

## **Jaime Caruana: Consequences of Basel II for SMEs**

Address by Mr Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, to the European Parliament Workshop on the "Consequences of Basel II for SMEs", Brussels, 10 July 2003.

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### **Introduction**

Good afternoon. I would like to thank the European Parliament for organising this important workshop on the New Basel Accord and its implications for small- and medium-sized enterprises in Europe, and for inviting me to participate. I'm privileged to join you as the new chairman of the Basel Committee on Banking Supervision, and I welcome this opportunity to offer our views.

As you know, the Basel Committee was founded almost thirty years ago to help promote safety and soundness in the banking sectors. We believe that, when banks are adequately capitalised and well-managed, they are better able to promote growth by providing credit to consumers and businesses alike. But more broadly, when banking systems worldwide are adequately capitalised and well-managed, the international financial system becomes more stable, better able to promote sustainable growth, and more resilient during periods of distress.

Of course, simply providing credit does not guarantee growth. Indeed, how credit is applied matters greatly to the development of an economy. And in every economy, small businesses have long been the true engines of economic growth. Small and medium-sized enterprises traditionally produce much, or even most, of the technological innovations in business and industry. They create new jobs at a faster pace than larger companies do. Their significance can furthermore be measured in the sizeable contributions they make to nearly all countries' gross national products.

Your workshop today reminds us that, if we are to promote growth by strengthening the banking sector, the Basel Committee must act in a manner that benefits banks and their ultimate customers as well. We must recognise that fair and reasonable access to credit matters, not just because credit helps small businesses to grow, but more importantly because small businesses help the economy to grow.

So we have taken seriously the need to ensure SMEs of continued favourable access to credit under the New Basel Accord. This afternoon I would like to share with you some of my and the Committee's views on why the New Accord is necessary. I shall then illustrate how the proposals will bear positively on small business lending. I'll conclude with an update on the status of our work, after which I look forward to a discussion on issues you may wish to raise.

### **The goals of the New Basel Accord**

Let me begin with some thoughts on why we need a new capital accord. From the supervisor's perspective, capital is the last line of defence in a bank. When risk management is not enough, when provisions are exhausted, capital is a bank's last hope. But when capital fails, the bank itself fails. The age-old question has been determining how much capital is enough.

In this regard, the 1988 Basel Capital Accord was a milestone. For the first time, supervisors in the major banking markets agreed on a definition of capital and a minimum requirement. While we all recognise that these rules are not sophisticated, they are easy to apply, a fact proven by their ultimate adoption in over 100 countries. More importantly, they reversed a downward trend in internationally active banks' capitalisation, thereby strengthening the soundness and stability of the international banking system and enhancing competitive equality among internationally active banks.

However, in the years since 1988, the drawbacks of a simple approach to capital regulation have become more apparent. Advances in technology and telecommunications, innovation in banking products and services, and the increasing globalisation of financial markets have changed the way banks measure and manage risk. Today, the 1988 Accord no longer provides these banks - and their supervisors - with reliable measures of the actual risks they face.

In response, the Committee decided in the late 1990's to refine the measures for assessing and managing risk. Rather than treating all loans to corporate borrowers the same way, for example, the New Accord will permit banks with less complex exposures to rely partly on external credit ratings when determining their capital requirements under the "standardised" approach to credit risk. In turn, more advanced banks will rely in part on their own internal assessments of a borrower's credit risk under the "internal ratings-based" approach.

Both the "standardised" and the more sophisticated "internal ratings-based" approaches will help to align capital requirements more closely with a bank's actual risks. Both will also help us realise two key goals: to make our capital rules more sensitive to the potential for loss, and to encourage ongoing improvements in banks' risk management. Understandably, aligning a bank's capital requirements more closely with its borrowers' creditworthiness has generated discussion among small business and others who want to ensure that the new rules do not encumber lending to that sector. The Basel Committee has worked hard to avoid creating such burdens. In fact, our studies have identified those characteristics of SME lending that reduce the risk to banks and hence the need for additional capital. In that vein, I'd like to turn now to the rules that will apply to SME lending, which is my second topic.

### **The treatment of SMEs under the New Accord**

If you've followed our work over the years, you'll know that our proposals have evolved considerably. For instance, after the Committee published drafts of the rules in 1999 and 2001, we heard the message loud and clear from small business that the rules did not fully distinguish between exposures to very large corporations as opposed to SMEs. Likewise, bankers themselves indicated that they typically view lending to large corporations and to smaller enterprises as very different businesses.

We have investigated thoroughly the economics of SME lending. Even though probabilities of default may be higher for individual SMEs, our research identified persuasive empirical evidence that most banks' holdings of loans to SMEs benefit from a greater degree of diversification than their holdings of loans to larger corporations do. Diversification helps to reduce both a bank's exposure to the credit risk posed by SME lending and the commensurate need for capital. Moreover, we've taken a closer look at the precautions banks take when lending to smaller businesses, such as asking for guarantees or collateral. These measures help to lower further the potential losses a bank might incur in lending to a small business and can similarly reduce the need for capital.

Our findings motivated revisions to the proposals that will prevent an across-the-board increase in capital requirements for SME lending. What's more, our "quantitative impact studies" have generated solid proof showing that, on average, many banks' requirements will actually decrease. Three changes to the New Accord are especially relevant.

- First, in addition to an overall flattening of the risk-weight curve for corporate credits, we have reduced directly the capital charges for loans to smaller businesses. For example, banks on the IRB approach will be permitted to adjust downward the capital requirements on exposures to small businesses with up to €50 million in annual sales. This adjustment will reduce the capital charges on a loan to an SME by as much as 20% compared to the new requirements for larger companies and may in many cases be lower than the current requirements.
- Second, the New Accord will recognise that some banks treat their smallest business credits as retail exposures. In these cases, banks group and administer their small business loans on a "pooled basis," similar to the way they manage most small personal loans. The New Accord will permit aggregate exposures to a single business borrower of up to €1 million to be treated as retail exposures. Because retail exposures enjoy a preferential treatment under both the standardised (reduction of risk weights by 25 percentage points, from 100% to 75%) and IRB (a different risk-weight curve) approaches to credit risk, banks making such loans may face lower capital requirements than are currently applicable.

Moreover, for those who have monitored our work closely, the Committee recently eliminated a controversial requirement governing the "granularity" of such loans. In plain language, the rules will no longer require that retail portfolios contain exposures to a minimum number of unrelated parties. Instead, national supervisors will determine whether such portfolios qualify for retail treatment. Although the media has not reported on this change widely, it is quite important because it will help more banks to enjoy the preferential retail treatment for their smallest business credits.

- Finally, the New Accord will recognise a far wider range of collateral and guarantees than the current rules do. When borrowers pledge eligible collateral or guarantees, and thereby reduce the potential loss on an exposure, banks will be able to hold less capital against that exposure than the 1988 Accord stipulates. This change is especially pertinent to SME lending, since national supervisors will be able to recognise several of the types of collateral and guarantees that SMEs provide.

### **Results of QIS 3**

How do we know that these adjustments will help SMEs? To ensure that we've got it right, the Basel Committee has conducted a series of "quantitative impact studies" with the active support of many commercial banks. Our most recent study, under the name "QIS 3," was the most comprehensive, involving an extremely detailed survey of how capital requirements will change for over 350 individual banks in more than 40 countries, including in all EU countries.

QIS 3 demonstrates clearly that the new rules will not increase the capital required for banks' credit exposures to SMEs if we compare the new proposals to the current solvency rules. In fact, our studies show that, on average, banks' capital charges on loans to SMEs included in the corporate portfolio will remain largely stable for banks using the standardised approach to credit risk and will decline by an average of between 3% and 11% for banks on the IRB approach. The capital savings are even more dramatic for SME loans that qualify for retail treatment: participating banks from Basel Committee member countries reported that their capital requirements on SME exposures qualifying for retail treatment would decline by an average of 12-13% under the standardised approach and up to 31% under the IRB approach.

Similar conclusions can be drawn for those European banks participating in this study. Actually, EU banks in general reduce their capital charges for loans to SMEs compared to the current rules, and this decline is slightly stronger than the average of all banks providing data.

I should note that QIS 3 did not fully recognise the risk-mitigating effects of collateral and guarantees, so we expect that, in some cases, banks may experience even larger "savings" when the New Accord comes into force.

Other studies concur. For example, researchers at my home institution, the Bank of Spain, combed through a database covering almost every loan made by a Spanish bank to evaluate the potential effects of the New Accord on SME lending. Their findings, which, if you are interested, I can share in written form with you, agree that the New Accord will not create tougher capital requirements for loans to Spanish SMEs and may, indeed, reduce them.

We are extremely pleased now to have tangible evidence that the New Accord will not create burdens for banks that lend to SMEs. As the savings show, our new rules do an even better job of recognising the characteristics associated with lending to pools of SMEs compared to other forms of credit-giving.

### **The status of the New Accord**

Let me conclude with a word on the status of our work. The Committee has asked for final public comments on the "third draft" of the rules by July 31 of this year. We would certainly welcome comments on any aspect of the proposals related to SME lending and will give full consideration to whether any final changes may be necessary.

The Committee expects to approve and publish the final text of the New Accord this year, and for the new rules to be implemented at the end of 2006, which gives bankers and supervisors three years to prepare. Other countries are likely to seek to adopt the New Accord in roughly the same timeframe, or perhaps thereafter, depending on national circumstances.

While this will require substantial efforts from bankers and supervisors, we all acknowledge that better tools are needed for measuring the risks that banks face. Likewise, we know that, for banking supervision to remain robust and relevant, our rules must keep pace with changes in the industry. This includes incorporating what we've learned about the unique characteristics of small business lending in recent years. We are confident that the New Accord will be worthy of the efforts made.

Thank you for your attention. I would be very happy to answer any questions you may have.