

SME Lending in Europe

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The Allianz logo symbol is a white circle containing three vertical bars of varying heights, representing the letters 'A', 'I', and 'A'.

Executive Summary

- Government and supranational institutions supported by regulators across Europe have implemented several initiatives to address the financing squeeze for small and medium-sized enterprises
- Lending to small companies will continue to be predominantly a banking business. In order to extend lending in this space, banks need more capital and regulatory clarity
- Additional programs can be successful if they either grant banks capital relief or allow new investors that are able to take additional SME risk access to the market. Selected initiatives are
 - **The UK Funding-For-Lending Scheme** leads to more funding for SME lending but do not address the capital issues and hence has limited potential to increase credit availability
 - Programs that give non-bank investors access to SME exposure like the **Spanish MARF**, **Italian Minibonds** and **French EuroPP** made a successful start but are focused on the larger end of the issuer spectrum. **German Schuldscheindarlehen** are well established and highly competitive
 - ABS securities have been scrutinized by regulators and politicians after the sub-prime crisis. A more pragmatic view towards **SME ABS capital charges** would help the funding problem. As banks have to retain the junior tranches, ABS cannot solve the capital issue
- Allianz and AXA are engaged in expanding their exposure to European corporate investments. Both insurers have participated in European SME loans and are amongst the largest investors in German Schuldscheine.
- We are constantly looking to diversify our credit portfolio. Our focus is on areas where we consider ourselves to be particularly well positioned to take investment risk, e.g. long duration, illiquid assets

UK: Funding For Lending Scheme (FLS)

The initiative

- The Bank of England introduced the program to boost lending of banks and building societies to UK households and non-financial companies

Scope

- Banks can draw down funding for 5% of their stock of loans as of June 2012 plus an amount equal to the new net lent amount
- Fee: 25bp for banks that maintain or expand their lending. The fee increases if the bank decreases its lending volume while using the program
- As mortgage lending has recovered, the allowances under the FLS scheme for lending to households ended in January 2014. The program now solely targets SMEs at 5 GBP funding for every 1 GBP net lending until January 2015

Potential / Expectations

- The program has helped to bring down mortgage rates by 1% during its first year and has crowded out UK RMBS (historically low issuance in 2013)
- However, The FLS scheme has failed to channel funding to SMEs. Net lending to UK SMEs has decreased each quarter since the program is in place, despite funding spreads/rates have been pushed down to levels which are not attractive from our investor point of view
- Finally, the FLS program does not offer a direct investment opportunity for insurance investors as it is meant for banks only.

Germany: Corporate Loans – Schuldscheindarlehen

The initiative

- Schuldscheindarlehen („SSD“) are bilateral loan agreements under German / Austrian law
- Since 2014, Austrian Insurers are allowed to invest in the product
- There is interest from other countries to develop similar markets

Scope

- Credit quality of issuers is predominantly investment grade or crossover area
- Arrangers for SSD are typically German commercial banks and Landesbanks. The arranging bank offers loan investors (banks, insurers, pension funds) the opportunity to enter into direct bilateral loan agreements with the issuer

Potential/Expectations

- Ongoing trend to funding from the capital markets is generating continuing demand in the SSD market
- Well established market segment
- Volume of arranged corporate SSD amounts to ca. EUR 8bn in 2013 representing ca. 100 transactions with individual transaction sizes between EUR 50m and EUR 300m; ticket size per investor between EUR 1m and EUR 25m
- 90% of transactions are issued by unrated borrowers, of which 90% come from Germany and Austria; currently focus on long maturities (i.e. 5-7 years and more) as opposed to medium terms (3-5 years) in previous years
- Attractive opportunity to earn illiquidity premium or to get exposure to issuers that are not accessible through bond markets **but** competition among investors for allocation of new issues increased and illiquidity premium is fading

▶ Already very successful market. Issuers rather medium size than small companies.

Germany: Schuldscheindarlehen – Key Features

Issuers	Investors
<ul style="list-style-type: none"> ✓ Lean documentation (based on German BGB) ✓ Confidentiality: Information is exchanged only between contracting parties ✓ Diversification of creditors / broadening of overall funding base ✓ Conservation of credit lines for credit-based bank products (e.g. derivatives, export finance) ✓ Access to buy-and-hold investor community / building a profile on capital markets 	<ul style="list-style-type: none"> ✓ Eligibility for fixed reserves of German insurance companies (Sicherungsvermögen) ✓ Mark-to-market exemption due to classification as loans and receivables (avoids P&L volatility) ✓ Portfolio diversification (in particular exposure to companies that do not issue shares or bonds) ✓ Additional return (premium over bond-spreads). But illiquidity premium almost disappeared
<ul style="list-style-type: none"> ✗ Higher costs compared to bank loans (little cross-selling potential for banks, investors ask for illiquidity premium) ✗ Collateral requirements or negative pledge with financial covenants. Rights of termination for the investors in case of violation 	<ul style="list-style-type: none"> ✗ Resources needed for fundamental analysis, internal rating assessment as well as monitoring ✗ Small secondary market / limited liquidity

▶ Lean documentation and the eligibility for fixed reserves are the key for the success of SSDs

Spain: Alternative Market for Fixed Income (MARF)

The initiative

- Created in 2013, MARF is a trading platform for financial instruments from companies not listed on an official market. The aim is to facilitate the issuance of SME debt (commercial paper, bonds and notes). Average issue size: EUR 20m
- It fulfills a commitments of the Memorandum of Understanding signed with the EU in 2012

Scope

- Issuers: EBITDA levels of at least EUR 12m and constant increases in turnover and in EBITDA in preceding years. Debt to EBITDA ratio of less than 3.5 times
- Investors: insurers can invest up to 10% of the technical provisions in MARF instruments. Pension plans and funds can invest up to 3% of their assets under management in MARF instruments

Potential/Expectations

- Expect limited issuers due to the target size of companies To date, the only issue is EUR 50m 5y bond by COPASA (Construction Company)
- MARF aims to produce between 20 and 30 debt issuances per year on this market, each in the range of 10-25 mn EUR.
- The overall size of the market is likely to be too small to be an attractive and scalable investment opportunity

Italy: Minibonds (ExtraMOT Pro)

The initiative

- In 2012, the Italian Government created the Minibond market (ExtraMOT Pro) for SMEs to issue debt instruments. Over EUR 5bn of debt capital raised up to date in 20 transactions

Scope

- Issuers: SMEs with audited financial statements and a sponsor (typically a local bank). The sponsor assists with the issuance but also retains at least 5% of the bonds and publishes a credit classification of the issuer
- Investors: Minibonds are sold solely to qualified investors. Italian regulator working on new rules allow investments into Minibonds as well as SME loan securitization

Potential/Expectations

- Mostly large issuers to date. Fund initiatives target to cover potentially large number of SMEs issuing in small size
- Potentially attractive program to get exposure to medium-sized companies and diversification
- But legal framework in Italy challenging for debt holders

Issuer	Maturity	Amount	Industry	Rating
Manutencoop Facility Management	7 years	425,000,000	Building-Maint&Service	B2/B+
Cerved Technologies	7 years	300,000,000	E-Marketing/Info	B2/B
Teamsystem Holding SpA	7 years	300,000,000	Computer Software	B2/B
Sisal Holding Istituto di Pagamento SpA	4 years	275,000,000	Internet Gambling	B1/B
Cerved Technologies	6 years	250,000,000	E-Marketing/Info	B2/B
Cerved Technologies	8 years	230,000,000	E-Marketing/Info	B3/CCC+
Rhino Bondco SpA	7 years	215,000,000	Auto/Trk Prts&Equip-Rep	B2/B
Rhino Bondco SpA	6 years	200,000,000	Auto/Trk Prts&Equip-Rep	B2/B

France: Charter for Euro Private Placement

The initiative

- Banque de France sponsored initiative to produce a guidance document based upon existing practices on the bond and loan market in Europe and in the US:
- Non-binding set of best practices
- Formal requirements: NDA, due diligence process and term sheets
- Main principles promoted by the Charter:
 - ✓ To rank pari passu with the existing creditors
 - ✓ To benefit from same protections as other creditors: covenants, cross-default, negative pledge...
 - ✓ To have access to the same level of information as the other creditors, from the due diligence phase to the full redemption of the transaction
 - ✓ To enjoy the same quality of documentation, whatever the format (bond or loan)
 - ✓ To be as close as possible to the ACPR requirements for senior unsecured instruments eligible to the French insurers balance sheet or FCT

Constraints

- Not implementable at this stage: needs to be enriched with a contract template for both IG and HY type of credit, both in a bond or loan format: WORK in PROGRESS

France: Evolution of the Regulatory Framework

The initiative

- The French insurance code has been amended to enable French insurers to invest in senior unsecured loans directly on their balance sheet, through a FCT or a contractual fund. The following conditions apply:
 - The French regulator (ACPR) needs to approve the loan program of the insurer, with a specific focus on credit risk analysis and risk monitoring processes
 - When an asset manager is mandated, the insurer is responsible to ensure investment guidelines are compliant with risk policy. The insurer needs to be able to monitor risks within the mandate

Scope

- Targeted borrowers: medium-sized companies, either IG or HY
- Since mid-2012, ca €8bn have been financed through Private placements in France both in a bond or loan format with a substantial pick-up above the public bonds issuance at equivalent rating

Europe: Treatment of Asset Backed Securities (ABS)

The initiative

- Reduction of charges under Solvency II for RMBS, SME ABS and consumer finance ABS in order to support financing of the real economy. Steer financing towards those segments (3y SME ABS risk charge ca 6.3%) rather than towards CLOs and CMBS (risk charge 35%). Initially Solvency II did not differentiate between segments
- Furthermore, investment by the EIB in junior tranches of SME ABS in order to increase investor confidence in this type of securitization (one transaction to date)

Scope

- SME ABS are securitizations from bank balance sheets. Bank is in charge of origination and servicing of the loans.
- Insurers would only continue to invest if charges did not significantly increase in Solvency II context
- Only few SME ABS in the market. Focus on periphery

Potential/Expectations

- Potentially increase of loan securitization activity in context of AQR
- Beneficial treatment of SME and consumer finance ABS is a step in the right direction
- SME ABS need to compensate for the higher risk compared to consumer finance ABS (e.g. RMBS)
- More generally, capital charges need to reflect historical performance of the asset class. High capital charges could reduce investor base significantly
- Enlarging investor base for senior tranches does not solve the underlying capital problem for the banks
- Basel III relief for regulatory capital through securitizations is not as favorable for banks as previously

▶ Attractive investment opportunity if capital charges are reasonable

Europe: Loan Market Association (LMA):

The initiative

- LMA promotes a detailed multi-lenders/multi-currencies funding contract model form in a loan format for European SMEs. The documentation is derived from the existing LMA standard for IG borrowers

Scope

- extension to a bond format or potential liaison with ICMA?
- extension to high-yield type of borrowers?
- inclusion of the arrangers?
- NDA template required?

Potential/Expectations

- The initiative is work in progress
- High hurdles for SME to work with complex international documentation

**see Arrêté Complémentaire, 12 December 2013*

Summary of Initiatives

	Sponsor	Date of creation	2013 Issuance (outstanding amount)	Type of asset/program	SME Funding	Additional Bank Capital	New/ Larger Investor-base	Investor view
UK Funding for Lending	Bank of England	June 2012; 2014 only for SME	GBP 13 bn. Overall, but most of it went to housing	Program to increase lending from banks to UK households and non-financial companies	✓			No investment opportunity
Spanish MARF	Government of Spain	2013	EUR 50 mn. (EUR 50 mn.)	Trading platform for financial instruments from non-listed companies	✓	✓	✓	Likely to remain small. Limited scalability, high complexity
Italian Minibonds	Government of Italy	2012	EUR 5 bn. (EUR 5 bn.)	Debt instrument allowing qualified investors to invest in Italian medium size companies with a 5% retention from banking sponsors	✓	✓	✓	Promising to diversify issuer spectrum. Not proven yet. Challenging legal framework for debt holders
European SME ABS	n/a	n/a	EUR 1 bn. (EUR 13 bn.)	Securitizations of loans to SME	✓		✓	Existing SME ABS are not particularly attractive and capital charges still unclear
German Schuld-scheine	Self regulated	1 st corporate issue in 1935	EUR 8 bn. (EUR 60-70 bn. estimated)	Bilateral loan agreements under German/Austrian law	✓	✓	✓	Established and attractive market. Solid but simple legal framework. Potential to expand. Highly competitive
Euro Private Placement	Banque de France	Started in 2012	EUR 4bn in 2013 EUR 3bn in 2012	bond and loan standard formats for private placements	✓	✓	✓	Attractive product. Too early to fully assess success but similar initiatives have proven to be very successful.
Loan Market Association (LMA)	LMA	Work in progress	Standardization initiative (no set amount)	multi-lender funding contract model in loan format for European SMEs	tbd	tbd	tbd	tbd

Recommendations from an Investor Point of View

Develop the European market to establish securitization as a more efficient funding tool for SMEs

- Acknowledge and support enhanced securitizations techniques to help the segment overcome its bad image from pre-crisis securitizations which performed badly: Spain, Germany, Italy
- Improve Basel III relief for regulatory capital through securitizations
- Provide credit enhancement by EIB through investment in junior tranches of SME ABS in order to increase investor confidence
- Explore the implementation of a European-wide SMEs securitization label such as the PCS Label or the development of ratings for SMEs such as S&P mid-market evaluations
- Establish homogeneous standards to provide detailed and comprehensive information on the underlying assets (incl defaults, recoveries, delinquencies date) to enable investors to perform adequate risk analysis

Work towards more harmonization of standards across Europe

- Investments need to be economically viable and pricing needs to fairly compensate for taking credit and illiquidity risks. Favorable regulatory treatment is necessary, not sufficient
- Harmonized contractual or legal frameworks across Europe need to improve visibility for both the investors and the borrowers and helps to enable growth of a non-bank investor market

Promote and support the role of the banking sector

- We see (bank) capital, not funding currently as the most constraining factor for lending. Once banks have clarity about the impact of the ECB's AQR and stress test, they will have more comfort to restart SME financing
- Banks will remain the predominant financier and should provide SMEs with an increasing funding capacity going forward
- Through credit process, distribution network and individual lending relationships, banks are uniquely positioned to lend to small and medium sized companies. Also, bank pricing can reflect ancillary business and thus increase competitive advantage vs. "pure" investors
- Insurers will not replace or compete with banks in their core lending activity, they can only offer complementary products to borrowers (longer term, bonds or loans, fully drawn financing). Our liability structure enables us to hold positions through a changing market environment

Issues for discussion

- Insurance regulation - how do regulators plan to steer insurance investments in the future ?
 - Liquidity based in France and Spain (securities need to be registered at a recognized market, availability of daily pricing)
 - (Credit) Quality based in Germany (investments predominantly need investment grade rating)
- How should financing of small companies be made accessible to insurers which do not have close lending relationship ?
- Legal frameworks e.g. bankruptcy laws and enforcement are local, leading to a fragmentation of European lending standards and markets. Is there a chance for greater conformity?

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