FACING THE CREDIT SQUEEZE

EFFECTS OF THE CAPITAL ADEQUACY & LATE PAYMENT DIRECTIVES ON SMES

Round Table Organized by CEPS and INTRUM JUSTITIA

November 30th, 2004

Opening Statement: Fred von Dewall, General Manager and Chief Economist, ING Group

Speakers: Sven Matthiessen, Head of Savings Banks Policy, Banking Supervision Division at Deutscher Sparkassen und Giroverband E.V. (DSGV)

Heinrich Von Liechtenstein, Professor, IESE Business School, University of Navarra

Hilde Gossens, Advisor Ministry of Economy, Flemish Community

Lief Hallberg, Director of Public Affairs, Intrum Justitia

Stefan Schär, Public Relations and Marketing Officer, Intrum Justitia

Juan Antonio Salazar Romero, DG Enterprise, European Commission

The New Basel Capital Accord, and the forthcoming new Capital Adequacy Directive, has sparked concerns that higher capital charges will further curb lending to SMEs. In this respect, the new regulatory banking framework could also worsen the effects of the long payment delays which typically undermine SMEs' commercial transactions. In fact, cash unbalances due to late payments might cast additional doubts on small firms' creditworthiness and, as a consequence, hamper their access to credit.

These and other critical aspects have been thoroughly discussed at a Round Table organized by CEPS and Intrum Justitia on November the 30th.

After having addressed the audience on the potential interaction between the new Capital Adequacy and the Late Payments directives, Karel Lannoo, Chief Executive Officer at CEPS, gave the floor to *Fred von Dewall, General Manager and Chief Economist of ING Group* after introducing him.

At the outset of his presentation, Mr. von Dewall stressed that the forthcoming Basel II/CAD III framework represents a remarkable improvement of the current prudential banking regulation, a "better answer", he said, to the complex issues which characterize the modern financial environment. In fact, large banks have already developed new techniques to improve their risk measurement and management in order to be more competitive and keep under control their credit losses. This has resulted to a significant change of the banking business model, which places risk management amongst the key objectives, not only to ensure an adequate level of economic capital but also to maintain a fair rating or achieve a higher one. The new Basel capital framework, as a natural regulatory response to these developments, was very much awaited from industry participants to align economic capital to the regulatory one.

Mr. von Dewall showed confidence that the spirit of new rules will be fully understood by the industry and turned into a sounder banking practice, enhancing the efficiency of capital and credit allocation without necessarily affecting risk appetite. However, he reckoned, the learning process is likely to take some time and effort, in particular as regards the establishment of a clear communication between risk managers and market supervisors, this may in fact resent of certain initial difficulties if regulators don't learn quickly how to draw on the expertise of market participants.

Mr. van Dewall recognised, however, the high level of sophistication and complexity of the new framework but he also noted that the state of the art of risk measurement and management should consent to update systems and procedures rather comfortably and that, after all, banks will be still offered varying compliance methods to suit their levels of sophistication.

Mr van Dewall added that allowing for a flexible implementation is particularly appropriate for Europe, where financial institutions are different and where the scope of the regulation is expected to be considerably vast, as this will help substantially to smooth the transition to the new regime. He acknowledged, however, that a high grade of flexibility, as for instance the possibility to adopt hybrid or mixed methods (partial adoption), could give room to regulatory arbitrage, that is, some assets might be receded from IRB back to standardized portfolios to allow for lower capital absorption. He also remarked that this strategy would not be convenient, particularly in the medium term, since excessive risk taking will end generating abnormal losses, with the consequence of tighter supervisory control and market penalizations. In particular, the strength of market discipline is likely to increase over time, along with the consolidation of the advanced methods as new standards of the banking system.

Besides, he emphasized that regulatory arbitrage might be a serious concern only in case the new capital requirements were somehow binding for banks. On the contrary, based on the estimates showed that in most countries, Holland in first place, the implementation of the new rules would actually reduce the overall amount of regulatory capital, to the extent that a correction factor of 1.06 would be needed to keep the computation at the current level. In addition, many banks have so far held capital in surplus of what imposed by supervisors, showing comprehension of the need to arrange buffers to resist shocks, more than simply to fulfil regulatory duties. In this respect, Mr. von Dewall stressed the importance of sufficient level of capital held by banks to ensure a fair rating, and envisaged that the new framework will spread positive incentives through the industry, adding further to this sense of responsibility.

Addressing the issue of SME lending, Mr. von Dewall pointed out that the favourable treatment granted to the retail portfolio under Basel II/CAD III, along with the provision of a special correction factor for SME loans in the IRB corporate portfolio, should suffice to correct the possible distortions due to the smaller scale and lower visibility of these companies. Actually, he said, such measures should make financing SMEs more convenient than other activities, so that, reasonably, one should expect to see more resources dedicated to this business and consequently lower prices. However, Mr. von Dewall stressed that commenting in general terms about the effects on credit supply remains extremely difficult, since much of the changes will depend ultimately on the individual characteristics of the various institutions. In this respect, he clarified, different lending procedures and varying risk management expertise will lead to very variegated outcomes throughout the industry, with better rated banks able to manoeuvre more and lend at better rates and, on the overall, the competitive intensity affecting remarkably the level of efficiency achieved in the diverse areas.

In any case, Mr. von Dewall warned that much of the discussion has focused on the supply side, too few has instead been said on the demand.

In fact, he underlined the importance to focus on how banks perceive SMEs. He noted that as long as SMEs want to fully take advantage of the new regulation, they ought to commit themselves to pursue a consolidation of their business development strategy, growing strategic thinking among their managers and improving the external communications with their stakeholders. As highlighted by Mr. von Dewall, cash flows stabilization deserves obviously priority among these efforts, since it is often the key tangible signal with which SMEs can negotiate their creditworthiness. Accordingly, late payment habits from clients might become a very serious threat to SMEs, since late and irregular cashing in of revenues could easily drag down the rating and, by limiting the perceived debt capacity of the firm, it may adversely affect company growth. He remarked however, that, besides the legislative efforts intended to penalize such malpractices, banks could also intervene, and probably with better results, to push principals to pay without delays. In fact, if the legal system were to consent a more efficient enforcement of creditor's rights, many financial institutions would have probably found it profitable to act as subcontractors of SMEs, purchasing their invoices and, as a result, exerting discipline over late payers.

Finally, Mr von Dewall concluded reminding that, although the new framework is clearly inspired by the idea of a more scientific approach to banking regulation, it is important that financial institutions preserve a personal knowledge of the businesses they are involved in. This expertise is particularly helpful when banks must appraise SMEs which deal with new technologies or innovative SMEs in general. In fact, these firms account for a modest part of small firms' population and generally have highly uncertain expected cash flows, nonetheless, funding such companies may reveal highly rewarding for financial institutions, because of their extraordinary growth potential.

BASEL II AND SME FINANCING: IMPLICATIONS AND PROSPECTS

Sven Matthiensen, Deutscher Sparkassen -Und Giroverband

Mr. Matthiensen opened his presentation stressing the importance of the SME sector for the European Economy and in particular for Germany, and pointing out that despite the widening and deepening of financial markets observed in recent years, small and medium firms still rely heavily on bank lending for external financing.

After having recalled the main features of the forthcoming banking regulation as regards SME financing, such as the rules for retail exposures and the special treatment of SME loans granted under the IRB approaches, Mr. Matthiensen placed some positive comments on the overall framework, highlighting how this will a) enhance efficiency and diversification; b) improve the level of information within banks and; c) abolish unfair cross subsidization of customers with poor creditworthiness by customers with good creditworthiness.

However, Mr. Matthiensen mentioned the necessity to give SMEs the possibility to fully understand and share the rules of the new rating culture, to avoid the risk that these firms would fail to take any advantage from the new framework and that the regulation would simply become an extra burden weakening further the relationship between banks and SMEs.

Accordingly, Mr. Matthiensen remarked that banks should play their role without hesitation and increase transparency with their customers by showing them how ratings impact their credit terms. This would be a fundamental step in the common effort to develop a new banking culture inspired by the transparency and disclosure principles under Basel II, in fact, SMEs would be able to recognise the advantages of sooner disclosure and more open communication with the house bank and, in turn, this strengthen the relationship of trust between the counterparts. On the other side, the efforts that ought to be done by SMEs are obviously expected to be even greater. In particular, these firms must urgently realize that a move towards more professional managerial practices is becoming mandatory at this stage, and that the use of management tolls such as business plans and complete and periodic financial reports is an obligation under Basel II, and not anymore an option.

He reckoned however, that many of these changes can be problematic for some SMEs, typically for the very small ones, but these firms could still try to improve their ratings "externally", that is, renewing the attention on some aspects of their business about which they have probably been negligent so far, such as keeping their bank accounts in straight line with the agreements, or communicate any change in the personnel and capital employed in the firm, or again arranging the successor question.

Finally, he concluded that the rating is a valuable advising and management tool, which could lead to a more transparent SME financing, and render its price clearer and fairer.

Heinrich Von Liechtenstein, IESE Business School, University of Navarra

Professor Von Liechtenstein focused on how innovation in financing SMEs can help entrepreneurs.

At the outset of his speech, he briefly reminded how, according to a recent research carried out by KfW, borrowing conditions for SMEs remain difficult, with banks asking for significant collateral to limit the exposure to risk and if not available, rejecting credit. Besides that, it seems that very poor alternatives are emerging from the equity market or other innovative financial instruments.

In this context, professor Von Liechtenstein warned that the new prudential regulation could render financing even more complicated for SMEs, restricting their access also to "plain vanilla" financing. In fact, the forthcoming regulatory framework may threaten the survival of relationship banking, that is, that lending technique based on informal information and market lore which consented so far to make up for the opacity of small firms and provide them an access to credit.

Entrepreneurs seem to have fully understood the necessity to adjust as soon as possible the structures and the procedures of their companies to fit into the new rating criteria. Nevertheless, professor Von Liechtenstein stressed how consistent, and probably time consuming, are the transformations imposed to SMEs. In fact, these firms should drastically improve, and in some cases develop for the first time, their accounting, controlling and managerial methods.

As concerns the effects and the state of art of financial innovation, professor Von Liechtenstein outlined a rather heterogeneous situation across Europe, explaining that such differences are mainly due to factors like: varying SME capital structures (financial leverage, debt maturity ect..), different consolidation patterns of the banking sectors, the existence of diverse barriers to entry and the dissimilarity of market critical sizes, or simply of historical experiences.

One of the main drivers of innovation, he explained, is the wish to transfer risk to other counterparts, off loading exposures, mainly through securitisation, from banks' balance sheets.

Despite such operation may have a harmful drawback, since if the exposure is reallocated inefficiently, from entities technically capable to manage risk to unprepared institutions, the result is lower instead of higher systemic stability, innovation is anyways often praised for its capacity to boost diversification and increase the supply of new asset classes to investors. Therefore, this process should reveal favourable for good SMEs, which may gain access to new financing means and capital markets. Nevertheless, professor Von Liechtenstein highlighted how such beneficial effects have not been so far materialized consistently, and innovation has been exploited virtually only by banks, which managed to reduce risk. Thus, while sub-investment grade SMEs suffer financing shortage, it remains also uncertain whether the forthcoming regulation may contribute to steer financial innovation in favour of solid and visible SMEs.

In any case, professor Von Liechtenstein concluded, that is well recommendable that entrepreneurs move their first steps towards a more active balance sheet management, trying to think also about the liability side as a mean to increase competitiveness.

LATE PAYMENTS: TRENDS AND EU REGULATORY INITIATIVES

Introducing the link between late payments and banking capital adequacy as regards SME financing, *Ms. Goossens,* reminded the empirical evidence which underpinned the approval of the Late Payment Directive in 2000.

The amplitude of payment losses was such that the EU felt compelled to intervene and, if similar figures were confirmed nowadays, as it somewhat seemed to be the case, malfunctioning payments might seriously restrain SMEs from joining the advances carried on by the banking community on the track of Basel II.

In fact, Ms. Goossens said, to the extent that SMEs lack collateral and transparency in governance, the quality of cash flows remains the most important source of information to examine the solvency of these firms. Thus, cash fluctuations linked to late payments, can still hinder the survival of small firms, since after the rating has been pulled down and the access to credit restricted, the initial misperception of high riskiness that they have induced may instead become actual.

Lief Hallberg, Director of Public Affairs, Intrum Justitia

Mr. Hallberg addressed the audience about the major problems that SMEs encounter as a result of the late collection of their revenues. He mentioned that about 1 billion invoices are not paid on time each year in Europe, which results to about 450.000 jobs losses every year according to estimates released by Intrum Justitia in 1997. These figures received the attention of the European Commission and, consequently, triggered the action of the EU, which in 2000 passed a directive (2000/35/EC) specifically meant to combat late payments in commercial transactions. This directive which entered into force in August 2002, establishes payment terms, including the length of time before an invoice should be paid (30 days) and the statutory right to a penalty interest rate of 7% above the ECB rate. It also simplifies enforcement mechanisms to recover unpaid bills.

Unfortunately, the practical follow-up of this initiative has been weak, slow and incomplete, so that European companies, and in particular SMEs, continue to be harmed by late payments habits. This negative outcome is clearly documented in the new survey performed by Intrum Justitia early in 2004, where more than 9000 companies interviewed in 22 European countries have indicated payment uncertainty as the major obstacle to cross-border trade.

Finally, Mr. Hallberg concluded by warning about a possible liquidity squeeze hitting SMEs in the near future. In fact, the interaction between late payments and the new risk-sensitive prudential framework may give rise to a vicious cycle, where late payments hamper SMEs' access to external funding and, in turns, such credit shortage strikes back and worsen the payment terms.

Stefan Schär, Public Relations and Marketing Officer, Intrum Justitia

Mr. Schär gave extra details about the survey carried out by Intrum Justitia in February 2004. He reminded that, according to the companies interviewed, payment uncertainties is the most important factor impeding international trade, and despite the implementation of the directive, the average payment delay has become paradoxically two days longer than what was showed in the survey of 1997.

Describing the geographical extension of late payment risk, Mr. Schär showed how in the Nordic Countries invoices are generally paid with a delay of one week, with respect to the agreed terms, while in the other countries delays average between two and three weeks, with the exception of Portugal, where payments are made up to five weeks after the due date.

A comparison across European countries of payment losses, roughly intended as the turnover reduction imposed by late payments when firms cannot refinance alternatively their operations, shows similar results and, in fact, the Nordic Countries are still the most virtuous, followed by Ireland, France and Switzerland. Whereas, on the opposite side, Portugal, Czech Republic, Lithuania and Spain remain the worst offenders.

Juan Antonio Salazar Romero, European Commission

Mr. Salazar Romero illustrated the content of the European Parliament and Council Directive 2000/35/EC on combating late payments in commercial transactions.

He reminded that this legislative intervention took place mainly to put an end to those abuses which, originating from asymmetric bargaining power between large and small counterparts, make the settlement terms of commercial transactions blatantly unfair for small and medium sized enterprises, forcing them to grant long lasting trade credit. Actually, he mentioned, while its inception, the Directive had a more ambitious goal to put in place some additional measures to further reduce SMEs' liquidity unbalances and ease their access to finance, but, unfortunately, much of these purposes succumbed in front of the complexity of the co-decision procedure between the European Parliament and Council. Moreover, in a broader sense, the Directive intended to target payment uncertainty, which is perceived as one of the major problems hampering the functioning of the Single Market.

As concerns the scope of the Directive, he clarified that the regulation regards all payments made as remuneration of commercial transactions and that, therefore, SMEs, as well as single professionals and other self employed, can claim its application also against the public administration.

Outlining the content of the text, Mr. Salazar Romero remarked the establishment of a statuary term of 30 days to settle the transaction after the receipt of the invoice or the provision of goods or services, and the setting of the penalty interest 7 % above the reference rate of the European Central Bank, or that of the Bank of England for the UK. However, these measures are not strictly speaking compulsory, since the counterparts are left free to amend them contractually. Notwithstanding, also in this latter case, the counterpart resenting from abusive payment terms inserted in the contract, can anyways claim the "gross unfairness" of this agreements before the national competent court and ask for the application of the Directive. In this particular respect, Mr. Salazar Romero stressed how the Directive explicitly allows also official organizations and representatives to initiate legal actions on behalf of SMEs, in those cases where it is possible to contest the inclusion of grossly unfair payment terms in general use contracting.

Another point that Mr. Salazar Romero strongly highlighted, was the provision which obliges the Member States to ensure that, in case of activation of recovery procedures, the pursuant should be able to obtain an enforceable title within 90 days from the filing of his or her claim and, even more importantly, with the application of the same conditions as for domestic creditors.

Finally, he pointed out that pessimistic appraisals of the effects of the Directive should not be drawn so easily, since this has been a first ambitious attempt to harmonize, without imposing, rules which are still strictly held in the realm of national legal systems and jurisdictions. Besides, the legislative text is somehow still through a study phase, since, as decided at the time of its approval, a further investigation starting early in 2005 will assess the depth of the legislation in practise and, reasonably, provide ground to a revising process.

GENERAL CONCLUSIONS AND POLICY RECOMMENDATIONS

The Round Table managed to fruitfully restart a debate, bringing forward new elements and thoughts, about the effects of the forthcoming prudential regulation on SME financing, enriching the discussion addressing the potential interference of late payments with the functioning of the forthcoming banking framework.

Herein are reported the key points and arguments which emerged during the discussion, along with the salient issues that are still open for future research:

- Ratings will be the absolute protagonist of future credit allocation.

  From the SMEs' perspective, this means that learning about the determinants of ratings becomes absolutely essential, since this would give them the possibility to adjust their structures and operations to achieve better assessments and better credit terms. Transparency in this concern may reinforce the bank-customer trust, with mutual benefits for both counterparts, however, uncertainties about whether banks will disclose their internal ratings and lending procedures to SMEs are still far from being solved. In addition, while the debate has highlighted a persistent strong reliance of SMEs on bank lending, it has still to be thoroughly assessed the extent to which it might be worth spending additional efforts to promote alternative funding for SMEs;

- Late payments undermine directly and indirectly SMEs financial conditions, through cash flows unbalances and negative effects on ratings.

  In this respect the key question is obviously how to combat more effectively late payments habits. Since the legal increase of penalty interest rates may not fully tackle the problem, a better solution may be encouraging SMEs to move towards a more effective management of receivable accounts. In this respect, the intervention of third parties, such as factoring or credit management services companies, looks particularly advantageous, since these entities have skills and knowledge to manage risks and exert discipline on debtors. However, these companies generally thrive on the presence of a secondary market; therefore, a very important question is whether an approach similar to securitization might be reproduced for the case of commercial credits. Surely, that of the mortgage market is a successful experience on which is possible to draw.

- The Late Payment Directive needs an urgent revision.

  More effectiveness is needed from the legislation, but how to include all problems related to late payments habits, comprising issues such as domestic versus cross-border recovery or the compensation of total costs, in the directive? Again, the legislation could encourage market oriented solutions and, instead of focusing on penalty rates, might place more attention on reforming the recovery procedures, making them quicker and abolishing any discrimination which impedes legal actions against debtors resident in different Member States. In fact, this would probably provide that level of legal certainty concerning the enforcement of creditors' rights, which is an essential condition for the development of international factoring and credit management. But, if also all this was put in practice, will it suffice to eliminate discrimination between large and smaller companies?

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