BUSINESSEUROPE

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Banks' capital requirements and SMEs

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BUSINESSEUROPE supports regulatory initiatives that serve the fundamental objective of ensuring financial market stability. But reforms must strike the right balance and be mindful of their effects on access to finance.

At a time when the precise details of the proposals for a directive and a regulation on capital requirements for banks (CRD IV file) are being discussed, in the context of implementation of Basel III, it is important to evaluate whether Basel II has been implemented satisfactorily, notably from the angle of ensuring long-term cost-efficient SME access to bank loans in the future. As is known, European SMEs are highly dependent on bank loans, and any measure which unnecessarily impedes the capacity or willingness to grant loans to SMEs is therefore completely undesirable.

At the 8 March meeting of the SME Finance Forum, Professor Dietsch, of the Strasbourg University, shed some light on this issue. He presented the results of a study the purpose of which was to assess if the level of capital requirements specified by Basel II were set at a correct level for covering the risk of unexpected losses in the case of SMEs loans.

The study, based on data relating to 900,000 French SMEs for the period 2003-2011, shows that the <u>regulatory</u> capital requirements defined by Basel II were significantly and consistently higher than the <u>economic</u> capital requirements over the whole period.

In other words, the regulatory capital requirements have been set at a much higher level than required by economic reality.

For French SMEs with a turnover of between 10 and 250 million Euros, the Basel II overcharge factor is:

- More than 3 for the health sector and the wholesale sector;
- More than 4 for the real estate sector and the construction industry;
- More than 5 for the services to business, and the retail sector;
- More than 8 for the transport sector;
- More than 30 for the manufacturing sector.

So, the study shows that in France the implicit risk weights attached to SME loans under Basel II have been excessive.

Professor Dietsch explained the reasons why there is this gap between regulatory charges and economic charges. This is largely due to the very simplified way in which the capital requirements on SMEs are calculated under Basel II.

The most currently used approach to determine, under Basel II, the potential loss distribution function and to measure unexpected losses consists in using the so-called Asymptotic Single Risk Factor (ASFR) model. Under this model, capital requirements depend on three parameters:

a) two parameters refer to a firm's individual risk: the probability of default (PD), and the loss given default (LGD)
b) the last parameter measures the sensitivity of credit risk to extreme events: this is the "asset correlation" (R).

PD data are volatile and this volatility depends on their sensitivity to systematic risk factors. Asset correlation measures this sensitivity of default rates to systematic risk factors, which are macroeconomic, industry and geographic risk factors.

The ASRF model was used by the Basel Committee to calibrate the regulatory Risk Weighted Assets (RWA) formula in the Basel II Accord. However, in the RWA regulatory formula, SMEs credit risk is measured only by using ratings, that is PDs. The formula for assessing the asset correlation is provided by the regulator; it represents a political element and is not based on scrutiny of real economic data. The regulator has defined asset correlation formulas such that required equity capital covers extreme losses. Banks are not allowed to use their internal models and own portfolio's databases to compute the asset correlation. With this top-down approach to setting mathematical formulas, it is not possible to capture the reduction in the credit risk made possible by a good diversification of loan portfolios. The top-down approach results in over-estimating the risk weights. The study shows that the gap between regulatory capital and economic capital comes mainly from the value of the asset correlation parameters.

To calculate asset correlation parameters accurately, it is necessary to carry out a multifactor analysis which considers macroeconomic, industry and geographic risk factors. Yet, the provisions of Basel II are not rooted in such a multifactor analysis.

The increased demands of the Basel III rules compared with Basel II will result in CRD IV containing implicit risk weights for SME loans which are even further removed from economic reality, with all the consequences this implies in terms of more difficult access to bank credit by SMEs. Driven by Basel III, the draft Commission capital requirements proposals have increased the implicit risk weights for SMEs by a factor of about 1.3125 compared to Basel II. With a view to remedying this inappropriate increase, a practical approach consists in correcting these risk weights by multiplying them by 0.7619 so as to cancel out the increase and restore the risk weights to Basel II levels (even if these can be considered to be too high). This has been asked by BUSINESSEUROPE in its position paper of 4 November 2011 on CRD IV.

Incorporating this corrective factor of 0.7619 would enable banks to lend more to SMEs because they would have to hold less capital to cover unexpected losses linked to loans granted to SMEs. Incorporating a corrective factor of 0.7619 is recommended in the amendments lodged by several MEPs regarding the proposal for a Regulation on prudential requirements for credit institutions and investment firms. (Notably, amendment 743 lodged by Mrs Vicky Ford concerning article 149, paragraph 1 of the proposal for a regulation, and amendment 745 lodged by the rapporteur, Mr Karas.)

These amendments go in the right direction. We will assess them in detail and make any contribution deemed useful. We hope that the concept of a corrective factor will be supported by the Parliament.

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