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SMEs, the engine of local entrepreneurship, in the framework of New Basel Capital Accord: Perspectives-opportunities and obstacles for their reinforcement by the Banking System

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Subject: SMEs, the engine of local entrepreneurship, in the framework of New Basel Capital Accord: Perspectives-opportunities and obstacles for their reinforcement by the Banking System

ABSTRACT: In the first part of my paper I will analyze the important role of SMEs as the most crucial factor for the development of the local entrepreneurship. In addition I will quote the arising difficulties in SMEs' access to loans. This part will be concluded by the presentation of the Third Consultative Paper of The Basel II Capital Accord, in relation to its impact on SMEs, focussing on the comments of the European Central Bank, World Bank Eurochabres, and of the European Private Equity and Venture Capital Association and more specifically, on those referring to SMEs.. **The second part** will refer to the Structure of the New Accord Three Pillars, focussing on the Basel II Capital Adequacy framework and specifically on the first pillar (Minimum Capital Requirement). Obviously, the said part will be completed by the consequences of the aforementioned topic for the SMEs. **In the third and last part** of my paper I will work out a critical analysis of the New Basel Capital Accord, concentrating on its pros and cons for SMEs' banking finance. Finally, my paper will contain an appendix of tables and graphs and of course the relevant references.

PART I

SMEs', THE FINANCIAL DIFFICULTIES THAT THEY FACE AND THE THIRD CONSULTATIVE PAPER (CP3) OF THE NEW BASEL CAPITAL ACCORD

1. SMEs and the financial difficulties that they face – Ways of solving it

The SME enterprises have played a very important role in the economic and regional development of the E.U's Countries and especially of Greece. In fact, about 800.000 enterprises in my Country fell into the <<small business>> category. These firms accounted for 80% of total employment in Greece. Generally, we can say that important as they are, small business are behind large companies in terms of productivity, technological experience, financial and other areas. Particularly, they often lack creditworthiness. They have trouble securing funds needed for their business activities, such as purchasing materials and products and investing in plant and equipment. Since most small companies have only limited capital resources, they have to rely on banks and other financial institutions for their funds. Banks require sufficient collateral or a well-established surety for their debtors to secure a loan. The lack of such assets or appropriate surety makes it difficult for many small business to obtain loans from financial houses.

European Union's aid for the reinforcement of the competitiveness of small medium enterprises is always of crucial importance for the development of Member-States productive environment. The European Investment Fund, (E.I.F.), by its SMEs Guarantee Facility (4 special windows), generally, provides support to Guarantee Societies, and of course, it provides also support and to the New Greek Institution. of Small and very Small Guarantee Fund S.A, in the form of counter-guarantee of commitments undertaking by it. More specifically, in the case of Greek SMEs Guarantee Fund backed by a E.I.F. SMEs Guarantee Facility, counter-guarantee, the risk is shared between the Guarantee Society and the Counter-Guarantor, without any further risk analysis. In the majority of cases, no fee is levied by the counter-guarantor, (E.I.F. SMEs Guarantee Facility), to the guarantee society, (Greek SMEs Guarantee Fund S.A.).During the period 1998-

2001, the E.I.F. SMEs Guarantee Facility. offered to cover 50% of the losses incurred by guarantee funds. In return, guarantee societies are expected to increase their risk profile by supporting higher risk SMEs investments with the objective of fostering <<growth and employment>>. Assistance, was provided either directly to guarantee societies or via publicly funded intermediaries, such as the aforementioned guarantee schemes. In fact, we can say that there will be a strong relationship between the two Guarantee Schemes. Focussing on their cooperation in the E.U's –National and Regional/Local level. Actually, we can consider the E.I.F. SME Guarantee Facility as a Counter Guarantee Fund, or as a Credit Insurance Corporation and the Greek SME's Guarantee Fund S.A., as a Credit Guarantee Corporation. The role of the above mentioned Institution, which was planned in the framework of the third CSF (2000-2006), in the context of Business Plan << Competitiveness >>, axis 2, measure 2.6. for <<the financial support and encouraging of the SME>>, is to allocate the business risk and to guarantee part of the bank loans to the SME.

Some characteristic Examples of Guarantee Schemes set up with assistance from the Structural Funds of E.U, include:

© In Italy, the Eurofidi, which is a mutual guarantee fund providing loan guarantees to SMEs. Thus, its primary objective is to facilitate access to finance for SMEs in the Piedmont Region. Moreover, it assists financial institutions in screening loan applications and in risk management.

© In Finland, Finnvera offers to SMEs three main categories of financial instrument:

- loans,
- guarantees and
- export credit guarantees.

The above case study focuses on Finnvera's portfolio of guarantee products, which are tailored according to the needs of SMEs depending on the business sector in which they operate and on their developmental needs and objectives.

The previous to the examined Institution scheme is the System of Mutual Guarantee Companies, that was founded in 1917 in France (nowadays, the

relevant Institution in France is called SOFARIS e.g. Societe Francaise de Garantie des Financements des PME. It is supported by the Banque du Developpement des P.M.E.) and simultaneously, it was developed in the majority of central Europe countries (such as Germany, where there are 2 relevant Organizations a) The Kreditanstalt für Wiederaufbau “KfW” and b) The Deutsche Ausgleichsbank “DtA”, Italy, relevant Organization “Mediocredito Centrale”, which cooperates with “Confindi” e.g. Cooperatives of Mutual Guarantee, such as Mutual Guarantee Companies, Belgium etc), during the 1980s’ decade. In the early of 1990 decade, the European Community (E.U), started to support the aforementioned Institution, in order to facilitate the Small and Medium Enterprises to obtain loans from the Banking System. In Greece, the Institution of M.G.C, was adopted in 1995, by the law 2367/1995. This System made up, in my Country, for facing the financial disadvantages of Greek Small Enterprises and reinforcing their important role, that is the creation of new jobs, by guaranteeing the repayment of their loans, which makes it easier for small businesses to borrow from the banks.

The Institution of Mutual Guarantee Companies hasn’t activate in Greece, because, no company has been established under this umbrella, due to:

- unwillingness and difficulty that face the chambers of commerce to participate in 65% of the shared fund and
- the fact that the Counter – Guarantee Institution is still pending, as the legislative framework which would govern the Mutual Guarantee Companies, has never been completed. Actually, Once the Fund was established, Companies would have to sign an agreement with it defining their rights and obligations. Moreover, an issue which might be complicated the relationship between the Counter-Guarantee Fund and the Companies, concerned the point of activation of the Counter-Guarantee Fund. There were two possibilities, either the Fund insured each loan individually or it insured the Company as a whole. In the former case, the Fund would intervene (i.e. compensate the Company) each time a loan was not repaid. In the latter case,

the Fund would intervene only once a Company had exhausted its provisions and was unable to fulfill its guarantee obligations.

The establishment of Small and very Small Mutual Guarantee Fund in Greece is governed by the Law 3066 / 18.10.2002, chapter A' and especially by its articles 1- 10.

2. The 3rd Consultative paper (CP3) of the New Basel Capital Accord and its impact to SMEs

On 10th July 2002 occurred a very crucial meeting of members of the Basel Committee on Banking Supervision. These members reached agreement on a number of important issues related to the New Basel Capital Accord that the Committee has been exploring since releasing its January 2001 consultative paper. In its discussions, the Committee has considered a range of issues related to both the standardised and internal ratings-based (IRB) approaches to credit risk. In this context, it is reaffirmed the importance of the revised standardised approach to be used by the majority of banks world wide. More specifically, as far as the SMEs concerns, the Committee approved new elements of the corporate and retail IRB frameworks and the standardised approach designed to ensure a more appropriate treatment of small and medium-sized firms under the New Accord. Thus, in recognition of the different risks associated with SMEs borrowers, under the IRB approach for corporate credits, banks will be permitted to separately distinguish loans to SME borrowers (defined as those with less than Euro 50 mn in annual sales) from those to larger firms. The deduction in the required amount of capital will be as high as 20%, depending on the size of the borrower and should result in an average reduction of approximately 10% across the entire set of SMEs borrowers in the IRB framework for corporate loans. In addition, banks that manage SMEs related exposures in a similar manner to retail exposure will be permitted to apply the retail IRB treatment to such exposures, provided that the total exposure of a bank to an individual Small Business is less than 1 Euro mn and a similar threshold will be established in the standardised approach.

On 29th April 2003 the Basel Committee, issued its 3rd consultative proposals on the New Basel Capital Accord. In August 2003, the Basel Committee published the comments received on this consultative paper and also issued a report on the high-level principles for the cross-border implementation of the New Accord. In this part, my analysis is focussed on the comments of the European Central Bank, World Bank Eurochabres, and of the European Private Equity and Venture Capital Association and more specifically, on those referring to SMEs.

- **European Central Bank** : The E.C.B. notes that the 3rd Consultative Proposals mark significant progress relative to the previous proposals of the ECBS. The improvement include, inter alia, the flattening of the risk weight curves for internal ratings based (IRB) approaches, the retail exposures, and the revised proposals for operational risk for banks or banking systems experiencing high credit margins and finally the treatment of banks exposures to SMEs, which is the main subject of my paper. But the right implementation of all the above mentioned elements, suggests a need for enhanced vigilance and close cooperation between central banks and supervisory authorities. Finishing this topic, I also would like to mention that the ECB continues to support the building up of additional financial buffers' in favorable economic times which can be used in less favorable economic conditions when, inter alia, equity financing may be more difficult to obtain on the markets. The counter – cyclical effect of such methods could be acknowledged by making an explicit reference to them in the text of Pillar II.
- **World Bank** : The World Bank supports the efforts of the Basel Committee to establish a string relationship between the empirical assessment of credit risk embedded in banks balance sheet and capital requirements. In addition, it feels that the calibration of current capital requirements has improved as a result of the quantitative exercises conducted by banks from both G10 and non-G10 countries. Furthermore, the World Bank still views the current risk weights as largely defined on the basis of evidence from G10 countries which may offer very different levels of protection in emerging economies. Going forward, the more important issues related to Pillar I, (the Pillar that I am

going to exam thoroughly in the 2nd part of my paper), on which the World Bank would like to work together with Basel Capital Accord, especially with regard to sharing cross country experiences, to provide more guidance to developing countries are the following:

-Risk weight of individual claims

-Concentration risk and

- Operational risk

In this topic, my analysis, is focusing on Risk weight of individual claims and especially on SME lending, because the definition of SMEs lending reflects standards prevailing in large industrial countries and doesn't appropriately capture the risk features of similar size firms in smaller economies. So, the discretion left to national authorities to set higher capital requirements for SMEs lending could as in the case of sovereign borrowers, be complimented by a list of criteria that could ensure some coordination among bank supervision in different countries.

- **Eurochambres:** The Chambers appreciate the results achieved since now, related to:

-Preferential treatment of Small-Medium Firms (retail loans)

-Lower risk weights for credit exposures (retail and corporate loans) of business

-Expansion of the range of eligible collateral for business

-Recognition for both external and internal credit ratings.

In particular, as far as the SMEs concerns, according to Eurochambres' estimations, the New Basel Capital Accord will still have major consequences for SMEs finances in the E.U. The most important think here is the significant progress that has been achieved in the negotiations in the Basel Committee, during the last 2 years. The proposed treatment of loan exposures to SMEs of up 1Euro million, as retail exposure, is an improvement for many loans to this category of firms, even compared to the existing capital regulations. In addition, they acknowledge that it is shown a significant reduction in the banks' capital requirements for retail loans to SMEs and in general a slight

reduction of the capital requirements for loans to SMEs. However, implementation costs in the banking sector must be kept within limits in order not to annul the advantages for SMEs. Thus, with a view to the high complexity of the 3rd consultative document, they ask the Basel Committee to reduce the volume and complexity of regulations significantly, so that the Accord can be implemented without large costs. In general, it is important that banks, (including the smaller ones), can implement an Internal Rating Based System, without disproportionate costs. Because, otherwise bank lending could become more expensive for Small – Medium Sized Firms. Moreover, there has to be a reasonable approach concerning operational risk, since that aspect reduces the room for banks to give loans to small companies. Nevertheless, the Chambers welcome the commitment of the Basel Committee that the aggregate level of regulatory capital in the banking system should not increase due to the new regulations. They also note that the Implication of the new framework for SMEs will depend very much on the discretion of the supervisory authorities. In fact, they think that some more guidance for the use of these discretionary powers of the authorities is necessary in the New Basel Accord itself. Otherwise there could be different supervisory interpretations having an indirect impact on SMEs and corporate finance and consequently a distorting effect on competition. Finally, the Eurochambres, welcome the proposals in pillar 3 (Market discipline) concerning the transparency of rating systems. For SMEs customers of banks, it is important that the criteria, under which a SME is rated, are transparent vis a vis the SME. The rating system of a bank should not be a dark horse for the SMEs ' customer. So, the relevant criteria affecting the rating of the SMEs should be transparent at least to the Small Firms itself when it is seeking and negotiating a loan.

- **European Private Equity and Venture Capital Association (EVCA):**
EVCA welcomes the further opportunity offered by the Basel Committee to comment on the 3rd Consultative Paper in respect of the proposals for a New

Basel Accord. More specifically its more crucial comments on the New Accord are:

- Banks play a crucial role in financing European Small – Medium Sized Companies by providing them with equity through private equity and venture capital houses.

- The current Basel II draft could lead to a significant retreat by banks from private and venture capital funds due to the proposed changes in risk weightings for assessing business risk.

- No quantitative assessment is publicly available regarding the exact impact of the proposed regulatory capital increases on private equity and venture capital. In short, there is a real risk that the current Basel II Paper , would not only harm the private equity and venture capital industry, but also significantly reduce annual flows of equity finance available to E.U companies (especially the Smaller ones) leaving them at a global competitive disadvantage.

- The risk weightings currently proposed for the industry do not correspond to business realities. EVCA urges the Bsel Committee to ensure sufficient flexibility in the Accord, so that by the implementation of it in 2007, the most recent risk available are used.

- EVCA urges National Supervisors to avoid the increase of risk weight for private equity and venture capital, as stated in the Standardised Approach.

- EVCA urges the Basel Committee to amend the paragraphs related to Grandfathering, in order to include positions taken until the date of implementation (end of 2006) and not till the date of publication of the final Accord.

Apart from the above mentioned, EVCA considers that more time is needed to ensure that standards not only meet the Basel Committee's aims of fostering improvements in Banks risk management and risk assessment capabilities, but also fully correspond to the changing small business realities of company financing.

PART II

THE STRUCTURE OF THE NEW BASEL CAPITAL ACCORD - APPLICABILITY, ITS OBJECTIVES / DIFFICULTIES OF IMPLEMENTATION AND ITS CONSEQUENCIES FOR THE SMEs'

1. The structure of the New Basel Capital Accord and its applicability

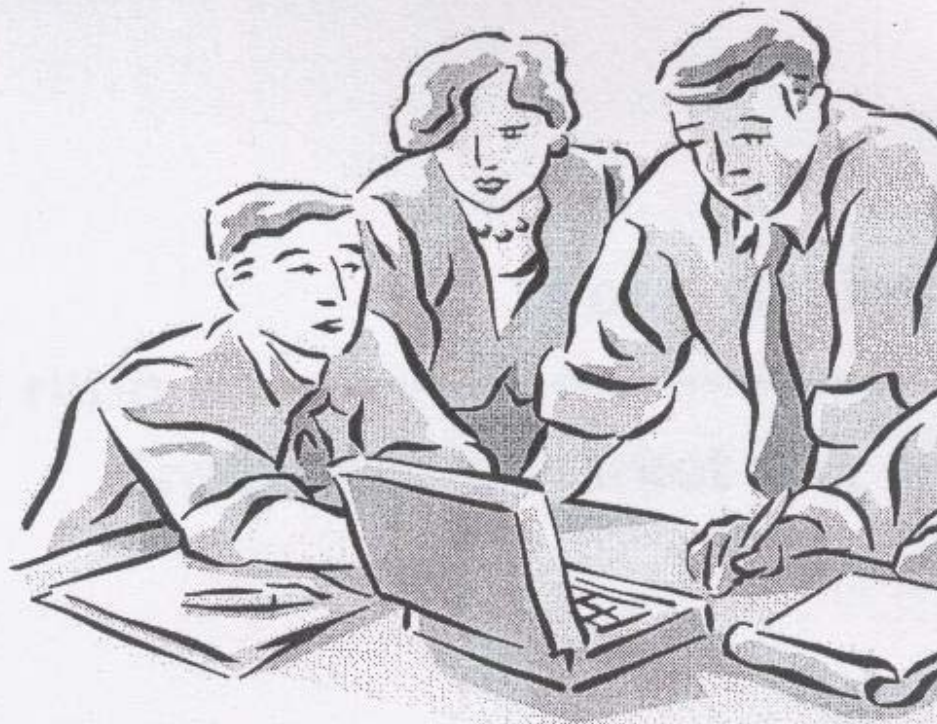
The New Framework is based on the following 3 pillars (see relative graphs of the Appendix):

- First pillar: Minimum capital requirement-Capital Adequacy
- Second pillar: Supervisory review process
- Third pillar: Market discipline

More specifically, by pillar¹:

¹ Phaidon Kalphaoglou , parts of his relative presentation in the post graduate program in <<Banking Studies>> (March, 2004)

NEW CAPITAL ACCO



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Structure of the new Three pillars

NEW CAPITAL ACCORD



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Objectives

- Better relations
- Taking
- Coverage risk
- Portfolio
- Possible requirements

Applicability

- For "internationally active banks" and on a consolidated basis on holding companies that are parents of banking groups

Difficulties

- National
- National
- National
- National

The applicability of the aforementioned structure relies on the <<internationally active banks>> and on a consolidated basis on holding companies that are parents of banking groups.

Basic Indicator Approach

- $\text{Capital} = a \times \text{Gross income}$
- $a = 17\text{-}20\%$ (provisional)
- $\text{Gross income} = \text{Net income} + \text{net non-interest income}$

PILLAR 2

2. The objectives of the New Basel Capital Accord and the arisen difficulties

The more characteristic objectives of the revision are the following:

- Better assessment of capital adequacy in relation to a bank's true risk profile.
- Taking into account hedging strategies .
- Coverage of credit, market and operational risk.
- Portfolio diversification is taken into account. and
- Possible arbitrage of regulatory capital requirements are tackled.

But unfortunately, the above mentioned, very important, objectives expected to find some difficulties concerning the involved countries and more specifically:

- Their national characteristics
- Their national accounting requirements
- Their national market conditions and
- Their national loan loss provisions.

In view of the above and for ensuring the effective implementation of the New Accord, the Committee has taken strides to clarify and simplify the structure of the revised Accord. Particular attention has been given to the market discipline component (Pillar 3), of the new framework. Thus, the Committee aims to provide investors with enough information to understand a bank's risk profile without imposing an undue burden on any institution. Accordingly, the disclosure requirements have been streamlined to focus on elements needed to accomplish this objective. Another area of emphasis has been given in streamlining the minimum standards for the Internal Ratings Based approach. These requirements were developed to ensure an appropriate degree of credibility and consistency in banks' use of internal ratings for capital purposes. The Committee has recently revisited the minimum standards. Furthermore, modifications have been made to allow for consistent application of the requirements, as well as to allow for innovation and appropriate differences in the way in which banking organizations operate. Changes have also been made to permit greater flexibility to banks in implementing the IRB approach across their various portfolios, in terms of both timing and scope. Apart of the above, the Committee will continue to look for ways to further streamline the New Capital framework, where appropriate. Generally, we can say that the

Committee is pleased with the progress made and looks forward to the successful finalization of the examined New Accord by the end of the year 2005.

PILLAR 3 Guiding Principles

- Complement to Pillar 1 and 2
- Market discipline through disclosure
- Market assessment of bank soundness
- Incentives for banks to conduct prudent business in safe and sound manner
- Incentives for banks to maintain adequate capital base

Market Discipline

3. The importance of The Basel's II New Capital Accord implementation phase and its consequences for the SMEs

A) The importance of The Basel's II New Capital Accord implementation phase

The New Accord is a complex framework in comparison with the current one. A full understanding of all its possible implications will be possible only some time after implementation, on an ex post evaluation phase. For this reason, close monitoring of the application of the New Regime will be important. In this regard, 4 issues can be highlighted²:

- First, in drawing up the agreement, the emphasis has been rightly placed on the implications of the New Accord for risk management and financial stability. The New Accord, however, is also set to have important structural implications for banks and banking systems through changing bank behavior. The very diverse effects on capital requirements for individual banks triggered by the New Accord are likely to influence their business strategies through, for example, mergers and acquisitions, a reallocation of their loan books (e.g. through credit risk transfers or a restructuring of existing transactions), an increased specialization on products and/or counterparts with a particular risk profit and a restructuring of retail banking activities in the form of revolving exposures. These structural changes will also have to be monitored closely from a central perspective.
- Second, pro-cyclicality concerns could be particularly relevant in the first phase of the implementation of the new framework when banks are adjusting to the new settings. This may require closer monitoring by central banks and supervisory authorities, so that potential problems can be detected and addressed in a timely fashion. Enhanced corporate governance by banks will also be an important complement to the activities of public authorities in ensuring a smooth transition of the new regime.
- Third, in the area of real estate lending the ECB has no objection to the new and more flexible treatment proposed under both the standardized and IRB (Internal Rating Based) approaches. However, it cautions that the extended recognition of real estate collateral should not lead to excessive real estate lending and an

overheating of property markets. This entails a need for prudent valuations by banks to prevent increases in credit availability from fuelling asset price bubbles for residential and commercial properties.

- Fourth, in the area of credit cards, the proposed reduction in regulatory capital is significant and, for some banks at least, will determine a level of regulatory capital well below the economic one. Under these circumstances, it is emphasized that excessive lending to retail customers via credit cards, especially in periods of booming economic activity, may lead to undesirable macroeconomic effects, such as increased consumer spending and increased household debt. In addition, the particularly low capital requirements for revolving retail exposures relative to similar types of unsecured personal consumer loans may have structural implications as banks could be induced to structure retail banking in the form of revolving exposures. This may hold true in particular, in E.U. countries, where unsecured consumer loans and other similar types of exposures are widely used in addition to credit cards. An expansion of the latter type of credit could have implications for banks' risk management as the mix of their risks could change (note the relative importance of operational risk for credit card based exposures). Also, the low loss rates and subdued volatility for credit cards seem to be a characteristic of the more mature US market. All the above elements suggest, as I have already mentioned, a need for enhanced vigilance and close co-operation between central banks and supervisory authorities in the implementation phase.

B) The New Basel's Capital Accord consequences for the SMEs

The debate about the effects of Basel II on SMEs is based on 2 main arguments³:

- a) The Basel II will lead to an overall increase in the cost of borrowing for SMEs.
- b) The Basel II will probably arise obstacles and consequently will reduce the supply of credit to SMEs in general.

² ECB<<The New Basel Capital Accord>> (August 2003)

³ Dorothea Schafer <<The New Basel Capital Accord and its Impact on Small and Medium Sized Companies>>, article in the Economic Bulletin, (Springer Editions, 2003)

As far as somebody understands, the aforementioned arguments, would have a negative effect on growth and employment, given that the SMEs are the main bon of the economies of E.U's countries, especially on those of Objective 1, like my Country Greece. Thus, we can say that Basel II may create many difficulties to the economies of E.U' s Member States. But before assessing the validity of these theories, it will be useful to be informed about the main characteristics of the SMEs in the majority of E.U's countries. More specifically:

- 90% of SMEs are family oriented, given that they have a maximum of 10 employees (e.g., 90% approximately, are owner managed) and an annual turnover of less than 1 EURO million.
- The average capital ratio is less than 25-30%
- The typical collateral for SMEs is either internal assets or chattel mortgages on life assurance policies and home savings agreements.
- The most of the SMEs take on long term loans.
- Very few SMEs have an external rating.
- The insolvency rate for SMEs was 1% maximum in 2001.

In view of the above, as it is obvious, the Small owned managed Business, with little liable equity capital, represent a higher statistical risk and, thus, tend to receive a lower rating than large firms, with high equity capital. For a long time, the Basel Committee didn't consider that Small-Medium Firms' typical collateral can reduce their lending risk. In addition, long-term loans are considered riskier than short-term loans. Consequently, in the light of the first 2 Consultative Papers (1999, 2001), these factors did indeed constitute a serious problem for the SMEs of the most of E.U. Countries, especially of those of the Objective 1 regions. However, their impact has been considerably weakened by the Committee's resolutions of July 2002.⁴ The above mentioned resolutions are also part of the new consultative paper that has presented in May 2003.⁵

⁴ The Basel Committee reaches agreement on New Capital Accord issues (Basel Committee press release of 10.7.2002).

⁵ The New Basel Committee Capital Accord <<Third Consultative Paper>>, (Basel 2003).

PART III

CONCLUSIONS AND PROPOSALS IN A FORM OF CRITICAL ANALYSIS OF THE NEW BASEL CAPITAL ACCORD AND ITS PROS AND CORNS FOR SMEs

1. Critical Analysis of the New Basel Capital Accord

From all the aforementioned, it is clear that The New Basel Capital Accord could lead to a significant retreat by banks, especially from private equity and venture capital funds, due to the proposed changes in risk weightings for assessing business risk. This could deprive European companies (mainly SMEs). In that framework, initially, everybody welcomes the approach of the 3rd Consultative Document to prevent negative effects arising from the implementation of the New Basel Accord, for SMEs and particularly for those whose loan volumes exceed the retail threshold by taking into account their revenues (firm size adjustment in the corporate portfolio-SME s Portfolio). But according to Eurochambres comments on the 3rd Consultative Document, this firm size adjustment should not be restricted to the Internal Rating Based Approach. So, they propose a special risk weight in the standardized approach for non-retail loans to SMEs with sales of up to Euro 50 m, which should be between 75% for retail loans and 100% for unrated corporates (in this case, the risk weight should be near the risk weight for retail loans, e.g.80%). In the IRB approach, risk weights for SMEs above the retail threshold should be lower and nearer the retail risk weights. This would also prevent a << cliff effect>> (e.g.large difference in risk weights for loans of up to E1 m and slightly above E1m). Therefore, risk weight curves for SMEs should be flattened further and the Chambres urge that this firm size adjustment should not be restricted to IRB-approach. Thus, they believe that in that way, risk weight calculations in the SME-portfolio/IRB-approach, should come to similar results to the risk weights in the proposed to the 3rd Consultative Paper approach. Furthermore, the European Private Equity and Venture Capital Association (EVCA), urges the Basel Committee to ensure sufficient flexibility in its Accord so that by the time of its implementation in 2007, the most recent risk models available are used, not those prevailing in 2002. This will avoid penalizing the private equity and venture capital industry on the grounds of a lack of impact assessment.

Therefore, EVCA urges the Basel Committee to allow itself more time to develop a framework that will not only meet its requirements in terms of soundness of the Banking System, but will also enhance the development of the European private equity and venture capital industry, whose crucial role in economic dynamism is widely recognized. In addition, EVCA urges National Supervisors not to increase the risk weight for private equity and venture capital as stated in the Standardized approach. Finally, EVCA urges the Basel Committee to amend the paragraphs related to Grandfathering ⁶ in order to include positions taken until the date of implementation (e.g. by the end of 2002) and not the date of publication of the final Accord. The Committee is reviewing carefully all the responses and issues that the industry and generally all the involving parties raised. However, it is important to underline that the Committee reached a very important agreement in mid-October of 2003, on a work plan for taking all the imposed issues and comments into account. Thus, a significant progress was made on major issues. What is most important to the Committee, is the quality and the consistency of the New Accord. At the same time, it is high need to provide banks with as much certainty as possible, while they plan and prepare for the adoption of the new rules.⁷ Consequently, we can consider that the implementation of the New Accord will require a substantial resource commitment on the part of banks and supervisors alike. So, it is important to emphasize that the efforts that banks will need to undertake to comply with Basel II, build on the efforts that some large and well-managed banks already had in train before the new framework was contemplated. According to William J. Mc Donough, President and Chief Executive Officer of the Federal Reserve Bank of New York⁸, many banks are devoting more attention to enhance tracking and assessment of the quality of the loans they make. Further, banks have been looking to strengthen their credit assessments by employing experts who don't stand to gain from overly favorable reviews. Time and effort has also been invested in working to pull all of this together

⁶ Third Consultative Paper, (CP 3), par.236, p.49

⁷ Jame Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, Keynote speech at the Market Discipline Conference, Federal Reserve Bank of Chicago and BIS, Chicago, (November 2003).

⁸ William J. Mc Donough, <<Implementing the New Basel Accord>> (Remarks, N . York, February 11, 2003)

in a management information and control system, that produces timely and accurate reports for senior management review. Thus, it is expected that much of the cost to banks of adopting the advanced approaches of Basel II will come from precisely these types of initiatives. Given that the largest banks, especially in the United States continue to grow, to prosper and to pursue new opportunities, they must simultaneously make the investments required to manage themselves appropriately. Likewise, the new framework is providing supervisors with an opportunity to enhance their ability to identify and respond to sources of banking risk and to share this knowledge within the supervisory community. The Basel Committee was established precisely to maintain an open and constructive dialogue among banking supervisors. This spirit of communication will be more crucial than ever, as the framework is adopted across national jurisdictions. In order to ensure that market competition is driven by each bank's strengths, rather than by differences in each country's regulatory capital rules, the Committee established the Accord Implementation Group. This group, comprised of senior line supervisors, is responsible for promoting the consistency and quality of implementation of the New Accord. Moreover, the group has been established to facilitate the exchange of information among national supervisors about banks and supervisory practices. And this is something that we view as being critical to successful implementation of the New Accord. Therefore, the sense of all the above is that banks have both the desire and commitment to continue to develop their internal ratings systems in a manner consistent with the ideals embodied in the IRB framework. The discussions with the industry have also highlighted a number of areas, where banks may need to expand their efforts in preparing for implementation. These measures include the design and structure of rating systems, the availability and quality of credit data and the role of corporate governance in evaluating bank assessments. To conclude this part of conclusions and proposals of my paper, I would like to underline, that the Banking System in order to be ready for facing the new standards of the New Basel Capital Accord, should therefore, continue strengthening the collaborations between central banks, monetary authorities, bankers and private sector. In this regard, central banks have to provide the infrastructure where financial markets rely on, so that the best practices can be

adapted. In addition, it is also very important to harmonize and standardize the structure of the financial institutions, skills and regulations with the New Basel's Capital Accord demands.

2. Pros and cons of the New Basel's Capital Accord Implementation for the development of SME's

The adjustments made by the Basel Committee have a specific impact on SMEs.

In fact, they are characterised by 2 main elements:

- The menu of risk weight functions, that was extended by a special function for corporate exposures to SMEs borrowers where the aggregate amount of loans is higher than 1 euro million and the annual sales are less than 50 million euro⁹.
- The eligibility criteria for classification in the private and retail sector have been made much less stringent. More specifically, all loans to enterprises under 1 euro million are now classified in this segment as long as they are given a standardised loan and lending treatment¹⁰. Classification in the retail sector also has the advantage that the rating procedure is less complicated. Instead of an individual rating, multiple rating pools can be formed. Thus, we can say that only the collateral and the delinquency status of the individual borrower are verified. These loans are also exempted from the obligatory annual update required in the case of full-scale rating.

The instruments for risk mitigation also contain elements that specifically concerns SMEs. The typical collateral held by SMEs is now recognised as risk mitigating but only on condition that the ratio of the value of the collateral to the value of the loan does not fall below 30% (0% for receivables). The secured part of the loan is then calculated on the basis of minimal of over-collateralisation, which varies according to the type of collateral.

Apart from the above mentioned:

⁹ Basel Committee on Banking Supervision : The New Basel Accord, (3rd Consultative Paper, Basel 2003, p.50)

¹⁰ Basel Committee on Banking Supervision : The New Basel Accord, (loc.cit.,p.47)

- As the general increase in cost of borrowing concerns, it is considered that the adjustments introduced in July 2002, are extremely important as regards the estimation that the Basel II will lead to an increase in the cost of borrowing. For example, the size structure of SMEs in Germany suggests that most SMEs loans can be classified as private/retail exposures.¹¹ In that view, all are agreed that the capital requirement will increase for marginal segments. SMEs loans with an extremely weak credit rating and those that are either too large for classification in the private/retail segment or are largely unsecured will require more equity capital than to date. However, even for this category it is difficult to estimate to what extent this will result in an increase in borrowing cost. On the one hand, the possibility to pass on increased capital costs suggests that the margins will not change from the situation under Basel I. However, it will be less the bank itself than the competitive situation that will decide to what extent this can occur. On the other hand, there is always the possibility that loans will open the door to other profitable transactions with the enterprise in question (e.g. administration of assets for the management, the management of interest and exchange risks). In such case, it can be more profitable for the bank to refrain from passing on increased capital costs in full. These considerations are confirmed by an Ernst & Young study. The banks surveyed plan to continue avoiding passing on costs in full if they are adequately compensated by other transactions. The segment in which there will undoubtedly be a higher capital requirement and thus higher financing costs is that of equity investments.
- Referring to the reduced credit supply, we can say that a reduction in lending to SMEs can originate either on the demand or the supply side. A decline in demand would be likely, if loans to SMEs became more expensive overall. However, a reduction for demand in this reason is not inevitable for the quantity response depends on the price elasticity of demand in the various credit-rating segments. But it has been shown above that the Basel proposals on capital requirements are

¹¹ Dorothea Schafer <<The New Basel Capital Accord and its Impact on Small and Medium Sized Companies>>, article in the Economic Bulletin, (Springer Editions, 2003)

unlikely to lead to an increase in borrowing costs. A supply-side reduction would be possible, if the following 3 conditions were fulfilled:

- a) Regulatory capital is scarce, in other words, the banks are operating close to the limit prescribed by the supervisory authority.
- b) Basel II leads to an increase in the capital requirement for a bank's entire SME loan portfolio and,
- c) The bank has more profitable alternatives , (e.g. loans to large enterprises or investment banking activities).

Overall, there is currently nothing to suggest that the capital requirement for SME loan portfolios is rising. But even this were the case, a reduction in credit supply could not be blamed directly on such a development. Capital costs are opportunity costs. Given that equity capital must be kept in hand for investment and trading activities, the opportunity costs for SMEs loan where capital is available are measured accordingly to the lost earnings from securities transactions or from loans to large enterprises. So, if the banks can earn higher profits from such alternative uses than from SMEs loan, then a supply – side reduction in lending can be expected. However, it is difficult to achieve higher profits in securities trading and in the highly competitive large loans segment . For all these it is obvious that if the margins are low enough (low opportunity costs), then additional capital will be freed up which could be used to back SMEs loans.

To conclude, I think that it is very important to underline that the declared aim of Basel II is the differentiation between good and bad risks and to distribute risk costs according to the quality of the respective risks. If this approach really forces SMEs banks to keep more capital on hand than in the past , then the increase would indicate that there has been inadequate protection against unexpected default risks to date. But, according to German Bundesbank¹² the most important thing is that the goals of a stable banking system and sufficient financing for SMEs may clash, at least in the short term.. Because of the extreme importance of a stable banking system for the

¹² German Bundesbank <<Credit Institutions capital viewed from a business and a regulatory perspective >> (Monthly report , January 2002, p.48).

economy of the Member States of the E.U. a conflict of goals of this kind , certainly cannot be resolved by subordinating the goal of stability to that of financing. One way to avoid the conflict might be to consider expanding the programs that promote better creditworthiness. However, this solution would also lead to opportunity costs, whose economic effect would be to have assessed.

Until recently, the discussion about the impact of Basel II on SMEs financing was held largely under the assumption of the worst-case scenario. Following the adjustments agreed in 2002, it is unlikely that such a scenario will ever become reality. In addition, one of the basic assumptions, in the discussion is that the SMEs sector is not capable of responding with adjustments of its own. Actually, Basel II could also act as a kind of mandatory cure that compels SMEs to adopt risk mitigating measures in their own interest and to thus improve their ratings.

For all the aforementioned arguments, it is arising a widespread belief , that banks, especially in Germany, (according to the relative reports of the German Bundesbank), are already extending loans in line with the new capital adequacy framework. Thus, if somebody follows that argument, then the German Bundesbank's view that the most recent reduction in net lending is mainly cyclically determined and is a further indication that the New Basel Capital Accord will not lead to any dramatic changes in SMEs access to loans.¹³

¹³ German Bundesbank << The development of bank lending to the private sector>> (Monthly Report , October 2002, p.40).

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APPENDIX

Standardised Approach

- Bank activities are divided into standardised business units and lines
- For each business unit and line an indicator is extracted to serve as a proxy for the amount of operational risk and a beta factor for the sensitivity

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Business Units

Investm
Banking

Banking

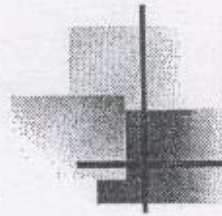
Others

Standardised Approach

- $K_{\text{retail brokerage}} = b_{\text{retail brokerage}} \times \text{Gross Income}$
- $\text{Total Capital} = \sum K_{1-8}$

PILL SUP PRO

- Banks' Capital Adequacy
- Supervisory Capital Adequacy
- Supervisory Capital Adequacy



Capital Adequacy

| | AAA to AA- | A+ | BBB+ to BB- | BB- |
|------------------|------------|-------|-------------|-------|
| | AA- | To A- | BBB- | To B- |
| Sovereigns | 0% | 20% | 50% | 100% |
| Banks (option 1) | 0% | 20% | 50% | 100% |
| Banks (option 2) | 0% | 20% | 50% | 100% |
| Banks (option 2) | 20% | 20% | 20% | 50% |
| < 3m claims | 0% | 0% | 0% | 0% |
| Corporations | 20% | 50% | 100% | 100% |

Total Capital

Capital ratio = -----

Credit risk + Market risk +



Approaches

Approaches

- **Menu of approaches to measure credit risk**
 - Standardised Approach
 - Foundation Internal Rating Based Approach
 - Advanced Internal Rating Based Approach
- **Menu of approaches to measure market risk**
 - Standardised Approach
 - Internal Models Approach
- **Menu of approaches to measure operational risk**
 - Basic Indicator Approach
 - Standardised Approach
 - Advance Measurement Approach

7

Stan

| | |
|--|----|
| | AA |
| | AA |
| Sovereigns | |
| Banks (option1) | |
| Banks (option2) | |
| Banks (option2 <3m claims) | |
| Corporations | |

IRB approach

- Categorization of exposures
- Risk components
- Risk weight function
- Minimum requirements

Categ expo

- Corpor
- Retail
- Sovere
- Bank p
- Equity
- Project
- **each p**
- **metho**

Standardised Approach

| | AAA to AA- | A+ to A- | BBB+ to BBB- | BB+ to B- |
|--|------------|----------|--------------|-----------|
| Sovereigns | 0% | 20% | 50% | 100% |
| Banks (option1) | 20% | 50% | 100% | 100% |
| Banks (option2) | 20% | 50% | 50% | 100% |
| Banks (option2 <3m claims) | 20% | 20% | 20% | 50% |
| Corporations | 20% | 50% | 100% | 100% |

IRB approach

Example

- Loan 100 E + 100 E committed
- PD=0.5
- LGD=50%
- then EAD=175E
- risk weight = $(50/50) \times 74 = 74$
- or $12.5 \times 50 = 625$
- RWA = $74 \times 175 = 129,5 \text{ E}$

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Credit mitigation techniques

- Collateral
- Netting
- Guarantees and credit derivatives
- Mismatched exposures

Cred

- Rec
- Risk
- PD
- LGD

Ha

- A ha
- colla
- vola
- A ha
- Adj
- adju
- Hair
- esti

The concept

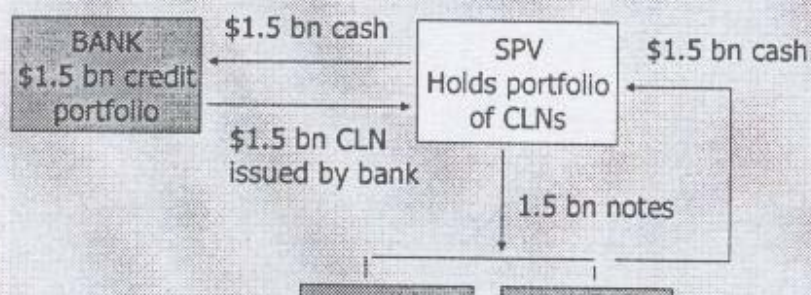
- Traditional securitisation: legal or economic transfer of assets or obligations to a third party (SPV) that issues asset-backed securities (ABS) that are claims against specific asset pools.
- Synthetic securitisation: structured transactions in which banks use credit derivatives to transfer the credit risk of a specified pool of assets to third parties.

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Trad

BANK
\$1.5 bn credit
portfolio

Synthetic Securitisation



Cred

R
TOTAL DATE OF RETIR

PD estimation

Own estimates (default experience, mapping external data, external models)
subject to :

- floor of 3 basis points (0.03%)
- average PD for each borrower grade
- one year time horizon
- forward looking

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PD e

Definition

Default has events ha

- firm is un
- credit loss of the firm
- firm past
- firm has f protection

LGD estimation

- Foundation approach
- Claims without collateral → LGD= 50%
- Subordinated claims without collateral → LGD =75%
- *Credit mitigation*

EAD

- Foundati
- On balan
- Off balan
- Transact drawdown
- OTC deri