DIRECTORATE GENERAL FOR INTERNAL POLICIES

**POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY**

# The ECB and Finance for SMEs

## NOTE


**Abstract**

The supply of loans by euro area banks is declining and there is widespread evidence of a severe credit crunch. This is having a particularly negative effect on small and medium-sized enterprises (SMEs). The ECB can take some actions to address the weak supply of credit for SMEs such as reducing the haircuts on credit claims and purchasing securities backed by loans to SMEs. However, the Bank of England's Funding for Lending scheme does not represent a useful template for the Eurosystem. Overall, it is unlikely that ECB-related policy initiatives will have much impact on the supply of credit to small firms. Europe needs a series of broader systemic approach to solving the problems with under-capitalisation and broken funding models that are incentivizing banks to restrict credit.



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# 1. INTRODUCTION

The euro area's ongoing economic crisis has many different aspects. While much of the focus in policy circles is on building institutions that will help keep the common currency intact, the euro area's economic problems are being exacerbated by the fact that it has fallen back into a long-lasting recession that is leading to ever-rising record levels of unemployment.

There seems to be a growing realisation among the euro area's leaders that Europe's weak, undercapitalised banking system is playing a crucial role in deepening and prolonging the current recession. The weakness in the banking sector is leading to a severe credit crunch, most notably in those parts of the euro area experiencing fiscal crises. Total loans from euro area banks, which had begun to recover in 2011, are now contracting again (see Figure 1).

This credit crunch is impacting every sector in the euro area's economy. In particular, however, the small and medium-sized enterprises (SMEs) that account for most of the output and employment in the private sector are finding credit conditions particularly difficult. The ECB's SAFE survey of businesses shows that firms in almost every euro area member state believe it is becoming progressively more difficult over time to obtain bank loans while the Bank Lending Survey confirms that banks are tightening up on terms and conditions for approving loans.

Restrictions in the supply of credit are severely interfering with the traditional transmission mechanism of monetary policy. For example, while the ECB's loosening of monetary policy has led to lower interest rates on small business loans over the past few years, rates on small business loans in countries like Spain and Italy have risen and are now about twice as high as in Germany. (See Figure 2.)

In many cases, the difficulty in obtaining credit is threatening the survival of firms that would be able come through the recession if the banking system was operating normally. The political pressures associated with the difficulties faced by SMEs are finally leading to Europe's leaders focusing on how this problem can be addressed.

In this paper, I first discuss the broader factors underlying the weakness of bank credit in the euro area and why this weakness has particularly affected SMEs. I then discuss policy proposals that have been put forward in relation to the ECB acting to ease the supply of credit to SMEs. I argue that the Bank of England's Funding for Lending scheme does not provide a model for a new approach from the ECB. However, the ECB could provide more certainty about the availability of long-term finance and could lower the haircuts it applies to the use of business loans as collateral. While sceptical of the idea that SME-backed securities are likely to become a popular product in financial markets, I do favour an ECB programme to purchase such assets and hope that debates about how to design these products do not delay this initiative.

Overall, however, I argue that tailored policy measures to address the SME sector's credit needs are unlikely to have a major impact. Europe needs to sort out the deep structural problems with its banking sector. While the various policy initiatives in place (the single supervisor, the upcoming asset quality review and stress tests followed by recapitalisations and bail-ins) are welcome, this process is occurring at a very slow pace and we are likely to be years away from the European banking sector playing its vital role in funding the economy. Every attempt should be made to complete the process of banking union and bank restructuring as soon as possible.

**Figure 1: Year-over-Year Loan Growth in the Euro Area**

**Source: ECB Statistical Data Warehouse**

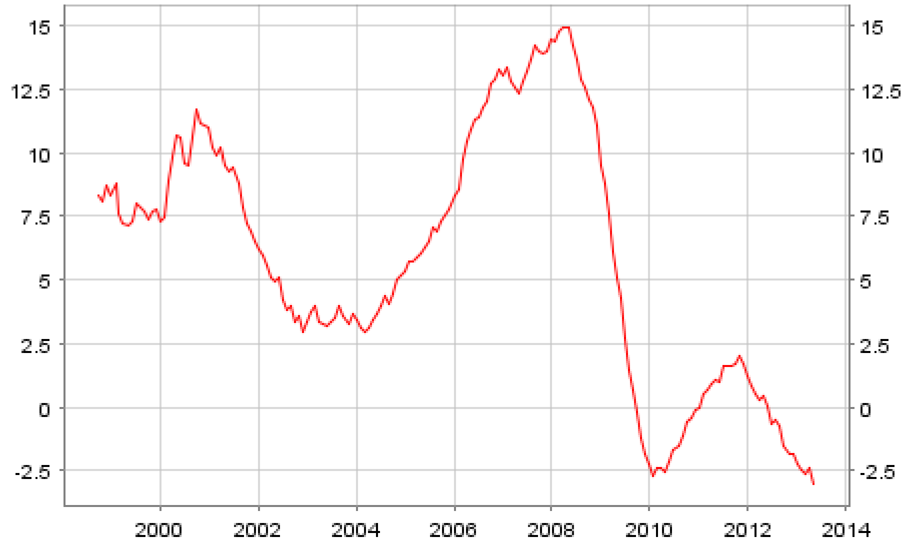
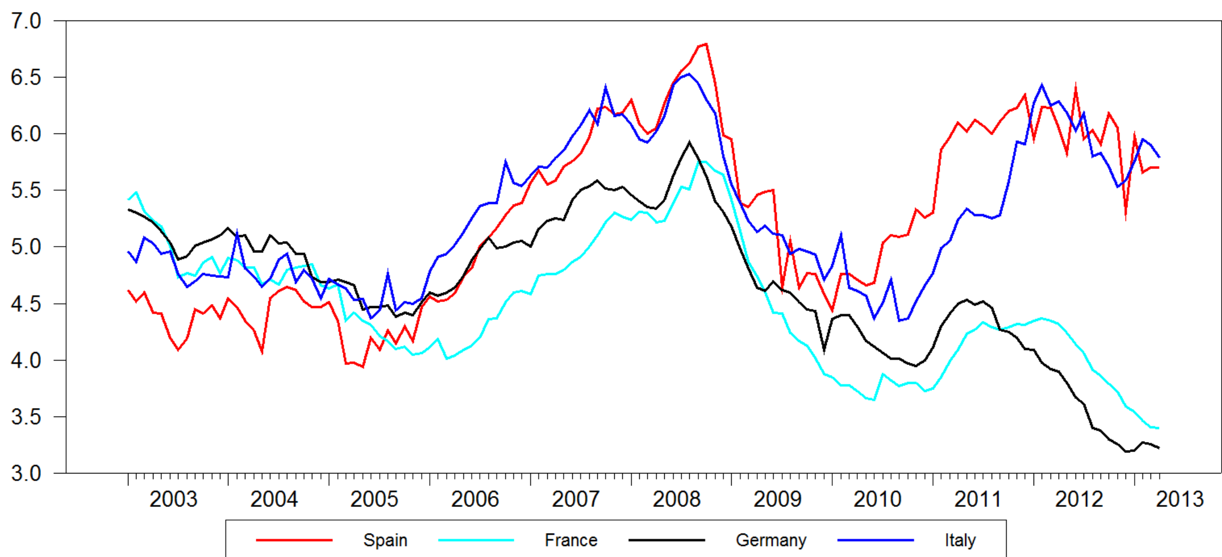



**Figure 2: Interest Rates on Loans Under €1 Million**

**Source: ECB Statistical Data Warehouse**



# 2. WHY IS SME LOAN GROWTH SO WEAK?

Before discussing the problems specifically affecting SME lending, it is worth focusing first on the broader reasons why the total supply of credit is so weak throughout the euro area.

## 2.1. Explanations for Weak Bank Credit

There are a number of different explanations for the weakness in bank credit. One explanation is weak demand. With the economy in recession, businesses are not planning to expand and consumers are holding off on purchases of durable goods and houses. Given the current slump, it is unlikely that credit growth would be strong even if the banking system was healthy.

That said, it is also clear that a significant aspect of the weakness in credit reflects restrictions in supply due to a range of structural factors affecting the euro area banking system. Here, I will focus on three: Funding problems, capital adequacy problems and changes in risk aversion.

***Funding Problems***

Many European banks had developed funding models prior to 2008 that relied heavily on non-deposit funding.[1] The global financial crisis of 2008/09 led to many financial market participants reassessing the risk of lending money to banks. European banks have reacted to the reduced supply of non-deposit funding through a combination of shrinking their balance sheet (by not making new loans) and replacing lost private sector funding with loans from the Eurosystem. The latter, however, are seen as a relatively temporary source of funding and so banks are reluctant to commit these funds to long-term loans.

Basle III will also require banks to have stable funding models in place by 2018 (as measured by net stable funding ratios). The European Banking Authority (EBA, 2013) has reported that 55 percent of Europe's leading banks currently fall short of the Basle III net stable funding ratio requirement and that the total shortfall in stable funding was €1.2 trillion as of June 2012. If such funding cannot be obtained, an alternative way to satisfy the Basle III funding requirements will be to run down loan assets over time.

Difficulties in obtaining non-deposit funding for euro area banks have, if anything, been worsening over time. Unlike the pre-crisis period, potential suppliers of bond market funds (or large corporate deposits) are now highly aware of default risk when dealing with banks. For a number of years, the euro area's approach to this wariness had been to reassure bond investors that "bail-ins" would only apply to bonds issued after 2018. However, this reassurance has never been seen as particularly credible and, with the EU council agreement on a draft resolution directive, it is clear that senior bank creditors are likely to lose money in the event of any serious insolvency in the euro area over the next few years.[2]

As the recession grinds on, concerns about asset quality at banks in countries such as Spain and Italy are mounting and this is combining with concerns about the consequences of insolvency to raise the cost of funding for some banks and shut others out of non-deposit funding markets altogether.

[1] Le Leslé (2012) contains a lot of details on how the European banking sector's funding differs from the rest of the world.

[2] This agreement can be found at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/137627.pdf

### *Capital Adequacy Problems*

In addition to having broken funding models, many of the euro area's banks also have problems with asset quality and capital adequacy requirements, which are also incentivizing them to reduce the size of their balance sheet. Equity market valuations of bank shares are generally well below their book value, indicating that investors believe these banks are sitting on large undeclared loan losses.

Even without considering future losses, satisfying Basle III regulations will require higher capital ratios for much of the banking system. Despite having raised about €200 billion in new equity capital since 2007, the EBA (2013) estimates that the leading European banks have a capital shortfall of €380 billion relative the amount they would require to meet the 10.5 percent total capital ratio target under the new Basle III standards.[3]

One solution to these capital adequacy problems would be for banks to raise large amounts of new equity financing. However, bank executives and shareholders generally dislike this approach on the grounds that it requires them to dilute their ownership and reduce dividends payments to existing shareholders. The alternative is to raise capital ratios by shrinking balance sheets gradually over time or at least to avoid expansion and raise capital ratios over time through retained earnings. Given this "capital crunch", Europe would likely be experiencing a period of tight credit crunch even if banks did not have serious funding problems.

One policy to avoid having capital shortfalls leading to a credit crunch is the recommendation of Hanson, Kashyap and Stein (2011) to require banks to reach target capital ratios purely by raising new capital, rather than by adjusting the size of their balance sheet. In general, however, this kind of program requires the government to stand as a "capital provider of last resort" in the (unfortunately likely in the euro area case) outcome that private investors are unwilling to provide the amount of capital required. However, while the US had the fiscal leeway to provide large amounts of money for bank recapitalisation via TARP, there is little appetite among European governments for a large programme of shared state-financed recapitalisation. The €60 billion limit currently placed on ESM's direct recapitalisation tool falls a long way short of the amount of money that would be required to recapitalise the euro area banking system. Many euro area national governments are also unwilling to issue the required amount of debt to recapitalise their banks.

### *Changes in Risk Aversion*

Another influence on the weak supply of credit is the widespread re-evaluation of risk within the banking system. Just as suppliers of funds to banks have re-assessed the risks involved in supplying funds, bank executives in charge of lending decisions have become far more aware of credit risk than they were during the pre-crisis period. Prior to the crisis, lending decisions were often taken without much consideration of default risk provided borrowers could use property assets as collateral. However, with default rates high and property prices slumping in many countries, lenders are now far more conservative in their decisions to supply credit.

[3] The source for the €200 billion capital raising figure is a recent presentation by ECB Executive Board member Benoît Cœuré (2013).

## 2.2. Why SMEs Are Hit Hardest

The factors just cited are having a more severe impact on SMEs than on large firms. This is for a number of reasons.

First, smaller firms are more likely to rely on banks for finance than larger firms which may be able to access capital markets. In addition, younger firms are less likely to have accumulated sufficient internal funds to maintain expansion plans without support from banks.

Second, SME loans are generally viewed as riskier than loans to larger better-established companies. Thus, if banks choose to be more careful in their evaluation of risks, small firms are more likely to have their applications rejected. Capital adequacy problems are also more likely to raise rejection rates for SME loans because regulatory capital ratios are reduced by cutting risk-weighted (as opposed to total) assets. Because SME loans have higher regulatory risk weights, banks will generally boost their regulatory capital ratios more by cutting back on these loans than by cutting back on other investments. (Though the decision to reduce the capital charge associated with SME loans in the implementation of the latest Capital Requirements Directive is welcome.)

Third, banks find it more difficult to assess the credit quality of SMEs than they do for larger, more established firms. With funding and capital adequacy factors already restraining credit, there may be little incentive for banks to incur the additional costs associated with assessing applications from small firms and with maintaining ongoing business relationships necessary for this kind of lending.

Fourth, it is well known that "informational asymmetries" (bankers not having full information about the quality of the borrower) can lead to credit being rationed or else the complete collapse of the market for a particular type of lending.[4] These problems with the market for SME loans may argue for a role for government intervention. For example, Mankiw (1986) provides a model in which a government guarantee scheme can prevent the allocation of credit from collapsing due to informational problems.

These kinds of considerations provide a theoretical case for the kind of programmes of supports for small business that exist in many member states and for the work of the European Investment Fund in supporting SME credit throughout the euro. There are strong arguments for allocating greater public funds towards such schemes over the next few years. In the next section, however, we consider specifically whether there is an important role to be played in this process by the ECB.

[4] Stiglitz and Weiss (1981) is the classic reference on how asymmetric information leads to rationing of credit. Mankiw (1986) illustrates how informational problems can cause lending markets to collapse.

# 3. OPTIONS FOR THE ECB

Here, I consider two types of policies that have been proposed in relation to the ECB acting to ease the credit crunch for SME firms.

## 3.1. Funding Programmes

With a credit crunch for SME firms also affecting the UK, the Bank of England has introduced a Funding for Lending Scheme (FLS) aimed at incentivizing banks to lend to small firms. The scheme sees the Bank of England providing commercial banks with £10 of cheap funding for every £1 invested in SME loans.

One theme in recent discussions about the SME credit crunch has been the idea that the FLS provides a model that the ECB can follow to encourage lending to small businesses. For example, on June 15, Reuters reported Spanish Prime Minister Mariano Rajoy as saying "*I would like the ECB to act like other central banks, to do as the Bank of England has done - giving cheap loans to financial entities so that these financial entities can lend at cheaper rates to small and medium-sized companies*."[5]

Despite these calls, I don't believe the FLS scheme represents a useful template for boosting SME lending in the euro area. This is for two reasons.

First, FLS has not, in fact, boosted lending from the participating banks. Figures released by the Bank of England show that lending to households and nonfinancial corporations by the banks enrolled in the FLS has fallen by almost £2 billion since its introduction.[6]

The idea behind the scheme is that it offers banks the opportunity to make profits via a "carry trade" in which the additional funds provided because of the SME lending can make a return that is higher than the low cost of borrowing the Bank of England. However, the UK's large banks are deleveraging for the same reasons outlined above, and their longer-term goals of being well-capitalised and having stable funding are more important to their strategic decision-making than the short-term profits that can be obtained from expanding lending via the FLS. Of course, it may well be that lending to SMEs is higher than it would be under the counterfactual in which the FLS was not introduced but the evidence so far hardly suggests that it is a successful template for increasing this kind of credit.

Second, it is not clear how a scheme along the lines of the FLS would fit within the Eurosystem's monetary policy operational framework or whether promoting SME lending in this way requires co-operation from the ECB at all. All ECB lending requires borrowing banks to post eligible collateral. However, unlike the FLS, it is not clear which fiscal entity is there to play the role of the UK Treasury in FLS by providing the eligible collateral that allows access to cheap borrowing. It is possible that the ESM could play such a role. However, ESM-issued bonds already count as eligible collateral for Eurosystem operations and these operations are currently being run on a full-allotment basis. In this sense there is no need for the ECB to make a specific decision to approve an FLS-style scheme. If Europe's leaders want to provide ESM bonds to banks that make loans to SMEs, then they can choose to do so. However, the ESM already has many demands on it and, given the limited evidence of the success of FLS, I suspect an agreement of this type is unlikely to occur.

There are, however, two concrete funding-related steps the ECB could take that could help marginally to improve SME lending.

[5] See http://uk.reuters.com/article/2013/06/15/uk-spain-smes-idUKBRE95E09V20130615
[6] These data are available at http://www.bankofengland.co.uk/markets/Pages/FLS/data.aspx

The first step is to lower the haircuts applied to so-called "non-marketable credit claims" (i.e. individual non-securitised loans). While the ECB extended its collateral framework in recent years to allow these claims to be used as collateral, they apply relatively large haircuts in this process. So, for example, some of the lower-quality credit claims have haircuts over 50 percent, meaning you can borrow less than half the face value of the loan. Reducing these haircuts could make loans to nonfinancial businesses more attractive for banks.

The second step is to reassure banks that long-term funding will be available from the ECB for a significant amount of time. The ECB has taken some small steps in this direction by assuring banks that three-month fixed rate tenders with full allotment will be available until at least the middle of 2014. However, this is still a relatively short time horizon. Certainly, it is too short to provide a basis for new lending to SMEs. An announcement that the ECB will conduct another three-year LTRO to replace the operations conducted in late 2011 and early 2012 would provide more certainty to banks facing funding problems and would reduce incentives to cut back on providing credit to the real economy.

One counter-argument to these proposals is that they involve taking risks with the Eurosystem's balance sheet and may lead to losses that could require public funds be used to recapitalise central banks. On this issue, the following points are worth making:

- Money creation via lending to banks can generate costs because the money can end up re-deposited with the Eurosystem and being compensated with interest in the deposit facility. However, this facility currently pays zero and traditionally pays 100 basis points lower than the Eurosystem charges on its refinancing operation. So, in general, monetary operations are profitable and there is room to take some losses on loans without wiping out profits.
- While media commentators regularly focus on the relatively small size of the ECB's capital and reserves, these figures are irrelevant when considering risk on monetary operations. This is because losses on monetary operations are shared across the whole Eurosystem and the system as a whole currently has almost half of one trillion euros in capital and revaluation reserves. We are a very long way away from the Eurosystem needing to be recapitalised.
- In any case, despite regular opinions from the ECB legal department that it is in favour of well-capitalised central banks, there is nothing in either economic theory or European law that requires any of the central banks in the Eurosystem to have positive capital, i.e. assets with a value greater than their (often notional) liabilities. Central banks have operated efficiently with negative capital in the past and there is nothing in the ECB's monetary policy operational framework that requires positive capital to keep control of interest rates or inflation.

Given these points, it is disappointing how often "protecting the ECB's balance sheet" has been used as a key objection to otherwise-worthwhile policy proposals over the past few years.

## 3.2. ABS Purchases

The other main policy suggestion relating to the ECB and SME lending has been that the ECB would purchase asset-backed securities (ABS) constructed from SME loans. One possible argument for this policy is that it would promote liquidity in the market for SME-backed ABS and promote their popularity as a financial instrument. This argument seems weak.

Even when ABS were at their peak prior to the financial crisis, SME-backed bonds accounted for only a very small percentage of these assets. SME loans have a number of features that make them less compatible with securitisation than, for example, household mortgages. SME loans contain a large amount of idiosyncratic risk; a much larger fraction of the risk associated with mortgage loans can be summarised through a few observable household characteristics. SME loans are also less homogenous in their terms and conditions, including collateral requirements and underlying interest rates. With small firms more vulnerable to economic conditions than large ones, the income flows underlying these securities will generally feature more correlated risk than mortgage-backed securities. Since these securities were unpopular with financial markets prior to the crisis, it is unlikely that the ECB's presence in this market will be sufficient to create significant demand during this current period in which investors are far more risk averse.

Still, given the crippling effect that tight credit is having on the SME sector, a tailored scheme in which the ECB purchases a significant quantity of SME-backed ABS is still a good idea. Unlike programmes that focus on providing cheap funding, ABS purchases by the ECB will be more likely to promote lending. Banks can make money (via fees) for originating loans to SMEs without triggering the funding or capitalisation concerns associated with expanding their balance sheets.

One potential problem with a large programme of ABS originated for subsequent purchase by the ECB is moral hazard with loan origination. Banks may make poor quality loans to collect the origination fee with losses being taken by the ECB. Somewhat predictably, given its consistent emphasis on "protecting its balance sheet", ECB President Mario Draghi has already indicated that the ECB are unwilling to take any credit losses on ABS purchases. At the June Governing Council press conference, Draghi said "*there is a task force working on this together with the European Investment Bank, and if they produce something, it will be collateralised, it will be guaranteed by other institutions*."

There are reasons to question the consistent refusal of the ECB to take actions that could result in credit losses. For example, what will the yield by on any SME-backed bonds purchased by the ECB? Will the ECB insist on being compensated with a market-consistent yield (as would be obtained by investors purchasing without being completely insured against losses) or will it be a low risk-free yield? If the ECB is not taking any risk, then it should not receive compensation for risk. This may seem like a simple principle but it was not a principle followed in relation to the the Eurosystem's purchases of Greek sovereign bonds. These bonds were purchased at a high yield reflecting considerable default risk. However, when the Greek debt restructuring occurred, the ECB used its considerable power to exempt itself from any debt exchange. Thus, it purchased high-yielding high-risk bonds but refused to accept any downside risk when it transpired.

Accepting, however, that other institutions (perhaps the ESM) will be called upon to provide guarantees to the ECB for bonds put together by the EIB, there will be debates about the need to make banks take on sufficient risk on loans they originate to discourage the deliberate adoption of poor lending standards. I would hope that such discussions are concluded quickly and still produce a scheme that is attractive for banks to take part in. The last thing the euro area needs now is another cumbersome scheme designed to help firms but which fails because of too much focus on moral hazard. A successful SME lending scheme that helps to promote the economy can play an important role in getting a recovery going and this, rather than eliminating possible public losses, should be the focus of a programme of ABS purchases.

# 4. A WIDER RESTRUCTURING NEEDED

While I fully support efforts by national governments, the European Commission and the European Investment Bank to promote SME lending and also favour a programme of SME-backed ABS purchases by the ECB, I am doubtful that these initiatives will do enough to normalise the market for lending to SMEs.

Despite an avalanche of press releases and reports boasting about various European initiatives to aid small business, the overall size of current initiatives (as described, for instance, in EIB, 2013) is small relative to the total shortfall in lending in the euro area. Also, I suspect the proposal for the ECB to purchase ABS will turn out to be a damp squib given the ECB's lack of enthusiasm for asset purchases and a reluctance to use up much shared European public money to provide the required guarantees.

The harsh truth is that SME lending is unlikely to return to normal until Europe's banks solve their problems with funding and under-capitalisation. These problems will not be fixed until the true extent of loan losses is recognised and banks are re-capitalised to high levels. This process is crucial because, once Europe's banks are recognised as being well-capitalised, providers of non-deposit funding will be more willing to invest with European banks, so fixing the problem of weak capitalisation will contribute towards fixing the problem with broken funding models.

Obtaining a well-capitalised and well-funded banking system is not going to be easy. It will require a far more honest assessment of the asset quality of Europe's leading banks than was seen with previous EBA-sponsored stress tests. And once banks are diagnosed as being insolvent, recapitalisation and resolution tools (including bail-in) need to be used swiftly and efficiently while preserving financial stability. It will be a difficult act to pull off. However, the current situation, with under-capitalised banks and potentially skittish depositors and bond investors is a dangerous and unsustainable one, not least because Europe's banking system continues to fail the small businesses that are the backbone of our economy.

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