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2015.10.01

FBF RESPONSE TO EBA DISCUSSION PAPER AND CALL FOR EVIDENCE ON SMEs AND THE SME SUPPORTING FACTOR (EBA/DP/2015/02)

I- General comment

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

The FBF welcomes the opportunity to comment on the EBA's discussion paper and call for evidence on SMEs and the SME Supporting Factor. Please find our main comments below and our detailed feedback within our answers to the EBA's questions.

From our perspective, the Supporting Factor has played a key role in allowing French banks to support and finance SMEs. Even if it is difficult to highlight the direct effect of this factor due to the wide range of elements influencing lending conditions, it is fair to say that the steady improvement of access to bank financing of SMEs would not have happened so rapidly without the relief provided by the supporting factor –indeed, cost of capital is a key issue for banks. Therefore we strongly advocate for maintaining the regime provided for by article 501 of the CRR. We note that French banks credit lending and assessment policies and procedures duly take into account the introduction of the SME Supporting Factor.

However we note that there are currently a number of different SME definitions. Having a harmonised definition would simplify the reporting and reduce the potential for misunderstanding. Therefore we fully support a harmonised definition of SME's for prudential purposes that would include not only medium sized companies but also micro-entrepreneurs and start-ups.

We think that such a harmonisation would also ensure a level playing field across all EU Member States.

Therefore we invite the EBA to adopt a wider approach to the matter of SMEs bank financing and consider the supporting factor as only one, albeit important, piece of the framework the European Commission is building as part of the Capital Markets Union project, with the ultimate objective to ensure accessibility and availability of capital and funding for SMEs.

II- <u>Answer to questions related to the consultation</u>

Q1: Do you have systems in place to track the reduction in capital due to the application of the SME Supporting Factor (capital relief)? Yes/No. Please explain and provide evidence.

The reduction in capital due to the application of the Supporting Factor must be reported in the COREP. The data reported for both Standard and IRB approaches include the total RWA before and after application of the Supporting Factor.

Banks have set up internal systems to collect relevant data to feed their internal monitoring and reporting systems (including COREP reports). The aforementioned systems are specific to each bank and adapted to their organization.

We would like to take this opportunity to raise the following issue regarding the interpretation of article 501 of the Capital Requirements Regulation (« CRR »). The conditions laid down by article 501 of the CRR contemplate:

- Inclusion of the counterparty in the retail or corporate portfolio ;
- Compliance of the counterparty with the definition of SMEs pursuant to the Commission Recommendation 2003/361/EC ;
- Exposure to the counterparty must not exceed EUR 1.5 million.

We infer from these conditions that the application of the Supporting Factor is not subordinated to the purpose of the loan granted to the SMEs. We kindly request the EBA to confirm our interpretation.

Q2: In your experience, is the reduction in capital requirements due to the application of the SME Supporting Factor (capital relief) being used to support lending to SMEs? Yes/No. Please explain and provide evidence.

From our perspective, the Supporting Factor has played a key role in allowing French banks to support and finance SMEs. Therefore we strongly advocate for maintaining the regime provided for by article 501 of the CRR.

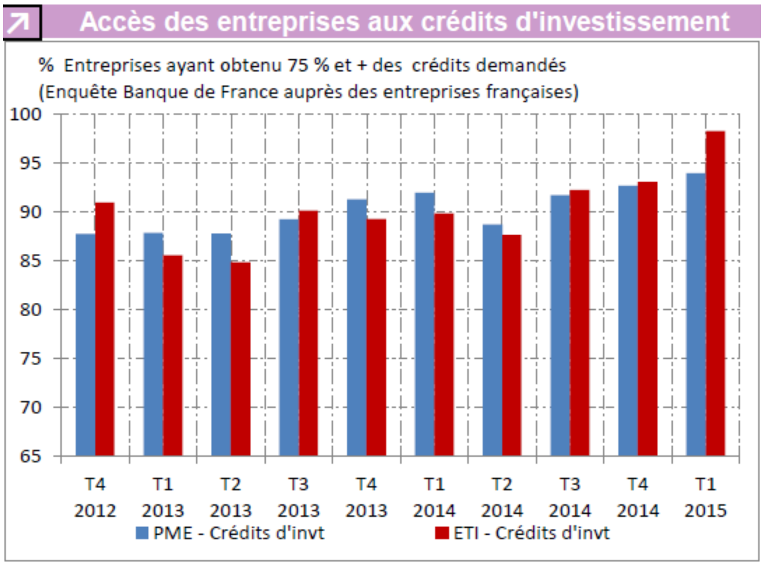
We also consider that:

- **it is premature to draw any final conclusion on the effect of the supporting factor considering its recent implementation date;**
- **it would be inappropriate to repeal this provision at a time when the economy is picking up;**
- **the EBA should adopt a wider approach to the matter of SMEs bank financing.**

As a matter of fact, French banks have continuously granted loans to SMEs to support their development and investment projects. Following the implementation of the Supporting Factor, in particular, the decline in loans granted to SMEs was clearly reversed as shown in (please see annex).

Furthermore, the acceptance rate for loan applications has always remained high during the crisis and did increase after the implementation of the Supporting Factor.

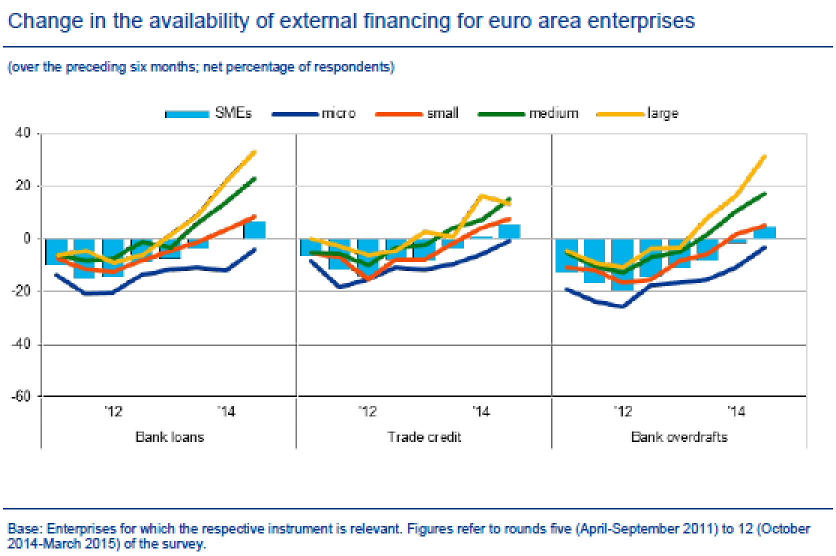
As an illustration the following graph shows that even during the crisis, applications for a loan from French SMEs to support a solid and relevant project would be successful in more than 85% of the cases (the blue bar represents SMEs, the red bar represents medium *size companies meeting the following criteria: 250<employees<2500; EUR 50 m<turnover<EUR 1.5 bn; EUR 43 m<total assets<EUR 2bn).*



Source: Banque de France.

Moreover, according to different studies released over the last months, access to finance for SMEs and more particularly access to bank financing has improved in 2015 compared to previous years.

In the June 2015 issue of its Survey on the access to finance of enterprises in the euro area (“**SAFE**”)[1], the European Central Bank (“**ECB**”) points out that for the period from October 2014 to March 2015, small enterprises reported a “*sizeable improvement in net terms*” of bank financing (loans and overdrafts) while medium sized-enterprises reported a significant improvement.



Sources: ECB, SAFE (June 2015)

[1] « Survey on the access to finance of enterprises in the euro area - October 2014 to March 2015 », June 2015, European Central Bank : https://www.ecb.europa.eu/press/pr/date/2015/html/pr150602.en.html

According to respondents to the ECB's survey, availability of bank loans improved significantly in Germany and Spain. Respondents also considered that difficulty in accessing trade credit eased in Belgium (-4%), France (-5%), Italy (-4%), Austria (-5%) and Finland (-1%).

In particular two key indicators should be highlighted:

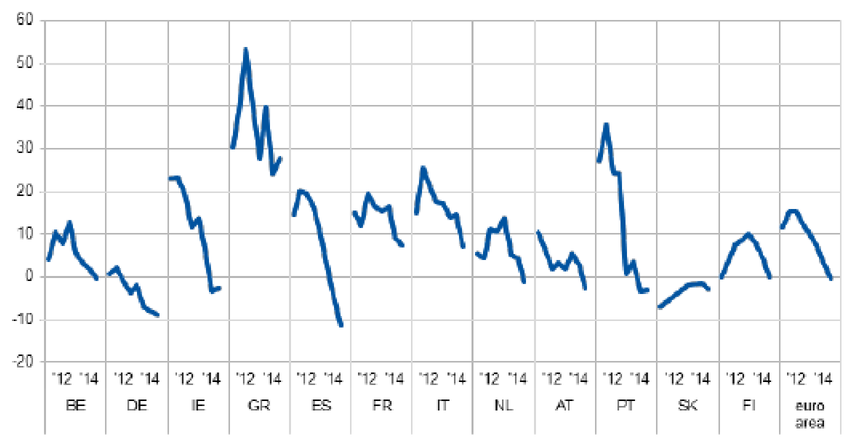
- the **external financing gap**, measuring the perceived difference at firm level between the need for external funds[2] and the availability of funds ;
- the overall **indicator of financing obstacles** defined as the total – expressed in percentages across the euro area – of SMEs reporting rejections of loan applications for which only a limited amount was granted, and loan applications which resulted in an offer rejected by the SME due to high borrowing costs, as well as the total of SMEs not applying for a loan for fear of rejection.

As regards to the latter, the indicator of financing obstacles declined from 16% in the previous survey to 13%.

Regarding the external financing gap, it has been reduced to zero (from 3% in the previous survey) for SMEs in the euro area : France and Italy reported still positive but clearly declining net balances ; a zero balance was recorded in Belgium and Finland; most other countries reported a negative financing gap.

Change in the external financing gap perceived by SMEs across euro area countries

(over the preceding six months; weighted net balances)



Base: SMEs for which the respective instrument is relevant. "Non-applicable" and "Don't know" answers are excluded. Figures refer to rounds five (April-September 2011) to 12 (October 2014-March 2015) of the survey.
Note: The financing gap indicator combines both financing needs and availability of bank loans, bank overdrafts, trade credit, and equity and debt securities at firm level. For each of the five financing instruments, an indicator of a perceived financing gap change takes the value of 1 (-1) if the need increases/decreases and availability decreases/increases. If enterprises perceive only a one-sided increase/decrease in the financing gap, the variable is assigned a value of 0.5 (-0.5). The composite indicator is the weighted average of the financing gap related to the five instruments. A positive value of the indicator suggests an increasing financing gap. Values are multiplied by 100 to obtain weighted net balances in percentages. For details, see Ferrando, A., Griesshaber, S., Köhler-Ulbrich, P., Perez-Duarte, S. and Schmitt, N., "Measuring the opinion of enterprises on the supply and demand of external financing in the euro area", in *Proceedings of the Sixth IFC Conference on "Statistical issues and activities in a changing environment"*, Bank for International Settlements, Basel, 28-29 August 2012, IFC Bulletin, No 36, February 2013.
In Slovakia, the survey was initially conducted every two years (H1 2009, H1 2011 and H1 2013). As from 2014, Slovakia is included in the sample in each survey round.

Sources: ECB, SAFE (June 2015)

According to the ECB's survey, the main concern for SMEs is **"Finding customers"** with 26% of SMEs in the Euro area ranking this as a top issue, followed by:

- **"Availability of skilled labour"**, **"Cost of production"** and **"Competition"** (14%),
- **"Regulation"** (13%),

[2] Including bank loans, bank overdrafts, trade credit, equity and debt securities.

- "**Access to finance**" (11%).

Access to finance is at the time being the least important issue for SMEs.

The steady improvement of access to bank financing for SMEs would not have happened so rapidly without the relief provided by the supporting factor. Nevertheless, we acknowledge that since the supporting factor was introduced on 1st January 2014, it might be too early to draw any definitive conclusion regarding the impact of article 501 of the CRR.

Therefore we consider that it would be premature to envisage any termination of the Supporting Factor before this particular provision had a chance to produce its full effect over a complete economic cycle. This is all the more important that access to finance for SMEs have been impacted over the last years by other economic factors, starting with economic growth and outlook.

As a matter of fact, financing need, or demand, from enterprises is a major driver for financing activities and considering the poor economic conditions and outlook of the last few years, these needs have decreased in proportion with the economic downturn.

As indicated in the June 2015 ECB's survey, Euro area corporates have however reported an increase in their need for external source of financing and more particularly for bank loans (3% of SMEs reported an increase in their need for bank loans, up from 1% in the previous survey round). SMEs in France, Spain and Italy have thus recently reported increasing financing needs. These needs, particularly for French SMEs, are mainly related to fixed investment and working capital financing. **We believe that it would be inappropriate to consider suppressing the supporting factor at a time when SMEs are facing an improved economic outlook, offering better investment prospects and increasing need for bank financing.**

Finally we invite EBA to adopt a wider approach to this matter of SMEs bank financing and consider the supporting factor as only one piece of the structure the European Commission is building as part of the Capital Markets Union project, with the ultimate objective to ensure accessibility and availability of capital and funding for SMEs. All new measures taken or legislation adopted in this regard, or amendment to existing measure or legislation, should be consistent with this ultimate objective given the fundamental role SMEs play in creating economic growth and providing employment in the EU.

As a matter of fact bank financing for SMEs is likely to be significantly impacted by several ongoing reforms representing major regulatory challenges for credit institutions. These reforms notably include the Basel Committee's revision of the standardised approach for credit risk and the introduction of capital floors. Moreover the adoption of IFRS 9, which application is mandatory from January 1st 2018, is expected to increase impairments on SME's exposures by substantial amounts.

Q3: Is your internal definition of SMEs in line with the definition of SME exposures subject to the SME Supporting Factor? Yes/No. If no, how are you reconciling the internal definition of SMEs with the definition of SMEs subject to Supporting Factor? Please explain and provide specific examples.

French banks' definition of an SME is in accordance with Commission Recommendation 2003/361/EC concerning the definition of micro, small and medium-sized enterprises.

We would like to take this opportunity to stress the fact that the way the supporting factor is applied to SMEs leads to a cliff effect. Indeed medium-sized companies with a turnover above 50MEUR would not qualify as a SME from a prudential standpoint, therefore the cost of capital of a loan granted to these medium-sized companies would mathematically increase by 30% all things being equal. Given this unintended effect related to the supporting factor measure, there is an incentive to stay under the 50MEUR turnover threshold. Such effects are well known and constitute a brake on the development of corporates from an SME to a medium-sized company. We think it would be very simple and efficient to smooth this unintended effect by extending the supporting factor to the medium-sized companies' sub-portfolio.

Q4: In monitoring the total amount owed to you, your parent and subsidiary undertakings, including exposures in default, by the borrower and its group of connected clients (as defined in CRR Article 4(1)(39)), what reasonable steps do you take to ensure that amount does not exceed EUR 1.5 million in accordance with Article 501(2)(c)?

We would like to take this opportunity to raise the issue of the 1.5 million euros threshold.

Article 501 CRR provides that the supporting factor shall apply to exposures meeting the conditions laid down in the second indent and particularly, where the total amount owed to the institution, parent undertakings and subsidiaries, does not exceed 1.5 million euros.

Since the goal of the supporting factor is to ensure a regular and sufficient flow of bank lending to SMEs, we don't see the rationale of the 1.5 million threshold. Moreover and as highlighted above, we believe that this limitation could be detrimental to medium sized-enterprises. Therefore we propose to remove the 1.5 million euros threshold.

Q5: Do you see merits in having a harmonised definition of SMEs for reporting purposes? Yes/No. Please explain and provide specific examples.

We fully support a harmonised definition of SME's for prudential purposes that would include not only medium sized companies, as suggested in our answers to question 3 and 4, but also micro-entrepreneurs and start-ups. All of these counterparties should benefit from a more favourable prudential treatment.

Q6: Do you agree with the proposed measures of SME riskiness? Yes/No. Are some of these measures more relevant than others? Yes/No.

SMEs as defined by the Commission Recommendation 2003/361/EC constitute a rather varied population considering the different sub-categories (medium-sized, small and micro enterprises).

In fact, according to the SMEs Observatory[3] and based on studies carried out by the French National Institute for Statistics and Economic Research (INSEE), the smaller the size of the companies the more heterogeneous they are[4].

This implies that the measures proposed by the EBA may not all be relevant for part of the SMEs population and that other non-financial criteria should also be taken into account when assessing the riskiness of SMEs including the business sector, the age of the SMEs and its Senior management (please refer also to our answer to question 7). The financial ratios described in EBA's Discussion Paper, for instance, are based on historical financial information that could be more or less relevant depending on the age of the SMEs. We would also like to point out that financial data are often more difficult to collect for SMEs than for large public companies.

Q7: Are other aspects relevant in your assessment of the creditworthiness/riskiness of potential SME borrowers? Yes/No. If yes, please provide a list of those aspects and explain how you measure SME riskiness.

The following criteria could be relevant in assessing riskiness of SMEs:

- Business model;
- Age of the company;
- Life stage of the products;
- Size of the markets;
- The extent to which the company is dependent on
    - patents or licences;
    - industrial, commercial or financial contracts;
    - clients and/or suppliers; new manufacturing processes;
    - key persons;
- Senior executive management experience;
- Composition of management or supervisory board;
- Structure of the company's shareholder equity;

Q8: In your experience, are SMEs as cyclical or more/less cyclical than large enterprises?

In our experience, cyclicality of SMEs depends on their relevant business sector. According to the SMEs Observatory, SMEs are mostly present in business sectors likely to be significantly impacted in case of an economic slowdown, such as consumer services, restaurants, construction and retailers.

[3] Established in 2010 the SMEs Observatory comprises all key actors of entreprises financing in France including representatives of companies and professional organisations, public institutions (Bpifrance, Caisse des Dépôts et Consignations), the Banque de France and the French National Institute for Statistics and Economic Research (INSEE) ; the observatiry is chaired by the Credit Ombudsman.

[4] « Rapport sur le financement des TPE en France » (Juin 2014), Observatoire du Financement des Entreprises.

Moreover due to their size and often more fragile financial situation, SMEs are more likely to be impacted by any downturn.

Q9: Do you agree with the proposed methodology to assess the own funds requirements in relation to SME riskiness? Yes/No. If no, please provide alternative methodologies or indicators, if available.

We acknowledge that the EBA has launched an “empirical project” to investigate the issue of consistency of own funds requirements with the riskiness of SMEs. We hope that EBA will make this report available, if conclusive, and allow professionals to comment on it.

Nevertheless we would like to take the opportunity to ask the EBA if such study could be useful for the discussion with the Basel Committee on the revision of the standardised approach for credit risk and the introduction of capital floors.

Q10: Did the arrears and loss experience in 2009/2010/2011 exceed an (internal) limit? Yes/No. Were (expected/unexpected) losses adequately covered by loan loss provisions? Yes/No. Please explain and provide specific figures.

Please see our answer to question 11.

Q11: Do you agree with the above interpretation of statistical data on lending trends and conditions? Yes/No. If no, please explain.

Generally speaking, we agree with the EBA’s interpretation of lending trends. However we would like to comment on the following points.

- **Increasing volume of new lending**

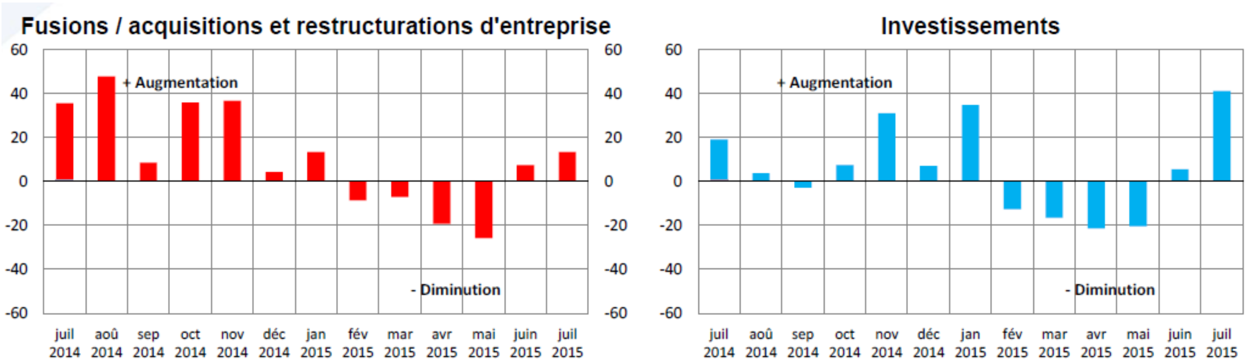
Despite a sluggish economy in 2014, credit to enterprises in France has increased by 2.2% in 2015, against 0.2% last year according to **the French Credit Ombudsman (“Médiateur du Crédit”)**. France is thus one of the largest countries in the Euro zone where credit flow to enterprises is increasing.

This momentum can be explained by evolutions of both demand and supply of credit, since the flow of credit does not only depend on the willingness of credit institutions to lend.

As regards to demand, surveys from the ECB (SAFEs) covering the periods from April 2014-September 2014 and October 2014-March 2015 show a steady increase in financing need from SMEs (please see also our answer to question 2). This trend is confirmed by statistics published by the Banque de France and based on a monthly Bank Lending Survey collecting qualitative data among French banks.

The last update of this survey published by the Banque de France, shows an increase in July 2015 of financing need for SMEs due to investments and, to a lesser extent, M&A transactions[5].

Financing need for corporates



Sources : Banque de France

Nota Bene:

- **The graph on the left shows financing need in relation with M&A transactions and company restructuring ;**
- **The graph on the right shows financing need due to investment projects.**

Increasing financing needs are in direct relation with the improvement of SMEs financial conditions in EU over the last 12 months (in the last edition of the SAFE, dated June 2015, a net percentage of SMEs within the Euro zone reported an increase in turnover).

As regards to supply, SAFEs show strong improvements in the conditions of access to credit for SMEs. As of today, approval rates for credit applications in France are among the highest within the Euro zone.

- **Conditions of access to credit have improved for SMEs**

According to **the Credit Ombudsman 2014 Annual Report**[6] 3 565 cases were filed with the Credit Ombudsman in 2014, down 16% against the average number of filings over the last two years. Nearly all these cases are related to the rejection of a credit application from an SME.

This decrease is due to gloomier economic conditions in 2014 impacting SMEs financing need (both working capital and investments) but, first and foremost, to a significant improvement of access to bank financing. According to the Banque de France, during the last quarter of 2014 (2014 Q4), 79% of SMEs which applied for a short-term lending were granted a loan, totally or in large proportion, compared to 68% in 2013 Q4. As regards investment lending, the acceptance rate rose from 92% in 2013 Q4 to 93% in 2014 Q4.

Access to credit is still difficult for one SME out of 8 according to Bpifrance, a public investment bank, but the reasons for such difficulty lay with the poor financial condition of the SME as well as its lack of profitability and prospects.

[5] https://www.banque-france.fr/uploads/tx_bdfstatistiquescalendrier/2015-07-stat-info-enquete-mensuelle-aupres-des-banques-sur-la-distribution-du-credit.pdf

[6] « Médiation du crédit aux entreprises », Rapport d'activité 2014 : http://www.economie.gouv.fr/files/files/directions_services/mediateurducredit/pdf/RapportAnnuel_MDC_2014.pdf

- **Rejections of credit application are linked to the financial condition of the SMEs**

According to the SMEs Observatory, overall statistics regarding access to credit in France are consistent with statistical reports on the financial condition of SMEs and, more particularly, micro-enterprises. In its report on micro-enterprises financing, published in June 2014, the Observatory pointed out for instance that although 39% of micro-enterprises had no, or only partial, access to credit facilities this proportion was to be viewed in light of the fact that one third of these companies were experiencing difficult situations with insufficient or negative own funds.

More recently, the Credit Ombudsman highlighted two other factors which could influence a rejection decision:

- access to bank financing depends on the type of loan the SME is applying for ; banks are more keen on extending investment credit to support an SME in its development than on lending short term credits to finance the company's working capital ;
- access to bank financing also depends on the SME's business sector; as a matter of fact companies in wholesale, construction, textiles and clothing sectors experienced more difficulties to obtain a loan.

- **French Banks are committed to SMEs**

Following recommendations issued by the SMEs Observatory mid-2014, French banks strengthened their commitment to ensure smooth relations with SMEs and a swift dialogue regarding credit applications, involving in particular commitment from banks to:

- reply to any complete application within 15 days;
- explain rationale of any credit application rejection;
- inform applicants of all means of recourse available;
- improve SMEs' financial literacy regarding short term financing means.

Q12: Since 1 January 2014, have you changed your SME credit lending and assessment policies and procedures, specifically as a result of the introduction of the Supporting Factor? Yes/No. If yes, please explain and provide specific examples.

Banks credit lending and assessment policies and procedures duly take into account the introduction of the SME Supporting Factor, each bank adapting it to its business model commercial practices.

Q13: Have changes to your SME credit lending and assessment policies and procedures been driven by other factors (e.g. competition from alternative sources of SME financing as described in section 4.1)? Yes/No. Please explain and provide specific examples.

Given the diversity in our members' business models and commercial practices, it would seem inappropriate to provide an aggregate comment this question.

Q14: In your experience, is there an impact of the SME supporting factor on the volume of SME lending compared to other loans? Yes/No. Please explain and provide evidence.

As mentioned in question 13, given the diversity in our members' business models and commercial practices, it would seem inappropriate to provide an aggregate comment this question.

Q15: In your experience, is there an impact of the SME supporting factor on the pricing and overall conditions of SME lending compared to other loans? Yes/No. Please explain and provide evidence.

As mentioned in question 14, given the diversity in our members' business models and commercial practices, it would seem inappropriate to provide an aggregate comment this question.

Q16: Do you consider SMEs are a consistent group when it comes to access to credit or should a distinction be made between different types of SMEs (e.g. micro, small and medium ones)? Yes/No. Please explain and provide specific examples.

Please refer to our answers to questions 3, 4, 5 and 6.

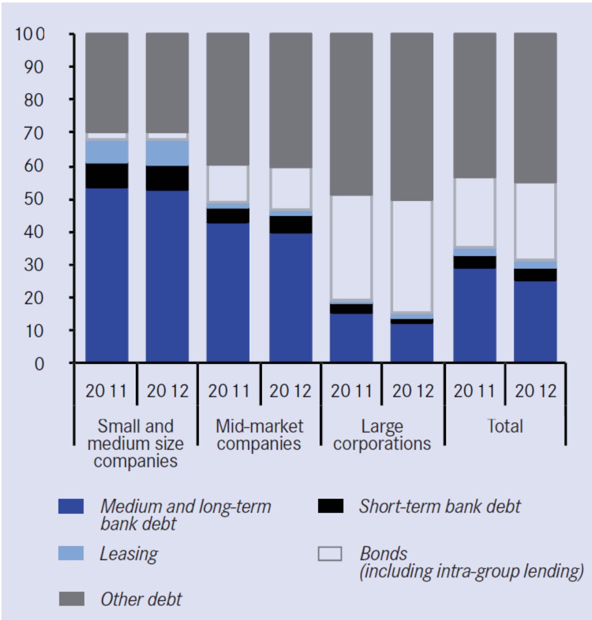
Annex –review by French banks economists on the impact of regulation on SMEs' financing

1. The importance of measuring the impact of bank regulation and capital requirements legislation on SME lending

1.1. SMEs play a crucial role in the economic growth and job creation. In France, SMEs accounted for more than 99% of companies and 43.9% of the economic value added in 2011, and employed nearly half of the total workforce (48.7%).[7]

1.2. SMEs are specific in their financing structure. As a result of organizational features and business strategies that are rarely publicly disclosed, capital market funding is seldom an option for SMEs which largely rely on bank loans for funding.

FRENCH COMPANIES: BREAKDOWN OF FINANCIAL DEBT BY SIZE OF COMPANY, IN PERCENTAGE



Source: Cailloux, Jacques, Augustin Landier, and Guillaume Plantin, 2014. Lending to SMEs: Identifying Difficulties and Recommending Targeted Measures. Les Notes du CAE 18.

1.3. It is therefore of importance to measure the impact of banking regulation and capital requirements on SME lending.

2. Some difficulties to disentangle the effects of regulatory changes on bank financing of the economy

2.1. The impact of CRR and CRD IV on bank financing the economy has attracted a relative small interest in the academic and institutional organization literatures. This lack of empirical evidence should encourage greater prudence: only a few studies (conducted by BIS, BCBS, IIF, IMF, FSB, and OECD)[8] try to analyse and assess the benefits and costs of regulatory reforms.

[7] See: République française, *Annexe au projet de loi de finances pour 2015. Effort financier de l'Etat en faveur des petites et moyennes entreprises*, 2015.

[8] Basel Committee on Banking Supervision, *An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity* Requirements, August 2010; Financial Stability Board and Basel Committee on Banking Supervision, *Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements*, December

Furthermore, predictions on the impact of banking regulation and capital requirements legislation are conclusive but contradictory on the overall net economic impact. Papers converge on the existence of additional costs reforms that may be imposed on banks and lending volumes. However, while some studies suggest that the total benefits of regulatory reforms outweigh the additional cost, other studies report a positive impact on lending spreads and a small but negative impact on GDP growth. The assessment of the contribution of prudential reform to financial stability is quite artificial and raises serious methodological issues. For example, the Long-Term Economic Impact Group (LEI Group, BIS) considers that the arithmetic product of the fall in the annual probability of financial crisis and the median long-term cost of a financial crisis (a cumulative 63% of GDP) gives the mathematical expectation of the annual GDP loss avoided. Controversially, the LEI group then assimilates the latter to supplementary points of GDP growth. All in all, the LEI experts put the benefits of a 7%-to-10% increase in the average common equity ratio at between 1.98% and 2.10% of GDP per year under their baseline assumptions, depending on whether liquidity requirements are respected or not. Furthermore, the BIS incorporates monetary policy *via* a Taylor rule. This tends to compensate for the restrictive impact of Basel III on the creation of money and significantly reduces the impact on economic activity but is not necessarily relevant through the economic cycle. Contradictory predictions abound, it is necessary to conduct empirical studies to try to disentangle the link between CRR and CRD IV and bank financing of the economy.

2.2. European banks are clearly on the way to achieving the adaptation to the new regulatory standards, at least for those which have been already finalized. This process has already impacted the European economy. In future, the ongoing regulation tightening could weigh on the financing of non-financial corporations – widely relying on banks' lending – and could hamper banks' ability to accompany the upturn of the credit demand from enterprises when economic growth will pick up again.

The decrease in the euro area banking system aggregated balance sheet between its peak in May 2012 (€34,855bn) and July 2015 (€31,514bn, corresponding to a variation rate over the period of -9.6%) has been, to a certain extent, attributable to the contraction in loans to euro area customers (-1.3%). However, this shrinkage in euro area banks' aggregated balance sheet was mostly due to the fall in "remaining assets" (-4.2%), mainly derivatives. Another reason of the reduction in balance sheets has come from the fall in banks' deposits with the Eurosystem (-3.4%), which has been only very modestly offset by the positive contribution from interbank loans (0.5%). Last but not least, the banking sector's deleveraging in the Eurozone has been noticeable in all countries but to a greater or lesser degree.

2.3. Analysing the *ex post* impact of banking regulation and capital requirements legislation is problematic. First, there is a lack of tangible data to observe any consequences of regulatory reforms. With most regulatory reforms still at an early stage of implementation, it remains too early to fully

2010; Institute of International Finance, *The Cumulative Impact on the Global Economy of Changes in the Financial Regulatory Framework,* September 2011; Financial Stability Board and Basel Committee on Banking Supervision, *Assessment of the Macroeconomic Impact of Higher Loss Absorbency For Global Systematically Important Banks*, October 2011; OECD (Patrick Slovik and Boris Cournède), *Macroeconomic Impact of Basel III*, Working paper, 2011; IMF (Douglas Elliott, Suzanne Salloy and André Oliveira Santos), *Assessing the Cost of Financial Regulation*, 2012; Financial Stability Board, *Update on Financial Regulatory Factors Affecting the Supply of Long-Term Investment Finance*, September 2014.

assess their impact on bank financing of the economy.[9] Second, it is difficult to disentangle the effects of regulatory changes from other economic factors that impact the supply and demand of credit.

2.4. The usual regression framework to assess the *ex post* impact of increased capital requirements on corporate lending should involve linking credit growth to SMEs as a dependent variable to regulation/legislation proxies and other bank and macroeconomic variables as explanatory variables, using the following specification:[10]

$\Delta Loans_t = \alpha_t + \beta_0 B_t + \beta_1 H_t + \beta_2 R_t + \varepsilon_t$

Where the dependent variable is the real credit growth to SMEs in time *t*; B_t represents the variables controlling for the bank characteristics including lagged credit growth, profitability, liquidity and solvency; H_t is the set of macroeconomic variables (such as GDP growth and inflation rate) reflecting the attractiveness of expanding credit to SMEs; and R_t refers to a regulation dummy taking the value of one for years in which regulation began, and zero otherwise.

However, given the lack of tangible data and the early stage of implementation of regulatory reforms, establishing a cause-and-effect relationship is by no means a perfect solution.

2.5. The monetary policy bias

Among other factors, new liquidity rules have certainly led the European Central Bank to do much more than what it would have done without them. To some extent at least, the LCR may be viewed as a mandatory reserve requirement, where commercial banks have to constitute reserves at the central bank in proportion to their deposits, and on which academic literature abounds.

The first effect of an increase in the reserve requirement is an arithmetic decline in the credit (or money) multiplier. The impact of this decline on bank lending has been hidden so far by the exceptionally accommodative stance of the monetary policy, which has allowed a huge increase in banks reserves with the ECB (from €378bn in December 2010 to €626bn as of 11 September 2015).

Moreover, non-conventional monetary policy measures artificially inflate euro area banks' stable resources (LTRO, TLTRO, bank deposits of securities sellers to the ECB under the QE) and help lower loan-to-deposit ratios. As a result, current NSFR and LCR, as measured in the last Monitoring exercise published by the EBA, are probably significantly higher than their "natural" levels that the monetary policy normalization may reveal in the coming years. In addition, the disintermediation process is likely to bring a transfer of banks' liabilities from retail deposits to corporate deposits. Since retail deposits are weighted between 90% and 95% in the "available stable funding" of the NSFR and between 3% and 10% in the "cash outflows" of the LCR whereas corporate deposits are weighted at 20% in the "cash outflows" of the LCR and at only 40% in "available stable funding", the disintermediation trend is likely to depress the future levels of both the LCR and the NSFR.

[9] See: Barut, Marie Laure, Nathalie Rouillé and Marion Sanchez, 2015, *L'impact du nouveau paradigme réglementaire sur le rôle des banques dans le financement de l'économie,* Revue de la stabilité financière 19.
[10] Allen, Franklin, Krzysztof Jackowicz, Oskar Kowalewski and Lukasz Kozlowski, 2015. Bank Lending, Crises and Changing Ownership Structure in Central and Eastern European Countries. *Working Paper*; Blaise Pua Tan, Tatum, 2012. Determinants of Credit Growth and Interest Margins in the Philippines and Asia. *IMF Working Paper*.

3. Preliminary findings on the impact of financial regulatory reforms on bank financing of the economy in France

3.1. French companies' stands out by both a strong increase of market sources of credit and a relative good performance of bank credit. Since 2009, market finance has more than offset the decline in bank loans to companies in the Eurozone as a whole. However, this conceals substantial disparities between countries. And France corporate lending stands out on both fronts.

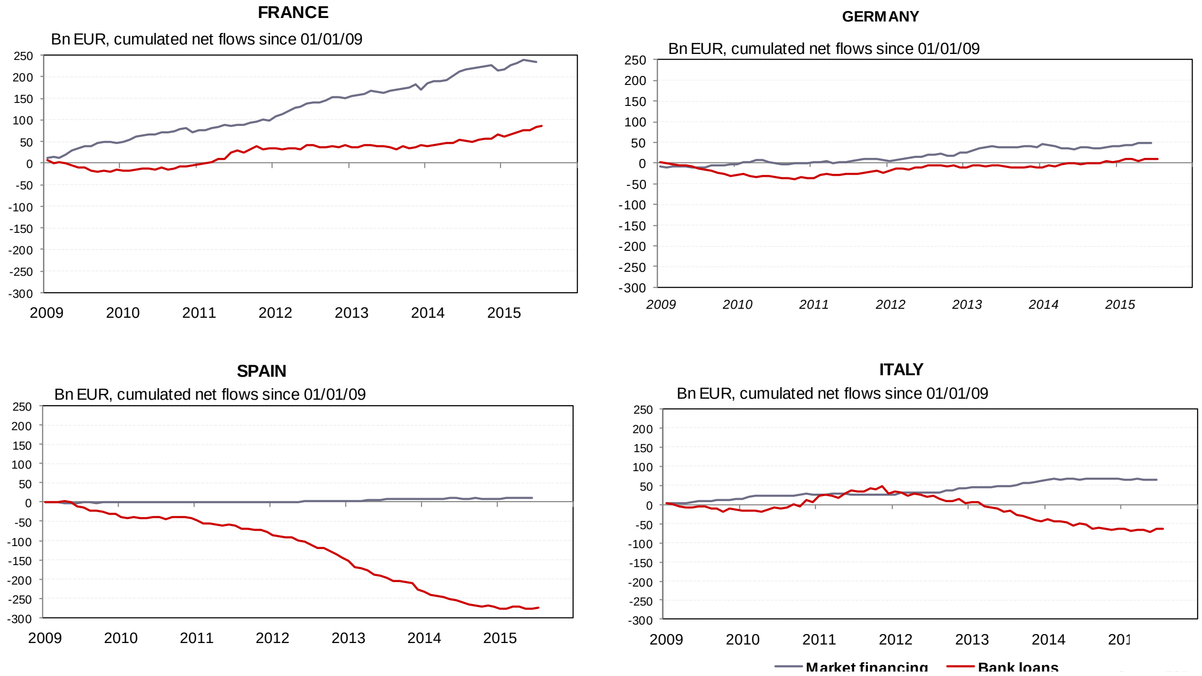
Indeed, in France, bank lending has proved resilient (no "credit crunch" has been observed): since 2009, outstanding loans have continued to grow slightly. Surveys on bank lending conditions suggest that – apart from during the height of the financial crisis in 2008/beginning of 2009 – sluggish growth in bank lending stems more from weak demand than restricted supply.

In parallel, France also stands out with regard to non-financial corporate market debt: the cumulative increase since 2009 is above €240bn in France. The disintermediation trend therefore seems to be more important in France (where market financing now represents 38% of total non-financial corporations' debt vs. 26% at the beginning of 2009; total Eurozone: 21%). Two factors may contribute to explain this French particularity:

- A corporate structural factor: the preponderance in France of major multinational groups, which are more likely to resort to market financing, whereas other major Eurozone economies are characterized by a substantial number of medium-to-small sized companies, which continue to resist to resort to bank financing;
- A bank strategic reallocation: the French banking sector is composed mainly of big universal entities. In reaction to the new economic and regulatory environment, they have strategically accompanied their big clients towards market financing, in order to keep RWA capacities for SMEs.

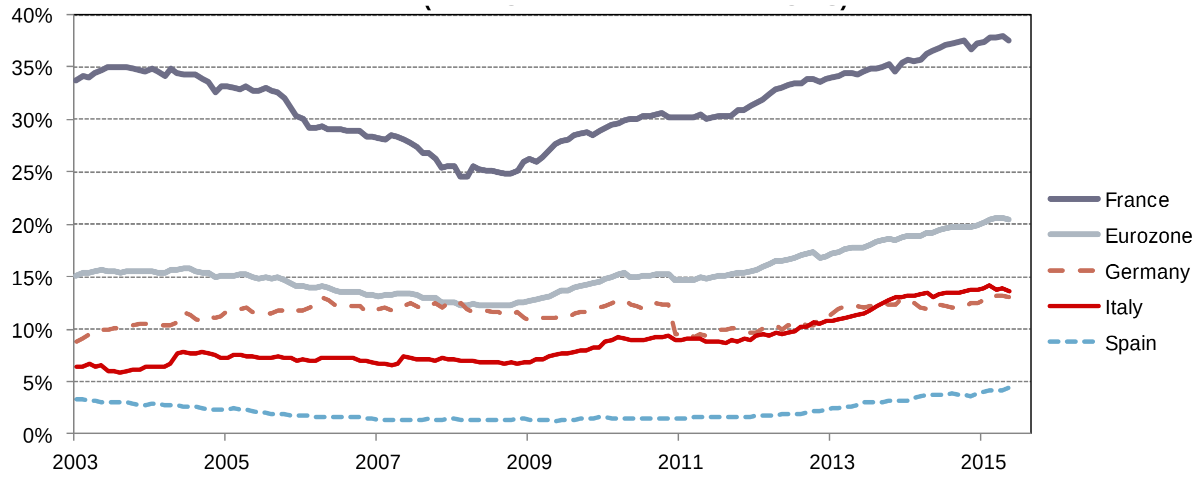
This disintermediation process has been possible thanks to very accommodative market conditions. Then, a normalization of interest rates could partially call into question the process. Moreover, the euro area does not currently have the same capacities as the U.S. to attract foreign capital (positive vs. negative current account) and the development of markets involves lengthening of the maturity of domestic savings, which is a long term process.

DEBT OF THE NON-FINANCIAL CORPORATE SECTOR



Source: European Central Bank

NON-FINANCIAL CORPORATE SECTOR: SHARE OF MARKET FINANCING IN TOTAL DEBT (BANK CREDIT + MARKET FINANCING)



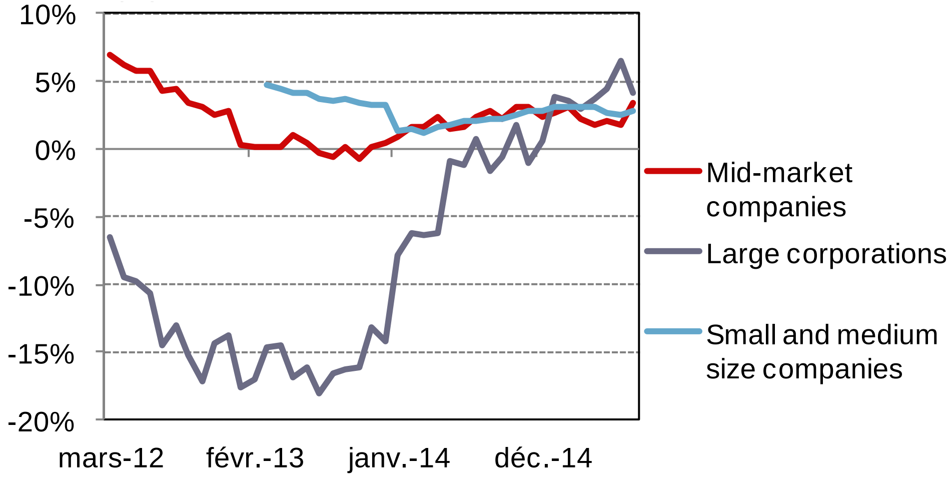
Source: European Central Bank

3.2. SMEs

More detailed data on French non-financial corporations show that over the period, bank lending has been declining for large companies and intermediate-sized enterprises (ETI, *Entreprises de Taille Intermédiaire*[11]), whereas it has continued to increase for SMEs. Disintermediation therefore appears to operate for companies having a size that allows them easier access to markets, whereas SMEs continue to obtain financing *via* the banks.

[11] An intermediate-sized enterprise is a company with between 250 and 4,999 employees, and a turnover which does not exceed 1.5 billion euros or a balance sheet which does not exceed 2 billion euros. ETIs represent an intermediate category between small and medium companies and large companies.

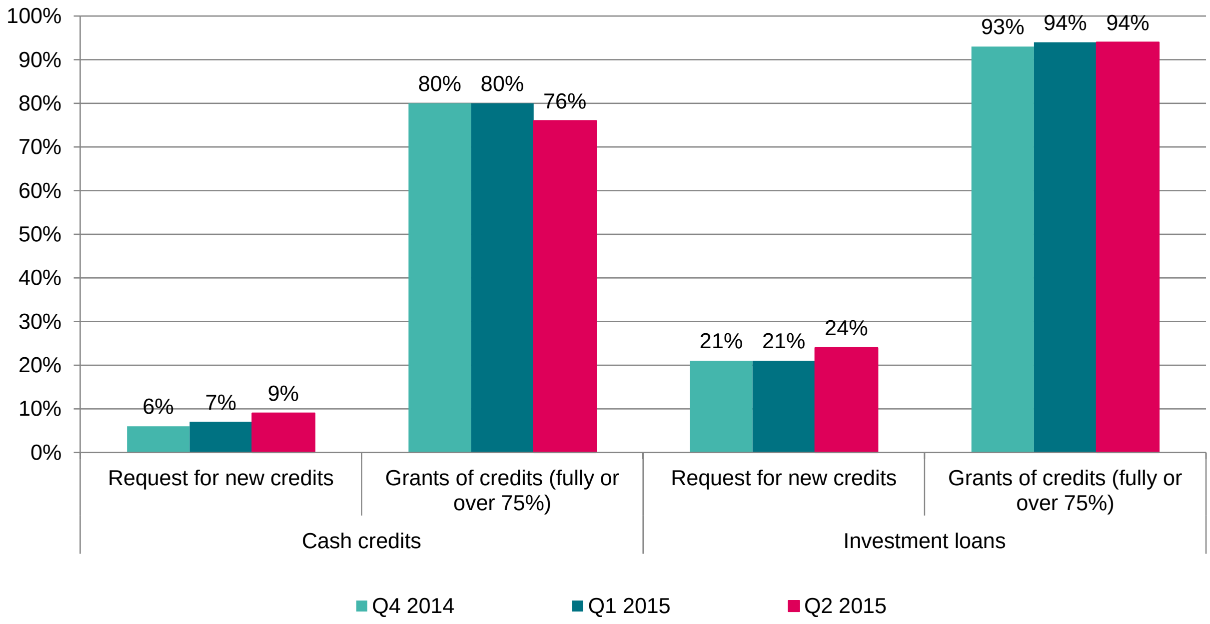
BANK CREDIT TO THE FRENCH NON-FINANCIAL CORPORATE SECTOR, IN PERCENTAGE, YEAR-OVER-YEAR



Source: Banque de France

In particular, lending to SMEs has remained but growth rates remain at low levels (yearly growth of +2.5% in June 2015). Access to investment loans remains easy: 94% of SMEs were fully or substantially granted. Weaker bank lending is likely to reflect a tightening in the demand for credit: over the second quarter of 2015, only 24% of SMEs requested for new investment loans.

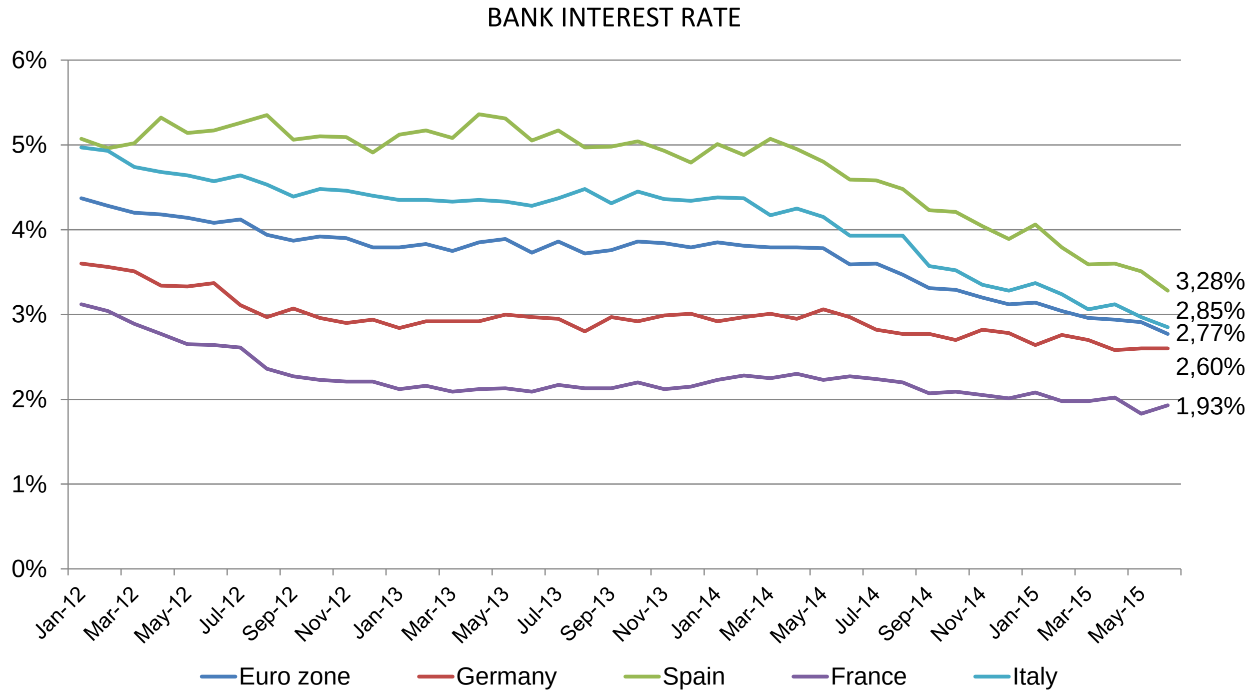
ACCESS TO BANK FINANCING FOR FRENCH SMEs



Source: Banque de France

Bank interest rates have been exceptionally and persistently low. This low interest rate environment is challenging for banks.[12] The ECB's quantitative easing program, which began in March 2015, maintains these low interest rates. When rates finally rise, credit could be negatively impacted.

[12] See: Banque de France and ACPR, July 2015, "Evaluation des risques du système financier français"; Bank for International Settlements, "85th Annual Report, 2014/15"; ACPR, May 2015, "French banks' performance in 2014", *Analyses et Synthèses* 46.



Source: European Central Bank. Loans up to EUR 1 million at floating rate and up to 1 year initial rate fixation.

3.3. European banks are much better capitalized today than prior to the crisis. The level of CET1 capital has increased by almost 50% between June 2011 and December 2014 for large internationally active European banks[13], in response to regulatory requirements and market pressure. However, the cost of equity required by investors (10-12%) has not decreased accordingly and does not reflect the fact that the industry has strengthened its balance sheet. This means that higher capital requirements are not neutral and create additional costs for banks and the economy as a whole.

European banks have adapted swiftly to higher regulatory costs in order to limit the pass-through into lending interest rates. This has contributed to the erosion of European banks' profitability. While the profitability of French banks appears to have been recovering faster than at other European banks, they are still less profitable than American banks, where the return on equity reached 6.8% in 2014 (vs. 4.5% in France)[14]. The average return on equity of the European banking industry has been standing below its cost of equity since 2009.

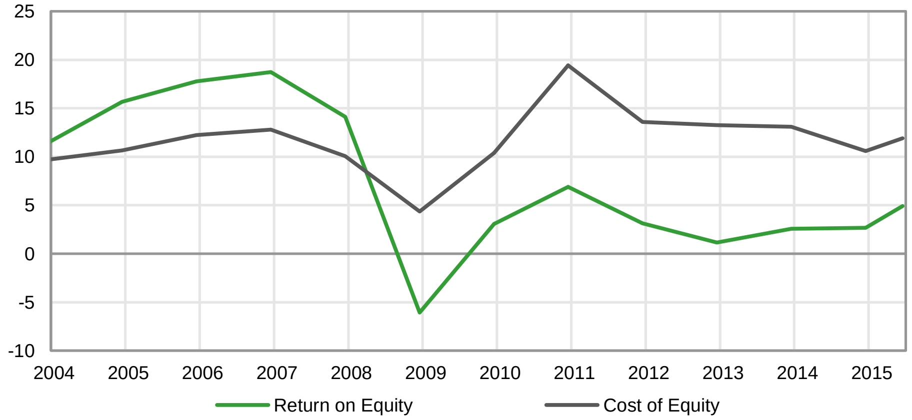
(1) Efforts from European banks to streamline their cost base were an important factor that helped to stabilize cost-to-income ratios. From 2008 to 2014, the number of euro area branches declined by 14% and the number of bank employees by 10% (-5% and -3% in France respectively, according to ECB statistics).
(2) Many global banks have shrunk or exited from activities like fixed income, currencies, and commodities. Most of them have rebalanced their business models away from capital-intensive activities to more fee-based activities (M&A, underwriting) and/or have refocused on commercial banking in home markets.
(3) As already mentioned before, higher capital requirements would have made credit to enterprises much more expensive without an exceptionally benign monetary policy.

[13] See: EBA, *CRD IV–CRR/Basel III monitoring exercise report*, September 15, 2015.
[14] See: IMF, October 2014, "Risk Taking, Liquidity, and Shadow Banking: Curbing Excess While Promoting Growth", *Global Financial Stability Report*; ACPR, May 2015, "French banks' performance in 2014", *Analyses et Synthèses* 46.

But there may be limited room left both in cost-cutting efforts and further loosening of monetary policy. Additional constraints are likely to lead to a significant credit repricing which could undermine the competitiveness of SMEs, which rely heavily on bank lending. It could also lead to more deleveraging when repricing is not possible due to international competition, especially in capital markets activities.[15] This raises concerns about the ability of European banks to support the international expansion of the European corporate sector.

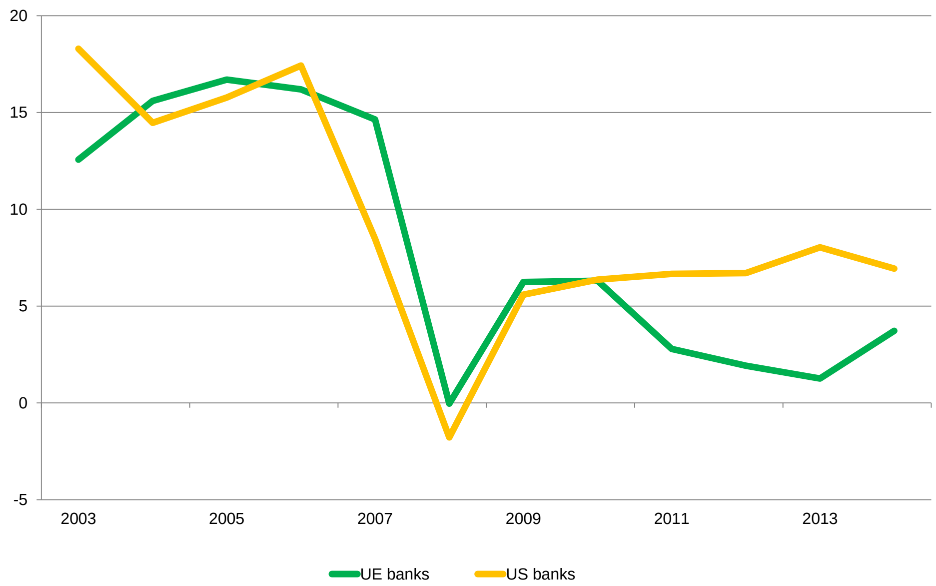
RETURN ON EQUITY AND COST OF EQUITY, IN PERCENTAGE[16]

Sample of 29 European banking groups



Source: Bloomberg, Crédit Agricole S.A.

COMPARISON OF BANK ROE, IN PERCENTAGE



Source: Bankscope, calculations by BNP Paribas

[15] According to the IMF, 46% of euro area banks would not be able to deliver more than 5% annual credit growth due to balance sheet constraints; 40% would need to increase lending margins by at least 50 bps on their entire loan books in order to preserve capital buffers. See *Global Financial Stability Report*, October 2014.

[16] The last two graphs are based on different samples.