STELLUNGNAHME

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Deutscher Industrie- und Handelskammertag

DIHK comments on the EBA Discussion Paper and Call for Evidence on SMEs and the SME Supporting Factor

The Association of German Chambers of Commerce and Industry (Deutscher Industrie- und Handelskammertag e.V. - DIHK) is the umbrella organization of the 80 German Chambers of Commerce and Industry and represents the collective interest of commercial and industrial businesses in Germany. Our legitimation rests on more than 3.6 million member companies from all sectors, regions and size classes that belong to the Chambers of Commerce and Industry.

Q2: In your experience, is the reduction in capital requirements due to the application of the SME Supporting Factor (capital relief) being used to support lending to SMEs? <u>Yes</u>. Please explain and provide evidence.

There is good reason to believe that the SME Supporting Factor has, in fact, helped SME access to bank finance. However, in our view, it is impossible to unequivocally demonstrate this empirically.

Loan volumes and lending conditions are affected by numerous factors, many of which have seen important changes over the last years: Expansive monetary policy has eased availability of central bank money throughout the Eurozone. Increased banking regulation – from own funds requirements through liquidity rules to increased clearing requirements for derivatives – have substantially increased costs for banks. Write-offs on bad debt have seriously impaired bank lending capacities in some member states. It is not possible to empirically separate the effect of the SME Adjustment Factor from these other developments – as well as from changes in loan demand – with any reasonable degree of certainty, and hence impossible to gauge its impact purely from aggregate statistics.

However, a positive effect of the SME Supporting Factor on lending to SMEs is both plausible and consistent with evidence concerning banks' internal decision-making. Since the SME Supporting Factor reduces own funds requirements, this reduces a bank's production costs for SME loans. In a competitive environment such as the German market for corporate financing, as a consequence, SME loans will be offered at better terms and some loans will be possible under these terms that otherwise would not have been. The internal chain of decision-making varies with the steering model employed by a bank, but generally takes own funds requirements into account when

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determining credit conditions. The biggest effect on SME lending volume probably occurs where banks use minimum margins to steer their loan policies, because reduced own funds costs will then allow more SME loans to pass the required margin threshold.

In some cases, credit institutions may currently have more own funds than needed and neither have the opportunity to disburse excess funds to owners nor to substantially expand their business activities. This can be the case, for example, for well-capitalized cooperative and savings banks in Germany that are bound to operate only in a pre-defined territory. In these cases, own funds may not currently figure prominently in loan decisions. However, the capital reserves of these institutes are not infinite. With any major hike in own funds requirements (such as through a cancellation of the SME supporting factor), own funds might become a binding constraint for these institutes as well, with negative consequences for SME access to finance.

Thus, in general, it is very probable that SME loans have in fact benefited from the SME Supporting Factor. However, the effect is less than it could otherwise have been due to two limitations in the current set-up of article 501. First, the review clause upon which the current review by EBA is premised casts doubt on the long-term stability of the SME Supporting Factor. Thus, banks handing out long-term loans to SMEs now do not have the necessary certainty that the factor will apply throughout the loans' lifecycle. Hence, for full effect, the SME Supporting Factor should not only be retained but should be clearly designated as a permanent feature of European own funds requirements.

Second, the cap at a maximum loan of 1.5 million euro in practice excludes many SMEs. As the Chambers of Commerce and Industry provide advice to SMEs on how to obtain funding, we can report from our own advisory that many SMEs need higher loan amounts. As an example, in Germany, many medium-sized companies are active in industrial manufacturing and in need of substantial machinery that cannot be financed with a total loan volume of 1.5 million euro. For maximum effect, we would therefore recommend to raise the threshold or to link the Supporting Factor only to the SME qualification of the loan recipient.

Q6: Do you agree with the proposed measures of SME riskiness?
No.

Q7: Are other aspects relevant in your assessment of the creditworthiness/riskiness of potential SME borrowers? Yes

The approach taken by EBA is one possibility among many to create a scoring system to gauge SME creditworthiness. Banks, as well as other providers of SME credit information, have their own systems in place to judge creditworthiness that may take a similar approach, but are usually substantially more sophisticated.

More fundamentally, however, in the context of the SME Supporting Factor, looking at the general riskiness of potential SME borrowers is not the relevant criterion. The crucial data to judge the appropriateness of own funds requirements is not general riskiness, but rather the amount of unexpected losses – i.e. the variability of performance in a given loan segment. Please refer to our answer to question 9 for more details.

Q8: In your experience, are SMEs as cyclical or more/less cyclical than large enterprises?

We do not have access to sufficient data that would allow a clear answer to this question. However, we would caution against a general belief that SMEs would be more cyclical. On the contrary, the higher prevalence of consumer, trade and service sector companies among SMEs compared to the entire economy, coupled with the smaller sensitivity of most service providers to the business cycle, would suggest that SME activity might actually be less cyclical than that of large enterprises.

Q9: Do you agree with the proposed methodology to assess the own funds requirements in relation to SME riskiness? No.
If no, please provide alternative methodologies or indicators, if available.

We support EBA's willingness to investigate variations in asset correlations among different size classes, as understanding these effects is crucial to understand the full effect of diversification effects in an SME loan portfolio.

However, in general, we are worried by a tendency in the paper to confound general riskiness (which is relevant for setting interest rate policies of banks) with variability of performance (which is crucial for calibrating own funds requirements). In the context of the SME Supporting Factor, looking at the general riskiness of potential SME borrowers is not the relevant criterion. Any difference, for example, in average probabilities of default between different groups of companies will be factored into the risk premium charged by banks. Hence, higher defaults would be compensated by correspondingly higher risk premia earned on other loans. Own funds requirements, on the other hand, are not meant to deal with expected losses but provide a buffer against unexpected losses arising beyond those forecast in aggregate. Hence, to judge the appropriateness of own funds requirements, the decisive factor is the relative variability/predictability of losses, not the average

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amount of expected losses. Even if probabilities of default or loss given default were higher for SMEs (but at least as predictable as for larger corporates), this would not be a reasonable cause to change the SME Supporting Factor.

Q11: Do you agree with the above interpretation of statistical data on lending trends and conditions? Yes

Q13: Have changes to your SME credit lending and assessment policies and procedures been driven by other factors (e.g. competition from alternative sources of SME financing as described in section 4.1)? Yes

In our experience, competition between banks (especially concerning medium-sized enterprises) has been a more important determinant of lending conditions in Germany than competition from alternative sources of finance. However, some alternative and emerging forms of finance (such as those forms of crowdfunding where investors either buy a future product in advance or acquire a subordinated debtor position) will actually enhance an SME's creditworthiness and may thus also facilitate access to traditional bank financing.

Q14: In your experience, is there an impact of the SME supporting factor on the volume of SME lending compared to other loans? Yes/No. Please explain and provide evidence.

We believe that there is good reason to assume a positive impact of the SME supporting factor in SME lending volumes, although the precise effect is almost impossible to determine empirically. The effect on loans volumes will likely be strongest for those banks that steer based on minimum margin thresholds a loan must meet to be viable. Please refer to our answer to question 2 for details.

Q15: In your experience, is there an impact of the SME supporting factor on the pricing and overall conditions of SME lending compared to other loans? Yes/No. Please explain and provide evidence.

We believe that there is good reason to believe that the SME Supporting Factor has a positive impact on SME loan conditions, although the precise effect is almost impossible to isolate empirically. Please refer to our answer to question 2 for details.

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Q16: Do you consider SMEs are a consistent group when it comes to access to credit or should a distinction be made between different types of SMEs (e.g. micro, small and medium ones)? Please explain and provide specific examples.

As our regular surveys concerning companies' access to finance show, there are substantial differences between different groups of enterprises within the SME category. In particular, medium-sized enterprises in Germany often have substantial long-term capital investments and are often also oriented towards international, rather than only national or regional, markets. Correspondingly, they face different needs, constraints and opportunities than small and micro enterprises regarding funding. Nevertheless, we do not believe that it would be beneficial to add further complexity to the capital requirements regulation by differentiating between different types for SMEs for own funds purposes. All SMEs face more difficult access to finance than larger enterprises, and all SME portfolios benefit from greater diversification effects compared to large corporate loan portfolios. Hence, the SME Supporting Factor is justified for all of them regardless of their economic diversity.

In case of questions, please contact Dr. Tim Gemkow (gemkow.tim@dihk.de).

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