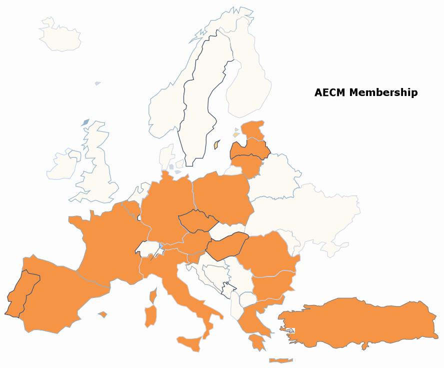
AECM Position Paper:
European Commission draft Directive and Regulation on changes to the Capital Requirements Directive (CRD)

Brussels, 9th November 2011

General Comments and background to mutual guarantee societies:

AECM, the European Association of Mutual Guarantee Societies, takes position on the recently published draft Directive and Regulation proposals[i] concerning the changes to be made to the Capital Requirements Directive (CRD) following the financial crisis.

AECM has 37 Member organizations in 22 countries (see map) that either are mutual or cooperative entities, or public institutions, providing credit default guarantees for SMEs, who for lack of sufficient collateral could not otherwise access bank loans. They have been set up with this exclusive aim in mind by their founders, i.e. beneficiary companies, banking groups, SME organizations and/or public authorities.



Their legal statute, composition of own funds, operating procedures, fields of activity, etc. are very different from country to country, responding to specific market needs as well as legal and economic framework conditions. Their activity is limited to the national or regional territory.

According to provisional figures on 31st December 2010, AECM members held in their portfolios more than 2 million guarantees for a value of **€ 71 billion** to over **2 million customers**, which represent about 8% of all SMEs in the European Union; in some countries (for example in Italy) this percentage is even higher (about 25%). This underlines the important contribution guarantee societies have made to fostering SME access to credit and their efficiency in acting as a facilitator to match demand and supply of SME loans.

The guarantee provides the following benefits for all parties involved:

- The SME obtains access to needed loan finance, often at a much reduced interest rate, less collateral requirements and for financing needs going from short term working capital loans to long term investment projects.
- The bank in turn gets a high quality collateral in form of a guarantee. The guarantee provides a high degree of risk sharing as well as lower own funds requirements, designed to encourage the bank to issue loans to SMEs. In many countries guarantee societies also provide a wide range of qualitative information about SME customers, which provides additional information

items to the balance sheet analysis performed by the banks and helps overcoming potential information asymmetries and further improving the risk assessment.

Specific comments:

- **Fundamental Remarks**

AECM understands the rationale behind the need of reviewing the supervisory framework against the background of the recent banking crisis. In the light of a comparably high dependence of European SMEs on loan finance, we however grave concerns with regard to the introduction of the new rules in Europe:

- In the light of the current uncertainty stemming from the sovereign debt crisis, which is effectively a second round effect of the 2008 crisis and the difficulties faced by a number of banks, we fear that the rules will exert additional pressure on SME access to loan finance;
- AECM questions whether other trading blocks will introduce provisions similar to the CRD in content and scope. Should e.g. the US chose not to do so, European Banks and SMEs would be a structural disadvantage. Any introduction of the CRD IV provisions should be conditional on such regulatory steps outside the EU.

Furthermore, AECM reminds the European Institutions of the fact that not all credit and financial institutions have had the responsibility of causing the recent banking crisis. In particular the European Guarantee banks and financial institutions have – by granting guarantees to SMEs – played a significant part in the attenuation of the crisis. We therefore continue to call for the application of the Principle of Proportionality for such credit and financial institutions in the finally adopted legal texts.

In fact, mutual guarantee societies present some distinctive elements which make them very different from regular banks: they are non profit organizations, usually restricted to issuing guarantees and almost only towards their member companies, their range of activities is limited and their risk is not comparable to that of banks. They do not exercise any deposit-taking activity. Nevertheless, even if they usually have a limited banking licence or are otherwise considered as a financial intermediary, national financial supervisory authorities have usually applied the full provisions of Basel II to them. In consideration of this, AECM suggests that the prudential requirements applied to guarantee societies should be "equivalent" to the ones applied to banks, however adapted according to the actual basis of activity, and proportionate to the risk incurred. This relates in particular to the liquidity requirements and the leverage ratio.

- **Eligible Credit Risk Mitigation Techniques and guarantees (Articles 197, 208, 209, 210, Draft Regulation)**

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 it is necessary to amend the list of eligible protection providers for unfunded credit protection in Art. 197 para 1 by "public or private mutual guarantee schemes and guarantee banks". According to Art. 210 para. 2 guarantees of mutual guarantee schemes or counter-guaranteed by entities referred to in Art. 209 para. 1 are obviously eligible as unfunded credit protection. Nevertheless theses guarantee structures are not expressively mentioned in Art. 197 para. 1. The amendment of Art. 197 para. 1 according to the above mentioned proposal will be of high importance because the legislation is binding directly in all member states and there is no possibility for the member states to expand the eligibility to other then in Art. 197 para. 1 listed protection providers. 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 banking directive 2006/48/EC and the proposals for a new legislation and directive. If mutual guarantee schemes respectively guarantee banks are not mentioned expressively in Art. 197 para. 1 there could be the danger that guarantees given by them to the benefit of thousands of SME in the European Union could not be approved as capital saving credit risk mitigation technique any more. In addition it would be also necessary to give mutual guarantee schemes respectively guarantee banks therefore at least the same risk weight as institutions (e.g. in Art. 107 (f) and Art. 116). 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 a clarification in Article 209, para. 1.a. in the sense that public counterguarantees covers all of the risks covered by the primary guarantee and not all the entire risk of the underlying loan. A similar amendment is necessary for Article 210, para. 2.b. In addition, it should also be clarified that guarantees, that are counterguaranteed by public authorities, should be recognized without any further restrictions.

Furthermore, there is a need to introduce a provision into the Regulation that would taken into consideration the mitigating effect of counterguarantees provided by mutual guarantee societies that are subject to Prudential supervision. To date, counterguarantees 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 counterguarantees issued by supervised private sector entities in the same manner as their first level guarantees and co-guarantees.

- **<u>Core Tier 1 capital (Articles 24 – 26, Draft Regulation)</u>**

As stated above, guarantee societies dispose of own funds, which are provided either by their shareholders (State, banks, industry associations, companies) or by the beneficiaries of the loans that they guarantee (companies).

These funds are either joint common stock shares, normally admitted in core Tier 1 capital, or cooperative and mutual shares, whose treatment under the current CRD status has been unclear hitherto and handled differently by supervisory authorities in the respective Member States.

The most common forms of shares issued by cooperative or mutual societies are on one hand the shares issued by cooperative or mutual societies underwritten by the beneficiary companies themselves and on the other hand certain forms of mutual guarantee funds paid in by the same companies or the shareholders.

Aside from this form of cooperative share capital, there is another type of funding, i.e. the mutual guarantee funds. These funds paid in by the shareholders or beneficiary companies work the same way as cooperative shares: they are paid in directly as the individual guarantee is issued and they cannot be reimbursed for the duration of the loan; moreover these funds cover the asset side of the guarantee society. They are in no way to be equated to normal deposits of banks, for which the depositant may ask for reimbursement at any time.

These shares represent the most important item to determine the volume of guarantees they may issue both shares and mutual funds (or grant). However, they are not explicitly listed as a possible component of Tier I capital.

Taking into consideration that they are directly linked to individual loan operations and that they are subject to strict reimbursement rules regarding the loan covered, other assets, liquidity situation, and that they involve the withdrawal of the beneficiary from the guarantee society, they should be treated as Tier 1 capital.

- **SME supporting factor – Retail portfolio risk weight**

As stated above, in principle, the traditional banks were not at the source of the financial crisis and should not be the main target of the proposals. Nevertheless, Basel risks being very heavy for all credit institutions and this is not entirely justified. On the other hand, the European economies are more dependent on loan finance than is the case e.g. in the US. Therefore, there would be a greater negative social and economic impact in the EU, all the more since the US might only apply Basel III to a few international banks.
Against this backdrop, and with a view of avoiding credit rationing for SMEs, AECM is in favour of introducing a multiplier (the "SMEs Supporting Factor") to be applied to the Risk Weighted Assets calculation for SME loans contained in the retail portfolio, in order to balance out the quantity increase in minimum capital requirements”
In essence, the SMEs Supporting Factor is….

- a mean to avoid unintentional negative effects on recovery ad growth in EU without changing the Basel 3 structure
- a solution that can be easily implemented by "rule makers" (condensed in a few line of legislative text)
- applicable to both Standardised and IRB banks, without operative/computational costs
- easily understandable and monitored by SME
- a way to resolve one of the main criticisms of Basel 3, i.e., a deficiency in the reorganization of the complex relationships among different risk weights, which fosters intermediaries to buy those stocks that, having a lower risk weight, allow a higher ROE.

In AECM’s view, a 50% multiplier would be appropriate. In addition, a second layer guarantee multiplier for the portion of the loan that is guaranteed by a Guarantee Institution would reflect the additional risk mitigation provided by a guarantor to the lending bank.

- **Leverage ratio (Articles 416 – 417, Draft Regulation)**

AECM has taken note of the introduction of a new regulatory requirement in form of a limited leverage ratio, the exact size of which will be maybe determined only after having conducted a Quantitative Impact Study.

Generally AECM is of the opinion that the leverage ratio considered in the working paper is even in the meaning of a supplementary measure contradictory to the risked based approach of the current capital regime and could therefore – in particular with regard to Guarantee institutions – result in a undesirable discrimination of their comparatively low risk portfolios counterguaranteed by states.

Furthermore, it is suggested that no netting resp. the use of credit risk mitigation techniques should be possible when establishing the exposure level used in the calculation of the ratio.

Guarantee societies are looking at this new rule from the following perspective:

- Many guarantee institutions do historically operate with a high leverage ratio,
- Guarantee exposures are mostly off-balance sheet

- Most guarantee institutions receive public counterguarantees, which counterguarantee either individual guarantee exposures (with a counter-guarantee rate ranging from 30 to 80%) or portfolios of guarantees. This public counterguarantees is contractually defined, fixed and mostly automatic.

AECM has the following concerns:

- We are of the conviction that a leverage ratio would not have prevented the crisis of 2008. On the other hand, a leverage ratio would lead to reducing low-risk loan business to the benefit to high-risk investment banking activities. We do not see the added value of it.
- In general, limiting the leverage excessively would force guarantee institutions to either reduce their guarantee activity (resulting in a reduction of access to finance for SMEs) or increase their capital base (rendering the guarantee instrument much less sustainable cost-wise).
- It would at least be necessary to differentiate between banks' speculative activities (i.e. securities trading, securitization underwriting) and activities which are meant to support the real economy (providing credit to manufacturing firms).
- We plead for a netting of guarantees and counterguarantees resp. the use of credit risk mitigation techniques, as these are individually and contractually linked, before the guarantee exposure is recognised for the calculation of the leverage ratio. We are aware that this goes against the fundamental thinking stated above, however, not netting the guarantees with the corresponding and directly linked counterguarantees resp. the use of credit risk mitigation techniques would grossly overstate the actual risk exposure of guarantee institutions, considering the relatively high counterguarantee rate. Barring such a provision, it is hard to see, how the business model of guarantee institutions could be maintained. As an alternative, the credit conversion factor of publicly counterguaranteed guarantees could at least been lowered.

- **Liquidity standards (Articles 400 – 402, Draft Regulation)**

There are different liquidity needs, depending on the specific type of financial products and services involved.

The situation of guarantee institutions for instance cannot be compared to retail financial institutions. For the former, liquidity needs concern the pay-out of liabilities arising from the guarantee activity to the extent that partner banks experience defaults in their loan portfolios. It also should be restated that most Guarantee schemes rely on state counter guarantees.

The liquidity requirements of retail banks in turn have a different dimension linked to the potential mass withdrawal of customer deposits (bank run). Guarantee institutions will never face a cash outflow comparable to that of a bank run, because they do not offer deposits. In some countries the member companies of guarantee institutions, which are at the same time both the beneficiaries of the guarantees and the very subjects that provide their own funds, cannot ask for the restitution of their funds until they have given the proper execution of the loan obligation. Therefore the liquidity requirements should be completely differentiated from the ones of banks for this type of specialized mono-line financial intermediary and the Principle of Proportionality should be observed. Problems resulting out of rescheduling or term transformation are not relevant for guarantee institutions. The liquidity requirements also need to be differentiated since the own funds of the guarantee societies may be liquidated immediately, as they are deposited on a bank account or mostly invested into public bonds. Furthermore attention has to paid to the fact that guarantee institutions just have – as mono-liners - limited space for changing their business structure and to impact therefore the Liquidity Counter Rate (CLR) and the Net Stable Funding Ratio (NSFR).

AECM would also like to state that although this kind of condition might allow for greater banking system stability, firms might ultimately suffer from more limited credit availability. While it is necessary to better define the banking institutions' own funds and liquidity requirements, it is at the same time crucial to continue to ensure that the banking system will provide adequate access to finance to companies that represent the productive tissue of our economy.

If we look at the experience from the year 2008, during which the financial crisis has reached a particularly critical level with tensions within the European banking system, we found phases of high rigidity in the interbanking market, expressed by eurribor rates of above 5% and a situation of illiquidity. This problem was only solved by the massive interventions by the ECB.

Consequently, the new regulation should not only ensure proper own funds and liquidity levels of credit institutions (while avoiding an undue restriction of access to finance for the productive economy), but also deal with the necessity to ensure le full efficiency of the interbank market.

- **Countercyclical measures (capital buffer)**

The proposed treatment of countercyclical measures is in conflict with the business model of guarantee institutions. Indeed, the recent financial and economic crisis, guarantee institutions have increased their guarantee operations to respond to the credit scarcity. This crucial activity would no longer be possible, if guarantee institutions were to be subjected to the same requirements as traditional credit institutions.

- **Governance, Management body (Article 87, Draft Directive)**

The restriction of the directorships as foreseen by Article 87 should only apply to directorships within institutions within the scope of the Directive proposal, directorships in companies falling outside of this scope of companies should not be taken into consideration.
In some countries, e.g., the executive directors of guarantee banks are often also executive directors of participation companies, which provide mezzanine finance to SMEs. The Guarantee banks and the participation companies do not form a group in a banking supervisory manner. This type of mandate cumulation should continue to be possible in the interest of synergies of knowledge within the promotional sector.

[i] Proposal for a Directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate –
Proposal for a Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms.