

Bank deleveraging, the move from bank to market-based financing, and SME financing

by
Gert Wehinger*

Banks have been lowering their high pre-crisis leverage levels and are preparing for stricter regulatory capital requirements, and in the process have been reducing their lending. With the banking sector expected to shrink considerably, other actors, especially institutional investors, and new forms of financial intermediation will have to meet the credit needs of the economy. This may not only require enhancing and enlarging the perimeter of regulatory oversight, but may also need policy incentives to encourage new forms of market based lending, especially as it concerns financing long-term investment, including infrastructure, and SMEs. This was the background for the discussions at the April 2012 OECD Financial Roundtable that this note summarises. On the current outlook, participants agreed that recent policy actions in Europe have had a positive impact but more and longer-term policy actions will be needed to restore confidence among market participants and set the basis for recovery. Deleveraging is necessary but only about half-way completed. Regulatory reforms should support this process in a balanced way, avoid unintended consequences and help the transition towards increased non-bank intermediation by not imposing bank-like regulation on, e.g., insurance companies and hedge funds. Securitisation should be revitalised – perhaps with some (initial) government and regulatory support – to close the bank lending gap, especially for SME lending. Covered bonds can contribute in this, too, but their benefits may be limited, i.a. due to asset encumbrance. Mezzanine financing instruments could be useful for SME financing, and informal forms of equity financing could help small dynamic start-up companies.

JEL Classification: F01, G18, G20, G21

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* Gert Wehinger is a senior economist in the Financial Affairs Division of the OECD Directorate for Financial and Enterprise Affairs. This article is based on a summary of the discussions that took place at the OECD Financial Roundtable held on 26 April 2012 with participants from the private financial sector and members of the OECD Committee on Financial Markets, and a background note prepared for that meeting. It also takes into account, where appropriate, selected developments that have taken place since the meeting, as well as various comments. The author is solely responsible for any remaining errors. This work is published on the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of the Organisation or the governments of its member countries.

I. Overview: background and summary

Banks have been lowering their high pre-crisis leverage levels and are preparing for stricter regulatory capital requirements, and in the process have been reducing their lending. With the banking sector expected to shrink considerably, other actors, especially institutional investors, and new forms of financial intermediation will have to meet the credit needs of the economy. This may not only require enhancing and enlarging the perimeter of regulatory oversight, but may also need policy incentives to encourage new forms of market based lending, especially as it concerns financing long-term investment, including infrastructure, and SMEs. This was the background for the discussions at the April 2012 OECD Financial Roundtable that this note summarises. Issues tabled for discussion covered the current outlook and risks as well as the impact of structural changes on the banking sector and alternatives to bank financing.

Regarding the current outlook, participants agreed that various policy actions in Europe have had a positive impact over the past few months, leading to a decline in sovereign yields and easing banks' funding stress. However, most believed that more, longer-term policy action will be needed to restore confidence among market participants and set the basis for recovery. Views were mixed on the inflationary implications of the ample amount of liquidity now awash in the system. Exit strategies will eventually have to be put in place to withdraw excess liquidity to avoid a risk of substantial inflation. However, some inflation may perhaps be needed to ease the burden of debt and help to rebalance economies.

Deleveraging of the financial system that was highly leveraged before the crisis should be regarded as necessary process on the path to recovery. But based on past experience this process takes time and is probably only half-way completed. Deleveraging is having both supply and demand effects, where supply-side effects are to some extent driven by new regulatory requirements. Regulatory reforms are being broadly supported by the financial industry, but there may be unintended negative consequences that may also lead to an overestimation of the net benefits of new regulations. For example, additional capital requirements for systemically important financial institutions (SIFIs) might make sense in isolation, but the wider, negative effects on the financial sector and the economy overall of these requirements may not have been properly taken into account in impact studies. A particular shortcoming of existing regulatory reforms is that they do not address operational capability, which in many cases was found worryingly lacking, especially in some of the large, globally active banks.

Revitalising securitisation was seen as necessary to close the gap left by reduced bank lending, perhaps by making it safer, simpler and more transparent and by offering some (initial) government and regulatory support. While covered bonds have attractive features (e.g. the risk stays on the balance sheet of the issuer, and these instruments are favoured by new regulations like Basel III, Solvency II and bail-in rules), they have some problems like increasing asset encumbrance (i.e. reducing banks' funding flexibility as they have to pledge more of their assets).

New securitisation instruments could, *i.a.*, also help to boost SME lending, as successful efforts by German and Spanish banks to securitise SME loans have shown. But for this to work confidence in the banking sector needs to be restored. Mezzanine financing instruments were also mentioned as potentially useful components of SME financing.

Non-bank financial intermediaries, including hedge funds, should also be supported as substitutes for reduced bank lending. In the US, where the economy is only about 25% bank financed, this substitution is already well advanced, while Europe, where the economy is about 75-80% bank financed, it has further to go and the effects of necessary adjustments to deleveraging will perhaps be felt more strongly.

While there was agreement for some regulation of shadow banking activities in general, it was also pointed out that many of the “shadow banks” are already subject to regulations (e.g. hedge funds in the EU are subject to the Alternative Investment Fund Managers Directive, AIFMD, and similar regulations apply for US hedge fund managers under the Dodd-Frank Act). As regards the long-term financing capabilities of insurance companies and perhaps pension funds, it was argued that they could be undermined by the move to Solvency II and more mark-to-market accounting.

II. Current outlook and risks

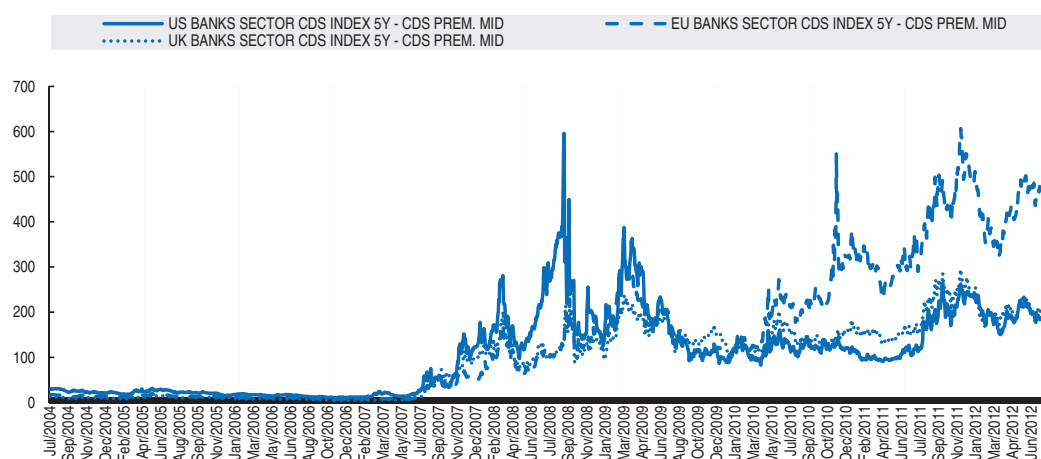
1. Global financial market outlook and risks

While economic prospects in major OECD economies were seen as having improved more recently, recovery was seen as remaining fragile, especially in Europe, and slowing growth in emerging markets (including those in emerging Europe) was adding to a sluggish scenario globally. Uncertainty around the outlook is high and market signals are not always conclusive. Prospects are conditional on the interdependence between sovereigns and the financial sector and the policy actions to break the vicious cycle that this interdependency creates. While fiscal consolidation is needed in the heavily indebted countries to restore market confidence and to bring debt back to sustainable levels, this is at odds with the need for growth in their economies.

Various policy actions in Europe have had a positive impact over the past few months that had led to a decline in sovereign yields (except Greece) since December. The improvements in sovereigns are feeding back positively into bank funding conditions that improved the (perceived) solvency of banks (as, for example, indicated by narrowing CDS spreads; Figure 1). The ECB's LTROs in particular helped to ease banks' funding stress. But this 'desperate' move has now geared up the ECB's balance sheet more than the Fed's. These measures also channelled funds to peripheral sovereigns – perhaps one of their unintended consequences. At the same time, these central bank policy actions were less successful in stimulating lending, as much of the additional liquidity was used to reduce debt and, arguably, these 3-year LTROs could hardly be used to fund 15-year mortgages. But while deleveraging reduces the supply of credit, its demand is depressed by austerity measures, therefore these two forces at work make it difficult to pin down the causes and effects of reduced lending. It was seen as strategic mistake by the ECB not to have participated in the loss-taking of the recent Greek debt restructuring.¹ This, it was argued, would undermine the recovery at a time when EU policy makers have reduced options to stimulate their economies.

While the exceptional liquidity increase provides short-term support, it bears risks of asset price bubbles and rising inflation in the future (even though these risks may be

Figure 1. Selected banking sector CDS spreads



Source: Thomson Reuters Datastream.

remote) and the question of an exit strategy from these extraordinary policies remains. But as effects of unconventional monetary policy materialise more sluggishly than those of conventional (interest rate) policies the outcomes are hard to judge at the current juncture. Some participants felt that eventually higher inflation will be needed to ease debt burdens and rebalance economies.

2. Deleveraging and its effects

There was agreement that deleveraging is necessary in a financial system that had become highly overleveraged in the run-up to the crisis – or even over the past 30 years. Based on past experience the deleveraging process may be only about half-way through. There were some considerations whether banks should perhaps be cut back to their core utility function. The question was then whether policy should take an active role in reducing the size of the banking sector – that had grown too large in some countries in terms of their GDP – or whether this reduction would come about by itself with the passage of time.

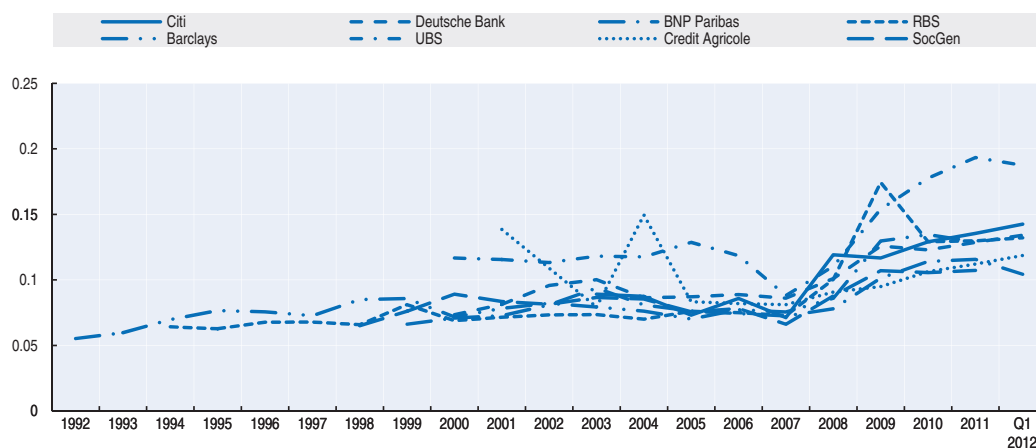
Already, a part of the current deleveraging is due to the new regulatory environment in which banks are preparing for the stricter capital and liquidity requirements imposed under Basel III. While these regulatory measures are being supported by the private sector in principle, there were some concerns about the unintended consequences of new regulations that could lead to an overestimation of their net benefits.² For example, the higher capital requirements for (global as well as domestic) SIFIs (Systemically Important Financial Institutions) may make sense, but do so only in isolation, disregarding their wider effects on the financial sector and the economy overall. It was also felt that the negative effects of new regulation on the real economy are being underestimated because the debate often rests on Modigliani-Miller's assumption of the equivalence of debt and equity financing, implying that requiring higher capital charges of banks will not affect their costs, but this is not the case. Many of the new regulations will not have the desired effects and no amount of capital would be sufficient to make banks really safe and avoid their taking of undue risks. To the contrary, it was argued that such requirements may even increase risk-taking as they put pressure on returns on equity. More generally, regulation was seen as often being behind the curve and this seems to be intrinsic to the regulatory

process. Therefore, tax exemptions could be considered as being more useful to improve the incentive system than more stringent regulation.

According to some views the previous build-up of leverage had to a certain extent been supported by regulation, especially in Europe where banks have been gaming the Basel II system via the internal model-based risk-weighting approach, which was less possible in the United States where Basel II was adopted at a much later stage (and limits to an unweighted leverage ratio imposed more binding constraints; Figures 2 and 3). But in defence of the banks it was noted that banks had to adjust to Basel II in a rush and with little data and experience to adequately build their risk models. The availability of tangible capital in the banking sector as well as the diffusion of risks through the capital markets favoured a relatively swift deleveraging and ‘cleanup’ of banks’ balance sheets in the United States; this has not been the case in Europe. Among the many necessary measures to tackle the problems in the banking sector in Europe, a joint European deposit insurance system was seen as a prerequisite.

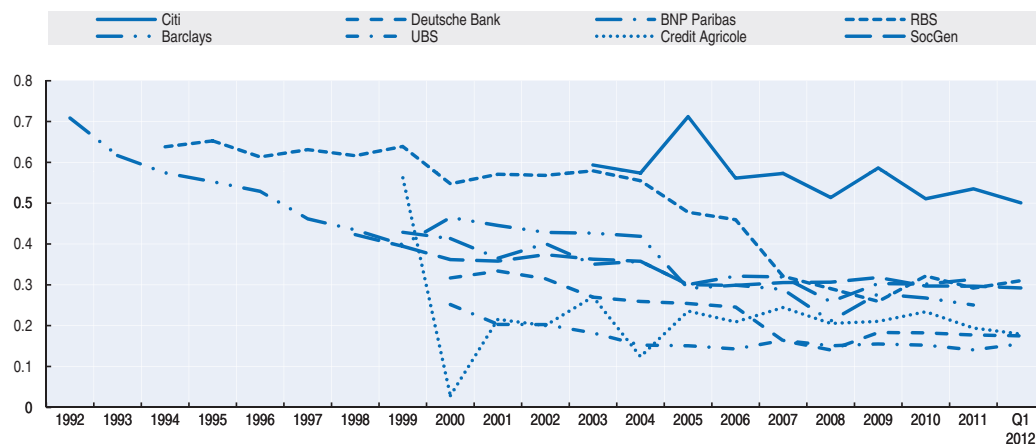
The flawed Basel risk-weighting approach is also the reason why regulatory capital ratios are almost dismissed by markets that are rather looking at simple leverage ratios

Figure 2. **Tier-1 capital over risk-weighted assets of selected major banks**



Source: Thomson Reuters Datastream, OECD.

Figure 3. **Risk-weighted assets as share of total assets of selected major banks**



Source: Thomson Reuters Datastream, OECD.

as indicator for a bank's health. In this regard the leverage ratio requirement introduced in Basel III should therefore be much welcome. On a related issue, it was also argued that the recent stress tests undertaken by the European Banking Authority (EBA)³ were the biggest driver of volatility because the resources for the needed recapitalisations were not available (contrary to the case of the US Fed's stress tests). About 25% of the resulting increased capital requirements (of EUR 116 bn) were achieved by adjusting risk-weighted assets⁴ – hardly something to enhance investor confidence, it was argued.

As a particular shortcoming of existing regulatory reforms it was highlighted that they do not address operational capability which was found worryingly lacking in many, especially some of the large, globally active banks. Many of these banks were not aware of the risks they were holding on their balance sheets. As a related point it was noted that one of the major causes of the crisis, the lack of transparency, has not yet been addressed by regulators. Regarding risk-modelling, there is as of yet no common regulatory approach for modelling probabilities of default (PD), either through the cycle or as point in time, where the latter often distorts risk assessments (e.g. favouring buy-to-let and some subprime mortgages in good times).

There are basically three ways in which banks can deleverage: raising capital, reducing (risk-weighted) assets, or restricting lending.⁵ While raising capital would be the best way to deleverage (in terms of its effects on the real economy), this is difficult in the current market environment where issuance possibilities for banks are limited. But sales of assets or their 'reshuffling' (in order to reduce risk-weighted assets) are also difficult under the given circumstances. Most of the asset sales were by banks that had received government support; European banks have "taken the easy way out" and sold relatively highly valued assets (at 90% or higher), and have not (yet) realised losses on others. US banks had started taking assets off their books early on when the property market started deteriorating, and sold them for a discount, but European banks keep holding on to their risky loans as long as they are being serviced even if the property market is collapsing. The third possibility for deleveraging, reducing lending, is the most 'unpalatable' one but is likely to be predominant at this juncture and can hardly be avoided.

III. Assessment of structural changes in the banking and non-banking sectors and their consequences for financial intermediation

1. Structural changes and the move towards market-based finance

a) Structural changes and players in the new financial intermediation landscape

The imposition of bank-like regulations (capital and liquidity requirements) on the asset management industry was seen as detrimental for this sector that should play a significant role in financing the economy. Under Solvency II, there is a higher capital requirement for life insurance and pension institutions to hold credit than to hold government bonds. In particular, it is noteworthy that the risk capital required for holding credit increases proportionally with duration. Thus, holding long-dated credit becomes relatively unattractive for these institutions. At the same time, they are penalised severely for duration mismatch between assets and liabilities: the strong underlying demand for long-duration assets can be expected to be covered primarily through investments in (low-yielding) government bonds, while picking up the necessary risk premiums in the credit market has likely to happen through shorter-maturity investments.

The reduced capacity of life insurers and pension funds to take on risk is likely to penalise corporate financing that will face higher costs for seeking long term borrowing. These effects may be particularly strong in smaller financial markets with relatively little supply of long-dated risk free debt in domestic currency which makes duration matching

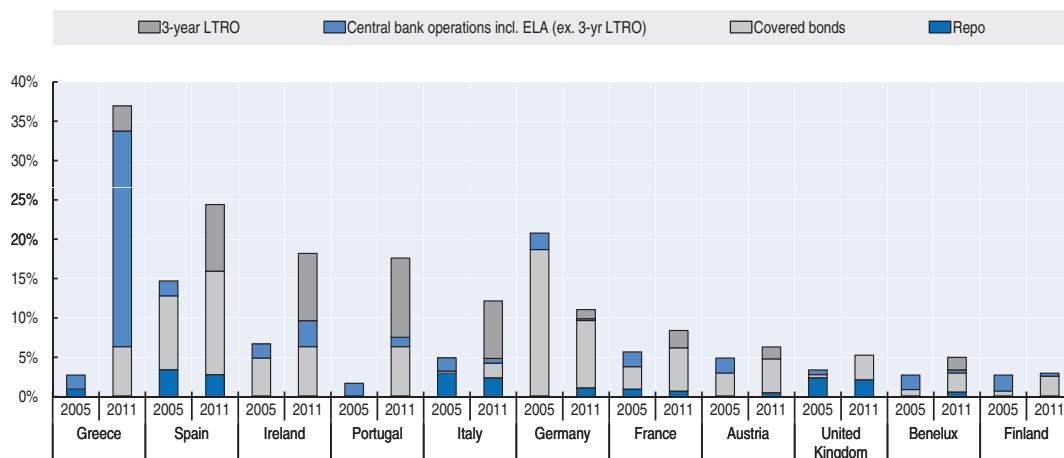
more difficult, tying up a large part of companies' risk bearing capacity. If this leads to an increase in the cost of long-term funding for the corporate sector, it will give corporations stronger incentives to borrow shorter and roll over debt more frequently. This will tend to increase their vulnerability in periods of financial stress.

Such procyclical regulation may also lead to higher equity volatility. Solvency II requires risk management to be based on stress testing of the entire balance sheet (rather than just stress testing the asset side). While this was in principle seen as a sound approach, it also introduces new challenges regarding the risk bearing capacity of life insurance companies and pension funds, especially due to the interest rate sensitivity of liabilities which becomes stretched in a low interest rate environment. In addition, equity market movements and fluctuating credit premiums require careful management of risk exposures involving frequent rebalancing that would tend to increase equity market volatility with likely spill-over effects.

Regulations were also found somewhat contradictory in the sense that they push many institutional investors into shorter-term investments while at the same time requiring banks to raise more long-term funding. Furthermore, the proposed EU rules on bail-ins were regarded as extremely negative for the overall funding of banks, because subordinating senior unsecured debt to many other creditors would push investors more towards covered (and other secured) bonds, creating increased asset encumbrance. To illustrate this point, it was noted that covered bond spreads for French banks are now at levels at which senior unsecured debt was a year ago. In Europe, asset encumbrance has also increased as a consequence of the EUR 1tn LTROs (Figure 4). Regulators were thus asked not to only focus on increasing banks' capital requirements and quality but also take into account the consequences that this has for bank funding overall (the match between investments and the banking business).

Figure 4. **Asset encumbrance**

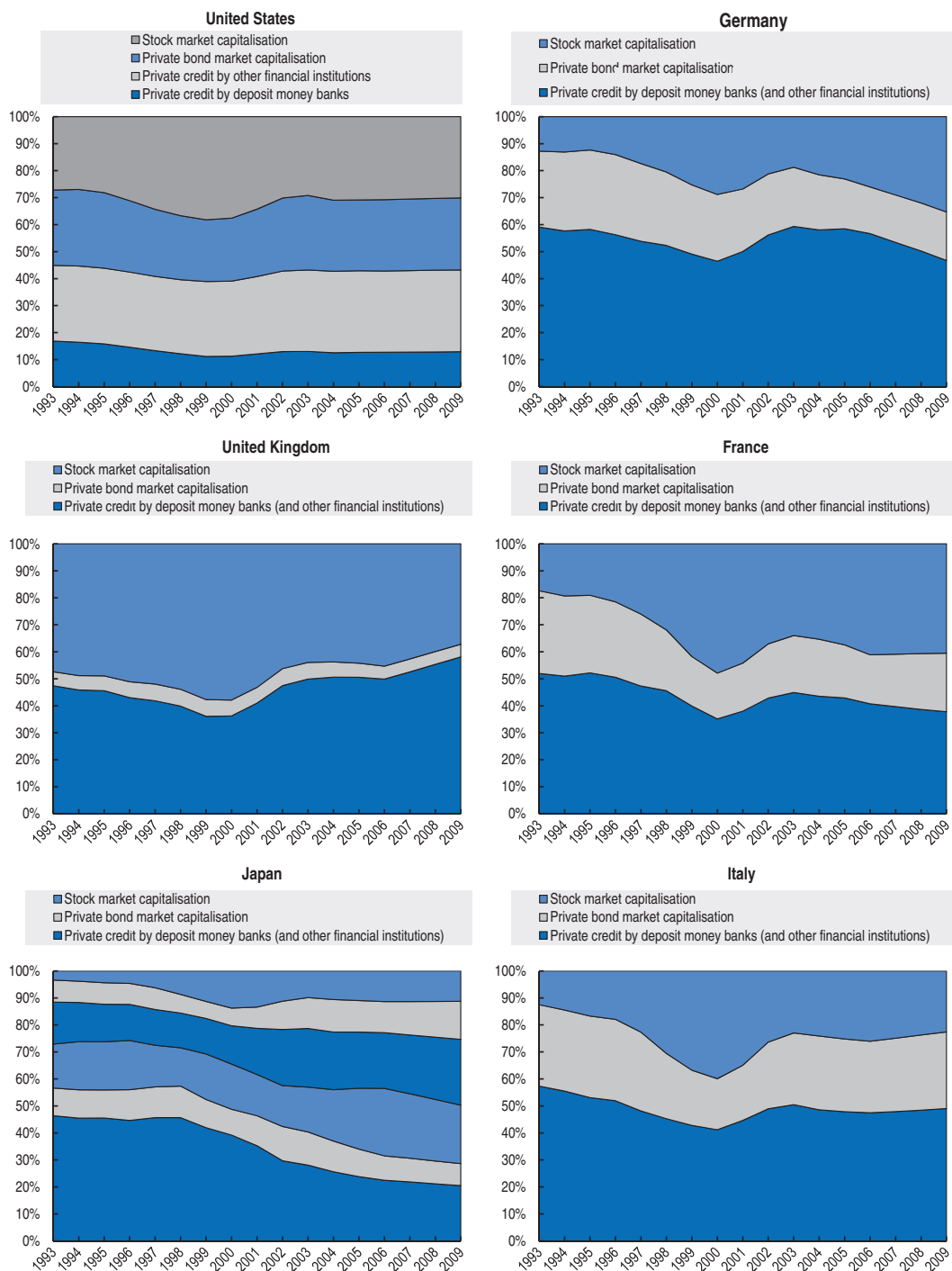
Proportion of banking system balance sheets encumbered, 2005 vs. 2011



Source: Barclays Capital.

So far, new regulations are pushing more lending into the non-bank sectors which may not be as well equipped to manage risks as banks are. The effects of this dislocation, i.e. the shift from bank lending to alternative forms of finance, will be felt relatively more strongly in Europe, as its economy is about 75-80% bank financed and this substitution has further to go (Figure 5). In comparison, the United States economy is only about 25% bank financed and the substitution of bank lending is already well advanced.

Figure 5. **Financial intermediation in selected countries**
Equity and credit intermediation, as shares of total

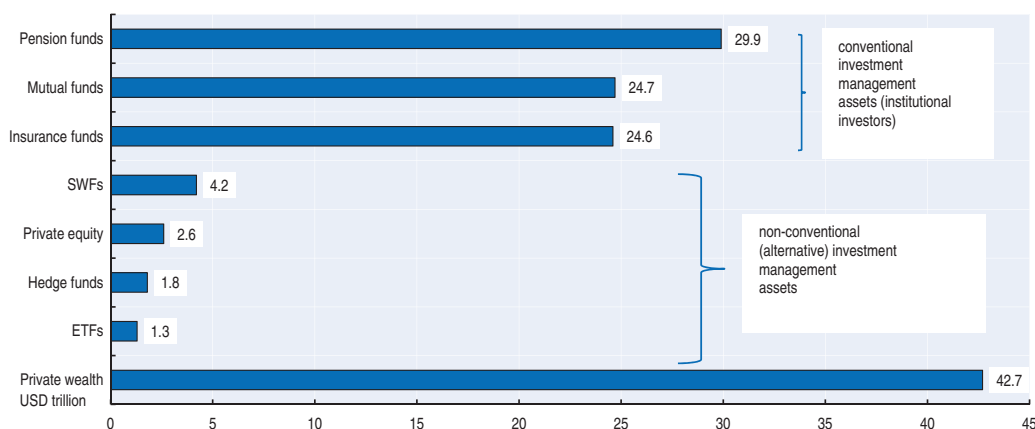


Note: "Other financial institutions" comprise (a) bank-like institutions (that include, e.g. savings banks, cooperative banks, mortgage banks, building societies, and finance companies), (b) insurance companies, (c) private pension and provident funds, (d) pooled investment schemes (e.g. mutual funds), and (d) development banks. Bank-like institutions in the non-US countries shown are mostly classified as banks thus "private credit by other financial institutions" in these countries is nil or insignificant.

Source: OECD, based on World Bank Database on Financial Development and Structure.

While insurance companies and pension funds are major players (Figure 6) they would not be able to fill the lending gap left by bank deleveraging, and therefore other non-bank entities are needed. The shadow banking sector should therefore be “brought into the light” and be called “alternative banking”. But these non-bank intermediaries should not be unduly constrained by regulators so they can perform their role in buying the assets that will hopefully be created to finance the economy. In the United States, money market funds have USD 1.6 tn of assets (non-government funds) of which 30% are commercial and other corporate paper, and these should not be pushed back into the banking sectors that cannot support these assets.

Figure 6. **Institutional investors and alternative asset managers**
2010 Global Fund Management Industry, assets under management (AuM)



Source: TheCityUK estimates.

Hedge funds and private equity were also regarded as being able to play a role in closing the lending gap, and regulation should support this. It was pointed out that hedge funds are risk takers, not deposit takers, and they (as well as private equity) should therefore not be regulated like banks so they can continue to take risks. However, with its USD 2 tn of assets under management the hedge fund industry was seen as being able to play only a relatively small role in helping to attenuate the effects of the banking sector deleveraging process, given the size of the problem: the IMF estimates deleveraging necessary for European banks alone to be USD 2.6 tn, i.e. 7% of their assets, with 25% of that coming from lower lending and 75% from asset sales or profit retention.⁶

b) Financing instruments

Securitisation was broadly agreed to be necessary to support the deleveraging process. An active and high-quality securitisation market would enable banks to deleverage to meet the higher capital requirements without damaging lending to sectors which cannot themselves tap the securities markets. In this vein, securitisation was seen as a good way of moving liquidity lost to insurance companies, pension funds and other investors back to banks who could then extend their lending activities (in particular to SMEs).

However, some concerns were raised that securitisation is not without problems, part of which may have been caused by regulatory intervention (like the 5% ‘skin in the game’ rule – even though this was not a majority view). Pricing and the appetite of investors will

be essential for the securitisation mechanism to work, as will be contractual security and the availability of unencumbered assets. Pension funds in particular should show increased appetite for these instruments, given their need for liability matching and higher returns, but they need to be allowed by regulators to invest in these instruments.

Covered bonds were seen as important and as having several advantages over other types of securitisation: they are simple, there was no tranching or leverage involved, and they stay on the balance sheet which has some merits regarding the sharing and assessment of risks, and gives some comfort to investors as they provide a backup for their claims. However, while covered bonds were seen as important, they also have certain problems. They not only encumber assets (as mentioned above), but also, as they are a single name paper, there is a limited amount of such bonds that a counterparty can hold. Furthermore, as they stay on the balance sheet, covered bonds cannot help to strengthen capital ratios by reducing the size of the issuer's balance sheet. Allowing uncompensated risk transfer by issuing covered bonds secured over a dynamic pool of assets may also be a problem – and yet another reason to favour (uncovered) securitisation over covered bonds. While some argued for a cap on covered bonds, others found it dangerous to introduce a regulatory cap in absence of good alternatives, noting that there was already a natural cap placed on covered bond as there are limits to the assets these vehicles can encumber. As regards the markets in Europe, it was felt that EU-wide regulation was needed to address some of these problems in covered bond markets as well as to enhance their liquidity.

Regulators were asked to work together with the industry to establish new forms of securitisation that address the opacity and complexity of these vehicles (as well as their poor ratings performance) that were one of the causes that led to the subprime crisis. There was also a strong call on regulators to address the issues of fraud that had taken place at a large scale in the US mortgage (securitisation) markets, partly driven by the political push to “affordable housing” and implicit consent and neglect by the government that let this happen. It was noted that European securitisations (perhaps with the exception of CDOs, SIVs and RMBSs) had been less problematic than US ones and had mostly performed very well in the more traditional asset classes. If losses occurred they occurred, as expected, in the lower-rated tranches only. This was due to higher quality loans and due to the availability of loan-level information which allows ratings agencies and investors to evaluate the asset pool more closely. There was also a call on regulators to push requirements for such loan level information. Notably, the above-mentioned performance had been better independent of whether there was ‘skin in the game’ or not, like in the case of CLOs that are off the originators’ balance sheets. Likewise, securitised SME loans (mainly used by Spanish and some German banks) also performed well.

Given these positive experiences in Europe, it was suggested that the United States take lessons from it for its own securitisation markets. In the context of new US regulations, the negative impact of the Volcker rule on liquidity was highlighted as an example of an unintended consequence of new regulations. In order to sell the newly to be created securities one needs market makers that can hold an inventory until the securities are sold. But the Volker rule and other new regulations will reduce this function and make it more punitive and therefore reduce liquidity which is needed for the securitisation process to function, and will make markets more volatile. Thus, regulations should be reconsidered in that light.

There was broad agreement that the problems of the ‘old’ forms of securitisation should be overcome by the development of a ‘new’ securitisation market, with new

instruments, containing features making them less risky and more transparent, like limited tranching, standard prospectuses, a summary of risk factors, transparency on risk in the pools, loans going through bank lending standards, cross market default data and clear disclosure.⁷ It was felt that this would need a push equivalent to that provided by the central banks in the early days of the swap market which achieved standard contracts, netting agreements etc. Regulatory incentives could be an allowance to include the simple, high quality, securities in the banks' new liquidity pools to be held under Basel III (LCR, NFSR⁸) and also an allowance to use them as collateral in CCPs (Central Counterparties). It was pointed out that efforts in this direction are being undertaken by the European Securitisation Forum together with the European Banking Forum that had been working on the "Prime Collateralised Securities" (PCS) initiative to label products which meet best practice in terms of transparency, simplicity, and standardisation.⁹ More generally, it was felt that investors are learning to distinguish between 'good' and 'bad' (mainly the 'old') securitisation, and are also helped by new, totally overhauled rating methodologies for securitised products.

Some argued that it is, however, not necessary to reinvent history in securitisation; while mistakes had been made not all securitisation has been bad. It was noted that structure had often been confused with value, and it is the latter that matters and will be tested in difficult circumstances, not the structure that has often been a consequence of regulatory arbitrage.

It was also cautioned that securitisation could "not solve all problems" at hand. Perhaps the debate of covered bonds versus securitisation was not the right one, as the general requirement for 'skin in the game' would create asset encumbrance. While there was a view that covered bonds already play too large a role (and were said to have not yet been tested in a crisis), driving up risk premiums for unsecured lending, others felt that the important question was which investment was considered safe by investors. As had been mentioned earlier, there is now, more generally, less and less unsecured lending as investors are becoming more suspicious; and if there is, the risk premiums for unsecured lending have steeply increased. Expectations of bail-ins make unsecured funding almost impossibly expensive for banks, thus generating a further need for securitisation.

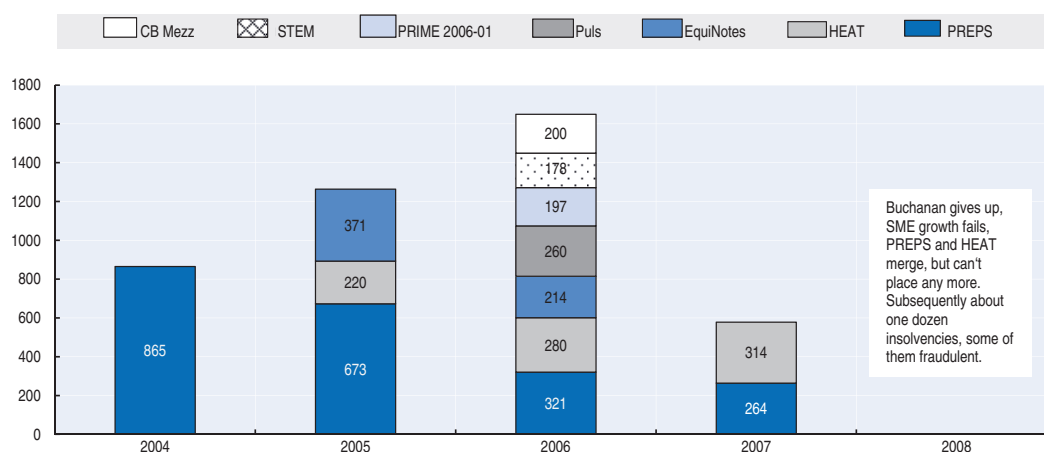
2. Specific issues related to SME financing

Promoting access to finance for SMEs was seen as important contribution to restoring economic growth and help overcome the current crisis. For lenders, the assessment of creditworthiness in case of an SME loan is much more complex and difficult as compared to a mortgage loan. This also makes securitisation of SME loans more complex and difficult than securitisation of mortgages. The companies in question are often internationally active and have a much specialised non-standard range of products which makes an assessment of their profitability difficult and fraught with uncertainties. While the loan size is relatively small, the investment in due diligence is about the same as for a bigger loan for a larger company. Given these difficulties, mezzanine financing was proposed as the most adequate form of providing finance for SMEs, giving banks more leeway to provide additional loans.¹⁰

There have been good experiences in Europe with corporate loan securitisations in general. Some of these securitisations have been initiated by the German lender KfW. Even though the amounts were relatively small (EUR 20-30 billion) when compared to the total deleveraging needs of banks the concept seems to be worthwhile to be pursued. What

is needed first is very sophisticated quality control which is, however, costly. Intelligent product design for securitised credit could help to lower some of these costs and make these securities also attractive on a larger scale for institutional investors like pension funds and insurance companies. Mezzanine finance offers such an instrument, but unfortunately its success and the fact that the model had been adopted by more and more banks that lowered the quality standards led to a boom that burst in 2007 with the collapse of the US subprime mortgage market (if not with the subprime crisis, it would likely have collapsed anyway later due to the weakening and corruption of the standards; Figure 7).

Figure 7. **Interlude of securitised SME programme mezzanine**



Note: PREPS pioneered standard SME mezzanine securitisations in May 2004: 6 pools aggregating EUR 2.1 billion from German, Austrian, Swiss, Belgian, Italian, Dutch and UK companies plus 10 additional mostly German pools from six other providers totalling EUR 5.5 billion with an overall average pool size of EUR 272 million. These mezzanine financings were originated to be packaged and securitised.

Source: Altenburg (2011).

It was proposed that some kind of platform, perhaps supported by the public sector, should be established to survey lending standards, due diligence, risk assessments and decent quarterly monitoring and reporting. In terms of volume, in Germany for example it was seen as hardly possible to generate more than EUR 4-5bn of SME securitisation in the mezzanine sector per year – and it would take probably at least two years to collect these sums. Thus the proposed platform should also have a warehousing function. Such a proposal could help to boost SME finance and much needed growth.

On a more general note, it was underlined that SME securitisation can only work when there is confidence in the banking system, but the currently high spreads indicate that confidence is very low. This is partly an issue of the sovereign debt overhang, but there is a fundamental solvency problem that has not yet been addressed. More capital injections will be needed to let banks write down their bad assets and restart the lending process. It was also felt that companies face too many bureaucratic hurdles (especially documentation requirements) in applying for loans, and currently it seems that only banks and governments get cheap loans. It was also pointed out that SME funding should differentiate between very small or micro enterprises and mid-sized companies that have very different capital needs, and policy makers could help by differentiating regulations accordingly.

There are also policy efforts underway to promote new lending by banks to SMEs. In the United Kingdom, for example, one policy aims at reducing the costs of credit – at

least during a transitional phase of deleveraging – and loan guarantee schemes have been introduced to achieve this. Another policy is to help SMEs to diversify their funding sources, mainly reducing their dependency on banks and perhaps facilitating a more direct access to institutional and retail investors, for example through peer-to-peer platforms.¹¹ The government could play an initiating role in establishing such platforms. A third policy approach is to reduce the capital needs of SMEs, by reducing their working capital they require to operate, for example by encouraging speedier payments by SME clients.

In the United States, the Small Business Lending Fund (SBLF) was enacted into law in 2010 as part of the US Jobs Act with the aim of encouraging SME lending.¹² It involves the US Treasury that is providing capital through preferred shares to community banks with the aim of incentivising them to lend to SMEs. These incentives are provided by reducing the rate of the dividends on Treasury's shares, with the reduction being based on the amount of SME lending generated. For example, if a bank increases its small business lending by 10% or more above baseline (based on its 2007 SME lending) then dividends will be reduced from the maximum rate of 5% to 1%.¹³ The programme is just beginning but it can be considered as showing promising results. As of January 2012, there were 280 participating community banks, 80% of which had increased their SME lending and 60% by the full 10% or more to achieve the lowest 1% dividend rate.¹⁴

Equity financing for SMEs, as opposed to debt financing, was seen as appropriate in particular for small, innovative start-up companies that are essential to improve an economy's competitiveness and underpin dynamic growth.¹⁵ Many company owners hesitate to raise equity capital for fear of losing control to investors, yet research shows that venture capital (VC) supported firms in the US are on average three times more innovative than comparable, non VC-funded firms. But the venture capitalist threshold is high, creating a so-called equity gap that is making it harder for most entrepreneurs to secure financing between EUR 200.000 and EUR 2.000.000. Business angels play a key role in filling this gap. Studies have shown that business angels are important for companies' survival and their ability to secure later-stage financing. It was noted that Europe is lagging behind the United States in this regard. To develop business angel channels, high-net-worth individuals should be encouraged to invest directly in young companies. But funding could also be more broadly based, like in the US where the JOBS Act recently legalised crowd funding for start-ups that can now raise up to USD 1 million per year from small investments online and through social media. While such an approach was found interesting, it was admitted, however, that it is too early to assess its impact.

In order to foster equity financing for SMEs several policy proposals were put forward: expanding capital gains deductions to all cash equity investments in SMEs, limiting tax credits to the investments that are focused on companies in the seed phase (and only in the seed phase), and raising the ceiling on tax deductions.

IV. Concluding remarks

The Roundtable discussions concluded that deleveraging is the major theme that influences the shifts that are currently seen in financial markets and their regulation. Restoring confidence is of utmost importance and regulatory reforms are being undertaken to help restore such confidence, and should be seen in that perspective (and not as “knee-jerk reaction” to the crisis). But a balance has to be found between tighter regulation that can help to restore confidence and the need to support bank lending to the economy.

Notes

1. In order to help making Greece's public debt-to-GDP ratio more sustainable, the Greek government announced in February 2012 the terms of the so-called "Private Sector Involvement" (PSI), a debt restructuring agreed at the October 2011 Euro Summit (see www.minfin.gr). Following earlier intense negotiations, the voluntary participation by bondholders was rather high (over 85%), and a retroactive introduction of collective-action clauses to force the participation of holdouts was to bring total private creditor participation to over 95%. This triggered a credit event facilitating CDS payouts – without upsetting financial markets indicating that investors had been well prepared and expected a rather smooth debt restructuring. This restructuring also created greater security for investors regarding Greek bonds as the new, swapped ones are issued under UK law which gives the Greek government little discretion in changing their terms.
2. Regarding the effects of the Basel III reforms, estimates by the banking industry (IIF 2011) emphasise the negative output effects and these results are significantly higher than those estimated by the official sector (e.g. MAG, 2010). Besides these effects on GDP, reforms will also have an impact on the structure and business models of the financial industry. For some further details and references on these issues see Wehinger (2012).
3. EBA (2011).
4. See also Enria (2012).
5. See also Blundell-Wignall and Atkinson (2012) in this issue of *Financial Market Trends*.
6. IMF (2012).
7. Jackson (2012).
8. A new element of the Basel III reforms is the introduction of liquidity ratios, in the form of a liquidity coverage ratio (LCR) which includes liquid forms of debt such as government bonds and highly rated corporate paper (but not SME loans), and a net stable funding ratio (NSFR) which makes the provision of long-term debt more expensive for banks by requiring them to match their liabilities with their assets. While these planned regulations would increase the cost of lending for banks, a multiyear study period was suggested by the Basel Committee at the time of adoption of Basel III in 2010 before the liquidity rules take effect. This was done because quantitative liquidity regulations are new and regulators want to avoid unintended consequences and ensure that the rules reflect actual experience regarding the stability and relative liquidity of various funding sources. After an observation period beginning in 2011, the LCR should be introduced on 1 January 2015, and the NSFR is planned to move to a minimum standard by 1 January 2018; see BCBS (2011).
9. The Prime Collateralised Securities (PCS) project, led by the industry to develop a label for high-quality securitisations, was officially launched in mid-June, and it is expected that the first PCS label can be granted (by the PCS Secretariat) towards the end of 2012; see AFME-EFR (2012).
10. Altenburg (2011).
11. Peer-to-peer (P2P) lending, whereby individuals lend to each other and small businesses via websites has been growing in the United States, China, Germany and the United Kingdom. By avoiding complex structures and procedures of normal banks and thus some overhead costs, as well as regulatory burden, P2P lenders can offer credit at relatively low rates (lower than, e.g., interest on credit card debt) and offer relatively higher returns to their investors to whom the loans are sold in slices. Many of these lending websites – in the UK the first of them was founded about seven years ago – are now becoming more active in lending to SMEs. While they currently account only for a small share of overall lending, they have been growing strongly and some policy makers see a bigger role for them in replacing bank lending and adding to SMEs' financing options. However, there are concerns that investors who are offered attractive rates (which have risks factored in) may not be aware of the risks involved and that there is no 'money back guarantee'. Should P2P lending grow and become, as some observers expect, an attractive investment for 'well-informed' institutional investors and wealthy individuals, these concerns may subside. At the same time, with the growth of such intermediaries and the creation of new instruments their regulatory oversight could be expected to increase.
12. See www.treasury.gov/resource-center/sb-programs/pages/small-business-lending-fund.aspx.
13. For a lending increase of less than ten percent rates will be reduced to rates between 2-4%; no lending increase in the first two years leads to increased dividend rates of up to 9% in case the bank has not already repaid its SBLF funding.

14. As of end-March 2012, 281 banks were participating in the SBLF programme, with 84% having increased their small business lending above baseline, and more than 69% of them having increased such lending by 10% or more above baseline, according to an updated report available on the Treasury's website quoted above.
15. This and the following paragraph are based on written remarks by Laurent Sachs, L.T. Sachs, submitted for the OECD Financial Roundtable, April 2012.

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