Annex to EACB – UEAPME open letter

**SMEs and co-operative banks are essential part of the "real economy" of the EU**

Co-operative banks and Small and Medium Sized Enterprises (SMEs) are deeply rooted in the European economic landscape. 99.8% of enterprises active in the EU are SMEs, of which about 92% are micro enterprises, employing fewer than 10 persons[1]. SMEs provide 67%[2] of the employment in the non-financial business economy. Thus SMEs have a crucial impact on welfare, economic growth, and innovation. As recalled by Mr. Benoît Cœuré, Member of ECB Executive Board, they truly are "special" and constitute "the backbone of the euro area economy[3]". Nonetheless, access to finance is for SMEs still a pressing problem for these companies[4].

Co-operative banks through their specific (unique) business model, based on the proximity to the local communities, with a presence even in the most remote areas, and a stable relationship with their members and clients, provide continued financing to the real economy and especially to SMEs. For instance, in Italy, France, Germany and the Netherlands, co-operative banks' market share in loans ranges between 25% and 45%. In those same markets SMEs represent between 20% and 50% of the total client portfolio of co-operative banks. In this context the co-operative banks weathered well the financial crisis and provided a liquidity anchor to the whole market.

The proximity of local co-operative banks is a key factor for the supply of credit to SMEs, especially for their availability of soft information that represents a core driver for small-business lending. A research from the Bank of Finland[5] showed that business lending to SME firms increases and reaches higher levels in countries with large number of local co-operative banks. This should be reminded when assessing the impact of new regulation and the trends towards the consolidation of the banking sector.

In the current context of bank deleveraging, also prompted by the new regulatory environment characterised by stricter capital and liquidity

[1] EIM – 2011
[2] European Commission – 2013
[3] B. Cœuré - SME financing, market innovation and regulation – April 2013
[4] European Commission – 2013
[5] Hasan Jackowicz, Kowalewski, Kozlowski – 2014

requirements, it is of the utmost importance that regulation does not discourage SMEs financing.

**Tailoring regulation in a way that takes into account the needs for financing of the European economy must remain a steady objective. Given the strong preference of SMEs for bank financing[6], it is extremely important that the credit channel is not impaired by burdensome regulation.**

In this respect, the reduction of administrative burden and the access to finance for SMEs are also in the focus of the ongoing Commission consultation on "*A strong European policy to support SMEs and entrepreneurs 2015-2020*". These critical aspects are crucial not only for SMEs but also for small entities in the financial sector. Addressing their role from the perspective of this consultation would represent a positive contribution in the recognition of the economic environment where they operate and the business conditions that characterise them.

### 1.1 Constant implementation of proportionality in regulation to avoid unintended impacts on co-operative banks and their lending to the local economy.

**We ask for a strict application of the proportionality and fit to purpose principle in any future piece of legislation in line with the Treaty of the European Union and the Statute of the European Co-operative Society. Such proportional, tailored legislation would have to properly reflect the legal form, needs and group structures of co-operatives and mutual.**

The banking industry is characterised by both a variety of business models and extreme differences in terms of scale of operations and size of activities among banks. While the largest banking group in Europe has total assets for nearly 2 trillions Euros, the smallest local co-operative banks may well be under 20 millions. It is a factor of roughly 100.000. Moreover, there is a large variety of business models and legal forms. Especially co-operative banks dispose of features that differ from many other institutions, especially regarding capital, group structure and governance. This variety is recognised by the Commission as something positive that needs to be maintained.

However, maintaining this diversity means that one-size-fits-all approaches cannot be applied and that the proportionality principle must always be in the focus.

We appreciate the attention of the regulator for the co-operative banking business model in the CRR and in EBA standards, especially regarding the full recognition of co-operative shares as CET1 instruments, of co-operative liquidity systems in the LCR or in some other areas. However, co-operative banks steadily have to fight for the acceptance of their structures and that they are not overrun by the mainstream thinking of regulation. The co-operative legal form is reflected in the Treaty of the European Union and its principles are defined in the

[6] 50% of SMEs took a loan in 2013 and 85% of these were provided by banks

Regulation on Statures of the European Co-operative Society. The consideration of the particularities of co-operative and mutual banks is therefore rooted in the principles of the European Union and should result in a legislation proportionate to co-operative banking groups. Therefore, the justification of any future proposal in banking regulation should explicitly state that it is proportionate also to the different legal forms of banks.

The impact of the financial crisis has forced the EU legislator to adopt a wide range of measures in a short time span. We note that this has lead to a mechanism according to which any recommendation of the Basel Committee will be implemented in the EU within short time and without broader reflections. In particular, the fact that there are enormous differences in size and that the Basel Rules were designed for systemic international banks is not sufficiently considered. Instead it seems that the big international bank has become the "guiding principle" in banking regulation. In addition, there seems to be a general trend in other areas of legislation to develop rule based approaches which goes into extensive amount of detail. Examples are Mifid I and II, CCD, MCD PADn SRM, SSM. The volume of this legislation, combined with a high level of detail, confront smaller banks with a legislative burden that can hardly be managed. Some banks will even be regulated out of the market and be forced into mergers.

This, however, is not in line with the EU policies: In its 2008 "Small Business Act" the Commission declared: *"The EU and Member States should design rules according to the "Think Small First" principle by taking into account SMEs' characteristics when designing legislation, and simplify the existing regulatory environment."* We strongly advocate for the respect of this principle which should also become a reality for small local banks.

Applying proportionality in regulation does not mean carve outs and exemptions. A positive approach to proportionality means designing options for rules for simpler and smaller institutions that are easy to implement and that do not require disproportionate amounts of resources. It is a fact that *compliance costs hit, in proportion, smaller institutions to a larger extent than larger and more sophisticated banks*. An example is the use of standardised approaches for credit risk and operational risk as opposed to the internal models or advanced approaches. The use of models that are easy to understand and implement for small institutions should be further developed.

Also, due to the decentralized structure, regulations cannot be applied uniformly like it is done by non-co-operative banks. This holds true for example for the proposed provisions regarding the corporate governance for products as proposed by ESMA and EBA (ESMA - Mifid II, EBA - Guidelines product oversight and governance arrangements). The ownership structure also needs to be kept in mind with regards to regulations dealing with the liquidity management and the regulations as mentioned above (Mifid I and II, CCD, MCD, PAD, SSM and SRM).

### 1.2 <u>Incentivises credit provision to SMEs through a differentiated leverage ratio.</u>

**We believe that it is essential that the leverage ratio is implemented in a way that properly reflects European specificities. Europe's economy relies more heavily than other economies on banking intermediation for financing. A rigid and unresponsive ratio may seriously harm economic prospects in the Union**.

The definition of a Pillar 1 measure for the leverage ratio will constitute a crucial factor impacting the asset-side structure of banks, and consequently the credit provision.

According to the CRR, the review process that will lead to the specification of a minimum leverage ratio will start in mid-2016.

Among other issues for review, the EBA shall evaluate the introduction of differentiated leverage ratio for different business models (Art. 511(3)(b),(i) CRR). Also Recital 95 and 115 CRR explicitly confirm the need to take into account the peculiarities of different business models and their risk profile.

The CRR is strongly favouring a differentiated leverage ratio based on the peculiarities of business models, risk profiles, and portfolio focus of different institutions.

A "one-size ratio" would be inappropriate for credit institutions whose main focus is constituted by traditional lending activities, and face limited risks because of their legal structure, their affiliation to an institutional protection scheme or their specialised business model. A uniform leverage ratio distorts level playing field across credit institutions and would jeopardise the existence of some long-standing business models without any obvious benefits in terms of stability or resilience, while on the other hand impairing the credit transmission channel and economy financing.

### 1.3 <u>Capital rules that do not constraint lending to SMEs.</u>

*We believe that it is essential that the adjusted* credit risk weights for exposures to SMEs is maintained and that the treatment of interest rate risk is sensitive to institutions specificities in order not to constrain SMEs lending.

Art. 501 CRR foresees a dedicated factor of 0,7619 for calculation of capital requirements for credit risk from exposures to SMEs. Maintaining a differentiated risk weight is of extreme importance to sustain credit provision to SMEs. We believe that future revision of this factor, with the work of both the EBA and the Commission to be undertaken in 2017, should carefully take into account the needs of SMEs lending.

In this context it is also of paramount importance to highlight that ***the future revision of the IRB approach, and any fine tuning of the standardised approach, to be carried out by the Basel Committee should be sensitive***

***to the reality of SMEs lending and encourage the financial sector to sustain their growth***.

### 1.4 SMEs and securitisation promotion: developing new sources of financing.

We believe that securitisations of SME loans can constitute a powerful tool to allow risk diversification and broader resource allocation for banks. An adjusted and calibrated capital treatment of securitisation instruments should be the guiding principle.

As recently pointed out by Yves Mersch, Member of the Executive Board of the ECB, for SMEs accessing non-bank finance is often a non-viable option[7]. Connecting SME financing needs with the funds of banks and other investors via securitisations of SME loans can constitute a powerful tool to allow risk diversification and broader resource allocation for banks.

European ABS have a high degree of transparency and quality. A key role in this sense is also played by the Eurosystem collateral eligibility criteria that influences the ABS structures and impose strict conditions. Moreover, while European ABS already have low default rates (0.6-1.5% on average), European SME ABS show an even lower risk profile with a default rate of about 0.1%. Therefore, ***reflecting the positive default performance of SME ABSs at the European level should be a guiding point for future calibration and enhancement of the securitisation framework***. Applying one-size-fits-all strict risk weights may certainly hamper growth in EU SME securitisation markets.

As suggested by Mr. Mersch, a way to do so could be ***distinguishing securitisation instruments into several categories, assigning preferential treatment only to instruments meeting the strictest requirements***. The central bank ABS eligibility criteria could be a useful starting point for identifying 'qualified' ABSs.

With regard to their treatment, preferential risk weights, similarly to what envisaged for covered bonds in the CRR, could be a viable solution. The discussion on high quality securitisation may also positively impact the coverage of liquidity requirements, with the possibility to extend in the future the extent to which ABS can be used in the LCR buffer.

SME ABSs can definitely have a key role bridging the gap between deleveraging banks and the need for a continued support of SMEs credit.

It should also be reminded that for many SMEs the access to finance through capital markets could still result overly complex, expensive and bound to a wide range of rules (e.g. minimum volumes, reporting and disclosure obligations), and that a promotion of capital market financing should not arbitrarily weaken the role of banks.

[7] Y. Mersch – Banks, SMEs and securitisations – April 2014

In a recent intervention, ECB Governor Mario Draghi pointed out that "the ECB welcomes efforts to have a differentiated regulatory treatment of simple, transparent ABS built on real assets" and that "the provision of public guarantees should be considered to support lending to SMEs, as other countries do, such as the US." While we support in principle the effort for a more transparent and developed securitisation market, we still have some doubts on the opportunity to provide public guarantees for ABS. This may create uneven playing field and interfere with competition on the market for financing. We support instead a more efficient and simplified framework that allows also smaller credit institutions to perform securitisations.

### 1.5 Avoiding disproportionate administrative burden and compliance costs.

The Basel Committee is currently looking into the possibility of establishing a revised framework for the treatment of interest rate risk in the banking book. The revised framework might include the specification of a Pillar 1 measure (capital requirement) for IRRBB. A single approach might well be overly detrimental for the sound management of credit activities and further constrain credit availability. A standardised Pillar 1 requirement would lack the sufficient and necessary sensitivity and flexibility to reflect institutions' differing business models, balance sheet structures, products, and customers behaviours. This would lead to significant deviations from the measurement of actual risk exposures and impair the fundamental task of maturity transformation provided by credit institutions. We believe that this risk should be monitored under an enhanced supervisory and disclosure approach.

The Basel Committee is also working on the review of the standardised approach (SA) for credit risk. We understood that the overall framework should result more sensitive and reliable. We believe that it is of the utmost importance that any change in the SA does not imply higher compliance costs and maintain the approach simple and easily implementable by less complex institutions. This would allow efficient risk management and credit assessment and ultimately fund channelling.

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