

Restoring Financing and Growth To Europe's SMEs

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AGENDA

1. Introduction & Report Focus
2. SMEs in Europe
3. Main Findings
4. Four sets of Impediments & “Best-practice” Initiatives
5. Recommendations

INTRODUCTION & REPORT FOCUS

Critical Role of SMEs for European economy

- SMEs account for 58% of EU value added and provide 2 of every 3 jobs
- Financing to SMEs has fallen sharply since 2007
- European recovery will remain constrained if SMEs are not able to access more financing on easier terms (offered lending rates, collateral)

Joint Report: IIF and Bain & Company

- Report based on >150 bilateral interviews conducted with banks, SME associations, officials and providers of alternative finance
- Focus on France, the Netherlands, Ireland, Spain, Portugal, and Italy



RESTORING FINANCING AND GROWTH
TO EUROPE'S SMEs
Four sets of impediments and how to overcome them

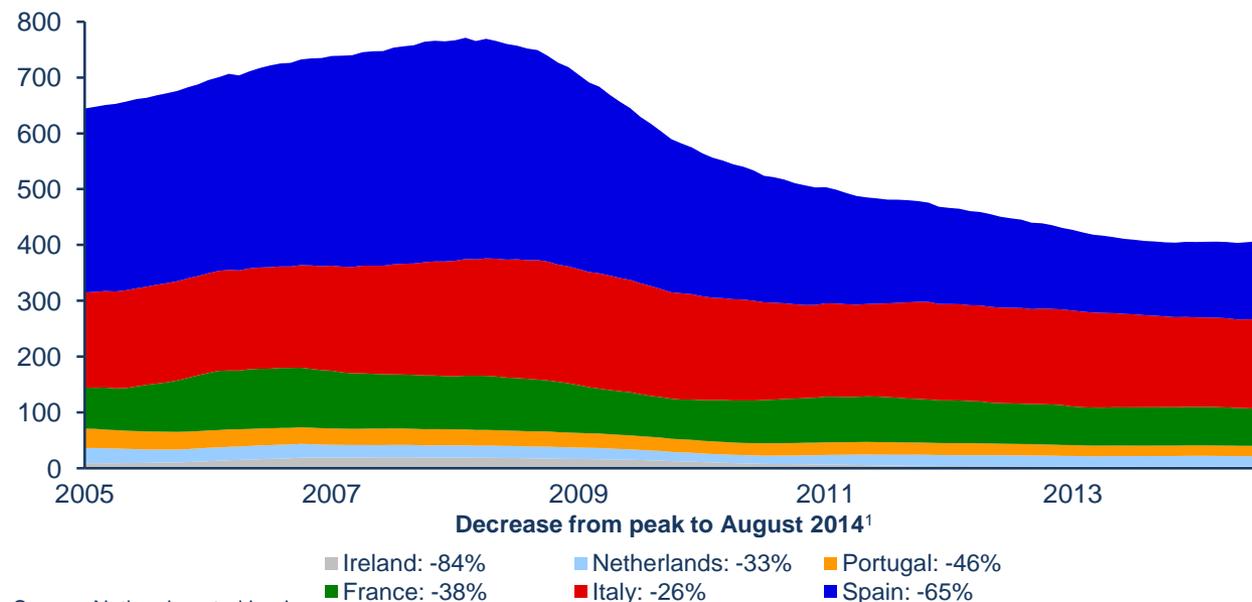


BAIN & COMPANY

SHARPLY REDUCED VOLUMES OF NEW BANK LENDING TO EUROPEAN SMES

- August 2014: 49% drop in the six countries from pre-crisis peaks
- Declines ranging from 26% (Italy) to 84% (Ireland)
- Little recovery since (better in Spain, worse in Italy)

Volume of New Loans to Nonfinancial Corporations up to €1mn
12-month cumulative flows



Source: National central banks.

¹ Percentage change calculated on a country-by-country basis from pre-crisis peak to August 2014

TIGHTER SUPPLY OR WEAKER DEMAND?

Supply Has Tightened

- Bank capital is more plentiful...
- ... but managed more carefully
- Traditional credit assessment capacity hit by consolidations/branch closures
- Bigger expected losses boost “cost of risk”

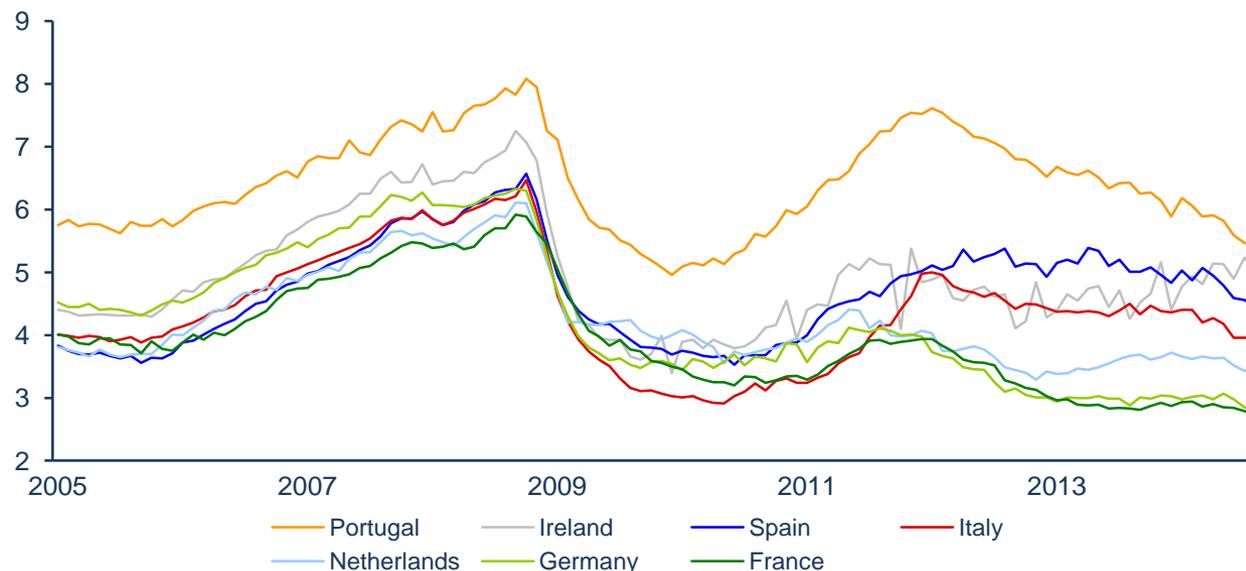
But Demand May Have Weakened More

- GDP still below pre-crisis peaks
- Working capital instead of investment needs
- Exporting firms rely on supply chain and own cash flows
- High offered lending rates and elevated requirements for collateral/guarantees

CONVERGING BORROWING COSTS?

- Increased “cost of risk” offset reductions in funding costs
- Offered lending rates higher than extended ones reported by ECB
- Higher credit quality, greater reliance on guarantees and collateral and shorter maturities in periphery than in core
- Spreads over funding costs as high as 600 bps, with few takers

Interest Rates on New Loans to Nonfinancial Corporations up to €1mn
percent



Source: European Central Bank.

FOUR GROUPS OF IMPEDIMENTS

- **Impediment 1:** Information about SME creditworthiness and potential is too costly and difficult to obtain
- **Impediment 2:** SMEs face many disincentives to achieving greater scale and financial health
- **Impediment 3:** Banks are less interested and able to shoulder credit risk than before the crisis
- **Impediment 4:** Alternative funding is less available; providers face many barriers to financing SMEs

TWO FURTHER KEY FINDINGS

- Promising initiatives have been taken across countries to address impediments
- Little is known in many of the countries about what has been done elsewhere

IMPEDIMENT 1: INFORMATION ON CREDITWORTHINESS IS OFTEN COSTLY AND UNAVAILABLE

“Annual accounts are difficult to access and up to 18 months out of date ... it’s difficult to get more detailed data such as cash flows and positive credit information.” (Spanish bank)

“The biggest issue for setting up funds for SMEs is that there is no standard loan documentation, as opposed to mortgages, where there is standardization.” (Dutch bank)

Priority

Reduce information asymmetry costs and increase transparency

IMPEDIMENT 1: INFORMATION ON CREDITWORTHINESS IS OFTEN COSTLY AND UNAVAILABLE

Measures to support information collection

- Ensuring the collection of all available data, including audited accounts, payment information, ownership and structure, credit information, banking relationships and guarantees
- Establishment of rigorous, comprehensive central credit registers along the Banque de France model

Measures to support information dissemination, rating and scoring

- Publication of information on payment performance and financial position
- Support development of market for private rating and credit scoring
- Publication of SME credit scores and ratings by public sector institutions

“Best-practice” Policies

- France: Credit registry and payments information supplemented by data on financial positions, supporting credit scoring by central bank for 280,000 firms
- Belgium/Netherlands: Standard Business Reporting, allowing firms to use simplified balance sheet and income statements done in XBRL

IMPEDIMENT 2: DISINCENTIVES TO GREATER SCALE AND FINANCIAL HEALTH

“The smallest companies don’t have all the ‘antibodies’ to reinvent themselves. Some are in the domestic market trying to optimize, while others are just trying to sustain daily life.” (Italian bank)

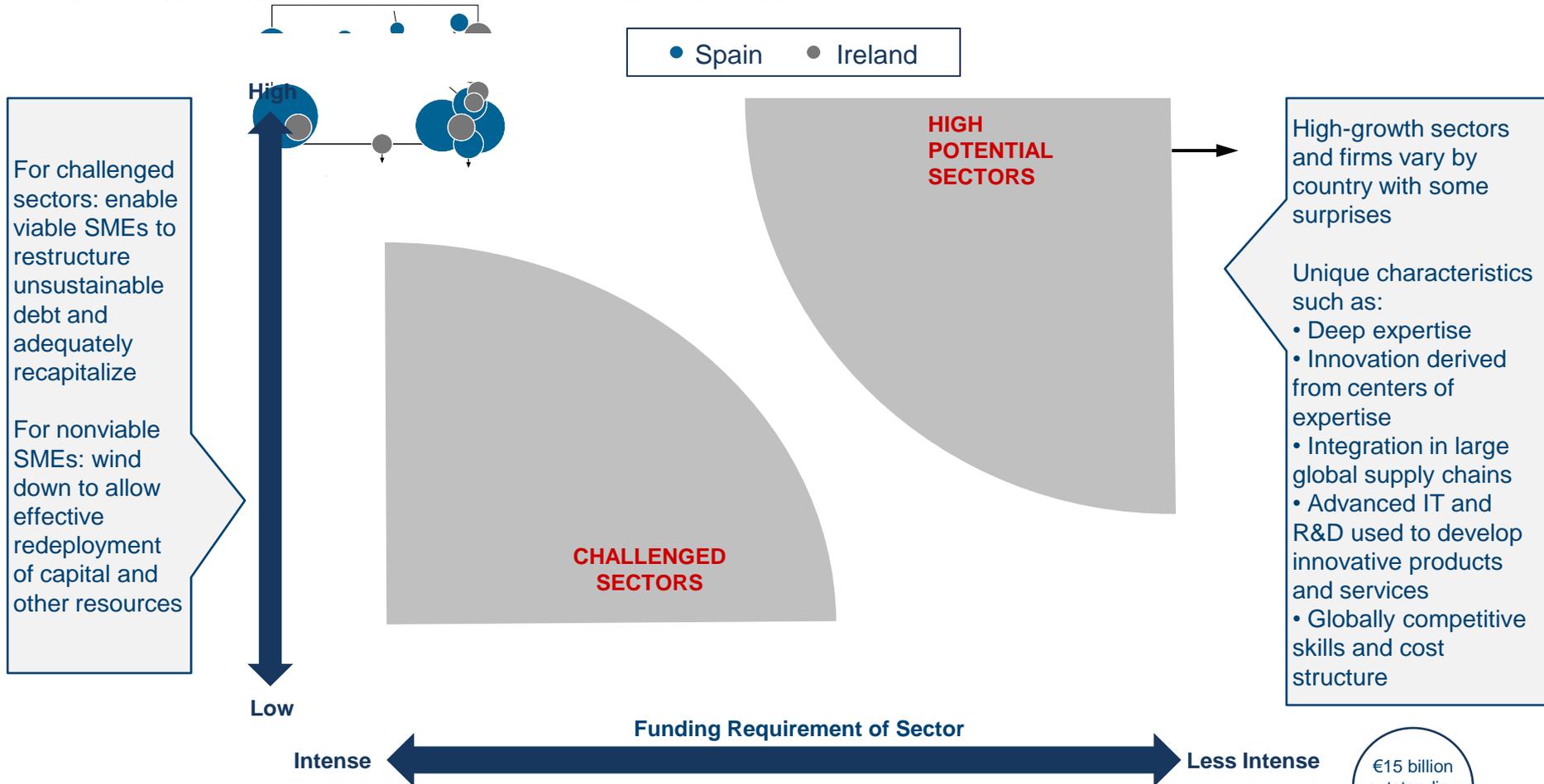
“There are very good SMEs in Portugal, but they stay as micro-SMEs ... Management is not prepared to become global ... Portugal is a very small country, so it’s difficult to expand alone and create economies of scale ... The mindset of entrepreneurs is to stay small and retain control.” (Portuguese association)

Priority

Reduce regulatory, administrative and fiscal burdens, focus resources on high-potential SMEs and support restructuring of challenged SMEs

IMPEDIMENT 2: DISINCENTIVES TO GREATER SCALE AND FINANCIAL HEALTH

The crisis has hit some sectors harder than others



Note: Funding requirement of sector estimated using 2011 data on loan to deposit ratios; outstanding loans data is for 2011; sector resilience for Ireland estimated using a ranking that incorporates 2010–11 data for GDP growth, GDP size and the number of large companies; sector resilience for Spain estimated using 2010–11 data for GVA growth

Source: Bank of Spain; INE BACH; Central Bank of Ireland; Central Statistics Office Ireland, IHS Herold, Bain analysis – 2011 data

IMPEDIMENT 2: DISINCENTIVES TO GREATER SCALE AND FINANCIAL HEALTH

Measures to improve incentives for achieving greater scale

- Reductions in costs of SME regulatory compliance
- Design reporting and auditing frameworks seeking to reduce disincentives to growth

Measures to support SME expansion and exports

- Provide education in management and business strategy for SME owners
- Introduce support for SMEs looking to internationalize

Measures to bolster SME financial health

- Increase access to equity, including risk capital
- Implement legislation allowing “second-chance” Chapter 11-style debt restructuring

“Best-practice” Policies

- Ireland/ Italy: Chapter-11 style second chance insolvency schemes to facilitate restructuring, freeing bank capital, liquidity and collateral
- Italy: Allowance for Corporate Equity whereby a set percentage of new equity can be deducted from taxable income to reduce relative tax advantage of debt

IMPEDIMENT 3: BANKS ARE ABLE TO SHOULDER LESS CREDIT RISK THAN BEFORE THE CRISIS

*“To address the problem of SME debt, banks are considering debt resolution strategies that provide sufficient incentives to viable borrowers to work through the debt overhang.”
(Irish business association)*

“The mutual guarantee system works well in a period of a crisis ... Mutual guarantees in Portugal are public private initiatives: the private mutual guarantee forms the basis of funding while the public authority guarantees form a reinsurance fund or counterguarantee fund.” (Portuguese authority)

Priority

Implement targeted actions that enable banks to make new loans without putting scarce capital and profitability at greater risk by reducing or sharing “cost of risk”, as well as finding cost-effective solutions to restructure NPLs

IMPEDIMENT 3: BANKS ARE ABLE TO SHOULDER LESS CREDIT RISK THAN BEFORE THE CRISIS

Measures to reduce uncertainty

- Press ahead with banking union, asset quality reviews and stress tests, with adequate fiscal backstops
- Reduce uncertainty for banks about likely capital and other regulatory requirements going forward

Measures to optimize official support

- Share knowledge and best practices to improve the design and implementation of national guarantee schemes
- Channel support to SMEs by establishing government-backed development banks

Measures to incentivize NPL restructuring and support lower lending margins

- Share learnings and best practices from innovative debt restructuring schemes
- Allow loan provisions and write-downs to be written against tax liabilities more quickly and consistently

“Best-practice” Policies

- Portugal: Mutual guarantee schemes, with focus on export or investment credit, have had high uptake and an outstanding portfolio of €3 billion end-2013
- EIF: Risk-sharing instruments that limit losses and contain moral hazard via risk-sharing and “skin-in-the-game” adjustment of incentives

IMPEDIMENT 4: ALTERNATIVE FUNDING PROVIDERS FACE MANY BARRIERS TO FINANCING SMES

“The lack of alternative funding sources is partly structural – the markets have not been set up, debt issuances need to be high – and also partly regulatory – institutional investors struggle to invest in SME debt.” (Spanish investor)

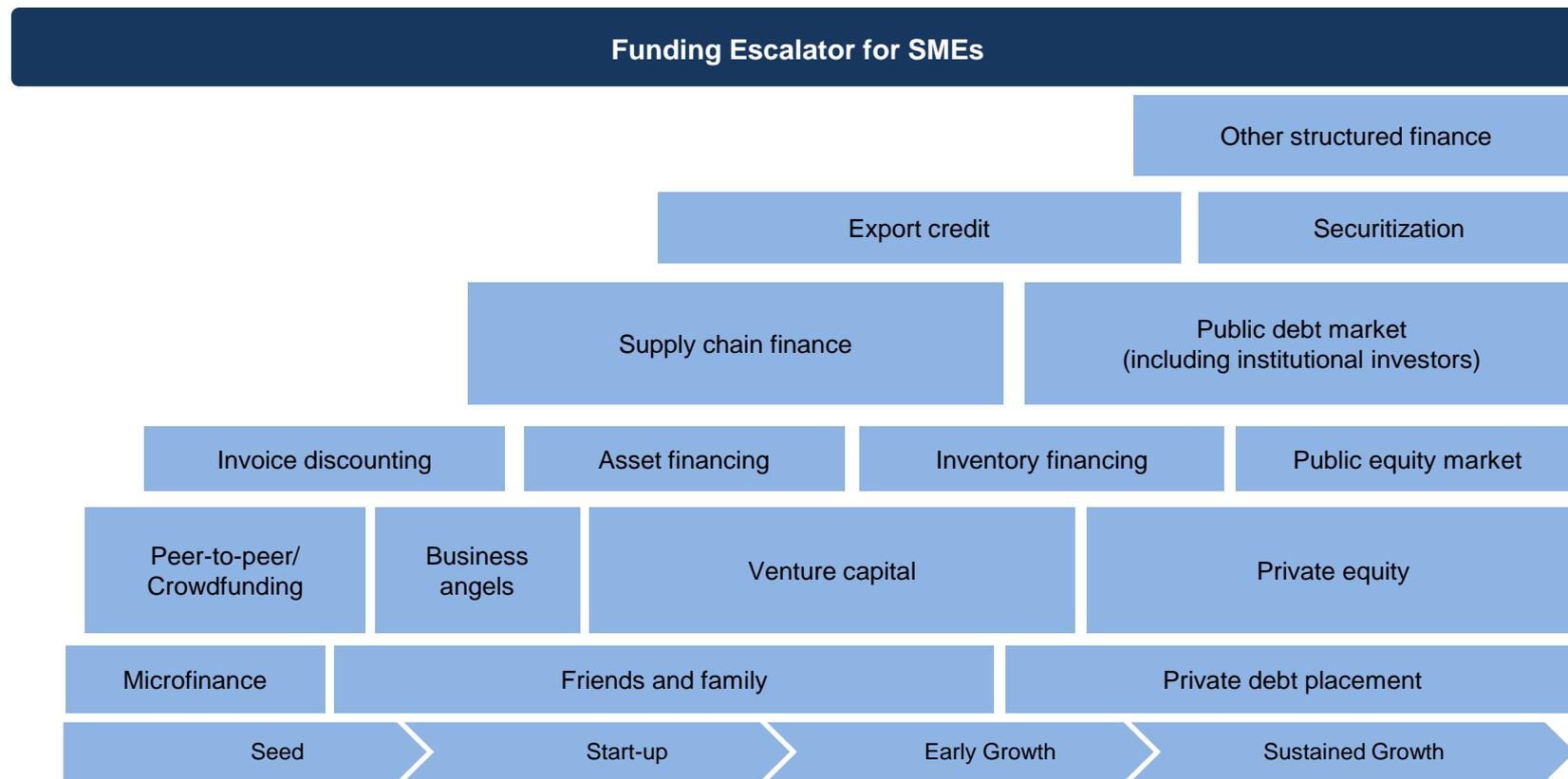
“Institutional investors currently have a low percentage of funds invested in non-listed assets – there is room to expand this type of investment. But this would require an intermediation scheme for financing by large institutional investors.” (Italian authority)

Priority

Foster an eco-system of finance providers needed to support SMEs across different stages of maturity

IMPEDIMENT 4: ALTERNATIVE FUNDING PROVIDERS FACE MANY BARRIERS TO FINANCING SMES

As companies grow, their financing needs change



Source: *Restoring Financing and Growth to Europe's SMEs*, IIF and Bain & Company, 2013.

IMPEDIMENT 4: ALTERNATIVE FUNDING PROVIDERS FACE MANY BARRIERS TO FINANCING SMES

Measures to address regulatory impediments

- Broaden scope for investments by pension funds and insurance companies in SMEs
- Support establishment of innovative funding models (e.g., P2P funding networks) by creating the necessary regulatory framework

Measures to support the emergence of alternative funding

- Use tax incentives to encourage broader investor base in SMEs or SME funds
- Provide additional equity investments through development banks and other national funding to bolster SME capital and borrowing capacity

Measures to support market liquidity and securitization

- Improve liquidity and facilitate greater SME access to additional sources of funding
- Kick-start the development of new and emerging alternative funding sources
- Reduce currently excessive regulatory capital requirements for ABS

“Best-practice” Policies

- Ireland: Irish Employment and Investment Incentive Scheme, allowing individual investors to make direct investments in SMEs and obtain income tax relief
- EIF: Works with private fund managers to allocate PE/VC for SMEs

CONCLUSION & RECOMMENDATIONS

- Policy measures to ease each impediment are needed mostly at the member state level, but EU “templates” based on good practice can help
- Call for the European Council to invite interested member states to establish “national task forces” of key stakeholders (lenders, investors, borrowers, government agencies, regulators and others) to support monitoring the design and implementation of best-practice policy actions
- Regular European level “progress reporting” to support “national task forces”, maintain drumbeat of support for action and facilitate cross-country dissemination of information about best policy practices

PROCESS RECOMMENDATIONS

European Council

- Recommend establishment of national task forces
- Mandate the European Commission to produce semi-annual progress reports

European Commission

- Draft semi-annual reports
- Ensure dissemination of “best practice” innovations
- Elevate issues to EU-level as needed
- Identify funding to support priority EU-level initiatives and pilot projects

National Taskforce

- Convene key officials, regulators and representatives of business and SME associations, banks and alternative finance providers
- Develop technocratic, consensus-based proposals to ease SME financing impediments
- Help formulate national action plans
- Liaise with other national task forces to share “best practice” innovations to address SME financing impediments
- Drive implementation and track progress at the national level