EUROCHAMBRES
ASSOCIATION OF EUROPEAN CHAMBERS OF COMMERCE AND INDUSTRY

31/05/01

European Business Position on

New Capital Adequacy Framework for Banks and Investment Firms

The new capital adequacy framework for banks and investment firms proposed by the Committee on Banking Supervision of the Bank of International Settlements (known as the Basel Committee) and the European Commission will have major impact on SME finances once put into action in all member states of the EU in 2004.

To remember:

- SMEs play a very important socio-economic role in Europe.
- More than 99% of all enterprises in the European Union are SMEs.
- SMEs are dependent on a sound financial basis, which is provided to a high extent by credit institutions in the form of loans.
- Access to credit institutions' loans for SMEs must not be impeded by new capital requirements for financial institutions

The European Chamber network welcomes that its **request to accept internal ratings** as an efficient alternative to external ratings in its European position on Basel I from March 2000 **was heard** and that both the Basel Committee and the European Commission could be convinced that the recognition of internal ratings will avoid potential competitive disadvantages of SMEs concerning access to finance.

This fact also fulfills another request of Eurochambres presented in its Basel I position paper to **consider both quantitative and qualitative aspects** (e.g. the personality of the entrepreneur, the business strategy of the company etc.), which helps to create an environment for more precise ratings covering individual criteria and which helps businesses to obtain a "fair and true rating", as good ratings can lead to better credit conditions and lower interest rates.
Ratings can also prevent liquidity problems of businesses whose credit lines were not prolonged or even decreased.

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Nevertheless, *many questions remain unclear* and Eurochambres proposes to co-operate with the European Commission to find solutions to the following issues of utmost importance to SME finance:

- **Retail loans**

Eurochambres favours the idea of lower risk weights to small business loans compared to corporate loans in order to facilitate access to finance for SMEs.

But unfortunately, there is **no precise definition for retail loans**. As the Basel Committee points out that it had not enough information on retail loans and wishes the proposed riskweights to be “seen more as illustrative or indicative” (see supporting document to the Basel II Internal Rating Based Approach, p. 287), it proposes that national banking supervisory organisations should choose a maximum loan amount for an exposure to be treated as retail loan (see Basel II Consultative Document, p. 156). Eurochambres can not accept this proposal which would cause **potential competitive distortion in the member states**, as different definitions of retail loans could be set up in the member states, which means that there could be different interest rates and rating costs for the same amount of SME credits in different EU countries.

- **Recognition of risk-reducing factors**

Eurochambres requests the recognition of collateral and other securities (e.g. mortgages, endorsements, transfer of assets of life insurances etc.)

- **Calibration**

Eurochambres criticises that the **calibration parameter** of the new capital adequacy framework **does not at all consider the situation** businesses find in access to finance **in the European Union**, but reflects parameter of the US credit culture. E.g., long term credits are considered above average risk by the Basel proposal, but are a substantial SME finance form in the EU. Furthermore risk capital systems are actually not well enough developed in the EU, which could lead to even higher demand and dependency of bank finance, especially of long term finance for companies.
Concerning the probability of default (PD), the Basel Committee did not consider SME finance at all, as the assumed probability of default (PD) of 0,7 % is only an average PD for large corporate loans. Eurochambres therefore calls on the European Commission to **meet the demands of the European SME culture** which is indeed different to the US credit culture.

New capital requirements for financial institutions must not impede access to finance for SMEs. Especially start-ups without any “company history” and SME with a natural higher probability of default asking for credits may not face additional burden in access to finance because of higher interest rates, which would dramatically jeopardise entrepreneurial spirit and thus job creation in the European Union.
The proposals of the Basel Committee and the European Commission also foresee higher capital adequacy ratios for financial institutions due to operational risks and expected losses. Eurochambres points out that these risks are already covered by the credits’ interest rates. **Financial institutions and businesses may not pay twice for the same risks**.

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- **Complexity of internal ratings**

Both financial institutions and businesses asking for credit finance may not be overburdened by the new capital adequacy framework proposed. We need more – not less – flexibility for banks in the risk assessment of SMEs, microbusinesses and start-ups, which create most of the new jobs and represent more than 99% of the companies in the EU.

In general, the European Chamber network welcomes to improve risk assessment for the stability of the financial system and for market economy credit costs. Unfortunately, the proposed new capital adequacy framework is too complex and unclear and not according to the **European Council in Stockholm, March 2001** requests that "Businesses and citizens need a regulatory environment which is clear, simple, effective and workable in a rapidly changing global marketplace". Also, the **Feira European Council, June 2000** stated in the European Charter for Small Businesses: "New regulations at national and community level should be screened to assess their impact on small enterprises and entrepreneurs. Wherever possible, national and EC rules should be simplified. Governments should adopt user-friendly documents." Moreover, the recent Stockholm European Council (March 2001) stated that amongst other policy instruments the Small Business Charter is an „important instrument helping to create a more favourable environment for business in Europe."

But the **economic impacts** of the new capital adequacy framework remain **highly unclear** as the current impact study only considers quantitative impacts on bank's capital and does not cover an impact assessment on corporate loans, especially SME finance. This demonstrates that the **consultation period is too short**, as no impact study is available before the end of the consultation period (end of May 2001). Moreover neither the Basel Committee can assess the impact of its proposal (see their Overview, 52), nor the European Commission as admitted during the conference on "Effects of the new capital adequacy framework on SMEs", 26 March 2001, Brussels.

Therefore, the European Chamber network proposes to carry out a survey on these open questions needing more clarification and requests to be involved in the preparation of the legislative act for the new capital adequacy framework even after the end of the consultation period at end May 2001.
