Benoît Cœuré: SME financing, market innovation and regulation

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the plenary Session 11 "Challenges and feasibility of diversifying the financing of EU corporates and SMEs", at the Eurofi High Level Seminar, organised in association with the Irish Presidency of the Council of the EU, Dublin, 11 April 2013.

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Why SMEs are special

Small and medium sized enterprises (SMEs) are special. They are the backbone of the euro area economy: they constitute about 98% of all euro area firms, it employs around three-quarters of the euro area's employees, and they generate around 60% of value added.[1] These figures happen to be even higher in those jurisdictions which have been most affected by the crisis.

SMEs are also specific in their financing structure. They turn more often to banks for their external financing than large firms but, at the same time, they are generally more likely to experience greater difficulties in obtaining funds. There are structural reasons for this, notably they are more opaque and their corporate capabilities more difficult to assess, because their financial statements are less informative and their credit histories are usually shorter. These characteristics are compounded by fixed costs in external assessment and monitoring. All this leads to higher transaction costs, especially those stemming from asymmetric information, for SMEs.

It is therefore to some extent inevitable that credit sources for small firms tend to dry up more rapidly than for large companies during economic downturns, thereby disrupting the business and investment activities of these firms to a greater extent.[2] And this has indeed been the case during the crisis in the euro area. The creditworthiness and financial health of SMEs have deteriorated more sharply than those of large firms, and the protracted period of weak economic conditions has exacerbated the asymmetric information challenges of SMEs. The statistics currently available do not provide timely and high-frequency hard data on the balance sheet position of a representative set of SMEs for the euro area. Yet, based on survey information provided by the ECB (the Survey on Access to Finance of Enterprises, SAFE), we see that SMEs' profits, liquidity buffers and own capital have developed less favourably than have those of large firms during the crisis[3] (Charts 1 and 2).

From the viewpoint of commercial banks' risk management, it may thus be partly understandable that banks take a more selective approach in supplying loans in a recession in order to preserve the quality of the asset side of the balance sheets. But, in general, such credit tightening currently appears to be very severe for SMEs, because they are perceived

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1 See "EU SMEs in 2012: at the crossroads. Annual Report on SMEs in the EU 2011/2012", EC DG-Enterprise.

2 See Fazzari, S., G. Hubbard and B. Petersen (1988), "Financing Constraints and Corporate Investment", Brookings Papers on Economic Activity 1, 141-195 and Duchin, R., O. Ozbas and B. A. Sensoy, "Costly external finance, corporate investment, and the subprime mortgage credit crisis", Journal of Financial Economics, Vol. 97, Issue 3, (2010), pp. 418–435.

3 Qualitative information on SME access to finance is extracted from the ECB's biannual survey on access to finance of SMEs in the euro area (SAFE). See http://www.ecb.europa.eu/stats/money/surveys/sme/html/index.en.html.

by banks to have a higher probability of default than larger firms, and because SMEs are often unable to switch from bank credit to other sources of external finance.

As a result, SMEs are more likely to be affected by excessive bank risk aversion and thus by outright rationing of credit provision than are large firms. Difficulties in borrowing, which influence not only their day-to-day activities, but also their ability to grow, may then easily transform liquidity constraints into solvency risk.

To illustrate this point, two facts are worth mentioning. First, SMEs tend to face higher costs for bank finance. A simple comparison between small loans (typically to SMEs) and very large loans (typically to large corporations) shows that euro area SMEs were paying on average around 160 basis points more than large euro area companies in the six months up to January 2013.[4] There is also a substantial divergence across euro area countries which has worsened since the beginning of the financial crisis (Chart 3). For instance, in the same period, the spread was around 50 basis points for SMEs in Austria and Belgium, but 261 in Spain and 174 in Ireland. Just to put this in a "historical" perspective: between 2003 and 2008 the same spread was 84 basis points in the euro area, 79 basis points in Spain and 44 basis points in Ireland.

The second fact that is worth mentioning is the higher rejection rates of loan applications of SMEs, as the ECB survey shows (Chart 4). SMEs are systematically reporting that they face more financing obstacles than large firms across major euro countries (except here in Ireland, where firms are reporting to be highly constrained irrespective of their size). This appears, at least in part, to be related to their financial position. Indeed, when linking information on the financial health of SMEs with the actual financing obstacles they experience, it turns out that firms in countries with higher leverage and interest payment burdens as well as lower profits tend to be more affected by financing obstacles than SMEs in other euro area countries (Chart 5).

However, it is worth noting that in conjunction with credit constraints, several other issues have an impact on the environment in which SMEs operate. For instance, they are more affected by downward trends in the economy and structural rigidities, i.e. a lack of demand for their products, high input prices, unfavourable regulation, heavy administrative burdens, inflexible labour and product markets, etc. Since such factors differ across countries, the financing costs of SMEs will inevitably also vary across the euro area. Obviously, the Eurosystem cannot influence these factors.

In periods of binding bank lending constraints, a mitigating factor is the ability of corporates to replace bank credit with alternative sources of financing. Since the outbreak of the financial crisis, internal financing and external financing instruments other than bank loans in general have increased in importance relative to bank loans. Depending on the financing environment, substitution effects have differed markedly across euro area countries (Chart 6). On the one hand, enterprises have replaced bank loans with market-based financing or financing via unquoted equity during the crisis. In this respect, the relevance of debt securities has increased, especially in some countries, such as France. On the other hand, inter-company loans have gained importance in other countries, such as Germany. In the same period, trade credit appears to have taken on a buffer role in some euro area countries.

We know, however, that some of these substitution activities have mainly affected larger companies, as in the case of debt securities, while trade credit, leasing and factoring are closer substitutes to loans for SMEs (Chart 7). But trade credit, leasing and factoring are

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4 The spread refers to the difference in the rates on small-sized new business loans (up to €1 million) and large new business loans (over €1 million). Euro area rates are weighted averages, based on new business volumes, of national rates.

strictly related to the business activity of companies and in recessions their buffer role might be limited by the reduction in the exchange of goods and services.

Taking a macroeconomic perspective, credit supply conditions have certainly been found to have an impact on real economic activity during the crisis. Analyses carried out by ECB staff[5] suggest a rather limited contribution of credit supply conditions to euro area economic activity between 2007 and the first quarter of 2008. By the fourth quarter of 2008, however, the impact of credit supply conditions appears sizeable. At the peak of the crisis, namely in the first half of 2009, model-based analysis points to credit supply effects accounting for an almost 2– percentage-point contraction in annual real GDP growth, namely around one-third of the overall contraction. As the sovereign debt crisis unfolded, credit supply factors turned detrimental to growth again. In this context, riskier borrowing segments are highly vulnerable to the self-reinforcing dynamics of weak economic conditions, low financial buffers and tight bank lending policies. Actually, the Eurosystem Bank Lending Survey shows over the recent quarters that both healthy and stressed banks report risk perceptions as their main concern and significantly tighten margins on riskier borrowers.

Policy actions supporting lending to SMEs

During the crisis, the ECB took exceptional monetary policy actions, distinguishing between standard and non-standard measures. Standard measures have included the reduction of all key interest rates. Non-conventional measures have comprised fixed-rate full allotment mode in refinancing operations, the lengthening of the maturity of such refinancing operations up to 36 months, the extension of the list of eligible collateral (see Chart 8), the liquidity provision directly in foreign currencies, the reduction in the reserve requirements from 2% to 1%, the covered bond purchase programmes, the securities market programme, and, finally, the announcement of the outright monetary transactions. Such actions have proved to be effective in alleviating bank funding constraints, containing the risks of a disorderly bank deleveraging process, and supporting the effective transmission of interest rates across the euro area, amid a dysfunctional financial market. These measures were exceptional in nature, scope and magnitude, and yet appropriate for the severity of the circumstances. These interventions have served to considerably ease the downside pressures to price stability by avoiding an abrupt credit crunch stemming from sudden shortages of liquidity and funding for banks. However, at times, the effectiveness of monetary policy itself has been hindered by financial fragmentation, in particular against the backdrop of a sovereign debt crisis in some euro area jurisdictions. As a result, the accommodative monetary policy stance set by the Governing Council has affected firms rather unevenly. The ECB will provide ample liquidity as long as needed, but market participants have to continue their efforts to facilitate the transition to a less central-bank reliant, more market-based financial system.

Against this background, attention has turned to the role of public policies in reducing impediments and unclogging credit channels towards SMEs. As a first measure, most governments have expanded credit guarantees to SMEs for the purpose of inducing banks to reopen their lending facilities, thereby reducing the risk that banks need to take on their balance sheets when granting new loans. Other measures have tended to stimulate the chronic shortage of supply of capital into new seed, start-up and early-stage firms. Venture capital (VC) funds have been channelled through public/private co-investment VC funds managed by private sector fund managers. Innovative instruments have included the promotion of investment in SME equity to cope with the undercapitalisation problem. Some of

[5] For a detailed description of a model-based methodology of this type, see Box 2 "Analysis of the impact of credit supply factors on economic activity using structural models", Monthly Bulletin Article, January 2011, European Central Bank. See also ECB Structural Issues Report 2013, "Corporate finance and economic activity in the euro area", *forthcoming*.

these measures have a longer-term structural perspective, rather than something that can address the immediate conjunctural weakness of SMEs.

Overall, loan schemes, especially guarantees, tend to have a much larger impact in terms of the number of firms affected, while venture capital and similar schemes are much more targeted and restricted to specific groups of firms. However, they have proved to be of limited effectiveness in stressed countries, given the higher funding costs faced by stressed sovereigns themselves.

In terms of impact, while governments have strengthened their support measures for SMEs during the financial crisis, it seems that SMEs in most countries have not yet seen a visible improvement, at least based on evidence from survey results (Chart 9). Apparently, while a range of government support measures exists for alleviating SMEs' access to finance, it has proved difficult to reach the policy targets, i.e. the SMEs.

Beyond government financing instruments to support SMEs' access to finance, other policy actions may be considered. This includes the development of deeper capital markets accessible also for SMEs and a wider use of ratings for SMEs. In addition, combating payment delays in trade credit financing helps to alleviate liquidity constraints and has already been put in place in some countries.

Besides governments, supranational institutions also offer support measures to SMEs – measures which could be enhanced. Traditional instruments of intervention are related to the European Investment Bank (EIB) lending to SMEs[6] and the European Investment Fund's (EIF) actions in the ABS market designed to revive investors' interest and confidence, by facilitating large and liquid transactions. An interesting pilot project on trade finance was launched by the EIB in December 2012 for Greece. For the first time, the EIB is involved in a short-term credit support instrument.

The regulatory framework

In addition to direct support measures by national governments as well as by European and international institutions, the regulatory framework may also have an impact on the incentives of banks regarding their exposures to SMEs. Let me note in this context that the European Banking Authority (EBA) has recently published a detailed analysis of the estimated impact of banking solvency regulation on SME lending, with a particular focus on the relevant provisions of the forthcoming capital requirements legislation in the EU[7] In this regard, a clear distinction should be made between micro- and macro-prudential policy objectives and tools that may have relevance for supporting SME lending.

From a micro-prudential perspective, minimum capital requirements and the underlying risk weights can be considered as the main factors potentially affecting banks' incentives to lend to SMEs. In the current regulatory framework, there are different provisions affecting SMEs, depending on whether a standardised approach or more sophisticated approaches are used. As regards the standardised approach, loan size plays an important role when defining the risk weight and thus the pertinent capital requirement. To clarify: small-sized loans up to €1 million are treated as retail exposures, and benefit from a lower risk weight of 75%, compared with a risk weight of 100% for unrated corporate loans. Hence, the current regulation treats small-sized loans, which are likely to be taken up mainly by SMEs, in a more favourable manner.

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6 In 2012, more than 200000 SMEs received EIB Group support, compared to 120000 in 2011. EIB signed loans for SMEs and mid-caps in 2012 amount to €12.1 bn and disbursements to €9.8 bn. EIF committed 1.4 bn of new venture capital in 63 new funds leveraging over €7 bn.

7 See European Banking Authority (EBA), "Assessment of SME proposals for CRD IV/CRR", September 2012.

However, for larger (over €1 million) loans there is no favourable treatment for SMEs under the standardised approach. For unrated loans exceeding €1 million, the treatment of exposures to SMEs and large companies is the same. Only companies with good credit ratings – which are typically larger corporates – benefit from lower risk weights.

Importantly, for banks using the more sophisticated approaches for credit risk, namely the advanced internal ratings-based (IRB) approaches, the current regulatory framework further provides for preferential treatment of SME loans vis-à-vis large corporate exposures.

The Capital Requirements Regulation and Directive, or CRD IV, entails a significant increase in the quality and quantity of capital. While the phasing-in is rather long and expected to end in 2019, the implementation of various capital buffers and the higher level of minimum capital requirements – though clearly beneficial for enhancing financial stability in the long term – are estimated to increase the overall cost of funds. This is likely to be reflected in the interest rates charged to all clients, including SMEs.

Aware of the potential implications for SMEs and with the aim of partly neutralising the potential adverse impact of increased minimum capital requirements, EU co-legislators have agreed on the inclusion of a specific discount factor for exposures to SMEs, for loans up to €1.5 million. This measure is expected to reduce capital requirements for SMEs by about 25%.[8] The ECB supports this proposal and considers it as an important policy tool that may help SMEs in their access to bank finance.

Taking a long-term perspective, together with micro-prudential considerations, the CRD IV will also provide a harmonised legal framework for a range of macro-prudential tools. In this regard, the first policy tool that is explicitly designed to address systemic risk is the counter-cyclical capital buffer, which will be phased in gradually from 2016 onwards. While the primary objective of this buffer is to enhance the resilience of banks by building up buffers in periods of excessive credit growth that can be released when the system as a whole is in distress, a positive side effect of the application of the measure is that it may contribute to smoothing the credit cycle, thus providing funds for corporate clients, including SMEs, also in recessions. This however also implies that as long as we do not have sufficient capital buffers that could be released to absorb losses or to loosen prudential measures regulated by EU law, the use of macro-prudential tools to support SME lending is very limited.

Finally, in a broader context, there is a need for structural market innovation to improve SME financing. Such an innovation would create a market for asset-backed securities, where the underlying assets are loans to SMEs. It could also support the revival of this market segment by increasing its transparency and therefore investor confidence. Having access to a diversified source of finance for SMEs will enhance their resilience through the business cycle. Because SMEs are characterised by their relatively small size and because it is costly to collect information on their projects, they have limited access to capital markets. In this context, securitisation offers an opportunity for the custodians of large pools of European savings, i.e. insurance and pension funds, to channel resources to SMEs. In this vein, the efforts put in place in the Prime Collateralised Securities (PCS) initiative should be commanded. The PCS has defined common criteria on standardisation, quality, simplicity, and transparency with the aim to improve market depth and liquidity for the ABSs. It also includes specific criteria on SME ABS.

Prudential reforms could also help to revive securitisation activity. A key initiative in this field is the so called Solvency II Directive for the insurance sector, which aims to align capital requirements with risks that insurance companies have actually taken in their investing activities. In the current proposal for Solvency II, which will probably come into force on

8 See Article 476a, Para (1), of the Capital Requirements Regulation (CRR): "Capital requirements for credit risk on exposures to small and medium sized enterprises shall be multiplied by the factor 0.7619."

1 January 2016 with a 10-year phase-in period, the capital requirements for certain securitised products will increase significantly, thus potentially reducing insurers' willingness to allocate funds to such asset classes. The appropriateness of the capital charges in Solvency II and their consistency with the capital requirement rules under the CRD IV are currently being reviewed by EIOPA. In this regard, particular attention needs to be paid to providing a level playing field for banks and insurers as well as to enhancing long-term financing of the real economy through the securitisation of debt.

Conclusion

In the nearer term, how can the impediments to bank funding of SMEs be addressed? In essence, these impediments are of three types: the banks' own funding conditions, their perception of the credit risk of their clients, and lack of capital. The ECB does not have a magic wand. The central bank cannot compensate for a shortage, or a misallocation of equity. That is something that has to be addressed, in one form or the other, by other stakeholders. Neither can the central bank alter the credit risk of individual borrowers, although governments can have an impact here through reforms that improve the operating environment of those firms – labour and product market regulation for instance. Where the central bank has a direct role, within its mandate, is primarily with respect to bank funding conditions. Indeed, the ECB has taken and will continue to take appropriate measures to ensure that bank funding is not a source of financial fragmentation or an impediment to bank lending. It is reasonable to think that simultaneous action on all three counts, by the relevant stakeholders in each case, would be mutually reinforcing.

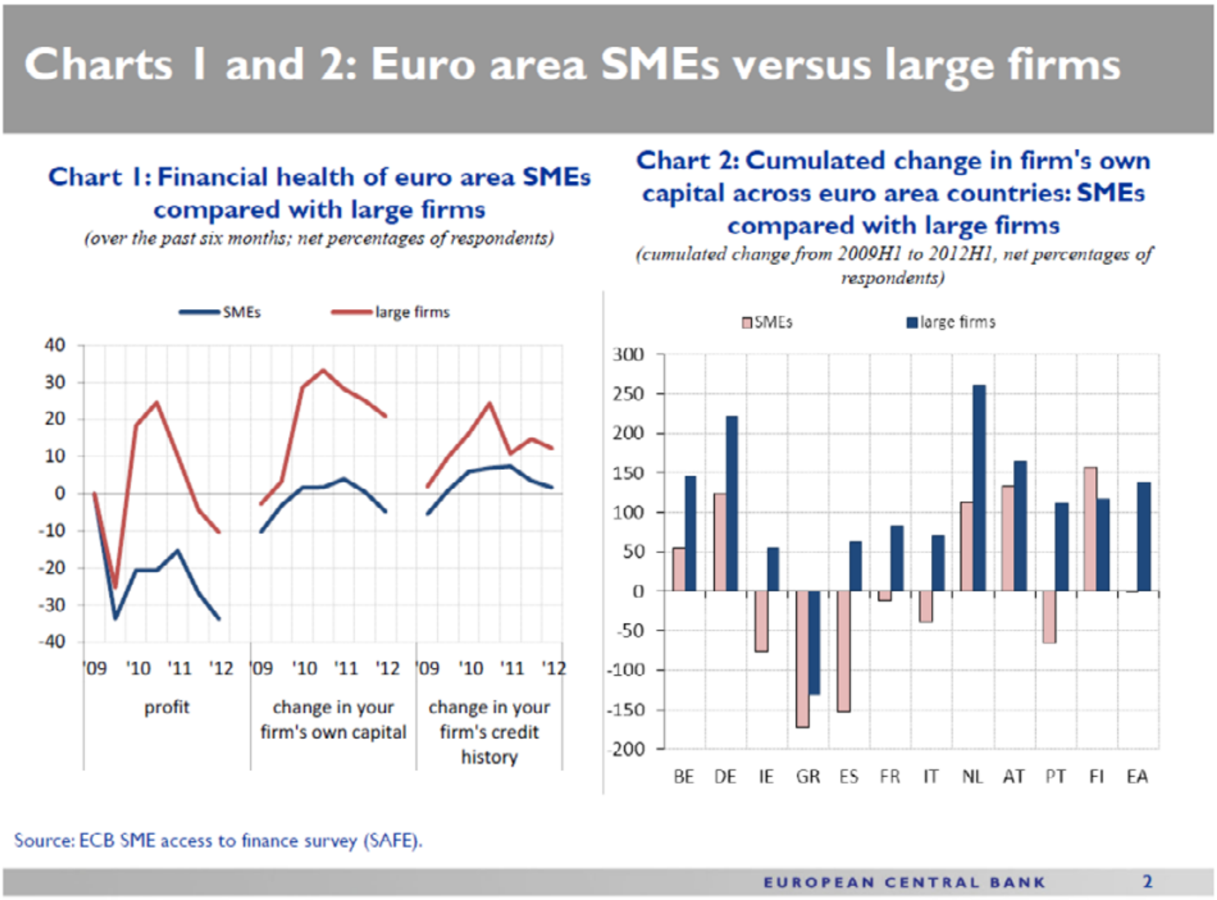
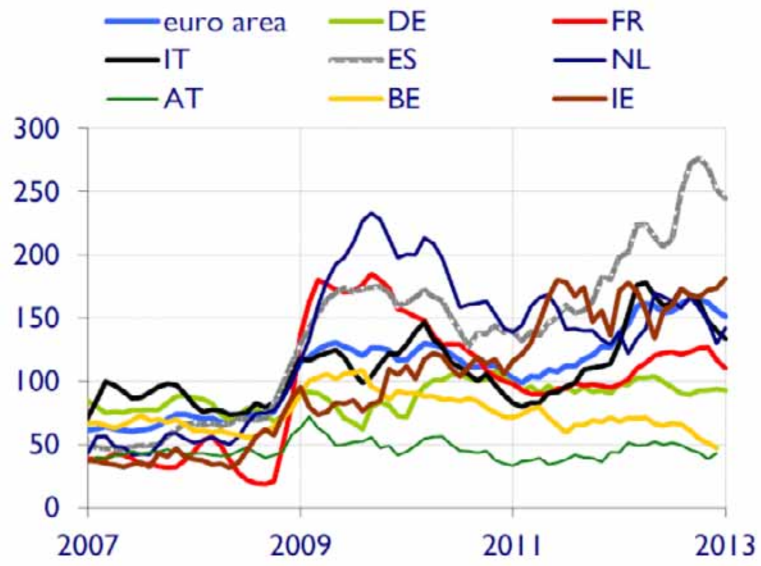


Chart 3: Spread between bank lending rates on small versus large loans across euro area countries

(percentages per annum; three-month moving averages)



Source: ECB (MIR statistics).
Notes: Small loans are loans of up to €1 million, while large loans are those above €1 million. Aggregation is based on new business volumes.
Latest observation: January 2013.

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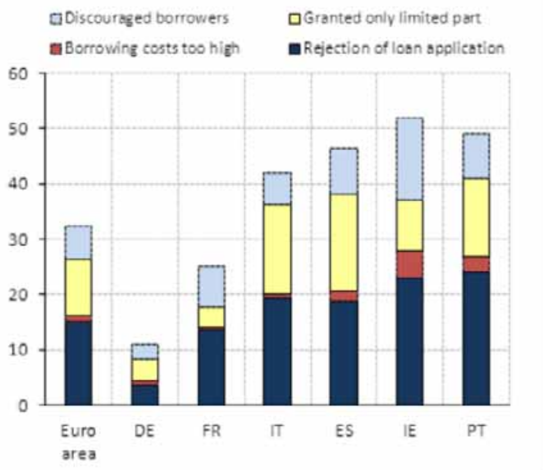
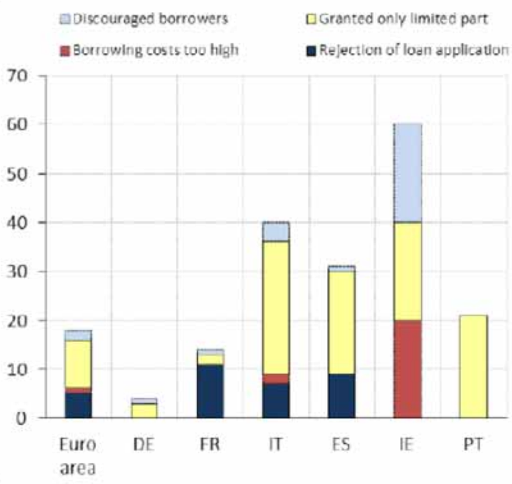
Chart 4: Financing obstacles reported by SMEs across euro area countries

Credit constraints reported by SMEs across euro area countries
(percentages of respondents; April to September 2012)



Credit constraints reported by large firms across euro area countries
(percentages of respondents; April to September 2012)



Source: ECB SME access to finance survey (SAFE).

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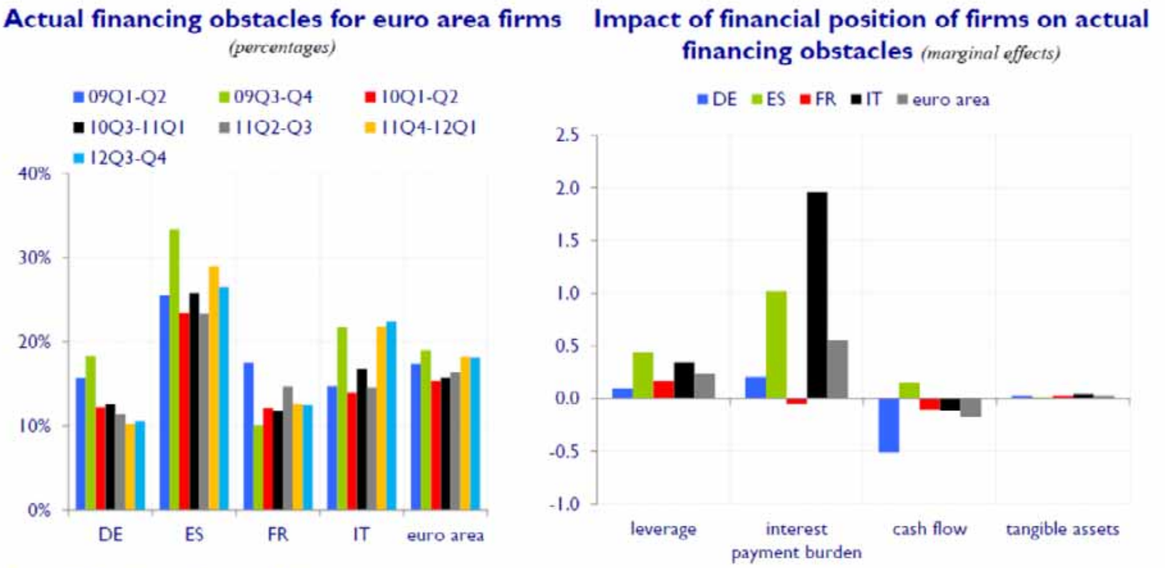
Chart 5: Financing obstacles for euro area firms derived from survey and balance sheet information



Source: SAFE and Amadeus Bureau van Dijk.
Note: Based on probit regressions with robust standard errors and time, sectoral, country, age and size dummies (Ferrando and Mulier, 2012). The dependent variables take the value 0 when a firm has successfully applied for a source of external finance or when it has not applied because of sufficient internal funds or alternative sources of external financing, and the value 1 when a firm has applied but the application has been rejected or when a firm has received only a part of the financing it has requested. It also takes the value 1 when a firm had to refuse a loan because the costs were excessive or the terms and conditions were unfavourable. Period: 2009 – 2011.

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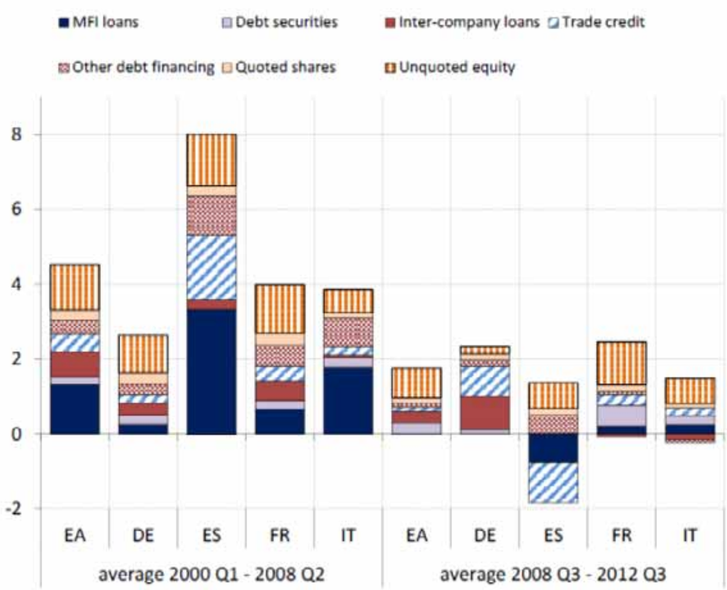
Chart 6: Substitution effects between euro area non-financial corporations' external financing instruments

(annual transactions; in percentages of the amounts outstanding of external financing)



Source: ECB (euro area accounts). ECB Structural Issues Report 2013 "Corporate finance and economic activity in the euro area", forthcoming.

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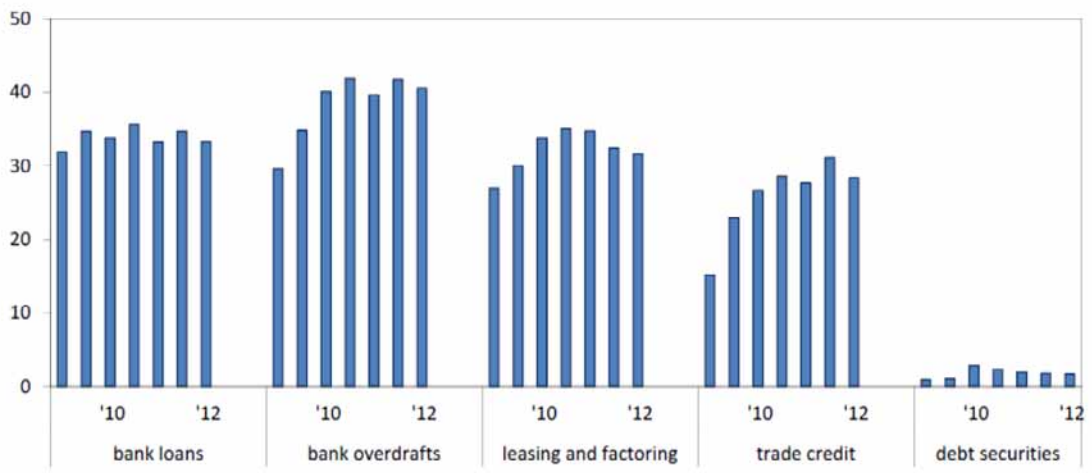
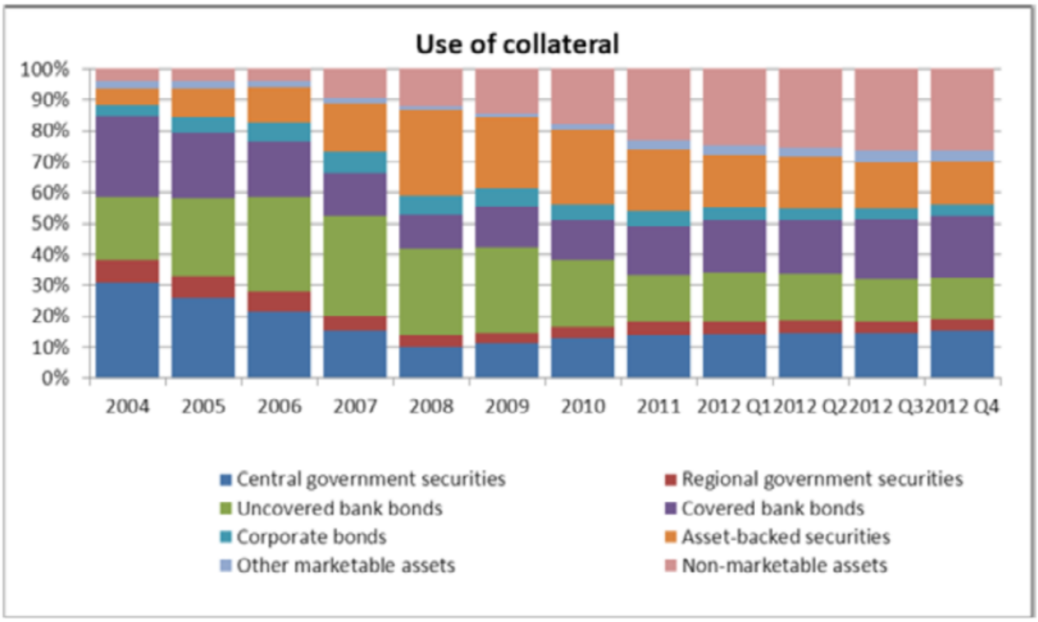
Chart 7: Use of financing instruments by euro area SMEs

(over the past six months; percentages of respondents)



Source: ECB SME access to finance survey (SAFE).

Chart 8: Collateral put forward in Eurosystem credit operations by asset group



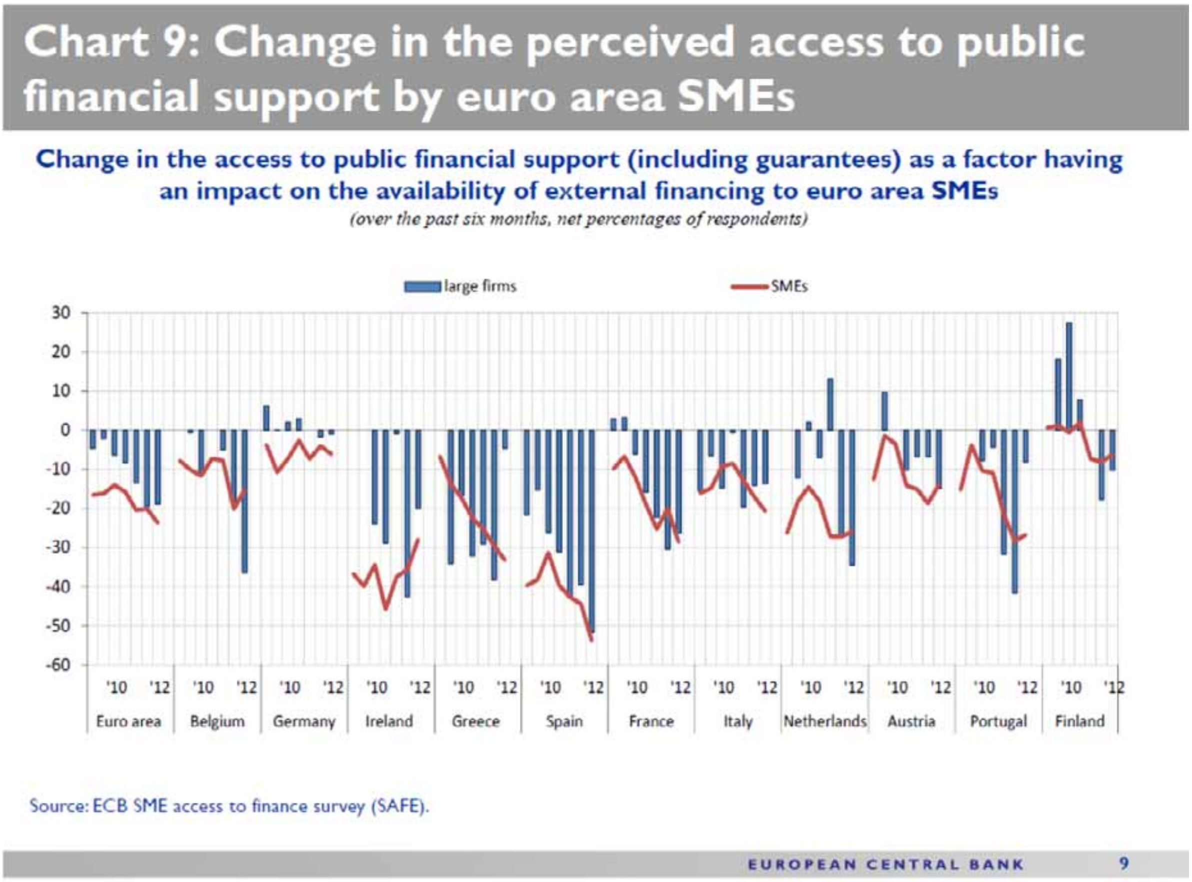


Chart 9: Change in the perceived access to public financial support by euro area SMEs
Change in the access to public financial support (including guarantees) as a factor having an impact on the availability of external financing to euro area SMEs
(over the past six months, net percentages of respondents)
large firms
SMEs
30
20
10
0
-10
-20
-30
-40
-50
-60
'10 '12
Euro area
Belgium
Germany
Ireland
Greece
Spain
France
Italy
Netherlands
Austria
Portugal
Finland
Source: ECB SME access to finance survey (SAFE).
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