AFME Response to European Commission Consultation on the EU2020 Industrial Policy Flagship Initiative

7th August 2012

Q2.2.1 Access to finance and risk capital: please explain the importance of the issue, giving examples and evidence.

Access to finance and risk capital is a critical issue for all companies, if they are to grow, but it is particularly important for small and medium enterprises (SMEs)[1]. SMEs are the backbone of the European economy; according to the Annual Report on EU SMEs 2010/2011, an estimated 99.8% of all enterprises in the EU are SMEs[2]. They account for 58.4% of the total gross value add (GVA) produced by private businesses and provide more than two-thirds of all employment opportunities in the private sector.

In this response we have addressed our comments to the supply of and demand for finance by SMEs and mid-cap companies, who have not tended to have direct access to capital markets. All references to SMEs in our response should be taken as including mid-cap companies, unless the context does not permit it. Whilst small, medium and mid-cap companies face distinct sets of problems, we have focused on the issues affecting smaller businesses.

Access to finance has been perceived to be a challenge for SMEs throughout the current economic crisis. According to the latest ECB survey on Small and Medium Enterprises in the EU, the gap between SMEs' demand for funds and their supply is widening[3]. In the six months to March 2012, the percentage of SMEs requiring bank loans (8%) and bank overdrafts (14%) was higher than the previous six months (up from 5% and 10% respectively), while 20% of SMEs reported a lack of availability of bank loans, up from 14%. 13% had had loan applications rejected, up from 10%. This percentage is at its highest level since 2009. Of course, not all finance propositions are viable or appropriately supported.

A significant factor is the heavy dependence of European SMEs on debt financing in the form of bank loans; approximately 80% of the financing of SMEs is originated by banks[4].

Traditionally SMEs have financed expansion of working capital or buying new equipment through overdrafts and bank loans. In the years of strong economic growth, debt finance was provided by some banks even to high risk businesses, where equity might have been more suitable. More recently, banks have adopted a more prudent approach while businesses have felt discouraged from requesting finance, partly due to uncertainty over their prospects and partly because of perceptions of the availability of finance. Furthermore, whereas interest margins prior to the financial crisis were low, as a result of low costs of capital and funding, funding costs relative to reference rates and capital requirements have risen substantially. This has all led to a common perception that small companies now find it hard to obtain bank loans at reasonable interest rates and without incurring substantial upfront costs.

A possible source of liquidity for banks providing finance for smaller companies is the loans securitisation market. However, the SME loans securitisation market was badly affected by the economic crisis and has yet to recover. In the first quarter of 2012, €7.7 billion of SME

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[1] The EU definition of SMEs, based on number of employees and turnover/balance sheet total, is set out in *EU recommendation 2003/361*
www.ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/sme-definition/index_en.htm

[2] *Are the EU SMEs recovering from the crisis?* Annual Report on EU Small And Medium Sized Enterprises 2010/2011, Rotterdam, Cambridge, 2011.

[3] *Survey on the Access to Finance of Small And Medium-Sized Enterprises in the Euro Area, October 2011 to March 2012, www.ecb.europa.eu.*

[4] *From Basel III to alternative sources of funding: Assessing the impact of financial regulation on access to finance for SMEs and the real economy;*
www.leaseurope.org/uploads/documents/SMEs/Summary%20Report%20on%20Basel%203%20Lunch%20Debate.pdf

securitised products were issued in Europe, a 50.9% decline from Q1 2011. Furthermore, only 19.1% of the total issuance of SME securitised products in Europe in the first quarter of 2012 was placed in the market, with the balance being retained by the issuer[5].

The amount of funding provided through SME loan securitisation has been significant, even though much of this type of securitisation has been retained by banks for central bank repo programs. Publicly-available statistics from Standard & Poor's show that in the period from 2007 to 2011, €103 billion of SME loan securitization were issued and rated by S&P. Moreover, the performance has been very good. The Standard & Poor's data shows that across all tranches of this issuance, there has been a very small cumulative default rate: 0.20% of total issuance during the above period.

Q2.2.2 Access to finance and risk capital: how can businesses themselves better respond to these issues?

In order to facilitate their access to finance, SMEs need to improve the depth and quality of their financial statements and business-related information. Users of this data, including investors, credit analysts and credit rating agencies, need clear and detailed information on the business for investment purposes and for making their economic decisions.

Given their size and nature, SMEs' public reporting requirements and their internal management information systems are different from those of larger corporations. In some member states, they are exempt by law from auditing their financial statements. They are usually not required to publish more than a minimum of financial data.

In addition, small firms are understandably reluctant to disclose commercially sensitive information, such as business growth, ownership structure and growth opportunities. However, this informational opacity can hinder their access to sources of finance. While capital markets investors should acknowledge these inherent characteristics of SMEs, collaboration between both sides to increase the amount of information available is desirable.

Small business entrepreneurs also need to be more proactive in increasing their awareness of possible sources of finance and the support which is available, including the measures included by the European Commission in the Small Business Act for Europe (SBA) and in the Access to Finance Action Plan (December 2011) and from national and regional bodies.

Policymakers on state, regional and local levels need to support SMEs in this information seeking process.

A measure which may help in this area is the production of small company credit ratings. This would enable a mid-size company, which could not afford a full-scale rating, to obtain a credit rating which would enable it access to finance at a more favourable rate.

Q2.2.3 Access to finance and risk capital: what can policymakers do to address the issues at Member state, local or regional level?

Member states and authorities at regional and local levels can both improve existing tools and devise new actions to improve access to finance for SMEs by:

- facilitating SMEs' access to the EU Structural Funds;
- encouraging dialogue between businesses and financing institutions in order to provide businesses with a better understanding of their funding options and increase information transparency on loan procedures, costs and conditions; developing alternative sources of funding aimed at lowering borrowing costs;

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[5] *Securitisation Data Report* Q1: 2012,AFME, 2012

- encouraging SME access to capital markets. In the current economic climate, capital markets investors tend to seek short term, liquid investments in larger firms, penalizing long-term investments in smaller enterprises. Authorities have a role to play in bridging the divide through possible encouragement of SME loan aggregation vehicles and the provision of various forms of guarantees to lenders. This may have implications for the EU rules on state aid. This issue will require further analysis;
- fostering the growth of business angel and Venture Capital (VC) finance through tax incentives and, at the same time, creating a level playing field within the EU for VC and business angel investment in SMEs. As for VC finance, while the forthcoming European legislation on VC funds represents a relevant improvement in regulatory terms, practical issues such as different tax treatments of VC in different member states will remain, with many member states' tax regimes weighted in favour of debt financing.

Some examples of such initiatives were provided in the recent UK government-sponsored Breedon Report on non-bank financing options for businesses[6]. The Breedon Report, released in March 2012, represents the result of research conducted by a Government-appointed committee; over 200 organizations and individuals contributed to the consultation. The Report showed that, unless the infrastructure and usage of sources of finance change, when significant demand for finance comes through as the economy recovers, there could be a possible shortfall in the availability of finance for businesses. The report also pointed out that, while bank lending currently dominates the market for SME finance, there is significant potential to develop both the demand for and the supply of non-bank finance in the UK and across Europe.

The Breedon Report made a number of recommendations for measures to support non-banking lending to SMEs, including two major new initiatives:

- It called for a single agency to oversee and run all the Government programs supporting SMEs;
- It recommended the launch a feasibility study, led by AFME, to explore the creation of an aggregation agency to lend directly to SMEs and/or to pool SME loans in order to facilitate SME access to the public corporate bond markets. AFME has formed a working group for this project which will report to the UK government in the autumn of 2012.

A possible model to look to is represented by the KfW bank, the German government-owned development bank. KfW has been in the forefront of supporting SME access to finance. Examples of the approaches pursued include the promotion of the capital markets and the securitization of SME loans[7]. Through securitization platforms it has helped commercial banks to transfer loan risks from SME portfolios to the capital markets, thereby giving credit institutions more scope to extend new SME loans. In cooperation with the EU Commission and the Council of Europe Development Bank (CEB), KfW also provides "Global Loans" to European commercial banks to help them finance SMEs on attractive terms[8].

This government-backed scheme has proven its effectiveness in channelling cheap funds to SMEs during the current economic downturn and represents a model that could be adopted successfully elsewhere, although it would require changes to EU state aid rules.

Another successful example of government intervention can be found in the US, where the government has been active in promoting alternative sources of capital, such as leasing, mezzanine finance, micro credit and VC. In the EU, VC and business angel finance currently provides only 2% of SME financing, while in the US the figure reaches 14%. An average venture

[6] *Boosting Finance Options for Business*, March 2012
www.bis.gov.uk/assets/biscore/enterprise/docs/b/12-668-boosting-finance-options-for-business.pdf
[7] *Danske Bank and KfW closed fourth joint synthetic securitization;* Press release ,Frankfurt, April 2008,
www.kfw.de/kfw/en/KfW_Group/Press/Latest_News/PressArchiv/PDF/2008/020_E_Securitization_Danske.pdf
[8] *Global loans for local financing in other European countries*,
www.kfw.de/kfw/en/KfW_Group/About_KfW/Mission/Special_Tasks/Globaldarlehen/index.jsp

capital fund manager in the EU manages assets of €60 million, while a US counterpart has, on average, €130 million in assets under management[9].

Q2.2.4 Access to finance and risk capital: what can policymakers do to address the issues at EU level?

At the EU level, policymakers have taken important steps to support SMEs and improve their access to capital markets, including the Small Business Act (SBA) of 2008 currently under review and the Access to Finance Action Plan of late 2011. Useful actions to stimulate access to finance include:

- improving access to VC, as well as targeted measures aimed at making investors more aware of the opportunities offered by SMEs;
- improving awareness of and attractiveness for financial intermediaries/banks of EIB/EIF programs and EU financial instruments;
- addressing the lack of information on financing options which hinders businesses' access to finance. SMEs are often unaware of all the funding options available and of the steps required in order to access funds. This issue can be addressed at the local and regional level, but the EU also has an important role to play in initiating and supporting information and education campaigns.
- improving and expanding access to loan guarantees for SMEs through strengthened loan guarantee schemes, well beyond what is currently offered in the framework of the Competitiveness and Innovation Program (CIP program) and the Structural Funds (JEREMIE program); moreover, the next Multiannual Financial Framework (MFF) 2014-20 currently negotiated at EU level will include measures to improve SMEs access to finance in a number of new program (COSME, Horizon2020 and the new Cohesion Policy).
- relaxing the rules governing state aid in the case of certain forms of state encouragement to SME lending. Application of the existing rules varies significantly between EU members.

EU institutions should encourage the development of a wide variety of alternative sources of debt and equity finance in order to maximize the choice of financing channels available to companies. A recent CSFI report has looked at emerging innovative sources of non-bank funding currently being developed (P2P business lending platforms, innovative business angel initiatives, internet-based non-bank sources of finance, alternative SME stock markets)[10]. The EU has a part to play in promoting the growth of these innovative instruments and increasing awareness among European companies of the availability of these alternatives.

From the industry side, AFME has recently launched an initiative to revive the securitisation market in Europe through its Prime Collateralised Securities ("PCS") securitisation labelling project. The purpose of PCS is to identify market best practices in terms of securitisation quality, transparency and simplicity/standardisation, leading to improved secondary market liquidity. SME loans will be a PCS-eligible asset class.

PCS, if successful, has the potential to provide an important additional source of funding to support European economic growth. We are pleased that the European Commission, ECB and EIB are observers in the PCS working group.

At the same time, EU regulatory measures (e.g. MiFID, CRD4, Solvency 2) designed to improve the stability and resilience of the European financial system can create the unintended

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[9] *From Basel III to alternative sources of funding: Assessing the impact of financial regulation on access to finance for SMEs and the real economy;* www.leaseurope.org/uploads/documents/SMEs/Summary%20Report%20on%20Basel%203%20Lunch%20Debate.pdf

[10] *Seeds of change; Emerging sources of non-bank funding for Britain's SMEs*, A. Davis ,CSFI Report, July 2012.

consequence of restricting the availability of finance, particularly to smaller, less creditworthy companies. For example, the Commission's proposed Solvency 2 capital charges of 7% per year of duration on EU insurer investment in AAA tranches of SME and other securitisations is highly likely to discourage all investment by insurers in all securitisations which support the EU real economy[11]. In CRD4, it is important that high quality securitisations be considered as eligible assets for bank liquidity buffers. On MiFID, AFME recently commissioned a study to inform policymakers of the potentially negative effects of MiFID's pre-trade price transparency requirements on the bond markets, which we have provided to you separately. We would urge that the needs of the real economy, especially of SMEs, are at the forefront of policy-makers' thoughts whenever new laws or regulations affecting the availability of finance are proposed.

[11] AFME's *Securitisation Investor Survey* received responses from 27 leading European investment managers and insurers during March 2012. The full survey results can be found at www.afme.eu/SecuritisationInvestorSurvey