EU Finance Day for SMEs, Italy

Remarks by Deputy Director General Luigi Federico Signorini

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1. Small and medium-sized enterprises in the European economy

Small and medium-sized enterprises (SMEs) are a key feature of the European economic landscape. They account for 99 per cent of all EU firms, employ 67 per cent of all payroll workers and generate 58 per cent of value added. Their contribution to economic activity varies significantly from sector to sector; in 2010 their contribution to value added ranged from under 25 per cent in energy to over 80 per cent in construction and real estate. Cross-country variability is also significant: SMEs' share was lower in the United Kingdom (50 per cent) and higher in Portugal, Spain and Italy.

In Italy SMEs account for about 80 per cent of total employment and 68 per cent of business value added. In 2011 micro enterprises – firms with fewer than 10 employees – accounted for around a third of the Italian firms' total value added, 8 percentage points higher than the European average.

SMEs rely heavily on internal sources (retained earnings) to finance ongoing activities and investment; their funding consists more of debt than equity and, among debt instruments, bank loans outweigh securities. The role of banks in SMEs' financing is linked to their ability to reduce the large information asymmetries typical of small firms. It is favoured by firms' inherent difficulty in going public, and sometimes their reluctance to do so, which limits their ability to place securities directly with non-bank intermediaries. Specifically, SMEs' access to capital markets is often hampered by high fiscal and administrative costs, lack of transparency and the low propensity of family businesses to dilute control.

Access to finance is a major challenge for SMEs in normal times; it has been much more so in Europe over the past five years. The deep recession that hit most countries – a double-dip recession in some cases – dried up internal resources; recurrent crises of confidence in financial markets, which put a brake

on funding flows, and mounting bad loans made banks tighten their lending policies.

These problems have been addressed with a variety of economic policy measures. Central banks have used monetary tools to ease the liquidity crisis of the financial sector; European institutions and national governments have used public resources both to help meet the SMEs' short-term financing needs and to fund guarantee schemes so as to mitigate credit risk. Regulators have envisaged specific provisions for SMEs in revising and strengthening the rules on banks' capital requirements. Supervisory authorities have put pressure on banks to bolster their capital and thus their ability to withstand macroeconomic risks.

In what follows I briefly summarize the effects of the crisis and recall the main contributions of the different policies to facilitate SMEs' access to finance in these circumstances, with special attention to the Italian case. I conclude with some general thoughts on the financial architecture of SMEs, with a view to making them more robust to external shocks and to promoting the long-term growth of our economies.

2. The crisis

The financial crisis in 2008 and the ensuing recession left a heavy legacy of joblessness and lost growth in the euro area. The area saw a mild recovery in 2010, but then the sharp worsening of the global growth outlook in the second part of 2011 and the EU's slowness in shaping policies to counter the crisis, together with a perceived risk of a break-up of the monetary union, fuelled renewed tensions. The economic impact of the so-called sovereign debt crisis was stronger in countries with larger internal or external imbalances and was further reinforced by financial markets' fragmentation along national lines.

The crisis quickly affected banks' funding conditions, since sovereign spreads have a significant impact on banks' funding costs, and hence on their ability to provide credit to non-financial corporations. Cross-country disparities in both the growth and the cost of loans to firms mounted during 2011; they moderated somewhat in 2012 and the first half of 2013 but they remain significant to this day.

The tightening of bank lending to firms was widespread, but findings drawn from qualitative and quantitative data consistently suggest that the effects were most severe for SMEs, owing to their limited ability to tap alternative sources of finance.

In Italy, where the increase in the sovereign risk spreads was substantial and the share of bank-dependent SMEs very large, these developments had even heavier repercussions than elsewhere. The average interest rate on new loans up to €250,000, a proxy for the cost of credit to SMEs, rose more steeply than that on new loans greater than €1 million. Moreover, large industrial groups, most of them listed, had in principle the alternative of going to the market as at least a partial substitute for bank credit, an option that is not available to most SMEs.

The adverse impact on credit supply conditions of banks' difficulty in accessing wholesale funds moderated in 2012, partly as a consequence of the extraordinary monetary measures adopted by the ECB, a point to which I shall return. Meanwhile, however, the crisis had spread again to the real economy. The worsening macroeconomic outlook in Italy and the consequent increase in credit risk were again reflected in a credit tightening. In 2012 and in 2013, the number of firms defaulting on loans increased substantially: in the second quarter of 2013 the ratio of new bad debts to outstanding business loans reached 4.7 per cent, 1.5 percentage points higher than a year earlier. The related deterioration in banks' asset quality has also contributed to the restrictiveness of lending standards.

Credit rationing hits SMEs disproportionately. While slightly less common in the immediate past, according to the latest qualitative data, rationing is still a constraint on the economy. It is important to understand that relaxing credit standards is not the solution. A robust, resilient banking system is a prerequisite for a functioning credit market. Prudence as regards banks' assets is essential to ensure safety for depositors and orderly access to funding markets. Confidence is indispensable. What is necessary is to ensure orderly funding conditions, enhance banks' resilience without imposing undue procyclical effects on the economy, and diversify the sources of finance for SMEs, with a view to fostering entrepreneurship, innovation and growth.

3. Monetary policy

The ECB moved swiftly to counteract the effects of the sovereign crisis on the economy and the impairment of monetary policy transmission across euro-area countries.

First, it adopted a highly accommodative monetary policy stance, reducing official rates to their all-time low, with the rate on main refinancing operations now at 0.50 per cent. Second, it took a number of non-conventional monetary policy measures to reduce the fragmentation of financial conditions across the euro area and avoid an unprecedented credit crunch, which would have had dire consequences on the macroeconomic outlook and price dynamics of the euro area as a whole.

In particular, in order to ensure more uniform wholesale funding conditions, on 8 December 2011 the ECB announced two 3-year longer-term refinancing operations, to be conducted as fixed rate tender procedures with full allotment. Further, to guarantee wide access to its refinancing operations, it also increased the range of eligible collateral by reducing the rating threshold for certain asset-backed securities and allowing national central banks to accept as collateral additional performing credit claims (i.e. bank loans) that satisfied

certain criteria. The set of eligible collateral was further increased during 2012, to support bank lending. These decisions, together with the announcement of Outright Monetary Transactions in August 2012, have been crucial in reducing financial segmentation and mitigating banks' funding difficulties.

Within the policy framework defined by the ECB Governing Council, the Bank of Italy has taken several further steps to ease the difficulties in the Italian credit market for credit-worthy firms that depend most on it. In February 2012, the Bank began to accept as collateral, subject to strict risk-control measures, so-called Additional Credit Claims (ACC), that is to say, performing bank loans that satisfy eligibility criteria different from those normally required by the Eurosystem. Specifically, the Bank of Italy has accepted some additional types of loans and allowed banks to use its internal credit assessment system for rating them, which has made it easier for small banks to participate in Eurosystem refinancing operations. Small locally-based banks, which typically have no internal rating system, traditionally play an important role in lending to SMEs. Also, like other Eurosystem national central banks, the Bank of Italy has lowered the minimum amount accepted for both ordinary and additional bank loans from €500,000 to €100,000, to allow loans granted to smaller firms to be used as collateral. We are working to enlarge the set of loans that comply with all Eurosystem eligibility requirements.

The unconventional monetary measures adopted by the ECB in 2011-2012 were effective in easing tensions in government bond markets and have had a beneficial impact on credit supply and money market conditions, supporting the economy and preserving price stability in the euro area. Our econometric analyses suggest that the effects of the ECB's extraordinary measures added more than two percentage points to the growth of Italy's GDP in the period 2012-2013 and were transmitted mainly through the improvement in credit supply conditions. While the policies did not prevent the Italian

economy from falling into recession, they did keep the credit crunch from being still more severe and the fall in output even larger.

4. Strengthening the banking sector

A healthy banking industry is essential to maintaining a stable flow of financial resources to the economy, and to smaller firms in particular. Strengthening banks' capacity to absorb shocks has been a major concern of policy makers, regulators and supervisors.

On the regulatory side, the changes have been far-reaching. Policy makers and the public are well aware of the international drive to improve banking prudential standards and to overcome the regulatory failures that had become glaring with the financial crisis. The effort is ongoing. Capital rules have been strengthened. Liquidity rules, a serious blind spot of the previous international system of standards, will be introduced. Systemically important banks, whose failure may trigger widespread disruption, will be subject to stricter standards.

On the supervisory side, these have been times of severe testing. The action to reinforce capital and liquidity standards was and is central. At the same time, however, it is essential that banks achieve this strengthening without undue restriction to credit. Capital reinforcement is the key.

From the very beginning of the financial crisis, the Bank of Italy has closely monitored the liquidity and the capital of Italian banks, prompting actions to increase high quality capital and cope with an increasingly risky environment. At the end of June 2013, the core tier 1 ratio had risen to an average of 11.2 per cent from 7.0 per cent in 2008.

In order for these actions to take place without aggravating lending conditions, we have insisted on the reduction of banks' costs and the injection of

new capital; we asked banks' shareholders to forgo dividends, managers to reduce or cancel bonuses.

This has not been without effect. As the IMF stated in its recent Financial System Stability Assessment for Italy, the provision of additional domestic resources, both deposits and capital, has enabled the Italian banking system to withstand the dramatic sequence of external shocks to the global and the European economy since 2007 almost exclusively with its own resources. The IMF also noted that the impact of additional "downside risks" on the banking system, as measured by several stress test exercises, would be "substantially cushioned by the existing capital buffer". It concluded that the banking system, though hard-hit by the crisis, has managed to avoid capital shortfalls that would have had dramatic consequences for the real economy and, most importantly, is in a position to prevent capital shortages in the near future.

During the crisis, the fragmentation of financial markets along national lines has also had a major impact on Italian banks. This has entailed high costs and limited availability of wholesale funding, and has affected domestic credit conditions. While the ECB's actions have eased tensions in the short term, a more structural action is required to make Europe's banks work as one system, one market. In a heavily regulated industry like banking, the single market requires a single framework for regulation and supervision; otherwise it cannot work properly, especially in difficult times.

The creation of the Banking Union is a keystone of the institutional reform to ensure stability in the euro area and in the EU at large. It should eliminate fragmentation, leaving only that portion of extra funding costs for banks that is associated with genuine extra credit risk.

The Banking Union comprises three key components: a single supervisory mechanism (SSM), centred on the ECB and based on the expertise of national supervisory authorities; a single resolution mechanism (SRM), which is central

to ensuring that the responsibilities of supervising banks and managing their recovery or resolution are effectively aligned; and a harmonized deposit guarantee fund financed by the industry, whose mission is to prevent bank runs.

In the summer of 2012 the European leaders decided to give priority to the construction of the first component, the Single Supervisory Mechanism, comprising the ECB and the national supervisory authorities. But this is a three-legged animal: it cannot be asked to stand on one foot. The resolution part is already under development. The third leg, a common deposit guarantee fund, must remain a target.

The purpose of the Banking Union is to bring substantial benefits to the Single Market, improve the monitoring, control and mitigation of the systemic risks that stem from the interconnectedness of banks and markets, break the perverse feedback loop between banks and sovereigns and counter the ring-fencing trends observed in the last years, thus fostering financial integration.

6. SMEs and the financial sector

Policies to improve the institutional environment must be complemented by actions to foster an efficient and diversified financial system that can adequately serve a set of enterprises whose financing requirements are quite heterogeneous, depending on firms' characteristics.

For smaller firms, which will continue to rely heavily on bank loans, it is essential that the prudential rules on bank capital be designed so as to avoid a negative impact on credit supply. The Basel II framework (CRD in Europe), which went into effect in 2007-08, had already envisaged more favourable prudential treatment for loans to SMEs than other corporate loans, justified by their reduced systemic impact. The 4th capital requirements directive/capital requirements regulation has introduced a further reduction in capital absorption for this class of exposures, facilitating bank lending to SMEs. Such a discount

will apply in the form of a “supporting factor”, an SME-specific coefficient that reduces – given specific conditions – capital requirements for lending to SMEs by around one fourth.

Loan securitizations represent an opportunity for smaller firms to access market finance. These operations have got a bad name during the crisis. But there are good securitizations and bad ones. Opaque, complex, multiple-stage securitizations have shown, beyond all possible doubt, their potential for wreaking havoc. They must be avoided. But a simple, transparent securitization framework can be useful to the growth of lending. The regulatory environment should encourage the adoption of two key features: first, risk retention, in order to align the interests of all parties; second, simplicity and transparency, in order to allow investors to assess the quality of the underlying assets.

The interest of investors in securitization instruments depends critically on the regulatory environment. The Basel Committee is working on a comprehensive review of the prudential treatment of the asset-backed securities held by banks, addressing the shortcomings of the current regulation by making capital requirements more prudent and risk-sensitive, reducing reliance on external credit ratings and easing cliff effects when credit quality deteriorates. The Committee is now reviewing the calibration of the new approach, following comments on a preliminary consultation. In setting the new capital charges the Committee must seek to strike a good balance. The Bank of Italy is taking an active part in the revision of the securitization framework. We also appreciate the international discussion on the recovery of securitization markets characterized by simple and transparent instruments. The promotion of these operations can bolster investor confidence and work to the direct benefit of the real economy.

For firms with higher growth potential, the financial system must offer non-bank financing solutions, which fit their risk profile better.

Although bank loans will certainly remain the dominant source of external financing for SMEs, long-term investments are better financed by equity capital. In particular, share capital is preferable to foster innovation and growth in businesses with uncertain results and pronounced information asymmetries. While banks can count on guarantees and long-term relationships with firms to reduce the information asymmetries, equity capital enables investors to benefit in full from the returns to successful innovation. Banks must understand that there is, here, a long-term benefit for them, too.

As margins on traditional intermediation shrink and the need to contain leverage sets limits on loan growth, banks should constantly improve their ability to provide more diversified financial services to firms, especially SMEs. They can play a key (and profitable) role in accompanying firms along a path to a better balanced, more robust and flexible funding structure. Progress in this direction would be beneficial both for banks and for their customers.

A number of empirical studies have found a strong positive causal link between the availability of capital and investment in innovation. A recent study for Italy concludes that the issue of shares increases the probability of a firm's undertaking R&D investment by around one third.

Venture capitalists and other investors specializing in financing innovative enterprises are undersized in Europe by comparison with the US.

Long-term financing, and equity financing in particular, is hampered by both demand and supply factors. On the demand side, the costs of disclosing the relevant information to external investors are often very high compared to the scale of business; often small firms' problems of asymmetric information are amplified by their family-based management model.

On the supply side, access to market financing is hindered by the low propensity of institutional investors to invest in these companies' securities. The high risk and low liquidity of SMEs' securities do not fit the preferences of most

institutional investors, which often lack the expertise to manage the risks associated with this asset class.

Designing policies to foster investment in securities issued by SMEs is a difficult task, and in the past the results have often been disappointing. But the challenge is worth taking up. The Commission's March 2013 Green Paper on long-term financing to support structural economic reform and return to a long-term trend of economic growth in Europe specifies a number of proposals that constitute a solid basis for future work. The essential goal is to make small enterprises and the entire economy more resilient vis-à-vis shocks to banks and to enhance the capacity to finance growth and innovation.

7. Conclusion

Small and medium-sized enterprises in Europe have been hit hard by the crisis, and in several countries their ability to raise external finance has been and still is constrained. A good many counter-measures have been taken, ranging from monetary policy to the allocation of resources from national and European budgets. More are in the pipeline. Regulatory reforms and the creation of a European Banking Union will help restore confidence in the financial system and in the banking industry.

Once the damage done by such a deep and protracted crisis has been repaired, it will be vital for the prosperity of Europe to build a thriving business environment in which smart ideas can be readily transformed into entrepreneurial initiatives.

SMEs are central to long-term economic development in many sectors. SMEs can be, and indeed often are, an engine for growth. Italy has seen a thriving system of small, innovative, enterprising firms, whose growth has been central to internal and external development. On the global level, most of the

breakthrough innovations that have reshaped the world economy in recent decades have come from start-ups and SMEs. To stay successful, SMEs must be able to adapt, transform themselves and grow.

The social, institutional, financial environment plays a fundamental enabling role. This is true for all firms, but even more so for SMEs, which have a limited ability to internalize the production of key inputs like human capital and interconnection services. We need to increase the proportion of dynamic small firms that work close to the technological frontier and whose smallness is just a stage of their life cycle. This requires action on several fronts: human capital, infrastructures and finance.

Building a financial system that can meet the needs of innovative SMEs with high growth prospects is a challenge we must take up. We must look beyond the crisis. Even as we act to improve the traditional bank-centred model of business finance and to make it more resilient, we need to create more scope for markets and non-bank intermediaries. There are no ready-made solutions. Best practices around the world and our own past experience must serve as our guide. All the key actors, the financial industry, policy makers and entrepreneurs must do their part.