AN ANALYSIS OF THE SITUATION OF LENDING IN SPAIN

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Introduction[1]

In heavily banked economies like Spain's, bank lending to firms and households plays an important role in the country's economic development.[2] In general, bank lending and GDP tend to move in tandem (although the former lags somewhat behind the latter) as a result of a number of forces that act in one direction or the other. The contraction in lending to the private sector in Spain since 2009, against the backdrop of a double-dip recession, is another example of this correlation.

In these circumstances, it is useful to have a diagnosis of the situation that enables the main factors underlying the observed behaviour of lending to be identified and, in particular, that ascertains whether there are frictions or market failures that may be hampering private-sector access to financing and, consequently, economic recovery.

Following this introduction, this article analyses the determinants of recent developments in lending, confirming the importance that demand factors have had, along with the presence of certain supply-side constraints, which primarily affect SMEs. On the basis of this diagnosis, the third section of the article briefly reviews the instruments used in Spain and in other countries to stimulate lending to SMEs, helping to identify, in the fourth section, measures that would be worth exploring to improve the access of small firms to bank financing. The final section summarises the main conclusions.

The evolution of lending in Spain and its determinants

THE EVOLUTION OF LENDING

During the last upswing in the Spanish economy, lending by domestic credit institutions to Spanish firms and households grew sharply, reaching rates three times as high as the nominal rate of growth of the economy. With the onset of the crisis, the outstanding amount of bank credit to these sectors began to decline (see Chart 1), in the exceptionally contractionary cyclical context of a double dip recession. Following a slight moderation of the decline in 2010, linked to the modest recovery in economic activity recorded that year, the year-on-year rate of contraction tended to rise until May this year. Since then, the decline has begun to moderate, the rate of growth standing at -6.6% in August 2013, the latest date for which information is available.[3] The decline is proving steeper for non-financial corporations (9.4% year-on-year in August 2013), but lending to households is also declining (3.9%), as are, within such lending, loans for house purchase (4.2%) and consumer credit and other lending to households (3%).

Within the segment of lending to non-financial corporations, the contraction is observed across all sectors, although there is some dispersion in the intensity of decline. In June 2013, the latest date for which this type of breakdown is available, the year-on-year falls ranged from 17.9% in construction to 6.8% in non-real estate services. In real-estate services the decline was 9.1%, and for industrial companies 11.3%.

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1 This article is based on the analysis carried out by an internal working group set up at the behest of the Governing Council of the Banco de España, of which the author was Rapporteur.

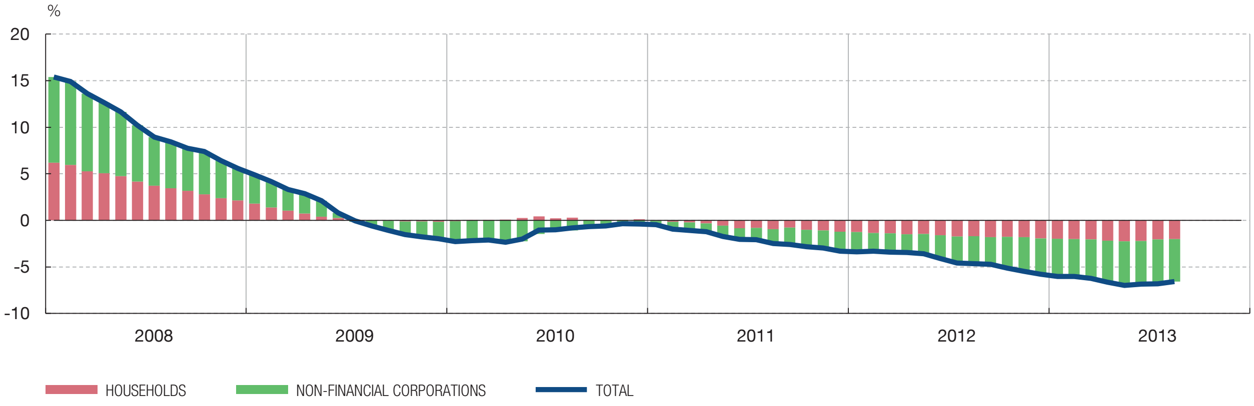
2 This article does not analyse sources of finance, basically corporate, other than domestic bank lending. Currently, the importance of other sources of financing (e.g. securities issuance and international lending) is low, except in the case of large multinational firms.

3 These rates are calculated excluding all the changes not associated with normal flows of financing, such as the transfer of loans to Sareb, which occurred in December 2012 and February 2013, and written-off loans.

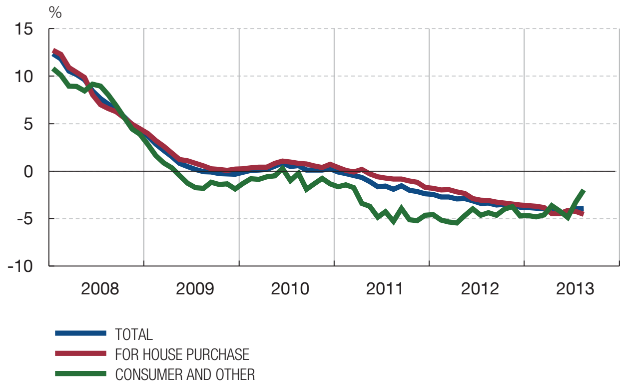
RECENT DEVELOPMENTS IN LENDING

CHART 1

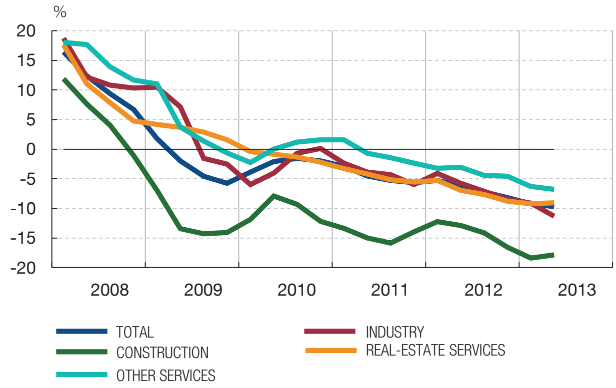
LENDING TO HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS
Year-on-year growth rate and contributions



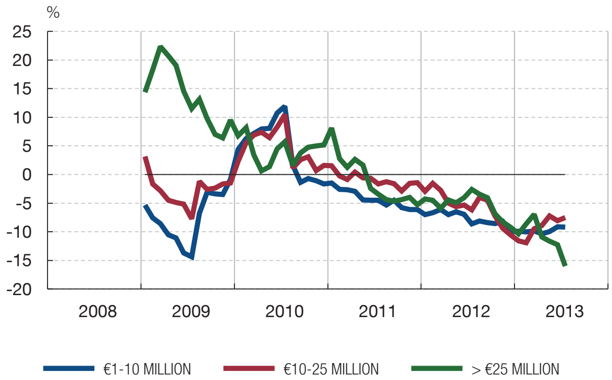
LENDING TO HOUSEHOLDS
Year-on-year growth



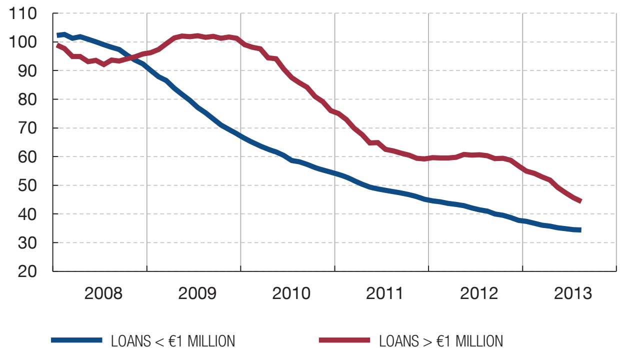
LENDING TO PRODUCTIVE ACTIVITIES OTHER THAN FINANCIAL SERVICES
Year-on-year growth



LENDING TO FIRMS OTHER THAN CONSTRUCTION AND REAL-ESTATE DEVELOPMENT FIRMS (a)



NEW LOANS TO NON-FINANCIAL CORPORATIONS (b)
2007 average = 100



SOURCE: Banco de España.

a Classified according to the total volume of debt recorded at the Central Credit Register (CIR).
b 12-month moving averages.

Analysis of the behaviour of lending in terms of firm size is hampered by the absence of sufficiently detailed statistics, available without long lags, that enable loans and firm size to be linked. In these circumstances it is usual to use the volume of loans (in particular, the amount of the debt recorded in the Central Credit Register) as an indicator of company size. The bottom left-hand panel of Chart 1 shows falls in credit in all segments since 2011, which are generally somewhat larger for companies with lower absolute levels of debt, among which SMEs are likely to be prominent.[4, 5]

An alternative approximation to the growth of lending by size of company can be obtained from the statistics available on interest rates, since they contain information on flows of new loans, distinguished by the volume of the transaction. In this case, the assumption on which the separation between SMEs and other firms is based is that transactions with an amount of less than €1 million will largely correspond to financing to SMEs, while loans of larger amounts will primarily be made to large firms. The bottom right-hand panel of Chart 1, which shows the volume of transactions broken down in accordance with this criterion, also points generally to somewhat more contractionary behaviour by lending to SMEs as against lending to large companies, although the differences are again clearer in 2009.

As regards interest rates on new lending, the spreads with respect to reference market returns have widened significantly since 2008. Again, the increases have been seen across the board, although they have been more notable in those segments with a higher level of relative risk and in which it is likely that the crisis has contributed more to the increases, as is true of consumer credit and other lending, in the case of households, and loans to SMEs (approximated on the basis of transactions with an amount of less than €1 million), in the case of corporations. Chart 2 shows how the cost of credit for Spanish firms and households has been diverging from its level in the core euro area countries. This spread is relatively narrow in the case of loans to households for house purchase, somewhat more significant in the case of loans to corporations with a value of over €1 million (a segment that approximates financing to larger companies, as seen above) and very notable in the case of small loans to corporations and consumer credit and other lending.

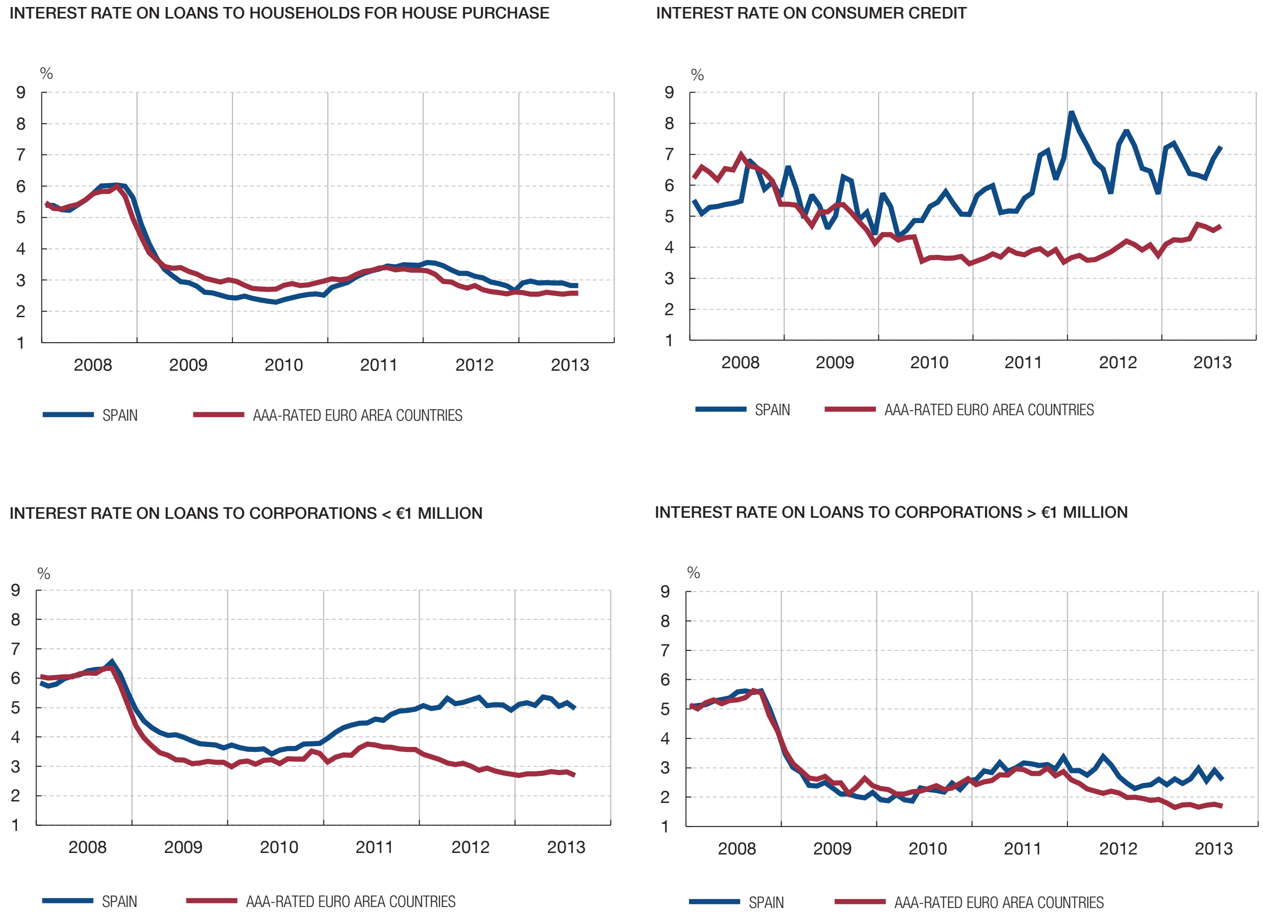
THE DETERMINANTS OF THE EVOLUTION OF LENDING

When analysing the factors explaining this sharp contraction in lending in Spain it is useful to distinguish, if only for the purposes of exposition, between demand and supply elements. Among the former, it is essential to take into account the sharp rise in the indebtedness of Spanish households and non-financial corporations during the last upswing, which strongly outpaced the growth in their incomes and which led to excessively high debt ratios. With the economic and financial crisis, the build-up of this macroeconomic imbalance was followed by a prolonged correction. However, despite the progress made, a comparison of current levels of indebtedness with the average euro area levels suggests that the process is still far from completion (see Chart 3). The consequent need to rebalance the relative weight of equity and borrowed funds in the financing of present and future spending plans represents a brake on the aggregate demand for credit. Indeed, correction of the over-indebtedness of the private

4 For this exercise, companies in the construction and property development sectors have been excluded, since the evolution of lending to these companies is dominated more by sector-related factors than by firm size. The sector breakdown (services, industry, etc.) basically displays a very similar pattern to that of the aggregate presented in this panel of Chart 1.

5 In any case, it should be taken into account that over the last few years larger companies have replaced bank loans by funds raised on the markets, so that the growth of the total financing (loans plus securities) of these firms is higher than would be deduced from the analysis of bank lending. Thus, for example, the sharp slowdown in bank lending in recent months to this group of companies, which can be seen in the lower left-hand panel of Chart 1, may be related to this phenomenon

LENDING RATES: SPREADS OVER CORE EURO AREA (a) CHART 2



SOURCES: ECB and Banco de España.

a The interest rates are NDERs. Operations with initial rate fixation period of less than one year.

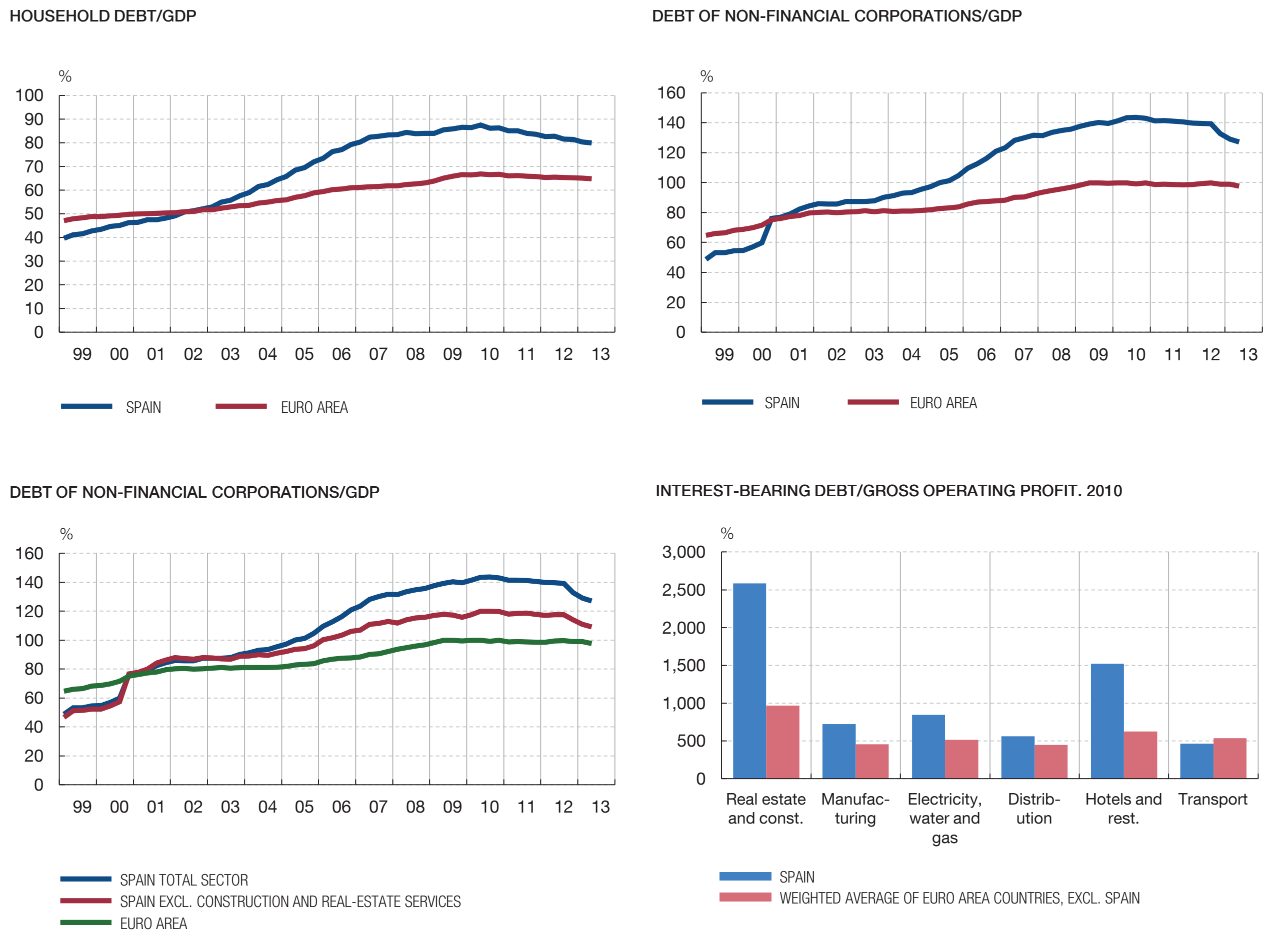
sector and adjustment towards sustainable debt ratios will mean that, for a certain period of time, credit in Spain will tend to grow, on aggregate, more slowly than activity and income.

It is important to point out that, in the case of firms, a significant portion of the growth of debt during the upswing was linked to sectors related to the real-estate market. However, excess debt is not confined to these companies, but is a problem that affects the rest of the sectors too (see the bottom panels of Chart 3), albeit less severely.

A second important demand-side factor relates to the adverse evolution of the current and expected income of borrowers, which limits current and planned spending levels and, in consequence, the need for loans with which to finance them. Likewise, the high uncertainty existing with respect to such future income also has a negative effect on spending plans (especially large purchases and corporate investment) and on the demand for credit. At the same time, the decline in incomes also generates an imbalance between current income and expenses, which firms and households will seek to cover, in the first instance, through borrowing. That said, it is important to determine, in this case, whether the imbalance is temporary or whether, in contrast, it stems from factors of a more structural and permanent nature. Clearly, in the latter case, meeting this insolvent demand for credit would amount to postponing a necessary adjustment in order to ensure that the economic recovery is sustainable.

DEBT RATIOS

CHART 3



SOURCES: ECB, Bank for the Accounts of Companies Harmonised and Banco de España.

On the supply side, the main factors that have a bearing on the evolution of credit basically include those relating to the situation of Spanish financial institutions, but also some linked to the credit quality of borrowers. Among the factors relating to the situation of institutions, is their financial position, which has recently improved as a result of the restructuring and recapitalisation of the sector. The capital of institutions is comfortably above the minimum levels required by Spanish law, while net exposure to the real-estate sector has been significantly reduced, mainly thanks to the large volume of provisions made in 2012 and to the transfer of assets to Sareb. These levels should not, in principle, entail a significant constraint on lending. That said, it cannot be ruled out that lending through this channel is still somewhat constrained by the prospects of weak economic growth, a regulatory environment in which some elements of uncertainty still persist and a certain pressure from international investors.

A second factor that has a bearing on the supply of credit is banks' liquidity position. When the financial tension in the Spanish economy was at its height in the summer of 2012, the policy of generous provision of Eurosystem liquidity and the availability of collateral to Spanish banks counteracted the effects of the drying up of external financing that was experienced at that time. Since then, the tensions in financial markets have subsided significantly and some Spanish institutions have been able to resume their securities issuance. Along with the positive evolution of deposits, these developments have mitigated the liquidity tensions, as has been clearly reflected in the appreciable reduction in borrowing from the central bank, including the early repayment of a significant part of the long-term liquidity obtained at the Eurosystem's special tenders of three-year funds. In addition, the ECB's policy of generous liquidity provision remains active, having been renewed in May this year, literally, for as long as necessary and, at least, until summer 2014. Thus, it seems unlikely that liquidity-related factors currently amount to a significant obstacle to bank lending.

Another relevant factor is the cost of borrowing of banks. Although, in parallel with the easing of tensions, this cost has fallen since summer 2012, it is still higher than in the core euro area countries. This differential is largely the result of European financial market fragmentation caused by the crises. The tensions in sovereign debt markets accurately reflect this fragmentation and the rate of interest on government securities usually acts as a floor for private-sector financing conditions. Moreover, this situation also affects retail deposits and, although there has been a certain reduction, the level of the average interest rate on new deposit transactions with households and non-financial corporations in Spain is still higher than in those euro area countries that enjoy an AAA rating. The banks pass these higher borrowing costs through to their lending operations, thereby reducing their customers' access to credit. In addition, the high interest rates on government debt act as a floor for the (risk-corrected) returns above which banks consider lending to the private sector worthwhile.

The existence of banks under restructuring is another factor that, at least potentially, affects the evolution of lending, since this group of banks must comply (on account of their having received public funds from the FROB) with plans that envisage a reduction in the outstanding amount of loans on their balance sheets over the next few years. Also, the mergers and acquisitions that have in certain cases accompanied these plans may affect those loans in which the customer-borrower relationship is especially close. One might expect, however, that part of this decline would be absorbed by those banks not subject to restrictions. The evidence available shows that between 2011and 2012 lending was already more contractionary at banks under restructuring than at other banks and that "dependent firms" (those that in December 2010 had outstanding loans from banks under restructuring) were able to replace around 65% of the credit that they failed to receive from the banks under restructuring with funds from other banks.[6] The substitution is thus not complete and varies from firm to firm according to their characteristics. It was lower in certain segments, especially in the small firm one. In the medium term, however, the positive effects on confidence in the Spanish financial system, stemming from the balance sheet clean-up and restructuring of the banks, should predominate over the contractionary effects on the supply of bank lending that may occur in the short term.

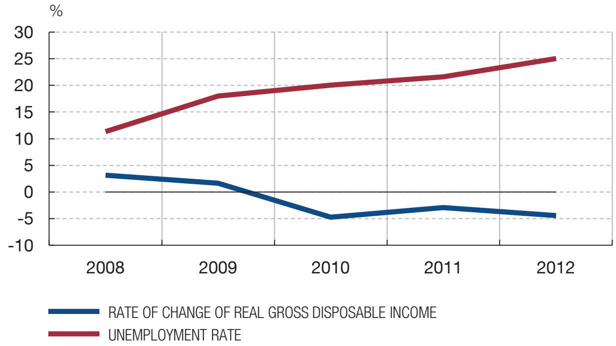
In addition to the factors relating to the situation of institutions, the crisis has led to a deterioration in borrowers' credit quality (see Chart 4), with adverse effects on their financing conditions. This factor is especially relevant in the SME segment since, on average, the credit quality of these firms is lower and they have greater difficulty providing the necessary information for banks to be able to readily distinguish solvent from more risky firms. This is particularly prejudicial, especially in the case of newly formed companies and companies attempting to establish relationships with new lenders. In this context, therefore, it is not unlikely that some SMEs face more restrictive financing conditions than would be justified by their solvency. The deterioration in credit quality and the divergence between firms according to their size is clearly seen in the data on non-performing loans and in the frequencies of default (see Chart 5).

6 For further details, see Box 6.1 of the 2012 Annual Report of the Banco de España.

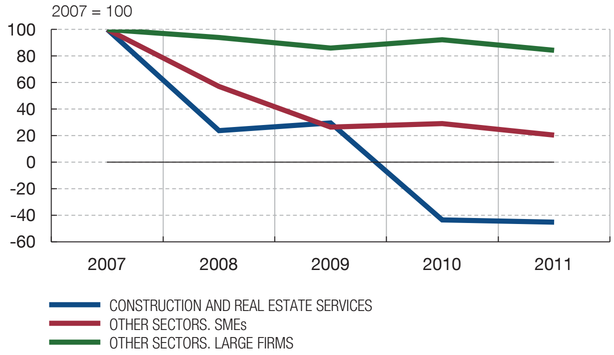
CREDIT QUALITY

CHART 4

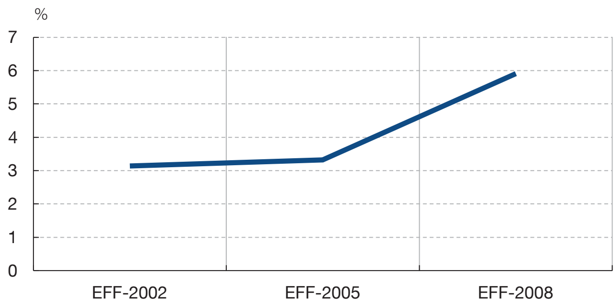
HOUSEHOLDS



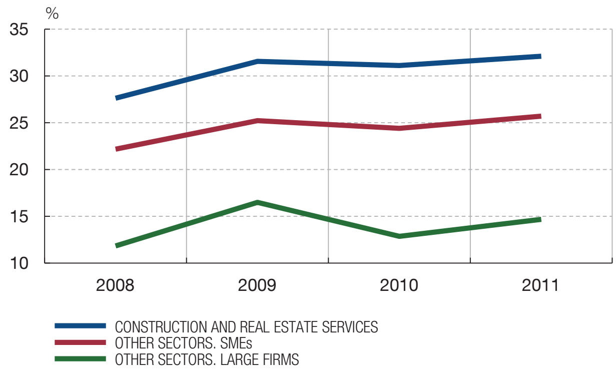
NON-FINANCIAL CORPORATIONS (a)
Ordinary net profit



PERCENTAGE OF HOUSEHOLDS WITH A DEBT PAYMENTS/INCOME RATIO OF OVER 40% (b)



PERCENTAGE OF FIRMS WITH INCOME LESS THAN FINANCIAL COSTS (a) (c)



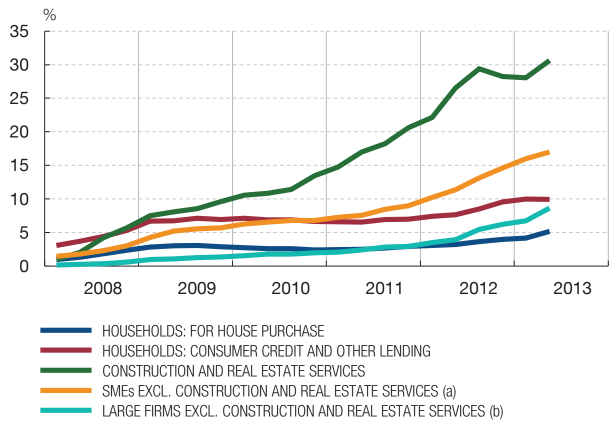
SOURCE: Banco de España.

a Based on integrated data of the Central Balance Sheet Data Office, which include the data reported to the annual survey (CBA) and the data from the accounts filed with the mercantile registries (CBB).
b Debt payments include redemption and interest payments.
c Percentage of firms for which the sum of gross operating profit and financial revenue is less than financial costs.

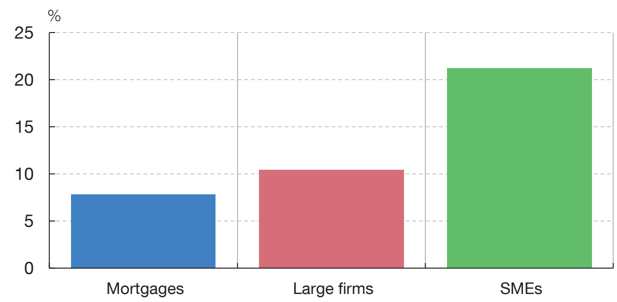
DOUBTFUL LOANS AND PROBABILITY OF DEFAULT

CHART 5

RATIO OF DOUBTFUL LOANS TO TOTAL LOANS



PROBABILITY OF DEFAULT (c)
2012-2014



SOURCE: Banco de España.

a Approximated by the ratio of doubtful loans to total loans of firms with total debt recorded by the Central Credit Registry of between €1 million and €10 million.
b Approximated by the ratio of doubtful loans to total loans of firms with total debt recorded by the Central Credit Registry of more than €25 million.
c See Box 2.3 of the Financial Stability Report of May 2013.

Furthermore, the decrease in the value of the assets (particularly real estate) normally used as collateral also reduces the availability of financing for this sub-sector. It should be taken into account that the proportion of loans to SMEs that are collateralised has tended to grow since the crisis began, rising from nearly 20% to nearly 30% for non-real estate related firms.

Although this separation between demand and supply factors is not immediately transferable to the empirical arena, there are certain indicators which allow us to test, albeit only roughly, the plausibility of the above analysis. Thus the responses of Spanish firms to the Bank Lending Survey (BLS) confirm the presence of both demand and supply factors in the fall in credit of recent years. According to these responses, loan applications have decreased in all segments (SMEs, large firms, loans for house purchase and consumer credit and other lending). They also reveal that standards for the approval of new loans have tended to tighten since the beginning of the crisis, while credit conditions (especially the spreads applied) have become harsher. Among the factors explaining these supply developments, the BLS respondents emphasise the deterioration in the perception of credit risk and the difficulties accessing financing in the markets, in line with the conclusions reached in the above discussion.[7]

From the standpoint of borrowers, the ECB survey on the access to finance of SMEs in the euro area (SAFE) shows, for Spanish firms, a decrease in the perceived availability of bank loans and a loan application denial rate that is consistent with a tightening of supply conditions and a worsening of credit quality, which is more pronounced for SMEs than for large firms.[8]

Another useful way of assessing how the volume and cost of credit have behaved in Spain is to compare the observed course of these variables with the projections obtained from the models that reflect in aggregate terms the historical relationship between these variables and the supply and demand factors which determine them, although the usual specifications tend, in general, to be dominated by demand-side factors. The results of this exercise, using the models of the Banco de España, for credit volume are shown in Chart 6. In 2012, the total credit to households and non-financial corporations contracted slightly faster than would be expected from the behaviour of its determinants, which include the interest rates of each loan type, macroeconomic variables (consumption, investment) and house prices. The sectoral breakdown shows that the fall not explained by the model is larger for firms than for households, suggesting that the frictions (presumably on the supply side) constraining the dynamism of bank lending may be comparatively more important for firms.

Chart 7 shows the results of an equivalent exercise for interest rates. In this case, comparing observed behaviour with the behaviour expected on the basis of the historical relationship with their determinants shows more marked differences.[9] Indeed, in the corporate lending segment, the projections show a decrease from mid-2011, which is consistent with the easing of monetary policy during this period, while the observed interest rate currently stands somewhat above its mid-2011 level. To determine to what extent the part not

7 For further details, see the quarterly articles summarising the main results of the BLS published in the Banco de España's Boletín Económico.

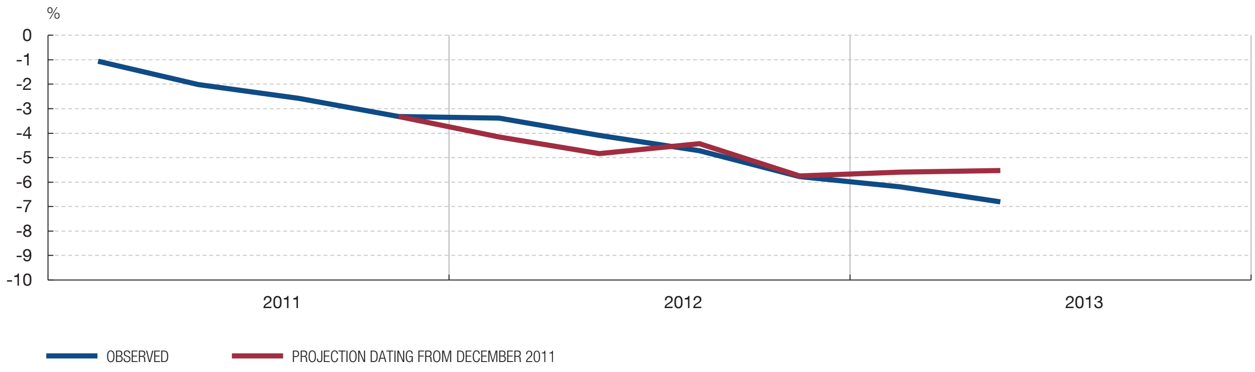
8 For further details, see Menéndez and Mulino (2012) and Recuadro 5 of the "Informe Trimestral de la economía española", Boletín Económico, July-August, Banco de España (2013).

9 The main variables included in this model are interbank interest rates and the unemployment rate. The latter is included to capture the effects of the worsening of the macroeconomic situation.

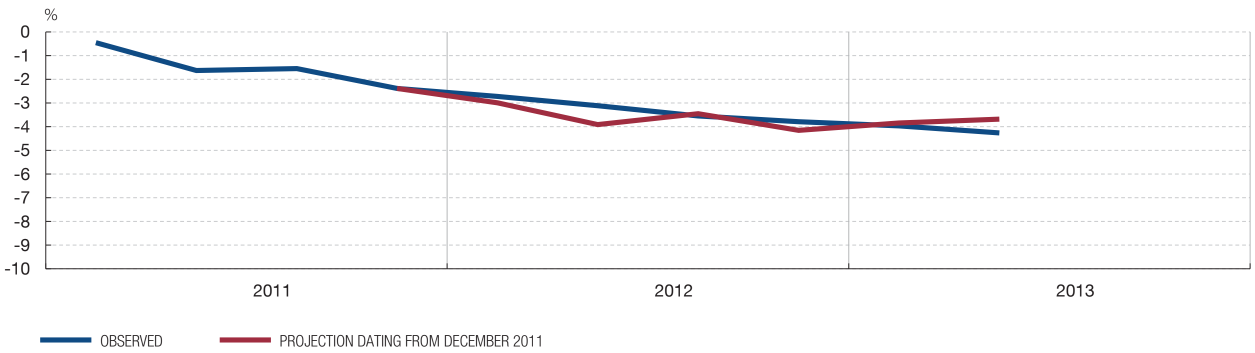
CREDIT. OBSERVED AND ESTIMATED CHANGES

CHART 6

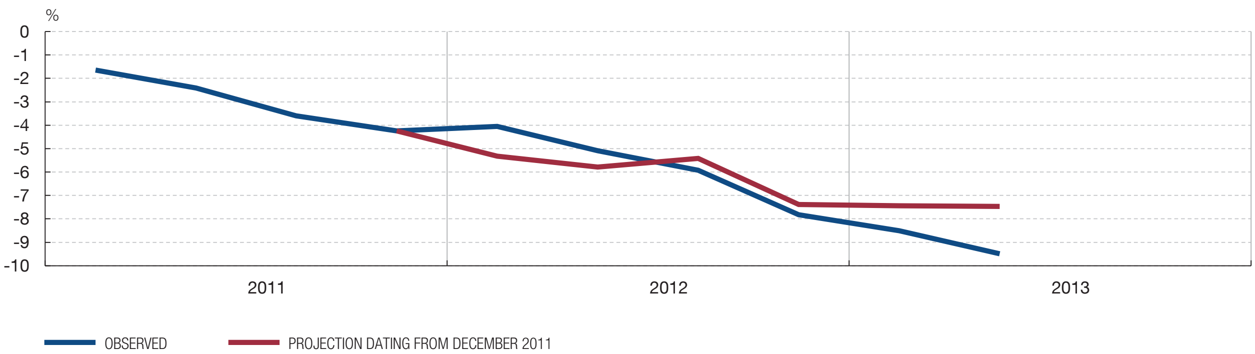
CREDIT TO HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS
Year-on-year growth



CREDIT TO HOUSEHOLDS
Year-on-year growth



CREDIT TO NON-FINANCIAL CORPORATIONS
Year-on-year growth

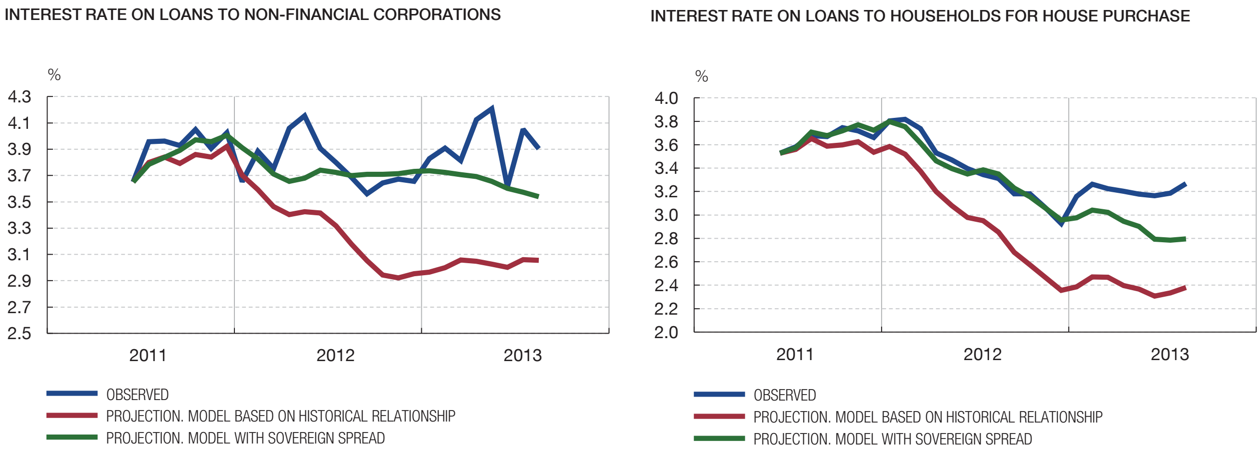


SOURCE: Banco de España.

explained by the model has to do with the fragmentation of European financial markets, the chart shows the projections based on an alternative model which includes the sovereign spread (as a variable to capture the problems of financial fragmentation) and interbank interest rates. Adding this variable allows the observed behaviour to be better replicated, although in recent months the gap between the two time series has widened, since interest rates have moved somewhat above those indicated by this model. This evidence suggests that the anomaly in the recent behaviour of the cost of credit is largely linked to financial fragmentation in the euro area.

INTEREST RATES. OBSERVED AND ESTIMATED CHANGES

CHART 7



SOURCE: Banco de España.

In short, the results of the analysis suggest, first, that demand factors, and in particular the need for Spanish households and firms to reduce their still high levels of indebtedness, are playing a dominant role in the evolution of credit. That said, at the aggregate level, the process of deleveraging can and must be compatible with an efficient redistribution of funds to the most productive and least indebted agents, for which credit should indeed grow. There is some recent evidence that this redistribution is taking place.[10]

In addition, frictions have been identified on the supply side, notably the high cost of borrowing of banks (which obviously affects the price that households and firms pay for funds), linked to the fragmentation of European financial markets. The deterioration in the credit quality of borrowers, associated with the business cycle, is also holding back the recovery of lending.

From the analysis carried out, it can be inferred that the main economic policy measures that could be taken to stimulate lending and reduce the supply-side frictions go beyond those confined to the market for bank loans. The most important and effective measures are those to reduce the degree of financial fragmentation in the euro area (e.g. moving towards a banking union) and to strengthen the economic recovery in Spain (e.g. the structural reforms being undertaken in various markets). However, the analysis also shows that some of the supply-side frictions have particularly serious consequences for a specific sector: SMEs. It is therefore necessary to explore and take measures specifically targeted at this segment.

Initiatives taken in Spain and other countries to boost the growth of lending to SMEs

This section reviews the main measures taken in Spain and other European countries to stimulate lending to SMEs. The review distinguishes between those measures basically intended to facilitate access by banks to funds which can then be lent to SMEs, and those intended basically to mitigate the effects of the credit risk of these firms on the terms and conditions imposed by banks.

MEASURES TO FACILITATE BANKS' ACCESS TO FUNDS TO LEND TO SMES

Policies to make bank loans to SMEs less expensive

One way to improve the financing conditions of SMEs is to provide banks with funds under more advantageous conditions, provided that those funds are used to make loans to SMEs. In Spain the most notable instruments in this respect are the ICO (Instituto de Crédito Oficial – Official Credit Institute) intermediation facilities. Through these facilities

10 See Box 6.2 of the *2012 Annual Report* of the Banco de España.

the ICO provides funds to banks at a lower cost than that available to them, but on the condition that the funds are lent for a certain kind of activity or to a certain type of firm, including SMEs.[11] In these transactions, the banks assume in full the credit risk of the loan and charge a premium to remunerate their operating costs and the credit risk assumed. The ICO sets a ceiling for this premium, which currently stands at about four percentage points after being increased in early June.

At the international level, there are many examples of instruments with similar characteristics. For example, both the European Investment Bank (EIB) and the German government agency Kreditanstalt für Wiederaufbau (KfW) have this type of product. In some small loans (particularly to start-up companies) KfW assumes a significant part of the debtor credit risk. The sharing of risks in relatively small loans is also common in the case of the French OSEO,[12] which offers financial support to SMEs mainly in the initial stages of their life.

Taking a different approach, the Bank of England and the UK Treasury developed in mid-2012 the "Funding for Lending Scheme" (FLS) programme, with the aim of improving the access to credit of households and non-financial corporations. As initially conceived, each bank participating in the programme could request a volume of FLS funding, on advantageous conditions, related to the total amount of its portfolio of loans to the non-financial private sector as at end-June 2012 and to the growth in this amount between that date and December 2013. A fixed fee was set for access to these funds, but the extent of the subsidy depends on the percentage growth of the institution's lending, so that there is an incentive to increase lending. In April this year the programme was revised to place more emphasis on SME loans. Although it is still too soon to assess its effectiveness, the evidence available so far suggests that the impact of the programme is somewhat clearer on the cost of borrowing than on the amounts available.

Prudential regulation measures

For a credit institution, the total cost of an SME loan depends also on how the loan is treated in the calculation of its capital requirements. In this area, Spanish regulation is harmonised with that of other EU countries and includes a discount factor for retail SME loans. This is an indirect way of stimulating the growth of lending to smaller firms. The definition of SME for this purpose is, however, not uniform throughout Europe and, in the case of Spain, until the approval of Banco de España Circular 4/2013, in late September this year, it was more restrictive than recommended by the European Commission (EC).[13]

The new EU regulation on capital requirements, which will transpose in Europe the Basel III accord and come into force in 2014, includes a new discount factor for SMEs (defined in terms of the turnover criterion in the EC recommendation).[14] In Spain, this discount factor has been applied several months early through the approval of the Entrepreneurs' Law (Law 14/2013 of 27 September 2013 to support entrepreneurs and their internationalisation), which came into force in late September.

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11 For further details of the characteristics of these instruments, see García-Vaquero (2013).

12 The OSEO is a holding company with the status of a government agency (reporting to the Ministry of Economy, Finance and Industry and to the Ministry of Higher Education and Research). Recently this company and other government agencies have been brought under the umbrella of Bpifrance (government-owned investment bank).

13 The EC Recommendation, for example, sets the threshold for the number of workers at 250, whereas the Spanish General Chart of Accounts for SMEs sets it at 50. The thresholds for turnover and balance sheet size are also more generous in the Recommendation (€50 million and €43 million, respectively, compared with somewhat less than €6 million and €3 million).

14 Specifically, the capital required will be that obtained using the present formulas, but multiplied by 0.7619.

From a different standpoint, it should also be noted that the refinancing of loans consumes funds which otherwise would be available for new loans. It is important that such refinancing should not take place to the detriment of households and firms in a better position to invest and generate economic growth. The Banco de España has been requiring the early recognition of potential unrealised losses and, consequently, an appropriate and prudent refinancing policy.[15] To the extent that these rules contribute to reducing the risk posed by an excessively lax refinancing policy, they foster a reallocation of credit to more solvent borrowers.

Securitisation of SME loans

Another fairly common way of reducing the cost of SME loans is to securitise them. Securitisation increases the degree of liquidity of the loan and reduces (in certain circumstances) the capital charge. In Spain, special purpose entities securitising loans to SMEs ("FTPYME" by their Spanish abbreviation) purchase loans (basically to SMEs) and finance their purchase through the issuance of marketable bonds which they place with investors. These securities are eligible for a State government guarantee of up to 80% of their amount if they meet certain requirements, including the following: at least 50% of the loans securitised must be to SMEs, the banks securitising these loans must reinvest at least 80% of the liquidity obtained in fresh financing to SMEs within two years and the bonds issued by the special purpose entity must have a credit rating of at least A1 or A+.

The activity of this segment was relatively important before the crisis, but in 2010 and 2011 it decreased significantly, and since the beginning of 2012 there have been no new transactions. Various factors contributed to this. First, the negative influence of the US subprime and securitisation crisis, since FTPYME bonds are, after all, "asset-backed securities". Also, against a background of sovereign debt crisis, the value of the guarantee of the Spanish State has been affected by the downgrades of its credit rating, which have also dragged down the ratings of most resident issuers. In the case of FTPYME bonds, ratings have been revised further downwards due to the deterioration of the underlying portfolios.

Looking at international experience, the picture is generally not very different. Before the crisis, OSEO in France and, above all, KfW in Germany were very active in securitising and transferring the risk associated with SME (and house purchase) loans from commercial banks to bond investors. However, since then many securitisation segments of the European markets have collapsed.

Recently, the EIB announced its intention to step up the financial support to SMEs in a joint initiative with the EC. More specifically, it suggests three possible approaches, including some based on the securitisation of SME loans, under which EIB and European funds (structural funds, in particular) would be used to acquire some of the asset-backed securities generated.

MEASURES TO MITIGATE THE EFFECTS OF THE SME RISK ON SME FINANCING CONDITIONS

Government guarantees to cover the risks on loans to SMEs

Another mechanism helping to stimulate the flow of financing to SMEs is the granting of government guarantees to cover, at least partially, the risk inherent in lending to firms of this kind. From an operational standpoint, guarantees can be provided for different

15 In September last year it introduced new transparency requirements on the volume of refinanced and restructured loans and on their credit risk classification (standard, substandard and doubtful). From December 2012 Spanish credit institutions have to disclose this information every six months, Spain being the first EU country to establish this requirement. Additionally, in April this year the Banco de España published and sent to banks a letter on the criteria to be applied to classify such loans by credit risk. The default classification, in the absence of sufficient evidence to the contrary, is set as sub-standard, meaning that the related provisions would have to be recorded if those loans had previously been classed as standard.

purposes. Thus a guarantee may be provided for a bank loan or credit, but also to guarantee collection on domestic or cross-border sales. A traditional procedure consists in offering a guarantee to those financial institutions which grant advances on the collection of export invoices. In Spain, Compañía Española de Seguros de Crédito a la Exportación (CESCE), a financial institution majority owned by the government, specialises in this activity.

An analysis of comparable experience in other countries reveals a wide range of similar guarantee schemes. Notable in the United States is the so-called "7(a) Loan Program" managed by the Small Business Administration, a government agency which offers guarantees for loans for diverse purposes. In Germany and France, both KfW and OSEO grant guarantees to credit institutions which offer financing to SMEs. Similarly, the EIB also grants guarantees to various types of financial institution.

Direct assumption of risk by the State

The State may directly assume part of the transaction risk or even make the loan directly. In Spain, in addition to the intermediation facilities described above, the ICO has so-called direct financing programmes, under which, apart from providing the funds, it assumes the default risk of the whole transaction. These programmes have traditionally been aimed at large-scale productive investment projects carried out both in Spain and abroad. Exceptionally, in 2010 and 2011 and the opening months of 2012, the ICO granted direct financing to SMEs and self-employed persons through the ICO-Directo Programme. However, the experience was not positive.

There are other public institutions which offer instruments to support SME financing through the assumption of SME credit risk, such as the Centro para el Desarrollo Tecnológico Industrial (CDTI), Compañía Española de Financiación del Desarrollo (COFIDES) and Empresa Nacional de Innovación, SA (ENISA), which specialise in granting financing to different types of firms, including SMEs.[16] These institutions, which sometimes have cross-shareholdings and whose instruments are very similar, make up a complex system of financial support for firms (see Chart 8).

As regards comparable experience at international level, the EIB also grants direct loans for projects whose total cost of investment exceeds €25 million, and is permitted to finance a maximum of 50% of the total cost of any project.

Risk diversification among SMEs

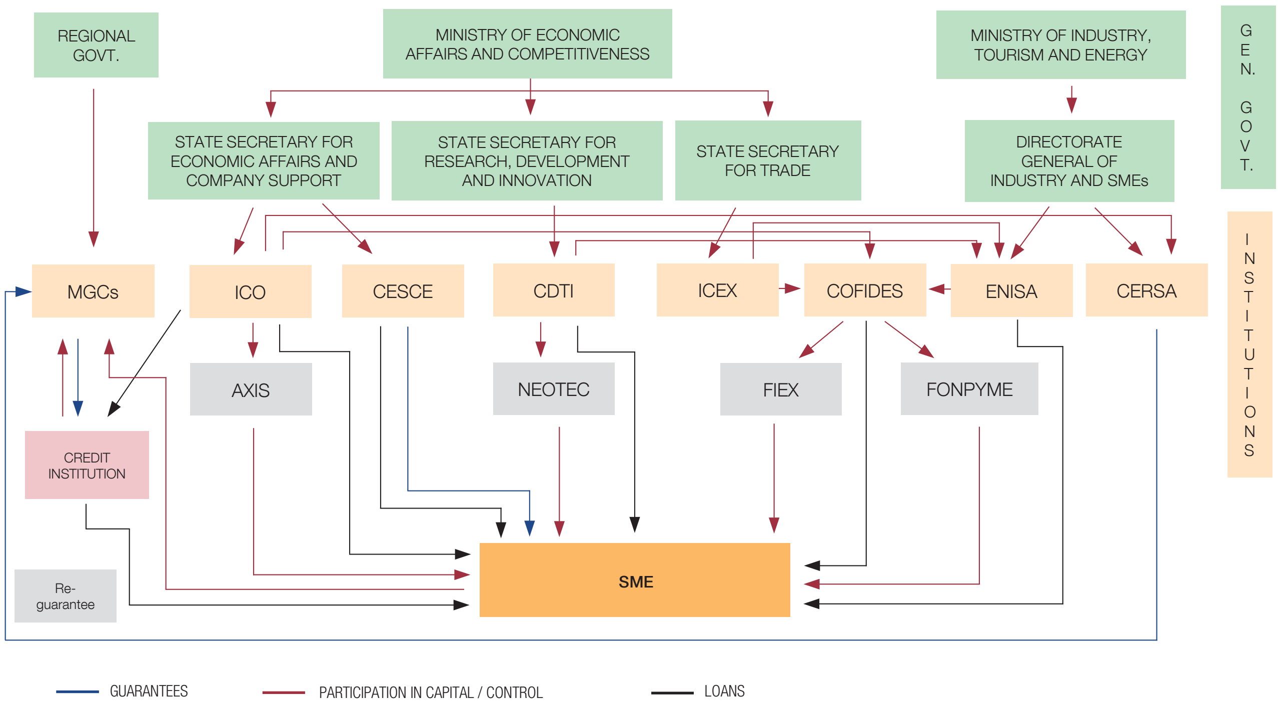
SME credit risk may also be reduced through groupings of firms which, by means of mutual insurance or similar mechanisms, permit better risk diversification of their members and, accordingly, lower the credit risk premia charged by institutions on their loans. In Spain there are mutual guarantee companies (MGCs), which are financial institutions whose objective is to grant guarantees to their members (usually SMEs) to facilitate their access to credit or to improve their credit conditions. A large share of the risk assumed by the MGCs (up to a maximum of 75%) is usually transferred to the Compañía Española de Reafianzamiento, SA (CERSA), whose activity is based on the partial coverage of the risk assumed by MGCs, and, to a lesser degree, to the related regional governments. There are 23 MGCs and the majority have very close links to their regional government, which also normally owns a stake in them.

In Europe, Italy's CONFIDI is the largest guarantee scheme of this type. However, the activity of this type of companies is generally limited in Europe. Apart from in Italy, activity levels of minimal significance are only achieved in Hungary, Greece and Portugal.

16 For further details on the activity of these companies, see García-Vaquero (2013).

FINANCIAL SUPPORT SCHEMES FOR FIRMS IN SPAIN

CHART 8



SOURCE: Banco de España.

Reduction of SME liquidity risk

In their relationships with larger firms, and even with the households demanding their products, the bargaining power of SMEs in their collection and payment management is limited. This gives rise to a liquidity risk, coverage of which, in short, results in greater financing needs. Measures aimed at reducing said liquidity risk will result, therefore, in improved financing conditions for this type of companies. In Spain the Fund for the Financing of Payments to Suppliers was set up in 2012 to speed up collection of the outstanding trade payables of regional and local government to firms. The programme was extended in 2013.

Another significant mechanism for reducing liquidity risks turns on regulatory measures to decrease SMEs' average collection and payment periods. In 2000 the first EU directive was published[17] which aimed to establish measures to contribute to decreasing late payment in commercial transactions and which was reformed in 2011.[18] This directive, transposed into Spanish legislation,[19] sets out maximum limits on periods for payments related to commercial transactions between firms, and between firms and the public sector. The legislation sets a maximum period of 60 days, which in transactions with the public sector is reduced to 30. Recently, several reforms have been introduced in this area by Royal Decree-Law 4/2013 of 22 February 2013 on measures to combat late payment in commercial transactions. In particular, the payment period which must be met by the debtor

17 Directive 2000/35/EC of the European Parliament and of the Council of 29 June 2000 on combating late payment in commercial transactions.

18 Directive 2011/7/EU of the European Parliament and of the Council of 16 February 2011 on combating late payment in commercial transactions.

19 Firstly, it was transposed by Law 3/2004 of 29 December 2004 establishing measures to combat late payment in commercial transactions and, subsequently, through Law 15/2010 of 5 July 2010 amending Law 3/2004 of 29 December 2004, establishing measures to combat late payment in commercial transactions. However, several aspects and limits have recently been reformed through Royal Decree-Law 4/2013 of 22 February 2013 on measures to combat late payment in commercial transactions.

has been reduced from 60 to 30 calendar days (if no payment period or date had been set in the contract), from the date on which the merchandise is received or the services are provided. The legal rate of interest for late payment has also been increased.

In Europe, since the onset of the crisis, several countries have also substantially cut the maximum payment periods for the public sector (Belgium, France, Hungary, Italy, the Netherlands and the United Kingdom, which has reduced it to ten days). Certain countries have permitted postponing the payment of taxes and accelerating the depreciation of fixed assets for accounting purposes (France and Germany), but these are countries which are not subject to the same fiscal consolidation needs as Spain.

Possible measures to stimulate lending to SMEs

Comparison of how the ICO and its French and German peers operate suggests that a measure that could be explored would be for the ICO to arrange operations in which it shares part of the risk of SME loans with private credit institutions, although the experience of the ICO-Directo Programme discussed above indicates that the assumed part of the risk should not be large. This would reduce the cost of these operations for banks and, insofar as the ICO charges a smaller premium for the risks assumed, it would also reduce the cost for SMEs. Note, however, that greater assumption of risk by the ICO would have to be accompanied by a simultaneous strengthening of its capital. Current levels of public debt in Spain represent a constraint which has to be closely considered when assessing, in practice, any possible measure in this direction (percentage of risk to be shared, scope of the new facilities, etc.). That assessment should also take into consideration the need to maintain all participants' incentives adequately aligned, which makes it advisable that the banks should continue to assume the bulk of the risk of the transactions in order to guarantee that they select counterparties efficiently.

In the same vein, it would also be possible to study whether a simplification of the current framework of public financial support for SMEs, which, as discussed above, rests on a broad variety of instruments provided by various institutions, would make for easier assimilation by SMEs whose ability to absorb information is probably more limited than that of large corporations. Simplification of the framework could also contribute to the achievement of greater economies of scale and result in greater efficiency and exploitation of all the possible synergies.

In the area of microprudential regulation, the necessary homogeneity of rules at European level leaves very little margin for national action. However, the recent change in the definition of an SME, to adapt it to the EC Recommendation, will expand the set of loans that may benefit from the softer conditions applied to retail loans to SMEs. Also, the early introduction (through the Entrepreneurs' Law) of the discount factor into Spanish solvency law will reduce, several months earlier than foreseen, the cost to banks of financing SMEs, which should improve the access to credit of these companies. In any case, stimulating lending to SMEs clearly cannot be to the detriment of the solvency of the banking system.

A different area in which possible measures may also be considered is that related to Spanish insolvency law. In adverse cyclical situations, a restructuring of the productive sector usually takes place, which necessarily involves replacing less efficient firms by more efficient ones. In order for those processes to unleash their full positive potential the legal framework needs to favour the restructuring and orderly winding up of inefficient units so that the resources needed to finance new more profitable projects can be smoothly released. Insolvency proceedings in Spain have traditionally been slow and costly and in the vast majority of cases have tended to end with the winding up of the company since such proceedings are only initiated when the company's deterioration is very advanced. Law 38/2011 of 10 October 2011 (the "Insolvency Reform Law"), however, introduced a series of reforms to facilitate the restructuring of companies and their debts at a sufficiently early phase in the process. Notwithstanding this, some international investors and analysts have indicated that there is still room for improvement in this direction. Notable among the proposals made are those designed to shorten insolvency proceedings and make them more flexible and those to provide non-judicial payment mechanisms, as a second opportunity, such as those envisaged in the "Entrepreneurs' Law".[20]

There also seems to be a substantial margin for improvement in the application of the legal provisions limiting the collection periods of SMEs in their commercial relations with other firms and, in particular, with government. The measures included in the draft Law on the Control of Trade Debt in the Public Sector, currently under discussion in Parliament, seem particularly appropriate. More specifically, the draft law envisages an amendment to the Budgetary Stability Law to extend the perimeter of the concept of financial sustainability so as to include not only financial debt but trade debt as well. Failure to comply with the legal 30-day limit would trigger the preventive, corrective and coercive measures envisaged in the Budgetary Stability Law.

It would also be worth exploring possible measures in relation to MGCs, especially to help consolidate and strengthen their capital so as to boost their role of diversifying and guaranteeing SMEs' risks. A reform has already been implemented to raise the minimum share capital of these institutions from €1.8 million to €15 million. The current reguarantee system, whereby CERSA reguarantees part of the MGCs' operations, could also be reviewed. At present, when an SME defaults on a loan the lender bank must make a claim against the MGC and the latter must enforce the guarantee given by CERSA. However, if the MGC becomes insolvent during this process, the bank has no claim against CERSA. The strengthening of MGCs' capital reduces the probability of such an event, but a reform permitting direct contact between the lender institution and the ultimate guarantor could have a further positive effect on loans to SMEs.

From a different time perspective, it is also important to remember that, ultimately, a large portion of the specific problems SMEs have accessing credit stem from the difficulties banks have assessing borrower creditworthiness. The crisis and the restructuring of the Spanish banking system have, in the short term, accentuated this structural deficiency. The challenge in this area is therefore to design mechanisms which lead to the regular production of uniform, quality data on the most important aspects of the business of SMEs.

Conclusions

The results of this article suggest that demand factors relating, above all, to the high level of indebtedness of Spanish firms and households explain a significant part of the contraction in lending seen in Spain. However, the process of deleveraging at the aggregate level can and must be compatible with an efficient redistribution of funds to more productive and less indebted agents, so that there is financing available for undertaking new profitable investment projects. There is in fact recent evidence that this reallocation is already taking place.

Certain frictions have also been detected on the supply side that may be holding back economic recovery, basically linked to the high costs of Spanish bank financing, as a

20 These mechanisms basically envisage debt reductions and reschedulings.

consequence of financial market fragmentation in Europe and the effects of the crisis on borrowers' credit quality. These frictions, moreover, bear particularly heavily on SMEs

Most of the possible economic policy measures that it would be advisable to consider in this context in order to ease financing conditions thus go beyond the purely domestic sphere (for example, taking further steps towards a banking union within the euro area, in order to sever the link between banking risk and sovereign risk) or extend well beyond the credit market (for example, all the measures needed to complete the process of correcting the macroeconomic imbalances that built up during the last upswing). These general measures have not been analysed in this article.

In contrast, more specific measures, more directly aimed at stimulating the segment of lending to SMEs have been considered. Following a review of the various measures that have been adopted in this area in Spain and in other countries, a number of measures have been identified that might be worth exploring to boost bank lending to SMEs: strengthening the role of the ICO, simplifying the framework of public financial support for SMEs, shortening insolvency proceedings and making them more flexible, providing non-judicial payment mechanisms, improving the application of legal provisions limiting the collection periods of SMEs, strengthening and consolidating MGCs and, in the longer term, designing mechanisms for the regular production of uniform, quality data on the most important aspects of the business of SMEs.

11.10.2013

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