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SAFE Finance Blog

SME Funding Without Banks?

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Interview: Günter Franke calls for a mix of bank- and marked-based financing

The Capital Markets Union project of the European Commission aims for an increase of market-based debt financing for small and medium-sized enterprises (SMEs) to reduce the dependence on bank lending. The action plan (http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52015DC0468) of the EU Commission mainly focuses on bonds and securitization.

In your recent policy paper (http://safe-frankfurt.de/policy-center/policy-publications/policy-publ-detailsview/publicationname/sme-funding-without-banks-on-the-interplay-of-banks-and-markets.html) you and Jan Krahnen criticize this approach. What are your points?

The discussion about improved financing opportunities for SMEs does not take into account that even in the USA SMEs hardly issue bonds. Although the ratio of bond financing over total corporate credit financing is at about 70 percent in the USA, there are almost no bonds issued below USD 100 million because of the high fix costs. Smaller US companies gain access to funding via unsecuritized loans. The Small Business Administration, which is run by the government, securitizes such loans and accounts for a part of the default risk. As a matter of fact: SME financing via bonds does not work in the US either.

In Germany, the market for SME corporate bonds (Mittelstandsanleihen) has a bad reputation, because financial intermediaries who took part in the process of issuing bonds did not work accurate. Their ratings have been too optimistic. As a consequence, many bonds defaulted. By now, a lot of SMEs are reluctant to issue bonds at all because of the bad market reputation.

What do you suggest?

It is important to strengthen non-bank sources of finance for SMEs. However, this should not be done by bypassing banks. Based on a long-term relationship, banks have built up a lot of expertise in credit screening as well as debtor monitoring. Also, banks have lots of experience in debt renegotiation, in case the debtor does not meet his obligations of debt repayment. Debt renegotiation is a complex process which calls for experts who have “skin in the game” and, thus, are highly interested in a successful debt renegotiation. With respect to corporate bonds a trustee is responsible for the renegotiation with a debtor. As the trustee is a servicer without any skin in the game, his commitment for the lender is rather weak.

What kind of model do you have in mind to combine bank- and marked-based financing?

Banks should continue to play a major role in SME funding. However, as banks contribute to systemic risk, the regulator should encourage risk transfer from banks to non-banks, for example by simple credit securitization. What is important is that all forms of lending require a persistent skin in the game. According to current regulations in the USA and in the EU, issuers of asset backed securities (ABS) are obliged to hold a minimum retention level of 5% of the nominal transaction size. Regulators should enforce the real minimum retention level in order to make sure that the originator screens and monitors the lender carefully. Therefore, originators should be obliged to report their real share of the overall potential losses of a given ABS transaction. This would make it easier for investors in ABS tranches to evaluate to what extent the originator has a stake in the transaction. However, the retention level of 5% is small compared to syndicated loans, where generally the lead manager holds a significantly higher retention.

Are there other possibilities for banks to share credit risk apart from securitization?

Banks can share their credit risk with non-banks not only via securitization. They can also use different forms of credit which include non-banks as lenders, for example syndicated loans, private placements or club deals. These lending instruments have in common that a considerable rate of risk retention stays with the lead manager. During the past years, we have observed a growing number of non-banks in syndicated loans. A relaxation of regulation, which allows alternative investments funds to specialize in certain loans and to take over the role from banks in in this respect, would be desirable.

Günther Franke (http://safe-frankfurt.de/de/forschung/wissenschaftler/details/showauthor/210-franke.html) is Professor of International Finance at Konstanz University.

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