UEAPME	UNION EUROPEENNE DE L'ARTISANAT ET DES PETITES ET MOYENNES ENTREPRISES EUROPÄISCHE UNION DES HANDWERKS UND DER KLEIN- UND MITTELBETRIEBE EUROPEAN ASSOCIATON OF CRAFT, SMALL AND MEDIUM-SIZED ENTERPRISES UNIONE EUROPEA DELL' ARTIGIANATO E DELLE PICCOLE E MEDIE IMPRESE

Basel II

Position paper on the

3rd Consultative Document issued by the Basel Committee

29th July 2003

1. Introductory Remarks

UEAPME has always supported the Basel Committee's goal of strengthening the stability of the global financial system.

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 1 Mio € 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.

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

In spite of this positive assessment in general, we think that there is still some work to do.

2. Retail loans

In our opinion a regulatory **preferential 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 into 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 Mio € (for "loans extended to small businesses", par 199, 3rd bullet point) to is to our mind the minimum for a possible threshold, esp. taking into account that for retail loans to individuals a maximum amount is not foreseen (par 199).

The **granularity criterion** which was proposed for the standardised approach in the QIS 3 Technical Guidance (no aggregate exposure to one counterpart can exceed 0,2 % of the overall regulatory retail portfolio) would discriminate SME-retail customers of smaller banks and should therefore be deleted. 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, (e.g. in the European Parliament on Oct 8th, 2002 and in Vienna on Jan 14th 2003) and by other members of the Committee that this criterion is not relevant anymore, the "0,2 % – criterion" again appears in the 3rd consultative document (this time as an example how granularity can be achieved).

The required **use test** for retail loans (par 200) could be a hindrance for a wide application of the retail loan category to loans to SMEs. It is also questionable that the retail segment requires an estimation of all parameters (not only PD, but also LGD and EAD) which means de facto 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. Therefore, a (simplified) rating of retail portfolios should be made possible also in he framework of the foundation approach.

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

In the standardised approach according to par 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 a deletion of footnote 19.

3. 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 Mio €, which should be between the 75% for retail loans, and 100% for non-rated companies (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 Mio € and slightly above 1 Mio €).

It will be important that all the thresholds (for retail loans and the SME-segment) will be **adjusted to economic growth and inflation** on a regular basis.

4. Corporate loans in the standardised approach

According to par 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.

E.g. if the authority decides to increase the risk weights for corporate 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.

5. Procyclical effects

We still think that the stronger focus on the creditworthiness of companies could **enforce cyclical downtrends in an economy**, but we appreciate that both the Basel Committee and the Commission have addressed these concerns (e.g. requirement of stress tests); see also various Working Papers published by the BIS.

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

6. Collateral

A wide-ranging recognition of SME-typical collateral is necessary:

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 (par 445). In some Member States 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 par 446 should be extended to the foundation IRB.

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

7. Business Start-ups

Since **newly created enterprises** can demonstrate no rating history when applying for a loan, we think that there should be special rules for this companies, because otherwise their financing condition could worsen under Basel II. Start-ups are crucial for the dynamic, innovation and change in an economy.

If a better solution for business start-ups is not achievable in the framework of the Basel II accord, all involved parties have to make clear, that other **instruments supporting the creation of new enterprises** have to be developed or improved (like mutual guarantee schemes, venture capital, business angels, tax measures).

8. Specialised Lending

High-volatility Commercial Real Estate (HVCRE; par 195, 196)

We ask the Committee to define more clearly what HVCRE 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, par 196)

9. 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.

10. Default definition

According to the proposed default definition, 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 par 414, footnote 80 (for the 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 (par 414, footnote 80).

11. 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 (1 Mio € 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. This would also reduce possible negative effects on venture finance.

We can also imagine a firm size adjustment for equity investments in SMEs which is 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, par 315)

We welcome the new approach in par 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.

12. 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 SME's point of view we welcome the proposals in **pillar 3 (Market discipline)** concerning the **transparency of rating systems** (par 775). For SME customers of banks it is important that that the criteria, under which a SME is rated, are transparent to SMEs. The rating system of a bank should not be a "black box" 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.

13. Administrative obligations

The Basle II accord and especially internal rating based systems have to be implemented without disproportionate costs to avoid additional expenses for SMEs, which would go against the aims of all efforts made in order to find an acceptable solution for SMEs. The administrative obligations for SMEs and for smaller bank institutes (reporting, partial use has to be allowed permanently) have to as limited as possible in order to avoid any unnecessary additional burden for Europe's SMEs. This would reduce the competitiveness of this important sector compared with larger companies and with companies in markets, where Basel II will not be implemented for all institutes (US).