BRUEGEL POLICY CONTRIBUTION

ISSUE 2013/10
JULY 2013

BANKING SYSTEM SOUNDNESS IS THE KEY TO MORE SME FINANCING

ZSOLT DARVAS

Highlights

- The SME access-to-finance problem is not universal in the European Union and there are reasons for the fall in credit aggregates and higher SME lending rates in southern Europe. Possible market failures, high unemployment and externalities justify making greater and easier access to finance for SMEs a top priority. Previous European initiatives were able to support only a tiny fraction of Europe's SMEs; merely stepping-up these programmes is unlikely to result in a break-through. Without repairing bank balance sheets and resuming economic growth, initiatives to help SMEs get access to finance will have limited success. The European Central Bank can foster bank recapitalisation by performing in the toughest possible way the asset quality review before it takes over the single supervisory role. Of the possible initiatives for fostering SME access to finance, a properly designed scheme for targeted central bank lending seems to be the best complement to the banking clean-up, but other options, such as increased European Investment Bank lending and the promotion of securitisation of SME loans, should also be explored.

Zsolt Darvas (zsolt.darvas@bruegel.org) is Research Fellow at Bruegel. This briefing paper was prepared for the European Parliament Committee on Economic and Monetary Affairs ahead of the European Parliament's Monetary Dialogue with ECB President Mario Draghi on 8 July 2013. The paper benefited from comments and suggestions from colleagues inside and outside Bruegel, for which the author is grateful. Alice Gambarin and Erkki Vihriala provided excellent research assistance.

Telephone
+32 2 227 4210
info@bruegel.org

www.bruegel.org

EXECUTIVE SUMMARY

- The access-to finance-problem for small and medium-sized enterprises (SMEs) is not universal in the EU, but is significant in some parts of Europe, in particular the southern euro-area countries.
- Southern euro-area members face a number of structural challenges and there are good reasons for the fall in credit aggregates and higher lending spreads, such as necessary deleveraging, higher credit risk, the low productivity of SMEs and the weak position of banks, which is reinforced by the deep recession and the 'doom-loop' connecting banks and sovereigns.
- Possible market failures, high unemployment and the risk that the possible worsening of the situation poses for Europe (including the risk to the integrity of the euro area) make giving SMEs greater and easier access to finance a top priority.
- Up to now, the various European programmes for SME financing have reached only a tiny fraction of SMEs. Access to finance for SMEs, especially in southern euro-area members, has continued to deteriorate despite these European initiatives. Stepping-up the allocated resources, while certainly beneficial, is unlikely to achieve a major breakthrough.
- Without repairing bank balance sheets and resuming economic growth, targeted initiatives to help SMEs gain access to finance will have limited success. Banks with weak balance sheets tend to lend less. Continued weak economic conditions will increase credit risk, thereby reducing both demand for credit by SMEs and the willingness of banks to offer credit at reasonable rates to SMEs.
- There are three main targeted options to improve SME financing conditions: (1) more direct lending by public institutions, such as the European Investment Bank, or public guarantees for lending by commercial banks, (2) enhanced securitisation of SME loans through either guarantees or European Central Bank asset purchases, and (3) long-term central bank funding at a low interest rate conditional on the expansion of net lending. These options are not mutually exclusive and could be applied simultaneously.
- A general problem of all publicly-supported options is that they may create incentives for banks to extend credit to less viable SMEs and lead to a Japanese-style scenario by distorting capital allocation.
- More EIB lending targeted at SMEs can be justified especially in the current environment in which banks face difficulties in supplying credit. But EIB lending has limitations and much more capital should be provided to the EIB than the €10 billion agreed last year.
- Securitisation of SME loans and their placement with private investors can help offload these loans from bank balance sheets, thereby providing room for more lending. But this market is not functioning at the moment: while securitisation of SME loans is already reasonably widespread in Italy and Spain, as almost none of the recent securitisations were placed with market investors, but instead they were retained by the originator banks and used for repo refinancing with the ECB. Most likely, the risk/return/liquidity characteristics of such securities are not attractive to investors.
- Public support for securitisation (eg in the form of guarantees) would either leave most of the risk with the banks (if the bank retains the most-junior tranche of the bundled security), or would load more risk onto the public sector accounts, which could be undesirable and also limit the scope for such support. Public support for securitisation does not address the problem of high bank funding costs in southern Europe.
- A decision on the ECB taking on more credit risk through purchases of securities backed by SME loans should be based on compelling evidence that such risk-taking by the ECB will greatly benefit SMEs. The benefits for southern Europe are unclear while banks have weak balance sheets and face high financing costs, and SME loans are risky because of the dreadful economic situation.
- SME loan securitisation practically does not exist in the United States, yet US SME financing has become more available since late 2009, probably due to the early clean-up of the banks and effective growth policies.
- A properly designed scheme for targeted central bank lending for several years, on the condition that banks increase their net lending to SMEs, can leave the credit risk with the banks, and also help banks' to meet the Basel III stable net funding ratio requirements.
- All three main options to support SMEs access to finance should be explored, but the discussion should not hinder the recognition that banking clean-up and economic growth promotion are the best tools to foster SME access to finance. The ECB should foster bank clean-up and recapitalisation by performing in the toughest possible way the asset quality review before its takeover of the single supervisory role.
- While an even more expansionary ECB monetary policy by itself will not solve the growth problem, but could contribute to the revival of economic growth.

BANKING SYSTEM SOUNDNESS IS THE KEY TO MORE SME FINANCING

ZSOLT DARVAS, JULY 2013

SMALL AND MEDIUM-SIZED ENTERPRISES (SMEs) play a major role in the European economy and especially in southern euro-area countries[1] – countries that face mounting challenges in achieving sustainable public and private debt positions, sound banking systems and improved competitiveness in the midst of a deep economic contraction and high unemployment, which are also fuelled by major structural weaknesses.

Access to finance for SMEs deteriorated in several countries after the crisis, as recorded by the OECD (2013), particularly as a result of higher interest rates and greater demand for collateral. The deterioration was more significant in the hard-hit countries of southern Europe (Box 1).

There is an intense discussion in the European Union on redoubling efforts to make it easier for SMEs to have more wide ranging access to finance. For example, the European Commission and the European Investment Bank submitted a report to the European Council of 27-28 June 2013 on options for increasing lending to the economy, with a focus on SMEs (see European Commission and European Investment Bank, 2013b).

This Policy Contribution assesses the rationale for targeted European-level support for SMEs, and the various options, focusing on broader design issues and the possible role of the European Central Bank.

1 SHOULD EUROPEAN SCHEMES TO SUPPORT SMES' ACCESS TO FINANCE BE REVAMPED?

While SMEs play a dominant role in the EU economy and there are clear signs of limitations to credit supply in some countries, the answer to the question raised in the title of this section is not an unambiguous 'yes'. There are several reasons why there may not be a need for a special new European effort:

- Lack of sufficient access to finance for SMEs is not a systematic problem in the EU, and not even in the euro area. As noted in Box 1, there does not seem to be a problem with access to credit in Germany and Austria, and the same can be said about some other better-suited EU countries. An EU-wide response is definitely needed when there is systemic market failure in the EU, such as the paralysis in financial markets after the collapse of Lehman Brothers in September 2008. But when a problem is regional, its causes should be well understood before European-level initiatives are pursued.
- In most southern euro-area countries, where SMEs face severe limitations in accessing finance, there was too much credit before the crisis and most likely a number of companies accumulated excessive debt. Therefore, a fall in the outstanding amount of credit can be an indication of the necessary deleveraging process.
- These southern euro-area countries have very bleak economic outlooks, due to their structural weaknesses, their weak price competitiveness, which significantly deteriorated before the crisis and has not improved sufficiently since, their still-vulnerable public sector fiscal positions which require further fiscal consolidation, and their banking sector weaknesses, which are reinforced by the weak economic outlook and the vulnerable public financial accounts (see Darvas, 2012b). This implies that credit risk must be higher in these countries than in economies with better outlooks, such as Germany. Consequently, the lending rate to SMEs should also be higher in southern Europe than in Germany.
- Small companies form a considerably larger share of total firms in southern Europe than in other member states. But SMEs are less productive than larger companies (see Gill, Raiser and others, 2012), which is particularly true in the southern euro members. Therefore, limita-

1. According to the European Commission's *Small Business Act for Europe (SBA) Fact Sheets 2012*, SMEs accounted for 99.8 percent of the number of businesses, 67.4 percent of employment and 58.1 percent of GDP in the European Union in 2011. In Greece, Italy, Spain and Portugal, the share of SMEs in employment ranges between 75.6 and 85.2 percent and the share of SMEs in valued added ranges between 65.7 and 70.2 percent, well above the EU average. In contrast, in Germany and especially in the United Kingdom, the role of SMEs is well below the EU average. See http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/.

tions to credit supply might in fact help a 'creative destruction' of less viable companies and the survival of better companies, which might then start to grow, also drawing resources from the ashes of the failed firms. Thereby, in the medium/long-term, a healthier company structure may emerge, especially if the process is enhanced by structural reforms in product and labour markets.

- Targeted financing schemes may lead to 'zombification', as argued by Deutsche Bank (2013) and Moec (2013), whereby firms with weak productivity receive financing. This would drain resources from the healthier part of the economy and entrench the weak growth potential.
- Finally, but related to the third point above, the banking system has been seriously weakened by the deep recession and also by the 'doom-loop' connecting banks and sovereigns, with weak banks exposed to their weak sovereigns. In the deep recession marked by high unemployment, the share of non-performing loans continues to increase, which erodes banks' capacity to take on new risks and supply credit. At the same time, during the crisis, banks in southern Europe even increased their exposure to their sovereigns (Merler and Pisani-Ferry, 2012), intensifying their vulnerability and strengthening the 'doom-loop'. Under such circumstances, banks might not be able to supply

BOX 1: CREDIT CONSTRAINTS

One, rather imperfect, indication of credit constraints is the evolution of the volume and cost of bank loans. While no reliable time series is available for SME loans, the charts the appendix show that total credit to non-financial corporations is typically falling in southern Europe. At the same time, the rates charged on smaller loans are higher in southern Europe (eg 4.4 percent in Italy, 5.4 percent in Spain and 6.6 percent in Portugal in May 2013) than, for instance, in Germany (3.0 percent), France (2.9 percent), Finland (2.8 percent), Austria (2.3 percent) and Belgium (2.1 percent) (see the appendix for all EU countries).

However, we argue that the fall in credit aggregates and the higher-than-German interest rates can be justified (at least to some extent) by the specific circumstances of southern European countries, and therefore it is difficult to draw a conclusion from credit aggregates and lending rates. But the recent survey by the European Central Bank (2013) suggests that there could be obstacles to credit supply in some euro-area countries. While 85 percent of German SMEs and between 72 and 79 percent of Austrian, Finish and French SMEs were granted the full amount of credit they requested during October 2012 – March 2013, the ratio is much smaller in the following countries: 25 percent in Greece, 57 percent in Italy, 32 percent in Ireland, 46 percent in the Netherlands, 55 percent in Portugal and 40 percent in Spain.

The ECB also calculates an indicator called 'financing obstacles for SMEs', which is the sum of the percentages of SMEs reporting loan applications that were rejected, loan applications for which only a limited amount was granted, loan applications that were dropped by the SME because the borrowing cost was too high, and the percentage of SMEs that did not apply for a loan for fear of rejection. The share of SMEs reporting such financial obstacles ranges between 51 percent and 64 percent in Greece, Ireland and Spain and between 31 and 46 percent in Portugal, Italy and the Netherlands. In contrast, the share of financially constrained SMEs is 9 percent in Germany, 14 percent in Austria and 18 percent in Finland. Yet SME profitability is much weaker in southern Europe and in Ireland than in Germany, Austria and Finland (Chart 2 of ECB, 2013) and hence it is not clear-cut if the reason for the financing obstacles faced by SMEs primarily stem from their poor economic performance or from major limitations to credit supply. Weak profitability and financing obstacles could reinforce each other: inadequate access to finance reduces profitability, thereby increasing non-performing loans and contributing to deterioration of banks' balance sheets, which in turn reduces the banks' ability to supply credit. The Netherlands looks like an outlier, because SME profitability is not as weak as in southern Europe, but there are similar financing obstacles.

much new credit, even if they are involved in certain publicly-funded schemes to foster SME lending.

However, while these arguments bring into question the suitability of targeted European schemes to improve access to finance for SMEs, especially in southern Europe, there are some powerful reasons why this should remain the top priority:

- Asymmetric information can lead to credit rationing and suboptimal lending to SMEs. Banks might find it difficult to assess the creditworthiness of SMEs, especially start-ups, and may lend primarily against collateral, and not based on assessments of expected returns (OECD, 2013; Kraemer-Eis *et al*, 2010). This problem lies at the heart of publicly-designed schemes for SME financing and might have become more entrenched during the crisis because banks' risk aversion has increased. Indeed, as OECD (2013) argues, greater demand for collateral was a major reason for the deterioration of SME access to finance. Therefore, because of this market failure, there is a rationale for scaling up public support schemes for SMEs at a time of recession. Since the hardest-hit countries in Europe do not have sufficient fiscal space for such programmes, there is a case for European action.
- The unemployment rate in southern Europe has reached such a high level that decisive action is needed to improve the employment situation. Since SMEs account for a very large share of employment, there is a need for targeted support to SMEs. Again, lack of domestic resources justifies the European approach.
- Difficulties in accessing finance might not only destroy non-viable firms, but might also stunt the growth of more creative firms. Even if viable firms obtain credit, but at a too-high interest rate, their profitability declines and a negative feedback loop between high financing cost and declining profitability can arise.
- There are major externalities emanating from the hard-hit euro-area countries to other euro-area members and beyond (Darvas, 2012b). Beyond the direct negative economic impacts through trade and financial linkages from the struggling southern members to other countries, there is also the major danger for the integrity of the euro. The deepening economic contraction in southern euro-area member states is the most pressing issue threatening the integrity, even the existence, of the euro. A continued increase in unemployment in certain southern European countries may lead to the collapse of governments, political paralysis, and an eventual disorderly exit from the euro area. That would be dramatic not only for the exiting country, but for the euro area as a whole and even beyond.

We therefore conclude that improving access to finance for SMEs has to be a priority at the European level, but any scheme should consider the deeper causes of the problem.

2 THE SCALE OF THE PROBLEM

There were almost 22 million SMEs in Europe in 2010, according to Eurostat[2]. Obtaining data on the outstanding stock of SME loans is more difficult, because there is no comparable database. We used OECD (2013), which presents data on SME loans in 14 EU countries in 2010[3], along with data from the European Central Bank, to estimate the total stock in the EU. We found that SME loan stock in the EU amounted to about €1.7 trillion in 2010 (Box 2 details the calculations).

The sheer number of SMEs and loans to them makes it practically impossible for publicly-funded initiatives to reach a sizeable share of SMEs[4]. For example, European Commission (2013), based on European Commission and European Investment Bank (2013a), lists the main results of existing European support programmes for SMEs:

- Competitiveness and Innovation Framework Programme (CIP), 2007-12:
  - **SME guarantee facility** (SMEG) helped nearly 220,000 European SMEs to access over €13.3 billion in loans;
  - **The high growth and innovative SME facility** (GIF) funded investments in venture capital funds, which provided more than €2.3 billion in support to 250 fast growing SMEs;
- EIB Group support for SMEs reached €13 billion in 2012, by supporting directly or indirectly more than 200,000 SMEs.

2. The number of SMEs in the six largest EU countries is: France 2.5 million, Germany 2.1 million, Italy 3.9 million, Poland 1.5 million, Spain 2.5 million and United Kingdom 1.6 million.

3. For most countries, data for 2011 is also available in OECD (2013).

4. The aggregate number for the EU overstates the problem, because there does not seem be a major issue with SME financing in, for example, Germany, Austria and Finland. Also, not all SMEs wish to get credit. However, in three EU countries more than half of SMEs faced financial obstacles, and in three other countries the ratio is between one-third and one-half (Box 1). This suggests that the number of SMEs facing financial difficulties is very high.

While these initiatives are undoubtedly important and have achieved a number of positive results, their financing has reached just a tiny fraction of SMEs even if more than half of SMEs do not require credit. Access to finance for SMEs, especially in southern euro-area members, has continued to deteriorate in recent years despite these European initiatives[5].

Because of the large number of SMEs and their huge loan stock, any publicly designed support scheme would be unable to reach a sufficiently large share of SMEs. The most ambitious option put forward by the European Commission and European Investment Bank (2013) aims to reach 1 million SMEs (about 5 percent of all EU SMEs) using €10.4 billion of public funds to mobilise €100 billion in SME loans (ie about 6 percent of the outstanding SME loans). These are respectable targets and if successfully implemented, could help several companies, but still only a small fraction of SMEs, get access to finance. Furthermore, it is always unclear if publicly funded programmes reach those SMEs that face financing difficulties, or those SMEs that have better fundamentals and get financing anyway. Therefore, while publicly designed schemes should be pursued, because they have the potential for improving the financing situation for a proportion of SMEs, no miracles should be expected and the underlying reasons for weak credit growth have to be fully understood and addressed.

3 OPTIONS FOR HELPING SMES GET ACCESS TO FINANCE

Before discussing the options, the main causes of the access-to-finance problem need to be understood.

BOX 2: THE STOCK OF SME LOANS IN THE EU IN 2010

There is no comparable database on the credit stock of SMEs for all EU countries. OECD (2013) developed a scoreboard for the financing of SMEs and entrepreneurs for 23 countries (of which 14 from the EU) and reports either the stock of SME loans or the amount of new loans for SMEs. Stock data is available for nine countries: France, Ireland, Italy, Hungary, Portugal, Slovakia, Slovenia, Sweden and the United Kingdom. The flow data is available for four further countries: the Czech Republic, Denmark, Finland and Spain. For the Netherlands total data for business loans is available for the stock, but for SMEs, only the flow.

OECD (2013) reports data up to 2011, but there are some missing values for 2011, while the dataset for 2010 is complete. Therefore, we use 2010 data.

When estimating the stock of SME loans in the EU, we used the stock data for the nine countries for which this data is available: they add up to €765 billion.

For the four EU countries for which only the flow data is available, we calculated the average share of new SME loans in total business loans during 2008-10 (earlier data is not available) and multiplied with this average share the corrected outstanding amount of loans to non-financial corporations as reported by the ECB[6]. Thereby, we estimated the outstanding amount of SME loans in these four countries (the Czech Republic, Denmark, Finland and Spain) to be €394 billion.

For the remaining 14 EU countries (we did not include Croatia), we approximated the volume of business loans by assuming that the share of SME loans in total business loans is identical to the share in those 13 countries for which we have either stock or flow data on SME loans (which is 27 percent) and again we used corrected ECB data on loans to non-financial corporations. This approximation suggests €537 billion for SME loans in these 14 EU countries.

Altogether, we estimate the stock of SME loans in the 27 countries of the EU in 2010 to be €1,695 billion, or €1.7 trillion.

The largest stocks of SME loans were in Spain (€356bn), followed by Germany (€270bn), Italy (€206bn), France (€201bn) and the United Kingdom (€131bn).

5. There was also a large number of national initiatives for supporting SMEs, such as increased amounts of government loan guarantees, special guarantees and loans for start-ups, increased government export guarantees, government co-financing, increased direct lending to SMEs, subsidised interest rates, venture capital and equity funding and guarantees, business advice, tax exemptions and deferments and credit mediation (source: Table 2.8 of OECD, 2013).

6. A correction was needed, because the ECB data on loans to non-financial corporations was in most cases somewhat smaller than the OECD data for total business loans, ie the ratio of ECB data to OECD data is 86 percent for France, 87 percent for Hungary, 81 percent for Italy, 100 percent for Portugal, 100 percent for Slovakia, 101 percent for Slovenia and 90 percent for United Kingdom. For Ireland, the same ratio is 248 percent, because the OECD – correctly – removed loans for financial intermediation and property. For simplicity, for the 17 countries for which the OECD does not report data for the stock of total business loans, we assumed that their stock is 10 percent higher than the data on loans to non-financial corporations reported by the ECB.

The main reasons for weak credit performance in the EU

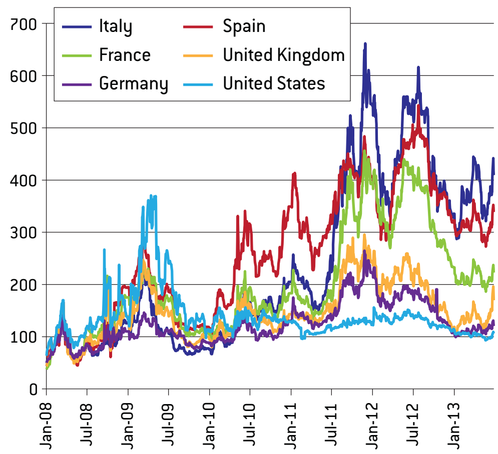
There are two major and interrelated reasons for the weak credit performance in some parts of EU, in particular in southern Europe: impaired bank balance sheets and the recession and bleak economic outlook[7]. Banks that have dubious claims on their balance sheet are less willing to take new risks by lending to new firms. A recession deteriorates bank claims, and thereby reduces banks' appetite for new lending, especially for those banks that have weak capital positions.

The most recent UK example is instructive. Forty banks participated in the UK's Funding for Lending Scheme (FLS, see next section), of which 27 increased their net lending. The three largest participating banks, Lloyds, Royal Bank of Scotland and Santander, which incidentally have major capital shortfalls, reduced their net lending to the private sector between 30 June 2012 and 31 March 2013[8]. Without these three banks, the outstanding stock of loans by the other 37 banks (ie the 27 banks that increased net lending and the 10 other banks that reduced their net lending) increased by 3.4 percent in the same period. A coincidence between capital shortfalls and reduced lending activities does not prove a causal relationship, but it is telling.

The Japanese example of the 1990s is also a warning signal for Europe. Caballero, Hoshi and Kashyap (2008) argued that Japanese banks feared writing down their claims, which became dubious after large stock and land price declines that began in the early 1990s, because that would have reduced their capital below mandatory levels. Instead, banks rolled over dubious claims *"gambling that somehow these firms would recover or that the government would bail them out"*. The Japanese government also pushed banks to lend more and there was a substantial increase in the prevalence of firms receiving subsidised loans compared to the pre-1990 period. Nominal lending rates to corporates fell significantly, and to a lesser extent real interest rates as well, yet Japan entered a lost decade. Caballero, Hoshi and Kashyap (2008) concluded that misdirected bank lending played a major role in prolonging the Japanese macroeconomic stagnation and limited access to finance for more viable firms.

It is difficult to assess the magnitude of Europe's banking problems, because the first two coordinated stress tests carried out by, respectively, the Committee of European Banking Supervisors in 2010 and the European Banking Authority in 2011, were discredited almost immediately by major bank failures and new stress tests have been delayed. Yet bank credit default swap (CDS) spreads suggest that there are still major banking problems in Europe (Figure 1).

Figure 1: Five-year credit default swap spreads (CDS) of the five largest banks in selected countries, 1 January 2008 – 26 June 2013



Source: Bruegel using data from Datastream.
Note: Simple average of the data of the five largest banks in each country. The following banks are considered: Italy: Unicredit, Unione di Banche Italiane, Banco Popolare, Intensa Sanpaolo, Banca Monte dei Paschi di Siena. Spain: Banco Santander, BBVA, Banco Popular Espanol, CaixaBank, Caja de Ahorros y Monte de Piedad de Madrid. France: BNP Paribas, Credit Agricole, Dexia Credit Local de France, Societe Generale, Natixis. Germany: Deutsche Bank, Commerzbank, HypoVereinsbank, Bayerische Landesbank, Norddeutsche Landesbank. UK: HSBC, Standard Chartered, Barclays, Lloyds, Royal Bank of Scotland. US: Wells Fargo, Citigroup, Bank of America, PNC financial services, BB&T.

'It is difficult to assess the magnitude of Europe's banking problems, because the first two coordinated stress tests were discredited almost immediately by major bank failures, and new stress tests have been delayed.'

7. We focus on banks, because banks have a dominant role in financing the European economy, in contrast to the United States where debt securities markets have a more significant role. There has been only a very limited reduction in the reliance on banks in Europe since the onset of the global financial and economic crisis (Darvas, 2013). Furthermore, SMEs are typically too small to issue debt securities and therefore depend very much on loan financing (from banks or other financial intermediaries, such as leasing companies).

8. Among the biggest UK banks, HSBC and Standard Chartered do not participate in the FLS. Barclays and Nationwide Building Society participate and increased their outstanding stock of loans by 3.6 percent and 3.1 percent, respectively, between June 2012 and March 2013.

Therefore, repairing bank balance sheets, by forcing banks to properly restructure dubious claims and raise more capital, is a major precondition for the resumption of healthy credit flows (see Darvas, Pisani-Ferry and Wolff, 2013). The European Central Bank can foster the bank balance sheet cleaning-up process by performing in the toughest possible way the asset quality review, which is scheduled before the ECB takes over the single supervisory role.

Similarly, beyond addressing bank balance sheets, effective efforts are needed to kick-start EU economic growth, including a more adequate approach to fiscal policy and an even more expansionary monetary policy. Undoubtedly, more monetary easing in itself would not solve the euro area's growth problem, but since inflationary expectations are well below the two percent target, there would be room for more monetary easing in the midst of a lingering euro-area recession, and it would also help intra-euro rebalancing (Darvas, 2012a). The structural reform agenda, which is at the centre of the EU's growth strategy, remains vital, but will not contribute much to the revival of economic growth at a time when private demand remains weak.

Targeted options for fostering credit to SMEs

In our view, any targeted initiatives to help SMEs get access to finance will have limited impact without major progress on repairing bank balance sheets and resuming economic growth. When this happens, normal lending will also likely resume, including to SMEs, and therefore additional targeted options to help SMEs get access to finance would not be needed. But there is a non-zero probability that the bank clean-up will not be impeccable. For example, the ECB might take a cautious approach to the asset quality review, if a weak bank under examination would not be able to obtain the required capital from private sources, the sovereign of the country in which the bank is located faces major fiscal challenges and there is no European fiscal backstop for directly recapitalising banks. Also, while bank clean-up is a major precondition for the resumption of economic growth, there will be in any case a long way to go before robust growth resumes (Darvas, Pisani-Ferry and Wolff, 2013).

The question is then which European initiative would be best, even if its impact is limited, to help viable SMEs get access to finance in the transition period until bank balance sheets and the economic outlook improves. (We also note that there are various other initiatives aimed at improving the regulatory environment for SMEs, their financing and more generally their business environments, which are generally important irrespective of the acute crisis in some southern European member states, see Box 4).

SMEs are typically too small to issue corporate debt and therefore either debt financing (eg loans) or equity financing (eg venture capital) can give them greater access to finance. We focus on debt financing from banks, though the main principles apply to equity financing as well.

In order to slow down or reverse the decline in credit aggregates and reduce lending rates whenever they are higher than what is implied by the fundamentals of the business, three broad options emerge:

1. Direct lending to SMEs, or loan guarantees, by public entities, such as the EIB group, national development banks or other institutions;
2. Promoting the securitisation of SME loans;
3. Supporting banks with cheap long-term liquidity.

To some extent, all three options are being implemented. The EIB and national development banks have various schemes for supporting SMEs, and the €10 billion increase in the EIB's capital (which was one element of the June 2012 European 'Compact for Growth and Jobs') will likely enhance this role. The European Investment Fund (EIF, part of the EIB Group) already guarantees certain tranches of securitised SME loans. And the European Central Bank has twice provided cheap liquidity with full allotment and with a maturity of three years to banks using its revamped long-term refinancing operations (LTRO).

Of the three options, we do not discuss in detail the first. Generally, some support to SMEs by public institutions, like the EIB, can be justified if it is based on sound investment principles and the effectiveness of the support measures is appropriately assessed. Such support is even more justified at a time of a deep crisis, when banks face difficulties in supplying credit. Nevertheless, public institutions do not have the resources to significantly increase their involvement in the allocation of funds to potential borrowers. The EIB should receive much more capital than the €10 billion it received recently.

We concentrate on the two other options, which also have direct relevance for the European Central Bank. Securitisation of SME loans targets the asset side of bank balance sheets by, for example, fostering the sale of SME loan portfolios, thereby providing space for new lending. Liquidity provision targets the liability side of bank balance sheets, by providing cheap fixed interest rate funding for several years, thereby helping banks to grant new credit. These options could be applied simultaneously.

Securitisation

There are two main types of securitisation based on loans to SMEs. The first is the creation of a security that can be sold to investors or used as collateral by a bank to obtain liquidity in repo markets. The second is bank borrowing collateralised by loans to SMEs, ie the issuance of a covered bond backed by SME loans. According to Standard & Poor's (2013), the first such covered bond issuance in the EU was announced in Germany in 2012[9] and they expect that issuances of such covered bonds will gain popularity in the years ahead.

But here we focus on standard SME loan securitisation.

Kraemer-Eis *et al* (2010) and Jobst (2008) present nice overviews of securitisation. Essentially, SME loan securitisation means bundling loans (typically through a special purpose vehicle) into a security, which is typically structured into various tranches: senior, mezzanine and first loss[10]. Even if the bank aims to sell the security, the first loss tranche is typically retained by the originator bank and only the senior and mezzanine tranches are sold.

- A bank could use securitised SME loans for the following purposes:
- Keep (some or all tranches of it) and use it as collateral with the central bank or in private repo markets;
- Sell (some or all tranches of it) to private parties;
- Sell (some or all tranches of it) to the central bank.

Public support would not seem to be needed in the first case. As we report in Box 3, SME loan securitisation continues to be reasonably widespread in Italy and Spain and these securities can be used in ECB repo operations. Furthermore, there does not seem to be an issue with the availability of collateral, at least for Italy, Spain and Portugal[11].

In order to increase the use of securitised SME loans as collateral at the ECB, the applied haircut could be reduced. However, in that case, either the ECB faces a higher risk, or another institution, such as the EIB, has to offer guarantees. But since the availability of collateral does not seem to be a major issue, a reduction in the haircut might not stimulate much bank lending to SMEs.

The second purpose of securitisation, offloading SME loans from bank balance sheets by selling them to private investors, offers a number of advantages, such as economic and regulatory capital relief for banks. Kraemer-Eis *et al* (2010) therefore argue that securitisation should have a pivotal role in SME financing in Europe. It can help banks raise finance by selling the security, which can be important for those banks (or other financial intermediaries, like leasing firms) that have limited access to capital markets, or for smaller banks that face lending restrictions due to their size. SME loans are among banks' least liquid assets and therefore SME loan securitisation can help banks better allocate their assets.

'Public institutions do not have the resources to significantly increase their involvement in the allocation of funds to potential borrowers. The European Investment Bank should receive much more capital than the €10 billion it received recently.'

9. Central banks purchased a large share of Commerzbank's SME-backed covered bonds, see: http://www.bloomberg.com/news/2013-02-22/commerzbank-s-debut-sme-covered-bonds-get-central-bank-support.html.

10. The mezzanine tranche is subordinated to the senior trance, but ranks senior to the first loss tranche. Sometimes there are more than three tranches (Moody's, 2013). An alternative way to securitise SME loans is the so called 'synthetic securitisation', where traditional securitisation techniques are combined with credit derivatives (see Kraemer-Eis *et al*, 2010).

11. According to Banca de Italia's *Financial Stability Report April 2013*, Italian banks had abundant free collateral and *"at the end of February banks would have been able, if necessary, to draw an additional €302 billion on the credit granted by the Eurosystem"*. For Spain we could not find such calculations, but the fact that the reliance of Spanish banks on Eurosystem lending declined by about €165 billion from August 2012 to May 2013 suggests that they may be able to raise a similar amount again if they wanted to. According to the Banco de Portugal, *"...it should be noted that the banks still have eligible assets which are not included in the pool and reference should also be made to their capacity to generate additional collateral based on loans and advances to customers."*

BOX 3: SME LOAN SECURITISATION TRENDS IN EUROPE

Table 1 looks at securitisation in Europe and its composition according to different types. At the end of the first quarter of 2013, the outstanding amount of securities backed by loans to SMEs was €154 billion. Given that we estimated the total stock of loans to SMEs as €1.7 trillion in 2010 (Box 2) and since then (most likely) there has been a decline, approximately 10 percent of SME loans are securitised. But securitisation is very uneven within Europe. SME loan securitisation is highest in Spain (€53 billion) and Italy (€35 billion), which jointly account for almost 60 percent of SME securitisation in Europe. Considering again that the provision of loans to SMEs has likely declined since 2010, SME loan securitisation is probably more than 20 percent of outstanding stock in Italy and Spain.

Table 1: Securitisation in Europe, outstanding stock in 2013Q1 (€ bns)

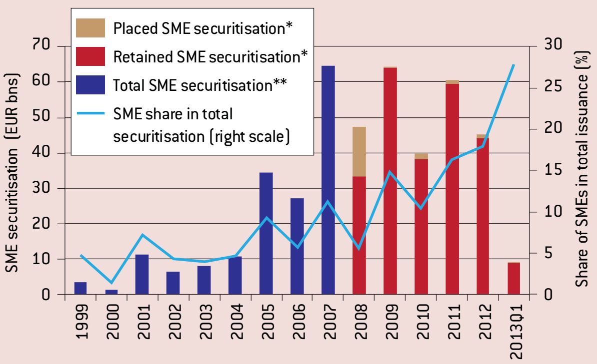
	ABS	CDO	CMBS	RMBS	SME	WBS	TOTAL
Austria			0	2			2
Belgium	0		0	70	18		88
France	20		3	16	3		42
Germany	36	2	14	17	6	0	75
Greece	16	2		6	10		33
Ireland	0	0	0	46	0		47
Italy	53	4	10	95	35	1	198
Netherlands	5	2	3	258	9		277
Portugal	5			29	5		39
Russia	0			2			2
Spain	22	1	0	124	53		200
Turkey	2						2
UK	41	18	67	282	9	58	475
Other (1)	3	1		0	0		5
PanEurope (2)	4	32	17	0	5	0	58
Multinational (3)	1	102	2		1	1	107
European total	210	164	117	946	154	60	1652

Source: Table 2.7 from AFME (2013). Note: In the US, securitisation amounts to €6,702 billion. ABS: asset-backed securities. European ABS outstanding collateral types include auto loans, credit cards, loans (consumer and student loans) and other. CDO: Collateralised Debt Obligations denominated in a European currency, regardless of country of collateral. CMBS: Commercial Mortgage Backed Securities. RMBS: Residential Mortgage Backed Securities. SME: Securities backed by Small- and Medium-sized Enterprises. WBS: Whole Business Securitisation: a securitisation in which the cash flows derive from the whole operating revenues generated by an entire business or segmented part of a larger business. 1. 'Other' includes European countries with outstanding securities that are too small to be displayed, such as Finland, Georgia, Iceland, Ukraine, Switzerland, and Hungary. 2. Collateral from multiple European countries is categorised under 'PanEurope' unless collateral is predominantly (over 90 percent) from one country. 3. Multinational includes all deals in which assets originate from a variety of jurisdictions. This includes the majority of euro-denominated CDOs.

Unfortunately, country-level data on SME security issuances is available only for 2010Q3 onwards (quarterly frequency), but for Europe as a whole, annual data on issuances is available for a longer period (Figure 2). Figure 2 suggests that the growth of this market stopped after 2007 and there have been some setbacks and volatility since then. But SME securitisation continued rapidly even during 2011-12, when the euro-crisis intensified, though almost all securities have been retained by originator banks since 2009 and only a minority of securities have been placed with the market. According to Kraemer-Eis *et al* (2013), in the SME securitisation market, originators retain newly issued deals mainly to create liquidity buffers and to use the assets as collateral with central banks. The share of SME securitisation in total securitisation is on the rise. By showing country-specific data since 2010Q3, Figure 3 indicates that Italy and Spain continue to dominate this market, though there has been volatility across quarters.

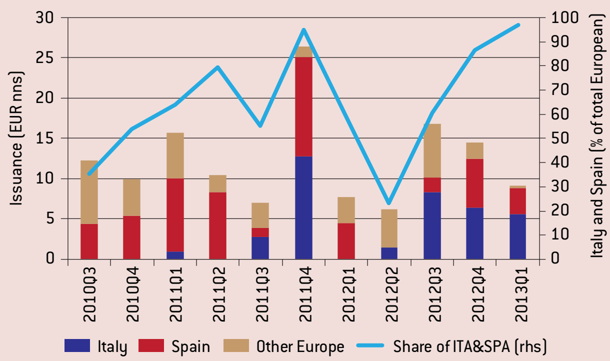
How much of the issuance was guaranteed by European and national public institutions? The EIF annual report 2012 says *"The guaranteed volume of securitisation and covered bond tranches for the year amounted to close to EUR 480m and supported SME lending volumes of EUR 2.1bn"* (European Investment Fund, 2013, page 24). There is no indication of how this was distributed between securitisation and covered bonds. If the full €2.1bn of supported loans was securitised, it would compare with €45.2bn of SME securities issuances in Europe in 2012. Therefore, in 2012 EIF guarantees played only a minor role in supporting this market, perhaps because there was almost no placement. Unfortunately, we could not collect data on possible national or other public guarantee schemes for SME securitisation.

Figure 2: SME securitisation in Europe, issuance per year, 1999-2012, and in the first quarter of 2013



Source: SIFMA (2013) converted to euros. For 2008-13 the division into retained/placed was obtained separately from SIFMA. Note: * For 2008-13, we show the division of total issuance between placed and retained securitisation. ** This division is not available for earlier years and therefore we show the total securitisation for 1999-2007.

Figure 3: SME securitisation in Europe, issuance per quarter, 2010Q3-2013Q1



Source: Bruegel based on data from AFME Securitisation Data Reports (2010Q3–2013Q1). Available at http://www.sifma.org/research/reports.aspx

The benefits that banks receive from securitisation can be channelled to SMEs in the form of more or cheaper loans. Also, the replenishment features of such securities allow banks to grant new loans and include them in existing securities. An advantage for investors is that they can get exposure to SME loans, which otherwise would not be available. Jobst (2008) also note that structured securitisation, by offering tranches with different risk/return properties, can help investors to select the tranche that corresponds best to their risk profile, eg pension funds may not buy from the most junior first-loss tranche, but from a more senior one.

However, Kraemer-Eis *et al* (2010) also argue that because the bank typically continues to hold the junior tranche of the security, *"securitisation does not transfer credit risk to third party investors but is rather used for regulatory arbitrage in which the originating bank merely exploits regulatory loopholes while most credit risk, except for maybe some remote catastrophic portfolio loss risk, are retained by the bank"* (page 10).

In our view, on the question of public efforts being stepped up to boost the issuance of such securities, the key issue is indeed related to the transfer of risk. Unfortunately, European Commission and EIB (2013) in their proposals for promoting SME loan securitisation do not discuss to which tranche(s) public guarantees would apply.

We have argued that credit risk related to SMEs is higher in those countries in southern Europe that face credit supply limitations. When there is no or only a limited transfer of risk via securitisation because the public guarantee applies to the mezzanine tranche (or even to a more senior tranche), the bank's risk profile does not greatly improve, even if there is a decline in regulatory capital.

It is not clear if end-investors wish to have a major risk exposure to the SME sector in southern Europe, which is getting riskier. Moody's (2013) report that there was almost no credit rating downgrade of securities backed by SME loans issued in Belgium and the Netherlands and only minor downgrades for German securities, but Italian and especially Spanish securities suffered from major downgrades. One reason for the Italian and Spanish downgrades is the severe economic recession. This suggests that the perceived riskiness of Italian and Spanish securities increased significantly. If public funds are used to enhance the securitisation via, eg guaranteeing a more junior tranche, then the question is the risk exposure of the public institution. The public institution can charge a fee for the guarantee, but if this fee is high enough to compensate for the risk, then the attractiveness of the guarantee is reduced[12].

Furthermore, even if banks can offload their SME loans via securitisation and are able to lend more to SMEs, their lending rates will still be determined by the funding cost. The bank funding cost from private sources is much higher in southern Europe than, for example, in Germany (as reflected by high CDS spreads, see Figure 1, and by high deposit rates, which have to be high to attract depositors to banks that are perceived to have weaker balance sheets than, eg German banks). Therefore, if SME loans are funded from private sources, lending rates will continue to be high in southern Europe even if securitisation helps to get rid of existing SME loans.

Fitch Ratings (2013) raises a different possible obstacle to the successful use of SME loan securitisation in placing the securities with investors. This obstacle is related to the risk/return/liquidity characteristics of such securities: the spread between SME lending rates and the yield investors demand has to be sufficiently large, reflecting market participants' view of the risk profile of the portfolio and the liquidity premium they require for holding such securities (these markets are rather illiquid now). This spread does not seem to be high enough for existing SME loans, or for new SME loans, in the main European jurisdictions. In contrast, for retained SME-backed securities, the asset spread can be lower (which explains why there were sizeable SME loan securitisations in Europe even recently, but almost all was retained by the originator banks, see Box 3). Also, securitisation of the loan obligations of larger companies has started to pick up in Europe and the asset spread of the underlying loans is much larger.

It is also notable that SME loan securitisation practically does not exist in the US[13], yet SME financing in the US has become easier since late 2009[14].

12. There is also a question about the volume that the public institution can guarantee, and the principles for selecting the banks, especially if funds are not sufficient to guarantee all issuances.

13. Liu and Shao (2012) report data on small business loan securitisation in the US. In each US state apart from Utah, less than half a percent of small business loans are securitised. In the US as a whole, the peak of small business loan securitisation was only 0.34 percent in 2007.

14. According to OECD (2013), US data indicate that the supply of credit to small firms has steadily recovered since the second half of 2009, although by 2011 it had not reached the peak level recorded at the end of 2007. As far as demand is concerned, a lower percentage of small firms are reporting that they are borrowing, indicating that some small firms, presumably the financially weaker ones, have not re-entered the credit markets, even though small firms that are regular borrowers are concurring with bankers that credit conditions have indeed been steadily improving.

The third possible use of securitisation, offloading SME loans from bank balance sheets by selling the securitised SME loans to the ECB, would offer the benefits we have discussed at the cost of increased credit risk for the ECB (if there is no external guarantee, such as from the EIB). Such moves could be motivated by the need to improve monetary transmission, similar to the motivation for the May 2010 Securities Market Programme (SMP) and the September 2012 Outright Monetary Transactions. In fact, the ECB has already concluded two covered bond purchase programmes, which also expose the central bank to credit risk. However, a decision on the ECB taking on more credit risk should be based on compelling evidence that such risk taking will greatly benefit SMEs. In our view, it is unclear how such risk-taking by the ECB would benefit SMEs when banks have weak capital positions and face high financing costs, and SME loans are risky because of the dreadful economic situation in southern Europe.

Overall, enhancing SME loan securitisation via public guarantees is an avenue to be explored, but the case is not clear-cut, especially for SMEs in troubled southern Europe, where there are more fundamental causes holding back lending to SMEs.

Long-term liquidity provision

In normal times, central banks do not provide long-term liquidity to banks, primarily because it could lead to moral hazard. The recent global financial and economic crisis, and its aftermath in Europe, has clearly been an exceptional period. The European Central Bank provided liquidity to banks with full allotment for three years using the revamped long-term refinancing operations (LTROs) in December 2011 and February 2012. The Bank of England, in cooperation with the UK Treasury, launched the Funding for Lending scheme (FLS) in July 2012, to provide cheap funding to banks for up to four years, on the condition that banks increase their net lending to the private sector (households and private non-financial corporations). Both operations are backed with collateral.

Under the FLS, banks can obtain funding amounting to 5 percent of their loan stock plus the amount of their net new lending to the private sector. Since most of the new lending was directed toward mortgages (which are generally safer than lending to SMEs), in April 2013 the FLS was extended to incentivise lending to SMEs, by giving banks financing from the FLS equivalent to 10-times their net new lending to SMEs (see Bank of England, 2013).

The cost for the LTRO is fixed at the main refinancing rate at the time, which was 1 percent. The effective cost of the FLS varies from bank to bank, due to its more complicated structure, yet Goldman Sachs (2012) estimated that for the UK banking system as a whole, the effective cost of the FLS was about 1 percent per year, well below the funding cost of banks.

More recently, the Magyar Nemzeti Bank (MNB – the central bank of Hungary) adopted a Funding for Growth Scheme (FGS) in April 2013, which is based on similar principles to the FLS, but is exclusively designed for lending to SMEs. The MNB provides funding to banks at zero interest rate for up to ten years (equal to the term of the loans to be provided to SMEs), on the condition that banks either increase their net lending to SMEs, or refinance earlier loans (including foreign currency loans) with cheap new loans[15]. The MNB also sets the ceiling of 2.5 percent as the maximum lending rate that banks can charge on loans funded from the FGS (see Magyar Nemzeti Bank, 2013). This margin is smaller than what banks' typical charge for SME loans, yet there was strong interest in the scheme from banks, and, not surprisingly, there is strong demand from SMEs for obtaining such cheap loans, which are significantly below market lending rates (see the appendix)[16].

Too little time has passed since the launch of the FLS to draw firm conclusions about its effectiveness. Yet a clear result is the decline in bank funding costs and retail interest rates. Also, as we have highlighted, 27 out of 40 banks that participate in the scheme increased their net lending between 30 June 2012 and 31 March 2013. If we exclude the three big banks (Lloyds, Royal Bank of Scotland and Santander) that have major capital shortages, then the aggregate net lending of the remaining 37 banks (including ten smaller banks that reduced their net lending) was increased by 3.4 percent from June 2012 to March 2013. New

15. New lending to SMEs should be used exclusively for financing investment, investing in working capital, or contributing to EU financial support. Thereby, the MNB wants to exclude possible arbitrage, whereby SMEs borrow at the 2.5 percent rate from the new scheme and purchase much higher yielding government bonds.

16. We note that there could be state aid issues over such dedicated central bank support to SMEs, because a company not receiving the aid may be put at a competitive disadvantage and competition within the single market could be distorted. In March 2013, the European Commission approved the FLS (see the press release: http://europa.eu/rapid/press-release_IP-12-244_en.htm), but to our knowledge the April 2013 modification of the FLS and the FLG of Hungary have not yet been examined.

lending largely concentrated on mortgages and there are some encouraging signs from the housing market. In April 2013, house prices in England and Wales topped the pre-credit crunch high and in May 2013 gross mortgage lending was the highest since 2008[17]. Certainly, the FLS was not the only factor supporting housing markets, yet it might have played a role.

The major question is if the ECB should consider a scheme similar to the FLS/FGS. Banks' funding costs, especially in southern Europe, are still very high, as reflected by the large CDS spreads (Figure 1) and deposit rates well above the deposit rates offered by German banks. Therefore, obtaining cheap long-term liquidity could incentivise bank lending.

In order to select the most suitable instrument, it is worth comparing the FLS/FGS with the LTRO and the FLS/FGS with the enhancement of SME loan securitisation.

The LTROs contributed, though only temporarily,

BOX 4: THE EUROPEAN ACTION PLAN

The action plan presented by the European Commission (2011) included several useful initiatives on regulatory, financing and business environment aspects. The key regulatory measures are:
- Improving the regulatory framework for venture capital;
- Using/reviewing state aid rules to support SME access to finance (such as allowing aid to banks, designing schemes to promote Europe 2020 objectives, altering the Risk Capital Guidelines for the benefit of SMEs);
- Improving SME access to capital markets (by, for example, fostering more visible SME markets though the Directive on Markets in Financial Instruments (MIFID) and more visible listed SMEs through the modification of the Transparency Directive, reducing the reporting burdens for listed SMEs);
- Reviewing the impact of bank capital requirements on SMEs (by considering appropriate measures addressing the issue of SME risk weightings in the context of the CRD IV (Capital Requirements Directive) and CRR (Capital Requirements Regulation) frameworks[18]);
- Accelerating the implementation of the Late Payments Directive;
- Designing an innovative regime for the European Social Entrepreneurship Fund.

There are also a number of plans for SME financing for the 2014-20 period:
- Measures to improve lending to SMEs (such as the Programme for the Competitiveness of Enterprises and SMEs (COSME)), including a Loan Guarantee Facility for debt financing and securitisation of SME loans; the Horizon 2020 programme, including a debt facility with an SME window to support research and innovation; the Creative Europe Programme, including a Cultural and Creative Sectors Facility; and the EU Programme for Social Change and Innovation);
- Measures to improve access to venture capital and other risk financing (funded by COSME and Horizon 2020).

Also, various other measures are foreseen to improve the business environment, such as better information for SMEs and about SMEs, monitoring the SME lending market, stimulating cross-border investments and policy coordination.

The 2013 Annual Growth Survey also calls on governments to restore normal lending to the economy (see European Commission, 2012). The following priorities were set:
- Promoting new sources of capital (business-to-business lending, corporate bonds, venture capital);
- Reducing late payment by public authorities, which currently creates particular burdens for SMEs;
- Developing the role of public banks and guarantee institutions in the financing of SMEs;
- Supporting public schemes, which allow banks to borrow at a lower rate if they increase their long-term lending to businesses or provide cheaper and more accessible loans to SMEs;
- Ensuring a balanced approach to repossessions in case of mortgage lending.

17. See the 14 and 20 June 2013 *Financial Times* reports 'House prices in England and Wales top pre-credit crunch high' at http://www.ft.com/intl/cms/s/0/0eeea7ac-d374-11e2-95d4-00144feab7de.html#axzz2Xw0igA4E and 'Mortgage lending soars as funding initiatives lift housing market' at http://www.ft.com/intl/cms/s/0/3fb1a4c8-d993-11e2-98fa-00144feab7de.html#axzz2Xw0igA4E.

18. See http://www.europarl.europa.eu/news/en/pressroom/content/20130412BKG07195/html/EU-Bank-Capital-Requirements-Regulation-and-Directive.

to the stabilisation of Italian and Spanish government bond markets (see Darvas and Savelin, 2012), which was a major achievement at that time. But they did little to trigger lending to the private sector. To a large extent, banks either deposited the cheap central bank funding at the ECB for rainy days, or purchased higher yielding government bonds. Thereby, the LTROs in effect supported liquidity, ensured stable long term (3-year) financing, subsidised the banking system and helped to restore profitability, and temporarily supported distressed government bond markets. However, there is also a negative reading. Belke (2012) and Pill (2013) argue that the LTROs delayed the bank restructuring efforts and prolonged the existence of non-viable banks, with major negative side effects.

An FLS/FGS-type scheme could be more instrumental in fostering credit growth than the LTRO in the future, especially if central bank lending is fully conditional on new lending[19]. And in September 2012, the ECB launched the new Outright Monetary Transactions (see Darvas 2012c), which is a powerful instrument for supporting distressed euro-area sovereign bond markets, under appropriate conditions, and therefore there is no need for supporting sovereigns via the backdoor of banks. Therefore, should the ECB ever consider again providing liquidity with maturity of several years, an FLS/FGS-type scheme would be clearly preferable compared to the design of the two earlier 3-year LTROs. Since bank funding costs from private sources in the troubled southern European economies remain high and the new Basel III regulations, in particular, the net stable funding ratio (NSFR), are likely to be particularly binding, long-term central bank liquidity provision will likely have a major role in the future as well.

On the question of FLS/FGS versus support for SME loan securitisation, the key question is if the ECB is willing to take credit risk onto its balance sheet or if other EU institutions (like the EIB Group) are ready and able to take on such risk. With a scheme designed along the lines of the FLS/FLG, which would essentially mean central bank lending against collateral, the credit risk can be left with the banks[20]. But with public support to increase SME loan securitisation, either the ECB or the EIB, has to take on the risk.

Our preference would be for the credit risk assumed by the ECB to be minimised, especially because there is a first-best solution to overcome undue credit constraints: cleaning-up the balance sheets of the banks and supporting economic growth.

We should highlight that an FLS/FGS-type scheme can have drawbacks. Banks could extend credit to less viable SMEs and enter into a Japanese-style scenario by distorting capital allocation. This could be especially the case if SME lending is rewarded by as much as the UK's April 2013 revised FLS scheme, in which banks can get £10 of new funding from the Bank of England for every extra £1 net new loan they grant to SMEs. But when the central bank funding is provided one-to-one for every € of net new credit, then this concern is reduced. And this potential drawback is not specific to central bank liquidity provision: public support to SME loan securitisation and direct lending by publicly-owned investment banks (or public guarantees of lending by commercial banks) also entail the risk that banks extend credit to less viable firms.

4 CONCLUDING REMARKS

While southern European countries have major structural weaknesses that explain, at least in part, their severe SME access-to-finance problem, market failures and the high unemployment which ultimately threatens the integrity of the euro make a strong case for properly designed European support. There are arguments in favour of stepping-up all three main options: lending by development banks, public support for securitisation, and central bank liquidity provision. All three options should be explored to break the vicious circle between the credit crunch and weak economic conditions. However, more lending by development banks has limitations. Public support for securitisation could either leave most of the risk with the banks, or might transfer substantial risk to public accounts, which could be undesirable and could limit the scope for such support. And securitisation does not address the problem of high bank funding costs in southern Europe, and there are questions over the risk/return/liquidity characteristics of such securities. Cheap long-term liquidity provision by central banks, especially if it is fully conditional on expanding lending to SMEs,

19. Note that in the UK, banks could borrow under the FLS up to 5 percent of their loan book, irrespective of their net lending activity. But when net lending declines, the cost of the FLS funding increases up to a certain maximum.

20. As we have argued, at least in Italy, Spain and Portugal, banks have ample eligible collateral and therefore banks in these countries should be able to access ECB liquidity.

can be an effective tool to to alleviate the problem of high bank funding cost and help banks comply with the net stable funding ratio requirement of Basel III. Only central banks can provide such funding on a massive scale. Since central bank funding is provided against collateral, the increase in the risk exposure of the central bank would be limited.

However, our main conclusion is that without repairing bank balance sheets and resuming economic growth, targeted initiatives to help SMEs gain access to finance will have limited success. Cleaning-up bank balance sheet should be the top priority and the European Central Bank should foster this process by performing in the toughest possible way the asset quality review ahead of its takeover of the single supervisory role.

REFERENCES

Association for Financial Markets in Europe, AFME (2013) *AFME Securitisation Data Report, Q1 2013*, available at www.sifma.org/research/reports.aspx

Bank of England (2013) 'Bank of England and HM Treasury announce extension to the Funding for Lending Scheme', *News Release*, 24 April, available at www.bankofengland.co.uk/publications/Pages/news/2013/061.aspx

Belke, Ansgar (2012) '3-year LTROs – A first assessment of a non-standard policy measure', Briefing paper prepared for the April 2012 Monetary Dialogue at the European parliament, available at www.europarl.europa.eu/document/activities/cont/201204/20120423ATT43715/20120423ATT43715EN.pdf

Caballero, Ricardo J., Takeo Hoshi and Anil K. Kashyap (2008) 'Zombie lending and depressed restructuring in Japan', *American Economic Review*, 98(5): 1943-77

Darvas, Zsolt (2012a) 'Intra-euro rebalancing is inevitable, but insufficient', *Policy Contribution* 2012/15, Bruegel

Darvas, Zsolt (2012b) 'The euro crisis: ten roots, but fewer solutions', *Policy Contribution* 2012/17, Bruegel

Darvas, Zsolt (2012c) 'The ECB's magic wand', *Intereconomics: Review of European Economic Policy*, Springer, 47(5): 266-267

Darvas, Zsolt (2013) 'Can Europe recover without credit?', *Policy Contribution* 2013/03, Bruegel

Darvas Zsolt and Li Savelin (2012) 'Chart of the week: the ECB's power on Spanish and Italian bond yields', *Bruegel Blog* 10 October, available at www.bruegel.org/nc/blog/detail/article/913-chart-of-the-week-the-ecbs-power-on-spanish-and-italian-bond-yields/

Darvas, Zsolt, Jean Pisani-Ferry, Guntram B. Wolff (2013), 'Europe's growth problem (and what to do about it)', *Policy Brief* 2013/03, Bruegel

Deutsche Bank (2013) 'The SME problem', *Focus Europe*, Global Market Research, Deutsche Bank AG/London, March

European Central Bank (2013) *Report on the results of the survey on the access to finance of SMEs in the euro area, October 2012 to March 2013*, available at www.ecb.int/stats/money/surveys/sme/html/index.en.html

European Commission (2011) 'An action plan to improve access to finance of SMEs', COM(2011) 870 final

European Commission (2012) 'Annual Growth Survey 2013', COM(2012) 750 final

European Commission (2013) 'Improving access to finance of SMEs: key to economic recovery', MEMO/13/393, 2 May

European Commission and European Investment Bank (2013a) *Supporting small and medium-sized enterprises in 2012*, Joint Commission-EIB report, 2 May

European Commission and European Investment Bank (2013b) *Increasing lending to the economy: implementing the EIB capital increase and joint Commission-EIB initiatives*, Joint Commission-EIB report to the European Council, 27-28 June

European Investment Fund (2013) *Annual Report 2012*

Fitch Ratings (2013) 'Economics of European SME Securitisation Not Working', 3 May, available at www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/Economics-of-European?pr_id=790367

Gill, Indermit and Martin Raiser (2012) *Golden growth: Restoring the lustre of European economic model*, World Bank, available at www.worldbank.org/goldengrowth

Kraemer-Eis, Helmut, Markus Schaber and Alessandro Tappi (2010) 'SME Loan Securitisation. An important tool to support European SME lending', *Working Paper* 2010/007, European Investment Fund Research & Market Analysis

Kraemer-Eis, Helmut, Frank Lang and Salome Gvetadze (2013) 'European Small Business Finance Outlook', *Working Paper* 2013/18, European Investment Fund Research & Market Analysis

Jobst, Andreas (2008) 'What is securitization?', *Finance and Development*, September: 48-49

Liu, Pu and Yingying Shao (2012) 'Small business loan securitization and interstate risk sharing', Small Business Economics (online first), Springer

Magyar Nemzeti Bank (2013) 'Launch of the MNB's Funding for Growth Scheme', 30 April, available at english.mnb.hu/Sajtoszoba/online/mnben_pressreleases/mnben_pressreleases_2013/mnben_pressrelease_20130430

Merler, Silvia and Jean Pisani-Ferry (2012) 'Who's afraid of sovereign bonds?', *Policy Contribution* 2012/02, Bruegel

Moec, Gilles (2013) 'Europe faces a risk of "zombification"', *The Economist Free Exchange*, 16 May, available at www.economist.com/blogs/freeexchange/2013/05/european-central-bank-1

Moody's (2013) 'European SME ABS securitisation: Economic conditions drove negative rating migration in 2012', *Moody's Investor Service*, 15 April

OECD (2013) *Financing SMEs and Entrepreneurs 2013: An OECD Scoreboard. Final Report*

Pill, Huw (2013) 'The ECB can't substitute for periphery financial reform', *The Economist Free Exchange*, 20 May, available at www.economist.com/blogs/freeexchange/2013/05/european-central-bank-5

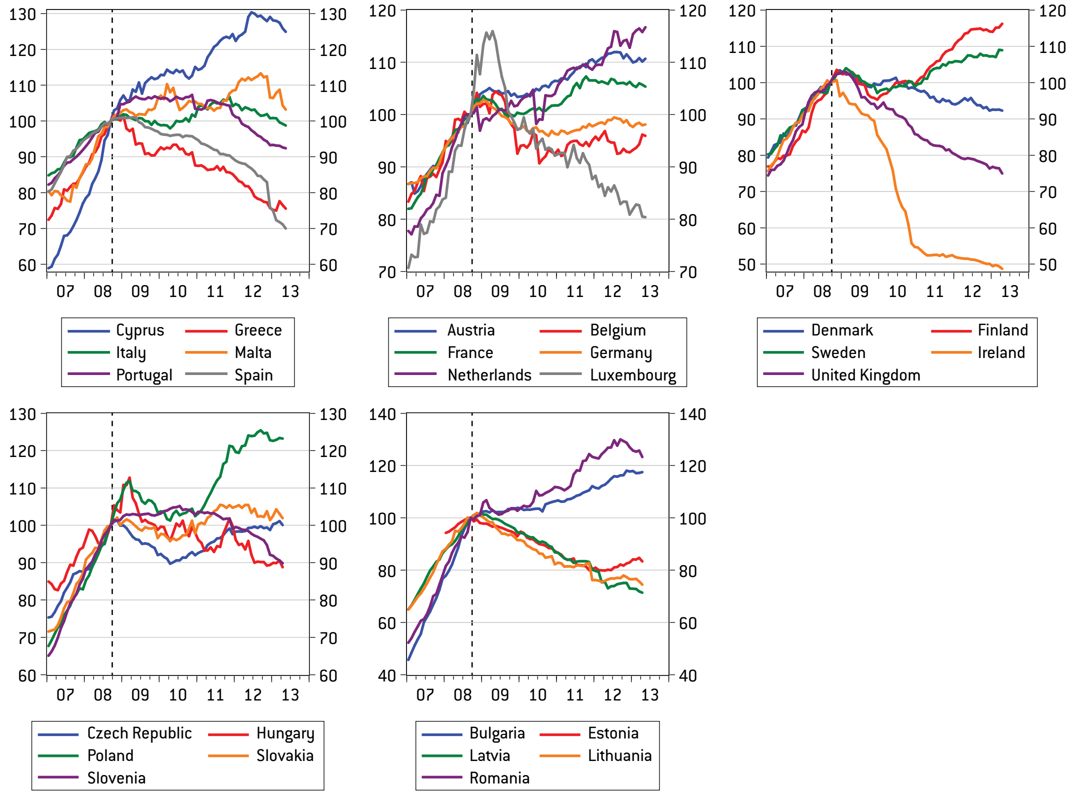
Securities Industry and Financial Markets Association, SIFMA (2013) 'European Securitisation (in partnership with AFME)', Excel sheet, available at www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/SF-Europe-Securitisation-AFME-SIFMA.xls?n=86602

Standard & Poor's (2013) 'Could SME-backed covered bonds gain popularity with investors?', *RatingsDirect*, 4 February

APPENDIX: CREDIT AND INTEREST RATE DEVELOPMENT IN EU COUNTRIES

Specific time-series for SME loans are not available. The figure below shows data for all non-financial corporations.

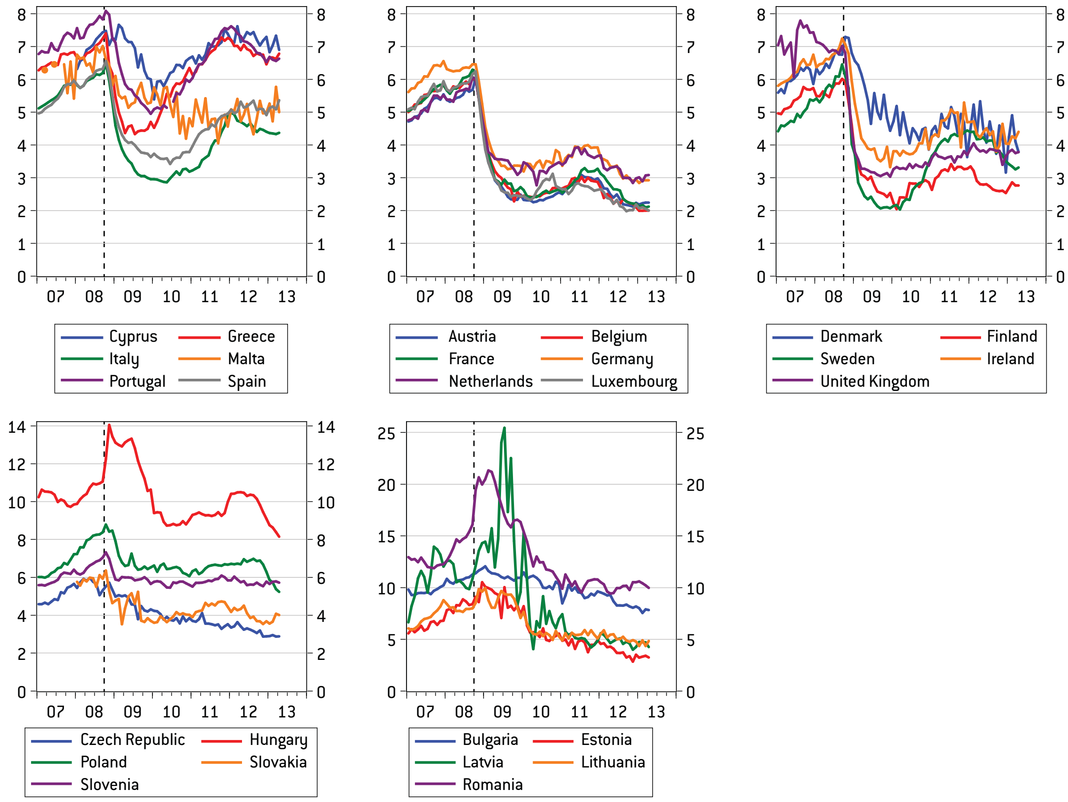
Figure 4: Credit to (all) non-financial corporations (in domestic currency unit, September 2008 = 100), January 2007 – May 2013



Source: Bruegel using data from the European Central Bank (outstanding stock of credit in euros) and Eurostat (exchange rate against the euro at the last day of the month). Note: We converted the data published by the ECB in euros to national currencies. In those floating exchange rate countries in which foreign currency loans have a large share (Hungary, Poland, Romania), some of the changes are due to the revaluation, as exchange rates depreciated since 2008. The vertical line indicates September 2008. Data for Croatia is not available.

Specific time-series for SME lending rates are not available. The figure below shows data for loans below €1 million to all non-financial corporations.

Figure 5: Interest rate on loans below €1 million to non-financial corporations for less than one-year maturity (percent per year), January 2007 – April 2013



Source: Eurostat except for the UK, for which is from the Bank of England. Note: UK data refers to loans below £1 million and for all maturities. The vertical line indicates September 2008. Data for Croatia is not available.