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Introductory Remarks: Banking and Capital Markets Union – Financial Regulation and SMEs

Ladies and Gentlemen,
Ten years after the global financial crisis that led to the market exit of three large Austrian banks and a substantial bank rescue package, the Austrian banking system is considered one of the most stable banking systems worldwide. Just last month, the credit rating agency Standard & Poor's raised its Banking Industry Country Risk Assessment (BICRA[1]) of Austria's banking sector from group 3 to group 2 (there is no country in group 1). The upgrade reflects material improvements in banking sector stability. Stronger capitalization was a main reason (S&P 2018). Such an upgrade leads to lower funding costs for banks, which benefits banks and borrowers alike.

Having this success story in mind, let me briefly outline why stronger bank capitalization also benefits SME-lending (Small and Medium Enterprise-lending).

The role of capital regulation for bank credit to SMEs

Overall, capital requirements for banks have increased since the global financial crisis. Does this affect lending?

Higher capital requirements affect banks' liability mix and their weighted average cost of funding and thereby the pricing of loans (ECB 2015). This is largely intentional. Regulators aim at shifting the cost of financial crises from the public back to banks; economists call this "the internalization of externalities".

In the short run, higher requirements can lead to lower credit demand due to higher lending rates. However, the ECB's bank lending survey shows that cost of capital plays a rather modest role in banks' lending decisions (ECB, BLS 2018). Indeed, capital levels are just one of many factors.

One of the most important lessons of the past is that the strongest and most sudden decline in banks' lending to SMEs was triggered by financial instability when the financial crisis unfolded. Capital requirements aim at reducing this risk.

The role of banks in SME financing

Banks play an important role in funding the real economy, but that role has changed over the past 20 years. For example in Austria, the balance sheet structure of Austrian banks shifted towards more mortgage lending, while the share of funding of non-financial corporates in banks' total assets decreased. The following figures show this in detail.

Funding of non-financial corporates amounted to 23% of total unconsolidated assets in 1999 and decreased to 17% in 2017. SME lending is currently at around 6% (no historical data available). In contrast, mortgage lending increased strongly from 5% to 12% of total unconsolidated assets in the same period (OeNB, ECB). Both supply and demand drive these developments.

The demand side mirrors the development of lending to non-financial corporates seen in banks' balance sheets. The share of bank loans in total liabilities of Austrian non-financial corporates

[1] The Banking Industry Country Risk Assessment (BICRA) of Standard & Poor (S&P) classifies national banking sectors on a scale from 'group 1' (lowest-risk banking system) to 'group 10' (highest-risk banking system). It is the starting point for S&P's single bank ratings.

declined from 36% in 1999 to 20% in 2017 (OeNB, financial accounts).

SMEs have three major sources of financing (BACH data as of 2016). Each accounts for about one third of total financing: (1) bank credit (29% of total assets), (2) equity (34% of total assets) and (3) other non-bank sources (38% of total assets; thereof loans from non-financial corporates accounting for the largest share of 23%)[2]. These figures show that SMEs are already diversifying their sources of finance.

Diversification of SME finance supported by European initiatives

Several European initiatives are underway to reduce the reliance of SMEs on bank credit somewhat.

First, the report of the High Level Expert Group on SME and Infrastructure Financing identified a number of possible actions in this regard already in 2011 (EC 2011). These are in particular, action to facilitate credit analysis via public and private databases, the aggregation of business registers, a standardized and more widespread use of credit scoring, and standardized loan-level information on asset-backed securities, or a granular credit risk dataset (so-called AnaCredit).

Second, the Commission's action plan for SMEs[3] covers a wide range of initiatives and regulatory measures (e.g. EC 2018). They may be more promising and effective in promoting SME lending, compared with the SME Supporting Factor, which aims at lowering banks' capital requirements for SME loans.[4] Examples are to promote venture capital and the use of ratings by SMEs, to improve SMEs' access to capital markets or to explore better enforcement of late payment rules. These measures would in particular strengthen SMEs' creditworthiness and the access of smaller firms to external financing.

Third, the capital markets union (CMU) is often referred to as the spare-wheel for financing. In times of need and when banks do not provide lending, the capital market might step in. Under the CMU, the European Commission aims to develop a more diversified financial system that complements bank financing with deep and developed capital markets (CMU 2018). This should unlock more investment for all companies, especially SMEs.

No complete substitution of bank lending as CMU advances

However, I would like to caution against the belief that bank lending for SMEs would be completely substituted as the CMU advances.

First, we expect banks to be among the major investors in SME bonds in the CMU.

Second, just like with large corporates, access to bank credit is a complement and not a substitute for bond financing.

Third, in Europe and Austria we see a slow shift towards equity financing and issuing bonds by larger corporates. Such additional funding for large corporates provides ancillary capacity in banks to supply credit to SMEs.

Fourth, in banks' rating models the equity level of SMEs is often a key variable. If SMEs can increase their equity through the CMU, we will see an increase of the quality of SME lending via this channel, which benefits the real economy and financial stability simultaneously.

In that sense, the CMU will not be just a spare wheel, it will serve as another stone reinforcing an ever-stronger foundation for access to funding for SMEs and larger corporates alike.

[2] *SMEs defined as corporations with a turnover of less than EUR 50 million per year. Latest available data as of 2015 (BACH database).*

[3] *For example, see: Regulatory initiative to promote SME growth markets, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/securities-markets/sme-listing-public-markets_en#regulatory-initiative-to-promote-sme-growth-markets*

[4] *For more details on the SME Supporting Factor, see EBA (2016).*

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The future of SME lending from a financial stability perspective

Let us envision the future of SME lending from a financial stability perspective:

Banks will remain important for SME funding. Simultaneously, alternative sources of funding will be increasingly used by SMEs.

Ultimately, a better diversification of external funding for SMEs and the real economy will strengthen the financial system and the real economy.

In turn, the capital markets union is a project that needs to be advanced – from the perspective of SMEs, banks and the public.

Closing remarks

From a financial stability perspective, developing the capital markets union is an important complement to the banking union. A shift from bank-based to more market-based financing will also contribute to a healthy, stable and resilient banking sector and strengthen the European monetary union. Therefore, deepening the capital markets union is a priority of the Austrian EU Presidency.

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