Providing appropriate financing tools for EU SMEs and midcaps

This document was drafted by Eurofi with input from its members. It does not engage in any case the Greek EU Presidency nor the Greek Financial Authorities.

Banks are by far the main source of external financing for non-financial companies in the EU, covering 50 to 90% of their needs, depending on their size. The share of bank financing, as well as funding costs tend to be higher for SMEs (legally defined in the EU as enterprises with a turnover ≤ € 50 million and no more than 250 employees) and smaller middle market enterprises or midcaps[1], for which publicly available information and visibility about their projects and management capabilities is limited[2]. In the absence of a legal definition at EU level, midcaps are referred to in this paper as a proxy for the "middle market" which comprises enterprises with a turnover ranging from € 50 million to around € 1 billion.

In the US commercial banks and savings institutions are also the leading source of credit for small businesses (defined for most sectors as companies with no more than 500 employees)[3]. Direct market-intermediated financing (e.g. by non-bank institutional investors or venture capital firms) plays a larger role than in the EU but only represents a limited share of the overall US small business financing. The difference however with the EU is that market mechanisms supporting bank financing are generally much more developed in the US, with the role played by the Government Sponsored Enterprises (GSEs), which indirectly impacts the lending capacity of US banks to small businesses. The GSEs indeed purchase a significant proportion (up to 70%) of credits originated by retail banks (mortgages, consumer credit, auto loans…), thus freeing up capital to support lending by banks to their retail and small business clients.

Bank financing will be impacted by the Basel III capital and liquidity rules being implemented notably in the EU, which are expected to raise the cost of credit and reduce the availability of long term loans. SMEs and midcaps based in countries with poor sovereign ratings are moreover penalised by the impact such ratings have on their financing conditions[4].

Statistics published by the ECB in its survey on the access to finance of SMEs in the euro area indicate signs of credit rationing for SMEs[5] in some EU countries. This issue which first emerged in periphery countries (where loan rejection rates currently range between 20 and 35%) could touch other EU states. In France and Italy for example the proportion of bank loans facing obstacles (rejections, partial coverage or loans refused by the borrower because of a high price) has been increasing and was respectively of 29% and 48% during the second semester of 2013 according to the ECB survey. More generally new bank lending to SMEs appears to have declined by nearly 50% since the pre-crisis peaks in major Eurozone countries according to statistics compiled by the IIF[6]. This situation can be explained by a combination of demand and supply factors. However some observers believe that this could be a prelude to a decrease of credit supply in certain EU countries caused in particular by rising prudential constraints being progressively put on banks and the insufficient profitability of many EU banks limiting their capacity to raise additional capital.

Initiatives conducted by the ECB should help to reduce the fragmentation of financing conditions across EU member states: the ECB sovereign bond purchase programme (OMT facility), which is designed to ensure that bank funding is not a source of financial fragmentation in the EU[7] and the Banking Union which should help to strengthen the EU financial sector. Work is also under way conducted by the EIB to develop a common methodology for the credit scoring of SMEs and midcaps aiming to foster the provision of more complete and objective information on their intrinsic risks and to limit the sovereign risk bias in such assessments.

Many measures have been proposed by the EU public institutions since the beginning of the crisis to facilitate the financing of EU SMEs and midcaps and foster economic growth.

Besides the actions launched to strengthen the EU banking sector (e.g. with the Banking Union), regulatory frameworks for venture capital funds and European Long Term Investment Funds (ELTIF) have been adopted with the objective notably of channelling investments to unlisted companies and a specific label for growth SME equity and bond markets was created in MiFID II to increase their visibility and the adoption of common standards. Actions have also been put in place on a domestic level to implement private placement regimes (e.g. in France). Moreover the EIB has stepped up its financial support in favour of SMEs, increasing its funding to enterprises and their banks as well as the provision of guarantees for portfolios of SME loans and securitized SME financing instruments[8]. Furthermore, capital requirements more favourable to SME loans have been introduced in CRD IV. The Eurosystem has also reduced haircuts on SME ABSs posted as collateral for its regular monetary policy operations taking into

[1]Middle market enterprises are usually considered to have revenues ranging from € 50 million to around € 1 billion. There is no legal definition of middle market enterprises at EU level at present. In France, intermediate-sized companies (ETI) are defined as companies with a turnover comprised between € 50 Mio and € 1.5 Bio and no more than 4999 employees

[2]Additional arguments include the fact that SME loans are riskier therefore requiring a portfolio of loans with greater diversification and on-going monitoring, which are more easily achieved by banks. Most SME financing is also short to medium term and much of it is related to working capital needs which are not easily compatible with market-based financing solutions

[3]The most widely used, and SBA-endorsed (Small Business Administration), sizing criteria for small businesses in the US is the following - the business must have no more than 500 employees for most manufacturing and mining industries, and no more than $7 million in average annual receipts for most nonmanufacturing industries.

[4]Spreads between periphery countries and Germany / France for example are quite persistent (+100 to +300 bps)

[5]Source ECB: SAFE survey on the access to finance of SMEs in the euro area – April to September 2013. Around one third of SMEs that applied for a bank loan in 2013 faced obstacles according to this survey: 12% of SME loans were rejected (up to 35% in periphery countries), 16% of SMEs received less than applied for and the remaining percentage refused the loan because the cost was too high.
In the UK the trend is similar. According to a survey commissioned by TheCityUK (October 2013) bank lending to SMEs has been declining continuously since 2010 at an average rate of approximately -4% / annum. Rejection rates have risen from 8% to 19% between 2007 and 2012 for overdraft loans and from 6% to 23% for term loans.

[6]Source: IIF: Restoring financing and growth to Europe's SMEs – 2013 conducted in 6 Euro-area countries: France, Ireland, Italy, the NL, Portugal and Spain.

[7]The OMT weighs on domestic sovereign yields and activates laxer refinancing mechanisms for banks, extending temporarily eligible collateral. It is designed to ensure that bank funding is not a source of financial fragmentation in the EU.

[8]The EIB group provided financing to the tune of € 75.1 Bio in 2013 corresponding to an increase of 37% compared to 2012. Within the EU the amount reached € 67.1 Bio (an increase of 42%). Within this amount the support provided to SMEs amounted to € 21.9 Bio.

account the introduction of the ECB loan level data transparency initiative supported by the European Datawarehouse ABS repository[9]. A consultation was in addition recently conducted by the EU Commission (EC) on peer-to-peer lending (crowdfunding).

Following the green paper on long term financing published by the EC in March 2013, a high level expert group set up by the European and Financial Committee (EFC) and chaired by A. Giovannini and J. Moran published in December 2013 a broad range of short and medium term recommendations covering SME financing in particular ("Finance for Growth") and aiming to increase their access to capital markets. The report endorses the on-going initiatives mentioned above and makes some additional proposals regarding notably the access to appropriate corporate and credit data on SMEs[10], the cross-border investment of funds in SME loans and the setting up of an EU platform for mini-bonds[11].

A self-initiative report of the EU Parliament on long term financing drafted by W. Klinz and adopted in February 2014 covers similar ground. The role national and multilateral (EIB) development banks can play in supporting SME financing is stressed as well as the possible contribution of vehicles such as ELTIF and transparent securitisation mechanisms. The Commission is also called upon to propose an EU framework for less liquid investment funds [than UCITS] in order to channel the short-term liquidity of private households into long term investments and provide additional retirement solutions.

The priorities to be pursued in the short and medium term respectively for SMEs and midcaps however still need to be completely established, taking into account their potential impact, the time required for implementing them and possible emergencies to be addressed in certain countries or industrial sectors.

Suggestions have been made in this regard by the industry[12]. Concerning SMEs, given their dependence on bank financing, the expansion of the support provided by public banks or agencies (loans or guarantee programmes), the revitalisation of SME securitisation and developing an improved access to reliable information in order to facilitate credit provision by alternative providers are the main actions proposed[13]. As for midcaps, which have less difficulty in accessing market-intermediated funding, the development of a European private placement regime possibly expanding existing domestic frameworks, the expansion of EU high yield bond markets and efforts to improve the consistency of EU bond legislations are proposed, as well as actions to encourage equity financing and promote IPOs (e.g. rebuilding an appropriate ecosystem, better balancing incentives for bond and equity financing[14], adapting rules for SME and midcap issuers).

Developing an overall perspective on the financing needs of SME / midcap issuers and investors is also put forward as a priority by many industry players, in order to achieve a general and consistent approach of the regulation of the different instruments available (i.e. equity, bonds, loans, securitised products…) and ensure their coherence.

An idea that has gained traction in the past months for SMEs is revitalising loan securitisation in order to refinance SME loans and alleviate SME financing constraints for banks[15]. The objective is to complete the current acceptance of ABS as collateral for Eurosystem credit operations which provides banks with liquidity but does not increase their lending capacity as they have no impact on banks' balance sheets. The ECB notably has called for the development of high quality plain vanilla products capable of being rated and priced in a simple way. Several actions have been initiated by the private and public sectors but these have only had a limited impact so far (the PCS Prime Collateralized Securities initiative[16] and proposals made by the EIB and the EC to set up a joint securitisation instrument for new and possibly existing SME loans potentially combined with a joint guarantee instrument, both involving the use of EIB and structural funds[17]).

Relaunching EU securitisation markets on a sound basis (which should help to amend the deteriorated image of these products since the financial crisis) seems feasible. It however requires overcoming several obstacles in the short term. The sharp increases in capital requirements for securitisation exposures mandated in Basel III and Solvency II are due to be reviewed by

[9]ABS and credit claims are accepted as collateral for Eurosystem credit operations. In June 2012 the ECB extended the pool of eligible collateral to include SME-loan backed ABS with a second best credit rating of at least BBB-. The ABS loan-level initiative establishes specific loan-by-loan information requirements for asset-backed securities (ABSs) accepted as collateral in Eurosystem credit operations. Loan-by-loan information requirements for residential mortgage-backed securities (RMBSs) and ABSs backed by SME loans began on 3 January 2013. The European Datawarehouse launched in 2011 provides the means to collect and distribute standardized loan-level ABS performance data.

[10]Proposals include setting up an EU SME credit risk database and a corporate information portal, developing credit assessment systems where they are not available and implementing a unique EU company identifier. These databases and processes could build on those managed by some member states and the ECB as well as on the actions initiated by the EIB to develop a common methodology for the credit scoring of midcaps and SMEs

[11]Mini-bonds introduced in Italy allow the issuance of short / medium term and convertible bonds by unlisted mid-sized SMEs and small midcaps. These mini-bonds are eligible for listing and subject to the same tax regime as bonds issued by listed companies.

[12]For example: AFME – Unlocking funding for European investment and growth – June 2013 ; IIF: Restoring financing and growth to Europe's SMEs – 2013

[13]Other measures are proposed such as the development of credit mediation services and the review of laws concerning personal guarantees and sureties in order to make them less protective. Strengthening the financial structure of EU SMEs is also proposed, although this goes beyond the scope of this paper.

[14]Equity is penalized compared to debt by its tax treatment since interest paid for debt is tax deductible

[15]Covered bonds are an alternative instrument for outsourcing financial risk used in many EU countries, but with such instruments the credit risk stays with the bank which does not increase its capacity to lend since there is no impact on the related capital requirements.

[16]PCS aims to reinforce asset-backed-securities as sustainable investment and funding tools for both investors and originators by providing criteria and self-assessment tools, but only a limited number of operations have been structured on this basis in the EU so far

[17]The EIB and EC made proposals to the Council in June 2013 to set up a joint securitisation instrument for new and possibly existing SME loans potentially combined with a joint guarantee instrument, both involving the use of EIB and structural funds. It however appears that these proposals have not received so far significant support from member states as these funds are already allocated to specific domestic projects in many cases.

Basel and the EU Commission[18]. Common mandatory standards will also need to be defined and implemented at EU level for structuring and managing simple and transparent securitisation products[19]. Moreover, solutions are required to increase the rates and margins of bank loans in order to make them sufficiently attractive for investors when securitised. The absence of standardised and easily accessible information on SME loans is also pointed out, although some mechanisms such as ECB loan level data transparency initiative combined with existing domestic credit risk databases[20] could be the starting point of the system required.

Given the urgent need to step up lending in the EU, solutions involving the intervention of public institutions such as the ECB and / or national central banks (in order to impose appropriate quality standards based on the current criteria used for accepting SME loans as eligible collateral in central bank refinancing operations, support the emergence of securitisation conduits and purchase eligible loans temporarily, if needed to foster the launching of the market) and the EIB (in order to offer some guarantees for the securities issued) are proposed in order to revitalise the EU securitisation market in a relatively short timeframe[21].

---

[18]The review of capital requirements for securitization exposures in Solvency II should be possible on the occasion of the definition of the delegated acts by the EU Commission

[19]Definition of securitisation, standard requirements in terms of information disclosure and product structuring…

[20]An extensive credit data base is managed by the Banque de France and 3 national central banks have credit assessment capabilities: Spain, Germany, Austria.

[21]These issues and solutions are further developed in a more specific paper on securitization mechanisms published by Eurofi for the Athens seminar ("Reviving securitization in the EU for supporting SME financing")