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EBA Discussion paper and Call for Evidence on SMEs and the SME Supporting Factor

Italian Credito Cooperativo position paper

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EBA discussion paper and call of evidence on SMEs and SMEs supporting factor

Federcasse, the Italian Federation of Co-operative Credit Banks, represents the interests of about 370 Credit Co-operative Banks (BCCs). Although being the smallest banks in the Italian banking sector, they are relevant players in the SMEs and households lending market. BCCs almost solely finance SMEs (and households). Therefore, although a full evaluation of the impact of the Supporting Factor (hereinafter, SF) is extremely hard after such a short period of time, BCCs are surely in a good position to assess the overall effects of the SF under many aspects.

Therefore, Federcasse welcomes the opportunity to comment on the discussion paper issued by EBA, taking into full consideration the importance of the SF. Before providing any other detailed argumentation, we deem the SF should be kept in place since the fundamental rationale for SF does not seem to be phased out. Indeed, its cancellation after such a short period of time would not consent any full evaluation of it and could easily bring to detrimental consequences for a still very weak economy, like that of Europe.

Moreover, it has to be reminded that the EU jurisdiction's deviations from the Basel framework reflect the principal of 'local calibration within a clear set of global standards', *i.e.* the need to better reflect specificities of the local industries and markets. A specific local calibration for the EU jurisdiction is represented by the SF. It is of outstanding importance that this peculiar measure being recognized not only in the current CRR but also in the future one when the new Standardized Approach will be transposed into EU legislation.

General remarks

As pointed out in the EBA document, SMEs represent a large share of production and employment in Europe and they rely mainly on bank finance. Other sources of financing do exist but are suitable, at the moment, only for a small section of medium-sized firms or high-potential start-ups that can tap on venture capital. Therefore, any regulatory provision that is detrimental to the SMEs financing sources, especially bank loans, is likely to impact on the performance of this crucial sector of the European economy.

A thorough evaluation of the impact of the SF is extremely hard to carry out right now. Too many changes have taken place (and are still taking place) at the same time: changes in supervision methods, implementation of new regulation, uncertainty on levels of capital for banks (*e.g.* stemming from SREP outcomes), uncertainty associated to the impact of the BRRD on retail funding of banks markets (the evolution of funding through bonds issuance to retail clients).

Also, it must be recalled that the SF has been in force only for a very limited amount of time. Therefore, even though collecting data on its impact is not an easy task – and therefore the full impact of the SF could possibly not result in its completeness - we again strongly advocate for the SF to be kept within the regulation, because more time is needed to best evaluate its full impact, especially in times not hit by a recession or a deep crisis.

Moreover, in fact, across many EU Member States the recovery is still very weak and bank loans still prejudiced by uncertainty on the economy's outlook.

Therefore, within a productive tissue where SMEs represent such a strikingly relevant quota of added value, to eliminate the SF would translate into extensively striking down the chances of any economic recovery.

4.2 Regulatory treatment of SMEs and the SME Supporting Factor

Q1: Do you have systems in place to track the reduction in capital due to the application of the SME Supporting Factor (capital relief)? Yes/No. Please explain and provide evidence.

BCCs provide supervisory reporting data on the exposure to SMEs, including the RWA before and after the application of the SF. On this basis BCCs may calculate capital saving due to this provision. Since this is mainly ex post reporting, BCCs' IT and service providers have set up tools to enable them to evaluate ex ante the risk weight attached to different type of loans.

As a general trend, BCCs (although showing on average high level of capital ratios) are increasingly using the available credit management instruments to save capital; for example BCCs' access to the Central Guarantee Fund (that allows a zero weight on the guaranteed portion of the loan) have sharply increased in the last year (between December 2013 and December 2014 the number of loans increased by 38 per cent and the value by 46 per cent). BCCs' attention to the capital absorption generated by their loans (due also to the uncertainty on the levels of capital which will be assessed as adequate under the new supervision practices and under the cooperative model which does not consent quick capital increases) is, by analogy, an indicator of the relevancy of the SF for the credit assessments of BCCs.

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? Yes/No. Please explain and provide evidence.

Because of their size, their governance and their business model, BCCs lend almost exclusively to medium-small enterprises and households. Therefore any capital saving is likely to be addressed to these clients, provided that there is a suitable demand. The long economic recession in Italy has affected the credit market: credit risk has sharply increased over the past years, the demand for loans has been weak and mainly driven by restructuring, liquidity and working capital. Therefore, lending activity slowed down in 2013 and 2014. However, preliminary data seems to show that there has been a positive impact of the SF.

First of all we estimated (using supervisory reporting of 370 BCCs at December 2014) the impact of the SF on the RWA. The median value of RWA reduction is 4,7 per cent. This translate in an average increase of CET1 of 0,8 per cent. The overall capital saving is estimated in about 550 million euros (total CET1 of the 370 BCCs is approximately 19 billion euro).

We run a first exercise to evaluate whether there is a correlation between the capital saving and the CET1 ratio (to check if banks with capital ratio closer to the regulatory lower bound enjoyed a stronger benefit). The result shows a positive correlation between CET1 ratio and SF impact (correlation coefficient is over 60%). Therefore better capitalized BCCs show a larger impact of the SF.

In a second exercise we tried to gather some information on the dynamic of SMEs exposure in the period March 2014/March 2015. Using supervisory data we calculated the variation of Total Exposure, SMES exposure and SMEs exposure with SF factor in the 3 regulatory portfolios, Corporate, Retail and Real Estate.

Non weighted exposure in Corporate, Retail and Real Estate regulatory portfolio	
	% variation 03/2014-03/2015
SME	2,25%
of which SMEs with SF	3,31%
Other	-10,60%
Total	-3,74%
Federcasse calculation on supervisory reporting data- sample of 353 BCCs	

Although the total exposure decreased by 3,74 per cent, SMEs exposure increased by 2,25 per cent and SMEs with SF by 3,31 per cent. Therefore, it seems that there has been a re-composition of exposure in favor of SMEs.

As a general trend, BCCs market share in lending to SMEs have kept increasing during the recession even though they already had quite large shares before the crisis.

Stock of loans by sector – percentage variation 2008-2014 and BCCs market share			
	% variation December 2008- December 2014		BCCS market share
	Banking Industry	BCC	2014
Households	33,0%	27,2%	8,8%
Quasi enterprises < 20 empl	-10,4%	-2,4%	21,5%
Quasi enterprises > 20 empl	1,2%	13,0%	15,0%
Microenterprises	4,7%	14,5%	17,9%
Non financial enterprises	-6,7%	8,8%	7,3%

Federcasse calculation on Bank of Italy data

This represents a further indirect indicator that the relief produced by the SF, for banks such as BCCs, benefit SMEs.

Q3: Is your internal definition of SMEs in line with the definition of SME exposures subject to the SME Supporting Factor? Yes/No. If no, how are you reconciling the internal definition of SMEs with the definition of SMEs subject to Supporting Factor? Please explain and provide specific examples.

BCCs apply the definition of SMEs using Recommendation 2003/361/CE of 6 May 2003 as guidance. Due to the specific features of their corporate customers, almost exclusively medium-small enterprises, the turnover is the dominant criterion. Therefore, the BCCs internal definition of SMEs is in line with the definition of SME exposures subject to the SME Supporting Factor.

Q4: In monitoring the total amount owed to you, your parent and subsidiary undertakings, including exposures in default, by the borrower and its group of connected clients (as defined in CRR Article 4(1)(39)), what reasonable steps do you take to ensure that amount does not exceed EUR 1.5 million in accordance with Article 501(2)(c)?

BCCs have in place organizational processes and IT procedures aimed at identifying groups of connected clients. Using specific software they can therefore monitor the total amount of the exposure. The IT procedure automatically assigns the correct capital requirement if all the regulatory parameters (including the 1.5 million exposure) are respected.

Q5: Do you see merits in having a harmonised definition of SMEs for reporting purposes? Yes/No. Please explain and provide specific examples.

Yes. A harmonized definition facilitates the setup of common reporting procedures and IT instruments for the BCCs network. Moreover it allows the building of a reliable set of data for analysis and benchmarking purposes. It should not be too demanding in terms of information; for example, we believe that art. 501 par. 2(b) that identifies only one parameter (turnover) for the SME definition is a right balance between the need of harmonisation and complexity of data collection and update.

4.3 Riskiness of EU SMEs over a full economic cycle and consistency of own funds requirements with the SME riskiness

Q6: Do you agree with the proposed measures of SME riskiness? Yes/No. Are some of these measures more relevant than others? Yes/No.

The proposed measures are surely relevant but we'd like to add that in the BCCs' experience, the informative content of enterprise's balance sheet or financial data may decrease with the size. The smaller the size of the firm, the lesser informative the company's balance sheet. Indeed, it is a well know concept in the economic literature that SMEs are "opaque firms" because "*the key distinguishing characteristic of small-business lending is that it relies heavily on information that is "soft"— that is, information that cannot be directly verified by anyone other than the agent who produces it. (…) This situation contrasts sharply with, for example, an application for a home mortgage loan. Here the decision of whether or not to extend credit is likely to be made primarily based on "hard," verifiable information, such as the income shown on the borrower's last several tax returns*"[1]. Therefore, at least for small local banks, direct knowledge of the borrowers and of the economic environment where they operate is an important element of the risk assessment.

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[1] Stein J.C. Information production and capital allocation: decentralized versus hierarchical firms; The Journal of Finance 2002 n.5.

Q7: Are other aspects relevant in your assessment of the creditworthiness/riskiness of potential SME borrowers? Yes/No. If yes, please provide a list of those aspects and explain how you measure SME riskiness.

Usually BCCs (using scoring systems or other techniques) take into consideration all the information available on the enterprise, besides balance sheet data. For example one of the scoring models used by a large number of BCCs has 5 areas of measurement (Balance sheet-financial data, credit registry, relationship with the bank, qualitative evaluation and sector analysis) plus the possibility for the analyst to make a motivated notching. The correct use of quantitative and qualitative factors in the firm's risk assessment allows small local banks to maximize the impact of their expertise and knowledge of the local economy. As it can be seen comparing BCCs' credit quality with the average banking industry, small local banks show a better credit quality especially in the small and micro enterprise sector[2] (Federcasse calculation on Bank of Italy data)

Table 1 - Banking industry - NPL/Loans (including provisions) - December 2014

	Bad loans	Doubtful loans	Restructured	Past due	Total
Households	6,9%	3,0%	0,1%	0,7%	10,7%
Non financial enterprises	16,1%	10,9%	2,1%	0,8%	30,0%
Quasi enterpr. > 20empl	23,6%	8,5%	0,4%	0,7%	33,1%
Quasi enterpr. < 20empl	17,6%	8,7%	0,2%	1,1%	27,5%
Microenterprises	16,1%	6,9%	0,1%	1,2%	24,4%

Table2 - BCCs - NPL/Loans - December 2014

	Bad loans	Doubtful loans	Restructured	Past due	Total
Households	5,5%	4,0%	0,1%	0,7%	10,2%
Non financial enterprises	15,2%	10,9%	1,0%	0,9%	27,9%
Quasi enterpr. > 20empl	15,1%	9,0%	0,5%	0,3%	25,0%
Quasi enterpr. < 20empl	11,7%	8,8%	0,3%	0,9%	21,6%
Microenterprises	9,8%	6,6%	0,1%	1,4%	17,9%

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

BCCs lend almost exclusively to SMEs, therefore we do not have internal evidence on this issue. However, looking at the NPL ratios (table 1) and their recent evolution in the Italian banking industry (table 3), it appears that micro and small enterprises do not show, on average, a higher riskiness.

[2] The classification reported in the table is by juridical definition of incorporation and not by size but can be taken as a proxy of dimension.

Table 3 - Italian banking industry - Bad Loans – Ratio to total loans by economic sector		
	2008	2014
Households	2,5%	6,9%
Non financial enterprises	2,9%	16,1%
Quasi enterprises > 20 employees	6,5%	23,6%
Quasi enterprises < 20 employees	4,5%	17,6%
Microenterprises	6,2%	16,1%

Indeed, looking at the period 2008-2014 it seems that size may not be the element of discrimination between more or less risky enterprises (for example enterprises in different branches of activity show a large risk variation, with real estate and manufacturing showing much higher NPL ratio than agriculture or public services).

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

As for the methodology to assess the own funds requirements in relation to SME riskiness we think that at least the following considerations should be taken into account:

- we do not believe that the size of the company, as a purely quantitative criterion, should have an high weight as it is not necessarily reflective of risk. Moreover, the relationship between default rates and size of a corporate could be strongly country specific; as such it cannot be specified as a general rule. As an example we can quote the case of Italy where, according to an analysis performed by CRIF (the leading provider of banking credit information in Italy), businesses with revenues between €5 and €50 million show a default rate behavior similar to larger corporates;
- SME exposures, on a loan-by-loan basis, may have on average an higher default rates but at portfolio level they show lower asset value correlation which could mean lower unexpected loss level;
- generally, exposures to smaller corporates are highly collateralized relative to exposures to larger corporates (by guarantees and non-financial collateral types that do not qualify for being recognized as a credit risk mitigation technique). In such companies there is only a fiscal/virtual separation of the company and the patrimony of the owner. The owner's patrimony remains available as collateral for the bank, even though it may not appear on the balance sheet of the company. Thus in these partnerships and non-incorporated companies, differently from companies with legal personality, the liability of the entrepreneur is not limited to the own funds actually poured in the company. This may also explain why many of the smaller companies, many being non-incorporated, show lower capital ratios.

Q10: Did the arrears and loss experience in 2009/2010/2011 exceed an (internal) limit? Yes/No. Were (expected/unexpected) losses adequately covered by loan loss provisions? Yes/No. Please explain and provide specific figures.

Due to the prolonged recession, the Italian banking industry registered a large increase of NPL. Some sectors were hit harder than other (i.e. real estate more than agriculture). LL provisions are linked also to the level of guarantees. Coverage ratio on NPLs has increased recently: the crisis has in fact reduced recovery rates on bad loans. The level of LL provision has however resulted adequate to bear the losses in the vast majority of cases. The level of coverage is typically lower for BCCs if compared to other banks (53% on bad loans vis a vis 58%). This is due to the higher presence of guarantees and to a higher percentage of collection on bad loans.

For instance, BCCs have registered a percentage of collection on bad loans higher than the banking industry average between 2010 and 2014 (e.g. the collection average for BCCs between 2010 and 2014 was 7,6% vis a vis 5,2% of the banking industry). Also on sub-standards, BCCs register a rate of recovery which is on average higher than that of the banking industry.

Such data indicate that banks holding a credit portfolio composed mainly of SMEs and households manage to keep a credit quality which is not worse that the average of the banking industry.

We would like to point out that BCCs allocate to (indivisible) reserves more than 80% of net profit (minimum level by law is set at 70 per cent). This means that even if some BCCs may underestimate LLP, profits go to reserves and are available to absorb potential losses.

4.4 SME lending trends and conditions and impact of the SME Supporting Factor on lending trends and conditions

Q11: Do you agree with the above interpretation of statistical data on lending trends and conditions? Yes/No. If no, please explain.

We do agree that SMEs, during the long recession that hit Italy, faced more difficulties in accessing bank finance and that conditions were usually stricter than for larger enterprises. We would also like to point out that small banks supplied more credit to enterprises (see also Bank of Italy - Occasional Papers n. 264), at least until the end of the sovereign debt crisis (BCCs until today). Actually, we believe that, in order to get a more meaningful picture of the dynamics of the banking market, it is important to analyze not only general trends but also the behavior of different type of banks; indeed the European banking industry is composed by institutions that pursue different objectives (for example, shareholder value and stakeholder value oriented), with different business models (retail, investment, services), governance (cooperative, joint-stock) and organization (formal/informal network, standalone banks, banking groups). The market trend may hide strong behavioral differences that may be useful to take into consideration to understand the rationale behind different behavior and to propose effective policies.

Q12: Since 1 January 2014, have you changed your SME credit lending and assessment policies and procedures, specifically as a result of the introduction of the Supporting Factor? Yes/No. If yes, please explain and provide specific examples.

As already mentioned, BCCs lend almost exclusively to SMEs and households, therefore the SF is an incentive to maintain the usual policy to lend to SMEs especially in an economic environment characterized by regulatory and market uncertainty. Nevertheless, it is worth noticing that according to a study carried out by Bank of Italy in 2013[3], after the entry into force of Basel II rules BCCs basically changed their credit lending and assessment policies pointing to that rules in the area of minimum capital requirements do have a role in this regard.

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/No. Please explain and provide specific examples.

Other factors that positively affected BCCs lending incentive were the growth of retail funding (+2.4 per cent in 2014 and 3.8 per cent in 2013) and the availability of ECB funds (TLTRO and LTRO).

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.

See answer to Q2.

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)? Yes/No. Please explain and provide specific examples.**

As already mentioned, the so called "hard information" (especially balance sheet data) may be less reliable to assess the risk of micro and small enterprises compared to medium-sized enterprises. This means that direct knowledge of the borrowers and of the economic environment where they operate (*i.e.* the typical role of small local banks) can be an important factor in appraising the risk of small enterprises, facilitating access to credit to the smallest one.

Within the present market context and on the basis of the evidence on the riskiness of SMEs (which are not to be considered as conclusive, as pointed out clearly in the EBA document), we do not deem opportune to differentiate further the application of the SF according to the size; the current application method (where the definition of SME and the 1,5 ML limit to exposition

[3] Cannata F. et al. (2013), *Il credito cooperativo alla sfida di Basilea 3: tendenze, impatti, prospettive*, Banca D'Italia, Questioni di Economia e Finanza (Occasional Papers), No 158.

interact) guarantees already the trend compliance with the principles of granularity and does not jeopardize the growth of the smaller enterprises.