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Keynote Lecture 1: Financing the Economy – SMEs, Banks and Capital Markets

We banking supervisors like to stress that banks have one core task: financing the real economy. This, however, begs the question: who or what is the "real economy"?

When speaking of the real economy, many people think of large companies – and there are indeed giants out there. Of the 100 largest economic entities in the world, fewer than half are countries; the rest are private companies.

Companies such as General Motors, Apple and BP are huge. They earn vast revenues and are always in the public eye. But, at the same time, they divert attention from something else. And it is this "something else" I will discuss in my speech today.

SMEs and the economy

Let's start by looking at some numbers. The EU is home to around 45,000 large companies, companies that have more than 250 employees. But it is also home to almost 24 million smaller companies that have fewer than 250 employees. These are the small and medium-sized enterprises, SMEs for short.

99.8% of all companies in the EU are SMEs. They employ 93 million people, accounting for two-thirds of total employment. And they generate almost 60% of value added. And what is true for the EU is true for Austria. The proportions are almost exactly the same.[1]

So, when we talk about the real economy, when we talk about jobs and growth, we are in fact talking about SMEs. As the numbers show, it is these companies that make up the real "real economy".

If SMEs do not do well, the economy does not do well. And in the aftermath of the crisis, we have seen that SMEs are more vulnerable to changes in the business environment than larger firms. At the same time, they are more reliant on supportive policies. SMEs have comparatively fewer resources to invest in training, for instance. In order to recruit staff with the appropriate skill sets, they therefore depend more heavily on public investment in education. Recent survey results have indeed shown that the main concern for SMEs right now is the availability of skilled labor.[2]

So, SMEs make up the real economy, and, what's more, they also have the potential to drive it. Economic growth is driven first and foremost by productivity and innovation. And SMEs could play a major role here. On average, we see that larger firms are still more productive and innovative than SMEs. But there are exceptions. The OECD found, for instance, that here in Austria, SMEs have been more productive than large firms ever since the financial crisis.[3]

And many SMEs have become leaders in niche sectors. For example, SMEs owned 20% of biotechnology patents in Europe in 2014.[4] Specialization is important for SMEs as is the ability to create networks to maximize their potential.

But to be productive and innovative, SMEs first need access to finance. Their survival and success depends on it. So let's take a closer look at this specific aspect of running an SME.

[1] *EU Commission, List of country SME key figures 2017, https://ec.europa.eu/growth/smes/business-friendly-environment/performance-review_de.*

[2] *ECB. 2018. Survey on the access to finance of enterprises (SAFE). October 2017–March 2018.*

[3] *OECD. 2017. Small, Medium, Strong. Trends in SME Performance and Business Conditions.*

[4] *Eurostat. 2014.*

SMEs and banks – a challenging relationship

As a general rule, SMEs are limited in their choice of funding sources. Capital markets, for instance, are often closed to them: low volumes and high fixed costs keep them from issuing bonds or stocks.

Thus, SMEs mostly rely on banks to finance themselves. But when dealing with banks, SMEs face a structural disadvantage compared with larger companies. For banks, SMEs are usually opaque as they do not publish detailed financial statements and, in many cases, lack long credit histories.

As banks find it harder to assess the risk on a loan to an SME, the classic problems of asymmetric information arise and translate into higher premiums for the SMEs.

But there is another angle to this problem. Being more opaque than larger firms makes SMEs "dependent borrowers". Once they have established a relationship with a bank, it becomes very costly for them to switch. Potential new lenders would peg them as riskier than they actually are, regardless of their true financial situation. So SMEs not only depend on banks in general to obtain finance, but they often depend on specific banks.

This gives banks additional power over SMEs. In the language of economics, they are in a position to extract rents at the expense of SMEs.

So, even in normal times SMEs are at a disadvantage when sourcing funding from banks. In times of crisis, this is exacerbated: funding costs for SMEs tend to rise more steeply than those for larger firms. This happened during the recent financial crisis too.

But why exactly do SMEs suffer more than large firms in a financial crisis? Well, as I said, banks have some power over SMEs, and this might play a role.

There is indeed some evidence for this. A recent study of the euro area confirms that, during the crisis, banks raised interest rates for SMEs by more than they did for larger firms.[5] Having fewer non-bank funding options, SMEs are likely to be more exposed to pricing externalities related to banking market structures and impairments. Untangling this unequal treatment, the study finds a number of factors that play a role.

First: market power. The greater a bank's market share, the higher the interest rates it charges on loans to SMEs. Second: funding. Banks with a less stable funding base tend to impose higher interest rates on SMEs. And third: balance sheet strength. Banks with a high share of nonperforming loans (NPLs) also tend to charge higher interest rates for loans to SMEs than for loans to larger firms.

Adding all this up, the tentative conclusion is that banks that are in trouble and need to make up for losses turn to those who cannot easily run away. They turn to dependent borrowers[6], many of whom are SMEs.

To sum up: SMEs face a structural disadvantage when borrowing from banks. And this disadvantage becomes even more pronounced in a crisis. Given how important SMEs are for the economy, policymakers are rightfully paying attention to this issue.

[5] *Holton, S. and F. McCann. 2017. Sources of the small firm financing premium: evidence from euro area banks. Working Paper Series 2092. ECB. August.*

[6] *Santos, J. 2011. Bank Corporate Loan Pricing Following the Subprime Crisis. In: Review of Financial Studies 24(6). 1916–1943.*

The role of banking regulation and supervision

First of all, there is banking regulation. In the wake of the financial crisis, policymakers around the world tightened the rules for banks. In particular, banks are now required to hold much more, and far better quality, capital than before. This makes them more resilient and ensures that they can finance the economy throughout an entire cycle.

But some point out that capital requirements influence banks' lending decisions. They argue that whether a bank will grant a loan to an SME depends, among many other things, on the amount of capital it needs to hold against that loan. Following this logic, the calibration of capital requirements might thus influence lending to SMEs.

As you know, the crisis led to higher capital requirements. Among other things, new capital buffers, such as the capital conservation buffer, were introduced. This triggered some concerns with regard to SMEs. The argument was that the new buffers would oblige banks to hold more capital against loans to SMEs too – even though such loans had not contributed to the crisis. So, the new requirements would overestimate the amount of capital required.

To alleviate these concerns, regulators introduced an SME support factor which reduces the risk weights for SMEs so as to balance out the effect of the new capital conservation buffer.

Regulators will be able to come back to the question of how to treat SMEs when they implement the final elements of the Basel framework, which also envisages separate treatment for SMEs. Finally, the work on evaluating the overall impact of the crisis on lending will also provide additional insight.

So, rulemakers have tailored regulation to ensure that SMEs are not disadvantaged. And, of course, banking supervision also plays a role in this.

European banking supervision helps to make banks safer and sounder. This in turn makes crises less likely. And when there are fewer crises, SMEs will be less often exposed to disproportionate funding constraints. This is the general message, but we can look a little deeper.

Take nonperforming loans, NPLs for short, as an example. As I already mentioned: in times of crisis, banks with high levels of NPLs tend to charge disproportionately high interest rates on loans to SMEs. This presents another reason for reducing the amount of NPLs on banks' balance sheets.

That's why we have issued guidance to banks on how to deal with nonperforming loans. And that's why we later added guidance on how to provision for loans that become nonperforming in the future. Judging by the data, we are on the right track: from early 2015 to the end of 2017, the amount of NPLs fell from almost 1,000 billion EUR to just over 720 billion EUR. This number is still too high, but progress is visible.

So, tough banking regulation and sound supervision do lend some indirect support to SMEs. But here we are still assuming that banks are the main sources of funding for SMEs. And this brings us to a more fundamental problem which I touched on before: SMEs depend very much on banks, and often on one specific bank. This can weaken their negotiating position and make them vulnerable. The obvious conclusion is that SMEs would benefit from a wider set of funding sources.

Market power – from the banking union to the capital markets union

But a wider set of funding sources could still include banks. The main thrust of the banking union is to prepare the

ground for a truly European banking market. Such an integrated market would give SMEs the chance to reach across borders and tap banks throughout the euro area for funding. They could diversify their funding sources and become less dependent on individual banks. That said, it is still a long way towards a truly European banking market.

And this is not the only option. Beyond having access to loans from a wider set of European banks, SMEs should have better options for raising funds on capital markets. On this front, the ECB has been a strong supporter of the capital markets union. It is not just banking markets that need to grow together; capital markets should do so as well.

I know of course that the way towards a truly European capital market is as long as the one towards a truly European banking market – it might even be longer. After all, capital markets are very complex and very diverse. This underscores the need for initiatives on many fronts, including initiatives that would also help SMEs. For instance, SMEs might benefit from the new framework on securitization as well as from more harmonized regulation for SME listings on public markets across the EU.

And then, not all SMEs are equal. Newly founded SMEs face even bigger problems. Many start-ups might have the potential to grow into mature SMEs, or even into large firms. But for most of them, funding is still very hard to come by. They are deemed too risky for bank loans, and venture capital is close to non-existent in most EU countries. So, they have even fewer funding options. A number of fintech activities are now seeking to fill this gap. Peer-to-peer lending platforms, for instance, have expanded significantly in recent years. If policymakers want to support SMEs, they need to ensure that such innovations are supported, but also appropriately regulated.

Conclusion

It might be said that SMEs are the heart and soul of the economy. If they do well, the economy does well. So when it comes to SMEs, small is not only beautiful, it is also important.

But it is also challenging. When looking for funding, SMEs face a structural disadvantage, which can become even more pronounced in times of crisis. I have discussed how banking regulation and supervision can help alleviate some of the SMEs' funding constraints. But let me be clear: our job is to help banks remain safe and sound, nothing more and nothing less.

Ultimately, the issue of SMEs' access to finance comes down to choice. If SMEs had a wider set of funding sources to choose from, they would be less dependent on banks. The banking union, the capital markets union, and digitalization might help in this regard. At the same time, information asymmetries make it hard for SMEs to diversify their funding sources. These are the levers policymakers need to pull in order to improve access to finance for SMEs. The economy would certainly benefit.