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POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Access to finance of SMEs in distressed euro area Member States

NOTE

Abstract

Small and Medium Enterprises (SMEs) generate about two-thirds of total value added in the EU. Therefore, the current difficulties faced by SMEs in accessing adequate financing means in distressed euro area Member States represent a major obstacle to the recovery of both activity and employment in the whole euro area.

In the euro area, and in contrast to the US, bank credit represents the major form of SMEs financing. The combined effects of (i) a strong bank deleveraging to comply with higher capital requirements (ii) an increased risk aversion in a context of reduced activity and (iii) a severely impaired monetary transmission mechanism, resulted in large financing disparities across euro-area frontiers. These issued must addressed without delay. Enhancing equity and debt financing of SMEs should be a real alternative to bank financing and a step in the right direction. Conversely, a full-fledged level plain field for the financing of euro area SMEs can only be achieved with the completion of the banking union.

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INTRODUCTION

Why SMEs financing is problematic, particularly in distressed euro area economies?

Small and Medium size Enterprises (SMEs) are the backbone of the euro area economy. They account for 98 % of firms, 75 % of the employees, 85 % of new employment and 60% of total value added. The relative weight of SMEs is even higher in the distressed Member States of the euro area.

There are several reasons why access to finance of SMEs is falling and became more expensive, in particular in the euro area periphery.

First, in the euro area the financing of the economy is dominated by banks as 80 % of financial intermediation goes through the banking system and only 20 % goes through capital markets. This is in sharp contrast to the US, where 80 % of financial intermediation goes through capital markets and only the remaining 20 % through the banking system. In the UK, these percentages are somewhat in the middle, i.e. 50 % each. In the distressed euro-area Member States, banking loans represent an even larger proportion of total credit intermediation compared to the average (Bijlsma, Gijsbert and Zwart, 2013).

In terms of GDP, the size of the US economy is about 1.3 times larger than the euro area economy (US: EUR 12.41 trillion; euro area: EUR 9.48 trillion), in terms of total bank assets, the US economy is 4.5 times smaller (US: EUR 9.9 trillion; euro area: EUR 44.9 trillion), while in terms of market securitisation, the US economy is 4.5 times larger (US: EUR 6.9 trillion; euro area: EUR 1.52 trillion). Therefore, the banking crisis in the euro area must have affected non-financial companies and SMEs much more than it did in the US (and in the UK).

Second, in advanced countries, market-based financial systems have generally shown a higher resilience to systemic shocks than bank-based financial systems, as it has been the case in the UK and, even more so, in the US.

Third, banking crisis must be resolved swiftly to limit contagion effects. To a large extent, this has happened in the US with the US Treasury forcing all banks to recapitalize, converting investment banks into deposit institutions and the Federal Deposit Insurance Corporation (FDIC) resolving around 500 banks, mostly small. It took much longer to fix the problems in the euro area because of the bigger size of the banking sector and the absence of equivalent single supervisory and resolution institutions: a single regulator, a single supervisor, a single resolution system and a single deposit insurance system.

Progress on this front is slow. Single supervisory institutions (ESRB, ESAs) have bee set up but a single resolution system is still missing and a common deposit guarantee scheme may require a Treaty change.

Fourth, compared to large corporations, euro area SMEs are more prone to suffer the effects of banking crisis as: (i) they are more dependent on bank credit and cannot easily access financial markets; (ii) SMEs financial health tends to be lower and deteriorates faster. In the current situation of financial stress, strong deleveraging needs and high risk aversion leads banks to reduce lending first to SMEs and only afterwards to larger corporations and governments as SMEs` higher probability of default also implies a higher (risk-weight-adjusted) capital requirement ratio (Benoit Coeuré, 2013).

Fifth, the absence of a Banking Union is, to a large extent, responsible for the current fragmentation of the euro area financial system for the following reasons:

(i) A ring-fencing policy by the national supervisors of the relatively well-off economies of the euro area, whereby banks are advised to limit lending and reduce the risk exposure to both financial and non financial institutions in distressed Member States, as well as to reduce their holdings of sovereign and private debt.

(ii) A preference for banks of distressed Member States - which have lower ratings - to invest in their domestic sovereign debt rather than lending to local SMEs. Sovereign debt provides banks with relatively high rates of return at a still reasonable risk. Moreover, sovereign debt can be used as collateral to obtain liquidity from the ECB. Lending to SMEs entails a higher risk and, furthermore, the loan must be kept on the bank's balance sheet and, therefore, cannot be used as collateral for liquidity provision.

(iii) The effect of higher capital and buffer ratios following Basel III and EBA (European Banking Agency) new capital and banking solvency regulations. In order to comply, banks in euro area distressed Member States are forced to reduce the (risk-weighted) asset side of their balance sheet more than the rest of the euro area does because of the higher cost of capital and a larger proportion of non-performing loans.

(iv) The absence of a single supervisor, implying that banks in distressed members are subject to tough measures by their supervisors and to fully comply with the prescriptions of risk-weighted asset models. By contrast, supervisors in better performing countries tend to be more lenient with the application of the capital requirements rules, as banks are expected to comply due to better shape of the economy.

Most of these challenges have been highlighted in a recent speech by ECB president Mario Draghi (2013): "fragmentation has weakened the impact of monetary policy in the very parts of the euro area where it is most needed and has created divergent borrowing conditions for firms and households with equal creditworthiness but different country codes. As our main tool to combat fragmentation, we have adopted Outright Monetary Transactions (OMTs)". A Banking Union based on an independent Single Supervisory Mechanism (SSM) and an independent Single Resolution Mechanism (SRM) would provide a solution.

The role of governments is also extremely important. According to Jörg Asmussen (2013), they can address the root causes of fragmentation through three channels: First, by reducing the excessive level of public debt prevailing in some countries and therefore the adverse feedback loop between the sovereign and banks' balance sheets. Second, by implementing structural reforms to raise potential growth, as weak growth reduces banks' attitude towards risk and therefore lending to SMEs. Third, by strengthening banks' balance-sheets and addressing the issue of banks' recapitalisation and restructuring.

Recent empirical evidence confirms SMEs' difficulties to access finance

The bi-annual ECB Survey on the Access to Finance of SMEs (SAFE) in the euro area allows for a comparison of loan availability by SMEs, according to their size. The survey of April 2013 shows the following results:

At the euro area level, only 5 % of SMEs reported higher demand for bank loans and 12 % reported rising bank overdrafts. The factors affecting external financing the most were: fixed investment (13 %), inventory and working capital (12 %) and insufficient internal funds (7 %).

The proportion of SMEs reporting bank lending scarcity was the highest in Greece (31 %), Portugal (19 %) and Italy (12 %). SMEs reporting insufficient availability of internal funds were the highest in Greece (23 %), Italy (18 %), Spain (16 %) and Portugal (15 %). By contrast, SMEs in Austria (-6 %), the Netherlands (-5 %) and Germany (-4 %) reported a decline in their need for banks loans.

In the euro area as a whole, SMEs have reported a relative improvement of their financial situation in the period October 2012-March 2013: Italy (from -27 % to -7 %), Spain (from -30 % to -17 %), Ireland (from -35 % to -22 %), Portugal (from -42 % to -32 %) and Greece (from -53 % to -40 %). These numbers show a higher confidence derived from the ECBs non-standard monetary policy measures and from the announcement of the OMTs.

But in all Member States, except Germany, SMEs reported a worsening of the banks willingness to provide loans.

The highest number of SMEs applying for a bank loan was the highest in France (28 %), Spain (27 %) and Germany (26 %), the lowest in the Netherlands (12 %), Ireland (14 %) and Portugal (15 %). More than half of SMEs in Germany, Austria and Finland reported that they did not apply for a loan as they have sufficient internal funds, while in Greece (24 %) and Portugal (35 %) they did not apply because of fear of rejection.

In terms of price conditions, only 17 % of euro area SMEs reported better market conditions, down from 27 % in the previous survey. Developments were more heterogeneous among individual members states: SMEs in Spain (66 %), Italy (62 %) and Portugal (56 %) reported an increase in the level of bank lending rates, while Germany (-29 %), France (-27 %) and Belgium (-12 %) reported a decrease.

With respect to non-price terms and conditions, SMEs in Ireland (-24 %), Spain (-16 % and Netherlands (-8 %) reported, on balance, a decrease in the size of loans, while the rest of the euro area reported either no change or an increase. With respect to collateral requirements, SMEs in Spain (51 %), Greece (45 %), Italy (44 %) and Ireland (44 %) reported increases whereas only 15 % did in Germany.

In terms of expectations, euro area SMEs reported on average, a small deterioration of the availability of bank loans and bank overdrafts (5 % versus 15 % and 13 %) and broadly unchanged availability of internal funds. Among Member States, expectations regarding availability of banks loans were the worst in Greece (-27 %) and the most positive in Germany (+6 %).

In the six months up to January 2013, euro area SMEs were charged, on average, 160 basis points more than large firms. Looking at Member States, the spread was around 50 basis points in Austria and Belgium, compared to 261 basis points in Spain and 174 basis points in Ireland.

Between 2003 and 2008, the spreads have multiplied by 3.3 times for Spain and 3.9 times for Ireland (Benoit Coeuré (2013)).

Between 2010 and 2012, interest rates charged on loans worth less than EUR 1 million to non-financial corporations in distressed Member States increased by 110 basis points. By contrast, rates fell by 20 basis points in the rest of the euro area. Similarly, for loans above EUR 1 million, rates were up by 41 basis points in distressed members and down by 3 basis points in the rest of the euro area. Compared to business financing, interest rates for household financing have increased less in distressed euro area Member States (e.g. by 50 basis points in Spain and by 100 basis points in Italy).

In sum, the interest rate on loans of less than EUR 1 million is currently 164 basis points higher than on loans over EUR 1 million, a measure of SME risk premium. SMEs of distressed members pay higher interest rates both for loans below EUR 1 million (average surcharge of 269 basis points) and above EUR 1 million (average surcharge of 208 basis points). This means that SMEs in distressed members face a cost of bank financing that is 85 % higher than in other Member States, regardless of their size (Joaquin Maudos, 2013).

The same can be said about bank deposits. Between 2007 and 2012, the standard deviation of interest rates on time deposits up to one year offered to households across the euro area members was multiplied by a factor of 3.2 while in deposits from businesses was multiplied by a factor of 5.1.

These data confirm that the ECB monetary transmission mechanism is not working properly: interest rates on banks' loans reflect more the sovereign risk premium than the ECB main refinancing rate, adversely affecting the recovery in distressed Member States.

1. POLICIES

1.1 Policy measures to address the design and implementation of SME financing in the short term

In the short term, support for SMEs financing in distressed Member States should come: (i) from European institutions; (ii) from more securitisation and (iii) from a stronger engagement of the Member States.

Concerning the role of EU institutions, the European Investment Bank (EIB) has been granted a capital increase of EUR10 billion from EU Member States and has decided to allocate an additional EUR15 billion to SMEs between 2013 and 2015, mostly in peripheral members. EIB President, Werner Hoyer, mentioned that securitization could be a useful additional tool to revive SME financing, but stressed the need for caution.

In Greece, the EIB has set up a Guarantee Fund for SMEs. In Portugal, the EIB has introduced an innovative Portfolio State Guarantee, which will provide a lending envelope up to EUR 6 billion over the next few years. The EIB is also considering to increase the number of supported companies by extending - to the extent possible - the range of its banking partners. Finally, the EIB is considering to link favourable loan conditions to the creation of new jobs for young unemployed (EIB, 2013).

The Competitiveness and Innovation Framework Programme (CIP) proposed by the Commission has two distinct goals: (i) making SMEs financing through bank loans easier and (ii) enhancing equity investments for SMEs with high growth potential. CIP financial instruments will be managed by the European Investment Fund (EIF), through national or regional intermediaries such as banks and venture funds.

These instruments are EU-backed loans and guarantees granted to SMEs with the aim of facilitating their access to bank credit. Under the SME Guarantee Facility (SMEG), banks will be able to lend to SMEs at more favourable conditions, thus also facilitating lending to more risky categories (e.g. young companies, entrepreneurs without credit history or lack of sufficient collateral). Half of the CIP resources facilitating SMEs financing are to be invested in venture capital funds of start-ups and innovative SMEs with a high growth potential.

As the current CIP comes to an end in 2013, a new CIP program called COSME (Programme for Competitiveness of enterprises and SMEs) will boost support for SMEs in the period 2014-2020 through a loan facility, an equity facility and financing for research and innovation. (EC Memo: 02-05-2013). Finally, a new proposal for the Markets in Financial Instruments Directive (MIFID) will contribute and sustain the development of stock markets specialized in SMEs

Reduced bank lending to SMEs is related to the ongoing process of bank deleveraging following the adoption of the Capital Requirements Regulation Directive (CRD IV), which increased equity ratios and capital buffers, both in quantitative and qualitative terms. ECB board member B. Coeuré (2013) has supported the decision by EU co-legislators to include a specific discount factor for banks' exposures to SMEs, for loans up to EUR 1.5 million. This is expected to reduce SMEs capital requirements by about 25 %.

Securitisation could also provide support to SMEs, by channelling private savings to SMEs investment via pension and insurance funds or directly via SME financing. For instance, asset-backed securities (ABS) allow banks to reduce regulatory capital requirements by selling large portions of their commercial loan portfolios in national and international markets. To this end, the Prime Collateralized Securities (PCS) initiative aims to set common criteria on standardization, quality, simplicity and transparency of the ABS market, thus improving its depth and liquidity. The initiative includes specific criteria for SMEs ABS.

In principle, the ECB could finance SMEs by accepting SMEs loans as collateral, i.e. similarly sovereign debt. However, as SMEs loans carry a higher risk than sovereign debt, the ECB currently applies a larger discount factor (i.e. 16 %) to asset-backed security of SME loans used as collateral compared to government bonds. The ECB could, alternatively, ask national central banks to buy SME loans locally on its behalf. This may reduce the overall risk level, given the better knowledge of the balance-sheet by "local" supervisors and credit institutions. The ECB may also wish to broaden eligibility criteria for asset-backed securities (i.e. by accepting marketable debt instruments denominated in other currencies). Finally, the ECB could mirror the Bank of England "Funding for Lending Scheme" (FLS), which allows banks first to exchange bundles of SME loans with safe Treasury Bills with the central bank. Banks can then use this good collateral for additional borrowing. As the bank's creditor gets the safe asset if the bank defaults, this is a cheaper form of funding.

Euro area Member States also take initiatives to supporting SMEs financing. In this context, the German State owned bank KfW, (Kreditanstalt fur Wiederaufbau) will provide financial support to SMEs in both Portugal and Spain.

1.2 Policy measures to address the design and implementation of SME financing in the medium term

Compared to the US, long-term capital markets are underdeveloped in the European Union. A recent report by the G30 group "Long-term finance and economic growth" recommends the removal of the tax bias against equity in relevant EU Member States. While the rationale for removing the bias has been accepted, little has been done so far. At the same time, there is an urgent need to deepen equity and debt markets in the euro area.

Various policy options exist. The double taxation of equity could be removed, either by eliminating the tax deductibility of interest payments in combination with lower marginal corporate tax rates, or by applying tax deductibility to equity dividends while increasing the marginal tax rate.

The development of financial markets for loans, credit, capital and equity securities in the euro area should be stepped up and banks' financing reduced, to achieve a more balanced financial system in terms of number institutions, financial instruments and the term structure of interest rates. To this end, efforts should be concentrated on a euro area private placement market [1], an euro area high yield market, a euro area small cap market and a euro area covered bond market, where SMEs loans could become more important than mortgages.

Long-term financing and investment is key for the creation of larger and more diversified equity and debt markets in the euro area. And if the euro area wants to match with the US in terms of venture capital and private equity, it needs stronger equity and capital markets. The lack of long-term finance implies less investment opportunities, adversely affecting medium-term GDP growth and the sustainability of government debt. Compared to financial intermediation through banking, credit intermediation through capital markets offers liabilities of longer duration and a fairly transparent pricing of assets, even in euro area economies with a relative low share of financial investment (e.g. in Italy and Spain,

[1] The German corporate 'Schuldschein' is most important private placement market in the euro area. It is a market for bilateral loans, non quoted, non registered and based on German law. Similar markets were recently established in the UK and France.

household wealth takes mainly the form of investment in real estate with 84 % and 74 % of households being home owners). In this regard, it is interesting to note that corporate bond corporate issuance in Europe is recovering. In the first five months of 2013, issuance of corporate bonds accounted for EUR 31 billion compared with EUR 44 billion in the record year 2010. [2]

While large companies have a relatively easy access to capital markets, most SMEs do not as they need net earnings (as measured by Ebitda: Earnings before interest, taxes, depreciation and amortization) in the order EUR 100 million to access to high yield corporate bond market. Mergers of small firms into medium size companies should be therefore encouraged. Larger firms tend also to show higher labour productivity and a strong dynamics of exports (de la Torre, 2013).

Access of medium size companies (Ebidta between EUR20-100 million) to local high yield markets has improved in some large euro area countries, including Germany, (5 markets and EUR 3.5 billion of issuance since 2010), Spain (Mercado Alternativo de Renta Fija (MARF)), Italy as well as in some non-euro area economies (e.g. Sweden and the UK).

But small SMEs, particurlarly in the euro area periphery, are still facing barriers to access finance. Enhancing covered bond markets would help. Covered bond markets appear to be a better instrument than ABS as they offer a double guarantee - asset backed and covered by the credit risk of the issuer - and the issuance of bad debts is limited as the first loss is retained by the originator.

In parallel with the traditional European covered bonds mortgage packaging, covered bonds packaging of SMEs loans should be further developed, e.g. along the lines of the initiative taken by Commerzbank. [3]

However, as these type of markets are not available in all euro area member states, it may be worth investing in a euro area-wide market for covered bonds. In particular, regulatory support should be provided to develop this type of new market.

Banks could be encouraged to transform SMEs loans into covered bonds by retaining the first loss (first equity tranche), and placing the junior tranche with the support of the EIB or appropriate entities/agencies in order to obtain a rating for the senior tranche and sell it (e.g. to insurance companies and other long-term investors). Such operation would also allow a portion of the super senior tranche to be accepted and discounted at the ECB. The implications could be significant as solvency and liquidity coefficients would benefit, which in turn would provide incentives for banks to encourage further lending (de la Torre, 2013).

In Spain, for example, the Instituto de Crèdito Oficial (ICO) has expanded its balance-sheet by EUR 20 billion, clearly insufficient to offset a credit crunch estimated at about EUR 80 billion. The credit crunch could have been significantly alleviated had ICO encouraged the transformation of SME loans into covered bonds as the leverage would have increased by four. The improved benefits of these new "company covered bonds" in terms of Basel III ratios would have limited the banks` appetite to cut SMEs funding as from 2014 onwards with beneficial effects also in terms of government support (de la Torre, 2013).

Other SMEs financing facilities have already been made available. Reverse convertible bonds can be issued, whereby the principal is tied to the equity market price. Profits can be

[2] However, this compares still negatively with an US issuance of USD 346 billion in 2012. Conversely, the MSCI small caps market in Europe in May 2013 accounted for 925 members and a total size of USD 902 billion (the average size was USD 975.4 million and the median size was USD 630 million).

[3] To secure the payments obligations of Commerzbank AG, a guarantee is provided to the bondholders. The guarantee is backed by a pool of SME loans, while other assets, loans and related mortgages are registered in the Refinancing Register to assure the segregation from Commerzbank insolvency. The advantages are mainly in terms lower capital consumption (as the loan is converted into a covered bond) and higher liquidity.

distributed in cascade according to which the equity holder gets a higher proportion of profits as the profit is lower. A similar technique is pursued through the "alternative capital providers" (ACP) which invest in viable companies - albeit with distressed debt - at higher interest rates, and guaranteed by the company assets.

In sum, fostering credit and equity markets in the euro area is essential to spur entrepreneurship, innovation and growth. The euro area is lagging vis-a-vis the US. As the US financial market structures proved rather successful and resilient in the recent banking crises, the euro area could selectively borrow from the US experience.

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