AECM position on the Basel Package – update July 2022

The European Association of Guarantee Institutions (AECM) and its members acknowledge the efforts of the institutions to transpose the international Basel Standards in a faithful manner, taking as far as possible European specificities into account. Following up on our comments on the Commission proposal published in February 2022 and in reaction to the publication of the draft Parliament report, we would like to emphasise a few points regarding the further legislative process that are of keen importance for promotional guarantee institutions.

Background

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 financing from their house bank. By issuing a financial guarantee, they enable lending and help to overcome market failure in the area of SME finance. In times of crisis, as during the covid-19 pandemic, guarantee institutions take up an anti-cyclical role, supporting SMEs that suffer from the crisis and allowing them to survive as well as to prepare for the recovery phase.

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. This recognition needs to be translated into the legislative text by **allowing for favourable risk weights for exposures towards such institutions as well as by a far-reaching recognition of public counter-guarantees** from all government levels (EU, national, regional, local) for capital relief. As financiers of small and medium-sized enterprises, we **highly appreciate that the SME factor is confirmed**.

Brussels, July 2022

Comments on the CRR proposal

Unrated institutions

Most guarantee institutions are non-profit promotional institutions that usually operate with a public counter-guarantee and that are not listed on capital markets. Furthermore, in most cases they are very small institutions. It is therefore unusual for many guarantee institutions to have an external rating.

The current Commission proposal foresees an increase of the risk weight of exposures towards unrated institutions – even in the case of grade A from 20% to 30% or even to 40%. This increase would sensitively impact the financing costs of SME beneficiaries since banks will need to hold more capital for guaranteed exposures. Furthermore, it would reduce demand for credit guarantees and increase credit refusals especially for the smallest companies and for those with the least collateral. The increase does not only hamper SME financing, but it does so without any justifiable need to increase these weights from a risk perspective. The operations of most of our members are at least partially backed by their respective governments (or by EU funds). **We therefore suggest introducing a further bucket for promotional institutions that would benefit from a lower, 20% RW or to lower the proposed RW in the bucket for grade A to 20%.**

More than half of our members are not CRR institutions[1]. However, via Article 119(5) they fall into the scope of Article 121. As they are not required to meet the same capital requirements that are applicable to CRR institutions, it is possible that these exposures would not fulfil all the conditions to be assigned to Grade A or B under Article 121 and would therefore be automatically assigned to Grade C, ignoring the effective underlying risk of these exposures. Such a scenario would lead to a sharp decline in the promotional guarantee activity and thereby to a severe contraction of small companies' access to finance. We strongly recommend to correct this provision by allowing institutions to qualify for Grades A or B if they meet comparable prudential requirement.

See annex 1 for the proposed amendments of Article 121.

[1] As of end 2019, 24 members indicated that they are no CRR institutions and 9 members did not indicate their regulatory status. However, out of these, 8 members are located outside the EU.

Unrated corporates

Corporates that do not classify as SME or retail and that do not dispose of an external rating will face a substantial increase of the risk weight following a transition period until 2032. During this transition phase, companies without an external rating, can continue to benefit from the 65% RW provided that those exposures have a probability of default (PD) of less or equal to 0.5%. SMEs with a turnover exceeding mEUR 50[2] as well as small midcaps benefitting from promotional guarantee support usually do not have an investment grade PD. This, however, does not justify the blanket attribution of the 100% RW.

We are of the opinion that the attribution of the 100% RW 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 this blanket attribution of the 100% RW to unrated companies in the period after 2032 and during the transition period for non-investment grade exposures.

External ratings are costly, especially for SMEs and small mid-caps that do not intend to access capital markets. Therefore, **a long-term solution needs to be found that takes the particular situation of European SMEs and small midcaps into account. It could for example be envisioned to use the financing banks' or the guarantee institutions' rating as official rating in the case of companies that respect the EU SME or small midcap definition.**

During the transition period, no distinction shall be made according to the PD, meaning that **also companies with a PD higher than 0.5% should benefit from the transitional arrangement**. This is of particular importance in an in-pandemic or post-pandemic situation where the PD is not necessarily a good indicator for the viability of a company. Assigning a higher RW to viable unrated companies with a PD higher than 0.5% will seriously impair their recovery and thereby adversely affect the riskiness of the financing operation.

See annex 1 for the proposed amendment of Article 465(3).

[2] The SME definition used for this provision is not coherent with the official EU SME definition. It refers only to the turnover criterion, leaving the headcount and the balance sheet criteria unconsidered. A company respecting the EU SME definition by not exceeding the headcount and the balance sheet threshold, might not be treated as SME if its turnover exceeds the mEUR 50 threshold.

Retail exposures

We appreciate that the current proposal does not foresee a hard granularity criterion defining volumes only as retail business in case that they are less than 0.2% of the total volume of the retail business portfolio. This is important since 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 such a granularity criterion. The proposal, however, states that the exposure in question must *"represents one of a significant number of exposures with similar characteristics, such that the risks associated with such exposure are substantially reduced;"*

EBA is mandated to develop guidelines *"to specify proportionate diversification methods under which an exposure is to be considered as one of a significant number of similar exposures […]"*. **It is of utmost importance to make sure that a hard granularity criterion (in form of a fix percentage) is not introduced through the backdoor, since this would unduly disadvantage institutions with small retail portfolios.**

See annex 1 for the proposed amendment of Article 123.

Treatment of equity and quasi-equity exposures

Some AECM members offer besides their classical loan guarantees, promotional equity or quasi-equity products or guarantees covering such products. These instruments are crucial in order to strengthen the capital base of small and medium-sized companies. This is for example of outstanding relevance in the current recovery phase that many SMEs entered after having taken on considerable volumes of debt. In order to allow for a broad use of these instruments, it is important to account for the promotional character of such operations when attributing risk weights. Several factors contribute to the lower risk of promotional equity or quasi-equity respectively a guarantee on one of the two. These products are long-term oriented and in the case of our members mostly small in size allowing thereby for efficient risk mitigation. They are often granted for the purpose of stabilisation of a small company. With this in mind, **we call for a risk weight of maximum 100% for promotional equity and quasi-equity**. The share of these that is publicly counter-guaranteed shall bear a 0% risk weight. It is of utmost importance to note that the attribution of a product to the categories equity, quasi-equity or subordinated loans is not obvious and might differ between jurisdictions. It is therefore important to allow for the same

treatment of subordinated loans and equity that are both granted under legislative programmes. For example, so-called "silent participations" (in German "Stille Beteiligungen") in Austria and Germany would be located between subordinated loans and equity. The feature that renders it less risky is its promotional long-term oriented character. In fact, this kind of product stabilises the beneficiary company and reduces the risk of default on its debt. It should therefore not be penalised by an exaggerated risk weighting. The attribution of a 100% risk weight is therefore justified.

See annex 1 for the proposed amendments of Articles 128 and 133.

Amendment 101 limits the favourable treatment of equity exposures under legislative programmes to those that represent a share of less than 10% of the institution's own funds. This threshold is much too low, especially in the case of very small institutions. We therefore recommend to reject this amendment or to exempt small and non-complex institutions according to CRR from this limit.

Amendment 103 tabled by the rapporteur gives the impression that guarantees are not legislative programmes (it reads: *"legislative programmes or guarantees […]"*). This formulation is misleading since to our understanding, public guarantees are legislative programmes in the sense of CRR. We would recommend to clarify this point in the legislative text.

Eligibility criteria for guarantees

In order to be eligible, the CRR requires the *"credit protection contract [not to contain] any clause, the fulfilment of which is outside the direct control of the lending institution"*. *"A clause in the credit protection contract providing that faulty due diligence or fraud by the lending institution cancels or diminishes the extent of the credit protection offered by the guarantor, shall not disqualify that credit protection from being eligible"*. However, a credit protection is not eligible in case of a *"credit protection contract which can, in the event of fraud of the obligor, be cancelled or of which the extent of credit protection can be diminished"*.

This limitation is problematic because a guarantee institution needs to protect itself against fraud committed by both the onlender and the obligator. This protection is necessary in order to avoid moral hazard and to allow for an effective risk management. Disallowing credit protection providers to protect themselves against fraud might have unintended adverse effects on the effective risk position since onlenders could neglect their anti-fraud monitoring of obligators without needing to fear the loss of guarantee protection. That is why **we strongly advocate for allowing credit**

protection contracts to include measures that protect the provider against fraud, as it is currently possible.

We very much welcome the rapporteur's amendments 204, 181 and 182, which solve the above-mentioned problem and we call on the Parliament and the Council to back these amendments.

ESG Risks

The new CRR will require institutions to report their exposure to ESG risks to their competent authorities. It is undoubtedly important to take these specific risk exposures into account. Nonetheless, we urge the co-legislators to take a proportionate approach and to introduce **lighter disclosure requirements for small and non-complex institutions**, as defined in CRR Article 4.1 (145). The reason for this request is twofold. Smaller institutions do not dispose of the same resources as large institutions do. In order not to endanger their competitiveness, **it is important to take a proportionate approach when it comes to reporting and disclosure requirements**. Secondly, smaller institutions are less likely to be involved in the financing of large infrastructure projects that might pose the most relevant ESG risks. Their clients are tendentially smaller companies. This might also make it more difficult to assess risks since data/reportings from small companies are scarcer. **We therefore strongly recommend exempting SME financings of amounts smaller than EUR 3 million from the requirement to disclose the exposure to ESG risks.** Such an exemption makes sense since the concerned beneficiaries are not in the scope of CSRD. Institutions financing these entities would therefore lack the required input data. Moreover, the exemption is justified from a risk perspective since small financings already per se allow for risk mitigation. This is the basis for the SME factor.

We strongly welcome the rapporteur's amendment 280 that clarifies that any duplication of existing legislative disclosure requirements are to be avoided.

Article 449a already allows for some simplifications (frequency of reporting and reporting recipient). However, a lighter treatment is also needed in terms of content.

See annex 1 for the proposed amendment of Article 449a.

Operational Risk

We welcome the rapporteurs amendment 276 which deletes the requirement to disclose own funds requirements for operational risk and call on the Parliament and the Council to back this amendment.

Brussels, July 2022

Timeline

The new rules and their inherent procedural changes (IT, internal processing, etc.) will lead to a significant implementation burden for all institutions. New rules must be implemented before 2025. Depending on the duration of the further legislative process, this is likely to be a tough deadline, especially for smaller institutions. In order to ensure a level playing field between large and small institutions as well as to allow for a diligent implementation, we strongly **advocate for introducing an implementation period of at least 24 months** after coming into force of the legislation.

See annex 1 for the proposed adjustment of article 2.

EBA delegation

The current proposal foresees numerous mandates for EBA to elaborate Regulatory Technical Standards (RTS). These do potentially have significant impact on capital requirements and compliance costs for financial institutions. EBA mandates should therefore be clearly framed and **EBA should be required to take a proportionate approach, i.e. to keep compliance costs for small and non-complex institutions at a minimum**. This is important in order to ensure a level playing field for institutions of different size and type.

Comments on the CRD proposal

Fit and Proper

The Commission proposes amendments regarding the supervision of members of the management body and of key function holders. They clarify the role of banks and competent authorities for checking the compliance of board members, including the timing of such assessment. Furthermore, they set minimum requirements for key function holders.

In order to limit red tape and to honour the principle of proportionality, requirements for "fit and proper" should be limited to credit institutions that do not qualify as small and non-complex. Articles 91 and 91a to 91d shall therefore

be amended so as to exempt small and non-complex institutions from the scope and to define lighter requirements.

ESG Risks

The proposal contains a number of provisions concerning the management of ESG risks as well as regarding the inclusion of ESG factors in the prudential framework. **When setting up these provisions, it is of utmost importance to take a proportionate approach, relieving smaller institutions with regard to the growing amount of additional requirements.**

See annex 2 for the proposed amendment of Articles 76 and 87a.

The rapporteur's amendment 64 that requires an annual instead of a bi-annual review of the strategies and policies would lead to an increase in bureaucracy without any significant reduction of risks and should therefore be rejected.

Conclusion

SME credit guarantees are an effective and budget-friendly instrument of economic policy, the positive impact of which on growth, employment and the economy in general is scientifically proven by many impact studies[3]. Guarantee institutions do not only jump in for SMEs in times of crisis[4], but they also support them to overcome market failure in the area of SME finance[5] in normal times. **In order to allow guarantee institutions to play its promotional role and to maximise the positive impact they are providing to the European economy, it is paramount to take a proportionate approach with regard to reporting and disclosure requirements as well as to fully recognise the risk mitigating effect provided by themselves and by the public counter-guarantor.**

[3] AECM Statistical Yearbook 2021, 2020 and 2019, respectively Chapter V Impact Studies and Research.

[4] AECM (2021): SME support in the covid crisis – the role of guarantee institutions
AECM position on the need to keep up enhanced guarantee support (2021)

[5] OECD (2006). The SME finance gap. Vol. 1. Theory and evidence.
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.

Annex 1: Suggested amendments CRR proposal

Article 121

(1)

a)

[…]

(ii) the institution meets or exceeds the requirement laid down in Article 92(1), the specific own funds requirements referred to in Article 104a of Directive 2013/36/EU, the combined buffer requirement defined in Article 128, point (6), of Directive 2013/36/EU, **or any comparable prudential requirements applicable to financial institutions that are treated as institutions according to Article 119(5)** and any equivalent or additional local supervisory or regulatory requirements in third countries, insofar as those requirements are published and are to be met by Common Equity Tier 1 capital, Tier 1 capital or own funds;

[…]

b)

(ii) the institution meets or exceeds the requirement laid down in Article 92(1), the requirements referred to in Articles 458 and 459, the specific own funds requirements referred to in Article 104a of Directive 2013/36/EU, **or any comparable prudential requirements applicable to financial institutions that are treated as institutions according to Article 119(5)** and any equivalent or additional local supervisory or regulatory requirements insofar as those requirements are published and are to be met by Common Equity Tier 1 capital, Tier 1 capital and own funds;

[…]

(2)

[…]

b)

Exposures assigned to Grade A which are not short-term shall be assigned a risk weight of ~~30~~ **20** % where all of the following conditions are met:

(i) the exposure does not meet any of the conditions laid down in point (a);

(ii) the institution’s Common Equity Tier 1 capital ratio is equal to or higher than 14 %;

(iii) the institution’s leverage ratio is higher than 5 %.

ba)

Exposures assigned to Grade A which are not short-term shall be assigned a risk weight of 20 % where all of the following conditions are met:

(i) The majority of shares is held by the national, regional or local government or the institution benefits from a counter-guarantee of more than 50% of its exposure by the national, regional and/or local government.

(ii) The institution has a promotional task defined in its statutes.

[…]

Article 123

[…]

EBA shall issue guidelines, in accordance with Article 16 of Regulation (EU) No 1093/2010, to specify proportionate diversification methods under which an exposure is to be considered as one of a significant number of similar exposures as specified in point (b), by [OP please insert the date = 1 year after entry into force of this Regulation]. **These methods shall notably take the particular situation of small retail portfolios into account, exempting them from any percentual granularity criterion.**

Article 128

[…]

3. Institutions that have received the prior permission of the competent authorities, may assign a risk weight of 100 % to subordinated loan exposures incurred under legislative programmes to promote specified sectors of the economy that comply with all of the following conditions:

(a) the legislative programs provide significant subsidies, including in the form of guarantees by national, regional or local governments, the European Union or by multilateral development banks, public development credit institutions as defined Article 429a(2) or international organisations, for the investment to the institution;

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Article 133

5. Institutions that have received the prior permission of the competent authorities, may assign a risk weight of 100 % to equity exposures incurred under legislative programmes to promote specified sectors of the economy that comply with all of the following conditions:

(a) the legislative programs provide significant subsidies, including in the form of guarantees by **national, regional or local governments, the European Union or by** multilateral development banks, public development credit institutions as defined Article 429a(2) or international organisations, for the investment to the institution;

[…]

Article 449a

Disclosure of environmental, social and governance risks (ESG risks)

Institutions shall disclose information on ESG risks, including physical risks and transition risks, **for financings of companies that do not classify as SMEs and that exceed a financing volume of EUR 3 million**.

The information referred to in the first paragraph shall be disclosed on an annual basis by small and non-complex institutions and on a semi-annual basis by other institutions.

Article 465(3)

By way of derogation from Article 92(5)(a), point (i), parent institutions, parent financial holding companies or parent mixed financial holding companies, stand-alone institutions in the EU or stand-alone subsidiary institutions in Member States may, until 31 December 2032, assign a risk weight of 65 % to exposures to corporates for which no credit assessment by a nominated ECAI is available ~~provided that that entity estimates the PD of those exposures, calculated in accordance with Part Three, Title II, Chapter 3, is no higher than 0,5 %~~.

Article 2

2. This Regulation shall apply from ~~1 January 2025~~ **[OP please insert date = 24 months after date of entry into force of this Regulation]**, with the following exceptions:

Annex 2: Suggested amendments CRD proposal

Article 76 (b) in paragraph 2 the following subparagraph is added: 'Member States shall ensure that the management body **of institutions not qualifying as small and non-complex institutions as defined in Regulation (EU) No 575/2013 Article 4.1 (145)** develops specific plans and quantifiable targets to monitor and address the risks arising in the short, medium and long-term from the misalignment of the business model and strategy of the institutions, with the relevant Union policy objectives or broader transition trends towards a sustainable economy in relation to environmental, social and governance factors.';
Article 87a 5. EBA shall issue guidelines, in accordance with Article 16 of Regulation (EU) No 1093/2010, **and taking the principle of proportionality into account,** to specify: […]

About us

The 47 members of the **European Association of Guarantee Institutions (AECM)** are operating in 30 countries in Europe. They are either private / mutual 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. This so-called SME financing gap is recognised as market failure. By guaranteeing for these enterprises, guarantee institutions help to address this market failure and facilitate SMEs' access to finance. The broader social and economic impact of this activity includes the following:

- Job creation and preservation of jobs by guaranteed companies
- Innovation and competition: crowding-in of new ideas leading to healthy competition with established market participants
- Structure and risk diversification of the European economy
- Regional development since many rural projects are supported
- Counter-cyclical role during crises

SME guarantees generally pursue a long-term objective and our members, if public, private, mutual or with mixed ownership structure, have a promotional mission.

AECM's members operate with counter-guarantees from regional, national and European level. As of end-2021, AECM's members had about bEUR 312 of guarantee volume in portfolio, thereby granting guarantees to around 5.9 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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