From Basel III to alternative sources of funding: Assessing the impact of financial regulation on access to finance for SMEs and the real economy

On 9 February 2012, UEAPME, the voice of Small Businesses in Europe, ACCA (The Association of Chartered Certified Accountants) and Leaseurope, the trade association representing the leasing and automotive rental industries across Europe, jointly organised a lunch debate in Brussels to assess the real impact of the new capital requirements - especially in conjunction with other measures such as Solvency II- on the real economy and consider the trade-off between safeguarding against future financial crises and protecting the interests of SMEs.

The roundtable, moderated by Robin Jarvis, Head of SMEs affairs at ACCA and a member of the European Banking Authority (EBA) Banking Stakeholders' Group, consisted of distinguished speakers including; Othmar Karas, MEP rapporteur on the CRDIV, Erik van der Plaats, policy coordinator banks and conglomerates, DG MARKT, Santiago Carbó, Professor of Economics at the Department of Economic Theory and History, University of Granada and the Head of Financial Studies of the Spanish Savings Banks Foundation (FUNCAS), Gerhard Huemer, Director Economic and Fiscal Policy, UEAPME , Tilman Lueder, head of unit asset management, DG MARKT, Jochen Jehmlich, Managing Director, GEFA,Société Générale Equipment Finance, representing Leaseurope, Chiara de Caro, General Manager, EBAN , Doerte Hoeppner, Secretary General, EVCA, Vilmos Budavari, unit Financing Innovation, DG ENTR.

The conclusions indicate that it is crucial to strike the right balance between the need for financial stability and ensuring sufficient access to finance for SMEs. To that end, it is likely that the risk weights for SME loans will need to be revised when implementing the "Basel III" rules on capital requirements in the EU, and alternative sources of funding, such as equity–oriented instruments and leasing, must be further developed and encouraged.

Main highlights

The need for a new framework to increase the resilience of the financial system is commonly accepted by all. However, many stakeholders, including regulators, the banking industry, as well as small businesses and their advisors, have warned that Basel III and its European version, the Capital Requirements Directive (CRDIV), which require banks, amongst others, to hold more capital, is likely to have a disproportionately negative impact on small and medium sized enterprises' (SMEs) access to finance, even though this sector had little to do with the causes of the financial crisis. In Europe, given our SMEs' greater dependence on debt financing, the impact is likely to be even more adverse and it is more important than ever to develop alternative sources of funding, such as venture capital, micro credit, or leasing, including through vehicles such as the new European Programme for the Competitiveness of Enterprises and SMEs (COSME).

Othmar KARAS (EPP, Austria) MEP, Rapporteur on CRDIV

- It is important to look at the cumulative impact of Basel III and other existing or upcoming regulations
- The newly published European Parliament study indicates that the CRDIV proposal would impact the real economy.
- It is crucial to reduce the risk weights attributed to SME lending in the new Review of the CRDIV.
- However, these risk weights should not be considered in isolation. Other areas of the requirements, such as the leverage ratio, will also have significant impacts. For instance, the leverage ratio is likely to increase the price of trade financing

Erik van der Plaats, policy coordinator banks and conglomerates, DG MARKT

- The CRDIV proposal is a complex piece of legislation. The Commission is trying to balance two contradictory policy objectives: the need for financial stability and the need to lend to SMEs, who are the backbone of the EU.
- The cost of regulation should not fall disproportionately on SMEs. SMEs and small banks did not create the crisis, yet they are likely to be impacted by more stringent financial regulation. However, impact assessment shows that SMEs do not pay a higher price than others to ensure financial stability.
- The Directive contains a review clause which allows for SME risk weighting recalibration. The Commission has asked the European Banking Authority to look into the risk weights for SME lending and whether actual losses on SME exposures would justify lower risk weights.
- Under the CRD IV proposal the Commission must also take into account the impact of new instruments such as the liquidity and leverage ratios to assess any unintended consequences on SME lending

Santiago Carbó, Professor of Economics at the Department of Economic Theory and History, University of Granada and the Head of Financial Studies of the Spanish Savings Banks Foundation (FUNCAS)

- Presented the findings of a study on changes in solvency regulations, lending to SMEs and investment in Spain
- The estimates from this study indicate that capital requirements for loans granted to SMEs should be more flexible and individualized, based on 3 fundamental reasons:
    - the negative effects of increased solvency requirements are significantly larger on loans to SMEs. The reduced amount of credit to SMEs could be double the reduction in other loan types
    - increased cost of credit would make the economic situation even worse. A reduction in the number of loans, especially in countries that are highly dependent on banks, might have considerable negative effects on SME investment and growth
    - significant differences were found in their simulations across types of institutions: share of SME exposures on saving banks' balance sheets is higher than the average for the banking sector

Gerhard Huemer, Director Economic and Fiscal Policy, UEAPME

- There is no doubt that new regulation will make it more difficult for SMEs to access finance
- UEAPME - and SMEs- are interested in financial stability and regulations are needed. UEAPME is not against Basel III as such but deplores that it only looks at increasing capital requirements and does not look at the risk structure of different exposure types. Indeed, it is essential to differentiate between different loan types. Therefore UEAPME asks to immediately revise risk weights for SME exposures, especially as evidence shows SME loans are generally less risky.
- We need to make sure that guarantees given by guarantee institutions and mutual guarantee schemes are fully recognized by the regulation as a risk mitigating tool and are appropriately used at national levels
- SMEs also need public support instruments in cases where loans do not fulfill their financing needs
- Loans will remain an important source of finance to SMEs in the future. Nevertheless, debt finance has its limitations and is not always appropriate for start-ups or financing innovation projects. In these cases, more equity oriented instruments such as venture capital, private equity and business angels are needed. Leasing can also be a good alternative to traditional loans.

Tilman Lueder, head of asset management, DG MARKT

- SME finance is still very dependent upon debt (which accounts for 80% of SME financing)
- Alternative sources of SME finance are necessary. Venture capital, a form of equity investment where the investment's value rises or falls in line with the success of the portfolio undertaking, is less developed in the EU
- Venture capital financing currently only covers 2% of SME financing. In the US, venture capital accounts for more than 14% of SME financing.
- Venture capital - and some forms of private equity - are alternative sources of SME financing that need to be developed further. The framework provided by the recently adopted Alternative Investment Fund Managers Directive (AIFM) is not sufficient to address the specific needs of venture capital. Venture capital operators also need the European Passport, but the Passport conditions in AIFM are too onerous for these often small operators.
- An average venture capital fund manager in the EU manages assets of € 60 million, while a US counterpart has, on average, € 130 million in assets under management. A truly efficient VC fund needs assets of at least € 200 million. Average EU venture capital investments in a single start are low when overall capital managed by VC funds is low. In Europe the average single company investment in venture capital amounts to € 0.4 million while the average US single company deal size is over € 2.2 million.
- The new Regulation introduces a specific Passport only for managers of qualifying venture capital funds. These managers need to operate fund portfolios beneath the AIFMD threshold of €500 million.
- Qualifying European Venture Capital Funds are defined as follows:
  - Composition of portfolio (70 % of their assets should be invested in unlisted SMEs
  - The VC fund invests only in equity or quasi-equity instruments directly issued by the SME.
  - Investors have to be professionals (not a retail scheme for pension investors)
- Lighter supervision and a pan European Passport should increase capital raised by VC funds. The VC Regulation also aims to establish an international EU VC brand.

Jochen Jehmlich, Managing Director, GEFA, Société Générale Equipment Finance, representing Leaseurope

- Leasing is a unique form of asset based financing where a leasing company makes an asset it owns available to another party for a certain period of time, in exchange for payment
- Leasing is used to finance an extremely broad range of asset types, which include cars, trucks, plant & machinery, ITC, equipment, renewable energy equipment, healthcare equipment, real estate etc. Leasing companies include bank owned, manufacturer owned (captive) and independent lessors
- Leaseurope commissioned a report from leading European economic consultancy Oxford Economics on the extent and nature of leasing to SMEs in Europe. According to this study, an estimated 40% of SME firms used leasing in 2010, more than any other individual form of external financing. In particular, leasing was used more than bank loans > 3 years (38%) or overdrafts (37%)
- This 40% translates to just under 6 million individual SME firms in the 8 countries sampled who make use of leasing. SMEs financed 16.7% of their total investment in the EU in 2010 through leasing, expected to have risen to 18.6% in 2011.
- An estimated €100 billion of SME investment in fixed assets in the EU in 2010 was financed through leasing
- Leasing has great potential to contribute to improved economic growth by stimulating investment in Europe. Basel III limits available funding for leasing and therefore SME investment, which in turn will not be positive for economic growth. The EU implementation of Basel 3 should thus be designed and applied in a proportionate manner to leasing activities. It would be necessary to ensure that no unintended consequences arise from the changes made to the credit risk mitigation framework for physical assets.

Chiara de Caro, General Manager , EBAN

- Briefly introduced the concept of business angel financing, which can be an alternative way for SMEs to gain access to finance
- Business angels are wealthy entrepreneurial individuals investing in high risk start-ups. They take a high personal risk in the expectation of owning part of a growing and successful business
- In 2009 and 2010, business angel investment was stable, reaching €3.5 billion per year, which translates into 20 000 SMEs being financed
- Institutional investors can co-invest along with business angels
- The importance of professional training and support networks being provided for entrepreneurs was highlighted
- Tax incentives are crucial to develop this form of financing further

Doerte Hoeppner, Secretary General, EVCA

- 85% of private equity investment is made in SMEs. Venture capital is a very selective industry having specific requirements regarding SMEs. It invests only in high growth companies and is not engaged in micro-debt financing. There is high demand for venture capital financing from SMEs.
- The supply side of this capital is made up of institutional investors, who are impacted by Solvency II, IORPD and CRDIV, and tend to withdraw more from private equity and venture capital in anticipation of higher capital requirements and excessive risk weights. Through these regulatory files they are encouraged to invest in short term asset classes. If the supply side of venture capital is restricted there will be less equity capital available for SMEs.
- 3rd countries play a significant role in terms of raising capital for new venture capital funds as the EU institutional investors do not provide sufficient capital
- The private equity and venture capital industry welcomes all the initiatives of the European Commission to give SMEs a better access to finance, and supports any appropriate and proportional regulation.

Vilmos Budavari, European Commission, DG ENTR, Unit Financing SMEs

- According to the European Commission's latest survey on SMEs' access to finance, one third of SMEs did not get the finance they had applied for. The Commission will continue to monitor the situation.
- Presented the European Commission’s activities supporting SMEs through the CIP financial instruments, COSME Programme 2014-2020, Horizon 2020 and the PROGESS initiative on micro-finance, as well as presenting the support via the European Investment Bank. He explained that SMEs' access to capital is also facilitated by the review of the Directives for MIFID, market abuse, transparency and prospectus.
- Highlighted the Commission’s efforts fighting late payments (Member States are encouraged to accelerate the implementation of the Directive).
- The Commission will continue to provide a forum to discuss issues of importance for European SMEs (through the SME Finance Forum).

Robin Jarvis, head of SME Affairs at ACCA

- In wrapping up the meeting, Robin Jarvis concluded that it is widely recognized that SMEs make a massive contribution to the EU economy.
- If the economies of the member states are to break through this plague of austerity and recession it is critical that they have the opportunity to raise debt finance from banking institutions. Basel III must not be a constraint on these enterprises to raise debt finance.