POSITION PAPER

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ACCESS TO FINANCE FOR SMEs: THE COMMISSION ACTION PLAN AND POLICY CHALLENGES AHEAD

KEY MESSAGES

1 BUSINESSEUROPE supports a number of regulatory initiatives proposed in the Action Plan, notably the proposal for introduction of a harmonised regime for cross-border operations of small-sized venture capital funds. Other initiatives related to SME growth markets and financing of social entrepreneurship are much less well designed and should be thoroughly rethought.

2 The Parliament has recognised that the current Commission proposals for revising banks' capital requirements (CRD IV - CRR) would have severe undue negative impacts on the financing of SMEs. BUSINESSEUROPE strongly supports the amendments voted on 14 May 2012 by the Parliament's Economic and Monetary Affairs Committee, aimed at recalibrating in a more realistic way the formulae assessing the SME risks that have to be covered by bank capital. It is now vital that the Council of Ministers takes these amendments on board.

3 BUSINESSEUROPE strongly supports the introduction of the Equity Facility for Growth (EFG) and of the Loan Guarantee Facility (LGF) proposed in the COSME programme. Because of the high leveraging effect of these two instruments, the budget proposed for the EGF and LGF (i.e. 1.4 billion euros for 2014-2020) should be significantly increased.

WHAT DOES BUSINESSEUROPE AIM FOR?

- There has been deterioration in the availability of bank loans since the end of 2008, despite the fact that the demand for loans is still at a moderate level. Every effort must be made to prevent this problem from becoming worse when economic activity starts to pick up, placing a serious brake on this recovery.
- Given the deterioration in the availability of bank loans, it is essential to take measures at EU and national level to encourage the offer of and demand for alternative types of finance.

KEY FACTS AND FIGURES

SME success rate in obtaining lending (2007=100):			
Success rate 2007	100	Success rate 2010	81
Source: Eurostat, October 2011			

A. Background: trends regarding availability of external financing for European SMEs

Two recent European studies, namely:

- The ECB survey on the access to finance of small and medium-sized enterprises in the Euro area (October 2011 to March 2012) - (April 2012)
- And the Eurostat statistics on SME access to finance (3 October 2011),

find that the access of European SMEs to finance has significantly deteriorated. The salient elements of these studies are as follows:

- For the sixth consecutive six-month period, SMEs that had applied for bank loans have perceived a further deterioration in the availability (supply) of bank loans between October 2011 and March 2012. For this period, the perception of a deterioration increased in net terms from 14% to 20%. The deterioration in the availability of bank loans was much less pronounced for large firms (4% in net terms, down from 10%).

- When asked about the actual outcome of their bank loan applications, 13% of the SMEs reported that their application had been rejected (up from 10% in the first half of 2011). In particular micro firms (1 to 9 employees) reported a substantial rejection rate (20% up from 15% the first half of 2011).

- The success rate in obtaining finance severely decreased when comparing 2010 with 2007. The success rate decreased by 19 percentage points for loans, 15 percentage points for equity and 10 percentage points for other finance.

Regarding the flow of venture capital to companies, this shrank from € 17 billion in 2000 to € 3 billion in 2010[1]. At the end of this period, 60% of venture capital investments were being made by institutions in the public sector, a situation which is not sustainable in the long term.

B. Comments on the Action Plan initiatives with a budgetary dimension

BUSINESSEUROPE fully supports the Action Plan[2] proposals designed to use the leverage of the EU budget to improve SME access to finance (included in the COSME[3] and Horizon 2020 programmes). These proposals establish a good balance between measures aimed at improving access to loans and access to risk capital. BUSINESSEUROPE commented on the COSME programme proposal in an opinion dated April 2012.

[1] Source: EVCA
[2] Commission Action Plan to improve access to finance for SMEs – doc. COM 2011-870 final of 7 December 2011
[3] COSME: Commission proposed programme on the Competitiveness of Enterprises and SMEs

In particular, BUSINESSEUROPE strongly supports the introduction of the Equity Facility for Growth (EFG) and of the Loan Guarantee Facility (LGF) proposed in the COSME programme. Because of the high leveraging effect of these two instruments, the budget proposed for the EGF and LGF (i.e. 1.4 billion euros for 2014-2020) should be significantly increased.

While there are clear needs for mezzanine finance, these needs do not sufficiently attract the attention of fund managers. Against that background, initiatives like the on-going EIF Mezzanine Facility for Growth (MFG) are very important, and BUSINESSEUROPE insists that the EGF must amplify the action of the MFG.

Mezzanine finance should in fact receive more attention in the overall Commission SME financing strategy.

There are two reasons why mezzanine finance is important. Firstly, mezzanine finance is relevant for many owners of SMEs for whom it is not attractive in the given situation to give up to their ownership partly or fully. Secondly, mezzanine finance is relevant for companies unable to obtain debt financing due to low equity ratio. Finally, companies with mezzanine capital are often able to obtain additional and more attractive bank loans, since the mezzanine finance is subordinated to all other types of loans.

C. Comments on the Action Plan initiatives with a regulatory dimension

1. Proposed EU Regulation on Venture Capital funds

BUSINESSEUROPE supports the proposal. However, in the forthcoming legislative process it is of vital importance to pay close attention to the administrative burdens imposed on fund managers and on portfolio companies by this piece of legislation. Too heavy administrative burdens could hamper venture capital investment activities and/or prevent businesses from seeking venture capital.

2. The need to correct the artificially high SME risk weights included in the Commission proposal for revised bank capital requirements (CRD IV – CRR)

a) Analytical background

BUSINESSEUROPE supports regulatory initiatives that serve the fundamental objective of ensuring financial market stability. But reforms must strike the right balance and be mindful of their effects on access to finance.

At a time when the precise details of the proposals for a directive and a regulation on capital requirements for banks (CRD IV[4] – CRR[5] file) are being discussed, in the context of implementation of Basel III, it is important to evaluate whether Basel II has been designed satisfactorily, notably from the angle of ensuring long-term cost-efficient SME access to bank loans. As is known, European SMEs are highly dependent on

[4] CRD IV: proposed 4th revision of the bank capital requirements directive
[5] CRR: proposed bank capital requirements regulation (proposal for a regulation on prudential requirements for credit institutions and investment firms)

bank loans, and any measure which unnecessarily impedes the capacity or willingness to grant loans to SMEs is therefore completely undesirable.

At the 8 March 2012 meeting of the European SME Finance Forum, Professor Dietsch, of Strasbourg University, shed some light on this issue. He presented the results of a study the purpose of which was to assess if the level of capital requirements specified by Basel II were set at a correct level for covering the risk of unexpected losses in the case of SMEs loans.

The study, based on data relating to 900,000 French SMEs for the period 2003-2011, shows that the regulatory capital requirements defined by Basel II were significantly and consistently higher than the economic capital requirements over the whole period. In other words, the regulatory capital requirements have been set at a much higher level than required by economic reality.

For French SMEs with a turnover of between 10 and 250 million Euros, the Basel II overcharge factor is:

- More than 3 for the health sector and the wholesale sector (meaning that the regulatory capital requirements have proved to be three times higher than the economic capital requirements);
- More than 4 for the real estate sector and the construction industry;
- More than 5 for the services to business, and the retail sector;
- More than 8 for the transport sector;
- More than 30 for the manufacturing sector.

This gap between regulatory charges and economic charges is largely due to the very simplistic way in which the bank capital requirements for SMEs loans are calculated under Basel II. The formula for assessing a key parameter for risk calculation (the so-called "asset correlation") is provided top-down by the regulator, but is not based on scrutiny of real economic data.

With this simplistic top-down approach for risk calculation, it is not possible to assess SME risk weights in a way that captures the reduction in the credit risk made possible by a good diversification of loan portfolios. The top-down approach results in over-estimating the risk weights that have to be used for calculating the risk weighted assets to be covered by bank capital[6].

The overestimation of the SME risk weights present in the Basel II framework has been carried over in Basel III. This fact, combined with the enhanced bank capital requirements foreseen in Basel III and in the relevant Commission implementation proposals (CRD IV – CRR), will lead to a reinforcement of the artificial disincentives which exist today at bank level for providing loans to SMEs.

[6] More specifically, asset correlation for SMEs exposures (as well as for other exposures) is assumed by the regulator to range between predetermined values according to the type of portfolio (retail or corporate). Nevertheless, the SMEs asset correlations calculated on the basis of empirical data have an average (and maximum) value which is significantly lower than the minimum implicit in the Basel formulas.

The current Commission capital requirements proposals based on Basel III have increased the bank capital requirements for a typical SME loan by a factor of 1.3125 compared with Basel II[7], which already required too much capital. With a view to remedying this inappropriate increase, a practical approach consists in correcting the risk weights attributed to SMEs in CRD IV-CRR by multiplying them by 0.7619 so as to cancel out the increase.

b) Consequences for the future institutional negotiations

BUSINESSEUROPE welcomes the fact that the Commission's Action Plan reflects an awareness of the need to examine the impact of Basel III on SME financing. However, the Commission's timetable for working on this issue with the European Banking Authority is much too protracted. BUSINESSEUROPE very strongly supports the current approach developed by the European Parliament's Economic and Monetary Affairs Committee (ECON) to avoid creating a situation where lending to SMEs would artificially become an unattractive business proposal for banks.

In particular, BUSINESSEUROPE very much supports the adoption by the ECON Committee, on 14 May 2012, of amendments to article 87 of CRR introducing a "supporting factor" of 0.7619 to be applied after the traditional risk weight calculation. These amendments rightly indicate that the supporting factor should be applied to all SMEs irrespective of which risk assessment approach their bank adopts[8]. It is essential now that the July 2012 EP plenary session and the Council of Ministers take these amendments on board.

3. <u>The need to amend the CRD IV proposals with a view to preserving SME access to trade finance</u>

Short-term trade finance instruments and export credits are self-financing and subject to a very low risk, but Basel III does not take this into account and starts to have unintended negative impact on exporting and importing SMEs. Basel III requires banks to weight to 100% letters of credits that used to be weighted only 20%, (or for some other trade finance tools up to 50%). The capital charge is therefore multiplied by a factor of up to 5, and will be passed on as a cost to clients. These financing tools are also becoming a less attractive business proposal for banks. Being recognised as low risk, they generate low profits for them. On top of that, given that banks are already anticipatively applying Basel III rules, trade finance and export credit instruments are seen by banks as tying up a high amount of capital. Therefore many European banks have decided that they will not continue to provide this type of financing, should the CRD IV proposal become legislation. The real economy, and in particular the exporting SMEs, are the first to suffer, at a time where they have to look for clients where the growth is.

[7] 1.3125 = 10.5% / 8%, where 10.5% is the Basel III Tier I + Tier II capital requirement, and 8% the Basel II Tier I + Tier II capital requirement
[8] Internal Ratings-Based (IRB) approach or standard approach.

The ECON Committee of the European Parliament identified and addressed many of these issues in their “Trade Finance Package”. These amendments were included in the Parliament’s report on CRD IV, which was approved on 14 May 2012. BUSINESSEUROPE strongly supports this report and is now encouraging EU Member States to give favourable attention to this “Trade Finance Package” and to direct the Council negotiations along the lines described therein. The package amends CRD IV in a way that recognizes the importance of trade finance to European companies and will help to ensure their ability to engage in international trade.

BUSINESSEUROPE also encourages legislators to consider revisions that ensure that export credit is also properly treated under the CRD IV regulation. Medium- and long-term export credit provides borrowers, many of which are SMEs, with a stable source of funding for projects longer than a year in tenor, backed in large part by Export Credit Agencies (ECAs). Being guaranteed by ECAs, medium- and long-term export credit is also a low risk credit, a fact that is not recognised by Basel III. Including recognition for these important products in the CRD IV will also promote growth in European markets.

4. Measures to improve the access to capital markets

BUSINESSEUROPE welcomes that the Commission will reduce the burden on listed SMEs for example by eliminating quarterly reporting and through a wider use of templates prepared by ESMA (the European Securities and Markets authority). BUSINESSEUROPE also welcomes the Commission's intention to improve access to information about listed SMEs, thereby improving their ability to obtain financing.

Member States should consider the adoption of fiscal incentives for SMEs willing to be listed on a stock exchange, in order to offset, entirely or partially, the listing costs.

5. Fostering SME growth markets

We agree that access to capital markets for SMEs should be enhanced. As a consequence of the impact of Basel III on SMEs financing, we believe that this is a crucial issue which should be dealt with under a global approach. We are however not convinced that the technical measures proposed under the revised Markets in Financial Instruments Directive (MiFiD) with the specific aim of fostering SME growth markets provide the best response to the problems:

- Registration as an SME growth market could entail considerable administrative burdens for existing trading platforms and the requirement that the majority of issuers should be SMEs up to a market capitalisation of €100 million would likely lead to only new trading platforms registering. This would increase fragmentation in the market. It would thus be better if any company – regardless of the size of its market capitalisation – should be able to register.

- Furthermore, we object to expanding the scope of the Market Abuse Regulation to existing platforms. Expanding to SME markets the obligations applied to regulated markets is not the best way to improve SMEs access to financial markets.

We suggest that the Commission launches as soon as possible a public consultation on that subject in order to identify the main issues and elaborate an appropriate proposal.

6. Promoting the social entrepreneurs' access to finance

BUSINESSEUROPE is unsure whether an introduction of a specific European label for "European Social Entrepreneurship Funds" will ease social entrepreneurs' access to finance. Investors make their investments based on expected returns and risks, and BUSINESSEUROPE is unsure whether the benefits from the increased visibility a European label can outweigh the administrative obligations imposed by the proposal.

7. Other regulatory measures

An efficient internal market for capital is critical when ensuring companies' access to finance at the lowest possible price. Hence BUSINESSEUROPE welcomes that the Commission will explore the possibilities for strengthening the internal market for capital.

It is important that the Commission in the review and the possible subsequent revision of the state aid rules continues to ensure an effective enforcement control of state aid. The Commission still needs to ensure that the state aid is only used to target market failure.

D. Measures to improve the general context in which SMEs work

The measures to tackle the issue of asymmetric information between banks and enterprises move in the right direction, because they enhance the ability of businesses to obtain information on the financing instruments available and increase the transparency of the information on the conditions and costs of loans. For these reasons, BUSINESSEUROPE welcomes the proposal to expand - in cooperation with the EIB Group and the financial intermediaries – the information on financial instruments and on facilities specifically provided for loans to SMEs at European level through:

- A strengthening of the services provided to SMEs by the European Enterprise Network offices;
- Realisation of a multilingual portal. BUSINESSEUROPE expects that the Commission will integrate existing and future portals on business support initiatives.

On rating, BUSINESSEUROPE notes that, often, the rating models implemented by the banks are ill-suited to the evaluation of SMEs as they are too rigid and unable to capture the qualitative aspects of the business. These models should therefore be supplemented by "override" procedures that are not widely used in a number of countries, despite being allowed by Basel. As a consequence, the proposal to encourage the exchange of good practices and to encourage the banking sector and the associations representing SMEs to promote the use of qualitative factors in addition to the common quantitative analysis is to be welcomed.

Finally, BUSINESSEUROPE emphasises the importance of interventions aimed at strengthening the national systems of guarantee and counter-guarantee, in particular, by increasing and improving the operations of the EIF in this field. In our view, as proposed in the SBA review, Member States should adopt fiscal incentives to strengthen companies' assets, thus improving their position *vis-à-vis* the banks.

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