Association for Financial Markets in Europe

Unlocking funding for European investment and growth

An industry survey of obstacles in the European funding markets and potential solutions

OLIVER WYMAN

This report was commissioned by AFME from Oliver Wyman. It has been written jointly by AFME and Oliver Wyman.

REPORT QUALIFICATIONS/ASSUMPTIONS & LIMITING CONDITIONS

Oliver Wyman was commissioned by AFME to support its initiative to unlock funding European investment and growth.

Neither Oliver Wyman nor AFME shall have any liability to any third party in respect of this report or any actions taken or decisions made as a consequence of the results, advice or recommendations set forth herein.

This report does not represent legal advice, which can only be provided by legal counsel and for which you should seek advice of counsel. The opinions expressed herein are valid only for the purpose stated herein and as of the date the report is published. Information furnished by others, upon which all or portions of this report are based, is believed to be reliable but has not been verified. No warranty is given as to the accuracy of such information. Public information and industry and statistical data are from sources Oliver Wyman and AFME deem to be reliable; however, neither Oliver Wyman nor AFME make any representation as to the accuracy or completeness of such information and have accepted the information without further verification.

The findings contained in this report may contain predictions based on current data and historical trends. Any such predictions are subject to inherent risks and uncertainties. In particular, actual results could be impacted by future events which cannot be predicted or controlled. Oliver Wyman and AFME accept no responsibility for actual results or future events.

No responsibility is taken for changes in market conditions or laws or regulations and no obligation is assumed to revise this report to reflect changes, events or conditions, which occur subsequent to the date of publication of this report.

Unlocking funding for European investment and growth

An industry survey of obstacles in the European funding markets and potential solutions

Foreword, introduction, about the survey and participants

Executive summary 1

1. Objectives, structure and methodology 19

2. Overall market and regulatory context 23
2.1 Economic overview 24
2.2 The importance of corporate funding 27
2.3 Corporate funding levels and trends 28
2.4 Barriers to funding and specific problem areas 34
2.5 Regulatory context 37

3. Detailed analysis and interview findings 39
3.1 SMEs 40
3.2 Large/mid-sized corporates 52
3.3 Infrastructure investment 65
3.4 Commercial real estate 74
3.5 Financial sponsors and leveraged finance 79
3.6 Businesses in crisis-affected countries 85
3.7 Investors: insurers, pension funds and asset managers 91

4. European Commission Green Paper consultation - main topics 101

Annex A - Additional sources of information 103
Annex B - List of participants 105

Foreword

We are delighted that the wholesale financial markets industry has come together to invest in this major study to add data and insights of corporates, investors and intermediaries to the debate on how to create sustainable and consistent long term growth.

Growth must be the chief economic aim for Europe today, and the financial markets play a major role in that effort. This is not only my view: the European Commission makes precisely these points in its Green Paper on long term investment, published earlier this spring.

Clearly, a number of challenges must be overcome in order for Europe's financial markets to once again become a significant driver of long term growth. To understand and address these complex challenges, we have undertaken a detailed survey of market participants to benefit from their insights. We have interviewed the full range of market participants: from small business owners to the CFOs of multinational companies; and investors from specialist private equity firms to global insurance providers.

It is this foundation of interviews with so many market participants, both end users and intermediaries, that we feel adds real weight to the findings and recommendations contained in this report. We are grateful to all participants for their support and their insight. These valuable findings have been supplemented by economic research led by a working group of AFME members, supported by Oliver Wyman.

As the industry which arranges, underwrites, researches, distributes, hedges and makes markets in the bond, equity and loan products issued by a wide range of corporates to investors, we wholeheartedly support the European Commission's focus on long term growth. We hope this report provides meaningful insights on how various private and public market stakeholders, including ourselves, can best support this.

Michael Cole-Fontayn
AFME Board, Chairman, BNY Mellon EMEA
June 2013

Introduction

This report is produced by the member banks of AFME and provides a direct voice to the end-user – both borrowers and investors.

The report highlights their insights on the landscape, the issues they face and the solutions they propose for funding growth. These views are set within the context of independent research and data on the current state of the financing markets in Europe.

By concentrating on the perceptions and specific concerns raised by the users and providers of financing we believe this report provides a different perspective to help inform the debate within Europe on actions that can be taken to improve the outlook for growth. Seen through the lens of a diverse range of businesses from across Europe the report provides both clarity and granularity as to where the financing markets are working well and where there are problems to be addressed.

Understanding the reality and issues from the users' perspective will give greater focus on the key pressure points and practical recommendations for their resolution that have direct support at the grass roots level.

It has been a privilege to chair the group that has produced this report, particularly as we share the belief that by working in close partnership with our clients and a broad range of market participants we can collectively improve the status quo and influence the agenda for change.

On behalf of the group, I would like to thank the Oliver Wyman team who ran the interview process, produced the research and worked so closely with us through many early morning meetings. Also thanks to the AFME staff for their tireless efforts; and to the working group for all their hard work.

Finally, on behalf of the working group, I would like to thank all the clients, many of which are listed in Annex B, who took the time to share their thoughts, views and ideas which form the bedrock of this report.

Clare Francis
Chair, AFME Financing Growth Working Group
Managing Director, Head of Global Corporates, Lloyds Bank
June 2013

About the survey and the participants

This report has been commissioned by the Association of Financial Markets in Europe (AFME), which represents the voice of Europe's wholesale financial markets. The findings of the report can stand alone, but are also designed to offer constructive recommendations to the debate prompted by the European Commission's Green Paper on the long term financing of the real economy.

The report focuses on current barriers to funding and what could be done to improve availability of funding for growth. While overall macroeconomic uncertainty is highlighted as a key constraint, the report does not seek to address this issue, as it is a complex policy field already being considered by many stakeholders.

The report has been driven by a working group comprised of AFME staff and members, and written by Oliver Wyman and the working group. This document is separate from AFME's response to the Commission's Green Paper consultation on Long Term Financing of the European Economy dated March 2013.

The findings contained within the report are interview-based and industry led. The report captures and seeks to articulate the collective views from users and providers of funding, including large corporates, mid-sized corporates, SMEs, various types of investors, and banks.

To provide the evidence base for this report, Oliver Wyman has conducted interviews with 75 firms across eight European countries, involving over 100 of their employees and almost 120 interview hours. Interviews have been supplemented with specific input from some survey respondents as well as research and technical detail provided by Oliver Wyman, AFME and its members so as to provide further context to the reader.

Annual revenues for corporates interviewed total approximately €400 billion, ranging from €1.2 million to €110 billion. European assets under management of investors interviewed total more than €1.7 trillion. AFME member firms underwrite, distribute and trade the vast majority of the €1.1 trillion of new debt, equities and syndicated loans distributed in Europe in 2012, so are well placed to understand the funding needs of corporates and investors.

Key report statistics[1]

75

firms interviewed

120

interview hours

€400billion

combined revenues of corporates

€1.7trillion

investor assets under management

€1.2trillion

corporate lending by working group banks

1. Sources: Orbis, firm annual reports 2012. Corporate lending and assets under management for European business only, where reported separately

Interview participants and working group members[2]

2. Some interview participants chose to remain anonymous, therefore total participants do not equal the number of logos shown.

Overview

Economic growth remains the principal challenge for Europe. The Eurozone economy is currently in recession, and is forecast to contract over the course of 2013. Europe is not alone in experiencing sluggish growth, but what is notable is that since 2008, both the real economy and the financial sector in Europe have suffered continued setbacks. This report focuses on the role of finance in supporting growth. It examines the obstacles which currently prevent the wholesale markets from supporting growth and investment in Europe, and offers recommendations on how these may be addressed.

Growth and financing of real economy assets in Europe face structural challenges. Whilst some funding channels are currently working well (for large corporates for example), measures could be put in place to better meet demand through expanded capital markets funding. Other areas, particularly SME, infrastructure, commercial real estate and businesses in crisis-affected countries more broadly have significant funding challenges in many countries.

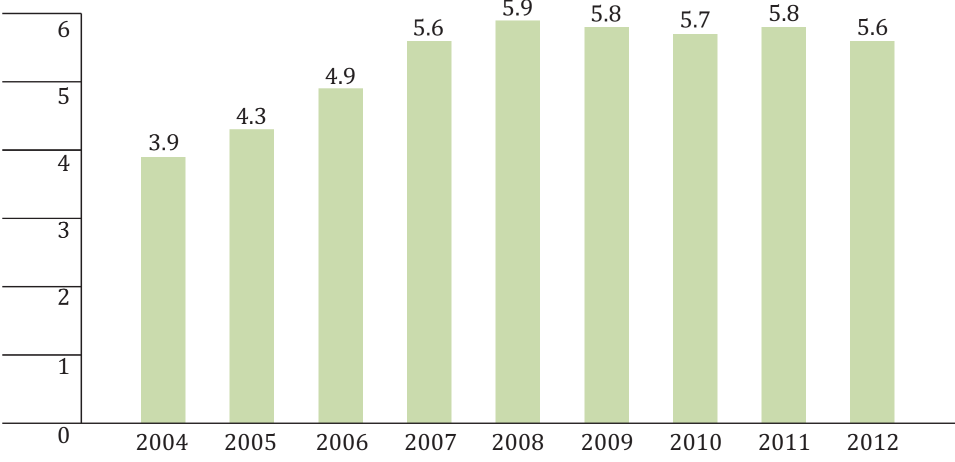
The two most significant barriers to increasing financing are common across both the demand and supply side: the overall macroeconomic environment and financial sector regulation.

The macroeconomic environment in Europe was highlighted by two-thirds of the companies surveyed and more than half of investors as a major barrier to growth and investment. The Eurozone situation was highlighted as a dominant factor in the investment decisions of corporates and investors, as well as a disruptive force to bank and capital market financing. Many corporates, particularly the largest ones, have significant and growing piles of cash, indicating a lack of sufficiently attractive investment opportunities, the need for a greater liquidity buffer and, in places, a reduced demand for finance. Market confidence plays an important role in the macroeconomic environment, and it is important that all stakeholders - financial market participants, issuers, investors and policymakers - actively contribute to the restoration of confidence.

Regulatory changes in the financial sector are constraining the availability of balance sheet and also the ability of non-banks to invest. However, despite bank deleveraging, lending to non-financial corporations by European banks remains at €5.6 trillion according to the European Central Bank (ECB) – the same level as in 2007. Market participants are also concerned about the impact of regulation on the availability and cost of hedging instruments linked to financing. Outside the banking sector, uncertainty over Solvency II remains a big issue.

Figure 1

European bank lending to non-financial corporations, € trillion



1. Outstanding volumes as at year end
2. EU 27 countries

Source: ECB, Oliver Wyman analysis

Other barriers differ both between demand side and supply side segments and between firms within a segment, depending on a firm's own situation. The next biggest demand side concerns include cost of funds, investor demand and obtaining/maintaining ratings. Supply side concerns centre on regulation, investment mandate constraints, insufficient risk/return of assets, asset liquidity, and ability to analyse risks of unfamiliar assets.

Addressing macroeconomic concerns to build confidence and demand is essential to stimulate investment and growth. Availability of funding is also a critical enabler and, while there is no 'silver bullet', the evidence gathered in this survey suggests that significant improvement is possible in long term funding markets, based on targeted action to address supply side and demand side obstacles. In this report we prioritise four key areas for action:

1. **SME lending.** Banks are expected to remain the primary lenders to small businesses due to the size of transactions and the local nature of the commercial relationship. The lack of availability of financing to some segments of SMEs emerged as a significant issue, and has been a key concern of policymakers. Given the financial pressure on banks, increased lending capacity to the SME sector may require further public support – either through increased capacity or increased risk appetite. In some cases, the public sector may have a higher risk appetite than a commercial bank, due to the broader economic and social benefits of lending to an SME, beyond the pure financial return. This could be delivered through a number of channels, including expansion of national business-support agencies and/or expanded guarantee programmes by public agencies. In addition further actions can be taken including: possible consolidation or simplification of existing pan-European and national SME lending schemes to improve user accessibility; creation of an SME risk and information database; and establishing or expanding credit mediation services. A further option is to support the expansion of SME securitisation, to increase funding and capital capacity for bank lending.

2. **Large and mid-sized corporates.** Mid-sized and particularly large corporates generally do not have difficulty accessing funding. However, corporates expressed concern about the impact of new wholesale market regulations on the cost and availability of certain hedging activity, much of which is linked to financing. These groups also expressed interest in increased flexibility in how they access funding, including instruments such as expanded European private placement and high yield bond markets.

3. **Infrastructure investment.** Infrastructure is crucial to long term growth and productivity. However, funding long term infrastructure investment has become much more expensive for banks, as a result of the Basel III reforms and changes to bank funding costs. In response, this market must be made more accessible to non-bank investors. A range of reforms should be considered, including rules to reduce political risks associated with infrastructure regulations or tariff structures, increased transparency of planning and procurement processes and greater acceptance of capital markets instruments as part of an overall financing package. While institutional investors can bring new funding capacity, public sector commitment will remain crucial in areas such as project budget capacity and certainty of tariffs.

4. **Lending to businesses in crisis-affected countries.** Funding issues in these countries are particularly acute and may require consideration of special types of solutions, including the possible relaxation of certain European Investment Bank (EIB) eligibility rating criteria for partner banks, and refinement of sovereign CDS regulations and swap contract triggers to improve investor ability to hedge the sovereign risk component of corporate financing transactions.

These recommendations are discussed in greater detail below, along with further specific recommendations for the commercial real estate sector, financial sponsors and investors. Action in these additional areas should be considered as part of a broad combination of initiatives to promote long term growth in Europe.

Barriers to funding and specific problem areas

Large domestic corporate

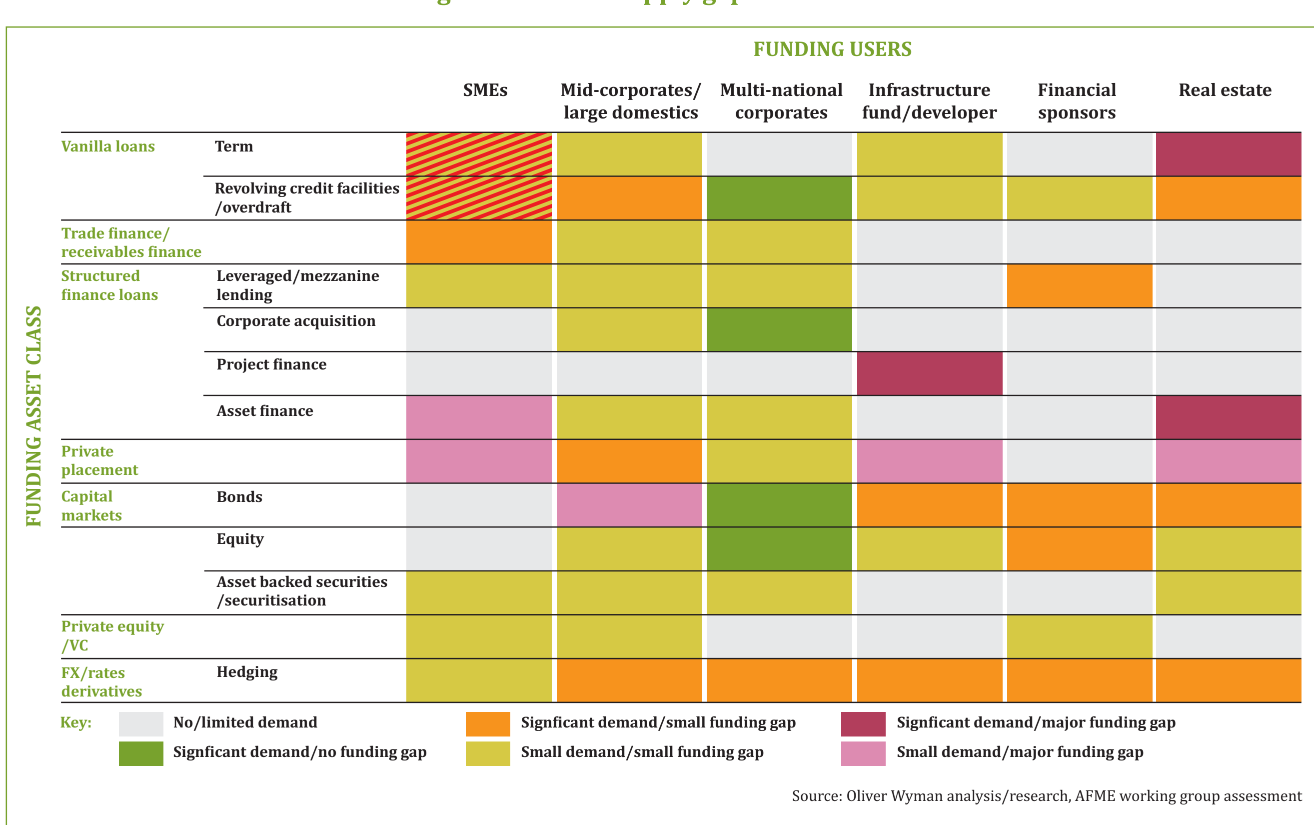
"Refinancing for a company our size is not a problem"

SME

"It has become more difficult to get a loan; banks are more stringent and there is more formality and need for documentation"

The current state of corporate financing in Europe is mixed (Figure 2). Macro-economic uncertainty reduces the number of viable investment opportunities, constraining demand for new financing. Nevertheless, demand for funding remains significant for borrowers looking to refinance existing debt, as well as those investing in growth. Capital markets funding remains open to large well-rated corporates, with many seeing unprecedented access to finance. However, some mid-sized corporates and a proportion of SMEs are unable to meet their funding needs, particularly in crisis-hit countries, and more specialised financing is not always easy to source. On the supply side, market and regulation-driven bank deleveraging present headwinds for what has historically been the primary source of supply for much of the market, although European bank lending to non-financial corporations remains at the same level as in 2007. Insurers, asset managers, pension funds and other market participants are active buyers of traditional corporate bonds but have potentially significant further capacity to step in to fulfil an increasing need for non-bank funding, if certain obstacles can be overcome.

Figure 2
Funding demand and supply gaps



Interviews reveal that the top two types of barriers to increasing financing are common across both the demand and supply side: macroeconomic environment and regulation. Other barriers differ both between demand side and supply side segments and between firms within a segment, depending on a firm's own situation.

Private equity firm

"The moment we feel we can provide a valuable return for investors from infrastructure, we will"

Mid-market corporate

"The funding that is available from new entrants in the real estate market only goes to prime locations"

Insurer

"Typically our investment strategy is fairly conservative with vanilla high quality assets but certainly we're starting to look beyond that"

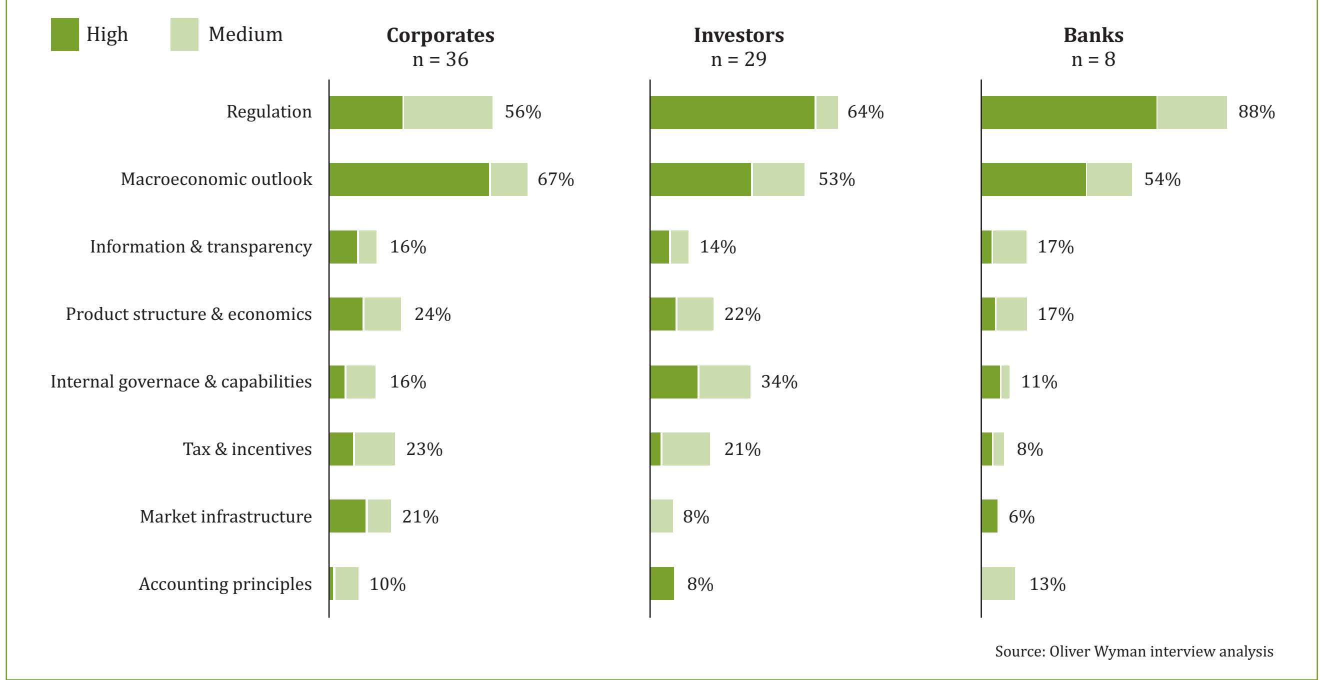
Pension fund

"There is a disconnect between what [assets] pension funds require and what the market is offering them"

A drill-down into barriers faced by corporations (Figure 3) reveals that the highest degree of concern is over macroeconomic outlook, followed by concerns over the knock-on impact of upcoming banking and market reforms. Additional barriers cited included the cost of funding, investor demand, availability and cost of hedges (particularly cross-currency swaps) and the ability to obtain and maintain a rating.

From a funder's perspective, regulations and macroeconomic uncertainty are also highlighted as key barriers. Beyond this, investors identified a much broader set of barriers relating to internal governance and capabilities and product structures and economics, including insufficient risk-adjusted return, restrictive investment mandates and poor secondary market liquidity of the asset.

Figure 3
Corporate and investor barriers - % of respondents citing high or medium[3]



3. Corporates include corporate industry associations and investors include investor industry associations

Multinational corporate

“Macro economy is a huge driver [of funding problems], especially in Southern Europe where loan to deposit ratios are as they are”

Investor industry association

“Our concern is the cumulative effect of market regulations”

Bank

“We are reallocating capital from mature to emerging markets”

Asset manager

“We have a core resource base for PFI and infrastructure but if it was to become a major asset class, we’d need to extend our capabilities”

Overview of actions to stimulate growth

The magnitude of the problem facing Europe should not dishearten those who wish to improve the situation. There are a large number of possible solutions to stimulate growth, some implementable solely by the relevant private sector industry groups, others likely requiring some type of public policy support/intervention and others a combination of the two. Public policy support can take many forms, such as changes to investor capital charges for targeted asset classes and products, changes to regulations on portfolio eligibility criteria for various types of investment portfolios in regulated entities (banks, insurers and funds) and guarantees or subsidised funding from public entities. While it is recognised that public sector capacity to provide funding is limited, the broader economic and social benefits of financing some segments (such as SMEs and infrastructure) mean that increasing the level of funding may be economically justifiable and result in a material uplift to long-term growth of the real economy. Actions considered to have the highest impact and traction are summarised in the tables below, including ‘action owners’ who could instigate steps to implement the recommendations. We then present an overview and detailed analysis of supply-side and demand-side segments in the main body of the report.

Table 1

Key: Interview support, impact and feasibility of solutions

Level	Interview support	Impact	Feasibility
	Unanimous support from interviewees	High impact across entire European funding market	Easily implementable solution requiring minimal capital expenditure and time
	Supported by all but one or two interviewees	High impact across majority of European funding market	Easily implementable solution requiring minimal capital expenditure and time; some complications likely
	Majority support from interviewees	High impact for specific sector across Europe	Implementable solution requiring some time, capital or resource investment
	Mixed support: supported by approximately half of the interviewees	Medium impact for specific sector across Europe	Implementable solution requiring significant time, capital or resource investment
	Supported by several interviewees or support weak	Limited impact for sector or medium impact in limited geographies	Solution requiring significant investment, time and resources and likely complications
	Limited and weak support from interviewees	Minimal impact expected	Solution requiring significant investment, time and resources and likely pan-European complications
	Solution not tested with interviewees	No impact expected	Not feasible given current political and economic climate in Europe

Asset manager

"What are banks for? Banks are meant to do the small scale lending because they have the team of bankers on the ground dealing with the companies every day"

Insurer

"If we thought an exposure to SME lending was attractive we might buy pooled funds"

Bank

"We need a framework around documentation requirements and ratings – that will drive transparency"

SME

"All I want is a one-pager with the loan criteria explained in a simple manner so I know what to expect"

SMEs

While some SMEs interviewed had access to sufficient funding, others highlight significant challenges which need to be addressed.

Survey respondents expected banks to remain the primary lenders to SMEs due to the small and often revolving nature of borrowing and the need for a local relationship with the borrower. The majority of non-bank investors interviewed did not have appetite to lend directly to SMEs as it did not fit with their business models and in some countries, regulations restrict loan origination solely to banks.

Solutions therefore focus on selectively increasing public sector support, where banks do not have the capacity or risk appetite to lend to certain SMEs. This could include the establishment of additional business agencies along the lines of the German KfW or the UK Business Bank, the expansion of existing European Investment Bank (EIB) and European Investment Fund (EIF) schemes (€12 billion and €750 million respectively today, some of which can be expanded), the potential further usage of national cohesion funds, the simplification of support schemes as well as communication of these schemes to improve accessibility to SMEs. Additional improvements to bank lending would include better credit mediation between banks and borrowers and improving SME data availability to enhance competition between banks.

Increased SME securitisation could also improve bank capacity to lend to SMEs. This may require policy support (such as the ECB's) recently-announced consultation with the EIB on how to expand SME securitisation), evidence-based capital charges for high quality securitisation for insurers in Solvency II, inclusion of certain high quality securitisations in liquidity portfolios for banks and support of Prime Collateralised Securities (PCS) standards for securitisation.

Finally, accounting changes could be implemented to reduce the disincentive for SME owners to invest equity in their business - in some cases additional equity is more appropriate than debt funding and would in turn improve the creditworthiness of the SME.

Barriers and potential solutions for SMEs include:

Identified barrier	Proposed solution	Action owner(s)	Interview support	Impact	Feasibility
1. Macroeconomic and Eurozone uncertainty reducing attractive investment opportunities	Out of scope of this study	N/A	◕	N/A	N/A
2. Fragmented and, in some cases, potentially under-funded government support for SME lending • Concerns are very region-specific, particularly focused on Southern Europe • Question as to whether size of pan-European and national government support programmes is sufficiently large in relation to size of EU economy, particularly for riskier end of SME lending • Variety of different schemes at pan-European and national levels, which is confusing to SMEs and leaders	Establish further national government backed SME support agencies, such as German KfW model or SME business banks	EU Commission, EIB, EIF, National Governments, Industry	◑	◕	◑
	Consider expansion of Commission, EIB, EIF guarantee programme sizes and explore further EU cohesion fund availability/usage as well as relative efficiency of the various types of public support. The most efficient solutions free up capital through partial guarantees		◑	◑	◔
	Consolidate and/or simplify various pan-European and national support schemes to improve SME access		◑	◕	◔
	Create comprehensive register and consolidate and/or simplify communication/navigation of various pan-European and national support schemes to improve SME access		◑	◑	◕
3. SME securitisation is currently not economic	Consider various types of regulatory support for high quality securitisation issuance and investment	EU Commission, Industry, EBA, EIOPA	◔	◑	◑
4. Nature of SME lending (small balances, local, short term, revolving, etc.) is not easily suited to non-bank business models	N/A	N/A	◕	N/A	N/A
5. Some SME relationships with banks strained due to crisis-related issues • Many SMEs cite increased funding costs, cross-selling, perceived overly strict enforcement of covenants, etc. as symptoms of a deteriorating bank-SME relationship	Improve communications by establishing national credit mediation services in countries where they currently don't exist	Industry, National Governments	◑	◔	◕
6. Perceived lack of competition for SME lending	Create national databases of SME information and ratings	Industry in coordination with SME associations and the EU Commssion	◔	◑	◔
7. Current incentivisation of SME debt compared to equity • Entrepreneurs feel penalised when selling equity stakes due to capital gains taxes • Tax-deductibility of interest payments incentivises SMEs to increase debt rather than equity	Enact capital gains tax relief for entrepreneurs when selling small business equity stakes	National Governments	◑	◑	◔
	Consider tax deductions for small business equity, akin to deductions for loan interest	Accountancy Industry	◑	◑	◔
	Consider stamp duty exemption for shares of small businesses to increase value of raising equity capital	National Governments	○	◔	●
8. Lack of clarity over MiFID proposals for reduced disclosure levels for SMEs trading on selected SME growth markets	Finalisation and clarification of MiFID proposals	EU Commission, Exchanges, Industry	○	◔	◑

Mid-market corporate

"If you want to develop a private placement market, you need a mix of incentives for both investors and corporates"

Mid-market corporate

"Need to put UK PP market on similar footing to US market, with documentation and NAIC ratings"

Bank

"In 2012, UK Corporates raised >$10 billion in the US PP market, much of which was in growth oriented sectors"

Multinational corporate

"If the firm can't demonstrate hedging [to be EMIR exempt] the trading arm may trip up the whole organisation"

Large/mid-sized corporates

Most large and mid-sized corporates interviewed did not have problems accessing finance, with many heavily using capital markets instruments. The main concern related to the availability and cost of hedges, particularly cross-currency swaps, due to the impact of regulation. Some firms also highlighted concerns over the current thresholds for clearing and margining under European Market Infrastructure Regulation (EMIR). Corporates emphasised the need for active engagement of end-users when defining new regulations.

It is expected that, over time, large and mid-sized corporates will rely less and less on bank funding. Expanding funding choice is thus important to ensure firms have sufficient non-bank funding. This could include expanded access to the European private placement (PP) market using standardised documentation and ratings, and definitions of how broadly a transaction is placed in order to promote secondary liquidity. The US PP market (SEC Rule 144A and Rule 4(2) for securities and loans), as well as the German Schuldschein market for loans provide models for how an expanded pan-European private placement market could be structured. A European PP market would also give European insurance and pension funds better access to large sectors of European industry, rather than European issuers using the US market. Regulators should also consider the impact of MiFID 2 and proposed bank ring-fencing on corporate end users. Europe also has an underdeveloped high yield bond market, which is only one third of the size of US high yield market. Current EU national corporate insolvency regimes do not include a US Chapter 11 style of corporate restructuring, which discourages high yield bond investment by many European investors.

Barriers and potential solutions for large/mid-sized corporates include:

Identified barrier	Proposed solution	Action owner(s)	Interview support	Impact	Feasibility
1. Macroeconomic and Eurozone uncertainty reducing attractive investment opportunities for large and mid-sized corporates	Out of scope of this study	N/A		N/A	N/A
2. Availability/cost of hedging - some products used by corporates will be scarcer, or more expensive under CRD IV and EMIR regimes e.g. cross-currency swaps	Evidence-based approach to capital parameters for derivatives	EU Commission, ESMA			
3. Corporates are concerned about collateral requirements and increased costs if caught by EMIR clearing requirement	Amend EMIR rule detail so that non-financial corporates subject to clearing/margining if they breach threshold in one asset class are only subject to clearing/margining for the breached asset class not all asset classes	ESMA, Industry			
4. Lack of a sizeable European private placement market, which would provide faster and more flexible access to non-bank investors	Expand European private placement market, through possible pan-European and/or national regulation/directives	EU Commission, National Governments, ESMA, Industry			
5. Underdeveloped European high yield bond market	Simpler, standardised disclosure requirements for public/private bond issuance	Industry-led disclosure standardisation initiative already underway			
	Consider modification of existing pan-European and national insolvency regimes such as a US-style Chapter 11 regime	National Governments, EU Commission			
6. Corporate concerns about the compound impact of various proposed financial sector regulations (e.g. FTT, MiFID 2, UK ICB and Liikanen ring-fencing), which will raise costs of new issuance	Active dialogue between regulatory community and end users such as corporates and investors	EU Commission, Corporates, Industry			
7. Inconsistent national withholding tax regime	Reach pan-European agreement on withholding tax for capital markets issuance	EU Commission with support from industry			

Insurer

"We already take account of tariff risk as part of sovereign and project risk - it's the nature of the business"

Asset manager

"We are putting new teams together to watch the infrastructure pipeline, but the big problem for us is the construction risk and who pays for that"

Bank

"There is a demand for infrastructure, but there is a difficulty in getting capital where it is needed in the construction phase; the Government can play a role here"

Asset manager

"A credit guarantee and surveillance agency would help; we don't want to make day to day decisions on the project"

Infrastructure

Infrastructure funding has become significantly more difficult for banks to provide, due to its long term nature and capital charges associated with infrastructure finance. Institutional investors such as insurers and pension funds have significant capacity to provide infrastructure funding if various regulatory uncertainties and concerns are resolved. However, it should be noted that some investors surveyed also stated that expected returns were not sufficiently attractive at current levels.

Respondents on all sides highlighted important roles for government in committing to unlock new infrastructure investment. The current low level of infrastructure investment and uncertainty over future pipeline was raised as a major concern, with new investors cautious about building new capabilities. Additional public sector support should be provided through continued and, if possible, expanded funding and/or guarantees, such as the Project Bond 2020 initiative.

A further significant barrier to infrastructure investment is regional regulatory uncertainty on project revenue receipts. Governments of all sizes and the European Commission/EIB could proactively work to reassure investors by enacting simple and standardised national or pan-European tariff structure guidelines, regulatory risk compensation mechanisms, and simpler planning and procurement procedures. Investors we spoke to were relatively uniform in voice, saying that they can only invest in projects with cross party political consensus, with little scope for interference. Regulatory stability and funding commitment are critical to address the infrastructure gap.

Additionally, sponsors should increase transparency over tender processes and timing, and improve options for capital markets take-outs as part of the initial financing structure, possibly including a move toward segregated tender processes for the initial build and long term finance phases. Many long term investors do not want construction risks and so local authorities need to become comfortable with a capital markets take out as committed bank funding for term is no longer available for many projects.

Credit management agencies and new private and public sector well capitalised credit enhancement providers/insurers could also be developed. These would enable new investors to outsource certain activities and to drive standardisation of contracts (previously supported by now largely defunct monoline insurers).

Finally, industry fora should be promoted to bring together sponsors, investors and governments as a near-term initiative to increase communication and understanding.

Barriers and potential solutions for infrastructure include:

Identified barrier	Proposed solution	Action owner(s)	Interview support	Impact	Feasibility
1. Limited pipeline of new infrastructure projects	Increased transparency over planned essential projects	EU Commission, National Governments	◕	◑	◔
2. Reduction in availability of long term bank funding	Expand and extend the Euro 2020 Project Bond initiative	EU Commission, EIB	◔	◑	◔
	Encourage and expand funding for infrastructure investment by European public sector institutions, including use of national cohesion funds where possible	EU Commission, EIB, EIF, National Governments	◕	◕	◔
	Create/promote an infrastructure-focused forum to bring together borrowers, banks, non-bank investors and governments	Industry, EU Commission, National Governments, Regulators	◔	◔	◕
3. High degree of perceived political risk associated with changes to regulations or tariff structures of infrastructure projects	Establish EU guidelines governing long term tariff commitments and approach to and compensation for subsequent changes	EU Commission, National Governments	◑	◕	◔
4. Slow and opaque planning and procurement processes for infrastructure projects	Establish guidelines to increase transparency on planning stages and timelines for infrastructure projects	EU Commission, National Governments	◑	◑	◔
	Establish best practice guidelines for finance tendering process, including approach to capital markets take-outs including a move toward segregated tender processes for the initial build and long term finance phases		◑	◑	◔
5. Lack of stakeholder appetite for some project-related risks	Shift to availability-based structure for essential social infrastructure projects (e.g. roads), with governments taking volume risk	National Governments	◑	◑	◑
	Increase level of government guarantees or equity participation in infrastructure projects to cover risks where there is limited private sector appetite		◑	◕	◔
6. Disappearance of monoline insurers	Establish guidelines on permissible capital markets take-out structures to be included as part of initial financing proposals, with clarity on the bearer of refinancing and/or spread risk	EU Commission, National Governments, Industry	◔	◑	◔
	Consider development of new project finance credit management agencies and/or new, well capitalised private or public sector credit enhancement providers/insurers, to act on behalf of investors and drive standardisation of documentation	EU Commission, National Governments,	◑	◑	◑

Investor industry association

“As insurers realise the impact of Solvency II on real estate [assets], they become more cautious; we’ve been seeing this for two years now”

Mid-market corporate

“Provide investors with enough liquidity and reduce their capital costs which allow them to provide financing on real estate projects”

Insurer

“The CRE and infrastructure markets have been dominated by banks in the past, so the market has developed in a way that suits banks”

Commercial real estate

Many banks have scaled back lending to the Commercial Real Estate (CRE) sector, following losses and increased capital requirements. Very large real estate firms still had access to funding, but smaller firms face challenges either to invest or refinance, particularly outside prime assets.

Regulators and governments should pursue an evidence-based approach to CRE capital charges, both under Solvency II and Basel III to ensure that capital increases do not go too far. Pan-European real estate indices with deep historical data could help facilitate this.

There may be space for attracting a broader funding base through a pan-European Real Estate Investment Trust (REIT) structure, as well as expansion of the number of countries with REIT legal frameworks, which will attract cross-border investment, though since tax policy is a national rather than pan-European prerogative, further study is required.

Barriers and potential solutions for commercial real estate include:

Identified barrier	Proposed solution	Action owner(s)	Interview support	Impact	Feasibility
1. Perceived unfair treatment of CRE assets under banking and insurance regulations	Ensure evidence-based calibration of capital parameters (slotting criteria and risk-weights in UK)	EU Commission, EBA, EIOPA, UK PRA			
2. Underdevelopment and fragmentation of existing European national REIT regulation causes reluctance towards cross-border investment	Consider pan-European REIT structure, and/or growth in number of EU countries with REIT legal frameworks, and mutual recognition	EU Commission			
3. Withdrawal of bank appetite for CRE assets and desire for predominantly prime assets from other investors	Increase non-bank investor understanding of CRE debt, including development of pan-European real estate indices	Industry			

Investor industry association

"With CLO regulation, how do you retain 5% when you are not the primary or secondary issuer?"

Asset manager

"5% rule is a major hindrance to investors – managers are not banks and they do not have that kind of money lying around"

Bank

"Difficult for CLO managers to find investors - three letter acronyms are no longer fashionable"

Financial sponsors and leveraged finance

Although there are recent signs of improvement, the European Collateralised Loan Obligation (CLO) market remains much smaller than pre-crisis levels, due to a combination of market pricing on the underlying assets as well as for some issuers/managers the mandatory risk retention requirement. Meanwhile, the US CLO market has almost completely recovered to pre-crisis levels. Although interviewees had mixed views on the risk retention rule, some advocate the creation of certain exemptions from the risk retention rule for European CLO managers which meet specific governance standards.

Barriers and potential solutions for financial sponsors include:

Identified barrier	Proposed solution	Action owner(s)	Interview support	Impact	Feasibility
1. European CLO market has severely contracted from pre-crisis levels, although recently showing signs of revival	Consider creation of certain exemptions from the 5% risk retention rule for CLO managers which meet high governance standards	EU Commission, EBA, EIOPA, Industry			

Multinational corporate

“We’re not asking for more cash, we’re just asking for a level playing field between our peers across Europe”

Multinational corporate

“[Unrated bond] Pricing is more expensive but it’s better not having a rating than having a rating that is capped by the sovereign”

Multinational corporate

“EIB is taking money away from PIIGS because of credit rating restrictions. Lending is only available to countries like Germany who have a good credit rating”

Businesses in crisis-affected countries

Many, if not all, of the policy recommendations identified in this report apply to businesses in crisis-affected countries. However, these economies also face particularly acute challenges in their long term funding markets, which warrant specific treatment. The issue of rating is important and many corporates wished that rating agencies would reduce the credit rating constraints imposed by a low-rated domicile country, by altering the rating process to allow for independent corporate/country ratings.

However, many participants thought it would be inappropriate to contest sovereign rating linkage, since ratings are only opinions and investors can choose to ignore them. However, participants thought it could be worthwhile for the EU to explore creation of a new EU-level legal framework for EU-level corporate domiciles, which could potentially avoid the sovereign linkage for asset-based funding.

Associated with this, the bank rating policy of the EIB was a major concern. The EIB rating criteria for partner banks means the EIB cannot/does not partner in the crisis affected countries, whereas the need for the EIB is stronger than ever in these locations.

For many investors the short selling restrictions in the sovereign CDS market have impacted the ability of participants to hedge country risk associated with corporate financing. It was suggested that after appropriate data is collected on market activity subsequent to the implementation of the short selling regulation, the European Securities and Markets Authority (ESMA) does an impact assessment on the impact of crisis-related countries in particular and considers refinement of criteria.

Multinational corporate

"We are actually thinking of changing our holding base due to difficulties getting affordable funding because we are Portuguese"

Multinational corporate

"We have a super strong balance sheet but we do not warrant an IG rating because our HQ is in the wrong location within the Eurozone"

Multinational corporate

"The EIB is another source of funding we have used in the past and utilise now but in terms of cost competitiveness, it is less attractive than it was five years ago"

Barriers and potential solutions for businesses in crisis-affected countries include:

Identified barrier	Proposed solution	Action owner(s)	Interview support	Impact	Feasibility
1. Bank concern at changes in EIB support in certain cases in crisis countries	Consider relaxing EIB rating criteria for partner banks for specific targeted types of transactions with appropriate mechanisms to limit risk for EIB	EIB, Industry			
2. Country risk associated with corporate lending difficult to hedge due to Sovereign CDS restrictions and default definitions	Redefine eligibility criteria for sovereign CDS to enable hedging of country-risk component of corporate exposures	ESMA			
	Increase clarity over definition of and governance around default events for sovereign CDS	Industry			
3. Perception that credit rating ceiling governed by a firm's domicile overly penalises the credit ratings of some firms	Explore creation of a legal framework for EU-level corporate domiciles to ring-fence assets and reduce ratings impact of sovereign risk	EU Commission, Industry			

Insurer

"The illiquidity of our liabilities gives us an advantage over other investors; it allows us to crystallise the returns on those assets without taking risk"

Asset manager

"One of the fundamental issues of European loan market is the 27 different jurisdictions; Some consistency in those insolvency laws would increase certainty and speed of outcome [of insolvency cases]"

Pension fund

"As a pension fund our focus is on real returns, credit investment is only one part of that"

Investor industry association

"Solvency II capital requirements would limit the ability of pension funds to invest in more risky assets and ultimately encourage de-risking"

Investors: insurers, pension funds and asset managers

Regulatory uncertainty was highlighted as a major barrier preventing insurers and (albeit to a lesser extent) pension funds from playing a more active role in Europe's long term funding markets. Insurers are currently reluctant to make a heavy allocation to long term assets until important policy issues regarding the definition of matching adjustments, discount rates and the calibration of capital charges on certain important real economy instruments are resolved.

In the development of the IORP Directive (Institutions for Retirement Provision), the European Commission and the European Insurance and Occupational Pensions Authority (EIOPA) should act now to remove regulatory uncertainty and ensure evidence-based calibrations are used specific to pension funds. The potential extension of Solvency II to pension funds should reflect the different risks borne by different stakeholders. Questions were raised about whether existing pension fund investment mandates are too focused on traditional asset classes, with insufficient information to support allocations to new asset classes, including loans. Also, concerns were raised about pension fund ability to invest due to future EMIR derivatives clearing obligations, since many pension funds actively use derivatives to extend the duration of underfunded pension funds.

Market participants, governments and regulators can act collectively to increase institutional investor appetite for purchases of loans, including establishing a legal framework for loan funds (similar to Undertakings for Collective Investment in Transferable Securities (UCITS)), the removal of barriers such as banking license restrictions on the purchase of loans, and the creation of loan performance benchmarks. In the medium term, the development of illiquid retail instruments will be important as this brings large pools of money into play but initially distribution should only be to institutional investors, given the time to develop analysis on investor suitability.

Most asset managers quickly adapted to changing norms in post crisis environments. However, governments and the European Commission can do more to help cross border investment by attempting to harmonise insolvency regimes where feasible, though this is clearly currently an area of national discretion.

A variety of investors raised concerns about the impact of new financial sector regulations on cost, product availability and secondary market liquidity. Regulatory concerns highlighted included EMIR, financial transactions tax, bank ring-fencing proposals (e.g. Liikanen, UK ICB) as well as the compound impact of the reforms taken together.

Asset manager

“It is a paradox: The Commission is saying everyone ought to be investing in loans, but at the same time they’re not good enough to go into a UCITS fund”

Asset manager

“[Regarding UCITS eligibility] You've got to open the doors to retail and institutional investors and they will open the doors to liquidity”

Insurer

“We are looking into loans but it depends on how the regulations finally land”

Private equity firm

“Why would you ever lend in Italy and Spain? The insolvency regime is highly prohibitive”

Barriers and potential solutions for insurers, pension funds and asset managers include:

Identified barrier	Proposed solution	Action owner(s)	Interview support	Impact	Feasibility
1. Potential negative impact from Solvency II in various areas	Policymaker and industry agreement on Solvency II capital requirements for key asset classes	EU Commission, EIOPA, Industry			
• Capital requirements • Asset liability matching criteria • Delays and timing uncertainty	Resolve counter cyclical premium, matching adjustment and extrapolation methodology in Solvency II				
2. Potential negative impact if Solvency II extended to pension funds (IORP)	N/A (future regulatory approach not yet known)	N/A		N/A	N/A
3. Lack of legal framework for investment in illiquid loan assets	Establish legal framework for long term investment funds (LTIFs), separate to UCITS in order to preserve liquidity of UCITS	EU Commission, National Governments, Industry			
4. Lack of understanding and mandate for many institutional investors to invest in non-traditional assets, e.g. loans	Consider development of EU loan price/return benchmarks	Industry with EU Commission engagement and approval			
	Increase availability of information of non-traditional asset classes (e.g. loans) to inform investment mandates	Industry, including investment consultants			
5. Concerns that expiry of pension fund EMIR clearing exemption will reduce investment in growth assets and will increase ongoing cost of business	Review current three-year exemption for extension or preferably permanent exemption	ESMA, Industry			
6. Concerns about the impact of various proposed financial sector regulations on secondary market liquidity (e.g. FTT, MiFID 2, UK ICB, Liikanen ring fencing)	Active dialogue between regulatory community and end users such as corporates and investors on implications of secondary market liquidity	EU Commission, Investors, Industry			
7. Volatility caused by fair value of buy-to-hold loan investments	Review impact of IFRS accounting of credit-related assets on financial statement volatility, in coordination with development of Solvency II matching adjustment	Industry, Regulators			
8. Corporate insolvency regimes vary significantly across Europe, resulting in investors avoiding some asset classes and countries entirely	Harmonisation of European insolvency regimes	National Governments EU Commission to provide guideline			
9. Difficulties in matching long term investors with new European capital markets borrowers	Establish a European investor and borrower forum to improve education and how capital markets function versus bank lending	Industry, Public Authorities			

Summary of potential solutions

The table below summarises the potential solutions across all borrower/investor segments, based on the estimated impact and feasibility. The chart highlights the fact that no easily implemented solutions have been identified which will individually have a major impact on funding availability. However, there are several potential areas that could be implemented and, in combination, would materially improve the funding situation and support long term growth in Europe.

IMPACT	EASE OF IMPLEMENTATION: High	EASE OF IMPLEMENTATION: Medium	EASE OF IMPLEMENTATION: Low
High		• Expanded and/or reallocation of public sector support for SMEs • SME support agencies • Corporate dialogue on compound impact of regulation • Expand European private placement market • Refine sovereign CDS eligibility criteria • Solvency II matching adjustment and counter cyclical premium • Establish LTIF framework • Pension fund EMIR exemption • Investor dialogue on regulatory changes	• Consolidate SME support scheme • Modify pan-European insolvency regimes • Expand public sector intfrastructure investment • Infrastructure tariff stability guidelines • Government guarantees for infrastructure risks • Refine EIB criteria • Calibration of Solvency II capital parameters • Harmonise insolvency regimes
Medium	• Consolidate SME programme communication • Pension fund asset class eligibility review	• SME securitisation support • Derivatives capital requirements • Refine EMIR corporate clearing threshold • Simpler high yield bond disclosure requirements • Availability-based projects • Infrastructure guidelines on capital markets takeout • Review of accounting volatility of loans	• CGT relief for small businesses • Tax deductions for SME equity • National SME risk databases • Witholding tax harmonisation • Transparency on infrastructure pipeline • Expand Project Bond 2020 • Infrastructure planning transparency • Infrastructure finance tendering best practice • Infrastructure credit management/enhancement agencies • Pan-European REIT recognition • Selective exemption from CLO 5% rule • Evidence-based calibration of CRE RWA parameters • Refine sovereign CDS default criteria • EU-level legal framework for corporate assets • EU loan return benchmarks • Loan eligibilty and investment mandates
Low	• Improve SME credit mediation services • SME equity stamp duty relief • Promote infrastructure forum • Borrower and investor forum	• Finalisation of MiFID SME growth market proposals • Improve investor understanding of CRE debt	

Key: SME Large/mid-sized corporates Infrastructure Businesses in crisis-affected countries Other borrower sectors Insurers, PFs and AMs

1. Objectives, structure and methodology

1.1 Objectives

The objective of this report is to provide an interview-based and industry-led assessment of the barriers which are preventing Europe's wholesale financial markets from making their maximum contribution to long term economic growth. The findings of this report will also provide a basis for AFME's response to the European Commission's Green Paper on long term growth.

The report provides views from European market participants, including corporates, investors and several industry associations representing such players. The focus is on financing products used directly or indirectly by corporates including loans, bonds, commercial paper, securitisation, equities and bank services to support lending and the hedging of corporate risks, including derivatives. Investments in financial institutions, short term financing, repo financing and retail/consumer finance are out of scope.

The report is designed to help prioritise actions in response to the current corporate funding gaps, with a particular focus on debt funding issues. The ambition is that these recommendations can help shape policy making in the future at both country and at European levels. Our approach is to be pro-active and solution-orientated and so will focus on directly actionable solutions and corresponding issues. As a result, the report will not attempt to address broad macroeconomic concerns.

1.2 Structure of the report

Section 2 discusses the overall market and regulatory context, highlighting the importance of corporate funding and levels and trends across funding sources and sectors. Section 3 discusses areas of the market where specific problems and barriers exist, as observed from both the supply and demand side, through data and client interviews. For the eight demand side and supply side market segments, we review market participant interview feedback on the key barriers and discuss corresponding solutions and potential actions in detail. Each section concludes with a list of prioritised actionable solutions.

Interviews were structured around the perceived impact of eight potential barriers:

1. Macroeconomic outlook
2. Regulation
3. Information and transparency
4. Product structure and economics
5. Internal governance and capabilities
6. Tax and incentives
7. Market infrastructure
8. Accounting principles

Section 4 provides a brief summary of the four key questions in the Green Paper for which the European Commission seeks responses.

1.3 Methodology for the study

Potential interview targets were identified by working group banks, AFME and Oliver Wyman in order to achieve a diverse sample of corporates and investors that are spread in terms of size (revenues/assets under management), geography and industry. The final sample of 75 interviewees includes 32 corporates, 25 non-bank investors, 8 banks and 10 industry associations operating across Europe. Corporates interviewed have headquarters in the UK, Spain, Italy, Portugal, Germany and France with domestic and global operations. A number of AFME member banks participated in the working group. A list of participants can be found in Annex B.

Interviews were led by Oliver Wyman based on the following structure:

1. The asset funding profile of the firm;
2. Barriers to investing in corporate assets/acquiring funding;
3. Solutions to increase appetite for and access to corporate assets; and
4. Priorities for development.

Key quotes from each interview are captured and included to provide first hand feedback from market players on the barriers to, and solutions for, long term growth. Within each section the views expressed represent a combined view of the interview respondents, working group members and Oliver Wyman. Areas of disagreement between these groups are highlighted where these arise. A quantitative assessment of the perceived obstacles to funding is also provided.

Interviews were conducted on a confidential basis, with participants named only with given approval. Any quotes used have been pre-agreed with the interviewee, though are not directly attributed to individual firms.

2. Overall market and regulatory context

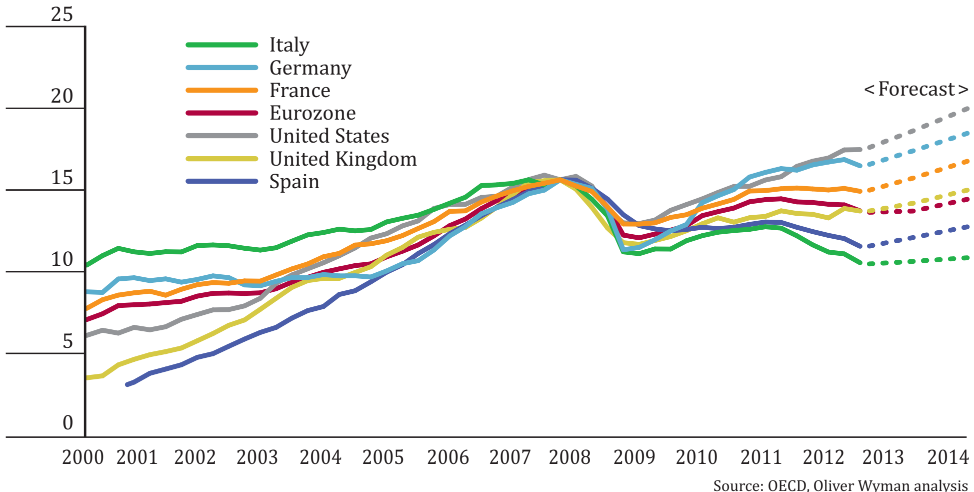
2.1 Economic overview

The economic situation in the Eurozone and Europe more widely has in recent years been the main topic of debate in the global economy. There is, and will continue to be, deep analysis of the causes and impact of the economic and financial crisis in Europe, which began in 2007 and has continued through various phases since. This study examines a specific and vital element of the economic situation in Europe: how Europe's long term funding markets are working and how to enhance their contribution to growth and investment.

The impact of the crisis on growth in Europe has been severe (Figure 2.1). Most large countries fell into recession in 2009, with a subsequent partial recovery in 2010/2011, supported by major central bank actions, including unprecedented low interest rates and quantitative easing. The recovery stalled in 2011 and growth rates fell sharply again in 2012, amid increased concerns over the sustainability of the Euro and solvency of individual governments. Several southern European countries in particular saw a return to negative GDP growth in 2012.

The outlook for Europe remains weak, with the IMF[4] predicting the Eurozone to shrink by 0.3% in 2013, then growing at 1.1% and 1.5% in 2014 and 2015 respectively, still significantly lower than the average of 2.2% from 2000-2007. These growth figures compare poorly to the US, which has been growing steadily since 2009 at approximately 2%.

Figure 2.1
European and US GDP by country[5]



Source: OECD, Oliver Wyman analysis

The economic and financial situation in Europe over the past five years has had, and continues to have, some important consequences for the development of Europe's long term funding and investment. These consequences include:

- **Slow growth in demand** and weak incentives for long term investment, particularly physical investment by corporates and in infrastructure.
- **High public debt and deficits**, an aspect which has created stress in the markets for sovereign debt and in the banking sector (particularly in southern Europe) and has also limited the scope for public authorities to undertake or unlock investment.

4. IMF World Economic Outlook, April 2013
5. GDP quarterly growth rates rebased to 100 in Q1 2008. Spain GDP data not available before 2001

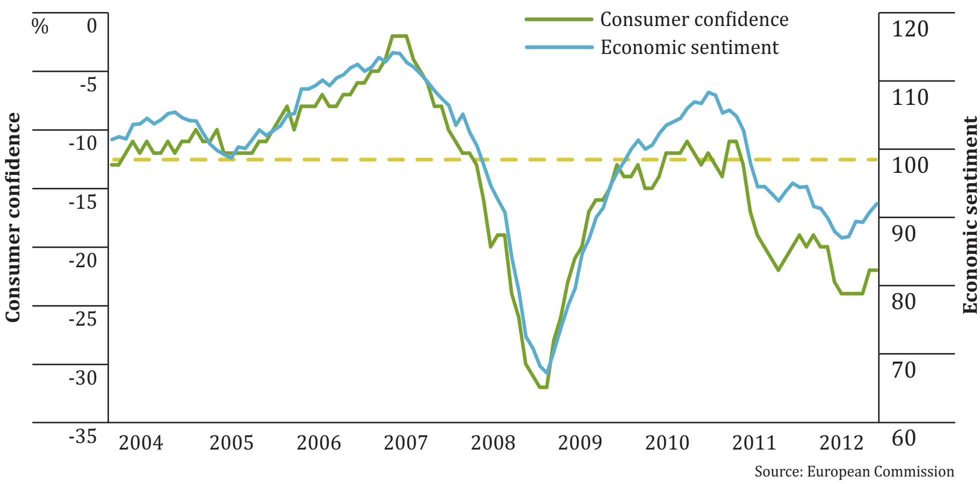
- **Deleveraging in the financial sector**, as banks across Europe shed assets (although not, in aggregate, loans to corporates), particularly outside home markets and in funding-intensive segments (e.g. project and infrastructure finance). This trend is the result of both regulatory reform and market-driven restructuring.

- **Sustained low interest rates**, as expectations of low future growth and inflation have flattened the yield curve, particularly for prime borrowers. At the same time, some analysts argue that this low-rate environment may weaken incentives for saving and for long term productive investment.

As a result of these and other factors, consumer and business confidence remains weak (Figure 2.2). Levels of confidence follow a very similar shape to GDP. Since a pre-crisis peak in 2007, confidence reached a low in 2009 as the full scale of the financial crisis was realised. During 2010 and in early 2011 confidence returned to long term average levels, before deteriorating again in summer 2011 as Eurozone concerns heightened.

Figure 2.2

European confidence and economic indicators[6]



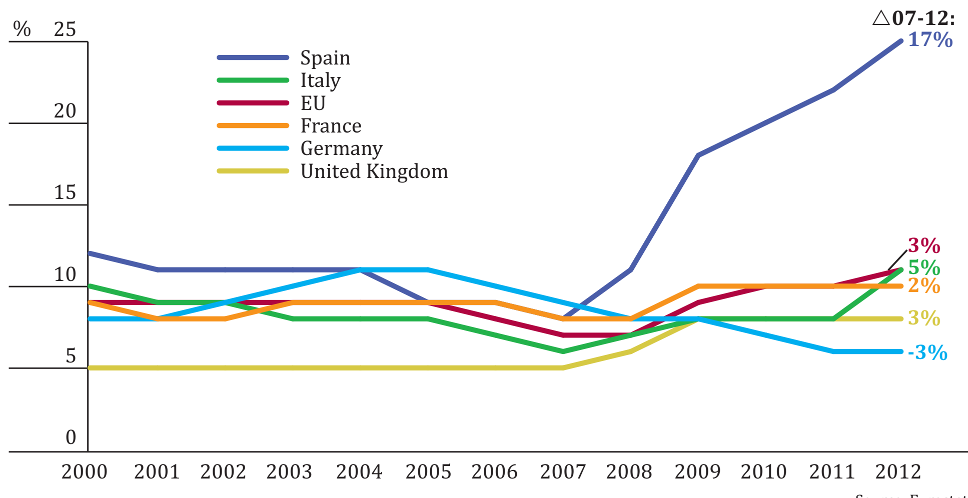
Source: European Commission

Unemployment has increased across many countries during the crisis. This is particularly an issue in more severely crisis-affected countries, where austerity measures have been implemented to repair public sector finances – either voluntarily or as a condition of bailout packages.

Given the weak growth outlook, the private sector has not yet been able to compensate for the reduction in size of the public sector workforce. Overall unemployment rate in the EU is up by approximately 50% since 2008, driven largely by sovereign crisis-affected countries, such as Italy (unemployment up by approximately 60%) and Spain (up 120%). Notably, German unemployment has fallen by approximately 30% since 2008 while simultaneously its SME sector is one of the fastest expanding in the entire EU[7].

6. The consumer confidence indicator is arithmetic average of the balances (%) referring to the questions on the financial situation of households, general economic situation, unemployment expectations (with inverted sign) and savings; all over next 12 months. Data are seasonally adjusted. The Economic Sentiment Indicator is made up of the weighted average of five confidence indicators comprising industry, services, consumers, construction and retail trade. The long term average refers to the period as from publishing of the indicator (1985) up to now
7. European Commission memo: small and medium sized enterprises in 2011: situations per EU Member State

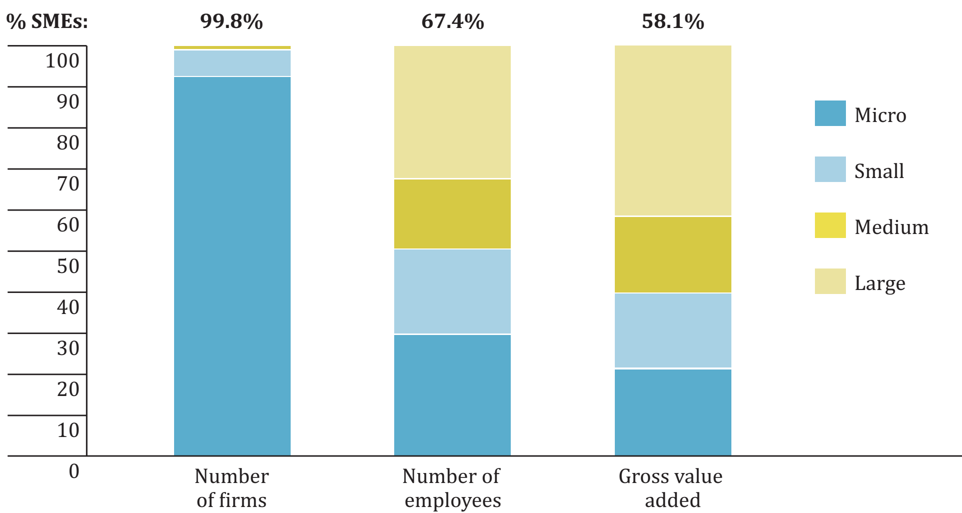
Figure 2.3
European unemployment rates by country



Source: Eurostat

Figure 2.4 provides a view of the private sector landscape in Europe. Although large enterprises (>250 employees) account for more than 40% of Gross Value Added (GVA)[8], it is SMEs (<250 employees, micro, small, and medium enterprises) that employ the majority of individuals (approximately 87 million people), accounting for 67% of total employment, and generating 58% of GVA.

Figure 2.4
European corporate landscape, 2012[9]

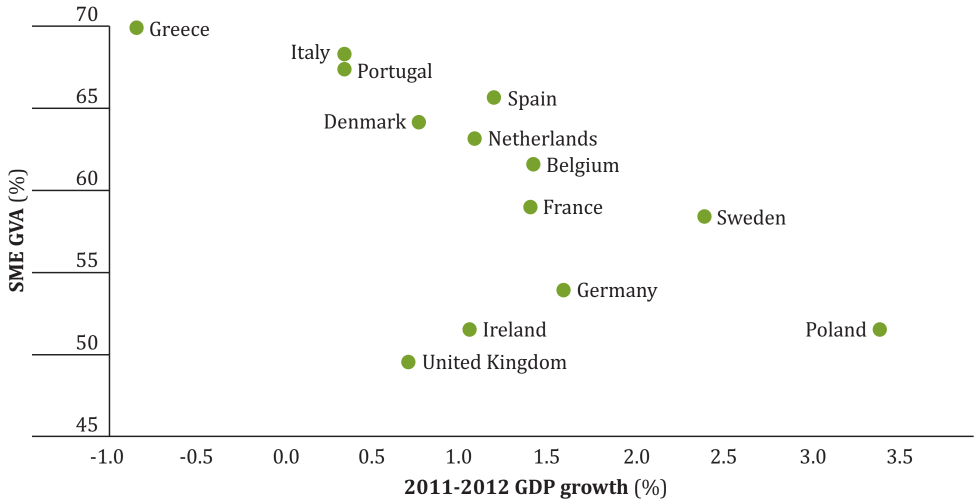


Source: Eurostat, National Statistics offices of member states, Cambridge Econometrics, Ecorys

The relative role of SMEs within the private sector varies between countries. It is worth noting that several of the more crisis-affected countries have a larger SME segment (>65%) by GVA, compared to less affected countries such as Germany and Sweden (<60%), as shown in Figure 2.5. Outliers on this figure are a result of specific economic differences, for example the poor GDP performance of the UK relative to SME GVA could be due to an economy overly reliant on financial services.

8. Gross value added is the value of output less the value of intermediate consumption; it is a measure of the contribution to GDP made by an individual producer, industry or sector
9. Micro enterprise = < 10 employees, Small enterprise = 10 - 49 employees, Medium enterprise = 50 - 249 employees, Large enterprise = 250 or more employees. Gross value added (GVA) at market prices is output at market prices minus intermediate consumption at purchaser prices

Figure 2.5
SME GVA versus GDP growth, 2011-2012



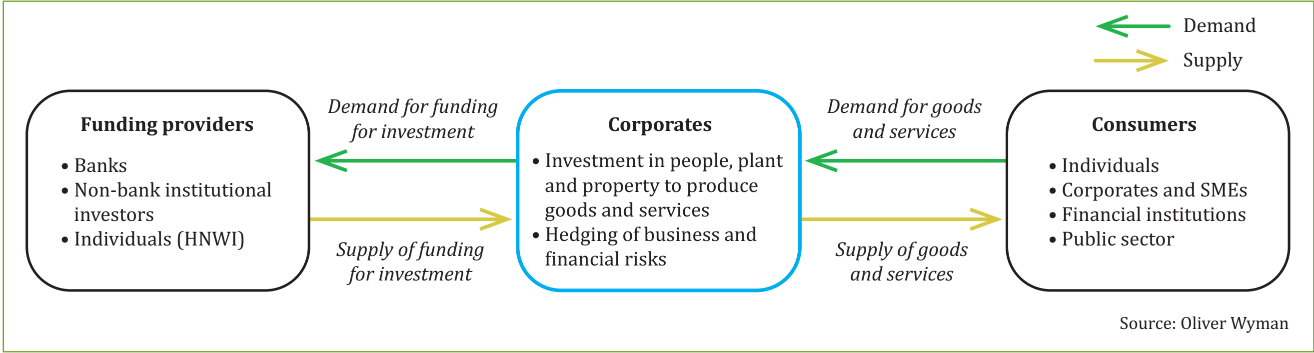
Source: European Commission, Ecorys Netherlands, Oliver Wyman analysis

There is a high level of political focus on supporting SMEs to return to growth, partially due to the importance of the SME segment highlighted above. It is worth noting, however, that over 40% of GVA added is provided by large companies. As a result, larger corporates also need to feature highly in any policy considerations – indeed it could be argued that transforming to a more large-corporate focused economy could be a source of growth for all participants, including the many SMEs which supply large corporates.

2.2 The importance of corporate funding

Funding, either through debt or equity, is an important enabler of growth, as depicted in Figure 2.6. Funding allows businesses to invest in people, materials, facilities or property to produce more goods or services. However, funding is not the only driver of growth. Businesses will only make economically rational decisions to invest if they see an increase, or potential increase, in demand for the goods or services they produce, or if they believe that the investment will enable them to generate current output more efficiently.

Figure 2.6
Demand and supply flow diagram



Source: Oliver Wyman

As already highlighted previously, the financial crisis has had a negative impact on demand. Returning to growth requires not only ensuring the availability of funding, but also changes to improve the underlying drivers of demand in specific regions and sectors, whether for corporate or consumer funding. There will always be pockets where funding is required to achieve growth – and if funding is not available, growth will be constrained.

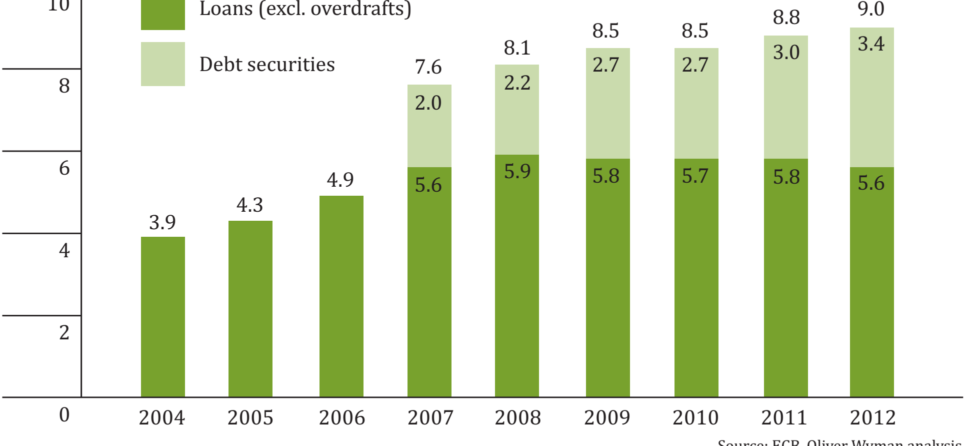
2.3 Corporate funding levels and trends

Corporates can access numerous sources of funding in order to invest in growth. These include bi-lateral loan and credit facilities, their syndicated equivalents, project finance, asset-backed lending, corporate bonds, securitisation, commercial paper, equity issuance and leveraged/mezzanine lending, etc. The simplest and most widely used form of corporate financing is debt, both loans and bonds.

Outstanding corporate debt (loans and debt securities) in Europe increased from €7.6 trillion in 2007 to €9.0 trillion in 2012 (Figure 2.7). The balance of outstanding loans declined slightly at 2% per year between 2008-2012, compared to growth of 12% per year from 2004-2007. This relatively small decline in outstanding loans comes despite widespread perceptions of both bank and corporate deleveraging and the lack of availability of funding for corporates. On the other hand, Figures 2.7 and 2.8 indicate that bond issuance and outstandings have risen considerably since 2007, with larger corporates increasingly tapping the capital markets for funding needs. The relatively stable aggregate picture masks significant differences at the country, segment and sector level which will be discussed later.

Figure 2.7

European non-financial corporate debt outstanding by asset class, € trillion[10]



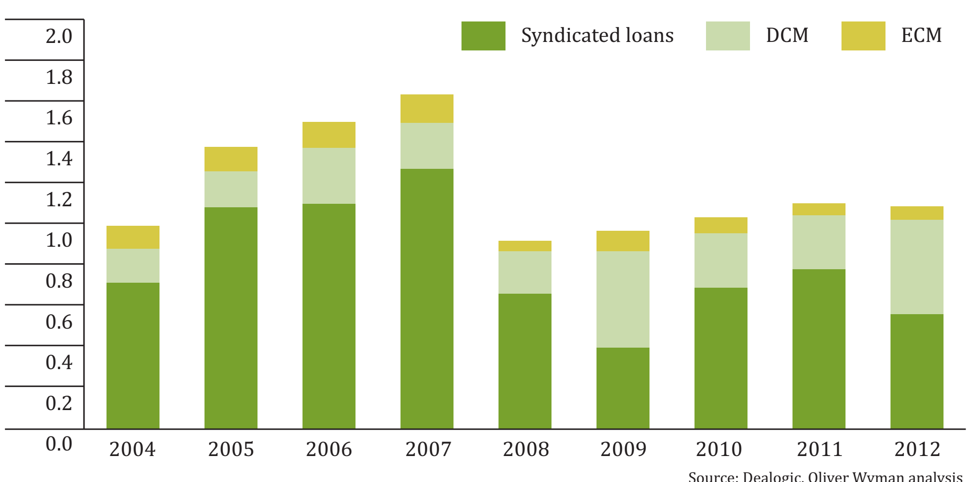
Source: ECB, Oliver Wyman analysis

New capital markets issuance volumes have been more volatile. As indicated in Figure 2.8, issuance volumes grew dramatically from 2004 until 2007, with a boom in acquisition and leveraged finance driving growth in the syndicated loan market. New loan volumes then fell by two thirds to a low in 2009, driven by a crisis-related collapse in M&A and leveraged buyout activity among broader supply and demand issues. New equity issuance, including both primary and secondary offerings has remained largely flat since 2008 and remains a relatively small proportion of new capital markets funding.

The types and levels of funding used vary depending on corporate size and the nature of the business. There are no robust sources which give a comprehensive and detailed breakdown of corporate funding. Figure 2.9 has been compiled based on a combination of sources and expert judgement to give an indication of current funding levels by corporate type and asset class.

10. Outstanding volumes as at year end. Debt securities include all long and short term debt securities excluding shares and derivatives; full dataset not available for debt securities before 2007

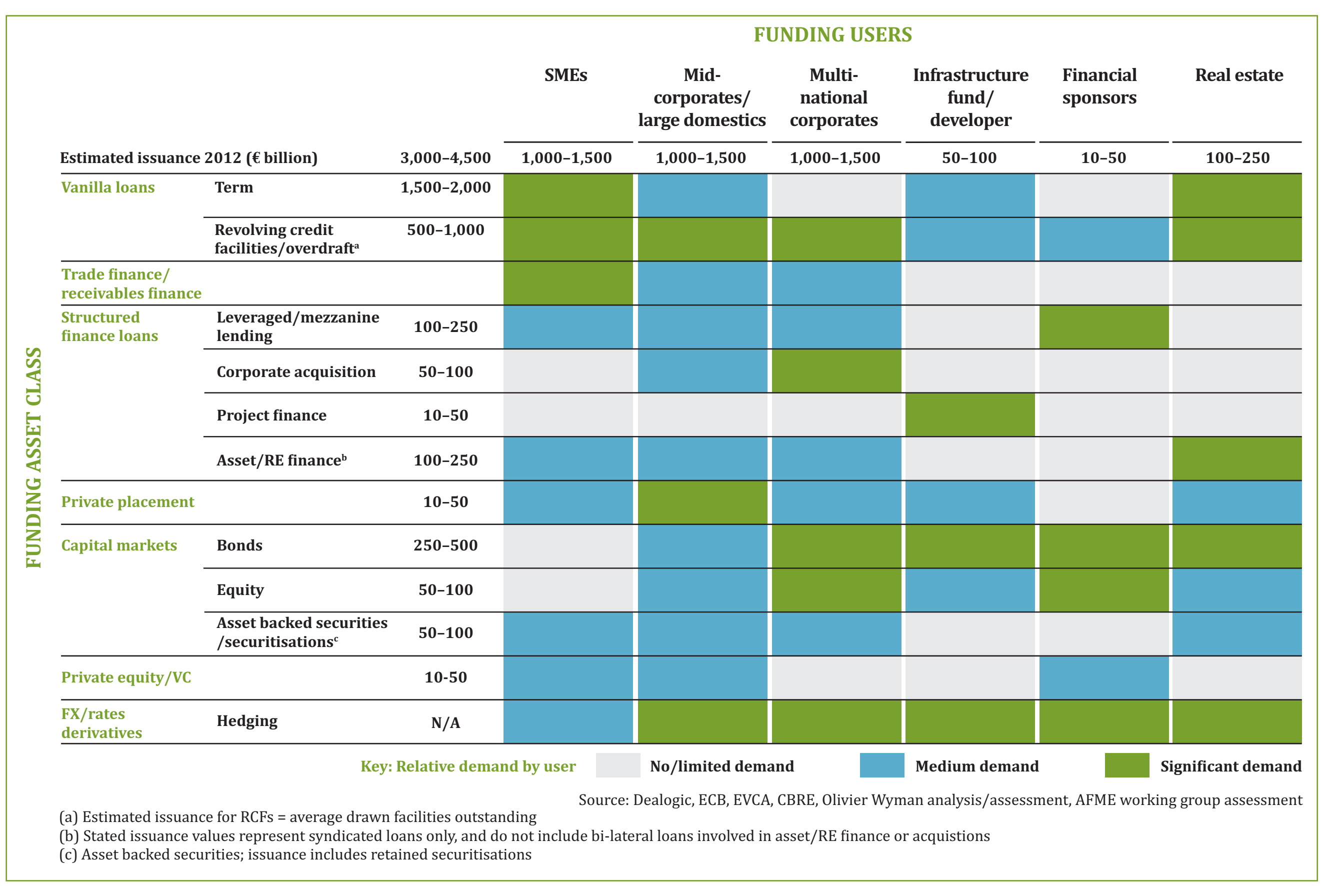
Figure 2.8
Non-financial corporate new issuance by asset type, € trillion[11]



Source: Dealogic, Oliver Wyman analysis

For many corporates, particularly smaller firms, vanilla bank lending (including both term loans and credit facilities), is the main source of finance. The cost and ticket size required for capital markets issuance by corporates is typically prohibitive for transaction sizes below €500 million. However, mid corporates can access private placement markets where a broader range of institutional investors can invest in corporate debt. Some corporates also tap retail investors, either through listed or sometimes unlisted transactions, such as the M-bond issues for the German Mittelstand.

Figure 2.9
Typical funding demand by corporate type and asset class[12]



FUNDING ASSET CLASS			FUNDING USERS: SMEs	Mid-corporates/ large domestics	Multi-national corporates	Infrastructure fund/ developer	Financial sponsors	Real estate
Estimated issuance 2012 (€ billion)		3,000–4,500	1,000–1,500	1,000–1,500	1,000–1,500	50–100	10–50	100–250
Vanilla loans	Term	1,500–2,000	Significant demand	Medium demand	No/limited demand	Medium demand	No/limited demand	Significant demand
	Revolving credit facilities/overdraft[a]	500–1,000	Significant demand	Significant demand	Significant demand	Medium demand	Medium demand	Significant demand
Trade finance/ receivables finance			Significant demand	Medium demand	Medium demand	No/limited demand	No/limited demand	No/limited demand
Structured finance loans	Leveraged/mezzanine lending	100–250	Medium demand	Medium demand	Medium demand	No/limited demand	Significant demand	No/limited demand
	Corporate acquisition	50–100	No/limited demand	Medium demand	Significant demand	No/limited demand	No/limited demand	No/limited demand
	Project finance	10–50	No/limited demand	No/limited demand	No/limited demand	Significant demand	No/limited demand	No/limited demand
	Asset/RE finance[b]	100–250	Medium demand	Medium demand	Medium demand	No/limited demand	No/limited demand	Significant demand
Private placement		10–50	Medium demand	Significant demand	Medium demand	Medium demand	No/limited demand	Medium demand
Capital markets	Bonds	250–500	No/limited demand	Medium demand	Significant demand	Significant demand	Significant demand	Significant demand
	Equity	50–100	No/limited demand	Medium demand	Significant demand	Medium demand	Significant demand	Medium demand
	Asset backed securities /securitisations[c]	50–100	Medium demand	Medium demand	Medium demand	No/limited demand	No/limited demand	Medium demand
Private equity/VC		10-50	Medium demand	Medium demand	No/limited demand	No/limited demand	Medium demand	No/limited demand
FX/rates derivatives	Hedging	N/A	Medium demand	Significant demand	Significant demand	Significant demand	Significant demand	Significant demand

Key: Relative demand by user — No/limited demand; Medium demand; Significant demand

Source: Dealogic, ECB, EVCA, CBRE, Olivier Wyman analysis/assessment, AFME working group assessment

(a) Estimated issuance for RCFs = average drawn facilities outstanding
(b) Stated issuance values represent syndicated loans only, and do not include bi-lateral loans involved in asset/RE finance or acquistions
(c) Asset backed securities; issuance includes retained securitisations

11. Non-financial corporate based on Dealogic Specific Industry Group, excluding Financial Institutions and Sovereigns
12. Funding volumes are estimations only to show order of magnitude

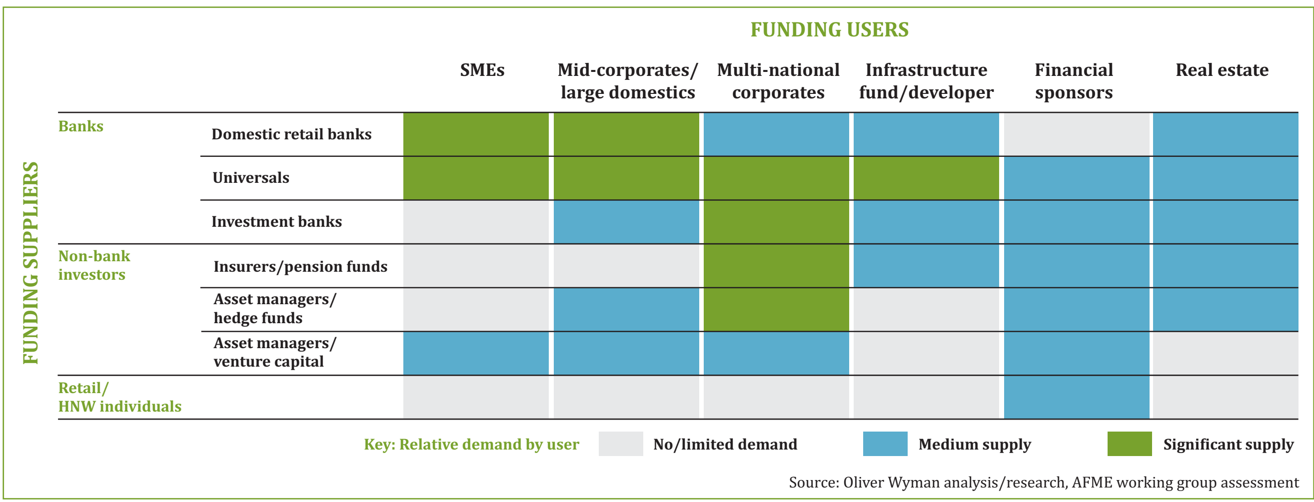
Large domestic firms and multinationals tend to have sophisticated finance and treasury departments, and are able to meet the requirements to issue debt and equity using the capital markets. These firms often require funding for acquisitions, in addition to on-going investment and cashflow management.

Infrastructure and real estate firms seek longer term funding due to the duration of the projects or assets being financed. This is often in the form of structured loans (e.g. project finance or asset finance), although a significant portion of projects and assets are funded on an aggregated basis at the corporate level.

Financial sponsors typically use leveraged loans to provide flexible short-term finance to enable deals to be executed rapidly. These loans are often subsequently refinanced in the high yield bond markets, although to a greater extent in the US than in the European market.

Figure 2.10 shows a similar breakdown of corporate funding, but this time maps funding suppliers to funding users. SMEs and mid-sized corporates have traditionally been serviced by domestic and universal banks, as these banks provide a local service and a full range of products. Investment banks remain providers to the largest of corporates, as well as offering products to infrastructure, financial sponsor and real estate borrowers. Institutional investor appetite for large ticket deals means debt offerings from only the largest of firms are of interest.

Figure 2.10
Typical funding suppliers by corporate type



Source: Oliver Wyman analysis/research, AFME working group assessment

There is considerable public debate around whether the lack of growth in funding levels is driven by a lack of demand from borrowers or a lack of supply (particularly from banks). In reality, actual funding levels will be a combination of both demand and supply factors and it is very difficult to show hard data which allows the two factors to be disentangled.

However, the ECB bank lending survey data[13] provides some insight into both demand and supply factors. Figure 2.11 shows changes in corporate demand since 2007 as viewed by bank survey respondents. This indicates that demand has been falling every year since 2007, except in 2011 when the economic outlook was comparatively positive. Changes in demand can be seen to be strongly correlated with aggregate GDP growth. The data also provides insight into lending to different segments of the market, with demand from large enterprises consistently declining faster than demand from SMEs. Equally, demand for long term loans has declined at a greater pace than that for short term loans.

13. http://www.ecb.int/stats/money/surveys/lend/html/index.en.html

Bank

"For larger corporates the demand has been reducing; Last year there was greater access to and reliance on bonds above classic vanilla loans"

Bank

"The supply side is constrained because we are trying to rebalance our balance sheet but the lion's share of the problem is borrower demand"

Bank

"All corporates I speak to are working at 85-90% capacity because there isn't the political stability to invest in growth"

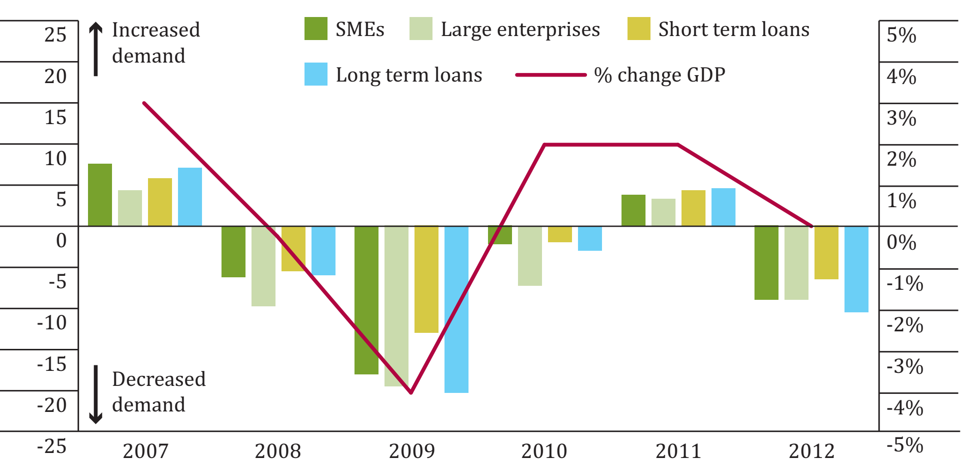
Bank

"We see a lot of demand for refinancing, but there has been very little new money being lent"

Figure 2.11

Corporate demand for new loans[14] versus GDP growth[15]

Average diffusion index[16]



Source: ECB Bank lending survey, Eurostat

The ECB data also provides some insight into the drivers behind the fall in demand for funding. Looking at 2012, corporate debt restructuring and reduced competition from other banks is increasing funding demand (Figure 2.12).

However, there are several drivers decreasing demand, particularly reduced investment in fixed assets and M&A and corporate restructuring activity. The stark reduction in fixed investment is particularly concerning and likely to be driven by a lack of confidence in growth and future demand for goods and services.

14. In response to: Over the past three months, how has the demand for loans or credit lines to enterprises changed at your bank, apart from normal seasonal fluctuations?
15. YoY change in GDP in EU countries
16. The diffusion index refers to the weighted difference between the share of banks reporting an increase in loan demand and the share of banks reporting a decline. The diffusion index is constructed in the following way: lenders who have answered "considerably" are given a weight twice as high (score of 1) as lenders having answered "somewhat" (score of 0.5). The interpretation of the diffusion indices follows the same logic as the interpretation of net percentages

SME

"Banks only want to lend to companies after their breakeven point [where costs and revenue are equal]"

SME

"If you don't have property, it's very difficult to get a loan [in Italy]"

Bank

"We don't find money on trees so we have to restrict ourselves and the growth of our businesses"

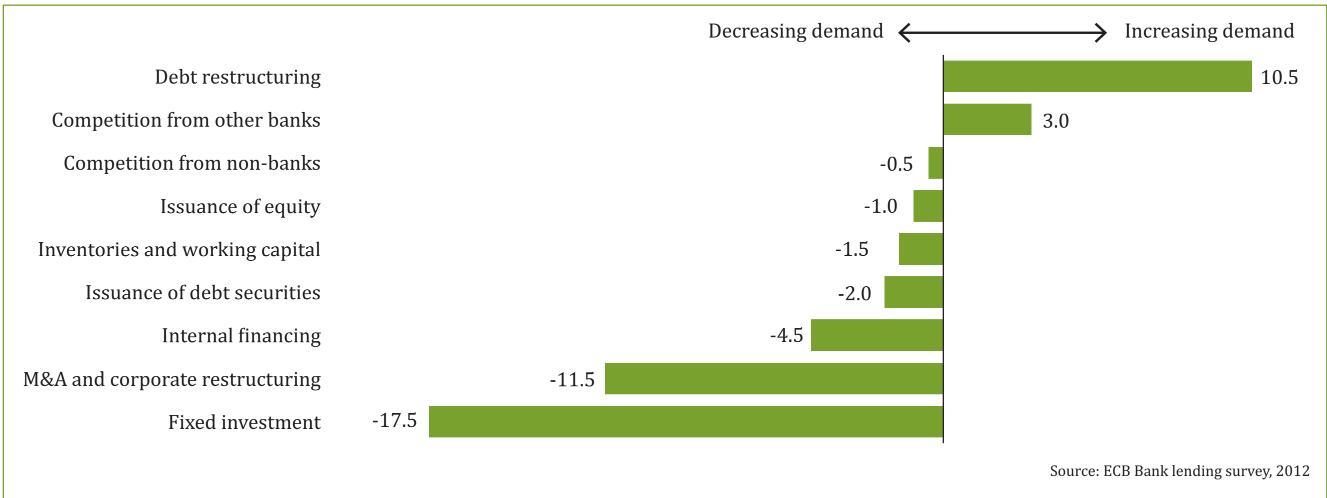
SME

"After nine months negotiating with a particular bank, they refused to give me a loan because they were afraid that the loan would not all be invested in the business"

Figure 2.12

Factors affecting demand for new loans

Average diffusion index, 2012[17]



SME

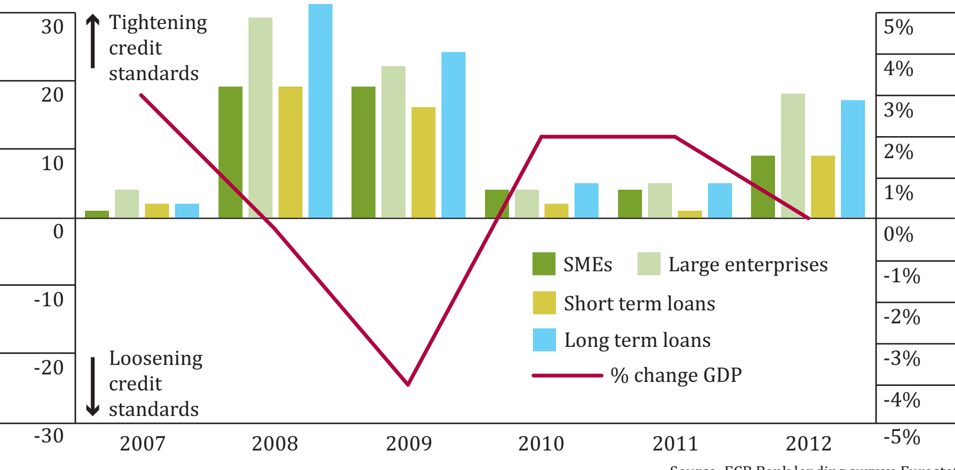
"All banks I speak to tell me that there is no problem with funding but then I hear horrible stories about banks closing credit lines overnight"

On the supply side, the ECB bank survey data shows that banks believe that credit standards have been continuously tightening since 2007. The biggest changes occurred during the early stages of the crisis in 2008-2009, with a more neutral approach in 2010 and 2011 (Figure 2.13). However, there was a significant tightening again in 2012 as the macro economy worsened.

As in the demand side data, credit tightening has occurred for all corporates, but, somewhat counter-intuitively, more so for large enterprises than for SMEs. Credit tightening has also affected long term funding to a greater extent than short term funding, a view which was ratified during the course of our interviews. Credit availability varies considerably across regions.

17. In response to: Over the past three months, how have the following factors affected the demand for loans or credit lines to enterprises?

Figure 2.13
Credit standards as applied to the approval of loans and credit lines for corporates versus GDP change[18]



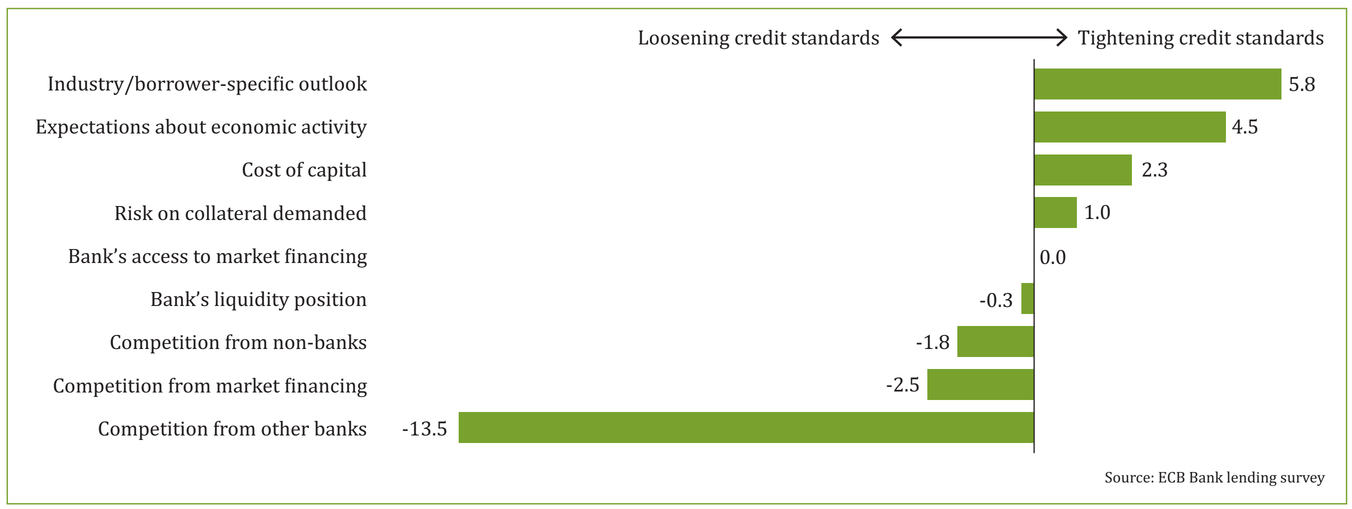
Source: ECB Bank lending survey, Eurostat

Industry association

"We do a lot of research – we do not know if the decrease in loans for SMEs is coming from the demand or supply side"

Figure 2.14 provides some insight into the drivers behind changes in credit standards in 2012. Bank concerns over borrower risks, including industry/borrower-specific and the macroeconomic outlook were primary drivers of decreasing supply. The increased cost of capital, partly driven by regulatory changes, was highlighted as the third biggest driver of tightening lending standards.

Figure 2.14
Factors affecting credit standards
Average diffusion index, 2012[19]



Source: ECB Bank lending survey

Bank

"We still see demand from SMEs, but their perception is it's difficult to obtain loans"

Much has been made in the press of reduced funding supply. However, the ECB shows there is both reduced supply and reduced demand. Some of this may be circular, as businesses choose not to seek funding due to their own expectations of the level of supply. What is certain is the European problem is not as simple as increasing the supply of funding or the demand from businesses.

18. Response to: Over the past three months, how have your bank's credit standards as applied to the approval of loans or credit lines to enterprises changed? GDP YoY change in GDP in EU countries
19. Response to: Over the past three months, how have the following factors affected your bank's credit standards as applied to the approval of loans or credit lines to enterprises?

2.4 Barriers to funding and specific problem areas

Interviews conducted as part of this research provide further insight into the barriers to funding. Figure 2.15 shows the proportion of corporates, banks and non-bank investors which cited high-level barriers as constraints for them in accessing or providing increased funding.

The macroeconomic outlook stands out as the biggest barrier for corporates, with the weak outlook reducing demand for funding from borrowers. The weak outlook also reduces the credit worthiness of borrowers, thus impacting the appetite of funders to lend. On the bank and investor side, regulations are seen as the biggest barrier to funding.

Figure 2.15
Corporate and investor barriers - % of respondents citing high or medium

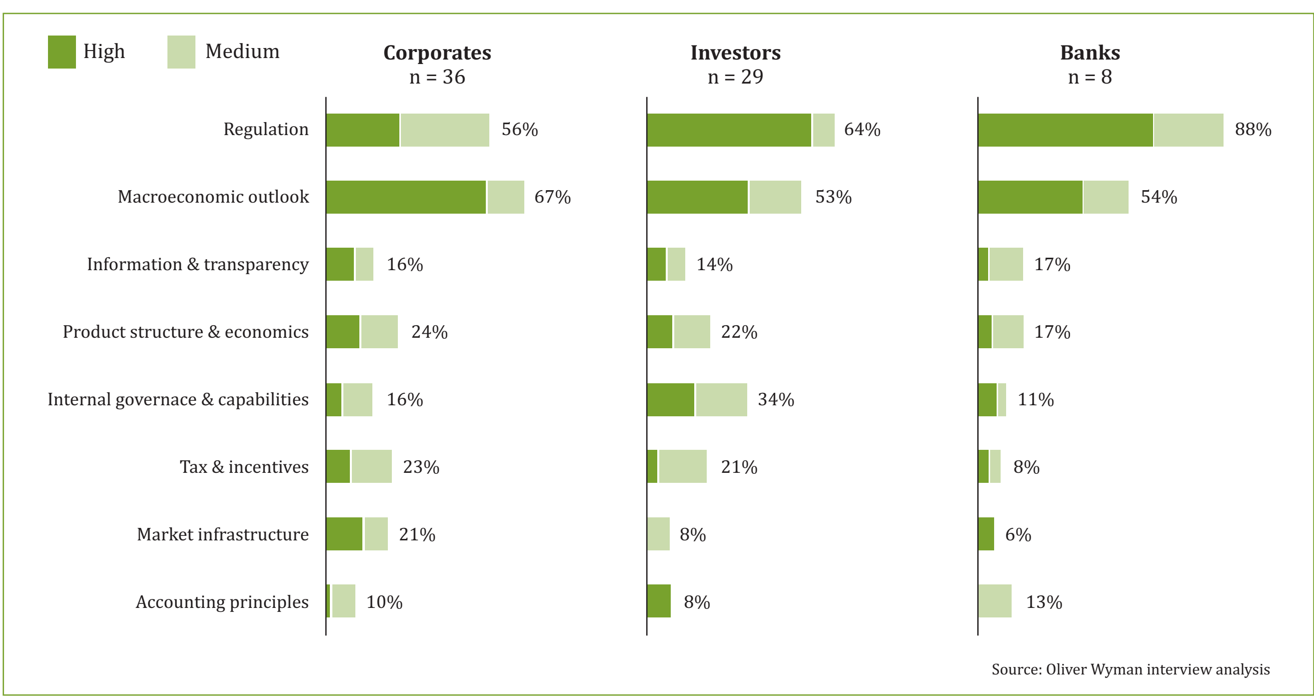
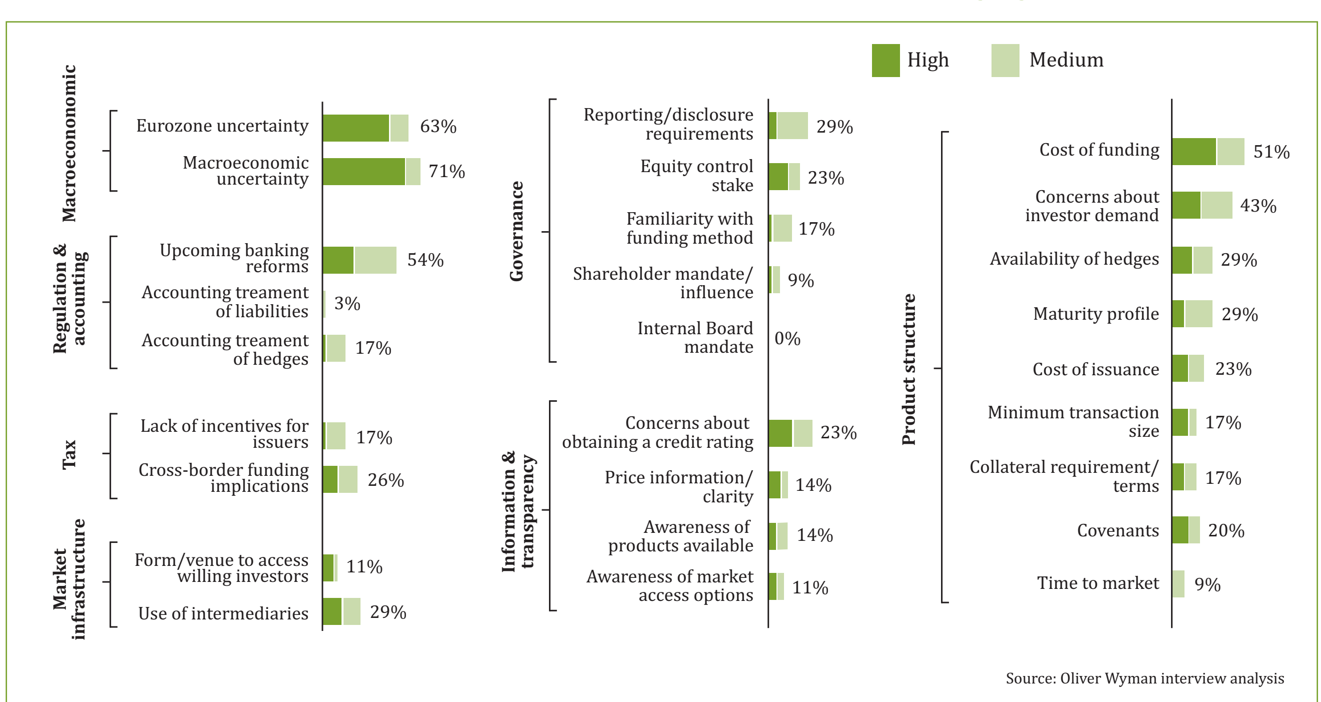


Figure 2.16 shows a more detailed view of barriers from a corporate perspective. In addition to macroeconomic concerns, the cost of funding was highlighted as a barrier by 51% of respondents, particularly for those in businesses in crisis-affected countries. Concerns over the impact of upcoming banking reform were also common (54%), with issues affecting both availability/cost of credit and credit-related products (e.g. cross-currency swaps).

Numerous other barriers were raised by a smaller proportion of interviewees, with relative importance depending largely on the specific situation, needs and challenges of a corporate.

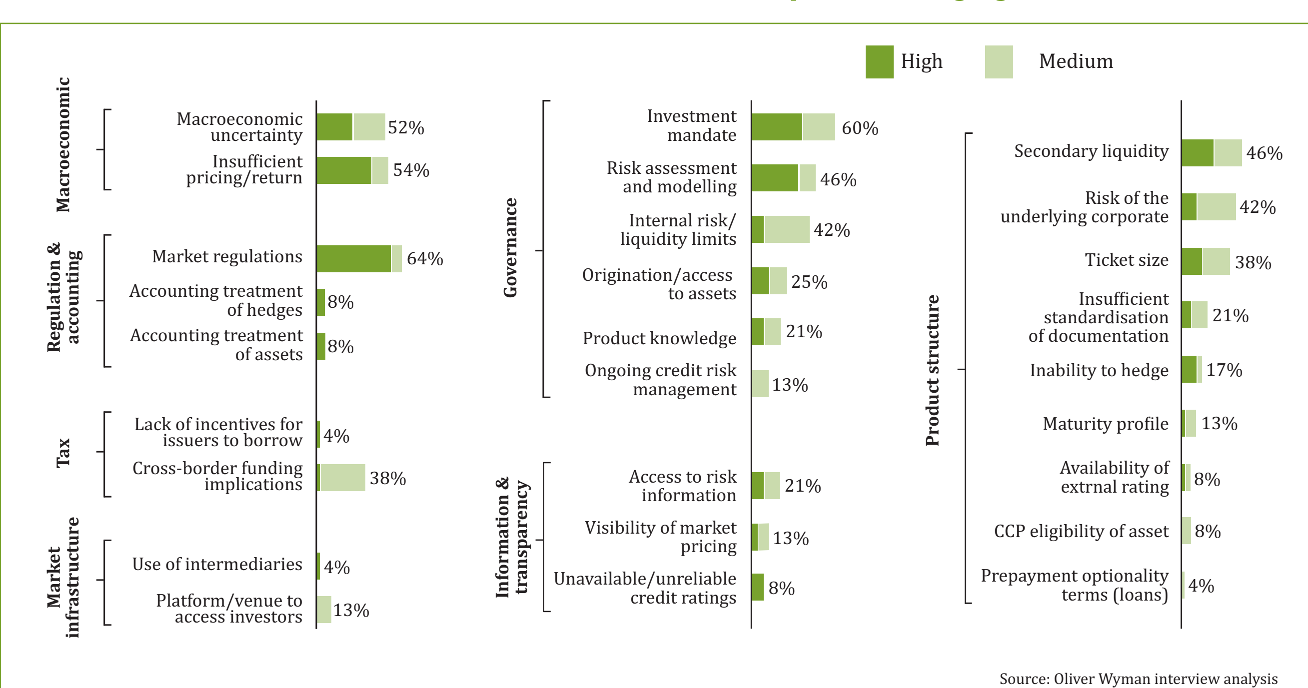
Figure 2.16
Detailed corporate barriers - % of respondents citing high or medium



Source: Oliver Wyman interview analysis

Figure 2.17 shows the equivalent view on barriers from a funder's perspective. Along with macroeconomic uncertainty (52%), market regulations (64%) were highlighted as a key barrier to increased corporate funding. Regulations are discussed further in the following section. Other important barriers to investors were insufficient risk/return (54%), investment mandate (60%) and secondary liquidity of the asset (46%). A much broader set of barriers was raised by banks and non-bank investors, particularly related to governance and internal capabilities, product structure and economics.

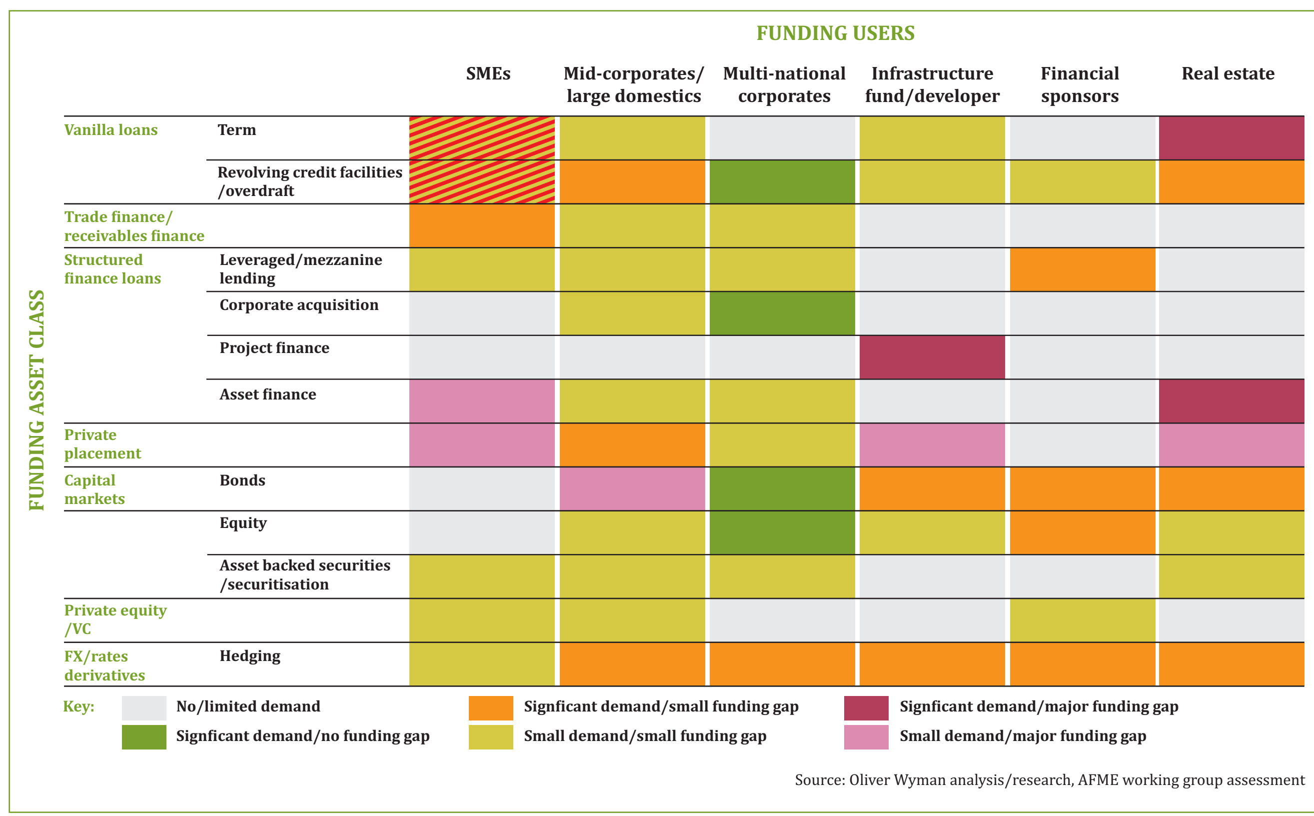
Figure 2.17
Detailed investor barriers - % of respondents citing high or medium



Source: Oliver Wyman interview analysis

Interviews highlighted that the availability of funding varies dramatically across Europe – both between countries/sectors and between names within a country/sector. Several corporates, particularly larger 'capital markets-eligible' names, stated that funding was not an issue – more than enough funding was available for them at historically low rates. However, there are several areas where funding is a problem. Figure 2.18 provides an overview of the gaps between funding demand and the available supply, by funding user and asset class.

Figure 2.18
Funding demand and supply gaps



Four main pressure points were identified:

1. **SMEs.** SMEs are too small to access traditional capital markets and so are reliant on bank lending. Macroeconomic factors have impacted the credit quality of many SMEs, but there is a general perception that a material number of good quality credits are struggling to get funding.

2. **Infrastructure finance.** Changes in funding costs and regulations make long-dated infrastructure loans more difficult for banks to supply economically. There is some appetite from institutional investors for brownfield projects, but limited appetite for greenfield construction projects.

3. **Commercial real estate.** A decrease in supply as many banks reduce concentration in CRE lending amid significant losses, combined with decreases in asset values in many countries which have left large proportions of CRE loans outside normal risk appetite and difficult to refinance.

4. **Businesses in crisis-affected countries.** Across segments, businesses in crisis-affected countries are suffering from the higher cost of funding and reduced availability – due to a combination of local bank deleveraging and a cautious approach from foreign banks and investors.

These elements are investigated further in Section 3.

2.5 Regulatory context

The severity of the crisis has prompted regulators to increase their oversight of the financial sectors and introduce tighter regulations. The main thrust of new regulations has been to limit systemic risk arising from institutions, market structures and specific asset classes and financial products – and interactions among all these elements. This effort has been accompanied by a push for greater transparency and a more intrusive approach to regulation.

European governments have recently begun focusing on structural reforms of the banking sector, with the UK government's Vickers report and the Liikanen report from the European Commission. The methods of these two reports differ. The Vickers report recommends ring-fencing core banking activities essential to retail and SME users, whilst the Liikanen report takes a view of ring-fencing out riskier trading activities once banks are sufficiently large, but with a single motive of separating retail and investment banking.

Wider reaching reforms are underway in the form of EMIR, designed to increase the stability of the Over-The-Counter (OTC) market; MiFID 2, which aims to increase consumer protection and transparency; and MAD/MAR, aiming to increase information transparency.

Table 2.1 shows the array of European regulations currently being implemented or discussed. This includes the solvency and liquidity requirements of Basel 2.5 and Basel III designed to increase the levels of capital and liquidity held by banks. The combination of these regulations will increase costs to end users and reduce the return on equity of banks – this is an acknowledged and understood cost. There are additional regulations affecting financial institutions outside the banking sector.

These include:

- **Solvency II.** Insurers are facing new rules in the form of Solvency II. These rules require insurers to hold significantly more capital to cover risks and include a matching adjustment the main purpose of which is to reflect the degree to which insurers are protected against credit spread volatility.

- **Alternative Investment Fund Managers Directive (AIFMD).** AIFMD is designed to put hedge funds and private equity funds under the supervision of an EU regulatory body. This includes greater disclosure requirements, investment criteria and fund leverage limits.

- **Shadow banking regulation.** This includes various proposed regulations to be imposed on 'shadow banks'.

Asset manager

"Funds that I manage are being constrained by insurance regulations; Solvency II is creating uncertainty"

Large domestic corporate

"At one point AIFMD looked like it would include REITS; we had to lobby to exclude it"

Bank

"Ring-fencing would have a massive impact; most corporates want one bank for plain vanilla lending and corporate finance work'"

Table 2.1

Main global/EU regulatory proposals

	Regulation	Elements
Solvency and liquidity	Basel III	• Quality of tier 1 capital, liquidity, funding, leverage; counterparty credit risk
• **CRD IV**	Basel 2.5 market risk	• Stressed VaR, incremental risk charges, securitisation treatment
• **Basel III**	Foreign banking organisation (FBO)	• Liquidity and capital requirements for foreign banks operating in the US, plus requirements of a US holding company
Structural reform	Supervisory oversight	• FSOC in US; ESRB in EU; issue warnings via national regulators
• **Recovery and resolution directive**	Ring-fencing	• Retail ring-fencing in UK, separation of retail and wholesale businesses. Liikanen/national structures in continental Europe
• **Common banking regulator**	G-SIFIs	• Increased capital requirement for G-SIFIs; levy on bank balance sheets
• **UK ICB reform**	Living wills	• Resolution and recovery plans ('Living wills')
• **Liikanen/Vickers**	Volcker rule	• Prop trading ban in the US
	Swaps spin-off (S. 716)	• US banks required to use separate affiliate for complex swaps
Market reform	Execution requirements	• Standardised OTC to electronic/specified platforms, SEFs/ OTVs (US/EU)
• **EMIR**	Central clearing	• Mandatory CCP clearing for 'standardised' OTC derivatives
• **MiFID**	Improved transparency	• Pre-trade transparency; post-trade reporting, registration with data repositories
	Short selling	• Short selling disclosure requirements; ban on naked short selling
	Commodities regulation	• Position limits, physical ownership restrictions
	Retail structured products	• Greater product standardisation and price transparency in EU
	Deposit guarantees	• National guarantee funds (EU only) replaced by single European institution
	Financial transaction tax	• Tax on securities and derivatives transactions
Consumer and investor protection	Conduct risk	• Treating customers fairly, KYC; Fixed retail sales incentives (RDR in UK)
• **Packaged retail investment products**	Consumer protection	• EU Consumer Credit Directive – product standardisation and transparency
		• Regulation of retail structured products
• **UCITS IV / V**	Investor protection	• Increase rating agency transparency; duty of care regulations
• **FATCA**		• US standard of care for investment advisors and broker-dealers working with retail investors
		• 5% credit risk retention limiting securitisation issuance
	Compensation	• Deferred compensation requirements, structure, quantum (including claw backs)
Tax	FATCA	• Reporting of accounts involving US, withholding taxes for certain Financial Institutions and individuals
	Balance sheet tax	• Levy/ tax on bank balance sheets (UK, some EU)
	Transaction tax	• Tax on financial transactions (EU under discussion)
Non-bank investor regulations	Solvency II	• New Insurer regulation requiring Insurers to hold sufficient capital to withstand a 1-in-200 event
	AIFMD	• EU supervision for hedge funds and private equity firms, including increased disclosure requirements and new investment criteria
	Shadow banking	• Proposed regulation to govern 'shadow banks', including greater transparency requirements

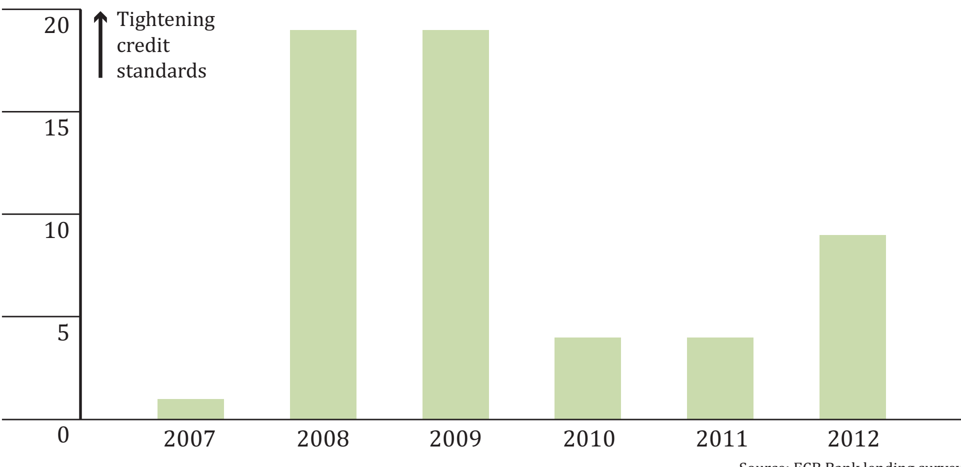
Source: Oliver Wyman analysis/research

3. Detailed analysis and interview findings

3.1 SMEs

3.1.1 Highlights

Bank credit standards applied to SME loans[20]
Average diffusion index[21]



Source: ECB Bank lending survey

SME

"Europe needs to allow small companies to grow faster in the critical venture period"

SME

"My new loan with a mandatory interest rate hedge and life insurance; cross-selling just leaves a bad taste in my mouth"

Perceived barriers

SME

"I'm not sure of the vehicle to support SME lending but this part of the chain is missing"

SME

"It has become more difficult to get a loan; banks are more stringent and there is more formality and **need for documentation**"

SME

"Our bank hinted to us in 2007 that the **credit facilities** we enjoyed would no longer be available"

SME

"Investment grade companies [in Germany] can get credit but most **SMEs do not have a rating**"

20. Response to: Over the past three months, how have your bank's credit standards as applied to the approval of loans or credit lines to enterprises changed?
21. The diffusion index refers to the weighted difference between the share of banks reporting an increase in loan demand and the share of banks reporting a decline. The diffusion index is constructed in the following way: lenders who have answered "considerably" are given a weight twice as high (score of 1) as lenders having answered "somewhat" (score of 0.5). The interpretation of the diffusion indices follows the same logic as the interpretation of net percentages

Potential solutions

Multinational corporate

"**State investment** (e.g. OSEO initiative) is helpful for small companies, especially nowadays"

Asset manager

"It's very much an **education process** for corporate treasurers to understand the benefits of capital markets"

SME

"I sometimes ask myself if we could **cut out the bank** as an intermediary because it's not cheap at all. We should be able to do all their work ourselves"

Bank

"From my perspective, clearly **refinancing SME loans at the ECB** will help restore credit from the supply side"

Key takeaways

- Survey respondents expected banks to remain the primary lenders to SMEs due to the small and often revolving nature of borrowing and the need for a local relationship with the borrower. The majority of non-bank investors interviewed did not have the appetite to lend directly to SMEs as it did not fit with their business models and in some countries regulations restrict loan origination solely to banks

- Solutions therefore focus on selectively increasing public sector support, where banks do not have the capacity or risk appetite to lend to certain SMEs. This support could take various forms, such as the establishment of additional business agencies along the lines of the German KfW or the UK Business Bank, and the expansion of existing European Commission, EIB and EIF support schemes for SMEs, including potentially expanded allocation to SMEs of EU regional cohesion funds. Increased SME securitisation could also improve bank capacity to lend to SMEs

- Additional improvements to bank lending would include better credit mediation between banks and borrowers and improving SME data availability to enhance competition between banks, as well as the potential consolidation of SME support schemes, and the communication of existing pan-European and national schemes

- Finally, accounting changes could be implemented to reduce the disincentive for SME owners to invest equity in their business - in some cases, additional equity is more appropriate than debt funding and would in turn improve the creditworthiness of the SME

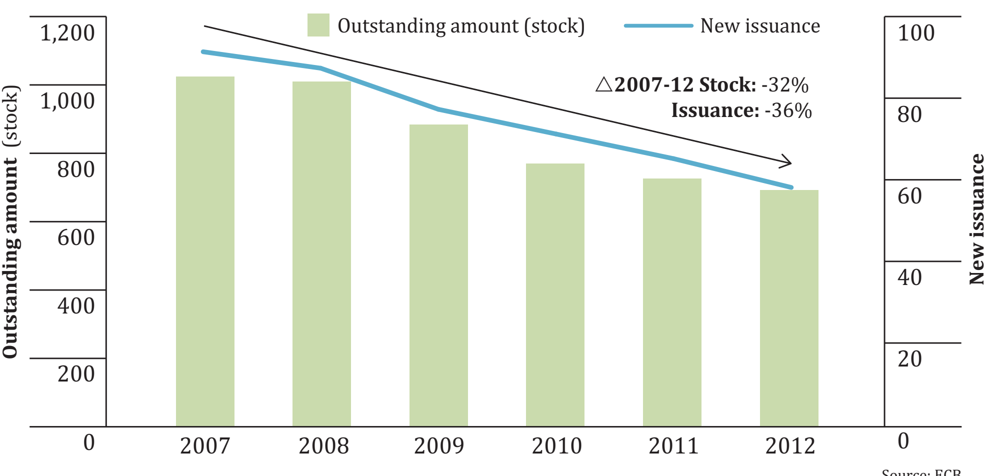
3.1.2 Market context

There has been much discussion over the difficulties facing SMEs in the current economic environment. As discussed previously, small businesses are the primary employer in Europe and contribute significantly to overall corporate revenues and gross value added. The importance of SMEs in the context of the current crisis is exemplified in Figure 3.1, which shows a clear correlation between low growth European countries and increasing importance of SMEs to gross value added.

Data for lending directly to SMEs is rare, given the differing definitions of SMEs across European countries. ECB data for loans below €1 million provides a useful proxy for SME bank lending. The total outstanding stock of small loans has decreased from approximately €1 trillion to approximately €700 billion between 2007 and 2012, with issuance volumes falling in step from €91 billion to €58 billion (Figure 3.1).

Figure 3.1

European new issuance and stock of bilateral loans <€1 million[22], € billion



Source: ECB

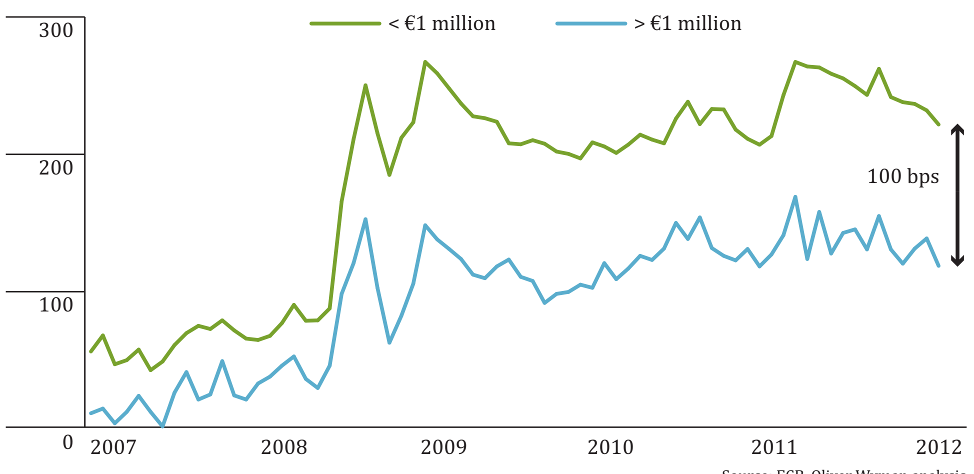
As discussed in Section 2, ECB bank lending survey data suggests both reduced demand from SMEs and tightening credit standards. Although, it should be noted that SME demand has fallen at a lower rate compared to demand from large enterprises. Additionally, credit standards for SMEs have not tightened as quickly as those for large enterprises, according to ECB data.

The costs of finance for SMEs can be viewed by examining the cost of small loans compared to the cost of larger loans, thus providing an indication of the absolute price, but also the relative price paid by SMEs. Figure 3.2 shows the ECB aggregated loan price data for small loans (<€1 million) and large loans (>€1 million). The price for small loans has risen from approximately 50-60 bps pre-crisis, to over 200 bps at present. This increase in funding costs compares unfavourably with larger loans which show an increase of approximately 80bps over the same period. The spread between large and small loans has increased from approximately 40bps in 2007 to approximately 100bps at the end of 2012.

22. New loans to non-financial corporates, excluding revolving credit facilities, totalled across time period and tenor

Figure 3.2

Cost of new loans by ticket size, 2012, bps[23]

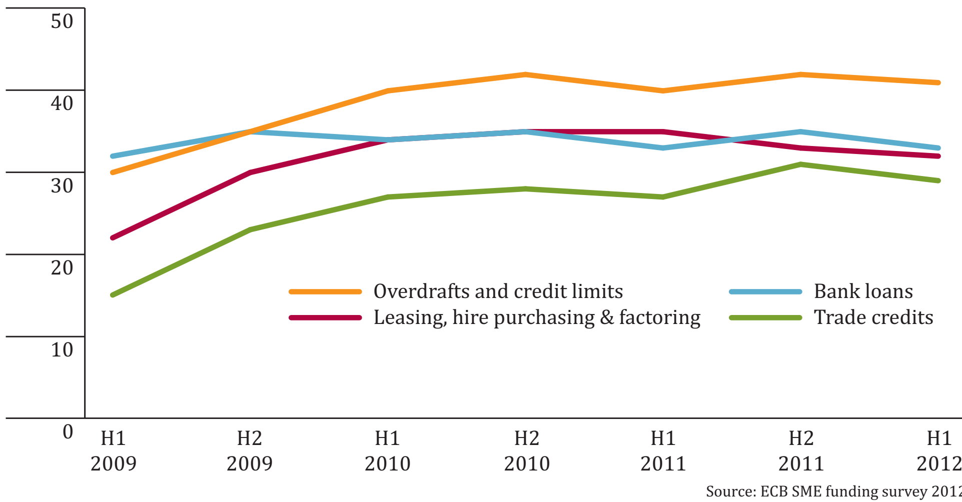


Source: ECB, Oliver Wyman analysis

As the cost of funding for SMEs has risen and economic conditions have remained poor, SMEs have been forced to alter their funding mix (Figure 3.3). Since 2009, the percentage of SMEs using overdrafts and credit facilities has increased from approximately 30% to approximately 40%. This may indicate constrained SME cash flows. The use of bank loans has remained steady with approximately 30-35% of SMEs using loans. Another sign of SME funding diversification is the increased use of leasing, hire purchase transactions, factoring and trade credit.

Figure 3.3

European SME funding sources[24]



Source: ECB SME funding survey 2012

In addition to the above data, it is important to note that in many cases, SME funding is in the form of personal finance, such as credit card or residential mortgage loans. Personal/consumer finance is outside the scope of this report, but it is clearly critical that everything possible is done by industry and authorities to ensure that this area of funding is also functioning as effectively as possible.

23. Average across tenor; spread calculated as corporate loan interest rates minus base Euro area base rate

24. Percentage of SMEs using source in last six months

3.1.3 Barriers to provision of funding

Interviews with SMEs have highlighted their varying views of the European funding market. For those with firm financials and cash flows, good relations with banks and presence in recession proof industries, their overall outlook remains good, and they report few funding concerns. For other firms, especially those in crisis countries, the outlook is less favourable.

SME

"I don't have any funding issues; the cost of funding is brilliant!"

SME

"Spanish, Italian and Greek businesses are stuck with expensive money"

Bank

"We have been forced to re-price in the wake of the sovereign crisis"

It is clear the macroeconomic conditions are a significant barrier for SMEs, both in terms of construing funding and opportunities. This headwind has prompted fiscal conservatism from many of our interview respondents who have sought to increase cash balances, repay loans early when possible and avoid overdrafts if possible.

Beyond the broad macroeconomic issues, our surveys have highlighted several particular areas of concern.

- **There is fragmented and, in some cases, potentially under-funded government support for SME lending.** Concerns are very region-specific, particularly focused on Southern Europe. There is also a question as to whether the size of pan-European and national government support programmes is sufficiently large in relation to the size of EU economy, particularly for the riskier end of SME lending. There are also a variety of different schemes at pan-European and national levels, which is confusing to SMEs and lenders.

  Existing available support comes in the form of an EIB annual budget of approximately €60 billion/year for all types of support, with €12 billion/year allocated specifically to SMEs; plus €750 million by the EIF in 2012, which can be expected to have an impact of approximately €6.6 billion through expected leverage; plus the possible usage of a portion of an annual EU cohesion fund allocation of €49 billion/year.

  EU REGIO websites provide further details of the themes on which cohesion funds could be spent. Member states have discretion on how these funds will be allocated each year. A portion is typically spent on SMEs. All cohesion policy programmes are co-financed by the member countries, bringing total annual potential cohesion funding, including the national contributions, to €98 billion/year.

- **Lack of clarity regarding financial terms and instruments.** Many financial terms and products are complicated. A lack of understanding and/or clear explanation on the part of banks means SMEs often do not fully understand the 'all in' costs or specific lending terms.

- **SME securitisation is currently not economic.** Due to the relatively low interest margins on bank-originated SME loans and issuers needing to pay credit spreads on AAA securitisation tranches which are not economic to issuers, SME securitisations are typically not cost effective for banks. However, securitisation structures offer potentially valuable mechanisms to implement

SME

"All I want is a one-pager with the loan criteria explained in a simple manner so I know what to expect"

public sector support for bank-SME lending, through senior tranches (focused on funding), junior tranches (providing risk transfer), or a combination of the two. For banks, the securitisation of SME loans is seen to have significant potential for additional capital markets funding, but only if the economics of securitisation can be restored. For a variety of reasons, including capital charges on SME loans but also other factors, bank-SME loans have relatively low interest rates of around LIB + 200bppa or slightly higher, as compared to the rates which direct capital markets investors such as fund managers are currently originating SME loans for funding through investment funds. As a result, the interest rate on highly rated securitised tranches sold to investors must be sufficiently low for the cost of funding to be economic to the issuing bank. As a result, the economics of SME securitisation simply do not work for most banks, unless some type of public support is provided.

- **The nature of SME lending (small balances, local, short term, revolving, etc.) is not easily suited to non-bank business models.** SME lending is typically for small balances and either short-term or revolving. It often also requires face-to-face interaction, as financial accounts are either less detailed or do not provide a full picture of the business. Direct capital markets origination of SME loans is feasible in some countries, but not in others where loan origination requires a banking license. Even where origination by non-banks is possible, many interviewees stated that it did not fit with their business model, due to the need for local origination capabilities, increased number of credit analysts, etc. As a result, SME lending is expected to continue to be provided mainly by banks rather than through direct capital markets origination.

- **Some SME relationships with banks are strained due to crisis-related issues.** SMEs cite increased funding costs, cross-selling, perceived overly strict enforcement of covenants, etc. as symptoms of a deteriorating bank-SME relationship. For example, mandatory interest rate swaps for floating rate loans to SMEs, the use of specified credit insurers, or even life insurance from 'in house' providers, have all been cited as mandatory requirements for loans provided by some banks. This sort of cross-selling is viewed negatively by SMEs and lowers trust between banks and SMEs. Firms have reported increased demands for loan security as banks seek to minimise potential losses. Although increased loan security requirements are understandable in a post-crisis banking world, it is clear this is adding to bank-SME tensions.

- **Perceived lack of competition for SME lending.** The difficulty for new providers to enter SME banking, due to the information asymmetry versus incumbent banks, was highlighted as a perceived barrier to increased competition.

- **Current incentivisation of SME debt compared to equity.** Entrepreneurs feel penalised when selling equity stakes due to capital gains taxes. Also, the tax-deductibility of interest payments incentivises SMEs to increase debt rather than equity. In many cases, equity may actually be a more appropriate form of funding for higher risk businesses.

- **Lack of clarity over MiFID proposals for reduced disclosure levels for SMEs trading on selected SME growth markets.** Recital 90 in MiFID 2 includes the following constructive wording: "The requirements applying to this new category of markets need to provide sufficient flexibility to be able to take into account the current range of successful market models that exist across Europe. They also need to strike the correct balance between maintaining high levels of investor protection, which are essential to fostering investor confidence in issuers on these markets, while reducing unnecessary administrative burdens for issuers on those markets. It is proposed that more

SME

"My new loan came with a mandatory interest rate hedge and life insurance; cross-selling just leaves a bad taste in my mouth"

Bank

"We still see demand from SMEs, but their perception is it's difficult to obtain loans"

SME

"All banks I speak to tell me that there is no problem with funding but then I hear horrible stories about banks closing credit lines overnight"

Asset manager

"SME market space is too crowded with a return that is too low, coupled with a high default rate"

Private equity fund

"Our model is based on looking into the whites of the eyes of the borrower – this would be highly time consuming for SME loans"

details about SME market requirements such as those relating to criteria for admission to trading on such a market would be further prescribed in delegated acts or technical standards." The resolution of how to strike this correct balance will need to be clarified by policymakers before implementation.

In addition to the concerns raised by SMEs, investors highlight potential difficulties if they were to consider investing in SME debt.

- **Insufficient returns** of SME debt compared to other available and more liquid assets was a concern for several asset managers and insurers.
- **Large volume of analysis required** to understand the risks of each firm. For many investors analysis is key and, given the small ticket size and the number of firms, such analysis for SMEs was considered extremely difficult and costly.
- **Potential lack of liquidity** of SME debt concerned many investors, although it was noted this may be resolved if the market were to mature.

Amount of Pan-European public support available

1. EIB annual budget of approximately €60 billion/year for all types of support, with €12 billion/year allocated specifically to SMEs, plus
2. €750 million by EIF in 2012, which can be expected to have an impact of approximately €6.6 billion through expected leverage, plus
3. Possible usage of a portion of annual EU cohesion fund allocations of €49 billion/year. EU REGIO websites provide further details of the themes on which cohesion funds could be spent. Member states have discretion on how these funds will be allocated each year. A portion is typically spent on SMEs. All cohesion policy programmes are co-financed by the member countries, bringing total annual potential cohesion funding, including the national contributions, to €98 billion/year.

Budgeted Pan-European funding and guarantee capacity for SME and infrastructure spending

Pan-European SME funding: The European Commission oversees programmes which provide access to finance for SMEs. The day-to-day management of these activities is handled by major International Financial Institutions (IFIs). SMEs are the main source of employment and development in the European economies, but they often experience difficulties in gaining access to financing for their business. To alleviate these difficulties, the Commission has put in place a variety of programmes for SME financing through equity, loans, guarantees and grants. The implementation of these activities is handled by the major IFIs (the European Investment Bank (EIB), the European Investment Fund (EIF), the European Bank for Reconstruction and Development (EBRD), and the Council of Europe Development Bank (CEB) in co-operation with the Kreditanstalt für Wiederaufbau (KfW)). See Annex A, note 1 for more information.

The EIB, EIF and European Commission operate a wide variety of programmes designed to assist private and public sector investment on a pan-European basis. In 2012, the EIB increased its capital base so that the annual amount of funding has been raised to approximately €60 billion per year. Some of the programmes provide low-cost funding to eligible banks, which are then used to directly fund eligible projects. The table below from the EIB Group 2013-2015 Operational Plan provides details on the types of overall support provided by the EIB. See Annex A, note 2 for more information on the Operational Plan.

Public policy objectives (inside EU and pre-accession), € billions

		2012 forecast	Orientations			2013-2015 average
			2013	2014	2015	
I.	Knowledge Economy	**8.9**	**11.5**	**11.0**	**11.0**	**11.2**
	- total loans (EIB)	8.9	11.5	11.0	11.0	11.2
	- total signatures – equity (EIF)[(a)]	1.4	1.5	1.6	1.8	1.6
II.	TENs Transport	**6.9**	**8.5**	**8.5**	**8.5**	**8.5**
III.	Competitive and Secure Energy (incl. TEN-E)	**4.0**	**6.5**	**6.5**	**6.5**	**6.5**
IV.	Support to SMEs	**10.9**	**14.1**	**13.9**	**13.9**	**14.0**
	- total loans (EIB)	10.9	14.1	13.9	13.9	14.0
	- total signatures – guarantees (EIF)[(b)]	1.3	1.8	1.8	2.0	1.8
V.	Support for Urban Renewal and Regeneration (incl. healthcare)	**2.6**	**3.0**	**2.8**	**2.8**	**2.9**
VI.	Environmental Protection	**3.5**	**5.5**	**5.5**	**5.5**	**5.5**
VII.	Renewable Energy and Energy Efficiency	**3.7**	**6.5**	**6.5**	**6.5**	**6.5**
VIII.	Sustainable Transport	**3.3**	**4.5**	**3.8**	**3.8**	**4.0**
IX.	"Non-transversal" Convergence and Climate Action[(c)]	**2.7**	**4.4**	**4.0**	**4.0**	**4.1**
	Total (inside EU and pre-accession)	**46.5**	**64.5**	**62.5**	**62.5**	**63.2**

(a) EIF figures not included in signature totals
(b) Guarantee figures do not reflect the leveraged amounts
(c) Projects that purely contribute to Convergence or Climate Action and no other policy objective

The European Union has a multi-year planning cycle, during which various new programmes are introduced to assist growth. Following is a brief summary of the programmes from the 2007-2013 and the 2014-2020 cycles.

Commission Horizon 2020 Programme: Horizon 2020 is the financial instrument implementing the Innovation Union, a Europe 2020 flagship initiative aimed at securing Europe's global competitiveness. Running from 2014 to 2020 with a budget of €80 billion, the EU's new programme for research and innovation is part of the drive to create new growth and jobs in Europe. Horizon 2020 provides major simplification through a single set of rules. It will combine all research and innovation funding currently provided through the Framework Programmes for Research and Technical Development, the innovation related activities of the Competitiveness and Innovation Framework Programme (CIP) and the European Institute of Innovation and Technology (EIT).

Commission COSME Programme for 2014-2020: The new programme for the Competitiveness of Enterprises and Small and Medium-sized Enterprises (COSME) will run from 2014 to 2020, with a planned budget of €2.5 billion (current prices). The objectives of COSME are to facilitate access to finance for SMEs, to create an environment favourable to business creation and growth, to encourage an entrepreneurial culture in Europe, to increase the sustainable competitiveness of EU companies, to help small businesses operate outside their home countries and to improve their access to markets. COSME is expected to contribute to an annual increase of €1.1 billion in the EU's GDP.

EIF CIP Guarantee Programme: The EIF Competitiveness and Innovation Framework Programme (CIP) provides financial intermediaries (banks, leasing companies, mutual guarantee institutions, etc.) with capped guarantees (EU Guarantees) partially covering their portfolios of financing to SMEs. These EU Guarantees are provided under the SME Guarantee Facility, which is funded by the European Union under CIP 2007-2013. Each euro spent leverages an average €6 of risk capital or €50 on bank loans, which means it should generate some €30 billion in new finance for SMEs from financial institutions and benefit up to 400,000 SMEs. See Annex A, note 3 for more information on CIP 2007-2013.

EIF RSI Guarantee Programme: The RSI (Risk Sharing Instrument for Innovative Research-Oriented SMEs and Small Mid-Caps (RSI) is a joint pilot guarantee scheme of the EIF, EIB and the European Commission (DG Research & Innovation) aimed at improving access to debt finance of innovative SMEs and Small Mid-Caps

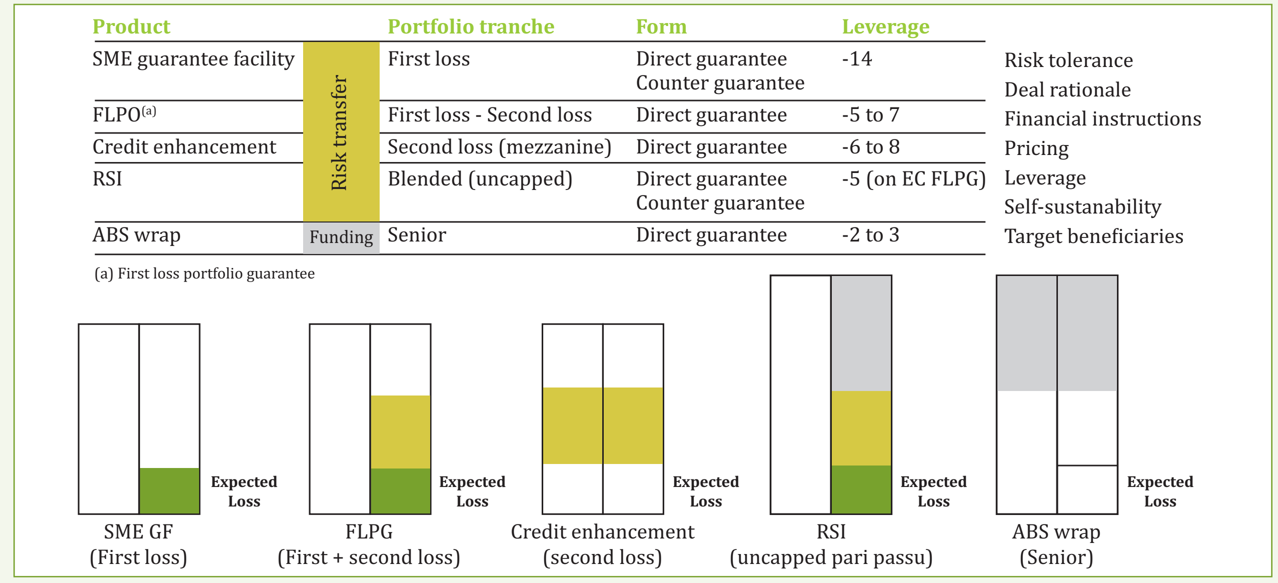
(enterprises with less than 500 employees) in support of their research, development and innovation (RDI) projects. By targeting research-based SMEs and Small Mid-Caps, RSI complements the scope of the existing Risk Sharing Finance Facility (RSFF), which is mainly addressed to large Corporates and Mid-Caps. The EIF does not support entrepreneurs directly but through selected financial intermediaries. Under RSI, the EIF issues guarantees and counter-guarantees to such intermediaries, thus allowing them to provide loans, financial leases and loan guarantees to research-based SMEs and/or Small Mid-Caps. See Annex A, note 4 for more information on the EIF RSI Guarantee Programme.

EIF Credit Enhancement Operations: The general purpose of the EIF's credit enhancement operations is to support new SME financing. The EIF focuses mainly on deals backed by SME financing, although it does not exclude other asset classes. Examples of SME financing securitised with the help of the EIF are SME loans, SME loan guarantees, small ticket lease receivables, SME trade receivables, venture financing (lease/loans) and micro-loans. The EIF guarantees senior and/or mezzanine tranches of risk, typically with a minimum rating equivalent to BB/Ba2. See Annex A, note 5 for more information on the EIF Credit Enhancement Operations. Ability to Leverage EIF Guarantees: The provision of partial guarantees can be a very efficient way for public entities to maximise the impact of public support. The chart below indicates the multipliers that the EIF calculates for the different products. The highest leverage (14 times) is achieved under the CIP programme (see below, as the EIF covers basically the expected loss of the guaranteed portfolio). For guarantees on mezzanine tranches of securitisation transactions the EIF achieves a leverage of 6-8 times. For senior tranches the leverage varies depending on the structure (e.g. whether there is replenishment or not) and it is about 2-3 times the guaranteed amount.

Ability to Leverage EIF Guarantees: The provision of partial guarantees can be a very efficient way for public entities to maximise the impact of public support. The chart below indicates the multipliers that the EIF calculates for the different products. The highest leverage (14 times) is achieved under the CIP programme (see below, as the EIF covers basically the expected loss of the guaranteed portfolio). For guarantees on mezzanine tranches of securitisation transactions the EIF achieves a leverage of 6-8 times. For senior tranches the leverage varies depending on the structure (e.g. whether there is replenishment or not) and it is about 2-3 times the guaranteed amount.

EIF JEREMIE Programme: The JEREMIE initiative (Joint European Resources for Micro to Medium Enterprises) developed in cooperation with the European Commission, offers EU Member States, through their national or regional Managing Authorities, the opportunity to use part of their EU Structural Funds to finance SMEs by means of equity, loans or guarantees, through a revolving Holding Fund acting as an umbrella fund. The JEREMIE Holding Fund can provide to selected financial intermediaries SME-focused financial instruments including guarantees, co-guarantees and counter-guarantees, equity guarantees, (micro) loans, export-credit insurance, securitisation, venture capital, Business Angel Matching Funds and investments in Technology Transfer funds. See Annex A, note 6 for more information on the EIF JEREMIE Programme.

Guarantee instruments development 2013 and beyond



Product		Portfolio tranche	Form	Leverage
SME guarantee facility	Risk transfer	First loss	Direct guarantee Counter guarantee	-14
FLPO[a]		First loss - Second loss	Direct guarantee	-5 to 7
Credit enhancement		Second loss (mezzanine)	Direct guarantee	-6 to 8
RSI		Blended (uncapped)	Direct guarantee Counter guarantee	-5 (on EC FLPG)
ABS wrap	Funding	Senior	Direct guarantee	-2 to 3

(a) First loss portfolio guarantee

Revitalising securitisation in Europe

SME securitisation and PCS independent quality label programme

Although over €100 billion of SME securitisations have been'issued' since the inception of the crisis in 2007, most of these transactions have involved converting corporate assets such as SME loans and leases into securities which can be used as repo with the ECB and Bank of England. The overall performance of European receivables included in securitisations has been very good, as described in "Economic Benefits of High Quality Securitisation to the EU Economy". See Annex A, note 7 for a link to download this report.

Further data on the overall European securitisation market, including issuance, outstandings and changes to rating and credit spreads is contained in the AFME Securitisation Data Report. See Annex A, note 8 for a link to download this report.

Despite the strong performance of European securitisations from both a credit and secondary market price performance standpoint, the European investor base for securitisations has severely contracted for a variety of reasons. These include loss of investor confidence due to very poor performance of the US subprime and CDO squared market, the dissolution of structured investment vehicles, and negative public signals from policymakers on securitisation as a product more generally (e.g. lack of inclusion of any securitisation in the Basel III bank eligible liquidity buffers, proposed punitive capital charges on European insurance company investors in Solvency II and other regulatory initiatives).

The European industry has taken a proactive response by providing funding for the development of a quality label, to distinguish a defined set of eligible high quality securitisations from those which do not have the label. The goal of the label is to improve quality (by limiting current eligibility to only four asset classes – SMEs and leases, auto loans, high quality residential mortgages, and consumer loans/credit cards), standardisation and simplicity (no resecuritisations/CDO squared) and transparency, through best industry practices on information reporting. Details on the Prime Collateralised Securities (PCS) initiative, set up by AFME and the European Financial Services Round Table (EFR) in 2012 but which now has an independent government structure, are available at www.pcsmarket.org. Various policymakers including central banks, the EIB and a regulatory authority participated as observers in the development of PCS. As of April 2012, 11 transactions had received labels, which represent approximately 75% of eligible publicly issued transactions. Part of the goal of PCS is to ask policymakers to carefully review the criteria for PCS and its performance and, if they take a favourable view, to create regulatory incentives for the purchase of these types of high quality securitisations. PCS can help to support non-bank funding not only for corporate assets, but also the large amounts of consumer assets which banks may choose to fund in the capital markets going forward rather than retaining on their own balance sheet. In addition, the ECB has recently announced a consultation with the EIB on how to expand SME securitisation. A link to the ECB press release on this topic is provided in Annex A, note 9.

3.1.4. Potential solutions

Given the reliance of SMEs on bank lending, there needs to be careful consideration of potential solutions. We still take the view that banks should remain the primary source of funding for SMEs, given their ability to analyse the credit worthiness of large numbers of businesses at a local level. This implies blockages in the bank-SME funding channel must be addressed, but does not dissuade us from exploring other SME funding channels to supplement this. We see the following potential solutions:

1. **Consider establishment of further national government-backed SME support agencies.** These could include similar structures to the German KfW model or SME business banks and provide either direct or indirect funding to SMEs.

2. **Consider expansion of public sector support for SMEs.** Evaluate whether the current level of public sector support for SME is sufficient, given the size of the EU economy, recognising public sector funding constraints. Further support could be provided by the EU Commission, EIB, EIF, national governments or further use of EU structural cohesion funds. Types of support could include further provision of guarantees and/or funding for SME loans, either directly or through securitisation structures. For example, guarantees on mezzanine tranches of securitisation tranches retained by issuing banks, if provided by a 0% risk weighted counterparty such as a national government agency or the EIF, would free up significant capital for new lending.

3. **Consider types of public support.** Public sector support could also include ensuring properly calibrated capital charges for investors in SME securitizations under Solvency II, and/or the potential inclusion of high quality securitisations in bank liquidity buffers. These could be similar to the type of existing public support provided for covered bond funding in Europe, which is also used by banks as a form of secured lending, mainly for residential mortgages.

4. **Consolidate and/or simplify communication of existing SME lending schemes** to maximise efficiency, usage, and impact. At present there are a range of schemes working within and across regions, which could potentially be used to greater overall impact if resources were pooled. Where multiple schemes remain for different purposes, a comprehensive register should be established and communication and documentation enhanced to make it easier for SMEs and/or banks to find the appropriate scheme(s). Banks should also be encouraged/mandated to highlight such schemes to failed loan applicants.

5. **Establish credit mediation services where they do not already exist**, to support SMEs in making credit applications and stepping in to resolve pricing/credit disputes between businesses and lenders. Communication could also be enhanced to increase usage of existing mediation services.

6. **Create centralised pan-European and/or national SME information and rating databases** using a pre-defined, pan-European standard template. Such common SME data from a centralised single website would improve communications and allow firms to quickly analyse comparative risks and market sector trends across borders. Rating calculations could be performed on this standardised SME data, using a fully transparent and simple methodology. This would allow quick cross-border comparisons and provide a benchmark for the risk of SME aggregated debt.

7. **Enact capital gains tax relief for entrepreneurs when selling small business equity stakes** to promote entrepreneurialism and reinvestment in other small firms.

8. **Consider tax deductions for small business equity**, akin to the current deductions for loan interest payments. This would reduce the financial disincentive for small firms to increase equity, which in many cases is more appropriate than increased debt funding.

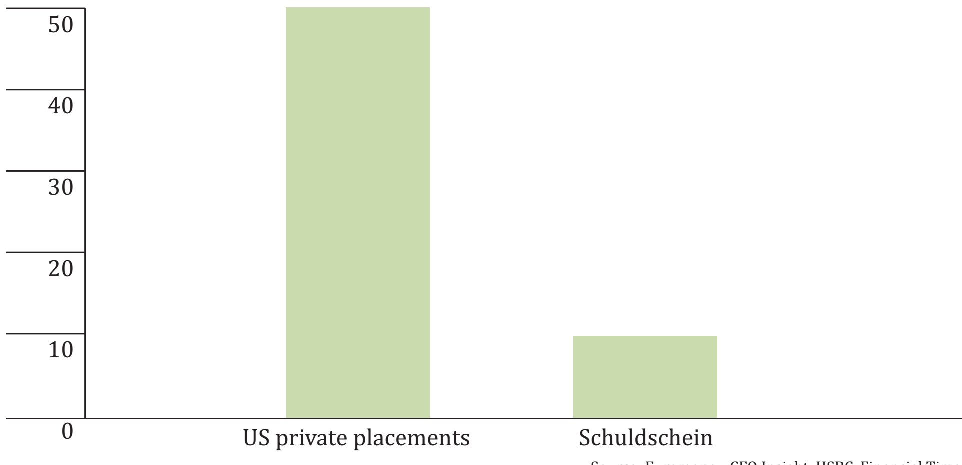
9. **Consider stamp duty exemption for shares of small businesses** to increase the value of raising equity capital.

10. **Finalisation and clarification of MiFID proposals.** Recital 90 in MiFID 2 includes the following constructive wording: "The requirements applying to this new category of markets need to provide sufficient flexibility to be able to take into account the current range of successful market models that exist across Europe. They also need to strike the correct balance between maintaining high levels of investor protection, which are essential to fostering investor confidence in issuers on these markets, while reducing unnecessary administrative burdens for issuers on those markets. It is proposed that more details about SME market requirements such as those relating to criteria for admission to trading on such a market would be further prescribed in delegated acts or technical standards." The resolution of how to strike this correct balance will need to be clarified by policymakers before implementation.

3.2 Large/mid-sized corporates

3.2.1 Highlights

2012 estimated new issuance by market, € billion



Multinational corporate

"We are opportunity constrained, not funding constrained"

Multinational corporate

"There is a transfer of fulfillment from the banking sector to the bond sector, at least for a big corporate like us"

Perceived barriers

Multinational corporate

"We use **US private placements** for longer maturity credit, which is not available on Euro market or Schuldschein"

Multinational corporate

"One of the frustrations [of the US private placement market] is the documentation which appears to be **stilted and archaic**"

Large domestic corporate

"We are internally preparing to get our **financing from non-banks**, as we cannot be certain what the situation with banks is going to look like in the near future"

Large domestic corporate

"The process of issuing bonds is not the problem, it is the **cost of issuing**"

Bank

"**Political instability** means corporates don't know whether or not to invest in their next Capex project"

Mid-corporate

"We have to manage a large **cash buffer** due to concerns over financing risks"

Potential solutions

Multinational corporate

“**Sharing internal ratings** would be an opportunity for banks and companies to exchange on their respective ratings and views of the business”

Multinational corporate

“We allocate **ancillary business** to them so would be pretty angry to find that our bank no longer holds our loan”

Multinational corporate

“My two wishes would be for a **transparent European bonded loan market**, and for the market to entail a **ratings assessment instrument** so that potential investors, are satisfied like in the US with the NAIC-Rating”

Multinational corporate

“A government or European **rating agency** is just another bureaucratic monster”

Key takeaways

- Most large and mid-sized corporates interviewed did not have problems accessing finance, with many heavily using capital markets instruments. The main concern related to the availability and cost of hedges, particularly cross-currency swaps, due to the impact of regulation. Some firms also highlighted concerns over the current thresholds for clearing and margining under EMIR. Corporates emphasised the need for active engagement of end-users when defining new regulations

- Mid-corporates rely more heavily on bank loans and credit facilities and use private placements where tickets sizes are too small for capital markets issuance

- The US private placement market for loans and securities is cited by many corporates as a reference market place, elements of which could be replicated in Europe

3.2.2 Market context

The source of funding for corporates varies by size, with smaller mid corporates typically reliant on bank finance, similar to SMEs, while large corporates and Multinational Corporations (MNCs) have access to the capital markets – either in the form of debt (syndicated loans or bonds) or listed equity.

Despite capital markets access, European large corporates and MNCs have traditionally still used a significant share of bank funding – either through bilateral or syndicated loans and credit facilities. However, since the crisis the mix between bonds and loans has been shifting towards bonds.

Figure 3.4

European versus US corporate debt new issuance, € billion[25]

Loan facilities
Term loans
DCM

2,000
1,800
1,600
1,400
1,200
1,000
800
600
400
200
0

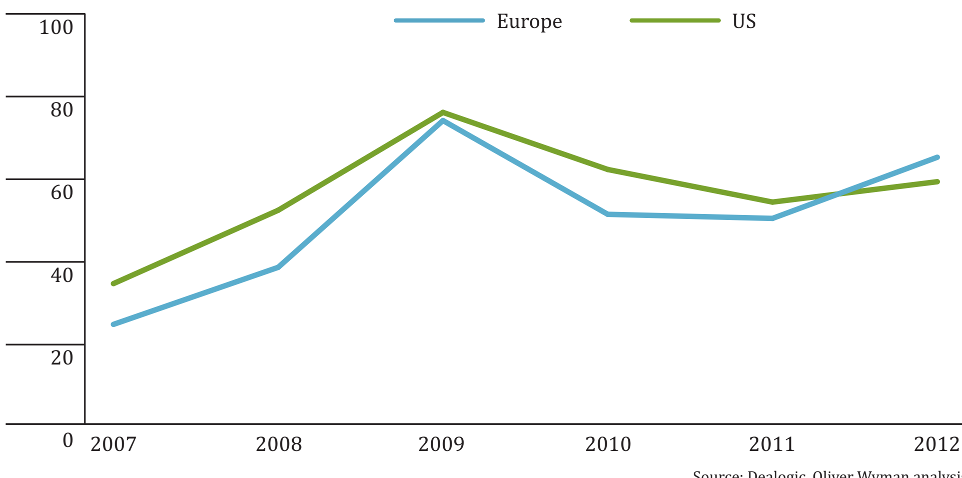
	2007	2008	2009	2010	2011	2012
Europe	1,490	870	860	950	1,040	1,020
US	1,920	960	800	1,270	1,730	1,870

Source: Dealogic, Oliver Wyman analysis

Syndicated loans comprise a combination of term loans and credit facilities, such as revolving credit facilities and back-up lines. Given that bonds are fully funded instruments, substitution will be largely limited to the term loan component of the loan market. In 2012, European corporates overtook US corporates for the first time in terms of the proportion of term debt issuance financed in the bond market, at 69% of the total.

Figure 3.5

Bonds as a percentage of corporate term debt issuance[26]



Source: Dealogic, Oliver Wyman analysis

The same trend of loan substitution can be seen from a stock perspective, although it is changing more slowly as the shift in new issuance takes time to flow through into stock.

During the fourth quarter of 2012 alone, European primary high yield bond issuance totalled €21.7 billion, while also providing a return to investors of 6.4%, which is quite favourable compared to other asset classes. For the full year of 2012, European high yield set a new record with €68 billion in primary issuance. While this is encouraging, the European high yield market is still dwarfed by the US high yield market, which is three times its size.

25. Syndicated loans and facilities only
26. Term debt includes DCM, syndicated loans and facilities

Interviewee comments validated these trends towards increased bond finance:

Multinational corporate

“In France, companies were generally using 20% capital markets and 80% bank debt funding. It will very certainly evolve towards a 50/50 situation”

Bank

“For larger corporates the demand has been reducing; Last year there was greater access to and reliance on bonds above classic vanilla loans”

However, this phenomenon is largely restricted to very large corporates. In practice there is a minimum size for issuance of bonds, which is approximately €500 million turnover, or approximately €250 million issue size. This is largely driven by three factors:

- Fixed borrower costs associated with public bond issuance, such as rating agency fees, registration and reporting/disclosure;
- Investor costs, in terms of analysis of the underlying corporate, driving a minimum investment ticket size; and
- Investor desire for liquidity driving a minimum overall issue size.

As a result, relatively few corporates below €500 million turnover are able to issue bonds cost effectively. However, even above this threshold, migration to bond finance has been slower for mid corporates than for the largest.

Figure 3.6
Profile of global corporate DCM issuers, 2011

Corporate size (by revenue p.a.)	% of corporates active in DCM		Average debt per corporate ($ billion)		DCM % of corporate LT debt profile	
	EU	US	EU	US	EU	US
<$0.5 billion	< 5%	5-10%	< 0.05	< 0.05	< 30%	< 30%
$0.5 – $5 billion	30-40%	50-60%	~0.4	~0.5	40-50%	~70%
$5 – $20 billion	70-80%	90-100%	~2.5	~3.5	~60%	~80%
$20 billion +	100%	100%	~12	~9	~60%	~85%

Source: Dealogic, Capital IQ, Orbis, Oliver Wyman analysis

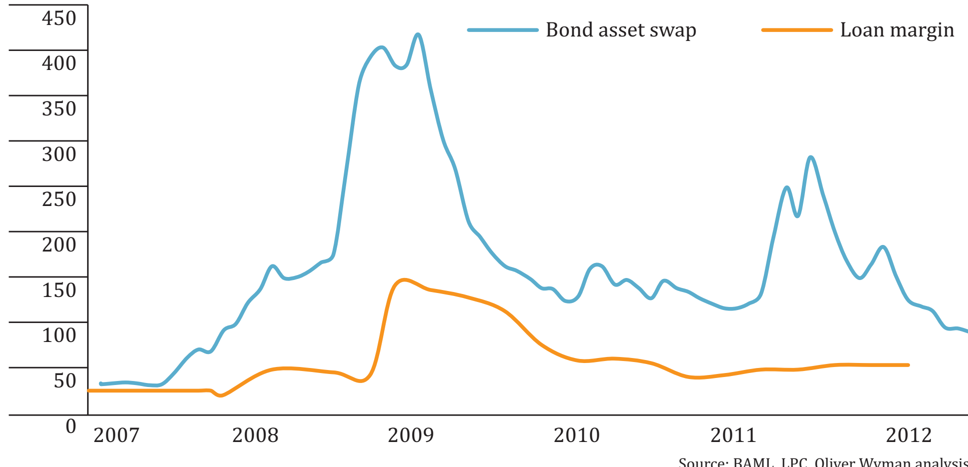
While bond markets have the capacity to provide larger volumes than bank lending, in many cases loan prices remain lower than bond spreads, partially due to relationship pricing strategies by banks, where loans are priced below economic levels but overall relationship economics are support by the sale of ancillary, largely fee-based products, such as payments and cash management, derivatives and capital markets issuance.

Figure 3.6 gives an indication of the relative use of bond markets by European and US corporates. European firms with turnovers below $20 billion are not only less likely to issue bonds, but also to have a lower proportion of funding from bonds.

Mid and large sized firms in Europe utilise syndicated loans if the ticket size is too large for a single lender. Public data on syndicated loan margins shows that loan spreads are generally lower than bond spreads, and are also less volatile over time.

Figure 3.7

European A-rated bond versus syndicated loan spreads, bps[27]

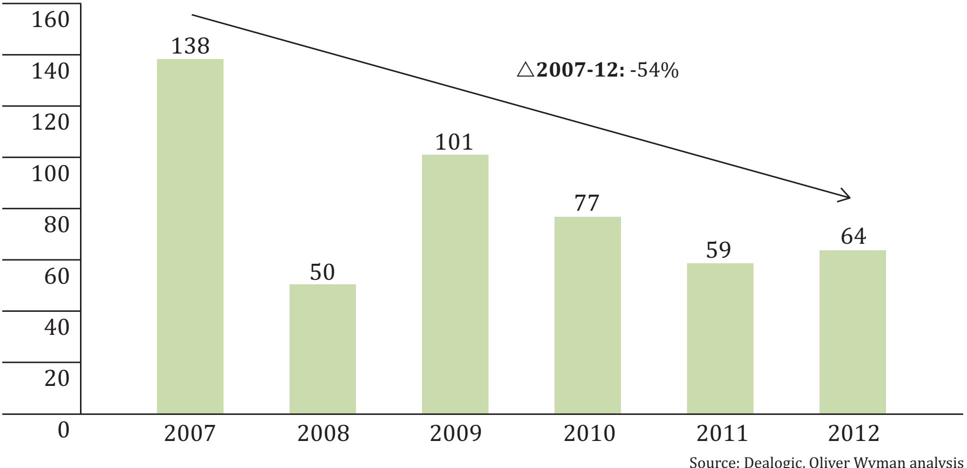


Source: BAML, LPC, Oliver Wyman analysis

In the equity markets, new primary and secondary issuance by European corporates declined by 54% from 2007 to 2012.

Figure 3.8

European ECM issuance, € billion

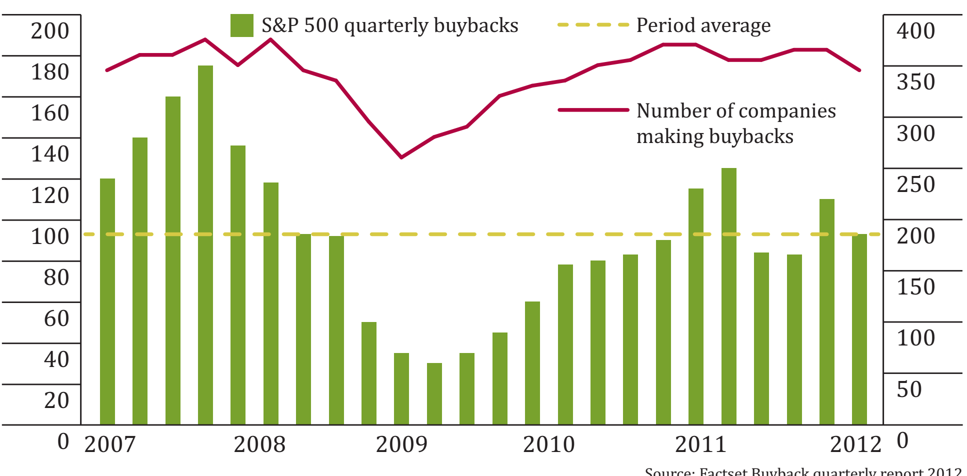


Source: Dealogic, Oliver Wyman analysis

Share repurchases have also been at high levels, indicating a lack of growth opportunities for corporates. Repurchases increased at the start of the crisis and then decreased in 2009 at the depth of the crisis when corporates took a more conservative view to retain equity buffers. As the economy recovered, but growth expectations remained weak, stock repurchases grew again.

27. Bond asset swap gives spread over forward LIBOR (swap) curve. Syndicated loan margins for multi-year drawn A-rated loans

Figure 3.9
Global share repurchases, € million[28]

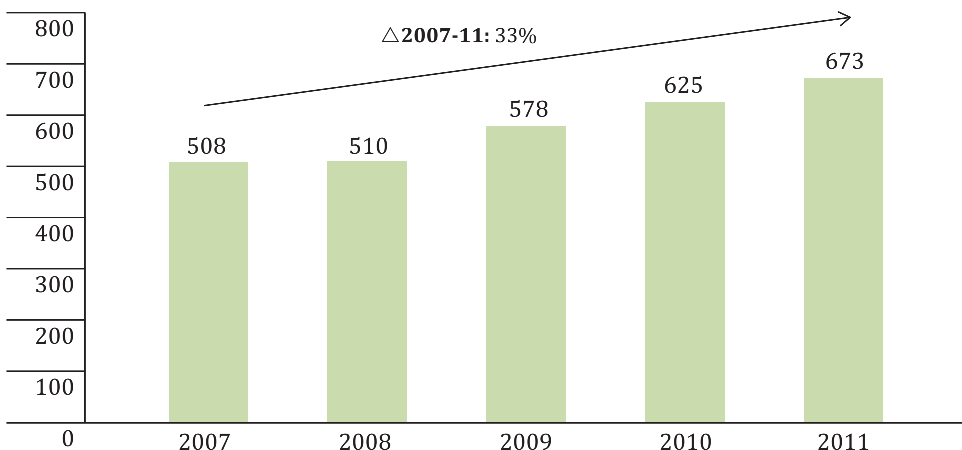


Source: Factset Buyback quarterly report 2012

Corporates are major users of securitisation, through both the term securitisation market as well as asset backed commercial paper (ABCP) programmes. In 2012, over €31 billion of European term auto loan securitisations were issued, mostly from the major European auto manufacturers. Many of these loans are originated by the captive financing subsidiaries of the major European auto manufacturers and are a very important part of their overall support for the sales of automobiles. Certain proposed EU regulations will discourage investment in term auto loan and other securitisations. As of March 2013, over €47 billion of European auto loan securitisations were outstanding. ABCP programmes are frequently used by large and mid-sized corporates to raise cash from the sale of trade receivables in a cost-efficient manner. According to Standard & Poor's, more than 75% ($39 billion) of the outstanding unrated assets in European ABCP conduits ($51 billion at February 2013) consists of corporate-related assets such as trade receivables, auto loans and leases.

Finally, corporates have been increasing cash reserves. Interviews suggested that the primary reason is to create a sufficient liquidity buffer to mitigate any future finance challenges due to market volatility. While the creation of liquidity buffers is clearly rational for corporates, the extent of cash hoarding is also concerning at the broader economic level as it indicates a lack of confidence in growth potential and also reduces the amount being spent in the real economy.

Figure 3.10
European corporate cash balances, € billion



Source: Thomson Reuters Datastream, Oliver Wyman analysis

28. S&P 500 corporates only

3.2.3 Barriers to provision of funding

Large domestic corporate

"We have no difficulties finding financing because of our good rating"

Multinational corporate

"In the last two years, if you were a German corporate it was good times, favourable rates all over the place"

Interviews with larger corporates in Northern Europe indicated that most corporates believe they are constrained by (a lack of) growth opportunities, rather than a shortage of funding. Most capital markets-eligible corporates stated that they had access to an ample supply of bond finance at low rates.

As discussed in section 3.6, the story is different for corporates in more crisis-affected countries, even for the largest names. However, several challenges and barriers were identified:

Availability and cost of hedging. Bank regulations, specifically Basel III/CRD IV, were highlighted as reducing the availability of, or driving up the cost of, hedging services, particularly cross-currency swaps used when funds are raised by issuing bonds outside a corporate's domestic currency and swapped back in the derivatives market. In addition, the higher cost of and, in some cases, unavailability of undrawn credit facilities, backstops and other products were noted by many. Also of concern are derivatives used when funds raised by issuing bonds outside a corporate's domestic currency are swapped back in the derivatives market. Other hedging services could also be impacted. The availability of hedging services could also be impacted by the calibration of position limits, if enacted.

Collateral requirements. EMIR (and the equivalent sections of the US Dodd-Frank regulation, which are not always aligned with EMIR) is a concern particularly for those corporates who will not be exempt from the clearing and margining requirements of the regulation. For example, corporates with trading arms that fail the exemption text for one asset class may currently have all derivatives in all asset classes required to be cleared and margined including commercial hedging. Some corporates are also concerned by prohibitive collateral requirements if caught by the full EMIR regulation and treated as NFC+. Posting of margin to clearing houses and/or on non-cleared derivatives under mandatory margining rules will significantly raise the cashflow implications of hedging, particularly for longer dated and high exposure products. Again, cross currency swaps were highlighted as being particularly impacted. However, it should be noted that other corporates that expect to be exempt stated that they are considering clearing anyway in order to reduce credit costs and exposure. Several firms were concerned that their trading activities would be captured by EMIR, creating increased compliance and transparency requirements across the whole firm.

Multinational corporate

"If the firm can't demonstrate hedging [to be EMIR exempt] the trading arm may trip up the whole organisation"

Mid-sized corporate

"Uncertainty over EMIR mechanisms is dissuading investors as it makes economics unclear"

Multinational corporate

"We are actually considering giving up our EMIR exemption to lower the price from banks on our derivatives"

Private placements. Some corporates use private placements, either in place of, or in addition to, public bond markets. While private placements were considered cheaper and more flexible, concerns were raised over documentation requirements in the US and the lack of standardised documents in Europe. In some cases, the PP yield expectations of investors was significantly above funding costs in either the bank or high yield bond markets. Several corporates we spoke to had issued Schuldschein loans in Germany and reported the relative efficiency of issuance and access to a wide range of investors globally.

Multinational corporate

“Entered the US PP market but felt it did not have the required size, moreover it had a lot of covenants and restrictions that did not make sense to us”

Multinational corporate

“We have expanded the number of banks that we are working with and also the geographical spread of banks; Trying to find more banks outside the Eurozone”

Multinational corporate

“If you achieved a critical mass [of European institutional investors] the PP market would see a large number of corporates willing to use the market”

Multinational corporate

“The European PP market should work well, but institutional investors have more attractive low hanging fruit”

Underdevelopment of European high yield debt market. Participants note that although the European high yield bond market has grown significantly, it is still only one third the size of the US market.

Compound impact of various regulations.

- **Ring-fencing.** There were varying levels of awareness on the proposals for ring-fencing, including ICB and Liikanen, and the potential impact on corporate banking relationships and other impacts. In some cases corporates were largely unconcerned about ring-fencing, while others highlighted a range of issues. In particular, some corporates were concerned about the complexity that dividing a bank between retail and trading activities would have on the overall relationship between the bank and corporate. This is of particular concern for international corporates dealing with banks across different jurisdictions and where exposures are required to be split across bank entities. Additionally, if the trading entity fell below a certain threshold (e.g. investment grade), this would prevent some corporates from executing swaps with them, which could also mean that the bank would be unwilling to provide just the financing.

- **Secondary market liquidity.** Some corporates were concerned about the impact of various regulations on secondary liquidity, including not just ring-fencing, but also those which impact the distribution model for bonds and market making, such as the financial transactions tax and MiFID 2. The concern expressed by corporates was less than that indicated by investors.

Multinational corporate

“I am wary of ring-fencing as it will be very difficult to split up banks – banks should be able to serve their clients’ needs, and this sometimes means trading”

Multinational corporate

“We would consider using foreign [non-ring-fenced] banks as we feel we have better protection under terms of ISDAs than with a ring-fenced bank”

Bank

“Ring-fencing will increase the cost of credit but people don’t talk about that because they don’t want to hear the downside of regulation”

Mid-sized corporate

“If ring-fencing creates bad banks, I won’t use them”

European high yield bond market barriers

In many European countries, as many as 90% of insolvent companies end up in liquidation. In 2010, this resulted in the liquidation of more than 220,000 European companies (or approximately 660 per day). Unfortunately, different European jurisdictions apply disparate insolvency proceedings and considerations, with stark differences in the treatment of creditors, debtors and employees under different European insolvency regimes.

A comparison with the US provides insight into problems with the European model. In Europe, there is still a great stigma attached to insolvency, which is generally seen as a preventable failure by the business and by management. In the US, insolvency proceedings are designed to ensure that a viable company can successfully reorganise. The US also recognizes that insolvency can occur due to factors that do not rule out future success by existing management. US managers are thus much more prone to initiate insolvency proceedings, while in Europe the vast majority of such proceedings are forced on companies by their creditors.

US and European corporate bond issuance, € billion

	2007	2008	2009	2010	2011	2012
US						
Corporate bond-high yield	87	31	87	146	114	187
Corporate bond-investment grade	203	196	261	240	244	364
Total	290	227	348	386	358	551
HY% of total	30%	14%	25%	38%	32%	34%
Total % of GDP	2.8%	2.4%	3.5%	3.6%	3.3%	4.5%
Europe						
Corporate bond-high yield	26	11	33	56	57	68
Corporate bond-investment grade	149	165	396	185	178	353
Total	176	176	429	241	235	420
HY%	15%	6%	8%	23%	24%	16%
Total % of GDP	1.4%	1.4%	3.6%	2.0%	1.9%	3.3%

Source: Dealogic, Oliver Wyman analysis

The US generally also follows a debtor-in possession (DIP) model, whereby existing management can run the business (including securing additional financing) during the insolvency proceeding. In Europe, however, after an insolvency proceeding is initiated, control of the company is passed to an outside administrator. Fear of being replaced might be another reason that European management is more reluctant to voluntarily initiate insolvency proceedings. The US also has more robust "automatic stay" provisions, whereby creditors are mostly prohibited from enforcement remedies and from receiving payments of principal or interest while the company seeks to reorganise its business. A European company might be more reluctant to inform the market and its creditors of any trouble until it is too late.

Other reasons that are often cited for the relatively slow growth of the European high yield market include:

- A continuing European stigma attached to high yield debt;
- A lack of issuer knowledge and experience with high yield debt, as well as uncertainty regarding expectations and requirements of entering the capital markets; and
- Comfort and experience with bank lending as the most favourable financing alternative.

3.2.4 Potential solutions

Several potential solutions were identified for large and mid-sized corporates.

1. **Ensure an evidence-based approach to the calibration of capital parameters for derivatives at granular implementation level,** particularly for cross-currency swaps and swaps to mid corporates without liquid CDS. Also, there should be careful consideration of the detailed rules on bilateral margin requirements for non-cleared derivatives.

2. **Carefully consider the implementation details of EMIR**, particularly as it impacts the non-financial corporate exemption for derivatives used for hedging commercial activities or treasury financing activities. Trading arms that fail the exemption text for one asset class should not necessarily trigger requirements that all derivatives across all asset classes should be cleared and margined including commercial hedging. However, banks highlighted that it is important that specific trading activities in non-financial corporates continue to be captured to ensure a level playing field. Also, fine tuning of the NFC- versus NFC+ categorisation for non-financial counterparties is required to ensure commercial hedging activity is always treated differently from non-hedging activity.

3. **Expand the European private placement market.** This could be done through a combination of initiatives.
   a. Create more standardised documentation, along the lines of the US 144A documentation for securities and loans, or the German Schuldschein programme for loans
   b. Utilise a rating system for private placement issues backed by an independent body, similar to the US NAIC rating system
   c. Increase transparency on private placement deal volumes and structures to increase both borrower and investor appetite e.g. creation of private placement deal database
   d. Create a European private placement forum to increase investor awareness and allow investors to state preferences for structures and issuers

4. **Expand the European high yield bond market.** Potential solutions could include:
   a. Creation of simpler, more uniform disclosure requirements for public and private issues: simplify and standardise the disclosure requirements across countries, utilising pan-European standards where possible
   b. Making a concerted effort to encourage European insolvency reform and harmonisation. European adoption of debtor in possession (DIP) financing regimes and more robust automatic stay provisions would help to increase efficiency and legal certainty. Further European education could change perceptions about what insolvency means about a company and its management, through substantive legal reform and also educational programmes that emphasise that insolvency proceedings do not necessarily mean that a company is no longer viable. These reforms and programmes should also incentivise company management to request assistance when needed and acknowledge the important role that existing management can play in returning a troubled company to profitability
   c. Encouraging further education in the issuance of, and investment in, high yield bonds through educational forums, and regulatory and legal reforms

5. **Reach a pan-European agreement on withholding tax for capital markets issuance.** There currently exist national withholding taxes which disincentivises certain types of issuance (e.g. Italian commercial paper issuance). A European agreement on these taxes would help harmonised capital markets access for firms.

6. **Active dialogue between regulatory community and end users**, such as corporates and investors, to ensure the cumulative direct and indirect impacts of regulatory changes are fully understood.

Private placements – German Schuldschein

Schuldschein are bilateral, unregistered and unlisted loan instruments which are sold directly to investors; in contrast to bonds. Schuldschein loans are not securities and are traded over-the-counter, rather than on an exchange. Issuers on the Schuldschein market tend to be entities with long term investment needs, typically public authorities, corporates and banks. Corporate Schuldschein issuance is estimated at €10 billion in 2012.

The large German private commercial banks and Landesbanks typically act both as arrangers and intermediaries for Schuldschein loans. There is a limited secondary Schuldschein market but it is less liquid than the bond equivalent, partially because documentation is required to be physically transferred, but also since investors put purchased loans into loan rather than securities portfolios.

There is no specific Schuldschein regulation in Germany. However, their issuance is regulated under existing German banking regulations. There are several benefits of Schuldschein loans over bonds:

- **Efficient issuance.** Loan agreements are regulated by the German civil code framework, which enables short documentation and consistent legal treatment. Documentation for non-German issuers tends to be more extensive, but remains shorter than for public bond issuance, resulting in more efficient and less costly issuance.
- **Unrated issuance.** Issuers are not required to be rated which attracts smaller firms.
- **Accounting practices.** Vanilla (i.e. not structured) Schuldschein loans do not require mark-to-market accounting which removes P&L volatility. This is particularly attractive to insurance investors, since otherwise the same corporate obligation in securities form would be required to be marked to market.
- **Confidentiality.** Schuldschein issues are confidential and therefore not reported by news organisations such Reuters, Bloomberg or the press.
- **Flexibility of terms and conditions.** Coupon, issue price, maturity and structure of loans can be adjusted to suit the issuer needs, which in turn can reduce the cost of funding for the borrowers. Structured Schuldschein loans have become more popular in recent years to match the needs of investors. Examples include inflation-linked, puttable and multi tranche loans.
- **Funding diversification.** The Schuldschein market attracts investors both within and outside of Germany and enables companies to attract multiple investors in one transaction that can otherwise only be reached through capital markets.
- **Restricted distribution only to institutions.** Schuldschein may only be offered in denominations of €1 million or more, and cannot be sold to retail investors directly.

German regulations permit both banks and insurance companies to originate Schuldschein loans. However, pension fund regulations do not permit the origination of loans. Schuldschein loans can however be purchased by German pension funds.

While Schuldschein share similar characteristics to the US private placement market, the documentation is shorter and sale to European investors avoids the additional cost of credit default and currency swaps otherwise required by many US investors.

Source: Oliver Wyman research, UniCredit research, HSBC research, AFME

Private placements – US Rule 144A and 4(2)

The United States Private Placement market (USPP) is a private bond market which is open to US and non-US institutional investors. It offers an alternative form of funding to bank lending and capital markets, typically at longer durations.

US private placement issuance, 2007-2011, $ billion

Source: PwC, Thomson Reuters

The USPP market is an important source of long term funding for US, and increasingly European, corporations. Issuance in 2011 was the highest since 2003, reflecting corporates' desire for funding diversification, to reduce reliance on bank lending. There are two frequently used exemptions from SEC registration requirements. Rule 144A, intended to provide more flexibility for issuers targeting reasonably wide investor distribution through slightly reduced disclosure and reporting requirements as compared to an SEC registered transaction, and for investors by creating secondary market liquidity by restricting onsales only to sophisticated institutional investors, called QIBs (Qualified Institutional Buyers). QIBs must manage at least $100 million of assets. On the other hand, Rule 4(2) transactions are intended to be offered to only a very small group of buy-and-hold investors who are unlikely to onsell the securities into the secondary market. Most European issuers utilised the Rule 144A alternative.

Benefits for issuers

- Flexible size of issuance, from $25 million to $1.5 billion
- Lower cost of issuance than public SEC registered market
- No need for public credit rating, though some transactions are rated, either publicly or privately. The debt is often given a rating by the National Association for Insurance Commissioners (NAIC), a regulatory requirement for Insurance investors
- Diversification of funding sources
- Less onerous reporting requirements compared to the SEC registered public market, although disclosure standards for institutional investors are still high
- Shorter time to issuance, since it avoids the SEC registration process otherwise required for public transactions, which could be distributed to both institutional and retail investors.
- US insurance companies have many years of experience with purchasing private placements, and have extensive and highly trained credit review staff.
- Private placements are often priced at a higher credit spread than an SEC registered public transaction
- Includes built-in covenants, similar to bank credit facilities
- Attractive form of long term assets, with maturities up to 15 years
- Typically structured with fixed coupons, removing the need for interest rate hedging
- Strong liquidity for Rule 144a issues
- Further research is required on mark-to-market treatment by US insurance company investors, since in the US insurers are regulated at the individual state level rather than nationally.

The USPP market has been gaining popularity among European issuers in recent years as investors price against the US public bonds market, which are currently very liquid.

Source: PwC, Oliver Wyman research, Thomson Reuters, Ashurst

Retail distribution for listed and unlisted corporates

Certain European markets have maintained retail bond markets for many years and are an established platform for companies to raise debt funding.

Borrower considerations

Issue size is smaller than the institutional bond market, typically around €30 million to €175 million in the listed market and around €1 million to €10 million in the unlisted mini-bond market. Funding is therefore possible for companies without the scale normally associated with public bonds. This may be important where bank funding lines are unattractive or unavailable. Large issuances are still possible but small issues can be more accurately matched to borrower requirements and may reduce the over-funding inefficiencies associated with 'benchmark' issues.

Standard bond terms and structuring, with both fixed rate coupons and index-linked returns, have prevailed in recent listed issues enabling issuers to benefit from established market mechanics. In contrast, the unlisted market has seen bonds paying out exotic coupons such as store vouchers, products or customer discounts. This flexibility can enable a retail bond issue to be as much a marketing and profile-raising opportunity as it is a funding exercise, and allows for highly tailored, bespoke issues. For listed issues, regulatory requirements for disclosure typically follow the standards for the institutional market though certain additional obligations can exist. Requirements are typically less onerous for unlisted issues.

Access to the retail bond market was once considered to be restricted to borrowers with strong corporate recognition, material assets, robust operating performance or large customer bases. Whilst name recognition and brand awareness still remain important factors, as the market continues to mature, the range of borrowers accessing retail funding could widen materially in the future.

Mittelstandbonds (listed via local stock exchanges)

German Mittelstandbonds are bonds with principal amounts issued of between €10 million and approximately €50 million (with exceptions that go up to €100 million). They are mostly issued by companies that are not listed and are traded via an electronic platform. The first Mittelstandbond was introduced in 2010 at the Stuttgart exchange, one of Germany's local exchanges. At the end of 2011, the volume of Mittelstandbonds was €1.8 billion and 36 different bonds were listed on local German exchanges.

Mittelstandbonds were originally intended for the individual retail investor with denominations of €1,000 on average. Most companies that issue Mittelstandbonds are not listed, they typically have revenues of between €25 million and €400 million, with the occasional exception of revenues above €1 billion.

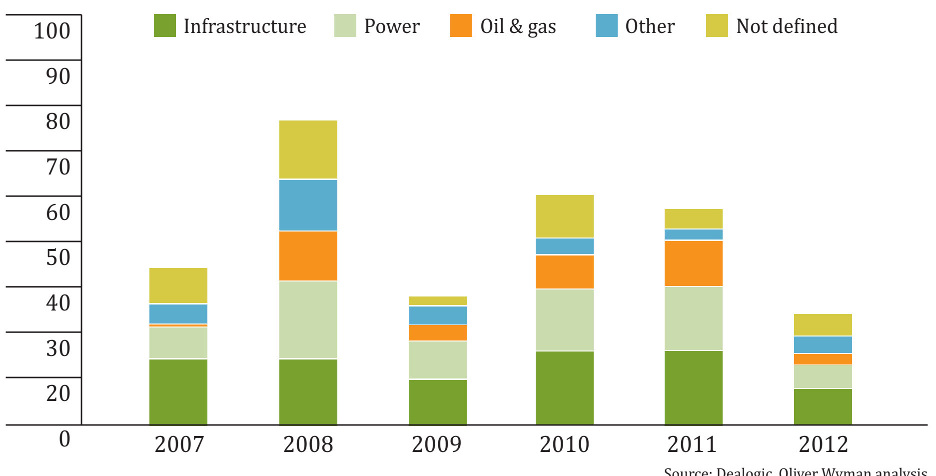
Source: AFME

3.3 Infrastructure investment

3.3.1 Highlights

Figure 3.11

European project finance syndicated loan issuance, € billion



Source: Dealogic, Oliver Wyman analysis

Infrastructure developer

"Regulatory risk is the biggest stumbling block for infrastructure development, with countries retroactively changing tariffs"

Bank

"There just isn't the pipeline – investors will give the funding and do the diligence but the demand isn't out there"

Perceived barriers

Bank

“You need to demonstrate to institutional investors that in 25 years there will be **no change in legislation**”

Infrastructure developer

“At the moment investors feel that there is high **regulation risk** in infrastructure investment”

Bank

“There is a demand for infrastructure, but there is a difficulty in getting capital where it is needed in the **construction phase**”

Bank

“There are issues with local versus central **Government alignment.** For example, a project was ready to go then local country council complained”

Potential solutions

Infrastructure investor

“[On government guarantee schemes] We welcome the Treasury having **skin-in-the-game**, it gives investors confidence”

Asset manager

“A **credit guarantee and surveillance agency** would help; we don’t want to make day to day decisions on the project”

Infrastructure investor

“Banks should become **aggregators** [of long term infrastructure debt] for institutional investors”

Insurer

“We would consider **infrastructure bonds** provided they are of the right quality and satisfy the matching adjustment eligibility requirements”

Key takeaways

- There is a limited pipeline of new infrastructure projects due to cutbacks in infrastructure spending by many local governments
- Private sector infrastructure funding has been heavily impacted by a decline in long term bank lending and the disappearance of many monoline insurers
- Expansion of public support through pan-European and national government guarantees and funding projects supported by institutional banks will help to attract additional investment from non-bank investors, particularly insurers
- Investors are highly cautious given recent austerity driven changes to tariffs and fee structures, cumbersome procurement and planning procedures and relative low returns
- Governments can act to restore investor confidence by providing greater transparency in structure and certainty in fee structures, and simplifying planning and procurement procedures
- More certainty could also be provided by establishing industry best practice guidelines for finance tendering process, including approach to capital markets take-outs including a move toward segregated tender processes for the initial build and long term finance phases

3.3.2 Market context

Infrastructure investment has traditionally been a keystone for countries across the world. Infrastructure projects cover a vast range, including energy generation, communications networks, transport, hospitals, and schools, to name but a few. They typically have high social returns on investment, being crucial to sustainable growth. A viable infrastructure investment regime thus provides the framework for any modern economy to function correctly, supporting individuals and businesses alike.

Infrastructure is not just valuable as a service to the economy. The sheer size of the projects means that the actual build and operation of these projects employs large numbers of individuals and generates lengthy supply chains. The recently announced new reactor at the Hinkley Nuclear power site in the UK provides an indicative example of the importance of large scale infrastructure projects. This will employ over 20,000 people and almost 6,000 at the peak of the build phase alone and will involve more than 1,000 sub-contractors, at a cost of approximately £14 billion (approximately €16 billion).

Levels of investment in infrastructure have been the subject of much debate during the current crisis. Over-indebtedness of some governments has reduced capacity for infrastructure investment. At the same time, new infrastructure projects can also be viewed as a way of boosting overall economic growth without creating inflationary pressures, as infrastructure spending enhances the supply side of the economy. This has been noted across Europe and the European Commission has initiated the Euro 2020 Project Bond initiative to support infrastructure.

The importance placed on infrastructure projects to economic growth is matched by the scale of funding required. The European Commission has indicated a requirement for €1.5-2.0 trillion of infrastructure investment, of which approximately €1,100 billion is in energy, €500 billion is in transport and €270 billion in is information and telecoms. This figure overshadows the amount spent on public private partnerships over the last 10 years, an estimated €270 billion[29].

Infrastructure projects can be funded in one of three ways:

- By government, via general government spending
- By a corporate, from a general corporate covenant
- By a specific financing package

The dynamics for these different funding models have changed. In the non-periphery, demand for government paper is at an all-time high with borrowing costs extraordinarily low. Governments could use this opportunity to issue more debt and fund infrastructure spending. Politically however this is challenging as governments don't operate on a balance sheet basis and are looking to reduce deficits.

For high-quality corporates, again cash is plentiful (see figure 3.10 for more information on corporate cash balances). Most companies in stable markets can access both equity and debt for general spending. However, they tend to view the environment as opportunity constrained.

Many projects are built by big operators, but specific infrastructure finance is important in many sectors (e.g. social housing, roads, hospitals, schools) and also for newer entrants in established markets (e.g. power, telecoms). In these sectors the lack of scale operators and the traditional reliance on individual project finance models means that projects in these sectors can't be funded until a new model emerges. These sectors are also important to growth.

29.Ernst & Young Property Investor News, 27th November 2011

Projects carry very different risks in build and operation phases (Figure 3.12). These tend to suit different investors. Given the wide variety of projects, risks can also vary. For example, a hospital may have a return based on availability, with the price agreed with the local authority. Alternatively, a power plant has a volume dependent component based on energy demand, and a price based on tariffs, which may be linked to commodity prices and inflation. Risks also include the cost and availability of hedging of various project risks.

Figure 3.12

Typical project risks through each phase

- Project risk
- Political risk

- Construction risk
- Political risk
- Market risks e.g. commodity prices, currency risk

- Operating risk
- Volume risk
- Regulatory risk

3.3.3 Barriers to provision of funding

First we note that the barriers to infrastructure funding are focussed on specific asset finance models. The general government model is not working due to a lack of political desire to spend the money and/or over-indebtedness of governments in some countries combined with concerns around the Eurozone. However the mechanics of the financing model in this case are credible. The general corporate model is currently well-functioning, but held back by a lack of appropriate projects with credible business cases that are shovel-ready.

To understand how to revive infrastructure funding it is important to look at the key factors behind the recent decline.

The decline of the projects pipeline. There has been a significant reduction in the volume of PPP (public private partnership) projects coming to market as a result of the reduced capacity of public budgets. Any problems in funding described can be viewed as distinct from the decline in demand for new projects.

The decline of bank lending. Project finance loans fell to €40 billion in 2012, down from €60 billion in 2011. Increases in bank funding costs, combined with greater emphasis on funding and liquidity ratios through Basel III, have been one of the biggest drivers of reduced bank supply, especially for long term funding. Banks are now less willing to issue the kind of long dated loans required for the build phase of the largest projects, which meant that the banks bore the refinancing risk. Many of these infrastructure project loans were also considered low risk, low return assets but some have not performed well, further disincentivising lenders. Many banks have booked loans at thin margins which would have a significant negative mark-to-market today.

The ability to provide infrastructure loans by banks has been exacerbated in sovereign crisis-affected countries (Section 3.6). Sovereign risk is also affecting funding from non-domiciled banks as they attempt to withdraw funding from projects within these countries.

High degree of perceived political risk. As the crisis hit Europe, some investors have found themselves with reduced returns as austerity driven countries have altered the operational terms of projects, e.g. changes to energy tariffs. Stories such as this may be the exception, but they spread quickly through the investment community damaging the low-risk return perception of operational infrastructure assets.

Slow and opaque planning and procurement processes. We encountered several examples of 'failed' projects, killed off in the procurement phase due to lengthy planning periods, and complex consultation and resolution processes. This uncertainty overlaid on the current economic climate makes many infrastructure projects unattractive for investors.

Lack of stakeholder appetite for some project-related risks. Several investors highlighted risks that they were not willing to take. These included construction risk for greenfield projects, volume risk (particularly toll roads) and some areas of technology risk (e.g. offshore wind).

The disappearance of monoline insurers. Pre-crisis, infrastructure bonds were guaranteed by monoline insurers in order to remove development risk. Many non-bank investors, such as insurers, need either an explicit or internal rating of A- to be able purchase an infrastructure investment. Monoline insurers provided a guarantee for bonds issued by SPVs, by enhancing the credit of many projects rated less than A- to at least this level of rating. Insurers do have a keen interest in funding infrastructure investment, but they need credit to be at this threshold or possibly slightly below A- in some cases.

However, monoline insurers also acted as a single conduit between bond holders and project owners, providing credit analytics support, acting as a decision making body for project changes, and resolving disputes. Most, but not all, monoline insurers have disappeared since the crisis due to over exposure to the US sub-prime securitisation market.

Capital treatment of tranched and securitised exposures. Some investors have expressed an unwillingness to consider EIB project bond structures since, as credit-tranched structures where the EIB provides a partial guarantee on a mezzanine tranche of risk, it is unclear as to whether they are considered to be 'securitisations' under proposed Solvency II capital charges, thereby stopping investment.

Securitisation capital charges for AAA structures are proposed by EIOPA to be 7% per year of year of duration, on the market value of the bonds. This capital charge is viewed as prohibitively expensive to insurers, whether for project bond investment or AAA securitisation.

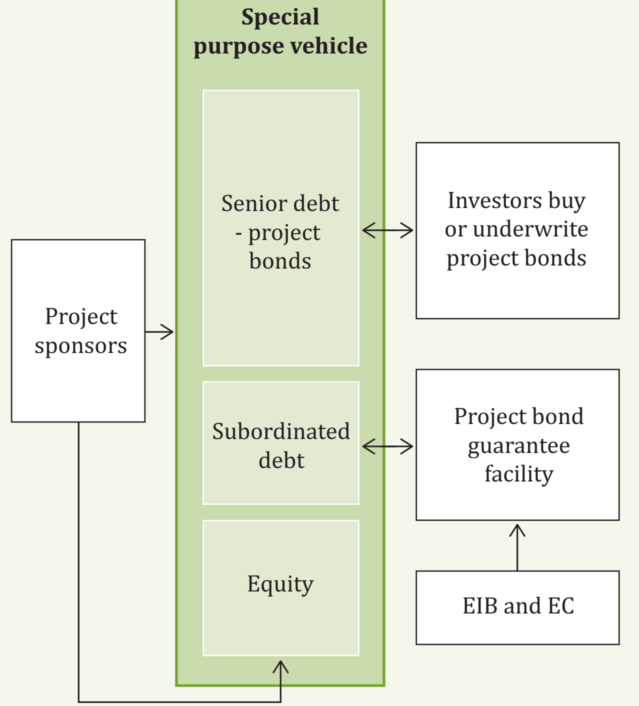
Solutions to this barrier are addressed in section 3.7.

Europe 2020 Project Bonds

The Europe 2020 Project Bond Initiative is designed to stimulate capital markets financing for pan-European greenfield infrastructure projects, including transport, telecommunications and energy.

It aims to attract non-bank investors, particularly insurers and pension funds, to infrastructure debt by enhancing the credit worthiness of the project bonds.

Project sponsors (typically private infrastructure firms) will establish a special purpose vehicle in which it will invest equity to fund a portion of the project. The remaining funding will come from debt raised by the SPV, split into a senior and subordinated tranche (see figure).



Through this mechanism, the senior debt – the Project Bond – is enhanced through credit support provided by the EIB and/or European Commission via the subordinated tranche. The credit support might be a direct loan or a credit facility which is released in case of project revenues being insufficient to service the senior debt. By improving the credit rating of the senior debt of project companies, the financing cost for longer maturities of debt is reduced and the attraction for institutional investors is increased.

The pilot phase of the initiative was activated in November 2012. There is a strong pipeline of projects, but tangible results are still outstanding due to the long lead time of designing and financing infrastructure projects. However, a first financial close is expected to emerge this year.

Source: European Commission, EIB, Oliver Wyman research

EU Pan-European Infrastructure/Project Bonds

Project Bonds/Infrastructure Bonds. The pilot phase of the EU-EIB Project Bond Initiative was established by Regulation No. 670/2012 which entered into force on 1 August 2012 in preparation of the main phase from 2014 onwards.

The Initiative aims to revive and expand capital markets to finance large European infrastructure projects in the fields of transport, energy and information technology.

The scope of this pilot phase is to test the project bond concept during the remaining period of the current multi-annual financial framework 2007-2013. The pilot phase of the Initiative started its operational phase in 2012 and will be implemented by the European Investment Bank (EIB). The cooperation agreement between the Commission and the EIB was signed on 7 November 2012. The objectives of the pilot phase of the Initiative are two-fold:

- to stimulate investment in key strategic EU infrastructure in transport, energy and broadband.
- to establish debt capital markets as an additional source of financing for infrastructure projects.

The aim is to attract institutional investors to the capital market financing of projects with stable and predictable cash flow generation potential by enhancing the credit quality of project bonds issued by private companies. The intention is to support capital market financing of projects as a form of finance to complement loans, not to replace other sources of financing, such as grants, nor to intervene in stages prior to financing, such as feasibility studies, assessments or procurement, where grants are also widely used.

Amount available. The amount of funding available for the pilot is €230 million, while the budget for the main phase is subject to confirmation of the EU budget and to the performance of the pilot phase. Links to an overview of the Project Bond Initiative programme and a download of the regulation can be found in Annex A, notes 10a, 10b and 10c.

EU regional cohesion funds – targeting growth

Regional cohesion funds. EU regional policy is an investment policy, intended to support EU job creation, competitiveness, economic growth, improved quality of life and sustainable development. These investments support the delivery of the Europe 2020 strategy. EU regional policy is also the expression of the EU's solidarity with less developed countries and regions, concentrating funds on the areas and sectors where they can make the most difference.

Regional policy aims to reduce the significant economic, social and territorial disparities that still exist between Europe's regions. During the period 2007-2013, the EU will have invested a total of €347 billion in Europe's regions (of which 25% has been earmarked for research and innovation, and 30% for environmental infrastructure and measures to combat climate change). See Annex A, note 11a for more information.

More details of the Cohesion Policy 2014-202 can be found in Annex A, note 11b. The proposed text shown in the link provided in Annex A, note 11c will repeal the Council regulation EC (No 1083/2006), particularly the section on page 44 (title IV: Financial instruments).

Uses of cohesion funds. The link provided in Annex A, note 11d provides information regarding EU cohesion funding for regional and cohesion policy in 2007-13 amounts to €347 billion - 35.7% of the total EU budget for that period – or just over €49 billion a year.

All cohesion policy programmes are co-financed by the member countries, bringing total available funding to almost €700 billion. The table references the types of projects and regions to which the cohesion funding is allocated, which include transport, research and technological development, environmental protection and other uses.

3.3.4 Potential solutions

With banks unable to provide historic levels of project loans, investors left without the services and protection provided by monoline insurers and a range of concerns over project likelihood and risk, it is clear that there is a funding issue that needs to be addressed. At the same time, austerity measures have resulted in a reduced level of infrastructure investment in several countries – as investment increases, the funding issues will become even more evident.

There are several potential actions which can be taken to address these issues and encourage greater investment in the asset class.

1. **Increased transparency over planned essential projects.** This will be provide investors with sufficient confidence about future deal flow to invest in building new capabilities required to provide finance to infrastructure projects.

Infrastructure developer

"Need a transparent tariff structure which enables revenue projections well beyond the development stage of the project"

2. **Expand and extend the Euro 2020 Project Bond initiative.** This is probably the best known infrastructure finance initiative at present, providing support through subordinated debt to enhance the quality of senior debt. However, the funding capacity is currently small relative to potential demand for finance and so would benefit from expansion.

3. **Encourage further infrastructure investment from European institutions,** thus creating a halo effect attracting other investors. There are several European institutions already involved in infrastructure lending (e.g. the involvement of the EIB in the Euro 2020 Project Bond Initiative). Greater involvement from these institutions on a pan-European basis would help reassure other investors, as well as providing direct funding capacity.

Asset manager

"The procurement process needs to place greater consideration on the financing side"

4. **Create/promote an infrastructure investor group and educational forum targeted to insurance company and pension fund investors** that would identify and prioritise which issues were causing funding blockages and feed that back dynamically to the authorities. Governments and other sponsors should also be closely involved.

5. **Enact EU guidelines governing changes to project fees/tariffs and compensation mechanisms.** Such guidelines would increase investor confidence during the operation phase, as returns would be afforded better protection. Defined compensation mechanism would provide greater investor security again perceived regulatory risk. If enforceable by EU law this would provide fiscal protection to investors should operation terms be altered – potentially funded by a small levy on projects to make fund self-financing.

6. **Establish guidelines to increase transparency on planning requirements and timelines.** While it is difficult to decrease specific planning requirements and timelines for projects, steps could be taken to increase transparency on key stages and expected timelines. This would give investors greater visibility on when projects will launch and give greater confidence to invest in analysis of potential funding opportunities.

7. **Define procurement procedure and financing best practice by** examining global procurement procedures and financing arrangements. Such a task would be a small undertaking and should result in defined set of recommendations for modifying procurement procedures. With procurement roadblocks identified and addressed, investor concern over pre-build project failure will sure be reduced. Adoption of the Commission's Concessions Contract and Public Procurement Directives will help require further consistency across Member States (see note

12a, Annex A). Also, the European PPP Expertise Centre (EPEC) has an important role in developing and implementing procurement practices and the financing of PPP projects (see State Guarantees in PPPs in Note 12b, Annex A and Termination and Force Majeure Provisions in PPP Contracts in Note 12c, Annex A).

8. **Separate tender processes by sponsors and lenders for the build and finance phases.** This would allow construction firms to take on risks associated with the build and procurement process, to which they are best suited, and then separately, permanent, financing risk could then be taken on by investors with knowledge once the construction phase has been completed. There are significant differences in lenders' appetites to fund 'brown field' established projects (such as an extension to an existing airport) compared to 'green field' projects which are entirely new (such as a new airport).

Asset manager

"We are putting new teams together to watch the infrastructure pipeline, but the big problem for us is the construction risk and who pays for that"

9. **Shift to availability-based structures for essential social infrastructure projects, with governments taking volume risk.** For example, adopting an availability-based structure for roads could attract additional investors who would be ruled out by lack of appetite for volume risk associated with toll roads.

10. **Government-backed guarantees for infrastructure funding** either through guarantees or partial government funding. Some schemes are in place currently, e.g. the £40 billion provision by the UK government to underwrite UK infrastructure projects. If such schemes exist it is important terms are regularly reviewed to ensure these schemes support projects which require guarantees rather than projects which would be successful in the absence of a government guarantee.

Infrastructure developer

"European institution funding is useful, but they don't have the people to do every deal; they should be focusing on the larger deals"

11. **Provide guidelines on acceptable capital market take-out structures** to procurement committees. Such guidelines could include details on appropriate loan tenors, refinancing windows, external conditions, etc. This would provide committees with greater comfort when considering financing which involves initial loans with capital market refinancing once operational.

12. **Consider development of new project finance credit management agencies and/or new, well capitalised private or public sector credit enhancement providers/insurers**, to act on behalf of investors and drive standardisation of documentation.

13. **EIOPA to review capital charges for Project Bonds, as to whether they are considered to be securitisations, as well as the calibration of capital charges for high quality securitisations.** EIOPA is currently reviewing capital charges for all corporate asset investments related to the real economy, including infrastructure as well as securitisation.

3.4 Commercial real estate

3.4.1 Highlights

Large domestic corporate

"The funding that is available from new entrants in the real estate market only goes to prime locations"

Investor industry association

"Solvency II capital requirements greatly overstate the volatility of real estate and therefore eat up more regulatory capital"

Perceived barriers

Property developer

"**Treatment of property loans** is unclear under Solvency II and there is a risk that this uncertainty will adversely impact lending decisions"

Investor industry association

"There is a scarcity of good **long term data** on real estate in Europe"

Investor industry association

"Smaller insurance companies will either have to develop their own models or move out of real estate because it eats up too much **regulatory capital**"

Asset manager

"If the risk return profile improves there is nothing stopping us from reinvesting in the CRE market"

Potential solutions

Investor industry association

"Research shows that the **Solvency Capital Requirement** should be no higher than 15% for RE"

Mid-market corporate

"Provide investors with enough liquidity and reduce their **capital costs** which will allow them to provide financing on RE projects"

Key takeaways

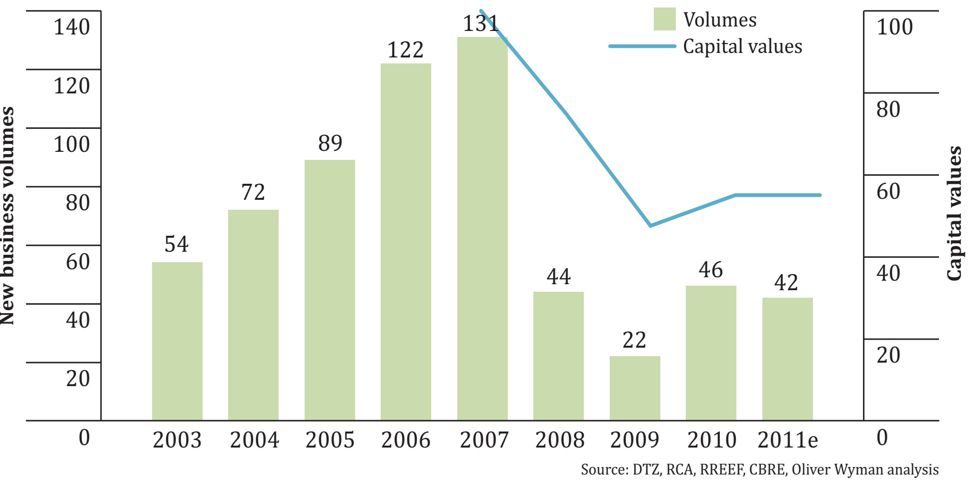
- While new CRE financing activity has remained depressed since the crisis, investment will be required when approximately €500 billion of outstanding debt matures by 2017
- Long term investors are well placed to take on this investment as banks deleverage their balance sheets, but low asset values and impending regulation is preventing this shift
- Capital requirements for CRE debt should be empirically calibrated to attract long term investors
- Meanwhile investment can be encouraged through expansion of European REIT-like structures. Mutual recognition and increased education for investors on CRE debt

3.4.2 Market context

Commercial real estate is a highly cyclical sector. 2001-2007 saw strong growth in asset values across Europe, supported by increasing debt volumes. Lending economics were very strong for banks, as the increasing capital values meant that risks quickly reduced as loans matured. However, this also led to increasingly aggressive lending structures and LTVs which caused major credit losses as the cycle turned and asset values dropped in 2008. As values dropped, so did lending volumes, with EMEA new business volumes falling by 64% in 2008 and remaining at low levels ever since.

Figure 3.13

CRE new financing volumes and capital values[30], EMEA, € billion

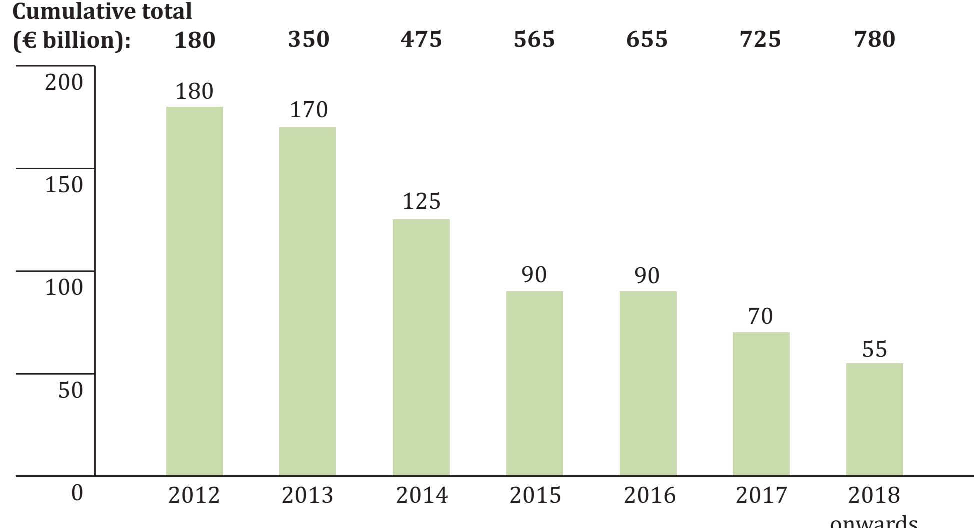


Source: DTZ, RCA, RREEF, CBRE, Oliver Wyman analysis

The impact of the crisis varies between countries, partly driven by the extent to which asset price bubbles inflated during the early part of the century. Southern Europe has been severely affected, with capital values more than a third below peak level by the end of 2012. Even relatively stronger economies are 10-25% below peak levels, creating problems for loans originated at the peak of the bubble at high LTVs. While there is limited new investment activity, over €500 billion of existing debt will mature over the next five years from 2013-2017, driving the continued need for CRE financing. At some banks more than 10% of existing debt is in breach of covenants (mostly LTV) and so will be difficult to refinance unless additional equity can be injected.

30. Capital values for all properties in Europe rebased to 100 in Q4 2007

Figure 3.14
European CRE debt maturity profile, € billion



Source: CB Richard Ellis, De Montfort University, November 2011, Henderson

The increase in risk, combined with increasing funding costs and capital levels, is pushing up CRE pricing. In the UK, for example, average margins have increased from 100-150bp pre-crisis to 300-400bp in 2012, depending on the sector and asset quality. This increase in price has been manageable in the recent low rate environment, but is likely to create debt service challenges when interest rates rise in the future.

Various countries in Europe and internationally have established legal and regulatory regimes intended to promote capital markets investment in real estate. Table 3.1 below provides an indication of the breadth of countries with REIT or equivalent regimes, including the current market capitalisation in each country. Since REITs are a product of the tax regime in each country, investment is inevitably highly fragmented by country.

Table 3.1
Selected European and international REIT regimes[31]

Country	Year enacted	Number of REITs	Market cap (€ million)	Official name
Netherlands	1969	5	6.7	FBI
Belgium	1995	16	5.8	SICAFI
France	2003	40	45.3	SIIC
Germany	2007	4	1.1	G-REIT
Italy	2007	2	0.5	SIIQ
UK	2007	21	33.9	UK-REIT
USA	1960	189	454.8	REIT
Canada	1994	37	39.1	MFT
Australia	1985	45	71.8	LPT
Singapore	1999	26	29.0	S-REIT
Japan	2000	35	37.4	J-REIT
Hong Kong	2003	9	15.3	HK-REIT

Source: European Public Real Estate Association Global REIT Survey 2012

31. Greece, Bulgaria, Lithuania, Finland, Spain and Ireland: these countries have programmes but there is currently little or no loan outstanding

3.4.3 Barriers to provision of funding

Interviews highlighted major barriers for CRE funding:

CRE asset values. CRE asset values, particularly secondary and tertiary assets, have fallen in many markets, increasing the loan-to-value on existing loans and creating difficulties to re-finance. In many cases, unless asset values recover, obtaining new funding will be dependent on first injecting additional equity to reduce leverage.

Bank regulatory capital. Increased capital requirements, through a combination of CRD IV and, in the UK, the FSA's slotting approach which imposes significantly higher risk-weighted assets, thus forcing up the cost of bank finance.

Mid-sized corporate

"Regulations should be counter-cyclical rather than pro-cyclical – hitting banks with new capital requirements in a difficult times"

Mid-sized corporate

"I do not have an issue with new regulations as long they are sensible and net positive for the economy. That is why I don't understand why EU proposes all these new regulatory changes all at once as it is hard to judge their individual effect"

Mid-sized corporate

"Most banks holding those assets are just rolling it over because interest rates are low – no point unwinding"

Withdrawal of bank capacity. Several banks have exited or scaled back CRE lending activities in the wake of material losses and/or over-concentration in the sector.

Investor focus on prime locations. Most new investors are exclusively focused on financing assets in prime locations, largely due to the need for local market knowledge and difficulty in gaining such expertise outside core areas. Given the asset-specific nature of CRE, this cannot easily be resolved through increased market data. As a result, secondary/tertiary assets are largely reliant on incumbent banks.

Non-performing loans creating bottle neck for new lending. Several interviewees highlighted concerns that a large volume of CRE NPLs are 'clogging up' bank balance sheets. Banks have exited or scaled back CRE lending activities in the wake of material losses and/or over-concentration in the sector.

3.4.4 Potential solutions

Mid-sized corporate

"Best solution is time – this will amortize the debt"

Mid-sized corporate

"We are pretty opportunistic acquiring funding from insurers – if it looks attractive and we have access, we will move to seize this opportunity"

Commercial real estate was broadly considered to be a challenging asset class, with continued fragility of asset values, particularly outside prime locations. Some investors stated views that more equity is required, rather than more debt.
Others had the view that the market would improve gradually, as debt amortised and was repaid.

Three potential solution areas were highlighted for commercial real estate:

1. **Ensure evidence-based calibration of capital parameters, particularly slotting criteria and risk-weights in UK.** We acknowledge that CRE has been a risky asset class and capital weights should reflect that – the key is to ensure both consistency (as achieved via slotting), as well as appropriateness (as was historically achieved by IRB). Evidence-based approaches for CRE will be important to maintain its future viability.

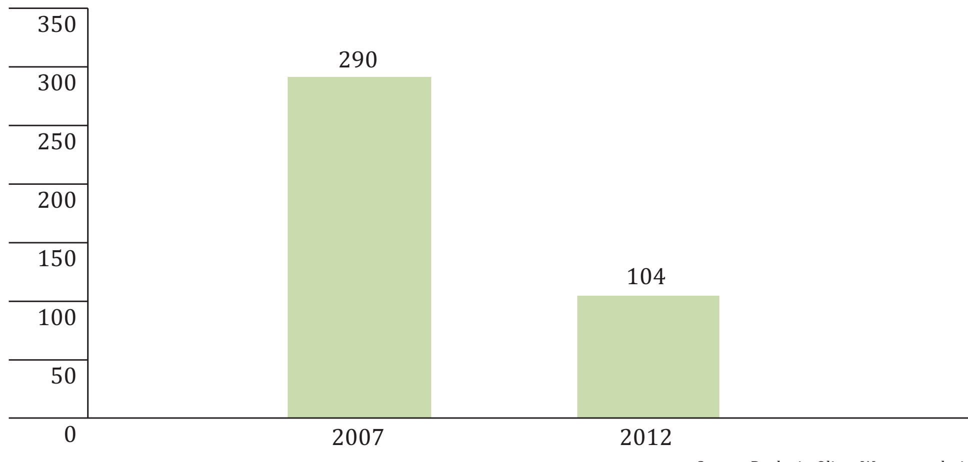
2. **Consider pan-European REIT structure and/or expansion of national REIT-like structures.** Increase portability across countries and/or promote potential mutual recognition to increase potential for cross-border investment. Create additional national REIT legal frameworks in countries which currently do not have them.

3. **Increase investor understanding of CRE debt.** Create a European CRE forum to increase investor awareness of debt profiles and allow investors to state preferences for structures and issuers.

3.5 Financial sponsors and leveraged finance

3.5.1 Highlights

European new issuance of sponsor-related debt, € billion



Source: Dealogic, Oliver Wyman analysis

Asset manager

"Not a single European CLO has defaulted these last couple of years"

Asset manager

"5% rule is a major hindrance to investors – managers are not banks and they do not have that kind of money lying around"

Perceived barriers

Investor industry association

"Europe is not bad at entrepreneurship, but there is a historic lag from dot com boom and **venture capital** firms have struggled to raise capital"

Private equity firm

"Tough economic times does not mean we don't want to invest, some of our best deals were in a tough **macro economic environment** – it all depends on the deal"

Private equity firm

"Given the volatility in EU market and capital constrained corporates – we are seeing a lot of opportunities, but it will depend on **macro environment** to make any deal happen"

Investor industry association

"**Tax treatment** of equity versus debt has contributed to the over-reliance on bank loans. The current system disincentivises venture capital or equity financing"

Bank

"Difficult for **CLO managers** to find investors – three-letter acronyms are no longer fashionable"

Potential solutions

Private equity firm

"Existence of **credit ratings** is entirely based on regulation, I don't know any investor who puts any emphasis on them"

Private equity firm

"[Although loans should be eligible for UCITS funds] It could be that for institutions which can buy loans, eligibility would be a bad thing as the **increased liquidity would bring down returns**"

Private equity firm

"To fix **liquidity**, you need to grow the market"

Asset manager

"Increase **skin-in-the-game** to 10% - Managers should hold equity in CLOs"

Pension fund

"Do not remove the **5% retention rule**"

Key takeaways

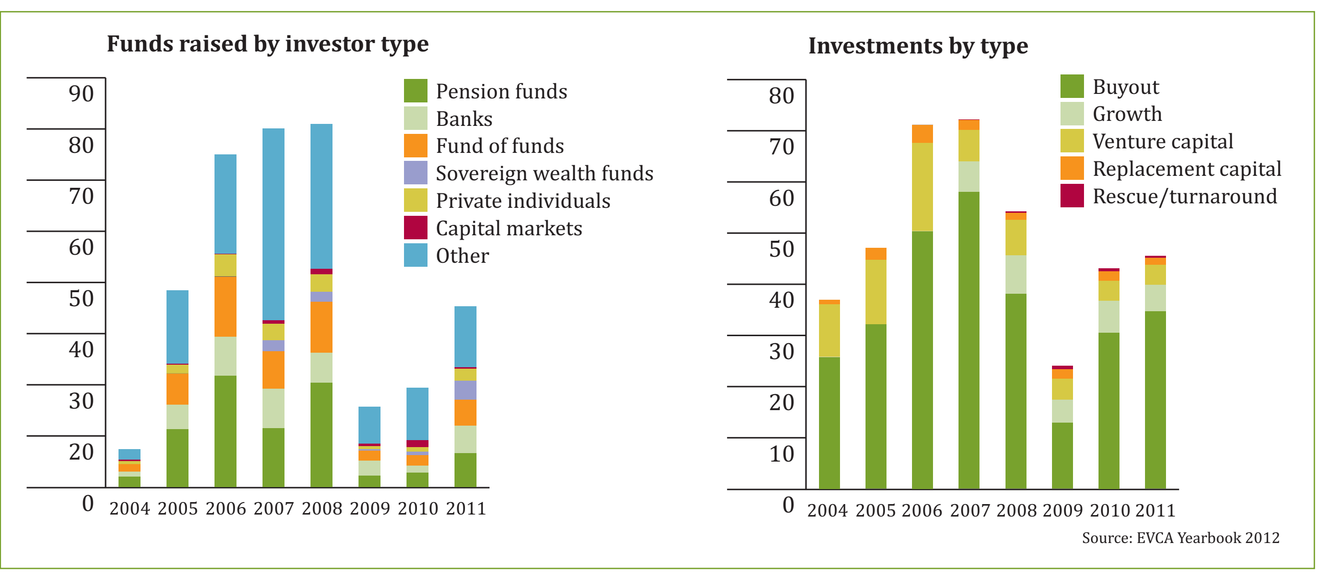
- Generally, financial sponsors indicate that sufficient funding is available for suitable projects, apart from funding formerly provided by CLOs
- The leveraged loan CLO market, used by sponsors to initially finance buyouts, has seen a dramatic decline since 2007, albeit the market has begun to show some signs of improvement with a small number of CLOs launched in 2013
- The 5% retention rule for securitised assets is likely to inhibit the revival of the CLO market. Sentiment is highly divided on the need for this rule in the context of leveraged loan CLOs managed by third party managers

3.5.2 Market context

According to the European Venture Capital Association, private equity and venture capital funds raised grew at a CAGR of 110% from 2004 to 2007, with investments rising by 25% over the same period. As the crisis hit, investments started to fall before the level of new funds raised began to decrease. Both then fell by more than 50% in 2009 before recovering slowly through to 2011, but both remaining below 2005 levels.

Overall fundraising decreased in 2012 by 43% to €23.6 billion compared to 2011. The overall amount of €36.5 billion invested in European companies in 2012 reduced by 19% compared to the previous year. This was due to the weak first half of 2012 coinciding with economic uncertainty in Europe. In contrast, the number of private equity backed companies remained stable at almost 5,000 European companies. Pension funds and fund of funds accounted for almost half of all sources of funds with more than 20% each. Family offices and private individuals, government agencies, and sovereign wealth funds follow as major sources with 10-12% each.

Figure 3.15
European private equity and venture capital funds raised and investments, € billion



Leveraged Buy-Outs (LBOs) and Management Buyouts (MBOs) are typically financed initially in the leveraged loan market, due to the flexibility and speed of loans, with subsequent re-financing in the high yield bond market if and when market conditions are favourable. Financial sponsor-related syndicated loan volumes fell by more than 90% from the boom level of 2007 to less than €20 billion in 2009, followed by a slow recovery. Smaller ticket, bilateral loans were still available during this period, although data on volumes is sparse.

Figure 3.16

European new issuance of financial sponsor-related debt, € billion

Syndicated loans - leveraged

Syndicated loans -IG

350 300 250 200 150 100 50 0

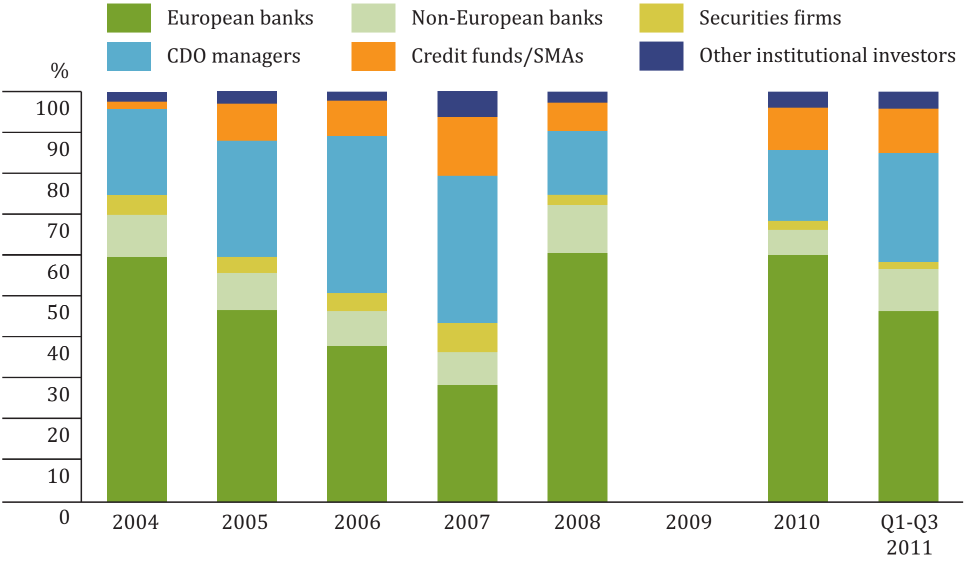
2004 2005 2006 2007 2008 2009 2010 2011 2012

Source: Dealogic, Oliver Wyman analysis

During the pre-crisis boom period, there was a structural shift in the buyers of leveraged loans, moving from primarily a bank market towards an institutional market, as it has been for some years in the US. In 2007, the biggest investor category was CLOs, which represented 36% of the total, with credit funds, separately managed accounts and other institutional investors representing another 60%. When the leveraged loan market opened up again in 2010, this trend had partially reversed with banks again buying two-thirds of deals, although the institutional investor share grew again in 2011, and is showing a further pick-up in 2013.

Figure 3.17

European primary investors in leveraged loans



Source: S&P Capital IQ Leveraged Lending

While the macro economy caused demand side issues reducing the level of financial sponsor deal flow, changes to the CLO market also restructured supply of funds. European CLO issuance volumes fell to virtually zero after 2007, due to a combination of increased spreads required by investors on CLO tranches due to perceived risk of securitisation structures, combined with new regulation which required CLO issuance, including both banks and independent CLO managers) to retain 5% of the total capital structure to retain ‘skin-in-the-game’.

Figure 3.18

Global CLO new issuance[32], € billion

Source: SIFMA, Oliver Wyman analysis

The US CLO market opened again in 2011, partially due to the fact that the 5% rule was not implemented in the US. However, the European market remained closed until Q1 2013, when the first new post-crisis deal was issued. Despite the lack of new issuance, CLO funding was available during the crisis years, as many CLOs issued in or before 2007 were still in a re-investment period. However, most are not coming to the end of this reinvestment period and so unless, there are more new issues, availability of funding for larger leveraged loan deals will decrease.

32. CDO issuance with high yield loans underlying

3.5.3 Barriers to provision of funding

The main issue highlighted by financial sponsors, which prevented higher deal volumes, was the macroeconomic environment and lack of attractive opportunities.

Private equity firm

"Our overwhelming issue is the macro environment but in the the absence of improvement, our business is fine"

Bank

"We are not growing a market for the sake of growing a market – only invest in a market that is appealing"

Private equity firm

"If I wanted to invest in anything else, I would do"

However, some additional challenges were raised:

5% retention rule for securitised assets. Issuers of securitisations must retain 5% of the total capital structure to maintain 'skin-in-the-game'. However, this is challenging for independent CLO managers without significant own capital - the main buyers of primary leveraged loans pre-crisis.

Lack of depth for jumbo deals. Banks and other investors have appetite for small and mid-ticket loans but there is not sufficient investor appetite for large jumbo loans, although this has begun to pick up in recent months.

Mis-perception of risk. Some interviewees felt that investor perception of risk of CLOs and underlying leveraged loans was over-stated.

Private equity firm

"A deal in similar size as Heinz would be very difficult in Europe because you would struggle to find the capacity in the market"

Private equity firm

"There is a misperception that senior secured loans are riskier than public debt, which is simply not the case"

3.5.4 Potential solutions

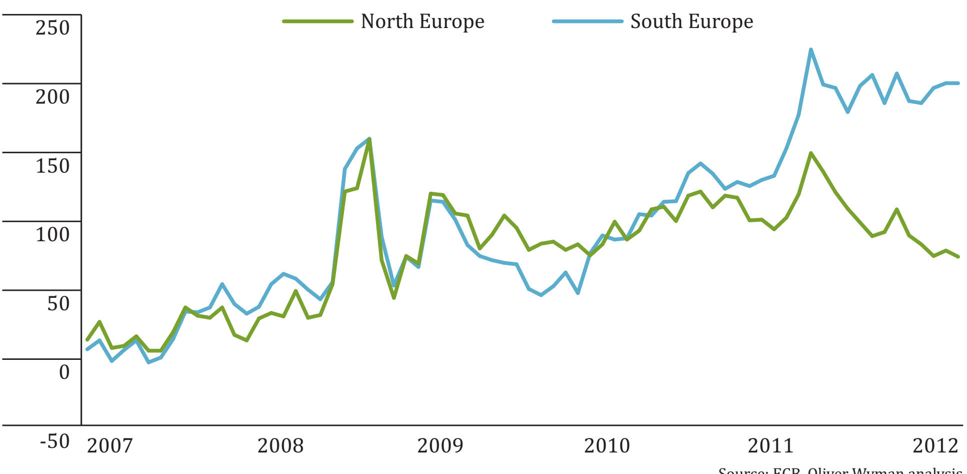
The main solution specific to leveraged loans was to consider creation of exemption from the risk retention rule for CLO managers meeting certain governance requirements such that additional 'skin-in-the-game' is not necessary. However, there were some concerns raised about exemptions on two levels.

- Banks are concerned in terms of creating an uneven playing field.
- Some investors feel that the risk retention rule is appropriate and don't want to see an industry where investors can support credits without any risk.

3.6 Businesses in crisis-affected countries

3.6.1 Highlights

Cost of new corporate loans[33] spread to base rate



Source: ECB, Oliver Wyman analysis

Multinational corporate

"We have a super strong balance sheet but we do not warrant an IG rating because our HQ is in the wrong location"

SME

"Spanish, Italian and Greek businesses are stuck with expensive money"

33. Spread to base rate. North Europe is the average spread of Germany and France; South Europe is the average spread of Italy and Spain

Perceived barriers

Large domestic corporate

"Simply because we are a **Portuguese** company, we have had a lot of difficulties acquiring finance"

Multinational corporate

"The EIB is taking money away from PIIGS because of **credit rating restrictions.** Lending is only available to countries like Germany who have a good credit rating"

Bank

"The **corporate CDS market** is still very liquid, you can't use this as a replacement for the sovereign CDS market"

Private equity firm

"We are not currently focused on Italy and Spain due to **macro instability** in those countries"

SME

"When obtaining a loan it's **not fair** that money in different European countries has a different cost"

Potential solutions

Multinational corporate

"Maybe the ECB should offer **currency convertibility protection** to lenders to remove euro-exit risk from the equation"

Large domestic corporate

"All I desire is that similar companies get **similar rates** – you should not be negatively disadvantaged just because you are based in Portugal"

Multinational corporate

"We're not asking for more cash, we're just asking for a **level playing field with our peers** across Europe. This competitive disadvantage will kill the periphery over time"

Key takeaways

- Corporates in crisis affected countries face more acute challenges than those in other European countries, including further reduced bank lending capacity, increased funding costs and the withdrawal of some institutional lenders
- Investors are increasingly wary of investment in these countries due to continued political instability and concerns over their ability to hedge against country risk

3.6.2 Market context

The global financial crisis has affected different countries to varying degrees, depending on the state of sovereign indebtedness, bank funding and capital strength, real estate over-valuation, and broader economic structure. Greece, Ireland and Portugal have received EU support, while other countries such as Spain and Italy have faced severe sovereign funding challenges.

In the more crisis-affected countries, the funding challenges for SMEs, corporates and infrastructure have been more extreme than in Northern European countries, although driven by a similar combination of factors:

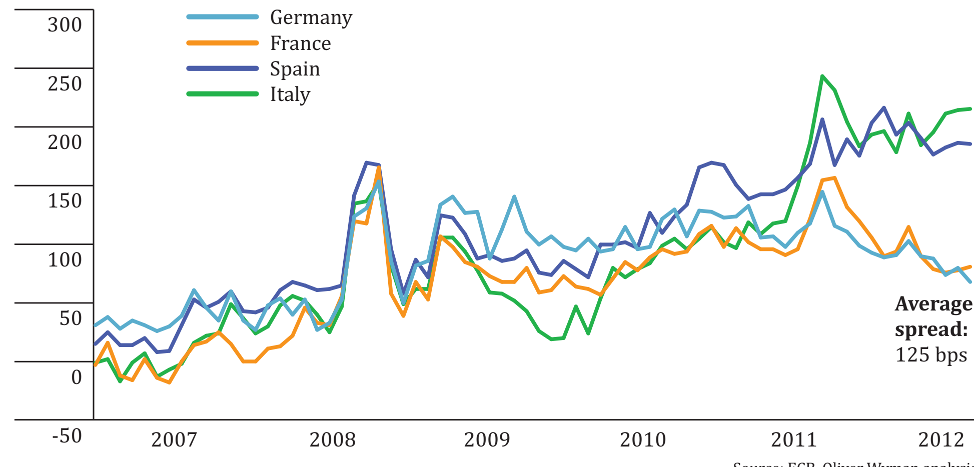
- Macroeconomic uncertainty is still by far the largest obstacle cited by issuers. The ECB's LTRO programme has been very effective in stabilising funding needs of the banks in the short term.
- Recessions have meant that many SMEs and corporates have reduced demand for products and services, thus reducing income and profitability and increase risk of default on credit obligations.
- Elevated credit losses impact bank capital levels, forcing banks to either raise fresh capital or reduce balance sheet size to repair capital ratios.
- A combination of increased sovereign risk, increased bank funding costs and deteriorating ratings SMEs/corporates increases the cost of corporate funding.

Multinational corporate

"Five year money costs us 4.5% spread, I am certain a company like us based in Germany would get money at 100bps"

Figure 3.19

Cost of new corporate loans by country[34], spread to base rate, bps



Source: ECB, Oliver Wyman analysis

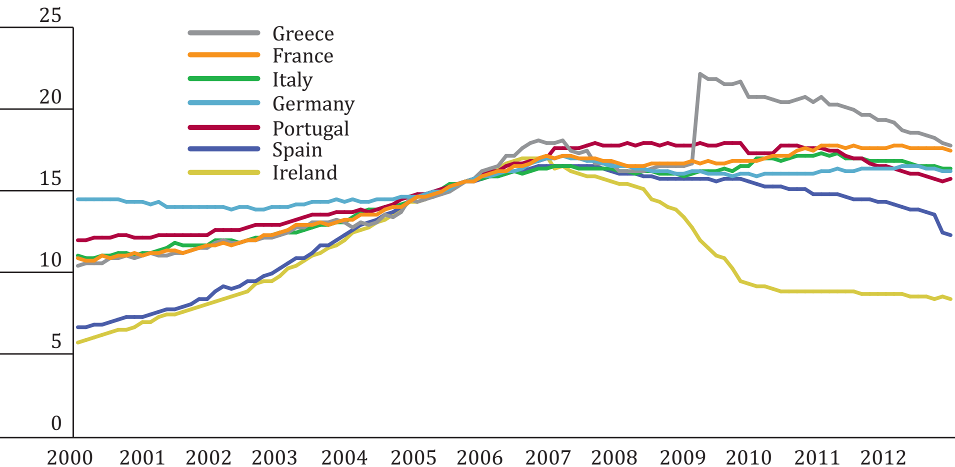
34. Totalled across tenor and ticket size; spread calculated as corporate loan interest rates minus base Euro area base rate

SME

“The greatest barrier to medium/long term funding of Italian SMEs is that banks do not have money to lend”

Figure 3.20

Outstanding loans to non-financial corporates by country[35], € billion

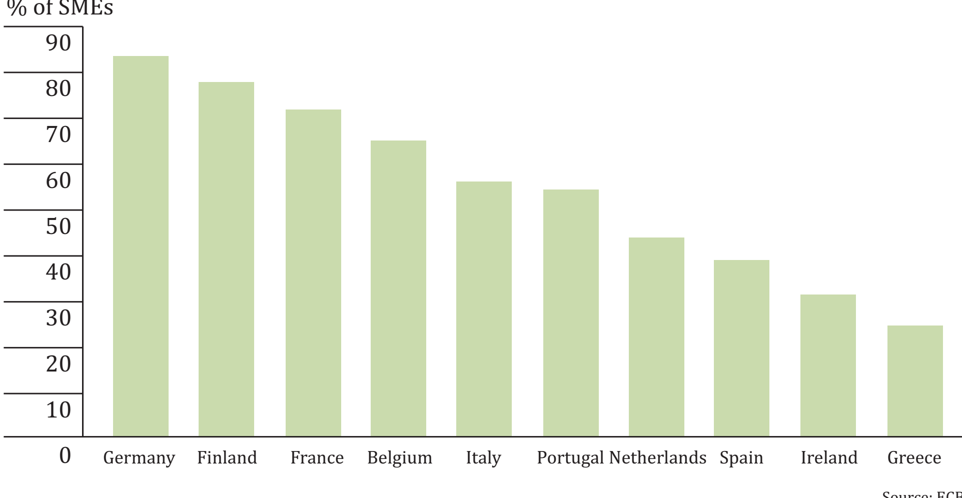


Source: Eurostat, Oliver Wyman analysis

Data from the ECB Lending Survey point to markedly different credit conditions for SMEs in crisis-affected economies, compared to the rest of the Eurozone. The chart below shows that in the second half of 2012, around two-thirds of SMEs requesting a bank loan in Spain, Ireland and Greece were not granted the full amount they requested. This contrasts with around three-quarters of SMEs in Germany, Finland and France which were granted the full loan amount they requested.

Figure 3.21

Eurozone SME loan application/acceptance ratios[36]



Source: ECB

Multinational corporate

“Refinancing for a company our size is not a problem because we have exposure to sophisticated banks and new funding sources; Problem is for smaller companies”

As highlighted in earlier sections, while overall funding levels are down, there is variation at segment and name level. Many large ‘capital-markets-eligible’ corporates have been able to continue to access funding, albeit at increased costs (relative to historical levels and current levels in other countries for similar corporates).

35. Volumes rebased to 100 in Jan 2008, outstanding loans across all tenors

36. Figures show the result of a survey of 7,510 firms conducted by the ECB in Q1 2013. The response shows the percentage of firms who applied for a new or renewed bank loan during the past six months and received the full amount

3.6.3 Barriers to provision of funding

The same barriers exist for businesses in crisis-affected countries, but the impact on funding has been amplified due to the more severe economic situation.

Some additional barriers, exposed by country-specific sovereign crises were raised during the interviews:

Restrictions on EIB funding through banks with lower ratings. The EIB runs an intermediated loan programme in partnership with commercial banks. However, there are minimum rating criteria, which means that EIB loans can no longer be made if the rating of a partner bank falls below this threshold. Given that a rating downgrade is likely to result from a challenging economic environment, this means than public sector funding is reduced at the time when it is most needed – when the local banks are having to deleverage – thus increasing pro-cyclicality.

Sovereign CDS are unusable to hedge sovereign risk element of corporate loans/bonds. The ban on purchase of naked CDS and strict regulations requiring a strong linkage to sovereign risk to qualify as a hedging instrument make it difficult to use sovereign CDS to manage the country risk element of corporate lending. The restrictions will also decrease liquidity in the CDS market, and likely make protection more expensive where it remains possible. Finally, uncertainty around payout criteria for sovereign CDS also reduces effectiveness. Some investors highlighted that these factors would decrease their ability to finance corporates in crisis-affected countries.

Impact of sovereign credit rating on rating of individual corporates within the country. While corporate ratings can go above the sovereign rating, there are defined criteria which constrain how far above they can go (see S&P example below). As a result the rating for corporates of similar financial strength and outlook in different countries can be very different. A lower rating can either prevent access to funding or reduce the amount of funding available, and will likely increase the cost of funding.

Table 3.2
Maximum rating differentiation between the sovereign and the issuer of transaction

Country risk exposure	Sovereign rating		
	Investment grade	BB+ to B	B- to D
Low	6 notches	5 notches	BB+
Moderate	3 notches	2 notches	BB-
High	2 notches	1 notches	B+

Multinational corporate

“[Unrated bond] Price is more expensive but it’s better not having a rating than having a rating that is capped by the sovereign”

Mid-corporate

“Due to difficulties getting affordable funding because we are Portuguese, we are actually thinking of changing our holding base”

3.6.4 Potential solutions

Many, if not all, of the same solutions apply to businesses in crisis-affected countries as apply to those in less affected countries. However, the challenges described above amplify the need for efficient financing markets, with as broad an array of financing instruments and investors as possible.

Additional solutions apply to the specific additional barriers identified above.

1. **Considering the relaxing of EIB and EIF partner bank rating criteria for SME funding and guarantee programmes**, with appropriate mechanisms to limit risks for EIB.

2. **Redefine eligibility for using Sovereign CDS within regulations** to enable loan and bond investors to hedge the country risk component of corporate debt.

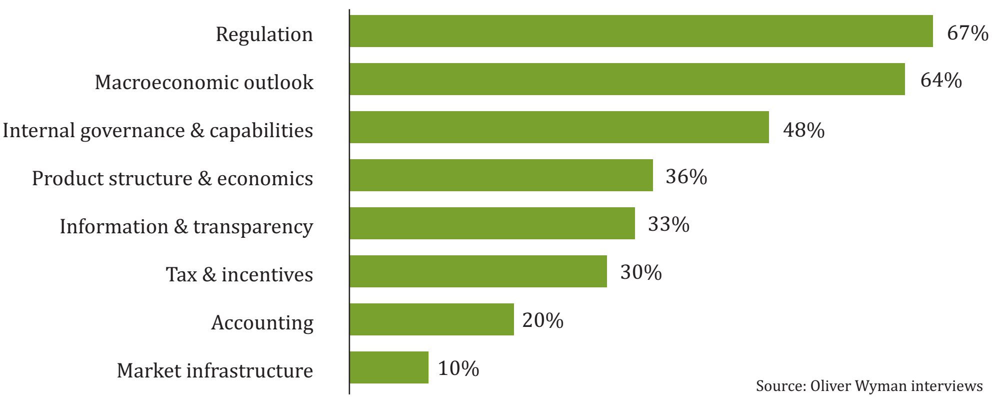
3. **Increase clarity/objectivity of definition and governance around default events for sovereign CDS.** This could improve the willingness of cross-border investors to provide corporate funding with CDS protection against country risk components.

4. **Consider creation of a legal framework for EU-level corporate domiciles** to avoid domiciling in a specific country and any perceived increased risk of expropriation/currency devaluation that this may entail.

3.7 Investors: insurers, pension funds and asset managers

3.7.1 Highlights

Interview respondents citing high or medium barrier



Source: Oliver Wyman interviews

Insurer

"It's difficult to act when you don't know when Solvency II will be implemented"

Pension fund

"A ramp up in Solvency II requirements in an era of deleveraging is asking for trouble"

Asset manager

"One of the fundamental issues of European loan market is the 27 different jurisdictions; Some consistency in those insolvency laws would increase certainty and speed of outcome [of insolvency cases]"

Perceived barriers

Insurer

"The matching adjustment is subject to Member State discretion, which is inconsistent with **Solvency II** harmonisation across Europe"

Insurer

"Our number one challenge remains the **macro economy** – it keeps us on the conservative side no matter what"

Insurer

"The **illiquidity of our liabilities** gives us an advantage over other investors; it allows us to crystalize the returns on those assets without taking risk"

Insurer

"**Investor experience** in another issue: there is an issue in re-tooling loans experts to become investment managers – timescales are different"

Insurer

"Scarcity of **collateral** is going to be critical for all of us, particularly as more of the instruments we trade will be mandatory clearable"

Insurer

"We will have to hold back some assets as **collateral**, which will be negative for yield and performance"

Hedge fund

"**Insolvency laws** are an issue for SME lending in Europe – they are very different between countries so have to take that into account in your price"

Asset manager

"In an organization of our size, there are numerous **investment mandates** and certainly funds that have restrictions on SME lending"

Asset manager

"We are building capabilities for [lending to] mid-cap size firms but we have **no competence for SME lending**"

Asset manager

"SMEs will not give us the disclosure we require and they won't have a credit rating, so our **clients don't want SME assets**"

Asset manager

"**Documentation** makes investment more time consuming – we have to read multiple different documents [when investing abroad]"

Insurer

"Lower cost of capital is crucial - if there was more certainty about **Solvency II** we could make changes"

Potential solutions

Insurer

“We believe the extended version of the **matching adjustment** is the right thing to do – it has quite relaxed asset eligibility requirements”

Insurer

“If you’re buying assets on a buy to hold basis then the balance sheet is effectively immunized from spread risk, so the **capital calculation** should reflect that”

Asset manager

“High yield bonds are illiquid by definition so not an issue selling them under **UCITS**, but the customers have to know what they’re buying”

Pension fund

“If banks are not willing to support us in granting loans to SMEs by performing **credit analysis**, we may consider setting up a lending consortium with other pension funds”

Pension fund

“Solutions that require **government support** will be difficult as they need the money themselves”

Pension fund

“Abandon **EMIR** – it is the wrong solution for the wrong problem, even if Pension funds are exempt for three years costs will still rise”

Insurer

“We would consider **infrastructure bonds** provided they are of the right quality and satisfy the matching adjustment eligibility requirements”

Asset manager

“If **retail funds could buy loans** just like in the US the benefits would kick in immediately and they would be felt throughout the market”

Investor industry association

“PF industry is extremely concerned about harmonisation of Insurer and PF regulation. This is big lever that EC could pull in regards and economic growth”

Asset manager

“**Tax reform** would be good but there will always be pushback”

Asset manager

“**Tax relief** is not a good solution as it attracts retail investors and they are not what you want”

Asset manager

“**IFRS** and treatments of leases are easy standardisations that would help us when looking at corporates across borders”

Key takeaways

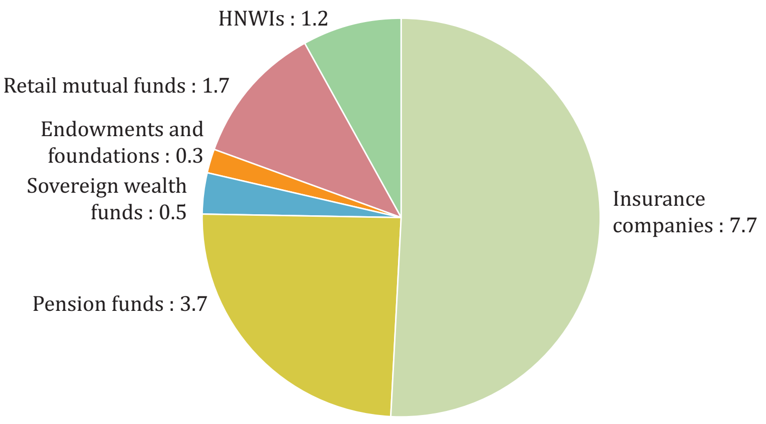
- Unanimous agreement that Insurers are well placed to invest further in long term corporate assets
- The main barrier to insurer allocations increasing is the uncertainty caused by impending Solvency II regulations including capital charges, matching adjustments and counter cyclical premium
- High priority solution proposed is to appropriately calibrate Solvency II and implement as soon as possible
- Concerns about potential negative impact of Solvency II if extended to Pension Funds (IORP). Pension funds also remain concerned about liquidity and many seek higher than debt returns for illiquidity
- Asset managers are largely able to adjust investment strategies based on the macroeconomic climate, and unlike other investors are not overly constrained by regulations
- Many institutional investors lack of understanding/capabilities and mandate to invest in non-traditional assets, e.g. loans
- Facilitation of investment in loans through LTIFs, loan matching platform and performance benchmarks viewed as positive step

3.7.2 Market context: insurers and pension funds

Insurers and pension funds are the largest non-bank institutional investors in Europe, managing approximately €12 trillion of assets as of the end of 2011, representing approximately 75% of non-bank institutional assets under management.

Figure 3.22

Institutional investor assets under management[37], 2012, € trillion



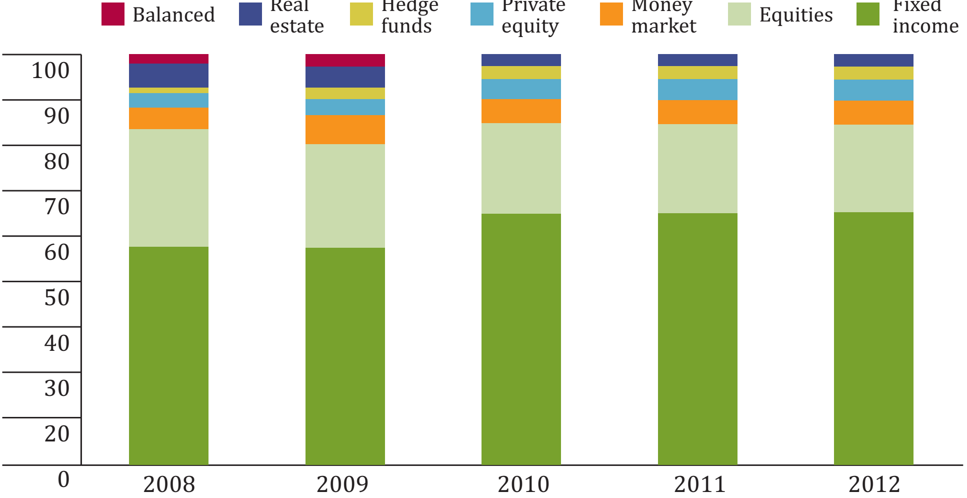
Source: Oliver Wyman analysis, OECD, IMF, EFAMA, Insurance Europe, Philanthrophy in Europe, Foundation Centre, ECB, FSB

Insurers offer different types of products – non-life (motor, household insurance etc.), life insurance and long term savings (traditional life and annuity and unit-linked). Life insurers typically have long-dated predictable liabilities and represent the largest share of total insurer liabilities (and therefore assets), while non-life insurers have a smaller pool of shorter duration liabilities.

Insurers and pension fund investment strategies are driven primarily by the characteristics of their liabilities, and so life insurers typically invest a large portion of their liabilities in bonds which provide stable and long-dated cashflows to match their liabilities. The largest share (36% in 2011) is invested in corporate bonds.

Figure 3.23

European insurer and pension fund asset allocation, %



Source: Oliver Wyman analysis, OECD, IMF, EFAMA, Insurance Europe, Philanthrophy in Europe, Foundation Centre, ECB, FSB

37. The OECD statistical year book represents institutional investors as pension funds, insurers and investment companies e.g. sovereign wealth funds, banks are not defined as an institutional investor. Notes: The asset figures include both assets which are internally managed by the investor and externally managed by third party asset managers

Given the low interest rate environment and low yields available on traditional government and corporate bonds, some insurers and pension funds have started investing in new asset classes that both match their liability profile and also provide more suitable risk-adjusted returns (given policyholder expectations) and diversification benefit. Real estate and infrastructure debt have been the main focus areas to date, but levels of investment remain relatively small at this stage relative to traditional bonds.

There is potential for significant increase in insurer and pension fund investment in non-traditional long-dated corporate debt, as it provides a natural match for long-dated liabilities and also enables them to monetise the illiquid nature of the liabilities through capturing a corresponding illiquidity premium on the asset side. In several countries the current cost of liabilities is also materially lower for insurers than banks, providing a structural economic advantage to insurers as long term holders of debt. If current barriers can be overcome, this could represent a structural shift in the funding landscape.

Solvency II

Solvency II is an EU-wide set of capital requirements and risk management standards requirements governing both financial and non-financial risks taken by insurance companies.

The objectives of Solvency II are to

- improve protection offered to policyholders;
- introduce risk-based, market consistent approach to solvency capital assessment;
- encourage and incentivise insurers to better understand and manage their risks;
- establish consistent and comparable regulatory framework across the EU and across life insurance and general insurance businesses; and
- enhance transparency and public disclosure.

The proposed regulation is structured into three pillars:

1. **Quantitative requirements.** Minimum and solvency capital requirements.

2. **Risk management and supervisory review.** Increased internal controls and focus on senior management governance issues, such as improved understanding of various types of risk, solvency assessment. Also, increased supervisory intervention regarding capital evaluation.

3. **Disclosure requirements.** Information disclosure requirements on risk and capital levels.

Solvency II is based on a market value balance sheet, which considers assets and liabilities at fair or market value. Insurers must then hold additional capital (the Solvency Capital Requirement, SCR) based on the risks they are exposed to (see figure). It is expected to have wide-ranging strategic and operational implications; namely it will trigger fundamental changes in insurers' business models and have implications beyond the insurance industry, e.g. on capital markets due to changes in insurers' investment strategies.

Solvency II was initially expected to be implemented in 2012 but latest estimations suggest it will not be enforced until early 2015.

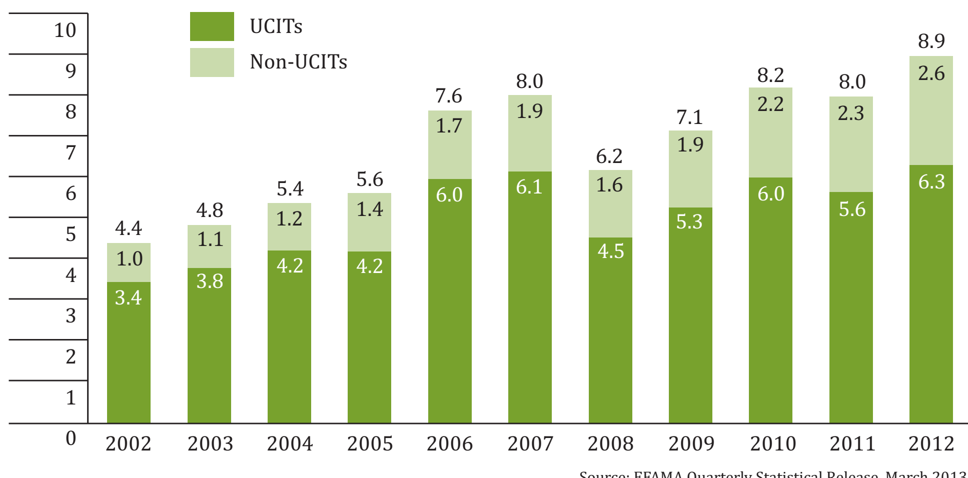
Solvency II balance sheet

Source: Oliver Wyman research

3.7.3 Market context: asset managers

The European asset management industry suffered badly when the financial crisis hit in 2008. As assets lost value, investors withdrew funds, and some funds closed, assets under management (AuM) in Europe fell by 23%, from approximately €8 trillion in 2007 to just over €6 trillion in 2008 (Figure 3.24).

Figure 3.24
European net assets under management for fund managers, € trillion



Source: EFAMA Quarterly Statistical Release, March 2013

Since the crisis the asset management industry has dealt well with new norms in the market, and investors have returned. AuM grew at an average of 10% since the crisis; this is not as strong as the pre-crisis bull markets which grew at approximately 13% per year up to 2007.

The increase in Investment fund assets in Europe of 12.4% to €9 trillion in 2012, was driven by a 14% increase in non-UCITS assets, with UCITS assets increasing by 12%.

Net sales of long term UCITS funds[38] and money market funds were positive in 2012 (approximately €200 billion), after recording a net outflow of €97 billion in 2011. This net outflow in 2011 corresponds to the deepening European crisis during that period. This theme is replicated during the relative recover felt in 2009 and 2010, which flowed a large net outflow of approximately €360 billion in 2008. The surge in demand for long term UCITS funds compared to money market funds may have resulted from the effects of the low interest rate environment, compounded by increased competition from banks for deposits.

Long term UCITS funds recorded net inflows of €239 billion. This was primarily attributed to bonds funds, which suggests investors remained cautious, preferring the safety of bonds over equities. However, this trend may be redressed in early 2013 as equity markets rebound sharply.

3.7.4 Barriers to provision of funding

Interviews and other industry discussions highlighted several challenges facing institutional investors in increasing funding available for corporates and SMEs:

1. **Solvency II.** Solvency II will introduce a harmonised capital adequacy framework for insurers across Europe with the main objectives of protecting policyholders and improving risk management. The industry is broadly supportive of the objectives and

38. Long term UCITS funds includes equity linked funds, balanced funds, and bond funds

approach of Solvency II. However, several issues were raised which may disincentivise insurers from investing in long term assets. These include:

- **Calibration of capital requirements.** Solvency II relies on either standardised or internal model-based parameters to calculate capital requirements. The insurance industry, as well as the European Commission (via Jonathan Faull's letter to EIOPA dated September 2012) highlighted concerns regarding the current level at which parameters are set for financial risks, particularly for infrastructure finance, project bonds, securitisation and SME financing. If capital requirements overstate the risk associated with investing in certain asset classes, this will naturally create a false bias away from investing in those assets.

- **Narrow definition of matching adjustment to mitigate balance sheet volatility.** Under the Solvency II proposals, assets are held on the balance sheet at market value, while liabilities are discounted at swap rates. While underlying interest rate changes will affect both assets and liabilities, changes in credit spreads will affect only the asset side, creating balance sheet volatility. For investments which are held to maturity, the change in credit spread does not necessarily affect the future asset cashflows (unless there is a default), and so this approach can lead to artificial volatility. Given that investors penalize volatility, this could disincentivise insurers from investing in long-dated credit assets (either loans or bonds). A matching adjustment approach has been proposed to align the discount rate applied to both assets and liabilities and thus reduce this volatility. However, there is concern that the current proposals have too narrow a scope and will not fully solve the issue. Moreover, matching adjustment specifics are subject to member state discretion, which could cause inconsistency of eligibility across Europe, in conflict with the harmonisation objectives of Solvency II.

- **Concerns regarding finer details of Solvency II.**

  – Funds cannot simultaneously qualify for matching adjustment and the counter-cyclical premium, which poses a concern if the extended matching adjustment version is applied, whereby not all assets qualify for matching adjustment.

  – Further, there are concerns about how the counter-cyclical premium and matching adjustment will be applied to businesses outside Europe. Argument that EU based insurers should be permitted to take credits for matching assets on non-EU balance sheet.

  – Extrapolation of data beyond last liquid point (LLP) opens up the risk that markets will put in place artificially short LLP to benefit balance sheet view. This could lead to inconsistencies between the curves used for assets and hedges.

- **Implementation timing.** Solvency II was originally proposed in 2009, but has been subject to multiple delays and is not yet finalized. This creates uncertainty for insurers and has caused some insurers to hold off making investments in new long term assets until the regulatory treatment is clarified.

Pension fund

“A ramp up in Solvency II requirements in an era of deleveraging is asking for trouble”

Investor industry association

“The short term volatility that Solvency II captures makes no sense for assets generally held for life”

Asset manager

“Funds that I manage are being constrained by insurance regulations; Solvency II regulations are creating uncertainty”

Insurer

“We have been waiting for Solvency II for years and years - if you want to make long term investments in loans, you need certainty”

Insurer

“Lower cost of capital is crucial – if there was more certainty about Solvency II we could make changes”

2. **Pension fund regulation – IORPs Directive.** The European Commission plans to review the Institutions for Occupational Retirement Provision (IORPs) Directive, including ensuring a level playing field between IORPs and insurers under Solvency II. Pension funds have raised similar concerns as those highlighted above by insurers on the impact that this could have on investment strategies and asset allocation.

Returns for pension funds are critical to providing sufficient pension pots for customers. Thus, any regulation that increases costs or restricts pension funds' ability to hedge risks should be considered carefully.

Investor industry association

"PF industry is up in arms about harmonisation of Insurer and PF regulation"

Investor industry association

"There seems to be a total lack of understanding in the Commission that if PFs cannot trade in the markets then they cannot achieve returns for their pensioners"

Investor industry association

"In a low return environment, the cost issues are extremely important - they can take the majority of the returns and future benefits for pensioners"

3. **Lack of legal framework for investment in illiquid loan assets.** The current UCITS framework is restricted to liquid assets, with no equivalent for illiquid assets such as loans.

4. **Lack of understanding and mandate for many institutional investors to invest in non-traditional assets, e.g. loans.** This is partly driven by lack of data on loan performance and other characteristics.

5. **Expiration of clearing exemption under EMIR.** Concerns that expiry of pension fund EMIR clearing exemption will reduce investment in growth assets. Pension use of long-dated derivatives would necessitate significant portions of funds to be placed in cash for collateral for clearing.

6. **Concerns about the impact of various proposed financial sector regulations on secondary market liquidity** (e.g. FTT, MiFID 2, UK ICB and Liikanen ring-fencing). Liquidity remains a key concern for many investors and any regulations which reduce secondary market liquidity in certain asset classes could restrict levels of investment.

7. **Volatility caused by fair value of buy-to-hold loan investments.** A key advantage of insurers is that they have long-dated illiquid liabilities which could be used to fund long dated illiquid assets. However, any mismatch between the way assets and liabilities are valued in financial accounts, could result in volatility which could then force investors to take a shorter term investment horizon, thus losing the illiquidity value of the liabilities.

8. **Corporate insolvency regimes vary significantly across Europe, resulting in investors avoiding some asset classes and countries entirely.** However some investors noted that this was not necessarily a barrier, but rather a competitive advantage for those investors willing to invest in gaining a deep understanding of the insolvency regime in a particular country.

9. **Difficulties in matching long term investors with new European capital markets borrowers.** Despite several conferences and other fora, there remains disconnects between borrowers, investors and banks in terms of asset class knowledge and preferences or requirements in terms of deal structuring.

10. **Expertise/resource constraints.** While some investors have appetite for new corporate asset classes, such as loans and/or infrastructure finance, they are restrained by their internal capabilities and resources for assessing and managing credit risk. Most investors have strong capabilities for investing in bonds, including corporate bonds. However, loans typically require a greater level of credit expertise than bonds, due to the tailored nature of loan documentation and increased level of credit management (drawdowns, covenants, security etc.).

    Some insurers have been able to leverage expertise from historical investment in physical assets (e.g. commercial real estate) to support investment in related loans. However, many insurers and pension funds still have a gap in illiquid credit capabilities. Willingness to invest in developing credit capabilities will depend on the expected volume of investment activity and the spread available. For example, one market participant highlighted that uncertainty over future volumes of infrastructure finance was deterring investors from developing infrastructure credit capabilities.

11. **Levels of return.** Some investors, particularly asset managers, stated that current levels of return available from some asset classes (e.g. SME) were simply insufficient to compensate for the level of risk and lower liquidity compared to other asset classes.

12. **Tax-efficiency of long term savings and investments.** In many countries there has been a trend towards removal of tax incentives associated with investment in insurance products and pensions. There is a risk that this reduces the level of long term saving and thus reduces the size of the pool of funds available to invest in SMEs and corporates.

3.7.5 Potential solutions

Several potential areas have been identified which could enabled greater availability of funding from insurers and pension funds.

1. **Ensure appropriate calibration and implementation details of Solvency II.** Ensure Solvency II parameters are appropriately calibrated in line with asset class risk profile, to avoid economic incentives/disincentives which are not risk-based. In particular, the European Insurance and Occupational Pensions Authority (EIOPA) has launched a review of how Solvency II could impact products with long-term guarantees. There are two key elements of the discussions:

    - **Capital requirements for financial risks**, including investments in loans and securitisations. Work has been launched by Jonathan Faull's letter to EIOPA dated September 2012, which is part of EIOPA's discussion paper.

    - **Artificial volatility** of insurer's balance sheets, including the impact of the counter-cyclical premium, matching adjustment and extrapolation, which is done through the long-term guarantee adjustment.

    Interviewees supported this review and the proposed changes to reduce artificial volatility and avoid discouraging investment in long-term finance. However, they cite the uncertainty of these elements as a barrier to current investment.

2. **Review impact of potential extension of Solvency II principles to pension funds.** Carefully consider the impact of any potential changes to pension fund regulation. In particular, recognize the economically significant differences (e.g. sponsor covenant, possibility to reduce pension benefits, guarantee schemes)

between pension funds and insurance companies when considering the extension of Solvency II principles to pension funds. However, one should also consider the impact of leaving the pension funds' regulatory framework unchanged while occupational pension products provided by insurers would be regulated by Solvency II. Care should be taken to avoid the potential for regulatory arbitrage, since this would have negative results for the insurance sector and would provide less pension security for pension fund members and beneficiaries.

3. **Establish legal framework for long-term investment funds (LTIFs)** or alternative structure, to enable institutional investors (only, at least in the initial stages, and then potentially make them available to retail investors) to invest indirectly in long-term assets. Solvency II requires that insurers look through to underlying assets in collective funds, which means data would have to be available to a high standard to allow Insurers to report on an individual asset basis. This means the big benefit would be in getting access to retail money over the longer term. By establishing a framework for such funds, this could enable institutional investors to assign an asset allocation to this asset class within investment mandates, potentially opening up a large volume of assets and increasing liquidity in the market. Some interviewees believed that the existing UCITS classification could be extended to include loans, which would also open up the asset class to a substantial universe of new investors. However, interviewee respondents had mixed views with a significant number of others believed that it was inappropriate to include illiquid loans within UCITS.

4. **Consider development of EU loan price/return benchmarks, and increase availability of information of non-traditional asset classes (e.g. loans) to inform investment mandates.** While this was considered important by some interviewees, it was also considered challenging because to really add value would require that the index is investible, which is likely to be difficult to achieve. However, a quasi-index might still be valuable.

5. **Review current three-year exemption to EMIR clearing requirements for pension funds.** Consider either extension or permanent exemption.

6. **Active dialogue between regulatory community and end users such as corporates and investors** on implications of secondary market liquidity.

7. **Review accounting treatment of securities and loan investment to ensure that accounting treatment is not a barrier to investment.** For example, experience with German Schuldschein indicates that the loan form of investment (as compared to the security form) can be crucial in order not to trigger mark to market accounting. This should include a review impact of IFRS accounting of credit-related assets on financial statement volatility, in coordination with development of Solvency II matching adjustment.

8. **Harmonisation of European insolvency regimes.** Again, as described earlier as a concern for corporates, a significant cross border concern for investors was the regional differences in insolvency regimes. At best these discrepancies increase the cost of funding in certain countries, at worst they prohibit investment altogether. Harmonisation of these regimes across countries could increase the level of cross-border investment and reduce the cost for borrowers in some countries.

9. **Establish a European investor and borrower forum.** Establish European or national forum to bring together institutional investors and borrowers from relevant asset classes (e.g. infrastructure, commercial real estate) to promote investor understanding of the asset classes, inform borrowers of investor preferences and support matching of borrowers and investors.

Unlocking funding for European investment and growth

An industry survey of obstacles in the European funding markets and potential solutions

4. European Commission Green Paper consultation – main topics

4. European Commission Green Paper consultation – main topics

The European Commission Green Paper on the long term financing of the European economy[39], was released on the 25th of March 2013. This report is intended to address some of the questions raised in that paper by the Commission. The Green Paper focuses on four key areas of long term financing:

1. The capacity of financial institutions to channel long term investment

2. Efficiency and effectiveness of the financial markets to offer long term financial instruments

3. Cross-cutting factors enabling long term saving and financing

4. The ease of SMEs to access equity

AFME will separately submit a detailed response to the Green Paper.

39. http://ec.europa.eu/internal_market/finances/financing-growth/long-term/index_en.htm

Unlocking funding for European investment and growth

An industry survey of obstacles in the European funding markets and potential solutions

Annex A
Additional sources of information

Annex A - Additional sources of information

Note 1: Pan-European SME Funding

http://ec.europa.eu/economy_finance/financial_operations/investment/sme/index_en.htm

Note 2: EIB Group 2013-2015 operational plan

http://www.eib.org/infocentre/publications/all/operational-plan-2013-2015.htm

Note 3: CIP 2007-2013 SME guarantee facility

http://www.eif.org/what_we_do/guarantees/cip_portfolio_guarantees/index.htmf

Note 4: EIF RSI guarantee programme

http://www.eif.org/what_we_do/guarantees/RSI/index.htm

Note 5: EIF credit enhancement operations

http://www.eif.org/what_we_do/guarantees/credit_enhancement/index.htm

Note 6: EIF JEREMIE programme

http://www.eif.org/what_we_do/jeremie/index.htm

Note 7: Economic benefits of high quality securitisation to the EU Economy

http://www.afme.eu/workarea/downloadasset.aspx?id=7307 (pdf download)

Note 8: Securitisation data report

http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=8411 (pdf download)

Note 9: ECB press announcement

http://www.ecb.europa.eu/press/pressconf/2013/html/is130502.en.html

Note 10: Project bond programme overview and regulation

10a. http://ec.europa.eu/economy_finance/financial_operations/investment/europe_2020/

10b. http://www.bei.europa.eu/products/project-bonds/index.htm

10c. http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:204:0001:0010:EN:PDF

(pdf download)

Note 11: EU regional cohesion funds

11a. http://ec.europa.eu/regional_policy/what/future/proposals_2014_2020_en.cfm

11b. http://ec.europa.eu/regional_policy/sources/docgener/informat/2014/financial_instruments_en.pdf (pdf download)

11c. http://ec.europa.eu/regional_policy/sources/docoffic/official/regulation/pdf/2014/proposals/regulation/general/amended_general_proposal_22042013_en.pdf (pdf download)

11d. http://ec.europa.eu/regional_policy/thefunds/funding/index_en.cfm

Note 12: Procurement procedure and financing best practice

12a. http://ec.europa.eu/internal_market/publicprocurement/index_en.htm

12b. http://www.eib.org/epec/resources/epec-state-guarantees-in-ppps-public.pdf (pdf download)

12c. http://www.eib.org/epec/resources/Termination_Report_public_version.pdf (pdf download)

Unlocking funding for European investment and growth

An industry survey of obstacles in the European funding markets and potential solutions

Annex B
List of participants

Annex B - List of participants

Aberdeen Asset Management

Alcentra

Anglian Water

APG

Associated British Foods

AXA

Babson Capital

BBVA

Bischof and Klein UK Ltd

British Land

Citi

CPP Investment Board

CVC Credit Partners

Drax Power

ECM Asset Management

EEF

Energias De Portugal (Edp)

European Association of Corporate Treasurers (EACT)

European Fund and Asset Management Association (EFAMA)

European Venture Capital Association (EVCA)

First Sensor

France Telecom

Funding Circle

Galp Energia

GDF Suez

Granarolo

Grosvenor Group

Group Pestana

Guardian Financial Services

Haymarket Financial

Heraeus

HSBC

ING

INREV (Investors in Non-listed Real Estate Vehicles)

Insurance Europe

Intergen

KBC Group

Kronos Kapital

Lloyds Banking Group

M&G Investments

Mercer

Montagu Private Equity LLP

National Grid

Naturex

Pensions Europe

Permira

Pick & Go

Pirelli

Polo Tecnologico di Pavia

Pru M&G

Rabobank PF

RES Group

RKW HydroSpun

RWE Group

SAP

Scottish Widows

Seibold & Cie

Société Générale

Stag Lodge Stables

Standard Life

Standard Life Investments

Swiss Re

UEAPME (European Association of Craft, Small and Medium-sized Enterprises)

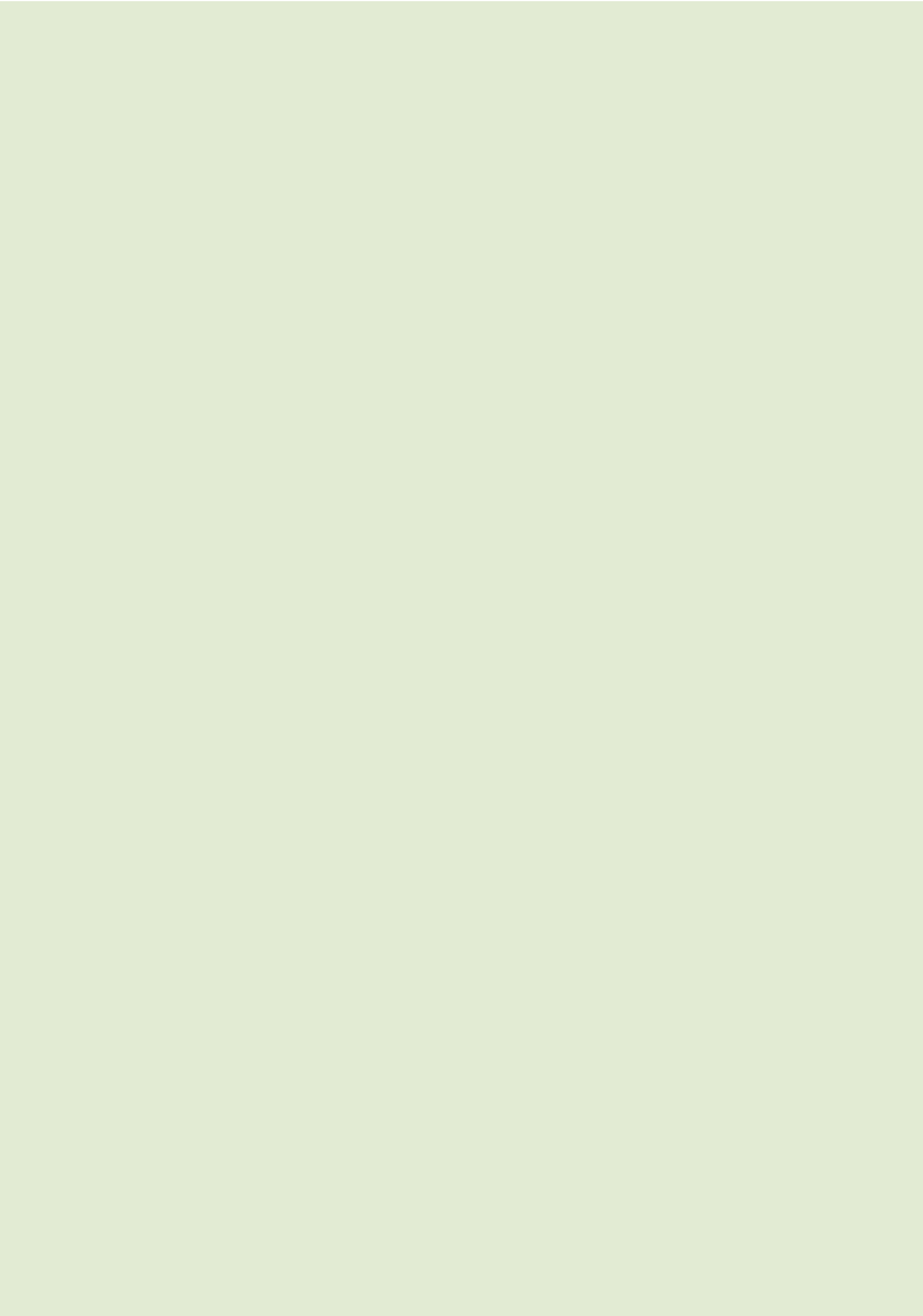
UniCredit

Wellcome Trust

Widney Manufacturing Ltd

Zeppelin

Note: Some interview participants chose to remain anonymous



London Office:
St Michael's House
1 George Yard
London EC3V 9DH
United Kingdom

Switchboard:
+44 (0)20 7743 9300
Facsimile:
+44 (0)20 7743 9301

Brussels Office:
Square de Meeûs 38-40
1000 Brussels
Belgium

Switchboard:
+32 (0)2 401 8724
Facsimile:
+32 (0)2 401 6868

www.afme.eu