SME Funding

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The Role of Shadow Banking and Alternative Funding Options

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ISBN 978-1-137-58607-0 ISBN 978-1-137-58608-7 (eBook)
DOI 10.1057/978-1-137-58608-7

Library of Congress Control Number: 2016957417

Printed on acid-free paper

This Palgrave Macmillan imprint is published by Springer Nature
The registered company is Macmillan Publishers Ltd.
The registered company address is: The Campus, 4 Crinan Street, London, N1 9XW, United Kingdom

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Foreword

In spring 2014, on the way back from a Saturday morning jog along the marvellous paths of Monte San Fruttuoso nearby Camogli, Liguria, a successful entrepreneur and friend of mine told me something which did not entirely surprise me, but, for sure, made me think. He described a blooming economic-environment for his business, which was enjoying a positive net financial position. Despite it had no needs of funding, his company was receiving many offers of credit at very favorabe rates, and was taking advantage of "treasury arbitrages" by making short-term deposits to Italian banks, funded by cheaper liquidity received from other Italian and Eurozone banks.

Since they were firstly introduced in late 2011, most of Italian banks took full advantage of the long term refinancing facilities (LTRO) operated by the ECB. Banks borrowed significant amounts from the ECB and entered in "carry trades" by buying Italian Govies, which had among the highest spreads (and the lowest prices) in the euro area. For a while, these financial strategies helped the P&L of Italian banks and, by reducing the spreads of Govies against Bunds, contributed to save the country from the risk of default. Although unconventionally and indirectly, these strategies were crucial (also) for the real economy. Thereafter, the ECB monetary stimulus have struggled to transmit to the real economy at the pace and for the amounts which were hoped. A combination of high stocks of non-performing loans (NPL), weak capital positions, rating models and risk management choices have reduced the appetite of Banks to lend to the part of the economy which needs it the most. Distortions like the one described in the anecdote have occurred. Yes, expansionary monetary policies are known to be less effective than contractionary ones. Yet, it is disappointing to witness the failure of such important stimulating measures, especially in an economy in desperate search of growth and employment. Paradoxically, liquidity is abundant for large and healthy companies (which do not need funding), and scarce for SMEs (which need it the most, both short term and long term). This is particularly frustrating as SMEs represent the backbone of the European economy (99.8 % of EU companies, 60 % of EU GDP and 70 % of EU employment).

Why is this? Is there anything the different stakeholders (policymakers, banks, financial markets, rating agencies, SMEs, etc.) can innovate, or do better, or do differently?

Should Europe at large develop towards the Anglo-Saxon model, where the role of capital markets instruments and that of non-banks in funding the real economy – overall and in respect of SMEs – is much more pronounced?

Are there any lessons to be learned from the digital economy and the digital platforms that are flourishing in financial services?

What are the key pillars of an effective short- and long-term funding ecosystem for SMEs?

By means of the contributions of a formidable blend of financial services academics and practitioners, this book analyzes and suggests some concrete and promising ways forward in regard to three key pillars underpinning the growth agenda of an SME.

Pillar I: Valuing SMEs' credit risk. How much of the credit crunch for SMEs is genuinely based on a proper assessment of their risks, and how much it is simply due to the lack of the information to be able to do so in an effective and efficient manner? What contribution to the above issues can come from the development of rating systems dedicated to SMEs, taking advantage also of the new frontiers offered by real-time analytics, structured and unstructured big data mining, and information pooling and sharing?

Pillar II: Policies for SMEs lending. What are the measures in place at EU and country levels? What are the successes, failures, contradictions and potential remedies for a higher harmonization of Basel III banking regulation, ECB monetary measures, EU policies and efforts to develop lending to SMEs? How does one limit the unwanted effects of pro-cyclicality amplified by banking capital requirements and prevailing accounting standards, in both the financial sector and the real economy? What is still lacking for the support of a healthier capital position for SMEs and to satisfy their funding requirements?

Pillar III: The potential role of so-called "shadow banking". Why and how are new players entering the lending market? What value propositions do they provide of which banks are not capable? Is it already possible to identify some patterns in this new lending landscape? What is the positioning of these players? Are they banks' competitors or banks' potential partners? And, in the latter case, how can one deal with asymmetric information?

In addressing the above questions, the authors suggest that a sound growth of the SME sector can come from the combination of dedicated and reliable information and tools for the proper assessment of the risk, a clear framework of proven policies and the sound development of new lending players for SMEs.

One final consideration on "shadow banking". The term was first introduced to describe the damages caused by non-regulated or poorly regulated financial intermediaries in the US crises of 2007–2008. Sometimes, and improperly, the definition is also applied to regulated non-banking players; for example, alternative asset managers such as specialized SME credit (closed-end) funds, and SME-lending brokerage platforms. Players in the first category pool long-term resources from institutional investors – mostly pension funds, endowments and insurers – and, without taking any mismatched risk, allocate those resources to the funding needs of the SMEs, according to agreed investment criteria (detailed in the prospectus). Platforms in the second category provide a marketplace where quality of information, streamlined digital processes and the market forces of supply and demand meet the financial needs of SMEs.

The contribution of these, and other similar players, to SMEs can further grow and complement the array of financial providers available to the sector. They deserve to be brought "out of the shadow", and to take a greater role in developing bright and sound financial solutions for SMEs.

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