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European regulatory changes will make banks less willing to lend to SMEs

Alternative financing is becoming increasingly important for European SMEs

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Key findings

- Bank financing is currently the most important external source of funding for small to medium-sized enterprises (SMEs) in Europe. Bank loans make up around 70% of external financing – much more than in the US, where bank loans constitute around 40% of external funding for SMEs. This dependence has arisen historically and has also been supported by the ECB's monetary policies on credit availability since the last crisis.

- Changes in the regulatory framework will raise barriers to bank lending to SMEs through the finalization of Basel III and the implementation of Basel IV in the years to come. The regulatory changes will increase funding costs and make banks less willing to extend loans, particularly to SMEs with rather poor creditworthiness. We estimate that funding costs may increase by more than 100 basis points for companies with low credit quality[1].

- Current mechanisms that reduce the capital requirements for banks that lend to SMEs, such as the SME Supporting Factor[2], have the potential to counteract the negative repercussions of increasing minimum capital requirements. However, they currently only apply to loans worth EUR 1.5 million or less. This accounts for 30% of total new loans to corporates in the Eurozone overall, but 47% in Italy and 53% in Spain (against 30% in France and 18% in Germany). This suggests that the impact could be higher in Southern European countries.

- To ensure SMEs have adequate financing and can further diversify their funding sources, the EU Capital Markets Union (CMU) aims to make it easier for them to tap alternative sources of funding and reduce their overreliance on bank financing. The framework for the CMU implementation is planned to be completed by the end of October 2019. While progress has been made in various areas in implementing the CMU, the original goals have not yet been attained and its finalization could take longer than expected, given that the topic is not a priority for all the mainstream European parties which are expected to form a coalition following the May 2019 elections.

- Direct lending by private and institutional investors to SMEs has become increasingly important in Europe. We assume that SMEs will rely more and more on non-banks and less on banks for their financing needs. The Eurozone household saving rate stands at a high 12.1%, amounting to around EUR 860 billion of available capital per year. We estimate that if, out of the 30% of total savings invested in securities, one fourth went to funds that invest in SMEs, this would unlock around EUR 65 billion per year. This additional funding would compare to an average monthly flow of bank loans to SMEs of close to EUR 41 billion in 2018.

[1] The Estimate is based on the results of a BVMW Study on the impact of Basel III (2011)
[2] The introduction of the SME Supporting Factor (SF) allows banks to reduce capital requirements for credit risk on exposures to SME.

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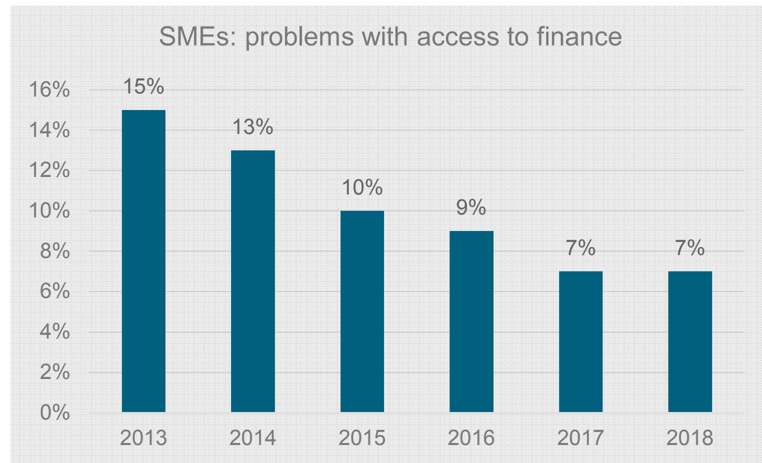
European SMEs rely heavily on bank financing

Since 2013, access to financing for European small to medium-sized enterprises (SMEs) has been steadily improving (see Figure 1) as a result of the very accommodative monetary policy of the European Central Bank (ECB), which improved credit availability, and reduced interest rates.

Figure 1: European SMEs: access to finance



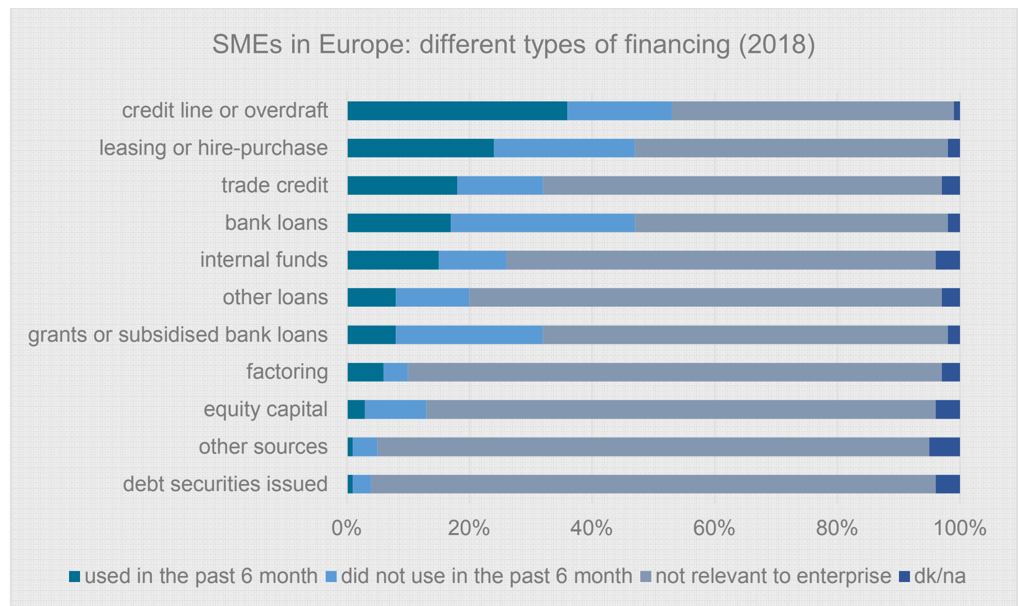
Source: ECB - Survey on the Access to Finance of Enterprises in the euro area (June 2018)

A recent survey conducted by the European Central Bank (2018) found that finance appears to pose fewer difficulties for European SMEs than other business challenges. SMEs have greater problems in other areas, such as finding customers, labour costs, competition, regulation and recruiting skilled staff.

Survey respondents' opinions on access to finance varied from one country to the next. While 6% of the SMEs surveyed in Germany and Spain in 2018 cited problems with accessing finance, 8% of their counterparts in France and 9% in Italy described access to financing as a challenge.

The improving access to finance has, however, made European SMEs heavily reliant on banks as an external source of funding. Though they also use overdraft facilities, leases and trade credit, among other sources (see Figure 2), it's bank loans that make up around 70% of external financing for companies – much more than in the US, where bank loans constitute around 40%. The lack of diversification in funding sources in Europe has arisen historically and is also attributable to the impact of the ECB's supportive monetary policies.

Figure 2: Key funding sources for European SMEs



Source: ECB - Survey on the Access to Finance of Enterprises in the euro area (June 2018)

As a result, the bank loan financing gap in the Eurozone reduced from 6% of GDP in 2015 to 3% of GDP in 2019, according to a joint study of Euler Hermes Economic Research and TRIBRating. This is closer to though still higher than the 2% of GDP seen in the US[3].

However, being dependent on bank financing in particular makes SMEs vulnerable to restrictions on lending, which could arise due to regulatory changes. This could widen the bank loan financing gap in the future.

Regulatory changes reduce banks' willingness to lend to SMEs and increase funding costs

Bank lending policies are significantly affected by capital adequacy regulations. This regulatory framework was significantly strengthened and fortified in Europe following the financial crisis in order to sustainably improve financial stability. Its key components include the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD IV).

The new regulatory framework will raise barriers to bank lending to SMEs[4] through the finalization of Basel III and the implementation of Basel IV. For example, Basel III will increase the minimum capital requirement from 8% to 10.5%. We believe this could also impose higher financing costs and/or stricter collateral requirements, particularly among SMEs with rather poor creditworthiness. We estimate that funding costs may increase by more than 100 basis points for companies with low credit quality[5].

[3] Euler Hermes / TRIBRating Credit Research: Filling the bank financing gap (2019)

[4] The European Commission defines SMEs as companies with an annual turnover of EUR 50 million or less. However, for SMEs that fall outside this definition, banks are free to ignore the changes.

[5] Our estimate is based on a study conducted by the Universities of Berlin and Wuppertal on behalf of the Bundesverband mittelständische Wirtschaft (Federal Association of SMEs) in Germany, which states that the volume of loans to SMEs could decrease by 4.47% and the interest spread for an average loan to SMEs could increase by 54 bp. Our analyses have shown that the average creditworthiness of SMEs in Europe is about BB. For companies with a low credit quality (B or lower), the expected loss and thus the capital requirements increase relatively strongly. We therefore estimate that the funding costs for companies with a low credit quality may increase by more than 100 bp by 2022.

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However, banks can still benefit from rules that reduce capital charges for loans to SMEs. The “SME Supporting Factor” (SME SF), for example, reduces capital requirements for SME loans by nearly one quarter, or approx. 23.81% (factor: 0.7619) (exposure to SMEs pursuant to Art. 501 CRR).[6] This is a valuable tool for protecting and increasing the flow of bank credit to SMEs.

We believe the SME SF has the potential to counteract the possible negative repercussions of increasing minimum capital requirements.[7] However, it currently only applies to loans worth EUR 1.5 million or less. This concerns 30% of total new loans to corporates in the Eurozone but 47% in Italy and 53% in Spain (against 30% in France and 18% in Germany). This suggests that the impact could be higher in Southern European countries.

The amendment to the CRR (CRR II) from the end of 2016 aims to provide even more regulatory relief for SME lending. For example, it reduces the SME SF and thus the capital requirements even more (factor: 0.7612) and extends it to larger loans (> EUR 1.5 million), meaning even more SME loans could qualify for lower capital requirements. However, larger loans receive less relief since capital charges are reduced by only 15% (factor: 0.85).

Alternatively, it may be possible in certain circumstances to classify SME loans of EUR 1 million or less as *retail exposures*. These SME loans will benefit from a lower risk weight of 75% in the standardized approach or a less strict correlation calculation in the IRB approach, which has a positive impact on risk weights. Finally, exposures that qualify as being *exposures to corporates* can be subjected to a lower risk weight depending on the company’s size (annual turnover up to € 50 million).

In a context of regulatory tightening on bank lending requirements, it’s clear that SMEs need a greater variety of financing options so they can become less dependent on bank financing. The planned EU Capital Markets Union would do just that by making it easier for SMEs to tap alternative sources of funding.

Easier access to alternative sources of funding with EU Capital Markets Union

The EU Capital Markets Union is a European Commission initiative designed to spark growth and increase employment in Europe. One of its main goals is to improve the access to finance for European SMEs, particularly with respect to equity and venture capital, by removing barriers in capital markets. The action plan, which was published on 30 September 2015, addresses not only improving access to finance through public bond and equity markets but also a wide variety of funding options for companies. By June 2017, about two thirds of the 33 measures announced in the CMU Action Plan had been implemented. The framework for the implementing the objectives of the CMU implementation is planned to be completed by the end of October 2019. However, its finalization could take longer than expected, given that the topic is not a priority for all the mainstream European parties which are expected to form a coalition following the May 2019 elections (See: European elections: What a fragmented parliament means for the EU’s priorities).

The CMU aims to create a true single market for capital. To achieve this aim, the Commission has defined six primary objectives: [8]

1. Remove barriers
2. Improve access to financing
3. Diversify funding
4. Help SMEs raise finance more easily
5. Help the EU attract investments from all over the world
6. Support economic growth and job creation in the EU

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[6] EU (2013) and EBA (2016)
[7] 8% / 10.5% = 0.7619
[8] European Commission: Goals of Capital Markets Union (2015)

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Some progress has already been made with regard to securitisation, which can unleash important funding potential for SMEs, and the modernisation of the Prospectus Directive, which requires the initiation of special consultations involving the European public.

Another declared goal is to enable SMEs to tap more funding sources and thus diversify their financing. The European Commission wishes to reduce reliance on national banks and encourage cross-border finance, in large part because banks reject around 13% of the loan applications filed by SMEs because their credit risk does not meet the banks' desired risk profile.[9]

Fundamental requirement for the CMU: public availability of SMEs' financial information

Approximately 20 million SMEs do business in Europe, but only around 3000 are listed on a stock exchange.[10] Typically, listed companies make their financial information available on a regular basis. We believe SMEs' access to capital markets can only be improved, or the investor base broadened, if credit and financial information is made publicly available. Banks, institutional investors and retail investors have to be able to properly assess the credit risk. A generally valid set of standard, readily comparable information used to assess credit risk could help mobilise more funding for SMEs.

This does not mean, however, that SMEs should be burdened with excessive reporting and information obligations. It is important to reduce regulatory barriers and the costs of issuing equity and debt instruments. At the same time, investors should be able to rely on efficient market conditions and transparent products. The latest revision to prospectus law (EU Prospectus Regulation as of July 21 2019) aims to achieve these goals by making it easier for SMEs to raise funds in capital markets. For example, offers of securities to the public worth EUR 10 million or less will be exempt from the obligation to publish a prospectus if the securities are not admitted to trading on a regulated market. In addition, simplified EU growth prospectuses can be published by SMEs and MidCaps with an average market capitalisation of EUR 500 million or less.

While progress has been made in various areas in implementing the CMU in recent years, the original goals of the Capital Markets Union have not yet been attained. As a result, European SMEs reliant on bank financing need to look at other sources, particularly direct lending.

[9] Cf. European Commission: Green Paper on Building a Capital Markets Union (2015)

[10] Cf. European Commission (2018)

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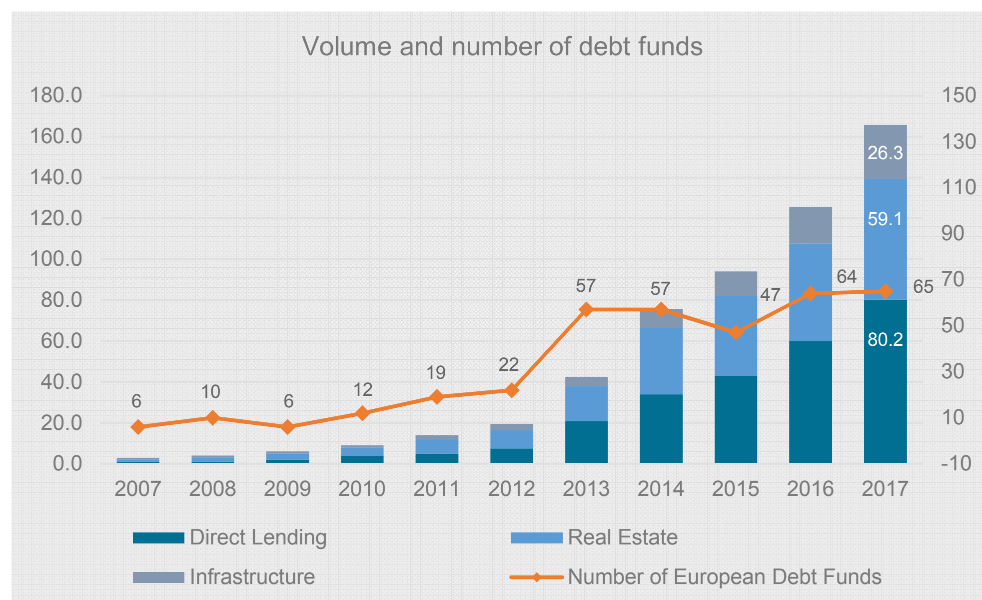
Importance of direct lending as a funding alternative for SMEs has grown in recent years

Direct lending to companies by private and institutional investors from outside the banking sector has grown in importance in recent years as an alternative to bank financing. Debt funds are still less constrained by current laws than banks. Direct lending funds in Europe are experiencing rapid growth as they catch up to their counterparts in the US, where debt funds have played a significant role for some time.

Fig. 3: Development of volume and number of debt funds in Europe



Sources: KFW Research, Preqin (2019)

After reaching the EUR 100.0 billion threshold for the first time in 2016, the aggregate debt fund volume climbed to an all-time high of EUR 165.6 billion in 2017. This was largely driven by direct lending funds, which accounted for around one-half of the overall market's growth. In 2016, the European direct lending market expanded by around one-third, growing from an aggregate volume of EUR 60.0 billion to EUR 80.2 billion. The number of new debt funds placed and raised in Europe rose from six in 2007 to 65 in 2017.

There are several reasons for this: First, stricter bank regulations have been an impediment to lending institutions' operations. Several banks responded by withdrawing from market segments that were no longer attractive, given the unfavourable risk/return ratio and capital adequacy requirements. These include in particular the financing of SMEs, if they do not have a very good creditworthiness. The resulting financing gap has been increasingly filled by debt funds. Second, low interest rates have increased the supply of capital available to debt funds. Institutional investors in particular are on the lookout for investment options with attractive returns. Credit funds have often been cited as a good way to diversify investment portfolios and reduce investors' dependence on government bonds. However, the risk that the growth of shadow banks in Europe, such as European debt funds, may also be caused by the increase in lending to companies with below-average creditworthiness (anti-selection) may affect the stability of the European financial system.

We expect debt funds to grow even more strongly in Europe in the years ahead and anticipate that SMEs will increasingly incorporate this funding source into their financing structures. This trend will be supported by a stricter regulatory framework for banks and burgeoning interest in alternative investment funds among institutional investors.

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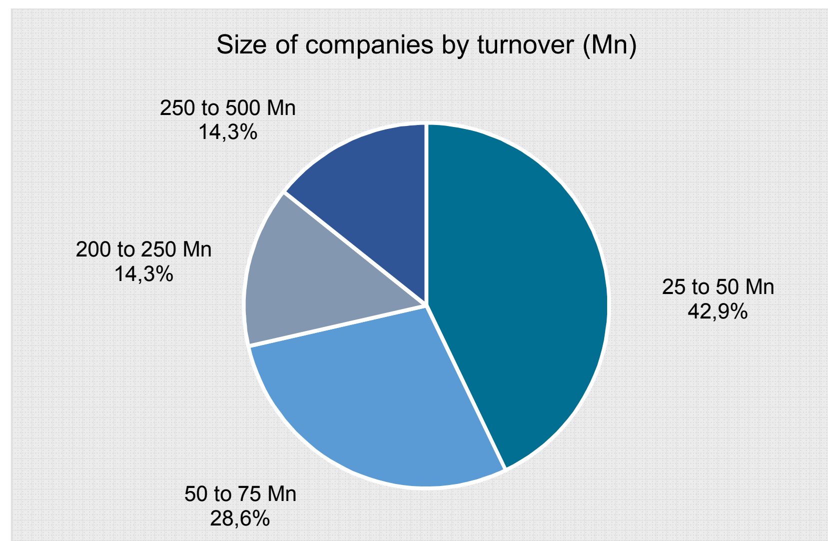
In April 2019, the Bundesverband Alternative Investments (BAI), a German advocacy association, published a survey of companies who had obtained funding from debt funds. Among other things, the survey asked respondents about their company's size[11]. The survey is restricted to German companies and had a relatively low response rate, but we believe the findings can still provide an initial guide for the size of businesses that currently tap this funding source.

Fig. 4: Size of the companies financed by debt funds



Sources: Bundesverband Alternative Investments, Euler Hermes Rating (2019)

According to the survey, 42.9% of the companies receiving debt fund financing had between EUR 25 million and EUR 50 million in turnover. Transaction costs associated with financing and the requirement profiles of debt funds also impose a floor on company size, which this survey found to be around EUR 25 million. We believe it is generally safe to assume from the data that debt funds focus on SMEs and MidCaps. This observation is borne out by the fact that several newly launched private debt funds intend to exclusively serve the SME segment.

[11] Cf. BAI Study: Unternehmensfinanzierung durch Nichtbanken in Deutschland (2019)

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