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Bank regulation and supervision

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DG FISMA consultation paper on the possible impact of the CRR and CRD IV on bank financing of the economy

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Ministry of Finance **Finansinspektionen** **Sveriges Riksbank**

Introduction

The Swedish Ministry of Finance, Finansinspektionen (the Swedish Financial Supervisory Authority), and Sveriges Riksbank welcome the opportunity to comment and present a shared view on the DG FISMA consultation paper. We share the Commission's priority to strengthen the European economy and increase investment to stimulate jobs and growth.

When used herein, 'we' should be considered as the common view of the Ministry of Finance, Finansinspektionen, and Sveriges Riksbank.

Bank Financing

Banks are a key channel for credit provision to the real economy and especially to SMEs, who receive more than 75 % of their external funding through bank loans. Banks' ability to provide financing to the EU economy in the future is therefore an important factor in stimulating jobs and growth. Capital regulations can help preserve this ability throughout the economic cycle, but the exact degree of regulation that leads to the optimal outcome in terms of financial stability and long-term growth is, however, subject to debate. Our perception is that the net effects of the CRR and CRD IV reforms that have been carried out in light of the financial crisis are positive.

Given the importance of the bank financing channel and the cost to society of financial crises, it is of utmost importance to have a stable and sufficiently well-capitalised banking system within the EU. Consequently, having banks with both performing loan portfolios as well as sufficient levels of capital is one of the best guarantees to ensure that credit supply from banks to the broader economy continues even throughout an economic downturn.

This is also the Swedish experience. Through joint initiatives, we have imposed a higher common equity Tier 1 capital requirement than the minimum requirement in the CRDIV/CRR for the four major banking groups in Sweden. Even though Swedish banks have had to abide by stricter capital requirements than some of their European peers, high levels of lending to the corporate sector have been maintained[1] with indications that around 80% of bank corporate loans have been extended to firms with less than 250 employees[2].

Perspectives from the Swedish SMEs

In fact, according to the annual Swedish SMEs survey[3] performed by the Swedish Federation of Business Owners (Företagarna), obtaining capital is not among the top hurdles faced by Swedish SMEs. Instead they identified finding qualified employees and a high regulatory burden as their main barriers to growth. A separate report from the same organisation[4] suggests that challenges obtaining capital to finance investments are predominately an issue for SMEs with less than 20 employees, a category of firms who usually have difficulty showing repayment capacity or pledging assets as collateral.

Even for those for whom obtaining capital is an issue, it can also be questioned to what extent regulatory discounts regarding capital requirements (such as the SME provision in Article 501 of the CRR) affect banks' provision of credit to SMEs. In general, banks' decision making around extending lending to a given firm is conducted before such discounts are taken into account. The primary factor in the decision is the repayment capacity of the firm. Once this hurdle has been passed, the capital requirement discount may be factored into the subsequent pricing stage of the loan. As such, it mainly acts to reduce the pricing of loans which would have been extended regardless of the discount. However, it does not appear to widen the population of firms who can access bank funding.

There are also indications that broader SME demand for bank loans has been weak since the crisis. This, according to the banks, is due to two factors: i) many firms remain uncertain about future growth and so are reluctant to invest/expand, and ii) many of the firms now seeking financing do not qualify for traditional collateralized lending - for example, software-focussed IT firms (who are generally more in need of venture capital). As such, when

[1] Kreditbarometern, page 7, figure 6, www.fi.se/upload/43_Utredningar/50_Statistik/40_Kreditmarknadsbarometern/2014/kmb_kv2_2014n.pdf

[2] www.almi.se/Aktuellt/Okad-utlaning-till-foretag/

[3] www.foretagarna.se/Opinion/Smaforetagsbarometern/

[4] Företagarnas finansieringsrapport 2015, www.foretagarna.se/globalassets/media/arkiv/finansieringsrapport-2015.pdf

considering these issues, it is important to consider which type of capital is required: borrowed capital (i.e. lending, provided by banks) or venture capital (i.e. equity, not provided by banks).

Revising capital requirements for particular asset classes

We believe that the purpose of financial regulation is to maintain high levels of financial stability, investor and consumer protection, and should not be a policy tool to incentivise investment decisions which might conflict with this purpose. Hence, we do not see that the road ahead to try to stimulate SME or infrastructure financing is via favourable treatment in capital requirements. All changes to capital requirements should be based on thorough impact assessments and consultations and linked to the underlying risks. Any indications of prudential incentivisation could establish a negative precedent for utilising capital requirements to influence lending decisions in order to meet non-prudential policy goals. We do not believe this is an appropriate method to stimulate such lending and could undermine the stringent credit risk standards across the EU. Instead of a reduction of capital requirements, there are other measures that would be more appropriate to incentivise capital allocation to SMEs.

Alternative ways forward

To encourage results more in line with the objectives of the Capital Markets Union, we would rather focus on a broader approach to increasing SMEs marketability and range of funding sources. Initiatives such as the modernisation of the Prospectus Directive could reduce costs for businesses to publicly raise funds and reduce barriers for SMEs to list. SME funding could also benefit from more support in the EU towards venture capital and equity financing, such as measures to encourage private investment through specialised funds or local jurisdiction initiatives such as government guarantees within their member state.

Increased standardisation of information on SMEs could decrease information asymmetry and increase investor confidence, potentially helping to increase allocation of equity investments to viable firms. Increasing focus on equity financing for SMEs could help them to both better match their structural needs as well as making capital markets more resilient. Especially for SME start-ups without steady cash flows, equity should be favoured relative to other funding sources. As such, we believe that measures that improve the operating environment for venture capital investments and SME financial information should be encouraged.

Proportionality

Regarding questions of proportionality, we believe that applying different sets of minimum rules to credit institutions only on the basis of size could prove problematic. The way the financial system is structured in a certain Member State could be a relevant reason for applying stricter requirements than suggested by minimum standards, such as those already implemented in Sweden for our four largest banks.

But we would support investigating the effects of allowing simpler, but no less strict capital requirements for smaller credit institutions in certain specific areas, especially given that the Basel agreements apply only to large internationally active banks. Such measures, if implemented, could also increase competition between banks so that smaller financial institutions can grow and increase their lending capacity to, for instance, SMEs.

In conclusion

We must ensure that any changes to the financial regulatory framework serve to reduce financial stability risks and do not introduce or enhance incentives that increase such risks. To this end, any eventual proposed changes should be subject to thorough impact assessments and consultations before introduction. Bank capital requirements should always be linked to the risk of realising unexpected losses. Such a bottom-up approach ensures that risks and capital are properly associated and assessed. An approach where an institution meeting a given threshold of capital is subject to less strict rules could introduce considerable risk.

Long-term sustainable growth, creation of new jobs and maintaining Europe's global competitiveness are dependent on a healthy and stable financial system. At the core of this system are the European banks. Therefore the long-term health of the banking system is a prerequisite to the stable funding of households and corporations, and in particular for SMEs that often lack alternative funding sources. The weakening of capital requirements to encourage lending or competition is not desirable and would most likely damage the long-term financial stability of the EU. Instead, it should be of utmost importance to deal with EU banks with high NPLs and/or low profitability. Against this backdrop, EU policymakers aiming to create sustainable long-term funding for SMEs should focus on ensuring successful implementation of the already agreed upon regulatory reform agenda for banks and the work to broaden the funding alternatives for SMEs in line with the CMU agenda.