Diversifying the financing of EU corporates and midcaps

Exchanges crucial for the growth of European companies

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Most of the European companies that have created the prosperity of Europe wouldn't be what they are today without the exchanges. They started as SME's and have gained access to efficient funding from the first IPO and throughout several rights issues.

Now there's growing awareness that Europe needs new SMEs that can grow and become the blue chips of tomorrow. SMEs create more jobs than large enterprises. Between 2002 and 2010, 85 percent of total employment growth was attributable to SMEs, according to a 2012 study conducted by the European Commission.

Therefore it's crucial that policy makers do everything in their powers to facilitate funding through exchanges. Public markets need a balanced regulatory framework that does not discourage companies from listing. It's crucial to ensure a level playing field for equity and debt financing and create "fast and simple tracks" for SMEs to have access to public markets.

All kinds of disincentives to public offerings and access to public markets need to be reviewed and eliminated, including existing taxation policy.

New incentives need to be introduced. UCIT funds should be allowed to invest more in companies listed on MTFs so that the collective investments are partly channeled towards the financing of SME's. The EU could also establish a fund to co-invest in listed SMEs at the stage of subscription and at later stages to improve liquidity.

However, the regulatory development is in some perspectives going in the opposite direction. Measures are imposed on listed companies for political or social reasons although such measures have nothing to do with the fact that the companies are publically held. Why should listed companies be treated different than government or privately owned companies when it comes to things like corporate governance and gender quotas?

Even more alarming is the FTT. It will have a significant negative impact on financing via equity markets and SMEs in particular. This needs to be reconsidered. Even more so since the European Commission itself has assumed a negative impact on gross domestic product and economic growth in its 2011 assessment. ■

The potentials for a European securitisation market for SMEs

Guido Bichisao - Director Institutional Strategy Department, **European Investment Bank (EIB)**

The current economic crisis has highlighted two important issues: the market fragmentation across countries and the reliance on banks for SMEs funding. The securitisation market can be one important instrument to ensure SMEs access to comparable funding conditions, but few prerequisites are required for that purpose.

Transparency and availability of information. The securitisation market reputation suffered from the sub-prime crisis. Many efforts have been made since and shall be further reinforced. The ECB has sponsored the loan level initiative whereby any securitisation transaction eligible as collateral for Eurosystem refinancing facilities shall provide minimum disclosure of information on its underlying assets. The Prime Collateralised Securities (PCS) initiative provides a label for deals which meet minimum criteria on transparency, quality, standards and liquidity.

Risk distribution. Proper distribution of risks across the economy shall be ensured to make it more resilient to shocks. The European Commission, in cooperation with the EIB and the EIF and with the support of Member States, the European Council and the European Parliament, has proposed ways to use the EU budget in risk-sharing instruments. Public funds are used to absorb a portion of the risks mobilising private funds and ensuring minimum skin in the game from originators. Specific risk-sharing initiatives are under discussion to reinforce actions in favour of SMEs.

Homogeneous credit assessment. Whereas banks have their proprietary models to assess SMEs credit quality, a uniform methodology with minimum disclosure to investors is a necessary step towards a European-wide market. This can take the form of a scoring system enhancing risk awareness.

Adequate investor base. An appropriate regulatory framework shall be put in place to ensure a wide investor base. Institutional investors (banks, pension funds, insurance companies, etc.) shall not be penalised by a restrictive regulation when they invest in instruments meant to support growth and employment. Retail investors shall have access to these instruments provided that appropriate transparency conditions are met.

Simplicity and standardisation. A simple and standard approach whereby SMEs can apply for funding with banks and banks can regroup such assets and sell them to investors at the appropriate level of risk within pre-defined standards and an appropriate institutional support would allow appropriate channelling of resources to SMEs. ■

Fragmented financial markets in Europe: a diagnosis of the Spanish case

Fernando Navarrete - Director General - Chief Financial Officer & Head of Strategy, **Instituto de Crédito Oficial (ICO)**

Access to credit by Spanish SMEs remains curtailed due to a combination of both supply and demand-side factors. Among the former, probably the most important factor is the impact a low sovereign rating has on corporate ratings and, as a result of this, on the much higher risk-weights of loans to SMEs under Basel's IRB approach. In other words, Spain's current sovereign rating as a consequence of Eurozone fragmentation makes it much more expensive for banks in Spain to lend to SMEs than in other higher-rated European economies, helping explain the downward rigidity of rates on SME loans despite improved funding conditions for local banks. On this front, risk-sharing instruments that help reduce risk-weights for new SME loans, precisely along the lines of what has been recently proposed by the European Commission and the EIB should be welcome.

Also important is that funding sources of Spanish corporates are not well diversified. Bank loans account for most of non-financial corporate liabilities. The size of the private equity and venture capital markets remain at a substantial spread below their potential and only large corporates have the ability to substitute bank loans for medium to long-term bonds. On this front, Spanish authorities are currently working on fostering the development of a fixed-income market for Spanish midcaps and ICO, through its subsidiary AXIS, has just launched a Eur 1.2bn fund of funds with the objective of promoting the creation of new privately-owned and managed funds that help enlarge Spain's private equity and venture capital markets over the course of next four years.

On the demand side, the biggest constraint SMEs face is the current level of interest rates since high funding costs reduce the total amount of profitable and investable projects in the economy. Lower Government bond yields and a faster pass-through to bank lending rates would translate into a higher number of investment projects turning profitable, therefore increasing the solvent demand for credit.

In this regards, ICO's traditional on-lending business is playing a key role by reducing interest rates on SME loans while helping commercial banks meet an increasing solvent demand for credit. In 2012, ICO funded 11.5bn in new SME loans in Spain, which is equal to the size of total new SME loans provided directly or indirectly by the EIB in Europe. ■

Thoughts on the potential of insurers as a source for SME financing

Gabriel Bernardino - Chair, **European Insurance and Occupational Pensions Authority (EIOPA)**

The availability of financing for SMEs is a crucial factor for economic growth. They represent more than 98 % of all enterprises in the EU and account for roughly 67 % of total employment. At the same time investors might be exposed to higher risks as SMEs benefit less from diversification and are generally more likely to experience difficulties in obtaining funds.

A crucial element of a regulatory framework is the capital requirements. EIOPA is aware of the effect that the regulatory risk charges for SME financing may have on the willingness of insurers to invest. However, the risk charges have to reflect the actual risk to ensure that policyholders are properly protected. EIOPA is currently reviewing the calibration. Any recommendation for a change has to be based on sufficient and reliable evidence.

Regulatory requirements are not the only driver of investment behaviour. Insurers have to surmount a number of non-regulatory obstacles before providing SME financing.

The area of SME financing has so far been dominated by banks. Banks often build a long-term relationship with SMEs and acquire detailed knowledge over time. Insurers may therefore lack the necessary information to provide loans directly.

A key competency of banks is the active management of credit risks. An example is the restructuring of a non-performing loan which involves renegotiations with borrowers as well as potentially the seizure and sale of assets. Insurers have traditionally not assumed such an active role.

As a result insurers will probably invest alongside banks (e.g. via securitisation). A potentially promising measure for increasing the willingness of insurers to provide SME financing might therefore be guarantees provided by public institutions on SME loan portfolios or SME loan securitisations. This allows for a better match with the liabilities of insurers. ■

The SME Initiative to support capital market financing for Europe's SMEs

Gerassimos Thomas - Director Finance, DG Economic and Financial Affairs, **European Commission**

Restoring economic growth and fighting high levels of unemployment are key priorities for the EU at the current juncture, when both the real and the financial sectors in Europe are experiencing a sluggish recovery from the financial crisis. Access of small business to finance remains difficult across EU while fragmentation of financial markets continues, effectively impairing the credit transmission channel.

Restoring the health of Europe's banking system through proper asset quality reviews and adequate recapitalisations along with a proper calibration of the financial regulation framework are the key pillars to addressing access to finance in Europe.

To support this process there is however a role for carefully targeted SME public support initiatives. By pooling resources from EU member states' European Structural and Investment Funds with the EIB and the EIF and national promotional institutions, the SME Initiative would allow banks across Europe to benefit from capital relief through EIF/EIB guarantees and in certain cases liquidity so as to increase the volume of credit available for SMEs. The Initiative if approved by the October European Council should strive to support bank lending to SMEs - the backbone of the European growth and employment - as we slowly move out of recession. In the medium-term, the SME Initiative has a real potential to help revitalise the European ABS market and thereby reduce the reliance of European SMEs on bank financing. Together with the recent revision to the ECB's collateral framework which supports securitisation and an appropriately fine-tuned regulatory treatment, securitisation could create benefits which would accrue over many years to come.

The Commission supported High Level Experts Group chaired by J. Moran and A. Giovannini has issued a favourable report clearly highlighting (a) the value added attached by private and institutional investors to a European Initiative and (b) the specific added value of the involvement of the EIF and EIB in structuring transactions by providing a standard approach and facilitating investors' analysis. ■