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Basel III and SME Financing

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* The statements above only reflect the opinion of the authors.

Content

Executive Summary 1.

The new Basel III regulations and their operational implementation are currently being discussed primarily among experts. By contrast, the broader debate we need on possible economic effects, in particular on small and medium-sized enterprises (SMEs), is not taking place. This research paper therefore analyses the possible effects of the Basel III provisions on SME financing and reaches the following conclusions:

- Blanket application of the Basel III regulations to those traditionally financing SMEs could in the medium term jeopardise the stability of SME financing and thus economic recovery.
- Those providing finance to SMEs do not have the same opportunities for capital accumulation as systemically important large banks, which are the real target group of Basel III. Liquidity requirements as well as the leverage ratio further impair the operational business of a banking group which, especially in the financial crisis, has proved to be system-stabilising.
- Adapting the regulations to the various business models and the relevant specificities of national banking sectors is therefore advisable. For systemically important banks active across the EU, by contrast, full implementation should be sought in order to avoid distortions of competition.

2. Introductory Remarks

In September 2008 the insolvency of US investment bank Lehman Brothers triggered one of the worst global economic crises since 1929. One year later, the heads of state and government of the G20 states, meeting in Pittsburgh, decided to improve the resilience of the financial markets by means of new regulations on banking supervision. The Basel Committee on Banking Supervision was tasked with implementing this decision. On 16 December 2010, it published the new set of rules known as »Basel III«.

The real economy needs developed and well functioning financial markets. The experiences of the financial crisis therefore require the redesign of the rules governing financial market participants and thus also of the rules on banking supervision. However, because of the significance of the financial sector for national economies a sound analysis of the effects of any planned new regulations is advisable in order to facilitate correct procedures and to keep unwanted side-effects to a minimum. The reverse side of any sweeping restrictions on the business activities which triggered the crisis would be the constriction of activities vital to national economies, such as general lending to companies.

SMEs, with an annual turnover of up to 500 million euros, make up more than 99 per cent of all German companies and employ more than 70 per cent of all workers (see KfW Bankengruppe 2011). SMEs are therefore the growth engine of the German economy. Consequently, the financing of this sphere, in particular in the form of investment and working capital, must be ensured.

The providers of financing to SMEs are banks whose business model focuses on this. These are not necessarily major players, in other words. Rather in Germany, as in many other EU member states, these are in particular decentrally organised banks.[1] In 2009, they issued almost 60

1 In particular, savings banks and cooperative banks.

per cent of all SME loans in Germany (see DSGV 2009: 7). Although these institutions did not cause the financial crisis, but rather proved to be a factor of stability in the crisis, Basel III includes them in its regulations, at least as the regulatory process stands at the moment. This approach could indirectly impede the issue of loans to SMEs.

This research paper addresses first and foremost the substantive contents of the Basel III provisions, as well as the current status of the regulatory process. It then analyses the possible effects of the Basel III provisions on lending, focusing on the intermediaries in the German banking market which are important for SMEs. The implications for SME financing are also considered. The paper concludes with a number of proposed measures.

3. Basel III – Current Status

a) Substantive Contents

The revisions of Basel III essentially encompass three sets of issues whose effects will also be analysed here:

- changing the capital mix and raising the minimum capital ratio;
- introduction of liquidity ratios (liquidity coverage ratio and net stable funding ratio);
- introduction of a leverage ratio.

In accordance with Basel II, capital to date has comprised core capital (tier 1, for example, paid-in capital, reserves and net earnings), supplementary capital (tier 2, for example, designated reserves and long-term subordinated liabilities) and third tier capital (tier 3, for example, short-term subordinated liabilities) (see Seufert 2010: 3f). Tier 1 capital is subdivided into »hard« and »additional« capital. This will gradually increase with Basel III by 2019 from 4 per cent to 8.5 per cent, consisting of 4.5 per cent hard equity capital, 2.5 per cent capital conservation buffer and 1.5 per cent additional equity capital. This change reflects the goal of Basel III: more and »better« capital to reinforce the cushion against losses and thus the capital an institution needs to continue (so-called going-concern capital) in contrast to capital which comes into play primarily in case of insolvency (also known as gone-concern capital). The latter, in other words tier 2 capital, consequently, falls from 4 per cent to 2 per cent. The category of tier 3 capital has been dropped completely. Determining the level of the capital requirement still depends on risk weighting, market price risks and operational risks. We shall not present the changes to individual capital components in detail.

Furthermore, in future, liquidity ratios will have to be maintained which are aimed at both the short-term and longer-term stability of a bank. The liquidity coverage ratio, for example, is supposed to ensure that a bank has sufficient high-value liquid assets, on a one-month basis, to be able to cover its liquidity needs in a stress situation (for example, a partial run on the bank).

The newly introduced leverage ratio, finally, limits the total business volume, regardless of risk weighting and thus of the composition of assets, to 33 times the tier 1 capital. This key figure has hitherto been viewed as a component of the so-called Pillar 1 and thus as a reporting indicator within the framework of disclosure requirements. With the migration of this key figure to a capital requirement within the framework of Basel III the influence of this indicator has increased.

b) State of the Legislative Process

The Basel Committee on Banking Supervision has no legislative competences. The G20 states must therefore transpose the Basel III regulations into national law in order to make them binding on the banks. This is supposed to happen by the end of 2012. However, this cannot be guaranteed. The USA has not even implemented Basel II yet. For EU member states, legal transposition takes place in the first instance at EU level. At present, it is not clear whether Basel III will be transposed as a Directive or at least partly as a Regulation. As a Regulation, Basel III would be equally binding on all member states without parliamentary process and without the possibility of adaptation to national circumstances.

There are good reasons for sticking to the customary practice of implementation in the form of a Directive. In particular, Germany's decentralised banking structure and the resulting possibility of negative effects on SME financing make it necessary to provide some sort of national room to manoeuvre with regard to legislative transposition (see also Weber 2011). Since the regulations of the Basel Committee are directed primarily at large banks, the USA, for example, is applying the provisions only to these institutions (see Zeitler 2011a).

Effects of Basel III on the Banks 4.

a) General Capital and Liquidity Requirements

The newly introduced liquidity coverage ratio implies »steering effects in favour of a deposit financed business model« (see Benzler 2011: 24). Against the background of demonstrable systemic risks with regard to interbank finance these steering effects are desirable for the purpose of reducing such risks. Focusing on private deposits, however, could put pressure on margins and thus lead to a deterioration of the profit situation, in particular with regard to banks with traditional business models already financed by deposits. A »battle for private deposits« is therefore conceivable. Even though this does not directly imply a reduction in lending, the scope for forming revenue reserves and thus tier 1 capital would be curbed. In a kind of second-round effect this can reduce banks' ability to lend.

The objective of helping individual institutions, by means of more and harder capital, to operate with greater caution and resilience, and thus also to increase systemic stability (see Zeitler 2011b: 4), is to be welcomed. Against the background of the principal-agent problem, however, one might consider whether capital is the right instrument as far as instilling caution is concerned. The problem of Basel III's undifferentiated approach also comes to light at this point. The real addressees of the Basel III provisions – banks that are supposedly too big to fail – can make direct use of the capital markets for their additional capital needs. In this way, for example, Deutsche Bank and Commerzbank have already carried out capital increases by issuing new shares. The intermediary banks concentrating on SME financing – in particular, savings banks, cooperative banks and also private bankers and regional banks – must in contrast cover increased capital requirements in the first instance from retained profits. Should the mechanism just described develop, this would make capital formation even more difficult for those banks as a result of the pressure on their margins. The »illiquidity« of the capital of these banking groups also impairs the setting up of (anti-cyclical) capital buffers, since hard core capital cannot be acquired short-term via the capital market, even given attractive conditions. In these circumstances, capital cannot breathe and over the long term, in the context of Basel III, it must be increased, either through retained earnings or through appeals to shareholders.

Capital formation is also hindered by the fact that for certain institutions Basel III foresees, among other things, the gradual introduction between 2014 and 2018 of abatements for the difference between reserves and calculated expected losses from the lending business (see Benzler 2011: 14 and Basel Committee on Banking Supervision 2010: 22). Therefore, if expected losses calculated with reference to rating systems are above the reserves required under commercial law this gives rise to an additional abatement from regulatory capital. Whether the effect of this will be to shrink the volume of credit allocated is not as yet clear. Because it can be assumed that the economic risk manifesting itself in, among other things, expected losses, has already influenced the economic management of the bank. Certainly, this applies only if regulatory capital does not represent a bottleneck. If regulatory capital does constitute a bottleneck these abatements will tend to have the effect of restricting credit allocation, all the more so because the role of regulatory capital in the capital management of the bank will be increasing as against economic capital (see Rabobank Group 2011: 27).

b) Capital Requirement for SME Loans

Hitherto, in accordance with Basel II, risk-weighted assets have had to be backed by at least 8 per cent own capital. Through the so-called SME compromise, however, certain loans can be regarded as being in the retail portfolio, provided that the total volume of credit to one borrower does not exceed 1 million euros. Basically, a uniform risk weighting of 75 per cent applies to the retail portfolio. This regulation concerns approximately 94.5 per cent of all companies (see Bundesverband deutscher Banken 2005: 13). SME loans at present have to be backed with 6 per cent own capital. By means of the across-the-board increase in the minimum capital ratio to 10.5 per cent without a simultaneous adjustment of risk weighting the capital requirement will rise to almost 8 per cent in accordance with the Basel III provisions. This corresponds to a risk weighting of 100 per cent according to the existing regulation. No objective reason for this is discernible. SME loans certainly did not trigger the financial crisis. This is questionable above all in the context of other risk weightings, for example, those for European government bonds. This point was addressed in detail, for example, in 2010 by Erste Group Bank (Erste Group Bank AG 2010).

There is also a regulatory paradox: why higher capital requirements when capital cannot be used to cushion risks since falling short of the minimum capital ratio already leads to sanctions (see Benzler 2011: 19)? In future, therefore, the banks must hold a capital conservation buffer which may be reduced in times of crisis (see Zeitler 2011b: 5). As a result, this means that the average effective capital requirement is increased to over 8 per cent.

c) Impairment of Capital Allocation to SME Loans due to Capital Consumption for Securities

Basel III is accompanied by an increase in risk weightings for trading book positions and securitisations (see Rabobank Group 2011: 15). At first sight this seems to be a step in the right direction in terms of SME financing since the risk weightings for private and corporate loans remain untouched and supposedly risky positions are covered by higher capital requirements. On the assumption that trading book positions or securitisations would be disposed of in response to this increased capital requirement even regulatory risk capital would be released for SME loans. In view of the still unstable situation on the money and capital markets – in particular the market for securitisations – it is questionable, however, whether it will really be possible to dispose of transactions with risk weightings that are higher under the Basel III regime. One obstacle to disposal could be valuation losses in income statements.

By design independent of a risk weighted view is the so-called leverage ratio, also known as the modified balance sheet equity ratio. This represents the relationship between hard core capital and balance sheet assets, including off-balance sheet items. Since no risk weighting underlies this indicator it is assumed that viewed in isolation this figure provides an incentive to prefer presumably high-yield assets to less profitable transactions (see Benzler 2011: 30).

Taking all the new indicators – capital (including abatements and risk weightings), liquidity and leverage ratio – the question arises of a »regulatorily optimal« bank portfolio which meets all requirements simultaneously. Different market participants now assume that, in this form, there is no such thing, in particular if other regulatory innovations, such as the Capital Requirement Directive II are included.

d) Possible Implementation Difficulties in the Case of Banks that Finance SMEs

One operational point is the question of whether SME credit institutions have available the kind of personnel and technical capacities they need to be able to implement the new regulatory requirements in time. Implementation will require significant efforts at both the institutional and the banking association levels. Assuming that the institutions concerned as a rule are not those that caused the crisis the question arises of whether any likely increase in stability would be commensurate with the cost.

Implications for SME Financing 5.

a) Credit Crunch and Increases in the Cost of Borrowing

The effects on banks' lending conditions described in Section 3 can have a negative impact on SME financing in two ways. On the one hand, capital could represent a bottleneck. However, this is not to be understood to mean that increased capital requirements tie up resources that might otherwise be used for lending: capital should not be confused with liquidity here (see FAZ 2011 and Admati et al. 2010: 10). Certainly, capital is a limiting factor with regard to lenders' transactions. Without raising further equity or securitisation, growth potential in lending is limited. In particular, because of the current limitations on their ability to pass on default risks by means of securitisations or other instruments on the capital market banks do not have further scope for lending (see Dentz 2010: 9). On top of this comes the newly introduced leverage ratio, mentioned above, which generally limits new business. The latter can, for example, have the effect of contracting low-margin, but high-volume business, such as state-guaranteed export financing (see Bundesverband deutscher Banken 2010).

In addition, the in the end stricter requirements with regard to regulatory capital can lead to increased financing costs. Certainly, the costs at enterprise level (private costs) are not to be regarded as isolated, but rather should be weighed against the costs at the level of the economy (social costs) (see Miles et al. 2011: 2). The point of departure of this consideration – from a recent English study (Miles et al. 2011) – is that no significant connection is discernible between the leverage of British banks and GDP growth. It is worth looking more closely at these lines of argument, especially in light of the fact that clearly no significant link is discernible between customer conditions for loans and the leverage of banks in the UK and the USA.

Theoretically, based on the Modigliani-Miller Theorem it could be argued that capital costs are independent of the relationship between equity and debt. With growing capital adequacy the return requirements of equity providers fall because of the lower risk premium (see also FAZ 2011 and Admati et al. 2010: 14). Even though the assumption of frictionless markets which underlies the theory is not met, the sensitivity of customer conditions with regard to the banks' capital ratio appears to be only comparatively low. These arguments seem to point in the right direction: higher capital requirements have a beneficial effect overall: on the one hand, customer conditions clearly cannot be too sensitive to the level of the capital ratio (low private costs) and on the other hand, with rising capital ratios the probability of bank crises and associated collapses in GDP (social costs) falls. The abovementioned study examines the situation for large British banks. One key finding is the following: »These estimates illustrate that … even doubling the amount of bank capital has a relatively modest impact upon the average cost of bank funds – ranging from just under 40bps to under 10bps« (Miles et al. 2011: 27).[2] The authors come to the conclusion that a level of capital above that required by Basel III would be desirable.

The question arises of whether this is applicable to SME financiers. That cannot be assumed ad hoc. On the one hand, the argument that the Anglo-Saxon financing structure of enterprises is not directly applicable to the German equivalent is valid. On the other hand, capital costs are calculated based on the capital asset pricing model. In capital market theory, the required capital risk premium can be ascertained with this model. Precisely this is to be regarded critically with regard to savings banks and cooperative banks since both groups of institutions have development mandates and the return on equity for shareholders is not a primary performance indicator.

2 The German Bundesbank, in a simulation calculation on the effects of the Basel III capital requirements, arrives at a margin of around 50 basis points for the German market (see Deutsche Bundesbank 2010: 112).

At any rate, to these banking groups the connection between private costs and social costs is not evident. With regard to the financing structure of German SMEs, however, we can assume that the consequences of higher forwarded capital costs would be more pronounced in Germany. In this connection the Bundesbank points out that the expected capital requirements of individual banks vary and »among others are fairly low for savings banks and cooperative banks« (see Deutsche Bundesbank 2010: 112). Nevertheless, the Bundesbank also points to the danger of higher interest spreads and potential negative effects on the real economy. The effects of the introduction of the new liquidity ratios mentioned above were not examined.

Finally, it is conceivable that the banks will try to reduce the risk they have to take into account by means of stricter requirements concerning credit quality.

The conclusion must be, therefore, that even if Basel III does not lead to a fall in the volume of financing for SMEs an increase in borrowed capital costs is at least possible or access to borrowed capital will be impeded due to higher requirements with regard to credit quality.

b) Current State of SME Financing

At present, there are no concrete indications of lending bottlenecks. According to the »credit hurdle« calculated by the ifo Institute only around 24 per cent of the enterprises asked recently complained about restricted lending (see ifo Institute 2011). This is one of the lowest figures since this statistic began to be recorded. It is true that banks are clearly issuing fewer loans than before the financial crisis. In comparison to 2008 the total volume of loans in 2010 showed a fall of over 34 per cent.[3] Against this general trend, in the crisis and thereafter

3 Result of an analysis by the Bundesbank's MFI-Zinsstatistik for the period 2008 to 2010.

decentrally organised credit institutions in particular were able to ensure the stability of SME financing. For example, in Germany in 2010 the volume of lending to enterprises and the self-employed by savings banks was 317 billion euros, an increase of around 7 per cent on 2008. The same applies to the cooperative banks which in 2010 lent a total of 178 billion euros to enterprises and self-employed, an increase of around 9 per cent on 2008 (see Deutsche Bundesbank 2011).

However, the situation on the capital markets remains tense. The Western industrialised countries will not be able to reduce their new debt to zero for the foreseeable future and thus will continue to resort frequently to the bond markets. There are also the bond issues of the Euro Rescue Fund. Looking at the schedule of introduction – the commencement of higher capital requirements in 2013 – it should also be noted that this coincides with the so-called »wall of refinancing«: in other words, in 2013 and 2014 many corporate bonds and loans will fall due (see Gisdakis 2011). This increased supply will lead to rising yields and thus indirectly to an increase in the cost of bank loans.

On the other hand, SMEs are restricted in their choice of forms of financing. Traditionally, house bank loans have been SMEs' main financing instrument: around 80 per cent of the volume of financing is covered in this way (see Blättchen/Nespethal 2010: 496). Capital market related financing instruments, because of the volumes required and documentation requirements, are not available to most SMEs.

The dependence on bank loans has not led to any problems to date with regard to financing in an economic upturn. Indeed, in particular the period before the financial crisis was characterised by a surplus of both domestic and foreign loans. Furthermore, a consolidation process is to be expected among the regional banks. The volume of credit is therefore not likely to reach the pre-crisis level in the foreseeable future.

The combination of Basel III, the tense situation on the capital markets and overall reduced credit volumes can thus result in a deterioration of the SME financing situation. Whether the interim arrangements and the gradual implementation of Basel III will cushion the possible negative effects on SME financing is questionable (for a different view, see Zeitler 2011b: 5). Apart from that, the technical basis is lacking for some of the consequences of Basel III, for example, the higher capital requirements with regard to SME loans and the unrestricted application to SME financiers.

6. Measures

New capital requirements and the introduction of liquidity ratios are a logical consequence of the financial crisis and thus are necessary. The breakdown of the interbank market and the state rescue packages to support the banks' capital in the financial crisis have clearly brought it about that a readjustment is necessary with regard to levels of capital and liquidity. However, there are well-founded doubts whether the »Basel III corset« should be applied without adjustments to the banking structure in Germany. To guarantee the stability of SME financing in the future the FES Managerkreis therefore recommends the following measures:

- Basel III, as has been the practice so far, must be implemented as an EU Directive. In that way national legislators would have the opportunity to adjust the Basel III provisions to the specific conditions of the national market.
- In particular, the regulations must be adapted to the typical SME financiers which in terms of size and business model sometimes differ considerably from the large institutions that are the real addressees of Basel III. At the same time, full implementation of Basel III for systemically important EU-wide banks should be sought in order to avoid possible distortions of competition.
- A new »SME compromise« must be found for Basel III (analogous to Basel II) in order that the capital requirements for SME loans are not raised. This could happen by means of a change in risk weighting.
- Despite the stability of bank-based corporate financing in Germany, in consideration of the possible negative effects of

Basel III on SME financing further extension of capital market access for SMEs is desirable on the grounds of diversification of financing sources.

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