NEWS RELEASE

EULER HERMES

Stricter regulation could force European SMEs to rely more on non-banks for their financing needs

- Currently, **bank loans make up around 70% of external financing** for small to medium-sized enterprises (SMEs)[1] in Europe, much more than in the US (40%).
- By increasing minimum capital requirements, the finalization of Basel III and the implementation of Basel IV regulatory framework may make banks less willing to extend loans to SMEs with below-average creditworthiness. This could **increase funding costs by more than 100 basis points[2] for these firms.**
- As a result, SMEs will need to **seek out alternative financing**. **Direct lending by private and institutional investors is becoming increasingly important for European SMEs.** We estimate that if, out of the 30% of total savings invested in securities, one fourth went to funds that invest in SMEs, **this would unlock around EUR 65 billion per year**, as compared to an average monthly flow of bank loans to SMEs of EUR 41 billion in 2018.

Paris, June 5th 2019 – **Since 2013, access to financing for European small to medium-sized enterprises (SMEs) has been steadily improving** as a result of the very accommodative monetary policy of the European Central Bank (ECB), which has improved credit availability and reduced interest rates.

This improving access to finance has, however, made **European SMEs heavily reliant on banks** as an external source of funding: bank loans make up around **70% of external financing** for companies – much more than in the US, where they constitute around 40%.

Read the study: **TRIB**Rating Credit Research - *European regulatory changes will make banks less willing to lend to SMEs.*

Through the finalization of Basel III and the implementation of Basel IV**, the new regulatory framework will raise barriers to bank lending to SMEs**. For example, Basel III will increase the minimum capital requirement from 8% to 10.5%. This could also impose **higher financing costs and/or stricter collateral requirements**, particularly among SMEs with below-average creditworthiness.

"*The banks' interest in extending or granting loans to SMEs with rather poor creditworthiness is likely to decline with the new EU directives on banking regulation*", says **Ron van het Hof, CEO of Euler Hermes in Germany, Austria and Switzerland**.

"Our analysis have shown that the average creditworthiness of SMEs in Europe is about BB. For companies with a low credit quality (B or lower), the expected loss and thus the capital requirements increase relatively strongly. We therefore estimate that the funding costs for companies with a low credit quality may increase by more than 100 bp by 2022", says **Ana Boata, Senior Economist for**

[1] The European Commission defines SMEs as companies with an annual turnover of EUR 50 million or less. However, for SMEs that fall outside this definition, banks are free to ignore the changes.

[2] Our estimate is based on a study conducted by the Universities of Berlin and Wuppertal on behalf of the Bundesverband mittelständische Wirtschaft (Federal Association of SMEs) in Germany, which states that the volume of loans to SMEs could decrease by 4.47% and the interest spread for an average loan to SMEs could increase by 54 bp. Our analyses have shown that the average creditworthiness of SMEs in Europe is about BB. For companies with a low credit quality (B or lower), the expected loss and thus the capital requirements increase relatively strongly. We therefore estimate that the funding costs for companies with a low credit quality may increase by more than 100 bp by 2022.

Europe at Euler Hermes. *"This puts many of these companies under pressure to take action. Alternative forms of financing are therefore becoming much more important."*

Mechanisms for easier granting of loans to SMEs only work for small loans

Current mechanisms that reduce the capital requirements for bank loans to SMEs, such as the "**SME Supporting Factor" (SF)**, could cushion the expected negative development in the financing of European SMEs - but only for smaller loans below the limit of EUR 1.5 million.

"*In the euro zone as a whole, only around 30% of all newly granted loans fall into this category*," says **Kai Gerdes, Director, Head of Analysis at Euler Hermes Rating**. "*In Germany, the figure is even lower at 18%. In Italy (47%) and Spain (53%), on the other hand, this buffer is likely to have a somewhat stronger effect, because the number of rather small loans is much higher*."

Capital Market Union: goals are far from achieved

The European Commission has launched the "**EU Capital Markets Union" (CMU)** initiative to create a true single market for capital and hence improve financing for European SMEs.

"*Although significant progress has been made in some areas such as securitization, the main goals of the Capital Markets Union have by no means been achieved*," says **Ana Boata**. "*So it will take some time before SMEs actually get their hands on truly barrier-free loans as it doesn't seem to be a top priority of the mainstream parties across Europe*".

Direct lending grows as a funding alternative for SMEs

Direct lending to companies by private and institutional investors from outside the banking sector has grown in importance in recent years as an alternative to bank financing, as debt funds are still less constrained by current laws than banks: after reaching the EUR 100.0 billion threshold for the first time in 2016, the aggregate debt fund volume climbed to an all-time high of EUR 165.6 billion in 2017.

"*We expect debt funds to grow even more strongly in Europe in the years ahead and anticipate that SMEs will increasingly incorporate this funding source into their financing structures*", says **Kai Gerdes.**

The Eurozone household saving rate stands at a high 12.1%, amounting to around EUR 860 billion of available capital per year. **We estimate that if, out of the 30% of total savings invested in securities (equity and debt), one fourth went to funds that invest in SMEs, this would unlock around EUR 65 billion per year**. This additional funding would compare to an average monthly flow of bank loans to SMEs of close to EUR 41 billion in 2018.

What is **TRIB**Rating?

TRIBRating is a valuable new service that can benefit all players in the SME and MidCap funding space. Using a detailed, tailored and transparent methodology and SME-specific modelling, **TRIB**Rating offers a robust assessment of creditworthiness. The independent, globally comparable credit ratings may enable small- to medium-sized businesses to attract a wider range of funding sources. The **TRIB**Rating methodologies, available in Germany, France, Italy and Spain, were developed in collaboration with Moody's Investors Service, a leading global rating agency with extensive experience of developing rating methodologies across a range of sectors. Coupled with Euler Hermes's extensive credit risk and sector knowledge, **TRIB**Rating identifies, analyzes and monitors the specific credit characteristics of SMEs and MidCaps.

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