

Increasing European SME Access to Credit with Non-bank Lenders

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The Background

Affordable access to credit has always been challenging for small and medium-sized enterprises (SMEs) in Europe, but the problem is probably more acute than at any time in recent history. This reflects a mismatch between the demand and supply of credit that is likely to continue for several years. In the long term, improvement in banks' capital levels and adjustments in SMEs' expectations might lead to the emergence of a smoother functioning SME lending market. But over the next few years many small and medium-sized firms are likely to find the terms of bank credit, already demanding, virtually unaffordable.

Growing demand Demand for credit among European SMEs will grow as the region's economies recover. In part this is about expanding capacity as firms seek to meet rising customer demand. But the need for investment is the leading factor. Businesses need to reverse the under-investment that has been a feature of European economies since 2009 (see Appendix – Figure 1).

Demand for credit will receive an additional boost from the hangover of the credit boom that ended in 2008. A large proportion of the credit raised by European SMEs between 2004 and 2007 is due to be refinanced by 2017, but many of the markets which were the source of this finance are either closed or operating at reduced capacity. The upcoming maturity bulge in European leveraged loans is a perfect illustration (see Appendix – Figure 2).

Falling supply Unfortunately as European businesses' demand for credit increases, European banks' ability to lend will decline. European banks have been under pressure to reduce balance sheet leverage since 2008, and this trend is likely to continue for several years. Several national regulators are adding their own capital requirements to those of CRD IV, and banks also face the ECB's Comprehensive Assessment and the Basel Committee's introduction of a new Leverage Ratio. The net effect is that European banks face a capital shortfall of around €280bn¹.

Banks will reduce their leverage in a number of ways. One will be to raise fresh capital, which should become easier as European economies begin to recover. Even so, asset restructuring via sale or run-off is likely to be a key strategy. The IMF estimates that European banks needed to reduce their assets by US\$700bn during the second half of 2013 alone², and PwC's Portfolio Advisory Group believes that European banks are carrying €2.4tn of non-core loans on their balance sheets³. The gradual withdrawal of exceptional support such as the LTRO⁴ will also make it harder for banks to lend.

1 PwC, De-leverage Take 2, November 2013

2 International Monetary Fund, Global Financial Stability Review (Table 1.6), October 2013

3 PwC, European Portfolio Advisory Group Investor Insights Survey, March 2014

4 The LTRO is the ECB's Long-Term Refinancing Operation

The Opportunity

We believe the shortfall in the supply of bank credit to European SMEs will last for another five years.

We also believe European firms will struggle to fill this gap using other existing sources of credit. Europe's medium-sized enterprises do not typically enjoy the same sort of access to bond markets as their counterparts in the US. European bond issuance has strengthened during 2012 and 2013 (see Appendix – Figure 3), but total bank loans still comprise the large majority of European corporate debt, compared with less than 30% in the US.

Europe's securitisation markets, which could help banks lend to smaller firms with limited credit histories, are also recovering slowly in the post-crisis regulatory environment. European SME securitisation only raised a total of €45bn in 2012 and just €16bn during the first three quarters of 2013⁵. Meanwhile retail bonds are currently barely known outside Germany and Italy, and peer-to-peer lending and crowd-funding platforms are still gaining traction in most European markets.

We see a major opportunity for non-bank institutions to extend credit to medium-sized European firms.

We believe this segment offers the greatest scope for growth in non-bank lending and would expect a typical loan to fall somewhere between €10m and €50m. Below that band, loans will be too small to interest non-bank institutions; above it, companies will typically have their own credit rating and easier access to other sources of credit.

We also see huge potential for non-bank lenders to combine new lending with the purchase of non-core loan portfolios. European banks hold an estimated €2.4tn of non-core loans, half of which are performing. Purchasing batches of these loans would enable non-bank lenders to augment their organic growth, accelerating their investment in this asset class.



SME securitisation only raised a total of €45bn in 2012 and just €16bn during the first three quarters of 2013

⁵ European Investment Fund, 'European Small Business Finance Outlook', December 2013

The Business Model

A wide range of non-bank institutions have the potential to act as direct lenders to mid-market companies. The most obvious are insurers and pension funds, but sovereign wealth funds and hedge funds could also be attracted to this market.

For lenders, the attractions include improved diversification, the covenant protection available to lenders but not to bondholders, and exposure to the SME sector. Above all, risk-adjusted returns are likely to be more appealing than for banks facing tough regulatory capital requirements. The range of returns on offer would vary depending on the borrower and the loan structure. We expect non-bank lending to cover a range of credit types. Senior debt backed by good quality security could offer lower but attractive yields and is likely to attract the greatest interest. Unsecured, uni-tranche or leveraged loans would offer stronger yields to investors with a greater risk appetite. The high risk-return profile of mezzanine debt might also interest a minority of investors.

Most non-bank lenders will want to lend for a fixed period. Non-bank institutions do not have the treasury functions to provide revolving credit facilities, and assets with fixed duration offer the best fit with the liabilities of life insurers and pension funds. These preferences complement those of the banks, which are better able to manage revolving credit. Banks also prefer to retain short-term lending for the opportunity it offers to cross-sell services such as foreign exchange, cash management and trade finance.

We therefore believe that co-lending, where banks and non-banks lend alongside each other, represents the most promising model for non-bank lending. In most cases, commercial banks will retain the primary customer relationship and continue to provide less capital intensive products and services. However private banks and investment banks could also use non-bank lending partners to meet their customers' credit needs without using up precious capital. For banks, the effect would be to move their corporate lending function closer to a debt capital markets model.

Not all non-bank lending needs to take place through intermediaries. European non-bank institutions could also lend direct to larger mid-market companies without a formal credit rating, as in a US private placement or a German *Schuldschein* loan. Standard & Poor's launch of a service offering creditworthiness opinions to mid-market companies is an indicator of the potential growth in this area.

Of course, some institutions may be deterred from direct lending by limitations on the speed with which they can exit investments. However many of the same institutions already invest in illiquid assets such as private equity holdings. These concerns should recede as the non-bank lending market continues its rapid development.

What might non-bank lending look like?

- AXA's joint venture with Société Générale is an example of a co-investment approach
- A partnership approach could see a bank provide underwriting, credit selection and servicing support to a sovereign wealth fund
- Asset managers could set up direct lending funds supported by their own proprietary platforms

The Practicalities

In our view, barriers to entry for non-bank lenders in Europe are comparatively low. Even so, there are a range of practical considerations that new entrants should be aware of.

We group these into four areas.

- **National variations.** European markets offer very different scope for growth in non-bank lending. Market size is the most obvious factor. France, Germany and the UK are Europe's three largest debt markets, followed by Spain and Italy. However the growing fragmentation of credit conditions within the Eurozone will also have an effect. Borrowing costs for SMEs in Spain can now be more than 2 percentage points higher than in Germany, compared with a gap of just a few basis points in 2010⁶. The effects of fragmentation can be seen in the varying outcomes of European SMEs' loan applications (see Appendix – Figure 4).
- **Organisational requirements.** Non-bank institutions acting as lenders will need to develop the right supporting structures and capabilities. At a minimum, this means acquiring in-house lending and credit risk management expertise. We note that several large non-bank institutions are developing in-house teams to identify and analyse lending targets⁷. Loan administration and other back office work can be outsourced to a third party service provider.
- **Time to market.** Setting up the right in-house structures should be quite straightforward, but identifying the right lending targets may take longer. European mid-market borrowers vary hugely in creditworthiness and transparency, and the most easily researched companies will offer the least attractive yields. It will take time for non-bank lenders to develop relationships with banking partners or, if lending alone, to find suitable borrowers. Negotiations over collateral could be sensitive, but have not proved to be a major obstacle so far. Co-lending agreements that rank both parties *pari passu* should offer the simplest solution.
- **Regulation.** A growing focus on shadow banking is a potential obstacle to the evolution of non-bank lending. European regulators are clearly sensitive to levels of leverage among non-bank institutions. However many non-bank lenders – such as insurance companies – are already regulated. So far, regulation shows few signs of preventing non-bank institutions from entering the direct lending market.

⁶ Financial Times, 'Eurozone SMEs struggle to access finance', 01.04.13

⁷ Allianz, Press release, 17.06.13; Financial News, BlackRock's new infra team to focus on bespoke funds, 26.11.12

Our Conclusion

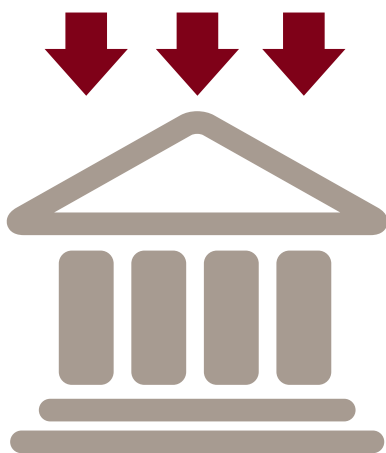
In our view, the scale of the non-bank lending opportunity in Europe is huge, and will only grow over the next few years.

European small and medium-sized businesses will increasingly wish to invest for future growth, but European banks will remain under pressure to reduce their levels of leverage. Raising capital or restructuring liabilities will not be enough to prevent the banks from reducing net new lending.

At the same time, institutions with capital to invest are increasingly interested in the possibilities of direct lending. We see powerful scope for non-bank institutions to lend to medium-sized European companies alongside commercial banks. There are some potential obstacles to non-bank lending, but none appear to be definitive and the market is evolving rapidly.

Now is the time for non-bank institutions to lay the groundwork for lending, by developing a strategy and building up their in-house capabilities. Existing non-bank lenders might also consider expanding their business through purchases of non-core loan portfolios. The market is growing fast from a low base. Société Générale and AXA have already set up a lending partnership,⁸ asset managers are creating direct lending funds and pension funds have begun to acquire leveraged loan portfolios from deleveraging banks.

Non-bank lending need not constitute a direct challenge to European banks. There are increasing signs that banks are willing to work with a range of alternative lenders to meet their clients' needs and relieve the strain on their own balance sheets. In our view, the potential benefits to both borrowers and lenders are compelling.



European small and medium-sized businesses will increasingly wish to invest for future growth, but European banks will remain under pressure to reduce their levels of leverage.

⁸ Risk.net, AXA enters corporate loan market with SocGen, 15.06.12

Appendix

Figure 1: Investment as a % of GDP

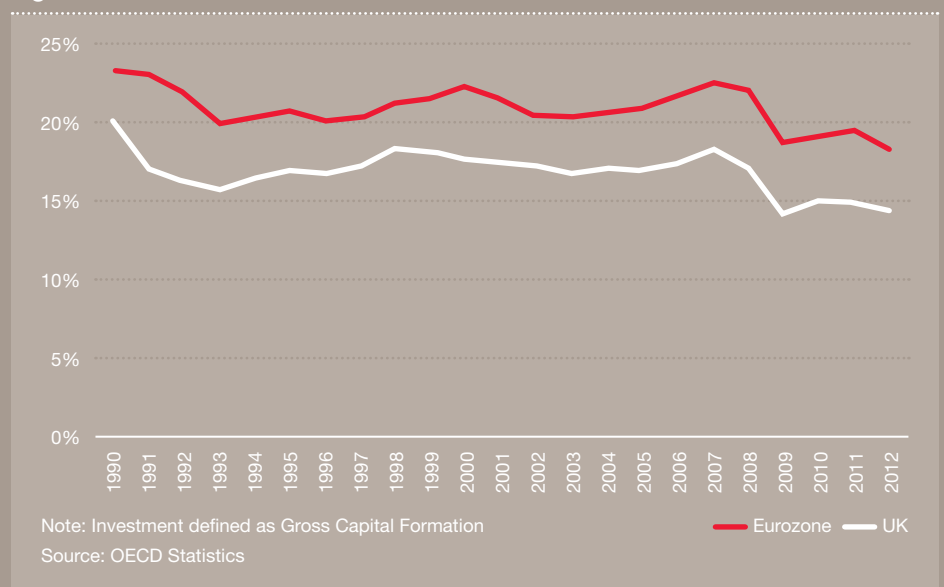


Figure 2: European Leveraged Loans Maturity Breakdown

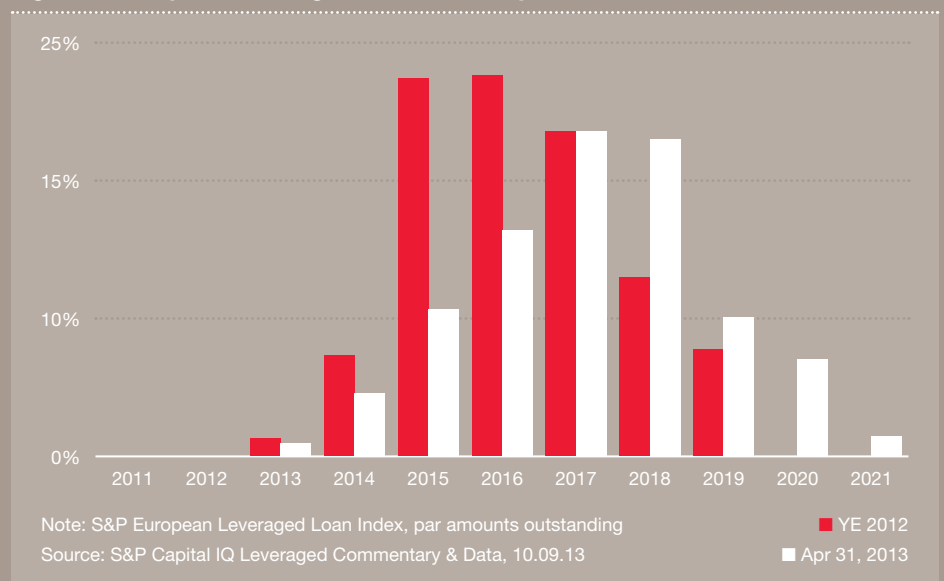


Figure 3: European Corporate Loan and Bond Issuance

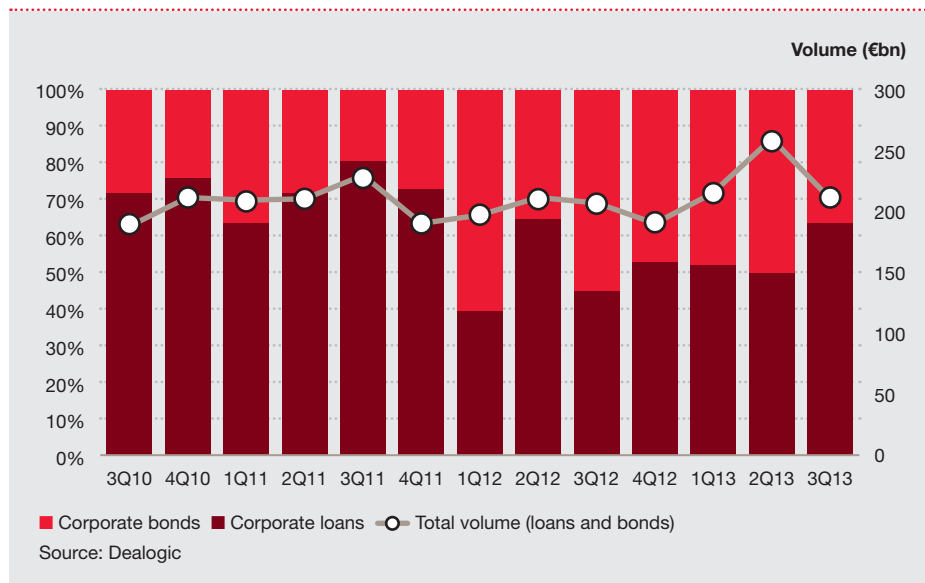
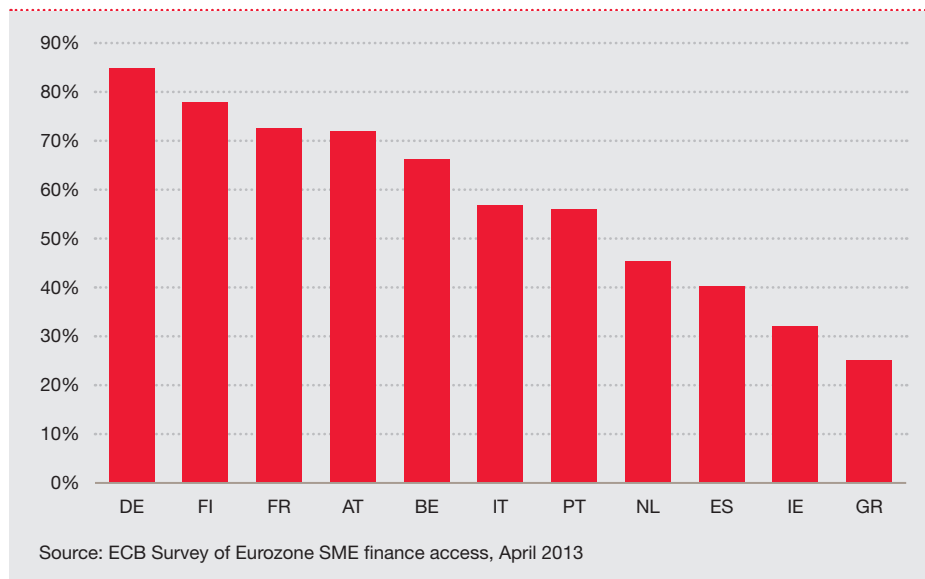


Figure 4: Proportion of SME loan applications approved in full, H2 2012 (%)



Contacts

If you would like to discuss any of the issues raised in this Report in more detail, please speak with your usual PwC contacts or anyone listed below.

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