Object: AECM input regarding promotional equity and treatment of financial guarantees

We are grateful for the recent exchanges with Ms BERGER and Mr SCHIRK on the European transposition of the finalised Basel III and for giving us the opportunity to send you further input regarding promotional equity programmes as well as the treatment of financial guarantees.

Promotional equity

For the first point, we are of the opinion that the definition of national legislated programmes is too narrow and that 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 therefore suggest the following modification (with regard to point 52 of the Basel agreement) of the provision (in bold):

National supervisors may allow ***financial and credit institutions*** *to assign a risk weight of 100% to equity holdings made pursuant to programmes that* ***benefit from a partial risk coverage offered by a national, regional or municipal government or by an EU programme and where the respective governmental support ensures the promotional character of the equity programme.***

Treatment of financial guarantees

Regarding the treatment of financial guarantees and their capacity to provide capital relief, we would like to bring your attention to the following practices that would need to be tolerated by the renewed regulation in order to allow financial guarantees to continue to play a supportive role for SMEs' access to finance:

Provisional payments

The CRR applicable today contains a special treatment of counter-guarantees of states and other public institutions such as the European Investment Fund (EIF) (Art. 214 and 215 (2) CRR). If the conditions set out in Art. 214 para. 1 CRR are met, it is allowed to apply the risk weight of the guaranteeing public entity to the risk position guaranteed by the counter-guarantee. Usually, this is 0% instead of 100% risk weighting for the counter-guaranteed portion of the risk position from the guarantee vis-à-vis the guarantor. This also applies to the financing bank.

This concept is also fundamentally laid out in No. 205 of the Basel IV paper of the BIS, whereby the operational requirements for guarantees must also be fulfilled. This includes the requirement for prompt payment under No. 194 (a).

In contrast to the current Art. 215 (2) CRR, the Basel IV concept does not allow the instrument of a "provisional payment" on the robustly estimated loss for state guarantees and counter-guarantees, not even for these guarantees within the framework of guarantee programmes.

The framework conditions for state counter-guarantees in some EU member states do not allow for prompt payment in the event of default prior to examination of the conditions for recognition of a default fixed in the counter-guarantee certificates for reasons of budgetary law. To ensure the efficiency of the state-supported guarantees, the obligation to make a prompt "provisional payment" of the robustly estimated loss was introduced, which is aligned with Article 215 (2) (a) CRR. This provision enables credit risk mitigation for the publicly guaranteed risk position.

The guarantee institution and the financing bank receive a prompt payment in the amount of the expected loss. This largely balances their liquidity and disadvantages from the default. The previous special provision in Art. 215 (2) CRR is granted specifically only to state-backed guarantees and guarantee programmes, thus creating access to credit risk mitigation. Without this provision, the risk weights of the state counter-guarantees and guarantees of the guarantee institutions would be assigned excessive risk weights massively exaggerating the risk situation. As a consequence, the promotional instrument is burdened in its implementation without necessity.

The regulations on minimum cover for non-performing risk positions (according to Art. 47 a to c CRR in conjunction with Art. 36 lit. m CRR) have also created exceptions for the state counter-guarantees in Art. 47c para. 4 CRR, which also ensure the high efficiency of the funding instrument and prevent unnecessary deductions from the Common Equity Tier 1 capital.

In order to ensure the efficiency of the use of funds and high recognition of public guarantee schemes, we advocate that recognition of a "provisional payment" under Art 215 (2) CRR needs to be maintained. This is of particular importance in the light of the current Covid-19 situation and future crises, which require an efficient guarantee instrument.

Adjustment of guarantee conditions and irrevocability of the guarantee

Referring to point 192 c of the Basel agreement, we would like to draw your attention to the fact that some guarantee institutions might adapt the guarantee conditions to changes in the rating of the final beneficiary. Such adjustments are clearly foreseen from the beginning in the guarantee agreements and are necessary in order to effectively manage the risk. In case such conditions will make guarantees ineligible for capital relief provision in the future, this might sensitively affect the cost of a guarantee since guarantee institutions will need to price in potential future rating deteriorations. The promotional character of the guarantee is then at risk.

A second issue with the above-mentioned reference is that according to footnote 82 it is not possible for the protection provider to change the maturity agreed ex-post. The current covid-19 crisis impressively demonstrated that such changes in maturity are necessary. The prolongation of the maturity and the granting of instalment-free periods were among the most effective tools of guarantee institutions in their support for small and medium-sized enterprises struggling due to lock-down and social distancing measures[1].

Thirdly, we would like to point out that the non-payment by the protection purchaser of the money due in respect of the credit protection contract is not the only justified reason to revoke a guarantee. A unilateral cancellation of the guarantee can furthermore happen in case of a significant breach of the contract by the protection purchaser. This is a standard clause that aims to protect the guarantee provider against fraudulent behaviour of the purchaser.

We urgently recommend to take these above-mentioned deviations from the irrevocability into account when transposing the Basel agreement into EU law and to adapt point 192 c accordingly. We suggest the following modifications :

(c) other than non-payment by a protection purchaser of money due in respect of the credit protection contract ***as well as a significant breach of the contract by the protection purchaser*** *it is irrevocable; there is no clause in the contract that would allow the protection provider unilaterally to cancel the credit cover or that would* ***unduly*** *increase the effective cost of cover as a result of deteriorating credit quality in the hedged exposure;*[82]

[82] There must be no possibility for the protection provider to ***unilaterally*** *change the maturity agreed ex post.*

These adaptions are necessary in order to maintain the important role of guarantee institutions in risk mitigation and business promotion. The eligibility for capital relief is a major reason for the financing banks to request coverage offered by a guarantee institution. If this eligibility is modified and restricted, this would push financing banks on the one hand to finance certain projects without coverage, taking more risks on their books which has a restrictive effect on lending and on the other hand

[1] An overview of covid support measures offered by AECM members can be found here: https://www.flipsnack.com/AECMeurope/aecm-covid-brochure/full-view.html

they would reject other credit requests, especially from more vulnerable - smaller and younger - enterprises. The overall effect on SME lending would be heavily restrictive.

We kindly ask you to take our considerations into account and are anytime at your disposal to discuss the above-presented topics.

Yours sincerely,

Felix HAAS VINÇON

Brussels, May 2021

About us

The 48 members of the **European Association of Guarantee Institutions (AECM)** are operating in 31 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 mid-2020, **AECM**'s members had about bEUR 259 of guarantee volume in portfolio, thereby granting guarantees to around 4.5 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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