Research, Industrial and
Economic Policy

Comments

on the BCBS Consultative Document "Revisions to the Standardised Approach for credit risk"

We welcome the opportunity to comment on the BCBS' proposals for revising the standardised approach for credit risk, published on 22 December 2014. We have always been supportive of a financial market regulation which aims to make banks and the financial sector more resilient to absorb shocks and at the same time secure their financing role for the real economy.

1. General remarks

We are deeply concerned that the envisaged revision to the current standardised approach for credit risk entails serious negative consequences for SMEs.

According to the Committee's proposal corporate exposures would no longer be risk-weighted by reference to the external rating of the corporate, but would instead be based on risk weights on the basis of corporate's revenue and leverage. Due to the high proposed risk weights, this would clearly lead to higher capital requirements for corporate exposures, thus deteriorating the financing conditions of these firms.

Our main concerns can be summarized as follows:

- The risk weights for exposures in particular to middle-sized corporates are unreasonably high.
- The cumulative effects of the revised standardised approach to credit risk, the restrictive retail definition that includes only small businesses but not medium-sized businesses and the re-calibration of credit conversion factors (CCFs) for off-balance sheet exposures would end-up in a significant push of financing costs for SMEs.
- The new methodology – based on corporate's revenue and leverage – is in our view inappropriate to measure properly the risk profile of corporate borrowers.
- The Committee notes that the calibration of the risk weights for corporates are preliminary and only indicative. Unfortunately, the Committee has not yet published its empirical analysis and results so far. This hinders a reliable evaluation of the appropriateness of the risk weights.

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2. Specific remarks

The introduction of the new risk drivers – revenue and leverage – would due to the proposed high risk weights lead on average to significantly higher capital requirements for exposures in the corporate segment and thus higher refinancing costs. This particularly applies for all companies with

revenues lower than 1 billion Euro and an equity ratio lower that 20 percent. In addition, the capital requirements for small companies would increase even with an equity ratio between 20 percent and 33 percent.

To overcome the supposed weaknesses with regard to off-balance sheet exposures, the Committee envisages a re-calibration of the current CCFs. According to the consultative document CCFs for commitments that are unconditionally cancellable at any time would increase from 0 to 10 percent. A dramatic increase of CCFs can be expected for commitments with a maturity less than one year and considerably longer than one year. We doubt whether this is appropriate.

As capital requirements for banks are an important determinant of the interest rate for loans and credit facilities granted to customers, the cumulative effects of the high risk weights for corporate's based on revenue and leverage as risk driver, the tightening of the criteria for retail exposures and the re-calibration of CCFs for off-balance sheet exposures would end-up in a significant push of financing costs for corporate SMEs. This negative impact on SMS would be aggravated by higher risk weights for subordinated loans which increase from 100 to 250 percent and higher risk weights for claims secured by real estate.

In our opinion the new risk weights for corporate SMEs' exposures are unjustifiably high. As a rule, most credit lenders of SMEs are using the credit standardised approach. Should risk weights for this class of exposures significantly be increased, this inevitably translates into higher financing costs of SMEs and shrinking capability of banks to grant loans to their corporate customers due to capital restrictions stemming from Basel III which is especially an issue for smaller banks in Europe that are important for the financing of SMEs.

We regard the newly defined risk drivers revenue and leverage as inadequate to reflect properly the risk content of corporate exposures.

SMEs generate per definition lower revenues. Furthermore, SMEs normally show lower equity ratios, not least due to limited access to capital markets. Lower equity ratios do not per se reflect a lower creditworthiness which justifies a disproportionate increase of risk weights. Moreover, equity ratios differ substantially between industrial branches. That does not tell anything about financial soundness of companies.

It is true that bigger companies default to a lesser extent than smaller companies. But this is particularly due to the fact that bigger companies are mostly in better financial shape. In contrast, size alone is not an appropriate indicator for measuring properly the risk profile of companies.

We have the impression that diversification effects have not been incorporated. However, this would be very important, because the capital requirements shall be determined to cover unexpected and not expected losses. It is true that the expected losses of SMEs on an average are higher than that of

large corporations. However, expected losses are covered in the calculation of the risk costs as part of the interest rates for loans. In contrast to this, the unexpected losses of corporate SMEs are in relation to the expected losses significantly lower than that of large corporations due to the low concentration risk of SME counterparties. In addition, SMEs do not bear any systemic risk. Exactly for these reasons, current EU legislation provides preferential regulatory treatment for smaller firms‘ exposures. The Committee is considering whether to maintain the 75 percent risk weight applicable to regulatory retail exposures. As a result the preferential treatment of exposures to middle-sized companies will be abolished. It would be unfair to discriminate this category of firms just for structural reasons although they are in good shape and have a good credit quality.

This adverse impact especially on SMEs cannot be desirable for the economy in the EU. We must instead make every effort to prepare the grounds for overcoming the severe financial and economic crisis by a smooth companies’ access to finance.

3. BDI proposals

To strike the right balance between the regulatory treatment of corporates’ exposures and the economic need to promote growth and employment by a smooth financing of companies we propose the following:

- The regulatory preferential treatment of exposures in the retail category should not be restricted to smaller companies but should also include medium-sized companies with a turnover of 50 million Euro.

- For practical reasons, we advocate for the maintenance of the flat risk weights in the standardised approach, provided that the specification of the risk weights is not or only possible with disproportionate expenses.

- A too conservative calibration of the risk weights for SMEs’ exposures must be avoided as these companies very often are financed by financial institutes applying the standardised approach for credit risk.

- For the specification of risk weights for SMEs’ exposures diversification effects should be explicitly taken into account because diversification effects reduce the level of unexpected losses significantly.

- The CCFs are calibrated too high. This especially applies to commitments that are unconditionally cancellable at any time.

- For large companies and those that are active on the capital market the external rating approach should continue to be permitted as this approach proves to be more risk-sensitive than the proposed new risk drivers.

- The quantitative assumptions and results of the analysis for the specification of risk weights should be published to ensure a proper evaluation of their re-calibration.