

**BASEL II**  
**EUROCHAMBRES'**  
**RESPONSE**  
**ON THE 3RD CONSULTATIVE DOCUMENT**  
**ISSUED BY THE BASEL COMMITTEE**

## **EUROCHAMBRES' POSITION**

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*On behalf of European entrepreneurs,  
EUROCHAMBRES seeks  
an enlarged competitive European Union –  
where entrepreneurial behaviour is promoted and rewarded,  
where the legislative and physical environment for profitable business is the best in the world;  
where SMEs are encouraged and supported;  
where competition is fierce but fair;  
and which is open to free and fair trade with the rest of the world.*

EUROCHAMBRES' detailed comments and proposals concerning the third consultative paper on the New Basel Capital Accord (Basel II) are contained on the following pages. However, in order to help prioritize the debate, the business community urges the Basle Committee to:

### **1. RETAIL LOANS**

1. Firmsize adjustment - No restriction to the IRB approach
2. Adjustment to inflation - Threshold for retail loans have to be adjusted to inflation in order not become lower in real terms
3. Granularity criterion – abandon the retail exposure size limit of 0.2 %

### **2. COLLATERAL**

Wide recognition of SME typical collateral

### **3. DEFAULT DEFINITION**

More flexibility is also necessary for non-retail exposures to SMEs

### **4. EQUITY**

Retail segment also for equity investments (with more favourable risk-weights for smaller equity investments compared to larger investments)

### **5. BANKS OBLIGATIONS UNDER BASEL II, TRANSPARENCY OF RATING**

Implementation for banks must be possible without disproportionate costs  
Rating structure and result must be explained to SMEs

## INTRODUCTORY REMARKS

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The new capital adequacy framework for banks and investment firms proposed by the Committee on Banking Supervision of the Bank of International Settlements is welcomed by EUROCHAMBRES because of its aim of strengthening the stability of the global financial system. The Chambers appreciate the results achieved already, such as:

- Preferential treatment for small businesses (retail loans)
- Lower risk weights for credit exposures (retail and corporate loans) of businesses
- Expansion of the range of eligible collateral for businesses
- Recognition for both external and internal credit ratings

Nevertheless, we think that the New Basel Capital Accord will still have major consequences for SME finances in the EU.

Concerning the treatment of loans to SMEs, we welcome the significant progress that has been achieved in the negotiations in the Basel Committee in the last two years. The proposed treatment of loan exposures to SMEs of up to €1 million as retail exposure is an improvement for many loans to SMEs even compared to the existing capital regulations. We acknowledge the QIS 3 results, which show a significant reduction in the banks' capital requirements for retail loans to SMEs, and in general a slight reduction of the capital requirements for loans to SMEs.

However, costs of implementation in the banking sector must be kept within limits in order not to annul the advantages for SMEs. With a view to the high complexity of the 3<sup>rd</sup> consultation document we ask the Basle Committee to reduce the volume and complexity of regulations significantly, so that the Accord can be implemented without huge costs.

We also note that the implications of the new framework for SMEs will depend very much on the discretion of the supervisory authorities. We think that some more guidance for the use of these discretionary powers of the authorities is necessary in the New Basel Accord itself otherwise there could be different supervisory interpretations having an indirect impact on SME and corporate finance and therefore a distorting effect on competition.

## **EUROCHAMBRES MOST CRUCIAL POINTS:**

### **1. RETAIL LOANS**

In our opinion, a preferential regulatory treatment for loans to SMEs is fully justified since portfolio and diversification effects in a bank's loan portfolio reduce the bank's risk. This has to be taken account through lower risk weights. Besides, the default of a loan to a SME does not endanger the Committee's main priority, which is enhancing the stability of the banking systems.

The proposed retail loan-threshold €1 million (for "loans extended to small businesses", paragraph 199, 3<sup>rd</sup> bullet point) to us is to our mind the minimum for a possible threshold, especially taking into account that for retail loans to individuals a maximum amount is not foreseen (paragraph 199). If there is no limit for a retail loan to individuals, does that mean that, for example, a €1.5 million loan to a person that wants to create a business can still be qualified as retail?

The achievements we have seen in favour of SMEs are still endangered by the so-called "granularity criterion" which relates the exposure of each debtor to the total size of the retail portfolio. It would further limit the ability of smaller banks to achieve preferential treatment for their SME loans, as their retail portfolio is simply not large enough to fully exploit the €1 m threshold. Although representatives of the Basle Committee have stated publicly on several occasions that this numeric criterion will be abolished, it is still part of the new document (paragraph 44) where it serves as one possibility for national supervisors to check for sufficient diversification.

The granularity criterion in the standardised approach (no aggregate exposure to one counterpart can exceed 0.2 % of the overall regulatory retail portfolio) **discriminates smaller banks and SME-retail customers of these banks and should therefore be not included in the final framework.** Leaving the possibility of a numeric granularity criterion to national supervisors will not foster an internationally level playing field. The effect of the criterion would be a strong distortion in the competition in the banking sector. Despite statements by the chairman of the Basel Committee, (in the European Parliament on Oct 8<sup>th</sup>. 2002 and in Vienna on Jan 14<sup>th</sup> 2003) and by other members of the Committee that this criterion is not relevant anymore, the "0.2 % – criterion" again appears in the 3<sup>rd</sup> consultative document (this time as an example of how granularity can be achieved). We again urge the replacement of this rigid criterion by a competition-neutral criterion that also guarantees the risk diversification of the retail portfolio of a credit institution.

The required use test for retail loans (paragraph 200) could be a hindrance for a wide application of the retail loan category to loans to SMEs. It is questionable that the retail segment requires an estimation of all parameters (not only PD, but also LGD and EAD) which means in practice that for the retail segment only the advanced IRB approach and not the foundation IRB approach is available. Since the justification for the preferential treatment of smaller loans to SMEs is the diversification and therefore lower risk in the bank's loan portfolio, we doubt whether these two restrictions to the application of the retail segment are really necessary.

The threshold for retail loans (€1 m) has to **be adjusted to inflation on a regular basis**; otherwise it will decline in real terms. Already by the end of 2006 when Basel II finally enters into force, €1 m will be less in real terms than now (Summer 2003).

In the standardised approach (paragraph 43, footnote 19) supervisors may determine higher risk weights for retail exposures. The conditions for increasing risk weights for retail loans by the authorities in the standardised approach should be described much more precisely. An increase in risk weights of retail loans by the authorities should happen only in exceptionally circumstances.

If the authority decides to increase the risk weights for retail loans in an economic downtrend, this could increase the pro-cyclical effects of the new framework.

Besides, if the supervisory authority is able to increase the risk weight, it should also be able to lower it, if there is a low risk and low default rate.

Taking into account the low risk of small loans to a bank's stability we would prefer more precise guidelines.

## **2. FIRM SIZE ADJUSTMENT FOR SMES IN THE CORPORATE LOAN SEGMENT**

We welcome the approach to prevent negative effects for SMEs whose loan volumes exceed the retail threshold by taking into account their revenues (firm size adjustment in the corporate portfolio; SME-portfolio) but we think that this firm size adjustment should not be restricted to the IRB-approach. We propose a special risk weight in the standardised approach for non-retail loans to SMEs with sales of up to €50 m, which should be between the 75 % for retail loans, and 100 % for unrated corporates (the risk weight should be near the risk weight for retail loans; e.g. 80 %).

In the IRB approach risk weights for SMEs above the retail threshold should be lower and nearer the retail risk weights. This would also prevent a “cliff effect” (large difference in risk weights for loans of up to €1 m and slightly above €1 m).

Therefore, risk weight curves for SMEs should be flattened further and we urge that this firm size adjustment should not be restricted to the IRB-approach.

Risk weight calculations in the SME-portfolio/IRB-approach should come to similar results to the risk weights in the proposed SME-portfolio/standardised approach.

### **CORPORATE LOANS IN THE STANDARDISED APPROACH:**

According to paragraph 41, supervisory authorities can increase the risk weight for unrated claims to corporates “when they judge that a higher risk weight is warranted by the overall default experience in their jurisdiction”; they can also increase risk weights for corporates in the case of individual banks.

The conditions for increasing risk weights for corporate loans by the authorities in the standardised approach should be described much more precisely. An increase in risk weights of corporate loans by the authorities should happen only in exceptionally circumstances.

For example, if the authority decides to increase the risk weights for corporate loans in an economic downturn, this could increase the pro-cyclical effects of the new framework.

Besides, if the supervisory authority is able to increase the risk weight, it should also be able to lower it.

## **3. PROCYCLICAL EFFECTS**

We still believe that the stronger focus on the creditworthiness of companies could enforce cyclical downturns in an economy, but we appreciate that both the Basel Committee and the Commission have addressed these concerns (e.g. requirement of stress tests).

Work by the Commission, the Basel Committee, supervisory and monetary authorities on this question has to be continued.

#### 4. COLLATERAL

EUROCHAMBRES urges a wide-ranging recognition of SME-typical collateral. Progress has been made, but the rules are still too restrictive (e.g. in the case of „commercial real estate,, the term „multi-purpose,, excludes many kinds of real estate that is used by businesses, e.g. factories).

We welcome the statement that there are no restrictions on the type of eligible guarantors (paragraph 445): In some member countries of the EU (like Italy and France) mutual guarantee societies play an important role in SME finance; these kind of financing support for SMEs should not be made obsolete or put at a disadvantage through Basel II. More flexibility concerning the criteria that a guarantee should be non-cancellable and irrevocable is necessary; the flexibility in paragraph 446 should be extended to the foundation IRB.

The requirement of periodic inspection by the bank of inventories that are collateral (paragraph 485, bullet point 5) is a negative incentive for banks to accept this kind of collateral.

#### 5. SPECIALISED LENDING

We ask the Committee to define more clearly what High-volatility Commercial Real Estate (HVCRE; paragraph 195, 196) is, since this term causes some confusion and concern among our members. HVCRE should be restricted to large and very risky commercial real estate projects.

In the current proposal it is in the discretion of supervisory authorities to decide what commercial real estate exposures are qualified as HVCRE (paragraph 196).

#### 6. MATURITY

In some Member States, long term loans play an important role in corporate finance. In our view, it is important that the New Capital Adequacy Framework takes into account the differences in corporate finance that can be observed in the EU Member States. We therefore welcome the current approach concerning maturity.

#### 7. DEFAULT DEFINITION

According to the proposed default definition, a default takes place when the obligor is past due more than 90 days on any credit obligation. The default definition could be to the disadvantage of certain businesses since this could heighten the PD for them. We therefore welcome the more flexible approach in paragraph 414, footnote 80 (where retail segment supervisors can substitute a figure of up to 180 days), but think such a flexibility is also necessary for non-retail exposures to SMEs. A preferential treatment for one member country of the Basel Committee is not an ideal solution (paragraph 414, footnote 80).

#### 8. EQUITY

The proposed treatment of equity has to be improved. For instance, concerning loans the proposals differ between retail and corporate loans, depending on the size of the loan exposure of the bank (€1m threshold). We propose to create a retail segment also for equity investments (with more favourable risk-weights for smaller equity investments compared to larger investments) –

both in the standardised approach and in the IRB approach. The lower overall risk of equity pools of a credit institution should also allow reducing risk weights like in the retail portfolio.

We can also imagine a firm size adjustment for equity investments in SMEs that are above the proposed retail equity threshold (in analogy to the proposed firm size adjustment for loans to SMEs in the IRB corporate loan segment).

The proposed risk weights for equity investments seem to be much too high (e.g. IRB, simple risk weight method: 300 % for publicly traded companies, 400 % for all other equity holdings, paragraph 315).

We welcome the new approach in paragraph 327 (preferential treatment for equity holdings in case of legislated programmes to promote specific sectors of the economy); to prevent distortions in competition this preferential treatment should be restricted to investments in SMEs.

#### **9. BANKS OBLIGATIONS UNDER BASEL II, TRANSPARENCY OF RATING**

In general, it is important that banks (incl. smaller ones) can implement an Internal Rating based System without disproportionate costs, otherwise bank lending could become more expensive for SMEs. Also there has to be a reasonable approach concerning operational risk, since that aspect reduces the room for banks to give loans to companies. We welcome the commitment of the Basel Committee that the aggregate level of regulatory capital in the banking system should not increase due to the new regulations.

From Europe's SMEs' point of view we welcome the proposals in pillar 3 (Market discipline) concerning the transparency of rating systems (paragraph 775). For SME customers of banks it is important that the criteria, under which a SME is rated, are transparent vis a vis the SME. The rating system of a bank should not be a dark horse for the SME customer. The relevant criteria affecting the rating of the SME should be transparent at least to the SME itself when it is seeking and negotiating a loan.