AECM position on the transposition of the finalised Basel III standards into EU law

Guarantee institutions of any kind – public, private, mutual or public-private mixed, with or without banking license – have the task of promoting small and medium-sized enterprises that have an economically viable project but lack the necessary collateral to get bank financing from their house bank. **By issuing a financial guarantee, they enable lending and help to overcome the existing market failure in the area of SME finance**[1].

It is of utmost importance that the transposition of the revised Basel III rules into EU law takes account of the specificities of European SME finance being very strongly dependent on bank financing. The new regulatory framework needs to comply with the principle of proportionality. Furthermore, it needs to recognise and account for the special roles played by promotional institutions, especially in the area of SME finance. In this respect, we emphasise that **financial guarantees** granted by guarantee institutions (being financial institutions or banks) **need to continue allowing for capital relief and a downward correction of the risk weight** attributed to the respective exposures.

Concerning the different sections of the current consultation document, we are happy to provide the following elements:

1.1.3 Exposure to corporates under the Standardised Approach

<u>SME share in portfolio</u>

Financial guarantees by our members (excluding export guarantees that are provided by a limited amount of our members) are almost exclusively granted to SMEs.

<u>Treatment of unrated corporates</u>

We consider the derivation of the risk weights by external ratings very important in order to obtain an appropriate risk weight for the claims. In our view, there should not be any

[1] For an overview of market failures in SME lending and mitigation techniques: OECD (2018). *Financing SMEs and entrepreneurs 2018. An OECD Scoreboard*, OECD Publishing, Paris.

restrictions here. If no external ratings are available for a financed company, a risk weight of 100% applies to those companies that are neither SMEs nor retail. This blanket risk assessment in no way reflects the financing reality and prevents the consideration of financial peculiarities in companies and ultimately does not lead to a risk-adequate assessment of the receivable. That is why we **object the blanket attribution of the 100% RW to unrated companies**.

The problem in SME financing is the availability of external ratings. Due to a lack of size and costs, this is not affordable for an SME and therefore not available in the standard. If external ratings are not permitted, a risk weight of 100% is applied if the total revenue limit of EUR 50 million for SMEs is not met. This general risk assessment does not reflect the financing reality in any case and prevents the consideration of financial peculiarities in companies and ultimately does not lead to a risk-adequate assessment of the claim. The newly introduced definition of the **criterion for small and medium-sized enterprises** with a total turnover of EUR 50 million should be revisited. In our experience, if a distinction is to be made on the basis of whether an external rating regularly exists for certain turnover classes, a **higher threshold should be applied**.

The Basel Committee recognises a favourable treatment (weighting of 65% instead of 100%) for companies operating in jurisdictions where the use of external ratings is not admitted for regulatory purposes and for those qualifying as "investment grade". Investment grade companies are those that have an adequate ability to meet their financial commitments properly, even in situations of negative market and economic cycle changes, and issue listed securities. For the implementation of this provision it is **necessary that the European Union, while maintaining the use of the rating for prudential purposes, recognises the possibility of applying for companies, unrated and classified as investment grade, the favourable 65% weighting**, and this in order to ensure an international level playing field. Moreover, the notion of "investment grade" should be qualified differently in order to make it consistent with the characteristics of the European market. In particular, **we recommend eliminating the condition relating to the issuance of listed securities** which in most European countries is indeed not very widespread.

<u>Leasing operations</u>

As with other unrated corporate exposures, in the context of the standardised approach the Basel Committee assigns a weighting factor of 100% also to exposures deriving from leasing operations, automobiles and equipment. In this regard, however, we emphasise that the operation for the leasing company has a lower risk, due to the maintenance of ownership of the asset, compared to other forms of financing. **This lower risk needs to be reflected in the RW**. In the process of transposing Basel rules into EU law, the occasion should be seized to consider this aspect also because of the importance that the leasing has for the renewal of the fixed capital of the companies, and especially for smaller businesses.

1.1.4 Equity and other capital instruments under the Standardised Approach

Treatment of equity exposures

Some of our members also support SMEs and start-ups by providing equity investment. If a **RW of 250% is to be applied to an equity investment in SMEs or start-ups** instead of currently 100%, such investments would no more be possible due to scarce resources. **This would seriously hamper business creation**. We do not consider such an arrangement to be risk adequate. The nature and quality of the investments are not sufficiently taken into account.

Treatment of promotional equity exposures

Discretion should be implemented, but the definition of national legislated programmes is too narrow. In our view, the **notion of significant subsidies is too vague**. There are promotional equity investments that benefit from moderate subsidies but still play a crucial role in business promotion and in overcoming market failure in the area of SME and start-up finance. Furthermore, we would like to point out that **promotional institutions are not necessarily working under narrow government oversight**. Many public institutions are independently managed without the government being directly involved in individual investment decisions. This **provision also does not take into account the existence and the role of private and mutual institutions that also have a promotional character**.

We suggest replacing reference made to a national legislative programme by a **reference to equity holdings for reasons of business promotion**: "Equity holdings under national legal programmes and financings with a promotional character in the area of SME financing, issued by financial institutions that are not profit maximising".

1.1.5 Retail Exposures under the Standardised Approach

Granularity criterion

The privilege for "Regulatory Retail" with a risk weight of 75% will only be applied if certain criteria, including the newly introduced hard granularity criterion, are met.

The receivables may now only be allocated to retail business if the volume is less than 0.2% of the total retail business. This granularity criterion has so far only been a recommendation of the Basel Committee to the national supervisory authorities. With the now planned finalisation of the reform package, this criterion will now be bindingly defined. The national supervisory authorities may only deviate from this criterion if an appropriate diversification of the retail business portfolio is ensured by other methods.

In the business activities of guarantee institutions with overall smaller portfolios, even small counterparty risk positions of significantly less than KEUR 100 could fail to comply with the granularity criterion. That is why **we argue for a threshold of maximum KEUR 100 under which activities are exempted from compliance with the granularity criterion.**

1.1.9 Other provisions

<u>SME factor</u>

We would like to express our **support for the SME factor**. SMEs are the backbone of the European economy. That is why SME finance is crucial for the economic development of our continent, especially in the areas employment, regional development and innovation. On a portfolio basis, **SME loans help to diversify the banks' portfolios and to mitigate risks.** This risk reducing effect of SME loans is generally recognised. It is a correction of the capital requirements of banks financing SMEs and should not be seen as a subsidy ("correction factor" instead of "supporting factor"). We very much encourage the European legislators to keep and confirm the SME factor.

1.1.6. Real estate exposures

In our opinion, the **exclusion of positions secured by real estate from the corporate sector, in particular from retail and SME business, is very critical**. The promotional activities of guarantee institutions focus on supporting investment projects. These are real estate properties that are frequently used for business purposes, which for a variety of reasons are incorporated into real estate property companies and leased to production operations. Formally, these projects would fall under Commercial Real Estate, even though they would need to be classified as investments in business assets. As project financing, they are subject to the higher risk weights of Commercial Real Estate (60%-150%). In contrast to "normal", i.e. non-SME, companies, the split-up leads to a deterioration. For this purpose, the option should be given to use the more favourable RWA rate for SMEs.

1.3 and 1.4 Credit Risk Mitigation

<u>Eligibility and treatment of conditional guarantees</u> under both the Standardised and the Internal Rating Based Approach

It is of utmost importance that **financial guarantees** granted by public, private, mutual or public-private mixed guarantee institutions to rated or unrated SMEs and midcaps are **recognised as collateral and allow for significant capital relief of the financing banks, i.e. for a downward correction of the RW attributed to the respective exposure**. Credit guarantee schemes are the most widespread instrument to overcome market failure in the area of SME finance[1]. Putting their risk reduction capacity into question does not increase risk sensitivity but increases risks by cutting many small businesses off their possibilities to get access to finance. Furthermore, it would undermine the efforts to make InvestEU – the second generation of the investment plan for Europe – but also national counter-guarantee programmes, a success. Even in situations where financial guarantees qualify as providers of capital relief, guarantee institutions might be discouraged by the heavy burden of proving that they comply with the conditions. Moreover, it might become more difficult for guarantee institutions to convince commercial banks to cooperate.

Eligibility and treatment of non-financial collateral under both the Standardised and the Internal Rating Based Approach

Both in the Basel III Reform and in CRR2, the criteria for the recognition of non-financial collateral for credit risk mitigation purposes are very restrictive and different depending on whether the standard approach or that based on internal ratings is used. **It should be taken advantage of the CRR reform, for the purposes of implementing Basel III, to redefine this framework and to widen the perimeter of the area of non-financial collateral other than real estate that can be used for credit risk mitigation purposes**. This would also be relevant for the purposes of the new regulations relating to the coverage of impaired positions (calendar provisioning), which envisage differentiated timing and provisioning amounts, depending on whether or not the impaired exposure is guaranteed by risk mitigation instruments recognised by the CRR. In particular, ships must be recognised among the eligible guarantees for credit risk mitigation purposes. On the other hand, the European legislator has already recognised ships as high quality guarantees in the framework of the covered bond framework (see paragraph 1 letter g of the art. 129 CRR). Likewise, for the internal rating based approach, it is considered that the EBA can generally assess the existence of the conditions envisaged in the art. 199 (6) for the recognition of collateral other than real estate, by inserting the ships in the list provided for in art. 199 (8) of the CRR.

6. Output Floor

The Basel III Reform provides for a minimum limit of supervisory capital determined with its own internal models (output floor), parameterised (based on a 72.5% regime) to the amount of the requirement calculated on the basis of the standard methodology.

In order to avoid an excessive reduction in the risk sensitivity of banks' internal valuation models, we ask to apply the **output floor in Europe only at consolidated level[2]** (and not at individual level).

7. Centralised supervisory reporting and Pillar 3 disclosures

Centralised disclosure

We principally support centralising the collection of supervisory and disclosure reporting. The thereby induced reduction in double documentation is very beneficial, especially for small institutions. However, we fear that EBA cannot sufficiently take regional specificities as well as the specificities of very specialised institutions into account. We therefore suggest that **data collection is centralised at the respective**

[2] At bank group level.

national supervisory authorities. In our view, disclosures shall not be accessible in one internet place.

8. Sustainable Finance

We strongly support that the new Von der Leyen-Commission puts an emphasis on sustainability. This is important since a sustainable change is not possible without the support of the financial sector. The difficult task, however, is not to set up rules that overcharge small actors and that respect the **principle of proportionality**. This principle urgently needs to find higher consideration in the entire sustainability debate.

The level of regulation of the European Financial Market Authority and its inclusion in the institutions is already very high in terms of sustainability aspects. However, it must be avoided in any case that an overregulation in terms of sustainability is made so that even with smaller financings (up to EUR 1 million) of small and medium-sized enterprises is constrained by excessive requirements regarding information on companies and projects. The specifications developed and planned for large and systemically important banks in terms of sustainability are not suitable for smaller, purely business-oriented institutions that are exclusively active on their respective national level such as guarantee institutions.

In our opinion, it is important that credit institutions take sustainability risks into account; this may apply to their own investments and business organisation as well as to risk management. In any case, it should be avoided that subsidies from small and medium-sized enterprises are limited on the basis of sustainability aspects, as this would lead to severe funding constraints with important negative effects on regional development and employment.

We propose a European solution in the area of regulating sustainability risks and advocate for adequate simplification measure in the area of SME finance.

Financing of founders and very small financings (up to EUR 1 million) should be completely exempted from the foreseen requirements.

9. Fit and Proper

Proportionality

In order to avoid excessive administrative burden and to ensure proportionality, **small and non-complex institutions shall be exempted from any fit and proper assessment**.

Final Comment

The provisions from the finalised Basel III Accord will lead to a strong increase of capital requirements for European banks. When transposing these requirements into EU law, it is of utmost importance that specificities of the European market are taken into account.

A strong increase in capital requirements will negatively affect the financing situation of the real economy and in particular of small businesses that are most sensitive to changes in their lending conditions. We therefore ask the European legislator to foresee provisions in EU law that ensure that promotional loans for SME financing will not be burdened with additional capital requirements.

Finally, we would like to emphasise that compliance with the new rules requires a considerable effort by banks and financial institutions. That is why a gradual implementation of the new regulatory system is encouraged in order to ensure that banks and companies have adequate implementation times, with reference to both the introduction of new methodologies and the need for greater capitalisation in relation to specific business lines.

About us

The 47 members of the **European Association of Guarantee Institutions (AECM)** are operating in 29 countries in Europe. They are either private sector guarantee schemes or public promotional institutions or banks. Their mission is to support SMEs in getting access to finance. They provide guarantees to SMEs that have an economically sound project but do not dispose of sufficient bankable collateral. AECM's members operate with counter-guarantees from regional, national and European level. At the end of 2018 AECM's members had more than EUR 112 billion of guarantee volume in portfolio, thereby granting guarantees to almost EUR 3 million SMEs. AECM's members are by far the most important counterparts of the EIF concerning EU counter-guarantees, handling EU guarantees from the very beginning in 1998.

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