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August 7, 2019

Mr. Dietrich Domanski
Secretary General of the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2 CH-4002 Basel
Switzerland

Re: Evaluation of the effects of financial regulatory reforms on small and medium sized enterprises

Dear Mr. Domanski:

The Institute of International Finance ("IIF") welcomes the opportunity to respond to the request of the Financial Stability Board ("FSB") to submit views on the effects of financial regulatory reforms on small and medium sized enterprises ("SME").[1] As we stated in our letter earlier this year on the initial FSB consultation on this topic[2], the focus on SMEs for the third evaluation project is timely and important. SMEs play a vital role in our society and are crucial in advancing real economic growth on a global basis.

In this regard, the FSB report and consultation provides a good initial basis for better understanding trends in the financing of real economic activity along with the contributions of reforms to the G20 objectives of strong, sustainable, balanced and inclusive economic growth. We believe, however, that certain conclusions drawn in the report do not capture the negative implications of some reform initiatives on the global and jurisdictional availability of SME finance. As such, our comments herein reflect upon the thirteen questions posed by the FSB in the consultation[3] and we offer our feedback on specific areas of focus where we believe recommendations on review and/or changes would benefit this lending segment.

We also emphasize again that the FSB's methodology for evaluating the post-crisis reform framework should be revisited. While we strongly agree with one of the main conclusions in this report that the post-crisis G20 reforms created significant benefits to financial stability[4], examining effects and potential unintended consequences from that framework is crucial in enabling regulatory fine-tuning and ensuring that reforms contribute to optimal outcomes for society as a whole. We believe the FSB will miss a critical opportunity to encourage lending to small and mid-sized firms if the final report to the G20 doesn't address issues and offer recommendations where the adjustment of regulation could lead to increased financial intermediation in this area.

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[1] FSB 2019. *Evaluation of the effects of financial regulatory reforms on small and medium-sized enterprises (SME) financing: Consultative Document* (June). Available at: https://www.fsb.org/wp-content/uploads/P070619-1.pdf.

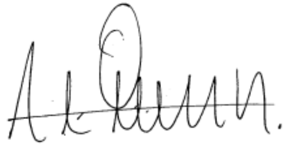
[2] IIF 2019. *Evaluation of the effects of financial regulatory reforms on small and medium sized enterprises* (March). Available at: https://www.fsb.org/wp-content/uploads/IIF-2.pdf.

[3] FSB 2019.

[4] ibid.

We continue to believe that both a robust and improved regulatory environment can have a strong impact on access to financing for SMEs. We look forward to engaging further with you on this topic and on future areas of regulatory reform evaluation. If you have any questions, please contact me or Matthew Ekberg (mekberg@iif.com) and Katie Rismanchi (krismanchi@iif.com)

Very truly yours,



Evaluation of the Effects of Financial Regulatory Reforms on SMEs

The IIF welcomes the focus of the FSB on understanding the effects of the post-crisis reforms and, in particular, their impact on real economic activity and their contribution to the G20 objectives for global growth. To assist with the review of the effects of reforms on SME financing, we offer our comments on two areas of the FSB report and consultation: (1) the scope of findings in the FSB report and the methodology for evaluation; and (2) specific issues for the FSB, the global standard setting bodies and national regulators to examine and address concerning regulatory reform and SME financing.

1. **Scope of findings and analysis of methodology**

The global review of the impact of post-crisis reforms in the context of certain lending segments is an invaluable project. However, in the longer term, the FSB should reevaluate the framework methodology for this work to ensure a comprehensive review of issues where adjustments to the regulatory architecture are warranted. The FSB should also take the opportunity to continue its review of SME financing through a more thorough process of jurisdictional and market-focused analysis of issues impacting small and mid-sized bank and non-bank lending. Lastly, the final report to the G20 should offer suggestions on working collectively to examine and correct unnecessarily punitive constraints on SME finance.

a. Review of evaluation framework conclusions

The results in this report are similar to the conclusions of the FSB in its previous analysis of Infrastructure Financing ("IF").[5] Namely, the FSB finds that regulatory requirements for, *inter alia*, bank capital, liquidity and leverage have risen across the board since the financial crisis and any potential costs exposed through the FSB evaluation should be framed against the wider financial stability benefits of the G20 reforms. While we strongly agree that the post-crisis regulatory framework has made the financial system safer and more secure, it remains important to review that framework in a dynamic and holistic fashion.[6]

The FSB should use its evaluation project to consider its role in working with the international standard setting bodies on recommendations for changes to the global framework where the analysis warrants such changes. Though we agree final responsibility for deciding whether and how to amend a particular standard or policy remains with the body that is responsible for issuing that standard or policy, we believe there is a missed opportunity if certain specific issues are not explicitly flagged and put forward to the relevant bodies for consideration of possible changes.

The effectiveness and utility of the evaluation framework will remain extremely limited if the processes cannot (or do not) consider the actual changes needed to mitigate any unintended consequences which

[5] FSB 2018. *Evaluation of the effects of financial regulatory reforms on infrastructure finance* (November). Available at: https://www.fsb.org/wp-content/uploads/P201118-1.pdf.

[6] FSB Chairman Quarles stated in the context of the Evaluation Framework: *"In any system as complex and consequential as the body of post-crisis financial regulations, there will always be aspects-and sometimes material aspects-that can be improved on the basis of experience and analysis. A credible review process that is both rigorous and dispassionate will find a few."* Randal Quarles 2019. *Ideas of order – charting a course for the Financial Stability Board* (February). Available at: https://www.bis.org/review/r190211a.pdf.

may emanate from the global regulatory reform architecture or actively examine areas where regulatory adjustment might bring about greater access to financing for the real economy. The topics undertaken by the FSB for evaluation are extremely important and improvements in access to SME financing in particular will have significant societal advantages.[7] The FSB should use its mandate to help coordinate changes on a consistent, global basis for the benefit of all.

As such, we believe that follow-up assessments on SME finance (and, indeed, infrastructure finance) should be conducted by the FSB taking into account an updated evaluation framework and mandate which considers the wider implications of regulatory reform on these activities and also undertakes an *ex-ante* quantitative assessment of some reforms impacting these areas of lending - along with the examination of ancillary issues to the reform agenda where broader review is warranted.

In particular, as relates to *ex-ante* assessment of reforms, there is concern that the finalization of Basel III from December 2017[8] will further increase capital charges for SMEs (and other lending areas such as infrastructure finance). The scope of the FSB assessment must be enlarged to consider *ex-ante* impacts to these critical areas of the global economy, given that impact studies conducted by standard setting bodies generally do not incorporate macro-economic effects in their analysis. The FSB should have a major role to play in the balancing of the financial stability and economic growth equation.

b. Review of report methodology

The FSB should further consider the methodology of their report and, in particular, further jurisdictional analysis and a review of market behavior and the indirect effects of reforms:

i. *Jurisdictional analysis*: The FSB acknowledges that due to important data and methodological challenges and the difficulty in isolating the effects of macroeconomic conditions from the effects of financial regulation at a global level, their analysis does not identify material and persistent negative effects on SME financing in general, although there is some differentiation across jurisdictions.[9]

   As can be seen from this conclusion, we believe that one of the main shortcomings of the report is that it is necessary to analyze a full economic cycle to arrive at more meaningful conclusions at a global level, which has not happened yet for a large number of relevant jurisdictions. In our view, the analysis carried out is, to an extent, premature and should be repeated in the future.

   We understand the challenges that exist in order to arrive at more in-depth conclusions internationally. Nevertheless, we believe there would be merit in the FSB engaging in a more detailed analysis in different jurisdictions and regions. This may provide an incomplete picture on a world-wide basis, but the effects of the different

[7] The FSB acknowledges in its research that across 99 countries surveyed, 66% of all workers in those countries were employed by SMEs. FSB 2019 (Page 7).

[8] BCBS 2017. *Basel III: Finalizing post-crisis reforms* (December). Available at: https://www.bis.org/bcbs/publ/d424.pdf.

[9] FSB 2019 (Page 2).

drivers identified in the report would be more clearly explained and assessed, because, as the report says, there is no one-size-fits-all pattern for all jurisdictions.[10] For example, where the FSB has conducted some in-depth analysis, it shows some significant negative effects of SME reforms:

"While the analyses based on cross country data do not show material and persistent effects on SME lending at the most affected banks, within-country satellite analyses provide more granularity to the results and paint a more nuanced picture, showing some differentiation across jurisdictions (Box 8 and Table 3). The analysis identifies some effects of the RBC [Risk-Based Capital] regulation in slowing the pace of SME lending. In some cases, affected banks reduced the share of SME loans to total corporate loans relative to other banks and (in few jurisdictions with this data) tightened the conditions of credit to SMEs. These effects show however some differentiation between regions and apply predominantly to jurisdictions most affected by a macroeconomic crisis or adverse macroeconomic developments in the post-reform years."[11]

Specifically, the FSB's analysis using the richest data – at bank-firm level – finds significant negative effects of reforms on SME financing – both temporary and persistent - in four out of six countries in the sample. In Europe, temporary significant negative effects of reforms on SME financing are found in four out of five countries and persistent effects in three out of six.[12]

The FSB's finding that a one-size-fits-all pattern for jurisdictions cannot be outlined - and that in countries hit by an economic downturn during the reform implementation period, the pace of lending was reduced for both SMEs and other firms - also indicates evidence of procyclical effects of the regulatory reforms. As the intent of the reforms is to foster financial stability and as procyclicality can be assumed to be an undesired outcome in this regard, we would request the FSB to further analyze this phenomenon in order to identify the regulatory measures giving rise to procyclical effects in order to address them.

Lastly, the FSB mentions elements limiting the comparability of results among jurisdictions. In some jurisdictions at the time the reforms were implemented, certain measures were already in force or policies were enacted aimed at enhancing access to finance for SMEs, such as the SME supporting factor in the European Union ("EU")[13]. Such cases could result in underestimating the effects of the reforms. This

[10] The report also acknowledges that it is often easier to analyze the effects at the local level. We think it would helpful if the FSB could provide a separate annex of national practices which support SMEs and assess where there is a clear positive or negative effect on SME financing. We find the list of policies listed in Annex B lacking an evaluation of their actual impact on the local market.

[11] FSB 2019 (Page 38).

[12] FSB 2019 (Table 3, Page 41).

[13] It is worth noting that fiscal stimulus can play a role in SME financing and that one of the areas of support highlighted by the FSB was the SME supporting factor ("SF") in the EU. A recent paper by economists from Banque de France finds significant positive effects of the SME SF on credit volumes – see Dietsch et al 2019 Lower bank capital requirements as a policy tool to support credit to SMEs: evidence from a policy experiment (February). The authors find a positive causal effect of the SME SF on the outstanding

point is significant as such measures could have contributed to lessening possible restrictions in credit supply. The FSB report investigates the net effect of the reforms; however, the analysis should be deepened to disentangle the effects of each component of the post-crisis reforms as well as other measures in place.

ii. *Market behavior analysis and indirect effects of reforms*: The FSB assessment methodology for this report also misses an important factor, as it focuses only on the direct impact on the provision of credit to SMEs and does not take into account the behavior of market participants. Banks have worked to maintain - to the extent possible - their lending activity to their critical franchises, of which domestic SMEs are certainly a key part. This is due to a combination of responsible lending practices by banks in a through-the-cycle approach (with the view of supporting their clients across good and difficult economic times), a commitment to society given that SMEs represent a major source of growth and job creation, and the practical set-up with local branches of corporate centers originating loans in their respective territories.

    The franchises of banks and their "raison d'être" can only be built over the long term, and therefore "stop and go" lending policies are generally avoided. Consequently, the efforts to absorb the increase in capital requirements in retail or SME domestic franchises have been weighing not on the domestic franchises, but on other activities considered as less core, more liquid or easier to deleverage, such as international businesses or trading assets.

    This indirect impact has damaging consequences, for example, in economies where the banking sector is largely foreign owned. Similarly, massive deleveraging in trading assets reduces market liquidity and banks' capacity to absorb shocks, leading to higher volatility and bifurcation in investor appetite between liquid and less liquid products. As many of these issues were not taken into account in the FSB report and consultation, we believe they should be examined in more depth in the subsequent, final report to the G20 and through much needed ongoing follow-up analysis.

c. Review of constraints on SME lending

The FSB acknowledges that bank financing is of high importance to SMEs[14] and, given their size, SMEs tend to be very dependent on bank credit, as they generally do not have access to other financing sources such as wholesale debt or capital markets. However, since the financial crisis, intermediation by financial

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loan amount after its implementation. They identify this effect by exploiting the €1.5m limit for the bilateral exposures and conduct a difference-in-difference analysis tacking the exposure of SMEs above the €1.5m threshold as a control group. The analysis conducted by the EBA in 2016, which is referred to in Box 4 of the FSB's report, was arguably less likely to identify the causal effect of SME SF due to the nature of the data used. The control group in their analysis was made of large enterprises but there is clear evidence that the credit dynamics of those firms can markedly differ from the one of SMEs, making them a poor control.

[14] FSB 2019 (Page 9): "Bank lending – whether to the firm itself or to its business owner – remains the prevalent form of external SME financing in all FSB jurisdictions."

institutions in the SME market segment has reduced[15], and constraints across bank portfolios have led to a reconsideration of appetite for lending to SMEs in certain circumstances. Though the report mentions these constraints at various stages, it fails to opine further on options for addressing them. Though we recognize that many constraints need to be considered at a jurisdictional level, the role of the FSB in coordinating action on a global basis would be invaluable in driving dialogue on solutions in an internationally consistent manner.

For example, the report references several areas raised in our initial letter where particular factors are sometimes unique to this type of lending segment, limiting traditional bank financing. We believe these issues remain relevant and are not addressed in a fulsome enough manner in the report. As such, these issues should be reconsidered in the final report to the G20.

For instance, SMEs face a difficult environment for readily available credit information. Beyond a relatively small number of SMEs on company registers, smaller and informal businesses are sometimes invisible to policymakers and regulators in many countries, making credit decisions more onerous. Today, credit worthiness can be inferred from a variety of sources that are easily accessible through digital footprints and thus a more forward-facing approach should be examined in order to help improve credit information. The report, however, does not expand upon the options to increase credit information availability. The FSB should consider its role and the role the international standard setting bodies in undertaking an examination as to how SMEs could voluntarily share and transmit the data they generate. The promotion of central storage of business and financial information could help to simplify and automatize the application process for new loans.

As we noted in our earlier submission, issues on the use of collateral and documentation for lending also raise similar hurdles for SMEs. Lenders must consider additional security in the current regulatory environment and, as a result, unsecured lending to businesses has been reduced. As smaller and newer businesses are less likely to be able to provide collateral and guarantees, increased reliance on collateral without an equal emphasis on information will mean fewer marginal borrowers have access to loans. The FSB should consider where recommendations on the passing of movable collateral laws and supporting collateral registries could go hand-in-hand with improving information sharing on financial obligations, improving insolvency regimes and strengthening the legal, regulatory, and institutional infrastructure for factoring and leasing as means to address issues in the system for SME financing. Such efforts should also consider implementation of the final Basel III reforms[16], in which the recognition of physical collateral is considerably reduced. Such a policy decision entails a major tightening of lending conditions, and provides banks with unwelcome incentives to lend unsecured, as the full value of physical collateral is not recognized.[17]

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[15] The FSB acknowledges this, though it found recovery was notably heterogeneous across jurisdictions. This emphasizes the difficulties in assessing a global snapshot of access by SMEs to bank and non-bank financial intermediation. FSB 2019 (Page 3, page 11).

[16] BCBS 2017 (Pages 66 & 103-107).

[17] The FSB report notes that in many jurisdictions: (i) SMEs generally use more immovable assets like real estate as collateral for loans; and (ii) there is some evidence that the share of collateralized loans to SMEs has increased since the crisis FSB 2019 (Page 14). While IRB models permit non-financial and physical collateral for credit risk mitigation purposes, the Standardized Approach (SA) does not. And Foundation IRB imposes LGD floors and haircuts on non-financial collateral. So greater reliance on Foundation IRB and the introduction of the output floor that tees off the SA could penalize SME exposures under the final Basel standards. This is discussed on page 21 of the Consultation Document, footnote 33).

The FSB acknowledges that a lack of consistent application of the definition of SME can also cause divergence in understanding of the market being addressed, however the report fails to discuss how such a lack of homogeneity can lead to disparity in credit decisions based on regulatory uncertainty. Basel III defines SMEs as "corporate exposures where the reported annual sales for the consolidated group of which the corporate counterparty is a part is less than or equal to EUR 50 million for the most recent financial year."[18] However, this is not uniformly applied in jurisdictions inside or outside the Basel Committee membership[19] and creates friction when applied in some Emerging Market and Developing Economies ("EMDE"), where the definition may be unsuitable to the business environment.[20] Further work by the FSB on the impact of definitional inconsistency should be part of any follow up to this report.

Lastly, the report documents that feedback from stakeholders suggests that SME financing trends are largely driven by macroeconomic conditions and factors other than financial regulation. These factors include the public policies put in place to address SME financing constraints as well as benign financial conditions (in particular, the low interest rate environment), which may have mitigated some of the negative effects of financial reforms.[21] We are concerned, however, that the last ten years of a low interest rate environment may have masked or, to some extent, partially offset the impact of the new regulatory constraints on SME lending. Although still hard to quantify, it is entirely possible that lending to SMEs would further contract under a normalized interest rate environment and reduce access to financing and this should be considered for further in-depth examination by the FSB.

2. Specific Issues Regarding the Impact of Regulatory Reforms on SME Finance

The findings of the FSB via this report and consultation point to its view that at an aggregate level, the G20 reforms are expected to reduce the probability of a crisis and, should a crisis occur, soften its impact by stabilizing the provision of lending. The FSB further acknowledges that while there is limited evidence that explores the specific effect of SME lending, there is no reason to expect that SMEs too would not also benefit from a more stable economy and in particular from more resilient banks.[22]

We fully agree with the importance of the post-crisis reforms to systemic stability and the assessment that systemic stability brings significant benefits to the provision of finance to all sectors of bank-led financial intermediation, including SME finance. However, addressing certain elements of the reform agenda where regulatory adjustments would in no way lead to additional risk - but would instead allow for greater access to financial services products - is also important.

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[18] BCBS 2017 (Page 13, Paragraph 43).

[19] For example, the European Commission defines an SME for the purpose of use in EU policies as enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding €50 million, and/or an annual balance sheet total not exceeding €43 million. In the United States, there are no distinct risk-weight functions for SME exposures, therefore SME is not defined anywhere in US capital regulations.

[20] We note that Basel III does state that "in some jurisdictions (*e.g*. emerging economies), national supervisors might deem it appropriate to define SMEs in a more conservative manner (*i.e*. with a lower level of sales)". BCBS 2017 (Page 17, Footnote 31).

[21] FSB 2019 (Page 3).

[22] FSB 2019 (Page 22).

As we referenced in our comments on the initial FSB consultation earlier this year, we believe the final report by the FSB to the G20 should consider certain points concerning prudential standards, risk mitigation and compliance issues for SME financing and should offer recommendations on follow up. These issues should be examined in the context of widening the availability of SME finance while at the same time constraining risk and ensuring stability, as these themes are not mutually exclusive.

i. Prudential regulatory reforms

The impact of reforms from Basel III, and specifically those concerning implementation of higher capital requirements, a binding global leverage ratio, the Liquidity Coverage Ratio ("LCR") and the Net Stable Funding Ratio ("NSFR"), include a largely intended tightening of credit conditions across banks. It is worth noting again that specific constraints can impact financial intermediation and contribute to the contraction of capital and liquidity options for short-term SME activity specifically. Punitive treatment of products such as trade finance or hedging also impact the capacity of SMEs to compete in the global value chain.

The quantitative and empirical analysis outlined in the FSB report would appear to suggest mixed results in terms of impacts from the agreed and implemented reforms on SME lending. The analysis also records that differences across jurisdictions in the status of implementation also plays a significant role. We note, however, that the FSB analysis does point to areas where changes to the cost of capital could directly impact SMEs but does not build on ways to examine mitigation of negative effects. For example, the Weighted Average Cost of Capital ("WACC") impact exercise performed by the FSB shows that there is a net increase in the WACC for SME exposures due to Basel III, accounting for the 2010 and 2017 phases of the reforms.[23] This is despite a relaxation in the standardized approach risk weights for unrated and BBB-rated SME corporates in the 2017 Basel III package. This also does not fully account for the Loss Given Default ("LGD") floor parameters agreed in the 2017 package, which will likely push up on these impact estimates as it would limit the risk mitigation credit given to overcollateralized SME lending. A higher WACC for SME finance is likely to be passed on to SME borrowers, which could reduce the supply of SME finance, all other things being equal.

The FSB report also provides discussion via Annex C of the report on the impact of Basel III on equity investment in SMEs[24]. The report describes the much more stringent approach to the treatment of equity investments under the 2017 Basel III package.[25] The impact of this is shown in the BCBS Basel III Monitoring report (March 2019), in which equity exposures see the largest absolute and relative increases in average risk weights – from 202% to 234% for Group 1 banks' equity exposures that are currently under IRB approaches.[26] Unlike for corporate SME lending, under Basel III there is no specific treatment of equity investments in SMEs, which could further constrain activity in this area in future.

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[23] FSB 2019 (Box 3, page 25).

[24] FSB 2019 (Box C-2, page 68).

[25] Equity exposures are to be migrated from IRB to mandatory use of the Standardised Approach, which imposes a risk weight of 400% to speculative unlisted equity exposures and a risk weight of 250% to all other equity holdings.

[26] BCBS 2019. *Basel III Monitoring Report* (March). Available at: https://www.bis.org/bcbs/publ/d461.pdf. (Pages 58 and 59, Graph 54). A very high impact on equity exposures is also found in the IIF's own analysis of the cumulative capital impact of the Basel III reforms.

Financing that contributes significantly to the good functioning of SMEs - such as trade finance - can also be constrained. Owing to the mixed global adoption of the NSFR, the FSB does not engage directly in analysis of that branch of the Basel liquidity standards, however, funding factors applied under the NSFR can force the use of long-term funding to finance short- term assets such as trade finance, forcing up the cost to borrowers.[27]

In its current design, the NSFR also imposes meaningful barriers on SMEs' ability to access capital markets. SME securities, by definition, generally do not qualify as Level 2B assets since SME issuers are not among the largest corporates whose securities are included in major indices. As a result, SME debt and equity securities will either receive 85% or 100% RSF factors, in contrast to the 50% RSF factor that applies to large companies' securities. This penalty on SME securities will incentivize banks to withdraw support for market-making in such securities, and in particular for debt securities which generally require bank balance sheet inventories.[28]

The treatment of operational deposits under the LCR can lead to higher costs for correspondent banking services which support SMEs, contributing to the "de-risking" phenomenon (the drivers of which are discussed in more detail in section 2(iii) of this letter) by putting additional pressure on local lenders financing SMEs with an international footprint.[29]

There is also evidence that stress-testing and G-SIB capital surcharges have significantly reduced bank lending to SMEs and certain borrowers in some jurisdictions (the US for example), because stress-testing

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[27] For example, paragraph 40 (e) of the NSFR assigns a 50% RSF factor for non-HQLA assets (not included in other categories outlined in the standard) that have a residual maturity of less than one year, including, inter alia, loans to non-bank financial institutions, loans to non-financial corporate clients and loans to retail customers and small business customers. Such a high RSF factor may have negative consequences for the supply of short-tenor, self-liquidating on-balance sheet trade finance loans used to support international trade flows by raising funding costs unnecessarily. See Basel Committee on Banking Supervision (2014), *Basel III: The Net Stable Funding Ratio* (October). This issue was recognized by the European Banking Authority in their 2015 report: *On Net Stable Funding Requirements under Article 510 of the CRR* (December): see Section 6.

[28] Basel Committee on Banking Supervision 2014. *Basel III: The Net Stable Funding Ratio* (October): Para 42(c) (85% RSF applies to non-HQLA debt securities with greater than one year maturity and exchange traded equities; 43(c) (100% RSF applies to non-exchange-traded equities); 40(a) (50% RSF applies to Level 2B securities, including debt and equity securities of major corporates).

[29] Specifically, the LCR recognizes deposits arising from operational accounts, which are assigned a 25% run-off rate. This lower LCR outflow factor recognizes the highly stable nature of cash balances linked to operational accounts held by banks on behalf of their clients. Other non-operational deposits are assigned different run-off rates and, in this case, 100% for deposits arising from "correspondent banking". However, the LCR definition of correspondent banking does not match the practical fact that much of financial institutions' correspondent relationships are operational in nature, displaying substantive dependency on the service provider and a high degree of deposit stickiness because the balances are supported by underlying commercial payments and collections. Clarification on a broader definition explicitly allowing for the inclusion of correspondent banking relationships as operational, and the allowance for a 25% outflow calculation for those operational deposits, will help support the necessary provision of correspondent banking services to client banks. As has been noted in the past, such a clarification would not change the basic functional premise of the LCR or its overall effectiveness as a sound risk management tool: Basel Committee on Banking Supervision (2013), *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* (January).

raises the implicit risk weights for small business loans given assumptions about losses on such business in an economic downturn.[30]

In addition, for some jurisdictions, we note again that implementation of Basel III will need to be done consistently with local measures regarding the future of internal models or the management of Non-Performing Loans ("NPL"), along with international or local rules for the calculation of expected credit losses under accounting standards such as IFRS 9. At a global level, divergent supervisory practices regarding implementation of regulatory reforms could introduce bias to their outcomes. Analysis of SME financing should incorporate the impact of both regulatory and supervisory visions and specifically the willingness of banks to lend going forward given new approaches to provisioning and the relationship with capital. [31]

Lastly, derivatives reform has in some cases increased the cost of SME financing activities due to the requirement to post margin and the internal structure required to carry out the necessary reporting on hedged transactions. In addition, the currently proposed Basel capital standards for Credit Valuation Adjustment ("CVA") risk further penalizing some hedging activities. Limitations on hedging activity can unduly restrict some SME credit transactions, or lead to poor risk management outcomes, and should be examined in that context.[32]

As a consequence of all these factors, we believe the conclusions of the report do not properly balance the impact of the new regulatory environment on bank credit decisions vis-à-vis the benefits of stability that are drawn from the post-crisis reforms. Both issues are important and should be evaluated by the FSB in equal measure globally and in terms of jurisdictional impact, with recommendations to the international standard setting bodies and/or relevant authorities to undertake specific further review of these issues.

ii. Risk mitigation

Regulation is intrinsically linked to the impact of macro-economic factors such as interest rates, government policy and financing by public sector guarantee schemes, and should therefore not be seen in isolation. For instance, the involvement of multilateral development banks ("MDB"), Export Credit Agencies ("ECA") and national business or development agencies can provide specific regulatory incentives such as credit enhancements to support SME finance.

As noted earlier, the FSB makes reference to these SME supporting schemes via Annex B of the report, detailing public policies implemented across jurisdictions to support small and midsize firm finance. The very evidence of such a large array of programs supporting this market segment points to the need for reexamination of some of the FSB's conclusions on the availability of bank intermediated SME finance, as there is obviously a continuing need for government or quasi-public involvement in this space to

[30] For example, see Archarya, Berger & Roman 2018 *Lending Implications of U.S. Bank Stress Tests: Costs and Benefits* (April) and Chen, Hanson & Stein 2017 *The Decline of Big-Bank Lending to Small Business: Dynamic Impacts on Local Credit and Labor Markets* (September).

[31] This was recently pointed out in an EBA study on the observations of post-implementation impact of IFRS 9 – but would apply to the introduction of accounting standards – whether CECL or IFRS (: https://eba.europa.eu/-/eba-provides-preliminary-assessment-on-post-implementation-impact-of-ifrs-9-on-eu-institutions.

[32] See IIF-ISDA-GFMA letter to Bill Coen, Secretary General of the Basel Committee on Banking Supervision, regarding *Industry Concerns with the Revised CVA Framework* (May 9, 2019).

compensate for insufficient funding capacity from the private sector. The FSB should engage in more detailed analysis of the effectiveness of the programs and the gaps they are meant to fill vis-à-vis private sector finance. The policy response should not be to develop more government guarantee instruments, but rather to see how the market can be improved.

However, assuming the need for these programs is still apparent, their effectiveness in terms of "crowding in" private sector lenders and encouraging greater credit intermediation for their target sector should also be evaluated. As we have noted, there are still limitations on how useful credit guarantee products (offered, for example by MDBs or ECAs) can be in terms of capital allocation for a private sector financial institution. If certain structural features are present, the proportion of the asset covered by the guarantee can instead be weighted using the guarantor's risk rating, which is strong in the case of development banks and government backed credit institutions. However, the products offered by the public sector often may not meet the requirements laid out by the Basel framework and thus such capital offset for Risk Weighted Asset ("RWA") calculations may be limited, reducing the attractiveness of financial product offerings to SMEs. In the same vein, such guarantees often do not qualify for a High Quality Liquid Asset ("HQLA") classification for the purposes of the Basel liquidity standards, thus reducing their benefit in terms of bank liquidity and funding profiles. For such schemes to be effective, further consideration should be given to their treatment under the Basel framework and the FSB should recommend review of this treatment to the Basel Committee.[33]

iii. Regulatory compliance

The FSB report acknowledges that financial regulations may also entail a higher overall compliance burden that in turn may affect SME lending. The FSB considers that SMEs are more reliant on "relationship lending", whereby lending decisions are based on soft information collected by loan officers at the local bank branch. Smaller banks may be better suited at collecting soft information by virtue of their flat or decentralized organizational structure. Higher, regulatory-induced compliance burdens, if they are at least in part unrelated to loan size, may make smaller loans less attractive for every lender. The report goes on to say that this might affect smaller banks relatively more and incentivize them to focus on larger loans, which may in turn affect the availability of "relationship lending", particularly in those jurisdictions where SMEs rely predominantly on those banks.[34] The report would appear to suggest the SME lending by large banks via their local branches would minimize these effects but in reality, the largest banks also must grapple with complexity in the system, particularly when dealing with SME clients in various jurisdictions.

It is well agreed that the post-crisis regulatory environment has led to a critical strengthening of the global financial system. It has, however, also led in some cases to this increased complexity in terms of compliance with new regulations. While banks have implemented robust and effective regimes to ensure strict compliance with agreed reforms, this has in certain circumstances brought about a considered review of lending activity where the complexity has warranted reassessment. This is compounded when operating internationally, where consistency in standards is vital. Banks do not function solely within national boundaries, and indeed some of the most important growth opportunities for financial

[33] For further commentary on the capital and liquidity treatment of guarantees, please see: Milken Institute/OECD (2018). *Guaranteeing the Goals: Adapting Public Sector Guarantees to Unlock Blended Financing for the U.N. Sustainable Development Goals* (April). Pages 20-25.

[34] FSB 2019 (Page 21).

institutions rest in their ability to serve clients abroad as well as at home. It is significant that while the compliance costs for banks of all sizes have increased post-crisis, this effect is magnified when operating across multiple jurisdictions in cases where there are inconsistent standards.

According to a 2018 Thompson Reuters global survey of 800 compliance practitioners across a wide range of banks, insurers, broker-dealers and asset managers, continuing to manage and cope with evolving regulatory change is their biggest challenge.[35] The survey went on to find that over half of firms (54 percent) allocate up to 25 percent of their total spend on operating costs maintaining continuing compliant business operations - which gives an indication of the level of investment needed to meet evolving risk and compliance with regulatory requirements.[36]

The costs associated with compliance complexity ultimately impact the users of financial products. In this context, international standard-setters play a significant role in helping to provide greater clarity as to how regulations are to be interpreted and applied. Regulatory coherence and level playing fields are critical for enabling banks to provide affordable financing to advance economic growth. Banks can also achieve greater risk diversification (and therefore greater stability) if they can expand geographically and develop successful businesses in different countries and markets, taking less correlated risks than those that exist in a single country. Consistent international standards and reasonable home-host rules are essential prerequisites for institutions to achieve this diversification, and inconsistency should be examined for its impact on SME lending.[37]

As we have mentioned previously, looking at innovative ways to deal with compliance complexity is also important. For example, in recent years the global correspondent banking market has shrunk due to a phenomenon known colloquially as “de-risking”, leading to significant difficulties for banks in EMDEs to finance SME clients.[38] The reasons for this are varied but are also linked to complexity in compliance for client onboarding and maintenance. A concerted effort to look at ways to improve the overall global compliance regime, and in particular the global compliance regime related to financial crime risk in Anti-Money Laundering (“AML”) and Countering the Financing of Terrorism (“CFT”), would aid not only in improving the market for correspondent banking but also the domestic appetite for lending to SMEs. This can be examined first via greater use of innovation in regulatory compliance (through Machine Learning/Artificial Intelligence (“AI”), the use of centralized Know Your Customer (“KYC”) utilities and the greater regulatory acceptance of digital onboarding for clients – there should ultimately be an alignment of regulation that enables digital interaction with customers) and secondly through improved channels of

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[35] Thomson Reuters 2018. *Cost of Compliance 2018*.

[36] ibid. Page 5.

[37] For further information on issues concerning market fragmentation and its downstream effects, see IIF (2019) *Report on Market Fragmentation and Need for Regulatory Cooperation* (January): https://www.iif.com/Publications/ID/3222/PageID/3222/IIF-Report-on-Market-Fragmentation-and-Need-for-Regulatory-Cooperation

[38] In a Communiqué in June 2019, the G20 Finance Ministers and Central Bank Governors commented that: *“We continue to monitor and address the causes and consequences of the withdrawal of correspondent banking relationships, and issues on remittance firms’ access to banking services.”*

information sharing on financial crime risk intra-bank, bank-to-bank, bank-to-government, and government-to-government, in both directions.[39]

Though we understand under the current evaluation framework parameters may limit the FSB's ability to further examine compliance complexity across all market segments, further consideration should be given to how this issue could be taken up by the FSB and the international standard setting bodies to ensure ill effects on SMEs - and their access to finance - can be obviated.

[39] For a discussion on current trends in issues for innovation and technology in AML, along with policy recommendations regarding information sharing for AML/CFT purposes, see: IIF 2018 *Machine Learning in Anti-Money Laundering* (October): https://www.iif.com/Publications/ID/1421/Machine-Learning-in-Anti-Money-Laundering.