general struck most by the new capital requirements. In rare cases banks have completely exited these segments. In this context it must be emphasized that portfolio-changes have up to now not significantly affected the core business of banks, such as Corporate, SME and Retail lending.

In more general terms the low interest rate level is the strongest driver for a continuing high lending level. However, lending activities would have increased more without the stronger capital requirements. In the long run, companies with a weak creditworthiness are likely to be effected much more by the higher capital requirements than other companies.

5. *Are the effects of increased capital requirements, such as they are, generally temporary and transitional or have structural changes been seen? Has the requirement to hold higher levels of capital increased the cost of funding banks? Has the per-unit cost of bank capital decreased as banks have become less risky?*

The cost of funding of banks has increased; but this may not be a result of increased capital requirements, only. Important implications stem from other regulation (like the new Bail-In-Framework (BRRD), anticipation of a leverage ratio or the new liquidity framework) and a changing environment, too. As a result, it is not clear if the per-unit cost of capital has changed in sum.

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6. *Have increased capital requirements affected the market for some categories of assets more than others? If so, which ones and how? Which of the provisions contained in the CRR, apart from those establishing capital ratios, are likely to have created the effects experienced by specific markets and/or exposures?*

Large, risky and long-term tickets are affected more than others.

The leverage ratio makes business/loans with low-risk and (at the same time) low-return less attractive. A LR may also affect loans to the public sector. As market participants expect a leverage ratio to be set, these effects take place already today.

7. *Do you think the phase-out of the transitional provisions under CRR could have an incremental impact on future lending decisions? If so, please explain how.*

Yes, the phase-out has had immediate impact as market participants anticipated the target level, initially only required after the transitional period ("fully-loaded").

Regarding Lending to SME:

8. *To what extent has this provision been effective in supporting lending to SMEs? Could you provide any evidence, preferably quantitative, of the change in lending to SMEs due to the introduction of the supporting factor as from 2014?*

If all credits were to be regulated without taking company size into consideration, it would have a significant effect on company financing. Additionally, one should not underestimate the significance of credits to medium sized enterprises as a stability anchor for companies such as banks. The 23 million small and medium enterprises (SMEs) represent the majority of all companies in the EU and create two thirds of the total number of workplaces in the private economy. It is much harder for them to obtain credit than for larger companies. Therefore, protecting the supply of credit from further limitations does not only benefit EU countries, who must accept the burden of the current reform, but the European economy in general.

Representative data is not available yet, due to the short time horizon since the introduction of the temporary supporting factor beginning of 2014. No final assessment can therefore be made about the effect of the supporting factor on changes in lending to SME. In light of this, the analyses conducted as part of the current EBA Discussion Paper on SMEs and the SME Supporting Factor (EBA/DP/2015/02) are highly important.

It is also crucial that the supporting factor is permanently introduced, so that banks have stable basis for calculation.

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9. *What specific difficulties do banks face when lending to SMEs, compared to when lending to larger corporates? Are these related to the CRR? How could the CRR and other prudential regulations contribute to addressing some of these difficulties in other ways than by adjusting rules for SMEs, or do they need to be resolved by some other means? If so, what other means would be adequate?*

In general, the lending situation in those countries, in which AECM's members are operating, differs from being currently very favorable for SME in some countries and quite difficult in others. Very small enterprises often face more difficulties when it comes to borrowing compared to larger SME. Low equity ratios, poor and/or insufficient information often lead to lower credit ratings. Combined with relatively small ticket sizes (disadvantageous transaction cost-return relation) and difficulty in putting up adequate collateral puts them into disadvantage and may in turn lead to a refusal to lend.

Stable lending to small and medium enterprise strengthens the financial system. This is due to the fact that numerous smaller SME loans are generally often lower risk than loans of equal amount to a small number of larger companies: SMEs loans are less dependent on large global fiscal trends. This reduces the risk that many creditors simultaneously get in trouble – and trigger a crisis which could threaten the bank's existence.

Therefore, the SME supporting factor is not a special concession which was introduced to privilege a specific group of companies. On the contrary: It simply recognises the stabilising effect that the spreading the risks through SME credits has on a bank's business. Further, there are a number of grounds which argue that it might even have been set too low.

The supporting factor should be retained in its current format, otherwise this could threaten the investment opportunities and therefore the competitiveness of small and medium enterprises.

However, it would be sensible to have a higher upper limit for SME loans. This is due to the fact that the maximum loan limit of 1.5 million Euros is quickly attained. For sole traders in particular, the entrepreneur's private credits are included in the calculation. As the risk does not dramatically increase when the loan limit of 1.5 million is surpassed, there is room for an increase.

10. *Has the CRR influenced the capacity of banks to provide loans to infrastructure projects? Which provisions are most relevant?*

11. *What are the specific difficulties that banks face when lending to infrastructure projects? Are they related to the CRR? How could the CRR and other prudential regulations contribute to addressing some of these difficulties or do they need to be resolved by some other means? If so, what other means would be adequate?*

12. *Should infrastructure projects continue to be treated as loans to corporate borrowers? If not, why? What common features of infrastructure projects or their subsets would justify a separate treatment from loans to corporate borrowers?*

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Regarding Proportionality:

13. *Should the provisions contained in the CRR allow for more differentiation in how they are applied to banks of different sizes or with different risk-profiles? How can they do this without compromising the objective of achieving financial stability and creating a level playing field within the single banking market? Are there any provisions that could potentially be applied with greater differentiation? If so, what are these provisions? Provided application on a differentiated basis is desirable, what considerations could be relevant to make such a differentiated application? Are any concrete changes desirable in this context? If so, what are these changes and the associated costs and benefits?*

For all institutions, the after-crisis regulatory framework is operationally very burdensome. Still, this especially holds true for smaller institutions.

It is therefore of utmost importance that the principle of proportionality is consistently taken account of in any piece of legislation. There should be further work done to make this principle operational in the Level I-legislation as well as in the work of the European Supervisory Authorities (ESAs). One possible option to be further analyzed could be a differentiation which takes the capital level (risk weight based solvency ratio) of institutions as a starting point.

Moreover, as to achieve financial stability and create a level playing field within the single banking market, it is of outmost importance to avoid any doubts and to make clear expressively that guarantees given by private or public mutual guarantee schemes resp. guarantee banks are eligible credit risk mitigation techniques. Therefore it is necessary mention "public or private mutual guarantee schemes and guarantee banks" in the list of eligible protection providers for unfunded credit protection. Until now in many member states credit guarantee schemes respectively guarantee banks had been treated under national law as credit institutions and had to fulfill the supervisory requirements, nevertheless they are just financial institutions according to the current legislation. If AECM's proposal is not accepted, there would be the danger that guarantees given by mutual guarantee schemes respectively guarantee banks to the benefit of thousands of SME in the European Union could not be approved as capital saving credit risk mitigation techniques. In addition it would be necessary to give mutual guarantee schemes respectively guarantee banks therefore at least the same risk weight as institutions. Otherwise the risk mitigating effect of the guarantees would be lost, which would have a negative effect on the provision of loan finance to SMEs in Europe. There should be indicated that public counter-guarantees covers all of the risks covered by the primary guarantee and not all the entire risk of the underlying loan. It should also be clarified that guarantees, which are counter-guaranteed by public authorities, should be recognized without any further restrictions. Furthermore, there is a need to introduce a provision that would take into consideration the mitigating effect of counter-guarantees provided by mutual guarantee societies that are subject to prudential supervision. To date, counter-guarantees provided via this type of entities are not recognized as a bank credit risk mitigating factor. This in our view is not coherent with the fact that first level guarantees and co-guarantees provided by the same private sector are recognized as risk mitigating. Therefore, in order to improve the efficiency of the guarantee sector and use its available financial resources in the most rational manner, it would seem logical to treat counter-guarantees issued by supervised private sector entities in the same manner as their first level guarantees and counter-guarantees.

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Regarding Simplification:

14. Which areas of the CRR could be simplified without compromising the Regulation's objective of ensuring prudence, legal certainty and a level playing field? Are there areas that could be simplified, but only for specific types of bank or business models? Would it be useful to consider an approach where banks that are capitalised well above minimum requirements or that are less exposed to certain risks could be subject to simplified obligations? What would be the risks with such an approach?

Legal opinion obligation under Art. 194

The obligation under Art. 194 subparagraph 2 CRR to obtain legal opinions on the validity and enforceability of credit protection arrangements needs to be reviewed and at least restricted to certain types of arrangements only.

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